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# Regional Financial Cooperation: An Andean Perspective

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## Needs for regional institutions

The creation and the strengthen of institutions, is necessary since in PECC area doesn't exist a regional hegemony country neither a monetary or financial institution, in contrast with America, where United States possesses the leadership (and according to some, it is seen by the region like the country lender of last resort ) or with Europe, where the monetary integration prevails[1].

On the other hand having solid institutions at regional level, for example in the financial framework, it would contribute to a better supervision of the regional countries, and it could be avoided the presence or development of future crises.

## Overview

As it has been evidenced during the Asian Crises, the negative effects of contagion among the neighboring economies is great. For this reason, the creation of a Regional Fund would act through two channels. The first one would be look for to give standards inside the global framework that allow prevent future crises and avoiding other member from the contagion possibility. In this way, who are propellers of regionalism in the macroeconomic and financial spheres, emphasize that the contagion effects provide an analytic base for the increase and development  of the regional economic cooperation.

The contagion has been proven by many researches.  De Gregario and Valdés (1999) found that contagion is directly dependent on geographical horizon “neighbourhood effects”. Krueger (1998) concluded that a currency crises in a regional economy raises the probability for an speculative attack on the domestic currency by about 8.5 percentage points[2]. Given the negative effects that take place in neighboring countries by great scale “overflow effect” and the

[1] Ramkishen S Rajan. Examining the case for an Asian Monetary Fund.
[2] Ibid.

denominated “neighbourhood effect”, it is necessary the creation of new regional institutions.

Although the existence of the IMF, the creation of other institutions that look for to strengthen the financial cooperation in the regions is fundamental because, in first place, the IMF has around $200 billion available to lend. This is still less than a tenth of the total external debts of low- and middle-income countries at the end of 1997[3], which limits its action margin. In second place, for the credit loans it imposes -in certain occasions- unviable conditionalities for the countries, according to the current political and macroeconomic situation. In third place, the decisions that it takes are carry out slowly and the help brought can even be insufficient. It's necessary to mention that the decisions inside the Fund are conditioned to the votes of the countries members[4].

A particular case is the one that was given during the Asian Crises, regional affected countries received a substantial support from members of the PECC representing, in some cases, similar or bigger quantities to those contributed by the IMF. An example of it is Indonesia that received US$11.2 billion from the IMF and US $21.1 billion coming from countries like Japan, Australia, China, Hong Kong and USA.

[3] IMF Staff. Resolving and preventing financial crises: the role of the private sector.
[4] Each member country has 250 basic votes and another vote for each DEG, for this reason the most important countries are the ones that take a great number of decisions.

| Country and source of assistance | Amount (US$ billions) |
|---|---|
| ***Indonesia*** | |
| IMF | 11.2 |
| World Bank | 5.5 |
| ADB | 4.5 |
| United States | 5.0 |
| Japan | 1.0 |
| Australia | 1.0 |
| China | 1.0 |
| Hong Kong | 1.0 |
| Malaysia | 1.0 |
| Singapore | 5.0 |
| Others | 4.1 |
| Total | 42.3 |

Source: Chang and Rajan. "East Asian Cooperation in Light of the Regional Crises: A case of Self- Help or No-Help?", 1999.

After the deep international financial crises of the 80s and the contagion episodes among diverse regions, especially during the second half of 90s, the questions about the viability of the current international financial system have been intensified, especially to maintain an exchange rate stability and an appropriate monetary convertibility.

It has shown that, in past situations of widespread financial crises it don't seem to exist enough resources to avoid the contagion of such crises, under an strict structure of recycle of international resources. The most serious problem faces in small economies and in development countries, because they lack negotiation power and put relative importance so that they aren't considered high-priority[5].

Guillermo Calvo[6] demonstrated that the currency crises in emerging market are more likely brought about Globalization Hazard, the risk generated by the sudden and unprecedented surge in capital flows to these countries in the first half of the 1990s, and their decline and instability. The key factors that explain this sequence are institutional and informational (weak local financial institutions,

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[5] www.flar.net. The Role of Regional and Subregional Financial Institutions in the International Financial Architecture.
[6] Calvo Guillermo, New Financial Architecture and Macro Policy under Globalization Hazard. Presented in February 7, 2002 at the Inter-American Development Bank.

development of the EM bond market and the lack of an international lender of last resort.

