

Regional Currencies and Regional Monetary Zones in Latin America: What Prospects?

Claude Gnos (CEMF-LEG, University of Burgundy) and Jean-François Ponsot (LEPII, University Pierre Mendès France of Grenoble)

Paper presented at the Eastern Economic Association Annual Conference, New York City, February 27 - March 1, 2009

1. Introduction

This paper aims at drawing lessons from the main cases made against Keynes's plan, in order to help improving regional monetary agreements in Latin America. Some promoters of the Bank of the South and the New Financial Architecture in Latin America are proposing to implement a regional clearing system designed to allow a multilateral offsetting of the liabilities and assets generated in the reciprocal transactions of member countries (Government of Ecuador, 2008). In order to think up this system, they refer to the 'Proposal for an International Clearing Union' that Keynes presented at the Bretton Woods Conference (Keynes, 1942, pp. 33-40). In words that the British economist certainly would not have denied, they advocate the creation of a Central Clearing Union (Unidad Central de Compensación - UCC) endowed with a currency unit they call "sucre" (Sistema Único de Compensación Regional de Pagos). This currency unit would be designed to keep member countries' accounts with the UCC.

To that end, the paper will first present previous regional payments and unit of accounts agreements in Latin America: the Reciprocal Payments and Credits Agreement of the Latin American Integration Association or ALADI, the 'Peso Andino' set up by the Latin American Reserve Fund (FLAR) and the Payment System on Local Currency agreement (SML). Despite their indirect dependence to the US dollar as international standard, such current arrangements could be used to facilitate the implementation of the SUCRE plan. Then the paper will show that as part of his proposal Keynes drafted a system for exchanging currencies that, if it had been completed, would have allowed him to deal more convincingly than he did with the

main objections arisen. Next section will examine those objections. It will also emphasise their relevance to the SUCRE plan or to any similar plan. Last section will focus on the exchange scheme drafted by Keynes and the means and ways of supplementing it in order to get over the objections under examination.

2. Regional Payments Agreements in Latin America

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

Such an agreement would economize in currency flows, and the associated transactions costs, on at least two ways. First, if the periodic settlement of the two accounts is done in a net basis, the amount of each settlement would only reflect the difference between accumulated sales and purchases during the settlement period. In contrast, if all transactions are paid individually, as would happen in a decentralized system, all sales and purchases would involve an international currency flow. Second, in order to pay for the bilateral trade between the two countries, the central bank of the country in deficit only needs to transfer a reserve currency at the end of the settlement period. In comparison, in a decentralized system each central bank would need to maintain enough international reserves to finance bilateral payments continuously during the period. Coupled with net settlement, this feature implies that each central bank can safely reduce its holdings of reserve assets. The last fact, reducing the need to hold international reserves was the primary motivation for the establishment of a

number of regional payments systems, starting with the European Payments Union in the 1950s.

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

In a number of cases, a group of countries have set up a common pool of international reserves and, at the same time, granted each individual country the right to borrow from the pool under specified circumstances. Such circumstances have been mostly related to temporary balance of payments problems, although it is conceivable for an agreement of this kind to allow members to borrow for longer term purposes. Let's give the example of the Latin American Reserve Fund (FLAR). FLAR evolved from the Andean Reserve Fund, which operated between 1978 and 1991. Its current members are Bolivia, Colombia, Ecuador, Peru, and Venezuela; in addition, Costa Rica's parliament is currently considering formal incorporation into FLAR. FLAR's capital is coming from members contributions. A second source of FLAR's funds is given by demand deposits and time deposits of member central banks. FLAR has used the resources thus obtained to grant loans to financial institutions of member countries in order to support trade and, in some circumstances, to assist member central banks experiencing a need for international liquidity.

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

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

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

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

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

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

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

Keynes did not convince the US negotiators, and the latter actually had good reasons for remaining sceptical. On the one hand, there is no doubt that in making drawing rights available to countries the clearing union grant credit to deficit countries and allow them to buy goods and assets from other member countries. To the deficit of some countries there necessarily corresponds a surplus in other countries. Then, contrary to Keynes's argument, it

is not up to creditor countries to reduce their surplus. On the other hand, the funding of deficit countries would result in inflation in creditor countries and deflation in debtor countries. According to Keynes's proposal, amounts in the international money would be credited to surplus countries' central banks that would in turn, through commercial banks, credit exporters in the domestic currency. This means that domestic money would be created as a counterpart to the amounts of the international currency credited to the account of exporters' countries. Reciprocally, deficit countries' central banks would meet a debit in the international currency, the counterpart of which would be made up of the sums of domestic currency spent by the importers and that in this way would be no more available in the economy for funding purchases on the goods domestically produced.

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

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

It is true that in order to ensure exchange rate stability Keynes recommended implementing strict exchange controls, especially in the early versions of his plan. In subsequent versions, he was more moderate but there is no doubt that foreign exchange controls were part of his plan: “[...] the universal establishment of a control of capital movements cannot be regarded as essential to the operation of the Clearing Union; and the method and degree of such control should therefore be left to the decision of each member state” (Keynes, 1942, pp. 185–86).

