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La coordinación macroeconómica y la cooperación monetaria, sus costos, beneficios y aplicabilidad en acuerdos regionales de integración

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MACROECONOMIC COORDINATION AND MONETARY COOPERATION : COSTS, BENEFITS AND APPLICABILITY IN REGIONAL INTEGRATION PROCESSES

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In an earlier paper[1] the author described the legal framework of the then-ongoing process of replacement of the national currencies of the EU Member States by a single currency (the "Euro", or €), and the resulting European Monetary Union ("EMU"), and discussed some of its foreseeable monetary and macroeconomic implications.

This paper goes beyond to compare the European business legal environment with those of other integration processes[2] following the balance of payments logic[3] a structural factor that constrains the ability of governments to pursue whatever macroeconomic policies they might fancy, and determines their actual bargaining power.

A first section details the lessons of the EMU, an initiative that has immediately been explored in detail by the best brain-power available, simply because it impacts almost half of the planet's wealth, an asset no other integration process can claim.

The second section comments WAEMU and ASEAN. The former is an experience that commands intelectual respect in terms of structure, timing and content; and disenchantment in terms of implementation and internal or external factors that periodically ruin whatever progress has been achieved. The latter was conceived as a free-trade area, and until the 1997 crisis showed the need for it, it had not even explored advanced monetary cooperation.

The third section is looking forward and focuses on the opportunities ahead for MERCOSUR. It acknowledges that no concrete steps have been taken by MERCOSUR towards monetary integration or cooperation. It stresses the interest of steps taken in common by countries that are among the most heavily indebted in the world –while not qualifying for HIPC relief[4].

• Abogado, Universidad de Buenos Aires; Docteur en Droit, Université de Paris. The opinions expressed in this paper are personal and do not necessarily reflect those of organizations to which the author belongs.

[1] Originally kept confidential for training of senior business executives, later published in electronic format.

[2] The same approach can be used beyond monetary implications, in areas such as the convergence of intellectual property law in different integration processes. Bertone, Louis. *Le transfert de Technologie en Droit Communautaire Comparé* (thesis), University of Paris:1981.

[3] Bertone, Louis*, Marco Juridico y Fiscal de los Pagos Internacionales de los Paises de America Latina*, INTAL:1984. This author also published in 1983 three papers that –surprisingly- can still be validly quoted today, developing the indebtedness dimension of this problem (« Radiografia de un Pais endeudado », « Radiografia Juridica de un Préstamo externo » and « Deuda Externa : Diagnostico y Tratamiento ») in *El Cronista Comercial* :October 1983.

[4] According to OECD estimates the debt of Argentina is more than one and a half times that of Korea, the 11th. Economy of the world; that of Brazil is only slightly inferior to those of Russia and China together. The aggregate debt of the two countries is similar to that of all European aid recipients. http://www1.oecd.org/dac/debt/xls/EDS_2000_2001.xls.

The conclusion counts economic critical mass and dilution of aggregate demand shocks among the advantages of advanced monetary cooperation. It claims that the costs and benefits that an integration process may expect from high levels of macroeconomic and monetary cooperation are hard to separate one from the other. Anecdotal evidence from Europe, Africa and Asia suggests that these processes were at risk of never finding an appropriate stage of integration and enough fulfilled prerequisites to increase monetary cooperation –if it hadn't been for crises that shook that torpor.

I. THE LESSONS OF EMU

Why a common currency ? The most obvious answer is that the boundaries of the geography where a currency is legal tender define the boundaries of an economy. But money is not everything, and the geography in which a currency is declared (and has the *sustainable* ability to remain) legal tender is exactly coincident with that in which the rules[5] of a consistent economic environment prevail.

The adoption of a common curency for certain European countries conveyed the highly simbolic message that the countries involved in this integration process *were serious* about behaving as a single economy ; and two other, more technical ones : One, enough has been achieved in the past in terms of convergence of macroeconomic fundamentals for this step to be taken ; and two, there is enough irrevocable resolve not to depart from parallel evolution in the future for initiative to be sustainable.

There are, obviously, *Euro*-scepticals (as there are, more generally, *euro*-scepticals) ; those who believe that the main benefit of a single currency resides in the reduction of costs of changing money and operating in different currencies when doing business european-wide can easily fall into this category, and even fear that the suppression of the exchange rate constraints and associated discipline will reduce rather than enhance the awareness of the need for further macroeconomic convergence.

These *Euro-scepticals* are half right, because when a common currency comes as a sign of the level of macroeconomic convergence already achieved and of the willingess to pursue, the additional benefits (reduced cost of transactions, simpler accounting) are just that – additional benefits; and the core benefit is the clear, legally enforceable determination shown to deal with what used to be several separate economies as a single one.

Section II of this paper pictures an integration process[6] in which certain Member States adopted a common currency[7] pegged to a foreign currency[8], and managed to show stability but not consistent growth[9], while trade among Member States that did not increase significantly if compared to that of

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[5] The use of « rules » rather than « policies » is deliberate to stress the fact that all monetary and fiscal choices are always hard written in laws and are something more socially tangible than penciled-in « decisions » or « policies ».

[6] The Economic Community of Western African States or ECOWAS, consisting of Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo, Nigeria, Ghana, Guinea, Liberia, Sierra Leone, and Gambia.

[7] The Franc CFA, common to Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo.

[8] The French currency, i.e. the Franc until 1999; and the Euro at present.

other countries outside the process[10]. That section will claim that currency unification without the prerequisite of convergent structural reform or without the aim of deepening it only scratches the surface, and yields no sustainable results.

Thus we will basically retain four lessons from the European Monetary Union: that of a process driven by Law; a trade-off between optimality and credibility; a gradual implementation, preserving stability and continuity of microeconomic transactions, and a skillfull management of the final countdown – including an unheard of immaterial phase in which no coins or banknotes of the single currency were in circulation.

- ***A process governed by Law***

Actioning the Law to permanently[11] reshape economic objects[12] is a well known operational tool of Law and Economics; better known theoretically than actually used effectively, though. Appropriate public international Law tools address the credibility issue better than internal Law tools, but still fall short of entirely dealing with expectations.

The Maastricht Treaty makes conventional use of this tool, inserting a new section in the original Treaty of Rome (the "EC Treaty"), to organize a progressive transition to an European Monetary Union. With a typically European gradualist approach[13], the step was taken when enough convergence had been achieved in monetary and fiscal regulations (collectively the « business legal environment » ; the detail of the legal process to introduce a sustainable single European currency was left for two subsequent Regulations (collectively the « Stability and Growth Pact ») ; the final countdown was structured around three steps respectively labeled « convergence phase », « immaterial phase » and « traditional phase ».

*This is the first lesson of the EMU: a tactful mix of classic international and supranational Law backed by direct democratic support is the right social choice between opposite theories advanced by economists***.** Their discussions sometimes appears byzantine to operations personnel who need to make individual choices (collectively, "market choices") within the framework of a business legal environment; and no matter how attractive, models are extrapolation and inference from facts open to

[9] Flirting with the 5% figure in Cote d'Ivoire between 1996 and 99; between 1995 and 2001 in Senegal; and between 1996 and 2000 in Mali, although with tangible slowdowns or negative growth in the past two years, due to either lower international prices of key exports (cotton, cocoa, coffee, and others), shrinking tax bases due to political unrest (Togo, Cote d'Ivoire), or the suspension of international aid after a coup (Niger).

[10] Uche, Chibuike. « The Politics of Monetary Sector Cooperation among the Economic Community of West African States », Working Papers, World Bank :2001 available at http://econ.worldbank.org/files/2326_wps2647.pdf.

[11] The Treaty of Maastricht does not provide for conditions under which a Member State could leave the EMU. Contrary to the existing EMS, the escape clause in case of balance of payments difficulties is no longer available to EMU participants from the start of the Immaterial Phase (Sections 109h(4) and 109i(4) of the EC Treaty as amended.

[12] One such complex "object" would be a new single currencythat is legal tender within the Union, supported by a single monetary policy defined by a common authority, the European Central Bank.

[13] The comparison with other integration processes suggests that there is no need for others to follow an equally gradualist approach. WAEMU used the opposite approach.

different interpretations. When the Law set the timing for the Euro to start its final straight line, for instance, some still discussed whether the adjustment difficulties experienced by Europe in 1992 (the very year of the Maastricht Treaty) was an isolated case or rather an example of future problems when the single currency would preclude any change of the exchange rates.

And there was still debate about repercussion effects of increased spending at a given point in time[14], their impact on inflation, or what the optimum level of inflation was –if any.

The European mix deserves the "tactful" label, because it did not attempt to set monetary rules in isolation from political compromise on macroeconomic policies; and also because such compromise consensus was not left suspended in thin air, but rather written down in the Law, coming down to a certain level of practical detail.

The Law came to provide graduated responses and enforceable sanctions when the sustainability of a common currency (or even fixed exchange rates) is challenged by diverging selected macroeconomic indicators, deficit for instance. And that the predefined time limits for the application of such legal remedies, ranging from a confidential recommendation through a public and final warning, to ultimately a fine[15], will restore sustainability *if and only if* handled as components of a system including all elements of the business legal environment.

The final straight line that led to full European monetary union by January 1, 1999 (for a first wave of Member States that achieved certain "convergence standards" of reasonable inflation[16] and deficits[17]) is fairly streamlined from the Maastricht Treaty[18], the Stability and Growth Pact adopted on June 16 and 17, 1997, and the European Council's decision of May 2, 1998, establishing the list of the first eligible Member States.

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[14] Repercussion effects are easy to understand, but doesn't automatically yield hard figures of deficit to write down in the projects submitted to Parliament.

[15] The European Stability and Growth Pact requires the defaulting Member State to make a non-interest-bearing deposit of 0.2% of GDP with the EU, that becomes forfeited, i.e., turned into a fine, and distributed among non-defaulting EMU participants, whenever the excess deficit is not cured within two years. This mechanism is easy to enforce through restrictions on lending by the European Investment Bank or deduction from European contributions to specific policies.

[16] The relationship between increases in M2 and the rate of inflation in the long run and after all adjustments is easier to verify due to the instability of demand for M1. But obviously velocity, supply shocks and expectations are also factors to be talen into account. The broad price stability objective was estabished as such, leaving the detailed mechanisms to align inflation rates to be written down later.

[17] Deficits may be a source of inflation no matter whether money-financed or financed through indebtedness. Sargent, T.J. and Wallace,N. "Some Unpleasant Monetarist Arithmetics", *Federal Reserve Bank of Minnesota Quarterly Review*, Fall 1981) suggested a model in which bond financing leads to even higher rates of inflation than deficit monetization. In presence of reserve requirements, this would be true even with a real rate of growth exceeding the real return on bonds. Other economists believe that this is not true in the short term, or when deficits do not increase beyond a constant debt / GDP rate, and this is what the European drafting seems to reflect..

[18] This Treaty, signed on February 7, 1992, was subsequently ratified by a short popular majority by the highest standards of direct democratic consultation in the Member states.

