Old Questions, New Responses or Former Dilemmas ?

Workshop CEPAL

Santiago - 12-13 June, 2014

Monetary and Financial Cooperation and Integration

Wagner Guerra Jr. Head of Deputy Governor´s Office for International Affairs and Senior Advisor to the Board

BANCO CENTRAL DO BRASIL

Integration and Cooperation – Dimensions and Instruments – is there a sequencing?

- Trade integration and reduction in structural and economic asymmetries
- Regional and National Development banks and convergence funds
- Macroeconomic dialogue, policy coordination and harmonization
- Financial System Integration and developing a regional financial market
- Local currency mechanisms of trade and payments
- Regional financial Safety Nets: RFA
- Monetary Integration

BANCO CENTRAL DO BRASIL

Regional financial arrangements

- **G20 meeting in Los Cabos (June 2012) recognized "the importance of effective global and regional safety nets"**

- **Regional arrangements are heterogeneous:**
  - **Type:** Ranging from government finance (EurAsian Economic Community – EurAsEC; European Financial Stability Facility EFSF/ESM) and FX reserve pooling (Latin American Reserve Fund - FLAR) to currency swaps (Chiang Mai Initiative Multilateralization - CMIM)
  - **Size:** FLAR \$2.3 billion; CMIM \$240 billion
  - **Membership**
  - **Governance, surveillance and conditionalities**

RFAs' characteristics

	CMIM	ESM	FLAR	AMF	EurAsEC ACF
Date of launch	CMI (May, 2000) CMIM (March, 2010)	October, 2012	March, 1991	April, 1976	June, 2009
Objective	US$ liquidity in response to short term liquidity and BoP difficulties	To secure financial stability of the Euro Area	Financial support to resolve BoP crises and contribute to the harmonization of monetary, financial and exchange rate policies	Assist member countries in financing BoP deficits and implementing structural reforms	Assist member countries in overcoming global crises, ensure financial stability, and foster economic integration
Membership	ASEAN +3 13 countries	Europe 17 members	Latin America 7 countries	Arab 22 countries	Eurasia 5 countries
Resources	$240 billion	€700 billion	$2.3 billion	$2.7 billion	$8.5 billion
Surveillance	AMRO	EU Commission and ECB	FLAR	AMF	EDB, Council of Experts, ACF Council
Relationship with the IMF	IMF- linked portion 30%	Independent but cooperate closely on co-financing for program countries	Informal information sharing and consultation	No specific cooperation except that the IMF reserve tranche should be exhausted before request of ordinary or extended loan	Co-financing and information sharing (if needed)

What a RFA can do

- **Liquidity support**
  - Provide fast support and short-term liquidity
  - Complement national FX reserves: could potentially increase the total insurance at a lower cost (cost of maintaining and managing FX reserves *versus* gains of avoiding a deeper crisis)
  - Complement multilateral resources
  - Decrease contagion between economies
- **Incentive for regional cooperation:**
  - Promote greater macroeconomic coordination and exchange of information
  - Peer pressure

What a RFA can not do

- **Substitute for sound macroeconomic framework and policies**
  - First and foremost line of defense against external shocks)
  - Market has demonstrated the ability to differentiate the macroeconomic fundamentals of the emerging economies, reducing the risk of contagion

- **The capacity of a RFA to reduce and share risk depends on the types of shock prevailing**
  - The capacity of a RFA to assist a country in times of need to depends on the degree and form of integration between the economies
  - In the event of synchronous shocks, the capacity for mutual protection would be seriously compromised

What a RFA can not do

- **Substitute multilateral financial assistance as the IMF:**
  - Limited resources could not be enough to help or to restore market confidence
  - Linkages among economies are amplified during stress/real-financial feedbacks (risk of idiosyncratic shocks turn global)
  - Difficult to swiftly differentiate between local and regional shock
  - Lack of conditionality difficult RFAs to demand adjustment

Safety nets and IFA

- **Would it be helpful to establish an international hierarchy among global, regional, bilateral arrangements and national policies?**
  - Build complementarities and synergies between regional and global arrangements
  - Partnership on surveillance and early warning
  - Short-term and long-term lending facilities
- **Regional cooperation goes beyond the financial field**
  - The LAC region participates increasingly in regional and global forums: Mercosur, CEMLA, UNASUR, BIS, IMF, G-20, FSB
  - Cooperation is an essential instrument for disseminating knowledge and sharing experiences among member countries' institutions and central banks

National polices as first line of defense

- **Countries' liquidity needs depend on macroeconomic regime adopted and nature of capital flows: determine capacity to absorb flows and necessity of FX reserves**
- **Keep frameworks that work well in a more integrated world:** e.g., fiscal responsibility, floating exchange rate with minimal interventions, inflation targeting
  - FX reserves accumulation
  - Strength prudential regulation and financial infrastructure
  - Capital flows less focused on external debt and limits to FX debt exposure
  - Improved financial supervision
- Although RFAs can have an important role during times of crisis, they **are insufficient to cover emerging economies' financial requirements (big regional economies should perform as anchor economy).**

Source: IMF , Datastream.