The Globalization Hazard view suggests that more government participation is necessary for reforming the international financial architecture. Many of the emerging market countries are weak, for this reason they need the assistance from international financial institutions to intervene in currency crises. In this situation, Calvo proposed an Emerging Market Fund (EMF), a specialized vehicle for containing contagion and minimizing the risk of moral hazard by supporting EM bonds.

Therefore, if financial systems inevitably work in an atmosphere of asymmetric information, it should be looked for alternative mechanisms at regional level, more than internals, that avoid the transmission from the deficit in balance of payments to the real sectors of domestic economies. For that, they should have the possibility of providing new liquidity by the creation of monetary tools, in case that it is necessary.

A LARF document suggest that, given the growing importance that carry out the banking and financial crises in the modern economies, one of the most significant weaknesses in the current architecture is their inability to prevent them and to assist them with readiness. The supervision or financial regulation mechanisms have demonstrated to be inadequate, since they don't allow to separate accurately liquidity crises of those of solvency. Great part of this originates in the fact that the supervision systems and control are applied locally without uniform empiric standards and rules in all the countries. Although, the Core Principles of Basle represent an available option for an standard regulation, their empirical application differs in intensity and depth among countries[7].

A control and supervision system at local level usually respond to legal frameworks and asymmetric regulatory standards. Depending on local instances of application and usually with different levels of authority, the same

[7] Ibid.

rigorousness degree is not always exercised. It is required, therefore, that it must exist a multilateral organization with enough authority to enforcement effectively, working at national level. This organization, a kind of an international banking supervisory agency, should be a supranational entity with enough authority for imposing technical approaches and punitive power[8].

In the 1990s, the financial system directed by international financial organisms has shown to be excessively slow to identify and to respond with readiness all the related to evidence of located crises, which spread regionally with a lot of easiness, and even to economies with solid macroeconomic foundations. The problem is worse for the small economies in development, to which are granted a secondary importance, since the small probability that they can cause contagion.

## REGIONAL INSTITUTIONS

### PECC Area

Inside of the PECC area there are institutions that contribute to prevent financial crises. Among them we have The Chiang Mai Initiative, ASEAN and ASEAN+3[9].

### The Chiang Mai Initiative

The first involving self-help elements and support mechanisms, as ASEAN-swaps (contract among the same countries), and through a network of bilateral contracts and repurchase agreement facilities among ASEAN countries, China, Japan and Korea. In the case of temporary problems of Balance of Payments, this initiative takes charge of providing liquidity.

### ASEAN

The second consist in a process that has allowed to monitoring the economic and financial development of the region. Since 1999, the Finance Ministers have

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[8] Ibid.

[9] See www.aseansec.org

been exchanged points of view on the recent economic development and discuss the policies to reduce the incidence of the crises. Last year, in Praga, the Ministers focused in the progress of the consolidation of fiscal goal and the restructuring of the private external debt.

In this year, in Kuala Lumpur, the adverse impact of the slowness in the economic growth has been recognized in the region, and the necessary measures to mitigate the risks of a global recession has been discussed. While expansionary fiscal and monetary policies are necessary to strengthen the domestic demand, to the Ministers it is fundamental to maintain the fiscal sustainability and the financial stability to have a trajectory of sustained growth.

It is important that the measures to strengthen institutions are reinforced to support the activities of surveillance or supervision. Therefore, it is necessary the establishment of some local units of surveillance in some of the ASEAN members countries, and strengthen the coordination in its secretariat.

**ASEAN+3**

On the other hand, to maintain the stability of the exchange rate is a form of avoiding financial crises. ASEAN+3 contributes to this cause involving countries with considerable monetary reserves and in this way made a step toward the monetary integration.

**Latin America Institutions and The Andean Community of Nations**

We find important and constructive facts to present the regional initiatives of financial cooperation in Latin American and Andean Region, in which our country participates. Among these initiatives we can find the Agreement of Reciprocal Payments and Credits of ALADI, the Latin American Fund of Reservations and the Andean Development Corporation.