Together with long time favorites (Germany, France, Austria and the Benelux countries), the list included a significant number of Member States who had been successful in their efforts to meet the legal standards of convergence (Finland, Ireland, Spain, Italy and Portugal)[19]. The first wave thus concerned 11 Member States out of 15, or roughly 80% of the population and wealth of the EU.

The boldness of the move created macroexpectations about the Euro's ability to spur growth and job creation across the EMU; and also microexpectations about the readiness of e-payment technologies and information systems in general to address accounting, tax and certain other practical issues. While a final answer to the former is yet to be provided, the answers to the latter came directly from the private sectors concerned, within the framework of a reasonably clear and detailed legal environment.

- ***A trade off between suboptimality and enforceability?***

Why move to a single currency ? Politically, it constituted a highly symbolic step towards an integrated Europe. Economically, those who cited as its main benefit the reduction of the cost of changing money and buying coverage questioned, understandably, whether the advantages of the single currency would outweigh the cost of the loss of flexibility in ajusting to economic shocks at national level[20].

The argument is dubious, firstly because exercising purely national "flexibility" in response to economic shocks is not optimal[21] either; secondly because it amounts to comparing advantages of national-level suboptimalities and diverging macroeconomic policies with community-level suboptimalities and converging policies[22], an evaluation that yields inequivocal results; and thirdly, because it assumes different national flavors of "flexibility", and denies convergence, both past and future.

Another, more original way of putting the same case against a single currency is that different levels of inflation (leading over time to devaluation) are desirable as a function of a country's internal indebtedness. This thinly veiled reference to southern European countries (casting doubts about the sustainability of their public debt if deficit could no longer be financed by money creation[23]) was worth addressing explicitely in the legal texts that implemented the EMU: only countries meeting certain criteria in terms of deficit and indebtedness are eligible for EMU memberhsip[24].

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[19] Taking the two basic parameters of inflation and long term interest rates, substantial convergence had been achieved under the previous EMS system. Inflation rates of the EMU countries ranged from 1.1% (Austria) to 1.8 (Italy, the Netherlands, Portugal and Spain) and long term interest rates ranged from 5.5 (France and the Netherlands) to 6.7% (Italy).

[20] Gros, Daniel & Thygesen, Niels *European Monetary Integration*. London: St.Martin's Press, 1992; Host Ungerer et al. "The European Monetary System : Development and Perspectives", *IMF, Occasional Paper N° 73* Washington DC:1990

[21] Optimality requires instantantaneous reaction, without under or over shooting. By definition, governmental reactions lag and most often proceed by trial and error, over or under shooting.

[22] Thus avoiding changes in competitiveness that would require further adjustment.

[23] Dornbusch, Rudiger. "The EMS, the Dollar and the Yen", *CEPR Discussion Papers* 216 / C.E.P.R., available from BibEc, at http://netec.mcc.ac.uk/BibEc/data/Papers//cprceprdp216.html.

[24] Thus resolving, by the same token, the question of future new entrants.

Coming back to the cause or consequence logic, there is yet another possible formulation of the same questioning: If the convergence of macroeconomic fundamentals is a prerequisite rather than a consequence of a monetary union, then what are the advantages of a single currency over -say- a system of fixed parities between the national currencies of the Member States? The question is somewhat misleading, and answers using different blends of econometric analysis and macroeconomic theory provide unconvincing results[25].

An answer based on the legal business environment would be more satisfactory. Firstly, enforceably fixed parities had not been attempted since the collapse of Breton Woods[26], and the EMS (implemented the same year in which that collapse became evident) was rather a monetary target zone system than a fixed parity system; in addition, it was not really enforceable[27], and each country remained free to leave the EMS[28]. Secondly, exchange rate rigidity cannot really be enforced in an open economy, where changes in the balance of payments prompt changes in parities, and vice-versa[29]; a fixed parity between european currencies would not be sustainable and cannot be credibly enforced if each floats against other major currencies. Thirdly, contrary to a more or less crawling peg of national currencies, a single currency created by an international treaty and supported by a single Central Bank burns the vessels of future macroeconomic divergence more credibly[30].

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[25] Melitz, Jacques. "Monetary Discipline and Cooperation in the EMS: A Synthesis", *CEPR Discussion Papers* 219 / C.E.P.R, http://netec.mcc.ac.uk/BibEc/data/Papers//cprceprdp219.html. This author suggests that if a country has been successful at containing inflation through a peg to the currency of the countries with lowest inflation, the effort would have been just as successful by the country acting alone, without an external binding commitment.

[26] The Bretton Woods system of exchange rate control collapsed because the adjustment mechanism was unbalanced, and possibly unfair: it always imposed the burden of devaluation on the weakest currencies. In theory, the bilateral parity system implemented with the EMS would have shared the burden of adjustment equally between all currencies involved; but in practice, its increasing reliance on the Deutschemark as anchor currency (much like Bretton relied on the dollar) yielded several perverse effects.

[27] Business Lawyers use "enforceability" as a rough equivalent of what "credibility" means for economists. It is the objective ability to make sure somebody's behavior is consistent with its commitments, and yields a widespread belief that the conduct will in fact comply with those commitments.

[28] Despite its obvious sucess in reducing exchange rate volatility, the EMS fell short of making the national countries close substitutes, or reducing risk premium to zero. The simple uncovered interest rate parity condition appeared more close to being fulfilled between the DM and the dollar than between the DM and other EMS currencies. This suggests that financial markets still questioned –understandably- the credibility of the EMS Member States commitment in the longer run. Artis, Michael and Taylor, Mark, "Exchange Rates and the EMS: Assessing the Track Record*" CEPR Discussion Papers* 250 / C.E.P.R, http://netec.mcc.ac.uk/BibEc/data/Papers//cprceprdp250.html.

[29] The balance of payments is a record of all transactions of an economy with other economies. The capital account describes transactions in assets, while the current account covers trfansactions in goods and services, and transfers.

[30] An international commitment brings larger credibility to formerly high-inflation countries: voters and investors are made aware of the government's awareness of the penalties attached to inflation, thus helping overcome the the inefficiency stemming from public scepticism. Giavazzi, Francesco and Pagano, Marco. "The Advantages of Tying One's Hands: EMS Discipline and Central Bank Credibility", *CEPR Discussion Paper* 135, available from BibEc at http://netec.ier.hit.ac.jp/BibEc/data/Papers/cprceprdp135.html.

This is the second lesson of the EMU: a single currency is politically more sustainable than models that require national Central Banks to support on occasion currencies other than their own[31]. A single european currency pitches less when floating[32], if compared to national pegged currencies subject to appreciation or depreciation[33] in varying degrees. In extreme cases, one european currency could have gained ground against the dollar while the other lost ground, forcing increasingly intense Central Bank intervention which does not appear politically sustainable for a foreign currency[34]. When the EMU was created, the reserves of EMU Member States in non-EU currencies and gold were pooled at the level of the European monetary authority to allow more effective open market intervention.

- ***Gradualist implementation : stability and continuity***

Between 1979 and 1992 Europe lived under a *monetary target zone* system known as European Monetary System ("EMS") that has been the subject matter of extensive analysis. The pivotal parity of the zone was set by reference to an abstract account unit (the "ECU") calculated as a function of the mutual parities of Member Country currencies.

This parity had occasionally to realigned, as a consequence of different national inflations and changes in competitiveness. The system proved to be robust[35], although far from orthodox[36]. It did curb

[31] For the strongest EMS currencies, steady depreciation (with correlative competitiveness gains) while the parities remained stable and inflation had not converged entirely outweighed both this cost and the attractiveness of an independently pursued inflation containment policy without any imported inflation (Melitz). But the assumption that Germany would continue to have low inflation and interest rates proved wrong, and in 1992 the cost of German economic, monetary, and political unification prompted the Bundesbank to raise interest rates to levels that no other Member State could sustain; in 1992, the weaker currencies started falling from the EMS, and on September 16 the pound left to pursue independently a policy of lower interest rates. A fine example of how national priorities change national law, and of the inherent legal weakness of a fixed parity system using a national anchor currency.

[32] A currency "floats" if its value is dictated by market forces of supply and demand. Clean floating lets market forces alone define the parity, and "dirty" floating includes open market operations by Central Banks to maintain the parity within given limits.

[33] Between January 2 1973 and January 2, 1975, both the DM and the Peseta, for instance, gained ground on the dollar (the former about 32%, and the latter about 13% only); and other differences occurred when they both lost ground (the DM about 12%, and the Peseta about 15%).

[34] In this sense, a single currency like the Euro is more resilient to speculative runs; even if the Central Bank responsible for the anchor currency had the will to defend a currency against persistent attack, it would not have by today standards enough reserves to defend its own currency, let alone other fellow currencies.

[35] Driffill, John. "The Sustainability and Stability of the EMS with Perfect Capital Markets" in R. Giavazzi, S. Micossi and M. Miller (eds), *The European Monetary System*, Cambridge University Press: 1988. Inflation differentials and other indicators converged sufficiently over time to reduce residual tensions and prospects for large speculative gains, and be accomodated by non-disruptive realignments. This prerequisite has been absent from Latin American experiments in currency stabilization and financial liberalization.

[36] Obstfeld, Maurice. "Competitiveness, Realignment and Speculation: The Role of Financial Markets". *Working Paper Series* No. 2539, National Bureau of Economic Research: 1989. Capital controls had been removed beyond what theory would grant for monetary zones with roughly fixed parities and incomplete convergence of inflation rates and macroeconomic fundamentals. But when a realignment was predictable due to a loss of local competitiveness to lead to, markets could also predict (from past and anticipated government measures) that the realignment would not fully offset cumulative excess inflation, and fiscal expansion would never fully offset a real appreciation.

inflation down [37] but this hardly yields a workable conclusion[38] other than that if realignment remains a national decision[39], Member States will not be equally credible in their macroeconomic commitments. In other terms, International Law obligations increase the stability and credibility of countries whenever their national business legal environment is perceived as excessively volatile.

The removal of any remaining restrictions on cross-border capital and data flows within the Member States[40] was facilitated by the fact that 'inflationary' Member States had no guarantee that they could fully restore competitiveness if they wanted to remain within the EMS; obviously these countries were free at all times to leave the system, but this built-in 'soft dissuasion' proved effective enough to stabilize the system and induce the countries with the potentially weakest currencies to prefer the proclaimed self-restraint that came with EMS memberhsip.

The third lesson of the EMU is thus one of consubstantial gradualism. The EMS was a compromise between enforceable macroeconomic and monetary convergence and full monetary autonomy[41], and came as part of an overall harmonization of all aspects of the European business legal environment. The conclusions of this paper discuss whether this feature is to be regarded as a consequence of individual characteristics of the European Integration process or whether it is rather to be considered as an essential prerequisite of all forms of advanced monetary cooperation.