BANCO CENTRAL DO BRASIL

Better safe than sorry

- **Strength regional integration as well as regional and global safety nets are important but are not substitute to national policies**
  - In an adverse global environment, external requirements exceed RFA's possibilities.
  - Coverage by multilateral agencies is potentially larger, but faces limitations.
- **Possible initiatives to enhance safety**
  - Importance of bank supervision sustainable macro policies
  - Tools that prevent crises (ring fence)
  - Global liquidity instruments complementing RFA
  - Global surveillance
  - Enhance IFA by IMF reform

Are the new Responses to Old Questions?

- **Integration:** is there a (mandatory) sequencing? How reasonable is a mutually reinforcing path with trade integration and macro convergence ?
- **Regional financial and monetary cooperation:** what RFA can and cannot do – national policies are first line of defense – Would it be possible to pose financial integration first ?
- **Recent South America context:** mosaic of multiple and divergent approaches to integration – multiple polarity versus regional dimension - macro policies` divergence undermines effective cooperation?
- **Horizons:** how to surpass the absence of a regional monetary anchor (China´s and Germany´s absences)

Former Questions and New Dilemmas

- **Brazil:** External Performance and Trade: Multiple Polarity versus Regional Focus – Long term stabilization in a global financial integration comes first ?
- **Timing for RFA:** how to scape the cyclical enthusiasm and provide governance and instruments in good times to use later
- **Sequencing? Economic and Policy Convergence or trade first?:** macro policies` convergence in a fragmented geometry for cooperation and integration – no absence of forums but are there genuine economic conditions? political will and envisage opportunity may not be enough
- **Horizons:** surpass the absence of a regional monetary anchor and scape the absence of a China´s pattern ? Trade surplus global versus regional anchor

Macroeconomic Coordination in South America

- Macroeconomic coordination
    - ✓Incentives
    - ✓Costs and difficulties
- Development model (foreign sector role) and Volatility of real exchange rates
- Monetary Union ?
- How to join political will and economic convergence?
- What are the lessons from Europe ? Institutions first or Earlier convergence?

Incentives for Coordination

- Interdependence (trade and financial)
- Political support for a deeper integration
- Discipline under domestic pressure
- Improvement of credibility (buy reputation) and peer pressure
- Elimination of distortions and reduction of fiscal costs
- Reduction of volatility in the block
- Opening room for more financial integration

Coordination: costs and difficulties

- Autonomy (partial loss) versus long-run benefits
- Cyclical Synchronism
- Differences in the underlying policy and development or foreign sector model (Argentina and Brazil during the nineties)
- Doubts about the cooperative behavior of partners (prisoner’s dilemma)

ANNEX

Mechanisms against external disequilibria

Type	Examples	Risk
Global	• IMF and WB lending capacity (quotas, NAB, bilateral IMF loans) • IMF Facilities (flexible credit lines & precautionary and liquidity line)	Global Non-diversifiable
Regional	• Regional financial arrangements (e.g. FLAR; Chiang Mai Initiative; Europe's Medium-Term Financial Assistance Mechanism; Arab Monetary Fund) • Regional development bank's (e.g. IDB and ADB)	Idiosyncratic Partially diversified
Bilateral	• Bilateral swap lines (e.g. Fed's with Korea, Mexico, and Singapore) • People's Bank of China's swap agreement with other central banks	Idiosyncratic Totally diversified
Unilateral	• Reserve accumulation • Macroprudential measures • Responsible fiscal policy • Sustainable FX debt-to-GDP ratio	Global Non-diversifiable

Multilateral mechanisms *versus* RFA

- **Multilateral mechanisms:**
  - Resources from multilateral funds are potentially larger
  - Larger memberships reduce the risk of simultaneous demands on multilateral resources
  - Multilateral funds keep large technical staffs
  - Limits: reluctance to request IMF assistance (stigmatization concerns), slow response, excessive conditionality
- **RFA:**
  - Usually approve financial assistance more expeditiously
  - Tend to impose softer conditions
  - Have greater follow-up capacity
  - Face less domestic resistance

Source: Ocampo and Titelman (2012).