**Agreement of Payments and Reciprocal Credits**

The Latin American Integration Association (ALADI) is an intergovernmental organism that promotes the expansion of economic integration with the objective of assuring economic and social development of the region. Its technical body is the Council for Financial and Monetary Affairs, formed by the maximum authorities of the Central Banks, responsible among other functions for "governing" the Reciprocal Payments and Credit Agreement (CPCR), agreement subscribed in 1982 by 12 central banks of the region[10].

The CPCR is the only financial cooperation mechanism that covering all Latin America. It was originally conceived like a view to starting a formal multilateral cooperation among central banks of the region so as to reach financial and monetary integration through the constitution of financial bodies. It consists on the voluntary compensation, through central banks, of international payments derived from trade transactions, that are processed and cleared at four-monthly periods. In such a manner at the end of every period only the overall balance of the central bank of each country with respect to the others, is transferred or received, depending on whether there be a deficit or a surplus.

Among their purposes are:

- To facilitate the channeling of settlements and intensify economic relations among their respective countries.
- To stimulate financial relations among financial institutions of the region.
- To reduce the international currency flows among participants.

The effectiveness of this mechanism is measured through the relation among the effective transfer of foreign currencies versus the quantity channeled by the CPCR. This indicator was of 16%, what means that for each 100 dollars channeled by the CPCR it became necessary to carry out effective transfers of foreign currencies for 16 dollars. Therefore one could say that the mechanism fulfilled its function. However, in 1999 this indicator was around 51%[11].

The financial institutions LARF and CAF coexist inside the Andean area. These were designed under the solidarity principle as they grant to Bolivia and Ecuador

[10] See www.aladi.org

a special treatment, because they are countries with relative less development, contrary to multilateral financial institutions as the IDB, the IMF and the World Bank.

**Latin American Reserve Fund**

The Latin American Reserve Fund (LARF), was created in 1991, as an monetary and financial international organism whose principal objectives are to support financially programs of macroeconomic adjustment, it means, to provide funding to member countries in order to contribute to the stabilization of their balance of payments; to safeguard, in a coordinated and combined way with Central Banks, monetary and financial stability of the economies[12].

The credit modes to Central Banks are four:

- Balance of payments loans and guarantees.- To support and strengthen the balance of payment in the face of structural imbalances.
- Liquidity loans.- To counter transitory liquidity problems.
- Emergency loans.-To increase international reserves in the face of speculative pressure.
- External Public Debt Restructuring[13].

**Total LARF Disbursement to Support Balance of Payment-Liquidity Loans 1978-2000 (April)**

| Country | US$ Millions | Participation % |
|---|---|---|
| Bolivia | 895.4 | 17.5 |
| Colombia | 1,164.0 | 22.8 |
| Ecuador | 1,607.6 | 31.4 |
| Peru | 1,154.0 | 22.6 |
| Venezuela | 293.6 | 5.7 |
| CAN | 5,114.6 | 100.0 |

Source: General Secretariat of the CAN

[11] CAN. Financial Cooperation Projection in the Andean Community.
[12] See www.flar.net
[13] Only had granted to Ecuador. This credit mode is for central banks and, in general, the external public debt is take by governments through Economic Ministers, Treasury and Finances.

Because the LARF cannot emit liabilities neither to be lever up in international capitals markets, the volume of its resources is only significant compared with the international monetary reserves of the small countries (Bolivia and Ecuador).

For that reason, the LARF is not very interesting for countries like Colombia and Venezuela, which are Andean countries with more size, since the capitalization and loan scheme doesn't satisfy its requirements[14].

If LARF pursuing to play a complementary role with the IMF in the necessities coverage of member countries and in to contribute to enlarge the financial sources in the face of crises situations, it is necessary to satisfy two different types of requirements. First, the amplification of its sources of resources and the adaptation to the specialized types of financing that they provides to the countries. Second, in the measure in that the financing of the IMF is limited only to countries that fulfill conditions preset as regards healthy public finances and appropriate supervision of the financial system, the LARF's work is developing discussion forum and center of formulation of common macroeconomics goals that allow significant advances as regards harmonization of macroeconomic policy among its members. In these way, it acquires renovated validity.