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[37] Giavazzi, Francesco and Giovannini, Alberto. "The Role of the Exchange Rate Regime in a Disinflation: Empirical Evidence on the European Monetary System", *The European Monetary System*, Cambridge University Press: 1988. With a reduced-form system of equations for the quarterly behavior of wages, prices and output, these authors demonstrated that countries trying to curb their inflation down through EMS membership achieved better results than predictable under pre-EMS data. The three high-inflation EMS Member States considered (Denmark, France and Italy) suffered little or no output loss; surprisingly, Germany suffered a substantial loss while achieveving worse disinflationary results then predictable under the pre-EMS data. The same conclusion is supported by other studies using different data and methods. Collins, Susan. "Inflation and the EMS*"*, *The European Monetary System.*

[38] The downward shift in inflation expectations was less dramatic than that of certain non-EMS countries such as the UK, where inflation dropped sharply below the predictable levels from 1981 onwards. Giavazzi & Giovannini (1988).

[39] In addition, while EMS currencies operated with respect to the other under the target zone principles, they floated with respect to other currencies such as the dollar.

[40] Assuming fixed exchange rates and perfect capital mobility, the slightest differential in interest rates should cause infinite capital flows; in other terms, under fixed exchange rates and perfect capital mobility, a country cannot pursue an independent monetary policy. Mundell, Robert. *Monetary Theory: Interest, Inflation and Growth in the World Economy*. Pacific Palisades, CA: Goodyear 1971. The same is true of a fiscal policy, and even with far from perfect capital mobiity, France experienced capital flight in 1981-1983 after the announcement of a solitary (more expansionary) fiscal policy. Obstfeld (1989). The experience made the case for convergent (although possibly differentiated) fiscal action as a part of the EMS monetary package.

[41] Mastropasqua, Cristina; Micossi, Stefano; and Rinaldi, Roberto. "Interventions, Sterilization and Monetary Policy in the EMS Countries, 1979-1987", *The European Monetary System* (1988) Using the extent of sterilized intervention as an indicator of the degree of monetary autonomy, these authors found that certain EMS Member States had sterilized twice as much of the net change in the foreign assets of their Central Banks. The Bundesbank, for instance, had roughly twice the capacity of its French, Belgian or Italian colleagues to sterilize its relatively more modest interventions in foreign exchange markets, in order to keep its preferred domestic monetary aggregate closer to target; the other countries conducted policy in terms of domestic credit expansion allowing external flows to influence domestic monetary conditions. The risk that this asymmetry would widen as perfect capital mobility was implemented, however, was ultimately more than offset by closer consensus on medium-term policies – thus opening the way for the common currency and a single Central Bank.

The 1992 crisis provided an opportunity to rethink a viable system, and the four possibilities available for this purpose -short of implementing a single currency:

- Setting in common aggregate monetary objectives for the EMS combined; preliminary research suggested that an aggregate EMS money demand function could prove as stable as the money demand function in Germany[42].

- Letting each country set a national objective for domestic credit expansion under the condition that it should refrain from sterilizing the interventions that would be required to sustain the fixed exchange rate[43]; without net interventions in dollars and other non-EMS currencies, the expansion of aggregate domestic credit would equal the total money creation, and the Member States could then jointly consider whether monetary growth for the are was desirable.

- Setting in common monetary rules for each country, subject to a common inflation target (such as stable average wholesale or retail prices across the Member States).

- Setting in common nominal income targets on a country basis, instead of monetary rules, subject to the same common inflation targets.

As it came out, every alternative required explicit agreement about common inflation objectives and the allocation of national monetary aggregates by an European Central Bank or Central-Bank-like institution, thus bringing in all the constraints of a move to a single currency without any of its benefits[44]. And in practice the feedback rules required to link deviations from the price stability objectives to changes in national monetary growth rates would be virtually impossible to implement.

Stability

The "Stability and Growth Pact" of 1997 goes into more detail regarding the former than the latter. It consists of a first Regulation on "reinforcement of budgetary positions screening, and coordination of economic policies", calling for the submission of a multi-annual "stability program"[45]; and a second Regulation on "implementation of the excessive deficit procedure", setting forth sanctions for failure to cure deficits in excess of 3% of GDP.

Programs under the first Regulation are updated on an annual basis, and both the programs and their updates are be published. The Council has subsequently used its power to issue early warnings as to deviations.

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[42] Russo, Massimo and Tullio, Giuseppe. “Monetary Policy Coordination Within the EMS: Is There a Rule?”.

[43] This would, at the same time, remove asymetries in terms of sterilized intervention.

[44] Bluntly stated, it would appear less credible and enforceable. If national currencies subisted, and implicitly the administration of the process was left in the hands of national authorities, some would inevitably be regarded as less accountable and reliable, or more prone to political opportunism.

[45] Each program had to include medium-term targets for balancing budget and list the measures required to achieve such targets.

The second Regulation establishes a time frame for the various steps in the screening procedure, so that sanctions can be imposed within a year from the reporting of an excess deficit. Exceptions include "exceptional and temporary" budget deficits, namely those due to a "severe" (over 2% of GDP) or "abrupt" economic downturn.

Continuity

If an integration process is serious about taking a bold monetary step, it needs to get into microeconomic detail to prevent the innovation from disrupting ongoing activities. This is what the European Council did in a first European Regulation[46] that established the principle of continuity of contract, decided that the Euro would replace the ECU in legal instruments, and defined conversion and rounding rules, thus regulating change in all legal and economic functions of money (unit of account, store of value, and legal tender) and channeling demand for money (to conclude a transaction, as a precaution or to speculate).

Payments stipulated in former national currency would continue to be made in this « national non-decimal sub-unit of the Euro » unless the parties agreed otherwise. This language did not address the case of contracts that became devoid of cause as a consequence of the establishment of fixed exchange rates between the € and its « 'national non-decimal subunits »[47], but the market easily cleared the issue by itself[48].

Existing LIBOR or PIBOR anchor clauses did not require urgent change and could still be used until the « national non-decimal subunits of the Euro » were no longer quoted. The same was true of *force majeure*, hardship, *rebus sic stantibus*, frustration, impracticability, event-of-default, alternative-currency, market disaster and termination events (in derivatives contracts in particular), although in practice these were scanned to make sure that they were not inadvertently triggered by, or did not produce unwanted effects as a result of, the introduction of the Euro.

Similarly, fixed rates for loans agreed in former national currency remained unaffected. The fear that debtors in traditionally weaker currencies with high interest rates might have been disadvantaged was pure speculation, because not only had the strengths of eligible Member States converged and become comparable[49], the situation is not different from what happens in practice when a traditionally weaker currency gets stronger.

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[46] Regulation 1103/97, adopted on June 17, 1997

[47] And not « national currencies », that had instantaneously disappeared as such by operation of Law. Generally, all contracts intended to provide for (or speculate on) exchange rate fluctuations became devoid of cause ; examples include swaps, currency options, and other derivatives.

[48] In a good example of "subsidiarity" of regulation. The economic situation of the parties was, after all, not different in substance from what it would have been if fixed exchange rates had applied without introduction of a single currency.

[49] One of the convergence criteria is that a Member State's long term interest rate should not be more than 2 percentage points higher than that prevailing in the three Member States that are performing best in terms of price stability. For the first wave of EMU Member States, interest rate levels had already converged to a few basis points across the maturity spectrum. These countries had nearly identical private yield curves, both in the shorter-term segment (as evidenced by Eurodeposit rates) and for longer maturities (as appears from yields on the fixed-rate side of interest rate swaps).

- ***Crisis and countdown management***

The name "convergence" phase given to the first step of the final straight line leading to EMU should not obscure the previous twenty-years period of convergence of economic fundamentals[50], through consistent and increasingly closer coordination of economic and monetary policies[51].

Previous convergence, however, had come to a critical stall by the time of the Maastricht Treaty, and the EMS that was both its consequence and its driving force[52] was for all practical purposes in crisis.

The fourth lesson of the EMU is thus one of constructive crisis handling. In 1992, a wave of speculative attacks hit the European currencies. Full capital market liberalization had been implemented before the full monetary coordination required by the Treaty of Maastricht went into force. Right after the Danish voted "no" in a ratification referendum, the crisis erupted with an attack on the Finnish crown and the Italian lira; whether there are cause/effect links between the two is debatable, because internal tensions had been building up before; in Germany, interest rates pulled up by the huge cost of political unification since 1990, to levels that did not look sustainable for other Member States.

Right or wrong, the market believed that short of enforceable monetary coordination, strong-currency Central Banks would use their power self-interestedly[53] and weaker currencies could be attacked. Before the end of the year, Italy and the UK fell from the EMS fluctuation band, the Peseta depreciated, and after a furious catfight[54] around the franc, the Banque de France and the Bundesbank forced speculators into retreat. But the punt was devaluated in January 1993, followed by the escudo and the peseta in May. The pressure decreased in spring when the Bundesbank reduced interest rates three times. But when in August the Bundesbank failed to reduce rates again, runs started against the currencies of Belgium, Denmark, France, Portugal and Spain, and this time the phenomenon was too wide to be contained even by massive market intervention. The narrow floating band of 2.25% was replaced with a wide 15% band, and the EMS became a free floating system in all but name.

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[50] It wouldn't be possible to maintain the value of a currency without strong convergence of the fundamentals (deficit, indebtedness, interest rates, balance of payments).

[51] Since 1979, several European countries, including Germay, France and Italy, engaged in *a target zone regime.* This system, called European Monetary System, or EMS for short (the short version also allows for « European Monetary Snake », although the term "snake" and "snake-in-the-tunnel" designate earlier similar European experiences) provided for substantially fixed exchange rates with narrow fluctuation bands above or below the agreed exchange parity.

[52] Over time, exchange rate realignments had come to be instruments to control inflation used in conjunction with domestic measures rather than passive reactions to inflation.

[53] Giordano, Francesco; and Persaud, Sharda. *The Political Economy of Monetary Union: Towards the Euro*, Taylor & Francis Books Ltd :1998

[54] Two types of currency crisis models coexist in the literature: first generation models view speculative attacks as being caused by economic fundamentals inconsistent with a parity. Second generation models claim self-fulfilling speculation as the main source of a currency crisis. Weber , Axel A. « Sources of Currency Crisis: An Empirical Analysis », *Discussion Papers*, University of Bonn:1997 ftp://ftp.wipol.uni-bonn.de/pub/RePEc/bon/bonsfb/bonsfb418.pdf. The second model focuses on attacks as duels between speculators and the monetary authority over inflation, unemployment and growth. Glick, Reuven and Rose, Andrew "Currency Risks – Currency Crisis: A regional contagion", *Risk* magazine, http://www.financewise.com/public/edit/riskm/currencyrisk/crsr-currencycrisis.htm.

The European monetary authorities learned this hard taught lesson: Uncoordinated monetary policies and fragmeted regulatory spaces were suicidal in a context of free capital movement; and no Member State, not even Germany, could ignore the warnings and signals from other Member States.

The Member States assimilated the crisis and –self-constrained by Law- aligned on schedule for the final straight line. By 1996, all (except for the Irish punt) had realigned on the narrow 2.25% band, at the cost of leaving the pound and the drachma outside the system. The Maastricht Treaty, however, is an exercise of constructive ambiguity[55] in terms of drafting, imposing initially « best efforts » obligations to avoid excessive deficit[56], to be specified later[57].