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

applied, they would run counter to a major goal of regional unions, to wit, to have a part in the economic and financial integration of the member countries.

4. The need for a novel system for exchanging currencies: Keynes's scheme and the ways and means to supplement it.

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

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

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

He also made it clear that

Within any member-country [...] the provision of foreign exchange to be concentrated in the hands of its central bank which would deal with the public through the usual banks. That is to say, a member of the public here desiring to obtain dollars for a specified purpose would instruct his bank to make application to the Bank of England. [...] Central banks would buy and sell their own currencies amongst themselves only against debits and credits to their accounts at the Clearing Bank (Keynes, pp. 33-34).

Unfortunately, this scheme does not counter the objection relating to the funding of deficit countries and its inflationist and deflationist effects. Central banks in creditor countries would supply their own currencies against credits in *bancors* while central banks in debtor countries would buy their own currencies against debits in *bancors*. This scheme, as well, would not be able to ensure exchange rates stability. Since foreign exchange would be concentrated in the hands of central banks, we may expect that the latter would be in a position to apply fixed exchange rates between their own currencies and the international currency. The difficulty, actually, would be to maintain exchange rates that would be less and less in accordance with inflation differentials, the system inducing inflation in creditor countries and deflation in debtor countries. Then, just as McKinnon emphasised, speculative

money flows would tend to anticipate any discrete change in official par values. In doing so they would worsen payments imbalances and deflation/inflation pressures.

How are we to solve the problem? The analysis we are developing shows that the issue lies in the way domestic currencies are managed per contra debits and credits in the international currency. Therefore, we may think along the same line as Schmitt (1988) who has suggested that the national organs through which countries would operate should borrow or lend in the financial markets of the countries they are trading with, the very sums of foreign currency they spend or receive as a consequence of their residents' foreign transactions. In other words, an importing country A should borrow in the exporting country B the very sums of money B that is needed in country B to pay for the goods it is importing. The exporting country B, on its part, should lend in country A the sums of money A it earns. Both actions would be simultaneous, because in every international transaction, two currencies are necessarily involved.

This proposal is actually in accordance with the logic of international payments, by which a country pays for its imports of goods and securities by means of the export of goods and securities (cf. Rossi 2009). As a consequence, the clearing of debits and credits in the international currency could take place on a very short term basis and would not result in an accumulation of imbalances. This would be so because any country importing or exporting goods would, as a counterpart, export or import securities. Deflation and inflation resulting from trade imbalances would be avoided and consequently exchange rates of domestic currencies against the international currency could be maintained fixed by the central banks without any need to implement capital controls.

5. Conclusion

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

In this paper, we have laid focus onto a key element of Keynes's plan, the system proposed for exchanging domestic currencies for each other. We have seen that as it stood, this system was unsatisfactory since it would have allowed the aggravation of disequilibria and imposed foreign exchange controls within the regional union. With reference to the pioneering work of Schmitt (1988) we have endeavoured to show that this issue admits a solution that confirms the feasibility of a clearing union intended to rule regional payments in a sounder way.

REFERENCES

Chang, Roberto (2000), "Regional Monetary Arrangements for Developing Countries", Intergovernmental Group of 24, *G-24 Research Paper*, November.

Fondo Latinoamericano de Reservas (2000) "Ampliación de las funciones del Fondo Latinoamericano de Reservas (FLAR) a las de un Fondo Monetario Regional." Working Paper, Bogota, April.

Government of Ecuador (2008), "Borrador de la Propuesta Ecuatoriana para la Configuración de un Sistema Único de Compensación Regional de Pagos (SUCRE) con Moneda Electrónica", draft paper, December.

Davidson, P. (2002), *Financial Markets, Money and the Real World*, Cheltenham, UK and Northampton, USA: Edward Elgar.

Gnos, C. (2006) "Reforming the international monetary system; an assessment", in LP Rochon and S. Rossi, *Monetary and Financial Systems: A Global View of Financial Crises*, Cheltenham: Elgar.

Keynes, JM (1942), "Proposals for an International Clearing Union", in D. Moggridge (1980), (ed), *The Collected Writings of John Maynard Keynes*, Vol. XXV. Cambridge: Cambridge University Press, pp. 33-40.

Keynes, JM (1943), "Speech before the House of Lords", in D. Moggridge (1980), (ed), *The Collected Writings of John Maynard Keynes*, Vol. XXV. Cambridge: Cambridge University Press, pp. 269-280.

Rossi, Sergio (2009), "A Common Currency for Middle Eastern and North African Countries? Lessons from the European Monetary Union", in D. Cobham and G. Dibeh (eds), *Monetary Policy and Central Banking in the Middle East and North Africa*, London and New York: Routledge, pp. 226-245.

Schmitt, B. (1988), *L'Ecu est les souverainetés nationales en Europe*, Paris : Dunod.