**Andean Development Corporation**

**The Andean Development Corporation (CAF)** is a multilateral financial institution made up by twelve Latin American and the Caribbean countries (Brazil, Chile, Jamaica, Mexico, Panama, Paraguay, Trinidad and Tobago and the Andean Community members: Bolivia, Colombia, Ecuador, Venezuela and Peru) whose mission is to promote the sustainable development of its shareholders countries and the regional integration.

Among its core activities, they are mobilizing resources from industrialized countries into the region and serving as a channel between the region and the international capital markets; finances the development of productive infrastructure, specially those that contributes to the sustainable development

[14] CAN. Op Cit.

and facilitate the physical and border integration; promotes and consolidates the financial and capital markets in its shareholder countries, specially in the Andean region; foment trade and investment; support the entire spectrum of the business sector; and lastly, the CAF promotes the regional competitive participation in the globalization process[15].

Their help is given mainly through loans for projects and the financing of commercial operations. It generally supports infrastructure development projects and those that promote the transborder development and the physical integration among its shareholders.

The CAF is currently the leading source of multilateral financing of the Andean countries, having approved during the last ten years over 40% of the total resources approved by multilateral agencies. (See next table).

**Net Financial flows to the CAN**

| | **90-93** | **94-97** | **98-99** |
|---|---|---|---|
| Multilateral organizations | 3.5 | 2.0 | 3.0 |
| **Of them CAF** | 0.4 | 0.9 | 1.4 |
| Others[16] | 2.7 | 10.5 | 0.4 |
| TOTAL | 6.2 | 12.5 | 3.4 |
| **Participation %** | | | |
| CAF/Total | 6.5 | 7.2 | 41.2 |
| CAF/Multilateral organizations | 11.4 | 45.0 | 46.7 |

Source: CAF. Thirty years of support the Andean Integration and sustainable development. June 2000. (Document presented in the XII Andean Presidential Summit) See: Financial Cooperation Projection in the Andean Community 2000.

The CAF consolidated its position as the Andean Countries's principal source of multilateral finance. This allows to affirm that the financial cooperation that brings has evolved positively and that it is possible that it takes the initiative in the financial attendance of the countries. This fact would question the idea that the

[15] See www.caf.com
[16] Capital market, international banks, bilateral suppliers, others.

CAF’s financial help supplements the help coming from the World Bank and the Inter American Development Bank (IDB).

This also happened during the "Lost decade" of the eighties. Although, these years were characterized by the rationing of the international credit and by high interest rates, in the context of external debt, the CAF was the only source of financing in extremely adverse international context.

On the other hand, the CAF plays an important role as a link between CAN and other similar initiatives in Latin America and the Caribbean, particularly Mercosur, The Group of Three and Caricom, and promote the interconnection between its shareholders countries and other of the world strengthening the economic, financial, commercial and investment relationships, specially with USA, Canada, European Union and Japan.

The CAN’s Border Integration and Development Projects Bank start operating with the encourage of the CAF. This bank would generate information to prioritize CAN's projects in function of border development, assign resources efficiently, promote the coordination among entities of a country and among countries. At the same time, it allows an integral vision of the regional border projects[17], that on the whole will contribute to the consolidation of its integration.

The CAF works like an orthodox bank, what has meant for it excellent qualifications and credibility. For this reason, the interest rates are not the lowest in the market, but the implementation of its credit loans don’t require some conditionality. This is particularly valuable in crisis context where the vulnerability of the countries is bigger. Its performance is undoubtedly positive. It has allowed the necessary incorporation of new extra-regional shareholders whose competition has strengthened the institution.

The Andean Community has also initiatives that would contribute to prevent crises and financial contagions.

[17] See www.comunidadandina.org

Since 1998 works the Advisory Council of Treasury or Finance Ministers, Central Banks, and Economic Planning Agencies with the backing of the CAN. This council recognizes that a destabilization in one country could affect neighboring economies. Their objectives are to assure the stability of members economies and, inside its work program it stands out the approval of community goals related to the inflation, fiscal deficit and public debt. In this way, it guaranteed, in member countries the development of economic programs that achieve internal stability and propitiate the approach of the economic cycles.

Inside their more important sectorial actions, it has supported the program of basic prudential standards for banking sector, advocated by the CAF.