The European Monetary Institute ("EMI") was created as a forerunner of the European Central Bank to strengthen cooperation between national Central Banks, support monetary cooperation and coordinate the preparations for the forthcoming Immaterial Phase of the Euro.

Wigth the definition of countries of the first wave and a fixed exchange rates between their currencies and the Euro[58], the European Central Bank ("ECB") and the European System of Central Banks (the "ESCB") became operational. The mission of the ECB, broader than that of the EMI, included the authority to make both internal (release of Euro banknotes and coins[59], intermediate monetary targets[60], key interest rates[61], supply of reserves, and reserve requirements of credit institutions) and external monetary choices[62]. In practice, the main instrument for one and the other would be open market intervention to steer short-term interest and exchange rates.

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[55] There may be good reasons for not adopting an overly precise definition of price stability targets. Economists have not come to an agreement as to the optimal rate of inflation. Theoretical and practical arguments have been advanced for and against an inflation equal to zero (Issing & al, 2001, p. 69).

[56] See Section 1098(4) of the Treaty of Rome as amended by the Treaty of Maastricht.

[57] The "Stability and Growth Pact" adopted by the European Council on June 16 and 17, 1997, provides for a maximum deficit of 3% of GDP and indebtedness not to exceed 60% of GDP.

[58] Which amounts to setting fixed exchange rates between such national currencies until the Euro system starts on January 1, 1999, contrary to the existing European Monetary System (EMS); In target zone or "dirty floating" systems such as the EMS, Central Banks are committed to intervention to keep the exchange rate from moving outside specified limits either way of a centrally agreed exchange rate, or parity.

[59] Obiously, this aggregate is only one of the elements to be taken into account to fine-tune the supply of money

[60] Although monetary targets (or monetary growth ranges) can be a tool of monetary policy making, in particular when the interest/spending curve (combinations of interest rates and levels of output matching planned income and spending) is the cause of an unbalance. But rigid commitment to monetary targets seems unlikely in view of the anticipated shifts in the money demand function.

[61] Interest rates influence aggregate demand, including investment spending, and are another tool of monetary policy making. Aggregate demand is, for any given level of income, negatively responsive to increases in interest rates, although such responses may be somewhat elastic. States with high demand for money (due for instance to high public deficits) cannot afford to lower unilaterally the yield of government bonds, and therefore cannot effectively curb down interest rates to fight recession.

[62] Such as exchange rate arrangements with third currencies.

The ECB decisions were made centrally (with price stability as its primary objective)[63], and implemented lcoally through the ESCB, consisting of the ECB and the national Central Banks of the EU Member States. Specific provisions of the Maastricht Treaty protected the ESCB from political interference in the conduct of monetary policy[64]. The initial capital of the ECB was esablished at 5 billion €, contributed by the national Central Banks according to a key based on population and GDP; the ECB's Governing Council may, by special majority vote, decide capital increases[65].

Readiness in the Immaterial Phase

In this phase the Euro started its existence as an immaterial currency unit, another unprecedented feature in monetary history[66], except that it could be perceived as a continuation of the ECU[67].

Government debt bonds issued after January 1, 1999, are denominated in Euros and traded in that currency[68]; and Member States were left free to re-denominate their old bonds to Euros without delay[69]. Similarly, firms were left free[70] to start operating in Euros for the purposes of account-keeping[71] and

[63] Section 105(1) of the EC Treaty. Irving Fischer analyzed the relationship between interest rates and prices increases (or inflation), and his equation ("Fischer effect") proposes that sustained increases in money growth lead, after an initial phase of decrease in nominal interest rates, to increased output and prices, thus driving interest rates gradually up. In the long run, interest rates increase by the same amount as money growth and inflation.

[64] Sections 107 and 108 of the EC Treaty. Short of this, monetary policy could be held hostage of political-cycle-related short-term tradeoffs between inflation and unemployment along the Phillips curve, although the likelyhood of those tradeoffs resulting ultimately in higher inflation with no lesser unemployment is well known. In a case such as that of the EU, where a dozen countries' electoral schedules need to be taken into account, independence of the Central Bank is vital. Independence as such, however, does not guarantee that the monetary policies pursued by the Central Bank will be correct.

[65] Sections 28 and 29 of Protocol No 3 on the Statute of the European System of Central Banks and of the European Central Bank

[66] The Euro was the first currency not to match the traditional definition of the M1 monetary aggregate (sum of banknotes and coins in circulation plus deposits with banks): no banknotes or coins were be available when the Euro became the single currency of EMU countries on January 1 , 1999.

[67] The ECU (a name reminiscent of the old French coin ecu) was an acronym for European Count Unit ; it never was a currency on its own, although some private contracts referred to it as a supposedly more stable unit of value (it relied on a basket of national currencies). The Euro replaced the ECU on a 1:1 basis regardless of the differences in the content of the currency basket. The operational question of whether in ECU-denominated contracts without an ECU definition or with an outdated ECU definition could survive the automatic 1:1 conversion to the Euro was efficiently cleared by the market without need for public regulation.

[68] Recital 14 of Regulation on the Introduction of the Euro. Government bonds are the traditional means of financing public deficits through public debt, as opposed to money financing (borrowing from the Central Bank Debt financing does not increase the nominal money stock but its effects on inflation are debatable. See note 17 and accompanying text above.

[69] Depending on the interest rate at which such bonds are offered, this may further increase demand for Euros.

[70] Thus leaving marginal demand for money unchanged. Demand for Euros would result from government bonds and private securities of companies who decided to denominate such securities in Euros.

[71] Annual accounts cannot be drawn up in Euros for fiscal years ending on January 1, 1999.

management of their supply and demand chains, and to re-denominate their securities[72] or shares to Euros[73] if they wished.

The financial markets and electronic malls operating in national currencies started operating in Euros immediately, with the former national currencies surviving as geographically limited non-decimal sub-units of the Euro. This required some detailed planning, and demand for "Euro-compliant" information systems increased significantly but temporarily. Indeed, the information systems needed to be ready to:

- Reflect for all purposes, including taxation and tax deduction, in the profit and loss account of the balance sheet any exchange gains or losses related to the conversion of national currency into Euro[74], as if realized as of January 1, 1999, except where deferral was justified under the "matching" principle, i.e., when directly related to offsetting future income or expense items[75].

- Distinguish between new and re-denominated Euro debt[76], and draw up accounts in Euros only for any fiscal years ending after December 31, 2001. Prior to that date, accounts could be established in either former national currency or in Euros.

- Allow conversion between the national nondecimal sub-units of the Euro (formerly "national currencies"), a process labeled "triangulation" (conversion to and from the Euro).

- Treat costs associated with the introduction of the Euro as an expense of the fiscal year in which they were incurred, or capitalized them or include them in the carrying amount of a fixed asset, when producing identifiable future benefits.

- Interoperate (in the case of banking and financial market related information systems) with the ESCB systems and allow payment instructions to flow on a transaction-by-transaction basis for individual settlement across Central Bank accounts continuously and in real time[77]. In particular, these systems needed to account for fully collateralized intra-day overdrafts or intra-day REPOS[78]

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[72] Non-governmental entities might select to re-denominate outstanding debt securities in Euros, with a possible liquidity advantage (benchmark issues are likely to be in Euros, with Government debt denominated in Euros). Market perception reasons might also be a valid reason for redenomination, if Euro debt and national currency debt were not perceived by the market as strict equivalents (and therefore trade with a yield differential). The costs and complexities of anticipated re-denomination might however outweigh the advantages, in particular in cases in which consent of holders is required.

[73] Re-denomination of shares during this phase may present even greater complexities. The By-laws will need to be amended by a supermajority in the shareholders' meeting, and rounding may require a capital increase or decrease, through transfers to or from the capital account from or reserves.

[74] Including those resulting from futures contracts, such as swaps, transformed into a unilateral right to receive a fixed amount of money.

[75] Exchange gains or losses on foreign exchange contracts used as anticipatory hedges had to be deferred when this made income and expense items match better.

[76] Issuers who decided to redenominate national currency debt to Euros were still likely to prefer keeping such redenominated debt under existing market conventions.

[77] This will eliminate the intraday settlement risk presented by net end-of-day settlement systems, but also requires some re-programming.

provided by the participating national Central Banks From to secure the intraday liquidity needed to process such payments across interlinked systems.

Minor adjustments were also required for light display systems in the industrial and retail sectors, (namely dual price display in the immaterial phase, together with willingness to accept Euro as tender) and heavier supply chain and order processing systems[79]

Debts[80] payable in a Member State[81] without manipulation of banknotes or coins (such as wires to bank accounts, netting or set-off) could -notwithstanding any agreement to the contrary- be validly discharged either in Euros or in the relevant national subunit, at the option of the debtor. The creditor's account was to be credited in the denomination of such account, converting (if required) at the fixed value relationship of that subunit vis-a-vis the Euro[82].

Traditional forms of commerce requiring manipulation of banknotes and coins (such as most of the retail commerce, with the significant exception of on-line retail) would instead rely on the existing ones –representing national non-decimal subunits as above- until Euro banknotes and coins were released by January 1, 2002.

Traditional Phase (January 1. 1002 and after)

Euro banknotes and coins were released, and started behaving like any other traditional monetary aggregate; during the six-month period ending June 30, 2002, national banknotes and coins were exchanged for Euro banknotes and coins.

The non-EMU european currencies were allowed to peg to the Euro with a relatively wide maximum fluctuation band (15% either way from parity). If this option was exercised, automatic and unlimited foreign-exchange market intervention by the Central Banks are backed by very short-term financing arrangements.

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[78] Overnight Repurchase Agreements or REPOs are transactions in which a Bank sells to a non-Bank customer a security it promises to buy it back at a preset price the day after. This amounts to borrowing for one day.

[79] Information systems are not limited to traditional client / server "heavy" applications. Most of the change will need to take place at POS terminal and cash register equipment, vending and ATM machines, etc. However, these changes will not need to be immediate thanks to the "no prohibition, no obligation" principle contained in the European Regulations discussed below.

[80] Regardless of whether such debt is denominated in national currency or in Euro.

[81] And, according to Recital 13 of the Regulation on the Introduction of the Euro, possibly in other participating Member States.

[82] The fixed Euro/national currency conversion rates use six significant figures, counted from the left and starting with the first non-zero figure. Conversion from an EMU national currency to the Euro is effected dividing the national currency amount by the relevant conversion rate rather than multiplying by its reciprocal (the latter method might produce inaccuracies for larger sums). Conversions between two EMU national currencies are carried out through “triangulation” in two steps (conversion into and from the Euro, the intermediate Euro being rounded to not less than three decimals); the operation is much less scary than business and accounting information systems vendors suggested at a point in time.

The Euro floats with respect to other currencies as a function of offer and demand[83]. The real exchange rate fluctuates depending interest rate differentials and other factors.

II. ECOWAS AND ASEAN

➢ *ECOWAS*

In the Economic Community of West African States (ECOWAS), like in the European Union, certain Member States have formed a monetary union (the WAEMU[84]) while others stayed outside. Contrary to the EU case, the ECOWAS Member States outside WAEMU showed signs of considering a separate monetary union between them[85]. The paper does not deal with the feasibility of this other project.

Originally adopted upon independence by former French colonies inside and outside the ECOWAS, the Franc CFA ("XOF") has also been adopted in 1997 by Guinea Bissau and is the single currency of WAEMU. The monetary authority is the Central Bank of the West African States or BCEAO (Banque Centrale des Etats d'Arique Occidentale)[86]. The XOF is pegged to the French currency (presently the Euro), with convertibility guaranteed by the French Treasury through cooperation and operations account agreements between the WAEMU and France[87].

All of the WAEMU countries qualify as Heavily Indebted Poor Countries (HIPC in IMF jargon) and three rank in the group of the ten poorest in the world[88]. Cote d'Ivoire is one of the main producers and exporters of coffee, cocoa beans, and palm oil ; Guinea Bissau is the 6th producer of cashews

[83] Including demand for Euros originating in other countries, e.g. to buy Euro denominated assets. During the eighties and most of the nineties, US deficits have been to a significant extent financed by selling US Bonds in the international market. Contrary to taxation, applicable only to nationals, borrowing can be international. The so-called Ricardian equivalence suggests that borrowing merely defers taxation; but the political significance of this is rather limited, as individuals (voters) have limited time scopes.

[84] See note 7 and accompanying text above.

[85] In the "Accra Declaration" of April 2000, the leaders of six non-WAEMU Member States "recognize the need for strong political commitment, and undertake to pursue all such national policies as would facilitate the regional monetary integration process", declaring their intent to proceed to monetary union by January 2003. The likelihood to miss this deadline is not really relevant, because this declaration is not an enforceable legal instrument and not much reliance appears to have been placed on it.

[86] Created by the Western African Monetary Union Treaty of May 12, 1962; this Treaty was amended by the WAEMU Treaty of November 14, 1973.

[87] Signed on December 4, 1973. The cooperation agreement was amended on Mai 29, 1984. The French Treasury currently has sole responsibility for guaranteeing convertibility of CFA francs into Euros, without any monetary policy implication for the French Central Bank or the European Central Bank. The WAEMU Central Bank maintains an overdraft facility with the French Treasury, subject to operating rules that have applied since 1973. The WAEMU Central Bank must keep at least 65 percent of its foreign assets in its operations account with the French Treasury; provide for foreign exchange cover of at least 20 percent for its sight liabilities; and impose a cap on credit extended to each member country equivalent to 20 percent of that country's public revenue in the preceding year.

[88] Burkina Faso, Guinea Bissau and Mali.

worldwide, and Togo is the 4th largest producer of phosphates. Most are subject to wide fluctuations in international demand and prices of their key exports, like cotton[89] phosphates and uranium.

Differently endowed with natural resources[90], all of these countries have pursued low inflation objectives[91], implemented IMF sponsored plans to attract foreign investment[92], contained public deficit[93] to various extents, and benefited to different extents from several donor and debt relief programs. After the 1994 devaluation of the Franc CFA, many have achieved 5% growths for several years[94]; although Senegal appeared as the best performer[95], results were rather encouraging for all, but were frustrated in two cases by civil wars[96].

When adopting the XOF as single currency, the WAEMU countries did not have behind them a history of monetary sovereignty similar to that of countries involved in other integration processes. As time passed, WAEMU showed lower and less erratic inflation than other sub-Saharan countries, thus allowing a slightly higher trade between Member States[97], but their growth cannot be said to have outperformed significantly other ECOWAS countries.

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[89] Benin, Cote d'Ivoire, Mali and Niger.

[90] Burkina Faso is a landlocked country with high population density, few natural resources, and a fragile soil ; 65% of Mali's land is desert or semidesert, with economic activity is largely confined to the riverine area irrigated by the Niger, and about 10% of the population is nomadic. Niger is landlocked too, and the agriculture of Benin is mainly subsistence. Guinea-Bissau world exports fish and seafood along with small amounts of peanuts, palm kernels, and timber, Cote d'Ivoire's economy diversified to export non-traditional primary exports such as pineapples and rubber ; and in Togo, cocoa, coffee, and cotton generate about 40% of export earnings The recently discovered offshore oil reserves of Cote d'Ivoire and Guinea Bissau could provide these countries with a significant revenue stream if oil prices came to increase enough to justify the investment required to exploit them.

[91] In Senegal, inflation dropped to as low as 1% in 2000, but rose again to about 3.3% in 2001. Inflation due to increase of the monetary base has been under control in all WAEMU countries under the currency board system, but this alone did not prevent peaks of price increases or panic buying in countries affected by severe political instability or armed conflict between government forces and rebels.

[92] Togo has been successful in attracting foreign investment towards its duty-free processing zone launched in 1989, and Benin seems - in spite of initial government reluctance- committed to more foreign investment in the areas of in telecommunications, water, electricity, and tourism.

[93] Togo failed to downsize the budget of the military forces on which government depended to stay in power, and Niger is largely dependent on foreign aid for government operating expenses and public investment. The financial prospects of this last country became bleak as international aid was suspended after the 1999 coup.

[94] Benin in the past five years, Cote d'Ivoire between 1996 and 1999, Mali between 1996 and 2000, Senegal between 1995 and 2001.

[95] Senegal undertook a bold and ambitious economic reform program with the support of the international donor community, including the dismantling of price controls and subsidies, and full Internet connectivity since 1996, creating a miniboom in information technology-based services. Investment rose steadily to 16.5% in 1997.

[96] The 1998 civil war in Guinea Bissau costed a 28% drop in GDP that year, with partial recovery in 1999-2001 ; and the latent civil war in Cote d'Ivoire, together with continued low prices of key exports and default in the agreements with international donors caused negative growth in 2000 and 2001.

[97] Uche (2001) quoted in note 10 above.

WAEMU illustrates that monetary union is neither necessary nor sufficient to achieve other aspects of regional integration, in particular intra-regional trade and macroeconomic consistency. It is true that if European Central Banks with a tradition of cooperation failed to help the national currencies crawl individually out of the 1992 crisis, nothing short of a single currency managed by a single independent Central Bank would secure monetary consistency within WAEMU, or effectively constrain macroeconomic convergence to the extent desirable for an integration process[98]. But on the other hand, convergence appears to have been influenced rather by externalities such as French or IMF pressure than by a strong internal drive. And monetary union has not been sufficient to countervail divergences in fiscal policies, mainly due to occasionally degrade internal political situations, nor should it be allowed to distract attention from the need for structural reform.

- *ASEAN*

Created in 1976[99], the Association of South East Asian Nations (ASEAN) originally comprised Indonesia, Malaysia, the Philippines, Singapore and Thailand. This is an Amity and Cooperation Treaty and does not establish a Common Market between the parties and sets the principles of cooperation in very general terms.

Progressively, the ASEAN extended to comprise much of South East Asia, with the entrance of Brunei, Cambodia, Laos, Myanmar, New Guinea and Vietnam. This is a unique case of a group of countries, some rich and some poor (Laos, Myanmar and Vietnam qualify for the "Heavily Indebted Poor Country" label[100]) some with communist-like (Vietnam, Laos) and some with western-like political regimes; some terrorism struck (Indonesia, Philippines), some terrorism resilient.

These differences, with regard to political institutions, economic systems, basic infrastructure and suggests dramatic differences in policies, objectives and approaches to achieving those objectives. Trade and service liberalization and customs harmonization are still objectives of the Association[101],

[98] Masson, Paul and Pattillo, Catherine. "Monetary Union in West Africa (ECOWAS) Is It Desirable and How Could It Be Achieved?", *Occasional Papers* #204, IMF, http://www.imf.org/external/pubs/nft/op/204/. A full monetary union may have advantages over looser forms of cooperation, such as providing a more effective "agency of restraint".

[99] Treaty of Amity and Cooperation in Southeast Asia, Indonesia, February 24 1976 ("Treaty of Bali").

[100] I.e. countries that are only eligible for highly concessional assistance from the International Development Association (IDA), the part of the World Bank that lends on highly concessional terms, and from the IMF Poverty Reduction and Growth Facility, (previously the "Enhanced Structural Adjustment Facility") and face an unsustainable debt situation even after the full application of traditional debt relief mechanisms (such as application of Naples terms under the Paris Club agreement).

[101] Namely the implementation of the ASEAN Free Trade Area (AFTA), including trade liberalization with tariffs between 0 and 5% for the maximum possible number of tariff lines (Section 2.1 of the *ASEAN Vision 2020*), customs harmonization (Section 2.1.2), removal of standard-based non-tariff barriers (Section 2.1.3) and services liberalization (Section 2.3). Beyond a sheer free trade area, a strengthening of industrial cooperation (Section 2.5) and cooperation in the field of industrial property (Section 2.7) are highly desirable priorities, as is the encouragement of electronic commerce (Section 2.8). Separate sections provide for infrastructure integration, namely in the fields of transport (Section 2.10.1), telecommunications (Section 2.10.2) and energy (Section 2.10.3).

but not much has been achieved[102], as some of the economies are more direct competitors than complements.

The 1997 wiped away much of the historical "ASEAN way", and its jealous preservation of national monetary sovereignty (either due to concerns about dominance by the more influential economies, or real differences in the monetary transmission mechanisms of Asian economies)[103]. The Member States gained a better perception of their common needs, such as currency stability, banking reform and transparency[104], and their helplessness when alone in face of the huge amounts of capital that had flown in over the past ten years, attracted by higher returns[105] and sound enough fundamentals[106]. Actually the attacks on the currencies of the Member States only ceased when speculators turned increasingly wary of concerted central bank intervention[107].

While Asia does need substantial investments in infrastructure[108] and these capital inflows had permitted faster growth, they had also allowed created homegrown problems[109]: domestic banks expanded lending rapidly, creating property and stock market bubbles[110], while lax prudential rules

[102] On the trade front, ASEAN reversed in part its heavy reliance on markets outside Asia for its products, and by 1996, around 35% of trade in South East Asia was conducted within the region, compared with the share of 28% with NAFTA countries and 20% with the European Union.

[103] On investment and capital flows, however, equity flows within the Asian region increased three-fold to almost US$80 billion in 1995 from only US$24 billion 1989. The figures showing that 50% of foreign direct investment comes from within the region are at the cost of including Japan.

[104] These objectives are stated in the *ASEAN Vision 2020* Protocol of Kuala Lumpur (December 15, 1997) in rather vague terms that hopefully will develop into constructive crisis handling rather than diverging interpretations dictated by short-term political opportunism. The ASEAN Vision 2020 agrees on the need to address the then-current situation and sets wider objectives such as macroeconomic and financial stability (1.1), and s strenghtening of the surveillance process at ASEAN level. Orderly capital liberalization is also a declared objective (Section 1.1). The ASEAN Framework Agreement will be the tool for financial services liberalization (Section 1.3). Cooperation in currency, taxation and insurance matters is mentioned together with a feasibility study for an ASEAN single currency and exchange rate system (Section I.4).