The core of their relevance rests on the recognition that the solvency and the stability of the financial systems are key factors for the economic development in general.

## PROMOTE THE COOPERATION AS A CHALLENGE

Although, such cooperation initiatives have achieved some of their objectives, they could be more effective if they undergo certain reforms.

Inside PECC Area, we perceive the necessity of the reinforcement of those institutions because don't exist patterns that the countries are force to pursuing. The institutions don't create rules neither obligations among the parts and the actions took are unilateral and voluntary. The commitments are not legal and for that reason their effectiveness depends on member countries policies. The institutional mechanism can be reinforced through the strengthen of a Secretary to achieve a better monitoring of the initiatives of member countries, or the strengthen of associations with foreign groups. While in Latin America and specially in the Andean region, lacks of different nature are perceived[18].

As for CPCR from ALADI, if what is looked for is to have a development perspective in the future, an integral change of the agreement is needed, beginning with a clear political definition on the participation of the central banks. As antecedent to this proposal, at the end of 1998, ministers of finances and Andean Community central banks directors asked to study the increment of the bilateral credit lines that maintained with central banks.

The LARF, apparently, would need of an increment of capitals of new members or the leverage in the capital markets to make in front of the requirements of relatively big countries.

A possible solution would be the subscription of Agreements of Loans to the LARF, on the part of the central banks, through which makes sure to the institution the readiness of resources to confront the demand of some country member. This doesn't mean that the entrance of new members is limited. An advance would consist in the fact that the LARF is able to cover other countries besides the Andean ones, as was its objective when being created. But this is possible being achieved if it becomes in a financial institution able to satisfy the demands of the small and also biggest countries in Latin America.

**Dollarization**

Calvo[19] suggest that the leading explanation of contagion effect is imperfect information. One of the reasons behind imperfect information is the size of a country, which is negatively correlated with volatility, making macroeconomic analysis more effective in large countries.

Dollarization may effectively increase the size of a country because its monetary policy would just be that of the US, a large country. Small countries that run an

[18] Villacorta, Wilfrido. CoalitionBuilding and APEC. Beyond Economic Cooperation: Institution-Building in APEC.

[19] Calvo, Guillermo. On dollarization.

independent macroeconomic policy may be excessively costly to monitor by financial analysts.

In his opinion, the critics raised against dollarization are wrong because devaluations in Latin America have been contractionary, no matter if a country conducted its own monetary policy or how much the currency was devalued and the lender of last resort role is not linked to the ability to print base money (there are alternatives ways of providing bank liquidity). The author suggest that the debt deflaction specter is the most serious threat to a dollarized economy specially relevant for emerging market countries that are open to international trade and whose terms of trade vary widely (Venezuela, Chile) and independently of the US price level.

Considering the country initial conditions before a policy decision of dollarization it is the liability dollarization. Calvo observed that the emerging market countries have depended and will likely depend on foreign savings (loans denominated in foreign exchange, thus creating incentives for dollar borrowing in terms of interest rates; exchange rates are difficult to predict (structural and policy incentives considerations). About international lending said that domestic firms are likely to have better information than uninformed international lenders. For this reason they will be wary when domestic firms increase their supply of national currency denominated bonds.

However, to deepen the Andean financial cooperation, it is necessary to examine covering areas to be able to achieve future demands. The schemes of official dollarization (Ecuador) and the real dollarization of the economy (Bolivia and Peru), where the respond and the government policies were limited in an external shock context due to the impossibility of using exchange rate policy and monetary policy. These facts reveal the necessity of developing tools to attenuate the derived risks of such situations. One of the options would be to evaluate contingency lines for previously qualified private banks and reinsurance tools for financial deposits.

It should not be neglected the relationships with the International Monetary Fund. The best scenario would be that the regional financial institutions are recognized by the IMF to channel some credit facilities and they are considered able to assume certain functions up to now reserved to the IMF.

As mentioned before, we considerate as a priority to consolidate and strength the financial mechanisms in each region and between regions. For the Peruvian case we must consider the risks and the possibilities that means the formal or real dollarization. The regional organisms must act jointly with the multilateral organisms and with which has the integration processes such us Andean Community and Central American countries.

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