[105] In the nineties, capital inflow into emerging margents increased five-fold to US$245 billion. Asia has received roughly half of this capital inflow.

[106] Thailand's growth had averaged almost 10 percent per year between 1987 and 1995, and the country had shown continuous public sector fiscal surpluses over the same period, attracting large capital inflows, much of it short-term.

[107] Roubini, Nouriel. "Chronology of the Asian Currency Crisis and its Global Contagion", Stern School of Business, New York University. http://pages.stern.nyu.edu/~nroubini/asia/AsiaChronology1998.html

[108] Infrastructure investments may require US$1.5 trillion between 1995 and 2004, and broad investment figures go as high as $8 trillion. Asian savings are not channeled towards these long-term investments: more than 80% of total Asian foreign exchange reserves amounting to US$600 billion are invested largely in North America and Europe, thus increasing the liquidity of speculators who search for short-term high yields without due regard to potential risks.

[109] If compared with the size and volatility of certain capitals, the ability of monetary authorities to deal with shocks is very low. The problems created by capital volatility are also highly contagious, and capital flows in or out in the same direction according to the perception of macroeconomic similarities or trade links amongst countries.

[110] Asset price inflation and current account deficits are known consequences of capital inflows. Imports alleviate excess demand and they are easily funded by capital inflows anyway. High levels of domestic credit, consumption, investment, growth and even budget revenues are sustained at the cost of rapid accumulation of foreign debt.

and financial oversight led to a sharp increase in imprudent investments and deteriorated the quality of banks' loan portfolios. Large external deficits piled up, currency pegs were maintained for too long (further encouraging external borrowing and leading to excessive exposure to foreign exchange risk in both the financial and corporate sectors).

In 1996, there was a perception that time had come to sell Thai shares and currency, and this set off a tumble in both exchange rates and stock markets. It took no more than a hint that Japan might raise interest rates to contain the decline of the yen to trigger an attack on the Thai baht. The Central Banks of Thailand and Singapore attempted to intervene jointly to defend it, and the Philippines Central Bank raised the overnight rate first to 13% and then 15% to defend the peso

From there, contagion to other economies within and outside ASEAN was instantaneous and relentless. Some of it was rationally attributable to competitiveness shifts or similar macroeconomic problems, but much mas sheer overreaction[111]. The exchange rate adjustment that followed exceeds by large any reasonable estimate of what might have been required to correct the initial overvaluation.

In the summer, the baht dropped to 28.80 to the dollar. Despite aggressive intervention of the Central Bank the ringgit fell in Malaysia to 2.76 to the dollar. An new increase of the overnight rate -to 24%- did not stop the downfall of the peso in the Philippines.

In the autumn, stocks kept on dropping in Bangkok, Kuala Lumpur, Manila, and Singapore. Vietnam doubled the permitted trading range to 10 percent either side of the daily official rate of the dong. New historic lows were set by the baht (40.20), the peso (32.43); the ringgit (3.50); and the Indonesian rupiah (3,845); while the Singapore dollar remained steady around 1.60 to the U.S. dollar. In December and January, the downward spiral continued with the dollar hitting record marks of 133 against the yen, 54.20 against the baht; 42.65 against the peso; 4.58 against the ringgit; and 1.76 against the Singapore dollar (whose major trading partners -Malaysia and Indonesia- were also sliding). The rupiah took a breathtaking plunge through the 15,000 per dollar level (against 2,400 in July)

Beyond ASEAN, in the autumn and early winter the dollar scored record highs of at 33.50 against the Taiwanese dollar; and 1,736 against the Korean won[112]; the Hong Kong dollar still held somewhere between 7.50 and 7.75, at the cost of massive intervention and tight overnight interest rate to 8%.

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[111] Fischer, Stanley. “The Asian Crisis: A View from the IMF” Address by Stanley Fischer, First Deputy Managing Director of the International Monetary Fund at the Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, D.C., January 22, 1998. http://www.imf.org/external/np/speeches/1998/012298.htm. As the currencies slided, the markets became fearful of the increased cost of the domestic private sector’s debt service. Domestic residents rushed to hedge their external liabilities, thereby intensifying exchange rate pressures.

[112] Korea shared certain macroeconomic problems with ASEAN countries, and competitive Japanese exports became cheaper with the yen still sliding. Like Thailand and Indonesia, Korea suffered from a weak financial systems, excessive unhedged foreign borrowing by the domestic private sector, and a lack of transparency about the ties between government, business, and banks. But the situations in these countries was not identical: Thailand’s current account deficit was large (8 percent of GDP), while Korea's was on a downward path, and Indonesia's was more manageable (3.25 %percent of GDP).

Miles away, Brazil orthodoxly implemented a sharp increase in interest rates, but the process that would make of the real the next emerging country target was already on its way, possibly due to remotely similar fundamentals, such as budget and current account deficits[113].

By February, the intensity of the attacks decreased in Asia; the currencies had already depreciated far more than was warranted or desirable, and investors eyed undervalued stocks. Stock and currency markets firmed (except for the rupiah) and volumes increased as longer-term, value-oriented funds flooded back into Asia from Europe and the US.

Painful as they were, the IMF-supported programs in Asia had at least the merit of highlighting common points between the ASEAN economies, and indirectly making the case for monetary cooperation between the Member States. All of these "packages" have called for a substantial rise in interest rates[114] and a forceful, up-front action to put the financial system on a sounder footing, closing down non-viable institutions[115] and bringing others into compliance with internationally accepted best practices, including the Basle capital adequacy standards[116] and internationally accepted accounting practices and disclosure rules through tighter financial sector regulation and supervision, increased transparency in the corporate and government sectors, and a greater openness of the Asian markets to foreign participants.

Although the fiscal "packages" varied slightly from country to country[117], all requested a fiscal adjustment to cover the carrying costs of financial sector restructuring (spread over several year) and to help restore a sustainable balance of payments. In Thailand, this translated into an initial fiscal adjustment of 3 percent of GDP; 1% in Indonesia and 1.5% in Korea[118]. In all cases, much of the savings will be achieved by reducing public investment in projects with low economic returns.

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[113] The probability that the East Asian crisis could have unexpectedly large negative effects on Japan, Latin America, and Eastern and Central Europe was perceived as small but far from negligible, and this possibility "should not be left solely to chance". Global financial markets, as currently organized, do not always achieve an appropriate equilibrium, or at least require time to stabilize. Greenspan, Alan. "The current Asian crisis*",* Testimony of Chairman Alan Greenspan before the Subcommittee on Foreign Operations of the Committee on Appropriations, U.S. Senate, March 3, 1998. http://www.federalreserve.gov/boarddocs/testimony/1998/199803032.htm

[114] Fischer (1998). Higher interest rates should also encourage the corporate sector to restructure its financing away from debt and toward equity, which will be most welcome in Korea and some ASEAN Member States.

[115] Fischer (1998). It would be a mistake to allow clearly bankrupt banks to remain open, and the best course is to recapitalize or close insolvent banks, protecting small depositors, and requiring shareholders to take their losses. At the same time, banking regulation and supervision must be improved. The timing is a function of the individual country circumstances.

[116] Basel Committee Working Papers: « Supervisory lessons to be drawn from the Asian crisis". This paper identifies changes in the practice of supervisors, banks and ratings agencies in the area of country risk measurement and management. http://www.bis.org/publ/bcbs_wp2.htm.

[117] Fischer (1998). Ideally, a stabilization of the fiscal position should happen at the outset of a crisis, to deal both with the future costs of financial restructuring and -depending on the balance of payments situation- the need to reduce the current account deficit. Then, if the economic situation worsens, automatic stabilizers can work and the deficit will widen somewhat, but never losing of sight the fact that a country in crisis has limited access to borrowing.

[118] Not a Member of ASEAN.

Clearly defined, shared and realistic common goals seldom translated into hard figures with the ability to constrain domestic policies in the ASEAN context until the crisis. Although Asian monetary cooperation is likely to proceed with flexibility and at a pace comfortable to those wishing to take part in it, a four point case for stronger monetary cooperation within ASEAN is easy to make:

- Information exchange and policy consultation are the loosest form of cooperation and has been effective under normal operating conditions: the EMEAP Virtual Secretariat has helped share market intelligence, techniques and experience in all areas of central banking, and there is no need to emphasize on the benefits of the initiative, except to remind the need to consider improvements o the legal framework of transborder data flows. Policy coordination required to handle critical times has not followed yet, and implementation in the midst of a crisis is virtually impossible.

- Resources (liquidity and credit) handled under a nework of bilateral repurchase agreements of US Treasury securities amongst EMEAP central banks were inefficient to prevent contagion and netowrking those bilateral agreements is probably the sole option short of a mutlilateral pooling of resources.

- A financial highway can be built at the fraction of the cost of physical highways required to integrate infrastructure for trade purposes, to establish a settlement and clearing system required if ASEAN is to ever rely less on European and American clearing. Financial markets fragmentation is at least as damageous as physical fragmentation.

- Liberalization can and should coexist with sound regulation: both are, after all, linked to increasing choice. Thus conceived, liberalization would be a tool for regional growth rather than a weapon in the hands of speculators. This requires cross-border regulations mirroring cross-border financial flows to safeguard the integrity of the banking and financial systems, including harmonization of supervisory practices.

III. THE OPPORTUNITY FOR MERCOSUR

The MERCOSUR created by the Treaty of Asuncion of March 26, 1991 sets the basis for the future creation of a common market between Argentina, Brazil, Paraguay and Uruguay. The creation of this common market implies:

- Free circulation of goods, services and factors, through –amongst others- the removal of tariff and non-tariff barriers, and the creation of a common external tariff.
- Coordination of macroeconomic policies between Member States in the agricultural, industrial, fiscal, monetary, exchange rate, capital movement, customs, services, transportation, telecommunications, and external trade areas.
- Harmonization of internal legislation in the relevant areas

The action plan 1995-2000 was ambitious and included trade liberalization, regulation of public policies that adversely affect competition and unfair competition practices, and the establishement of a common external tariff.

MERCOSUR was initially successful in terms of increasing trade between the different Member States, by removing tariff and non-tariff barriers, despite the lack of an enforceably consistent exchange rate system linking together the argentine *peso*, the *real*, the *guarani* and the *peso uruguayo*.

The flaw went, however, unnoticed until the ASEAN crisis showed pervasive critical masses of volatile capital moving more or less freely around the world more or less irrationally[119]. Within MERCOSUR, the *peso* was legally pegged to the dollar under the so-called Convertibility Act[120]; and the *real* was informally pegged to the dollar too, under a managed floating system[121], as was the *peso uruguayo*, while the *guarani* floated.

Brazil is the largest economy of the MERCOSUR[122], and when the *real* went under speculative attack in 1998, the weaknesses of managed floating based on purely national commitment, and supported by the sole resources of one Central Bank became apparent. After futile efforts to shore the *real*, at the cost of major losses in foreign-currency reserves and sharp interest rate increases [123], Brazil made an abrupt shift of course in January 1999, abandoning the informal peg and letting the *real* float, and the exchange rate almost double[124].

The devaluation obviously operated a transfer of competitiveness within the MERCOSUR[125], namely to the detriment of Argentina, the second largest MERCOSUR Member State[126]. The devaluation's main effect, however, was not felt on relative export and import prices, a relatively desirable

[119] For the role of the mutual funds in the propagation of crises, see Choueiri, Nadia, and Kaminsky, Graciela, « Has the Nature of Crises Changed ? A Quarter Century of Currency Crises in Argentina », *IMF Working Papers*, http://www.imf.org/external/pubs/ft/wp/1999/wp99152.pdf

[120] The 1:1 U$S/Peso parity established by the Convertibility Act implied that the peso would gain on other currencies if the dollar did, for instance due to the Fed's monetary policy at a given point in time. Obivously, there was no warranty that the Fed's policy would take into account Argentina's needs, or that an appreciation would not occur at a most unwelcome moment, a recession for instance.

[121] « Managed floating » and « Dirty floating » are equivalent terms (Dornbusch, Rudiger, and Fischer, Stanley, *Macroeconomics*, Sixth Edition, McGraw Hill :1994, p. 156. We prefer « *managed floating* », an expression that emphasizes that the system is actually abandoned as soon as it becomes *unmanageable*, due to massive loss of reserves, unsustainable domestic interest rates, or other motives.

[122] In terms of size (8,511,965 sq Km), population (176,029,560), and GDP (purchasing power parity ~ $1.34 trillion estimated in 2002).

[123] In August and September 1998, approximately 30 billion dollars fled out of the country, and the annual interest rate hiked to about 50%.

[124] The end of period nominal exchange rates for one dollar in the MERCOSUR countries are available at http://www.mercosur.org.uy/espanol/sinf/boletin/pagina024_Cambio_Nom_Fin_Periodo.XLS. The Brazilian average yearly average jumps from about 1.17 in 1998 to about 2 the next year.

[125] While constrained by the Convertibility Act the nominal parity of the peso remains at 1:1 in 1998 and 1999, the yearly averages of Uruguay slowly move from about 10.48 in 1998 to 11.36 the next year, and that of Paraguay from about 2.76 to about 3.16.

[126] In terms of size (2,766,890 sq km), population (37,812,817), GDP (purchasing power parity ~ $453 billion. Its GDP per capita (purchasing power parity ~ $12,000) is higher than that of Brazil (~ $7,400).

consequence[127], but rather on a capital flow contagion across the two major economies of MERCOSUR[128], aggravated by the mismanagement of the crisis in Argentina.

Contagion[129] in currency crises has only recently been studied by economists[130]. The changes in competitiveness that followed the depreciation of the *real* could by themselves create expectations of a similar move from Argentina[131], or at least significant changes in the Convertibility Act. Brazil had become more attractive in terms of cost structure, and the downward rigidity of Argentine wages, prices and public spending left little hope that it could adjust to Brazilian cost levels simply by undergoing a protracted recession and deflation[132]. The *peso* was still yanked upwards together with the dollar despite acute recession[133], and fiscal policies to fight recession did not appear available either.

Nor did Argentina fare better than Brazil in terms of IMF-approved commitment to a management of the monetary and credit aggregates in a fashion consistent with low inflation objectives[134], or the reduction of the public debt, or reforms in the areas of tax, administration, social security, social policies, fiscal responsibility, and the labor market.

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[127] Brazil had accumulated negative trade balances with Argentina between 1995 and 1998 at an average pace 1.7 billion per year. After the devaluation, the trade balance became less negative but there was still an average deficit of 851 million a year in 1999, 2000 and 2001. Measured in terms of dollars, the trade between the two countries declined from 7 and 8 billion Brazilian exports and imports respectively in 1998 to about 5 and 6 billion dollars in 2001; but interestingly, total Brazilian exports and imports that had amounted to 50.5 and 61 billion dollars approximately in 1998, amounted to 57 and 58.5 billion in 2001.

[128] Compared with those of Brazil and Argentina, the economies of Paraguay and Uruguay are relatively small, and were less exposed to major capital inflows and subsequent outflows.

[129] A currency crisis is said to be "contagious" if it spreads from its initial target

[130] Eichengreen, Barry; Rose, Andrew; and Wyplosz, Charles. "Contagious Currency Crises" , University of California at Berkeley:1997. http://faculty.haas.berkeley.edu/arose/congtn.pdf.

[131] It is true that a devaluation following a successful attack gives a country a temporary competitiveness boost in presence of nominal rigidities. Because countries lose competitiveness when their trading partners devalue, a currency crisis that hits one country may be expected to spread to its trading partners and those most adversely affected by the devaluation are likely to be attacked next, and devalue in turn. Eichengreen, Rose & Wyplosz (1997). Brazilian trade with Argentina accounted for only about 13% of Brazilian total trade; while for Argentina, trade with Brazil accounted for about 25/30 % of total exports and imports (respectively 26.2 billion and 31.3 billion in 1988.

[132] Both domestic prices and wages show downward rigidity, and a recession generates unemployment and bankruptcies rather than a fall in domestic prices and wages. The same is true of public expenditure, and wages and retirement benefits are known to be rather inflexible downwards, even outside electoral periods.

[133] From 1995 onwards, the dollar gained steadily on the European currencies (and the Euro later) and the yen. The value of the dollar is sometimes subject to a "speculative bubble" effect, i.e. significantly departs from the fundamentals that should determine its value: interest rates, the current account, and expectations about the future current accounts. Dornbusch & Fischer (1994), page 630. In itself, this questions the fairness of debt burden and value assessments based on fundamentals of another economy: even assuming identical interest rates, there was no reason to believe the current accounts of the US and Argentina, or expectations about future current accounts, would remain steadily parallel over a long period of time.

[134] See "Joint Statement of the Ministry of Finance of Brazil and the IMF Team", February 4 1999, *IMF News Brief*, http:// www.imf.org/external/np/sec/nb/1999/nb9905.htm.

The Central Bank could not legally act as lender of last resort[135] should a bank run occur in the Argentine *de facto* bi-currency economy[136]. Two years of unorthodox or counterproductive[137] trial and error convinced the IMF, other lenders and investors alike that Argentina was unable or unwilling to remove these rigidities or resolve dilemmas, and there was a moral hazard[138] in continued loans while Argentina maintained high public deficits that did not even pull the country out of recession.

Capital fled out of the country, the bank run expectation self-fulfilled and the Convertibility Act was *de facto* repealed in 2001 under the worst conceivable conditions[139]. The 300% depreciation of the peso *that* followed[140] did drastically reduce imports, but had a J-curved effect[141] on exports without immediately perceptible improvement. A timely devaluation does make foreign investment more attractive, but this is not true when it comes late, rather as a compulsion of events than as a deliberate policy. These processes are highly destructive, and the decline in investor demand for Argentine assets will persist while the damage caused to credibility in general and credit in particular is not cured.

When Argentina next faces the rescheduling of its public debt, long overdue creation of a fully compliant banking system[142], restructuring of the public sector, control of deficit and public

[135] The Central Bank was not legally allowed to issue money to act as lender of last resort, and neither such Central Bank nor the deposit-insurance system had enough funds to deal with a generalized run against the banking system.

[136] A large percentage of Argentine private and public debt was denominated in U.S. dollars, as were most bank deposits, and it was easy and common for depositors to switch from U.S. dollar deposits to Argentine peso deposits, and vice-versa, based on interest rate differentials and expectations.

[137] Among the former, the attempt to increase taxes in a context of recession. Among the latter, the partial freeze imposed on deposits, and the timing of the expenditure cutting project (that sank under immediate heavy congressional fire. The market signal thus became that since the Government could not attend both inflexible expenditures and debt servicing, Argentina would default on the latter: the value of Argentine bonds dropped accordingly. The alternative to the partial freeze on all deposits was letting the locally-owned banks fail, and hope that the parent companies would support their banking subsidiaries (with an inflow of funds that would have strengthened the Argentine peso and the financial position of the Central Bank); but the former appeared politically unsustainable and the latter looked much like poker-economics.

[138] A situation in which investors make placements regardless of the dangers objectively involved in such investment, reminiscent of the savings and loans ("S&Ls") associations that failed in the US in the late eighties. Dornbusch & Fischer (1994), page 433. A tacit element of the Argentine Convertibility Act was that the willingness of the IMF to ultimately behave as the FSLIC/FDIC had behaved in S&Ls crisis. In 1995 already, several banks had fallen but a general run against the banking system was avoided thanks to IMF support.

[139] Countries rarely adjust because tightening policy before it becomes inevitable is politically difficult. The Mexican crisis of the eighties was an example of what happens when foreign investors and lenders lose confidence and are no longer willing to buy assets in the country and the local investors send their capital abroad. A huge financial gap emerges. Dornbusch & Fischer (1994) page 609.

[140] The average nominal exchange rate for the dollar jumps from 1:1 in 2001 to 1:3.41 in 2002. The real slipped from 2.35 to 2.89, while the guarani followed slipping from 4.18 to 5.42 and, more sharply, the peso uruguayo from 13.41 to 19.73. The exact figures for the four MERCOSUR Member States are available from the ALADI Internet site at http://www.mercosur.org.uy/espanol/sinf/boletin/pagina024_Cambio_Nom_Fin_Periodo.XLS

[141] Dornbusch & Fischer (1994), page 611.

[142] Past reforms had left untouched the privileges of Government-owned banks and a general leniency towards liquidity reserve requirements. In theory, if a bank run occurred and depositors purchased dollars with pesos, the Central Bank would withdraw liquid funds from the banks in an amount equal to the pesos used for the purchase of dollars; the Banks needed to

indebtedness are likely to surface as conditions. This paper focuses on the case against national implementation of any of the available policies and for their implementation at MERCOSUR level.

The case for MERCOSUR monetary cooperation

Any case for advanced monetary cooperation starts from the self evident lack of preparation of the MERCOSUR institutions to this effect, calls for the EMS parallel, and takes into account the depth of the Latin American crisis.

Although the issue of a single currency for MERCOSUR had been raised in December 1997 and again at the regional summit in June 2002[143], there is no tangible evidence that MERCOSUR perceives a contradiction between the limited objective of a customs union and the existence of uncoordinated national currencies fluctuating against one another[144].

Threre are three basic arguments in favor of intra-MERCOSUR monetary cooperation:

1) The first one is, conservatively, linked to the trade balance. The weakness of the intra-MERCOSUR trade figures when compared to the huge capital inflows and outflows that Brazil and Argentina experienced, together with their slowdown further to the monetary disruptions, can be construed as a sign that without monetary cooperation, even the basic trade-related purpose of MERCOSUR itself will not be achieved.

2) The second one is, more aggressively, linked to the balance of payments as a whole. Monetary cooperation, with its associated imports and exports of stability and instability factors would dilute into a larger base the volatile capital inflows and outflows and their associated effects on aggregate demand[145]. This would dilute both wage and price raises during expansion periods and make

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have a liquidity strong enough to survive the crunch as the multiplier effect would curb down deposits. In practice, however, such is not the case when the monetary authority has been permissive with reserve and liquidity requirements, as would be the case in order to allow or pressure banks to hold government securities, starting with Government-owned banks.

[143] There had also been much more talks than concrete achievements since the early sixties about the possibility of an European Monetary Union since the early 1960s, and only after the creation of the EMS did that logic drive increasing support. Recognizing that in a context of floating exchange rates, the level of cooperation also floats, the European Union concluded that a monetary union was needed, and that union required price stability, because The Bundesbank, as the anchor of the system, needed to solve Germany's inflation problem first. Braithwaite, John and Drahos, Peter. *Global Business Regulation,* Cambridge University Press:2000.

[144] Eichengreen, B., « Does Mercosur Need a Single Currency », *EconPapers*, http://www.nber.org/papers/w6821.pdf

[145] This note uses the billion dollars as unit. Net inflow of direct foreign investment amounted to 23.88, 33.84, 49.82 and 41.449 for MERCOSUR as a whole in 1997, 1998, 1999 and 2000 respectively, with a sharp decline in 2001, returning to figures roughly equivalent to those of 1997. By way of comparison, the same figures for Brazil amount to 17.88, 26, 26.89 and 30.50 in 1997, 1998, 1999 and 2000 respectively, showing a different escalation and lesser decline (24.71 billion in 2001). In parallel, the aggregate MERCOSUR GDP dropped from 1,132 to 1,117 to 841.6 billion in 1997, 1998 and 1999 respectively, rising briefly to 906.27 in 2000, to fall again to 798.42 billion in 2001. Similarly the Brazilian GDP dropped from 807,81 to 787,89 to 531.06 billion in 1997, 1998 and 1999 respectively, briefly raising to 594,25 in 2000 to fall again to 503.86 billion in 2001. Overall, this multiplied the effect of capital inflow on aggregate demand and currency appreciation, although in varying degrees depending on the country considered and comparing with the MERCOSUR aggregate.

recession periods less intense, possibly with lesser unemployment. This dilution in turn would reduce or spread over time the IMF resources required to soften the capital flow fluctuations, bridging the gap between the rapid and brutal capital inflow and outflow and the longer periods required to adjust[146].

3) The third one is linked to the depth of the crisis: the two main MERCOSUR economies are in the process of rebuilding from scratch and their success is contingent on credible ability to implement beyond opportunistic political influences. A multi-national Central Bank or at least a structured system of Central Banks would be more credible in terms of independence vis-à-vis short-range behavior, and the pooling of resources, both monetary and human, would provide a credible basis for the policies that do not appear available for any individual Central Bank.

Thus formulated, the three arguments call for a parallel with the EMS, from which a certain number of similarities and dissimilarities can be derived:

a) The European Member States had progressed between 1958 and 1979 in the removal of tariff and non-tariff barriers and harmonization of the business legal environment beyond comparison with MERCOSUR, progressively increasing the significance of intra-EC trade[147]. Their vulnerability to volatile capital inflows and outflows was much lesser[148] and their attractiveness for capital originating from outside the region was comparable.

b) Their inflation and interest rates had not converged, and these countries had not perceived a link between their common market program and mutual restraints on national-managed public deficit and debt until 1979. When the EMS was implemented that year, the fluctuation bands between currencies were relatively higher for the economies that had made less progress in the containment of inflation, deficit and debt.

c) The implementation of the EMS was undertaken in the context of the worldwide crisis that corresponded to the collapse of the Bretton Woods system[149], and crisis is no argument to refrain

[146] This is also true with regard to external indebtedness. The ratio between total indebtedness (374.02 billion) and total exports (87,88 billion) was 4.26 in 2001, while such ratios are 5.43 for Argentina in the same year (total indebtedness, 144.45 billion; total exports, 26.61 billion); and only 3.355 for Brazil in 2000 (total indebtedness, 202.39 billion; total exports 56.94 billion).

[147] In 1997 and 1998, Intra-MERCOSUR exports accounted for 25 % of total MERCOSUR exports and 20% of global imports in 1997 and 1998, with such figures dropping to 21/20 in 1999 and 2000, with a further decrease to 17% in 2001.

[148] In the MERCOSUR, net foreign capital investment was 33,835 in 1998 and 49815 in 1999.

[149] Bretton Woods had become something very different from what Keynes had, somewhat naively, expected in May 1944: an International Clearing Union “that could issue a new unit to be called the "bancor, unitas, dolphin, bezant, daric and heavens knows what” and discipline deficit and surplus nations alike. D. Moggeridge (ed.), *The Collected Writings of John Maynard Keynes*, London. Short of that, the dollar became the anchor unit. The suspension of convertibility when the US also became a deficit country didn’t come as a surprise: Since the monetary unions in Ancient Greece, the consequence of using as anchor currency that of the hegemonic power are well known: the temptation to use that currency to run its own agenda and solve domestic, economic and political problems while transferring the cost of adjustment to others is just too great for the hegemonic power to resist it. Unsurprisingly, the American suspension of convertibility in 1971 came accompanied by bellicose demands that other countries should revalue their currencies so as to eliminate "unfair exchange rates," backed up by the imposition of a 10 per cent import surcharge until such time as they complied.

from taking bold action. The survival of the EMS was not linked, however, to any IMF approval, and the GDP/public debt ratio and inflation were below statistically significant comparison with those of other integration processes. All the participating Central Banks had considerably higher non-attached foreign exchange resources and could more credibly commit to open market operations in defense of each other, although important disparities at this level made in practice the Bundesbank the anchor of the system.

d) Within the EMS, each of the currencies was linked to the others, each floated vis-a-vis non-zone currencies, thus constraining progressive convergence of their macroeconomic indicators, but there was a lesser need for immediate results than that of the MERCOSUR main economies. Different price elasticities in each Member State for the goods produced by the others never disappeared completely, and the country risk premium that made certain currencies look preferable than others was constrained but never disappeared completely either.

e) Participation in the system was to a large extent voluntary, and leaving the zone due to declared unability to sustain the parity levels was seen as enough of a sanction to the defaulting country.

f) The system lasted robustly until the autumn of 1992, when each currency was attacked in turn. This crisis stands the parallel with the Mexican, Brazilian, Argentine and Asian crises to the extent that both involve speculative capital movements and domestic financial weakness, despite more moderate effects in Europe, within the context of full capital mobility[150].

g) The German unification and the associated costs reversed many anticipated trends, such as low inflation and interest rates in Germany. The Bundesbank had to set interest rates that were unsustainable for other Member States, and the British Pound was forced out of a system it had adhered to very late, only two years before.

h) In the aftermath of the 1992 crisis, the Member States made the choice of increased, not lesser cooperation. They entrenched in Treaty form a timetable and set of conditions for monetary union. Essentially, states wishing to be part of the union were committed to more than the prevailing principles of macroeconomic orthodoxy (a low inflation rate, reduced government deficits and the stabilization of their currency): they committed to specific figures for each of those indicators.

i) Progressively, differences between inflation rates, public deficit, and public debt were contrained by enforceable agreement into lower levels. In 1999, the European Monetary Union came into being with the adoption of the Euro as a single currency.

This parallel shows that the EMS was implemented under less dramatic circumstances, by bigger economies with more time ahead and with a better track record. It does not show that determined monetary cooperation within MERCOSUR would yield lesser benefits or that it would not be a vital option in the road ahead.

CONCLUSIONS

[150] Eichengreen, Barry. "The EMS Crisis in Retrospect.", *Working Papers*, National Bureau of Economic Research:2000. http://papers.nber.org/papers/w8035

This paper deliberately selects four integration processes in different continents, involving some of the countries with the wildest conceivable differences, some with market economies, others centrally planned, some terrorism or civil war infected, some under military leadership, some strongly committed to democracy.

Out of the sample, two (EMU and WAEMU) have achieved monetary union, neither including all Member States of the integration process (EU and ECOWAS respectively). In neither case have the Member States belonging to the monetary union significantly outperformed the others in terms of growth, but in both stability has been higher. In both EMU and ECOWAS, the Law was used as a driving force to achieve enforceable and credible monetary integration.

The two others, (ASEAN and MERCOSUR) have rather focused on free trade than on monetary cooperation until hit by the crisis in 1997-1999. Only ASEAN has since written down in legal form future action towards improved capital markets, namely through tighter and more transparent banking regulation.

The EMU is the only one to have written down in Law hard figures as to the maximum permissible deficit and GDP/indebtedness ratio; whether a redrafting to add "intelligence" to the system is required is the subject of current debate[151]. In all other integration processes, attempts to contain deficit and debt have appeared as the result of IMF recipes rather than as a consequence of autonomous or mutually imposed self-discipline.

In neither has monetary integration equalized differences in the transmission of monetary policy impulses (e.g. after an identical change in the short-term interest rate[152]) or in elasticity of demand vis a vis products of other Member States. These differences do not disappear after monetary integration

Suggesting that there is no optimal timing to proceed to advanced monetary cooperation, one of the integration processes in the sample has implemented gradually, refining a monetary target zone over twenty years (EMU) and one has implemented monetary union immediately upon independence (WAEMU) while neither of the two others (ASEAN and MERCOSUR) have implemented monetary cooperation in their 35 years of existence.

In all cases but WAEMU, decisive steps were taken (EMU) or are likely to be taken (ASEAN and possibly MERCOSUR) in response to a monetary crises. Crises, obviously, come at moments that are unrelated to political readiness. In the single case of EMU, the two steps of monetary cooperation

[151] The German and French deficits are likely to cross the 3% deficit/GDP borderline in 2003, but Spain and the Netherlands have higher inflation. Belgium, Italy and Greece are way beyond the 60% debt/GDP ratio, while outside the EMU, the UK has reduced indebtnedness below 40% of GDP. The rigidity of the figures has been criticized, but provides the legal and psychological pressure required to curb down indebtedness over time; this can only be achieved by way of exceents expansion, thus banning tax cuts or additional public expenditures. There is also a need for better focus on the quality of the fiscal policies (i.e. their impact on growth, employment and long-term fiscal position), as the ageing of European population is likely to cost between 4 and 8 % of the GDP per annum in the decades to come.

[152] The distributed lag phenomenon has been identified in macroeconomics. Open market operations impact interest rates with a lag, and another lag exists between changes in interest rates and investment. Fiscal policies and changes in Government spending (which both remain under national control) impact aggregate demand more rapidly.

(1979 and 1992) were taken as a consequence of internal drive, without excessive consideration as to whether the IMF was favorable or opposed to the move; in all other cases, implementation against the will of the IMF appears unthinkable.

In the case of EMU, costs and benefits are to a large extent inseparable from each other, and all of convergence of macroeconomic indicators, legally enforceable restraint on divergent national policies, and monetary union are so intimately involved that it is hard ot say which is the cause for the other.

EMU may have fulfilled Rueff's prediction in the fifties that European integration would happen through currency or not at all. The WAEMU example, on the other hand, is there to show that a single currency may not be enough to achieve success in integration.