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The Latin-American monetary system after the end of inflation

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Este artigo discute três tópicos interdependentes. O primeiro é o de que as reformas econômicas implementadas na América Latina a partir de meados dos anos 80 não foram suficientes para assegurar a estabilidade cambial na região. O segundo é o de que existem condições propícias para iniciar o processo de convergência macroeconômica entre os países latino-americanos. O terceiro tópico refere-se ao papel estratégico a ser desempenhado por Argentina, Brasil, Canadá e México como redutores do grau de assimetria gerado pela presença da economia americana.

1. INTRODUCTION

In a perfect international monetary system, all member countries would be entitled to non-inflationary economic growth with full employment and steady foreign exchange rates. National governments would carry sound fiscal policies, ensuring a long run balance between the State taxation power and the demand upon public resources. The random action of technical progress would eventually generate productivity shocks that might affect the equilibrium exchange rates, but the monetary system would be equipped with mechanisms for segregating ordinary shocks from primary shocks. Under free trade and capital mobility, ordinary shocks would be easily absorbed by the global economy through minor adjustments in macroeconomic policies, without exchange rate alterations; whereas primary shocks would require coordinated efforts among major countries in order to lead the system towards the new equilibrium exchange rates.

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The system sketched is far from being conventional wisdom among scholars. As Francesco Giavazzi and Alberto Giovannini observed, there are three views "on the future of the international monetary system. Two of them advocate reforms which would limit the degree of exchange rate flexibility; a third concentrates on fundamentals, and rules out the active management of exchange rates" (1989, p.191). The first proposal is Ronald McKinnon's (1988) system of fixed nominal exchange rates between the dollar, the yen and the Deutsche Mark. The system would be sustained by a rigid harmonization of monetary policies between the United States, Japan and Germany, and trade balances would be managed only through fiscal policies. A more flexible approach was suggested by John Williamson (1985): exchange rates would be allowed to float within an agreed target zone, and fiscal policies could be used for broader objectives, such as supporting domestic growth strategies. The third view is shared, though under assorted connotations, by many authors. Morris Goldstein and associates, for instance, argued that "fixed exchange rates are not a panacea. Without a credible commitment to more disciplined and more effective policies, a shift from floating rates to a fixed rate regime might simply shift instability from the exchange rate to other macroeconomic variables (including interest rates), and the resulting instability of these other variables could undermine the credibility of the fixed exchange rate regime" (1992, p. 22). In a similar vein, Rudiger Dornbusch commented that "in discussions of the exchange rate regime there has been too little emphasis on differences in economic philosophy. Europe and Japan are significantly more monetarist than the United States; when the chips are down, they prefer recession or depression to inflation. If our preferences do not run that way the union is flawed from the outset" (1988, p.111).

In fact, this debate is about one basic question: in a global economy, how much freedom should be bestowed on national governments in order to secure full employment, growth and price stability? It is increasingly evident, as Manuel Guitián has noted, that the answer lies beyond the realm of pure economics. "All possible frameworks encompassing a national and an international dimension must include, to a greater or a lesser extent, some rules and some discretion. Without discretion, any system of rules is likely to become unsustainably rigid; without a minimum set of rules, discretion is likely to create a system so disorderly that it cannot endure" (1992, p.1).

This paper examines the outlook for monetary stability in Latin America under the framework derived from the above debate, which implies two parameters for the region. The first is that steady domestic prices do not curb exchange rate volatility if the country's macroeconomic policies are not convergent with those adopted by its main trading partners. The second is that Latin-American and Caribbean countries are natural members of the US dollar area. Thus, taking for granted that the region's current efforts on trade liberalization and macroeconomic adjustment will proceed, section 2 briefly reviews the links between inflation and real exchange rates, in order to point out the preliminary steps toward a new regional exchange rate regime. Section 3 concentrates on the domestic and regional obstacles to be faced and discusses the crucial role played by central banks in the provision of a clear-cut set of fiscal and monetary policy instruments. Concluding remarks are presented in section 4.

2. TOWARD A NEW EXCHANGE RATE REGIME IN LATIN AMERICA

Among OECD economies, the concern with exchange rate instability always has been a matter of public interest, even when domestic prices are steady. The origin of this concern is the dual role played by exchange rates. "On the one hand", as Sebastian Edwards pointed out, "exchange rates, jointly with other policies, play an important role in helping maintain international competitiveness. On the other hand, exchange rates — also jointly with other policies — help promote macroeconomic stability and low inflation" (1993, p. 3). In Latin America, however, despite a decade of severe macroeconomic imbalances, the debate on exchange rates is mainly focused on overvaluation; instability is viewed just as a byproduct of the inflationary process. Thus, scant attention was given to the damages imposed by exchange rate volatility on Latin-American economies in the 1980s.

During those years, a chain of events accelerated the globalization trends in OECD economies. A remarkable decline of information costs, together with the efforts made by the G-5 governments after 1985 towards exchange rate stability, allowed a deep reduction in transaction costs.[1] This in turn provoked an industrial restructuring process in those countries, marked by the internationalization of small and medium firms, and by the partition of old multinational corporations into semi-independent business networks. Finally, these changes were matched by an intense growth of world trade, particularly intra-industry trade sustained by long-term contracts between independent firms. This chain of events had no significant impact on Latin-American economies.

It is important to stress that without steady exchange rates the decline of information costs would not have been converted into lower transaction costs and, consequently, international operations based on long-term contracts would have remained a risky business. The European Single Market is a convincing illustration of such linkages: the creation of the European Monetary System (EMS), in 1979, paved the way for a series of path-breaking agreements in the trade, industrial and agricultural areas during the 1980s.[2] The achievements in terms of economic integration were not restricted to the European Community members, but affected the whole region. In 1990, Western Europe's intra-regional exports corresponded to 72.2% of total merchandise exports of the region, whereas, in Latin America, that share was only 13.4%. In order to identify the requirements for exchange rate stability in Latin America, it is useful to review briefly the region's monetary performance in the 1970s. That period provided sufficient evidence on the subtle relationship between exchange rates and inflation. Table 1 and the graphs on the next page describe that relationship in six countries (Argentina, Brazil, Chile, Colombia, Mexico and Venezuela).[3]

[1] For a discussion on this interplay between globalization and domestic policies, see Tavares de Araújo (1993).
[2] See Giavazzi and Giovannini (1989).
[3] The quarterly real exchange rate indexes presented in the graphs are measured as follows: nominal exchange rate (nominal currency per dollar) multiplied by the US wholesale price index and divided by the consumer price index of the domestic country.

TABLE 1

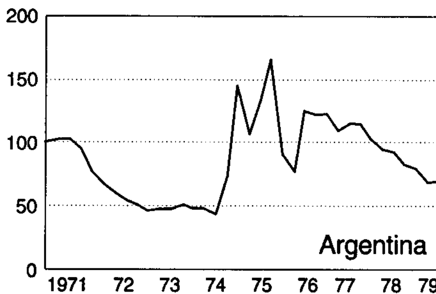
Annual inflation rates in Latin America, 1970 — 1979 (%)

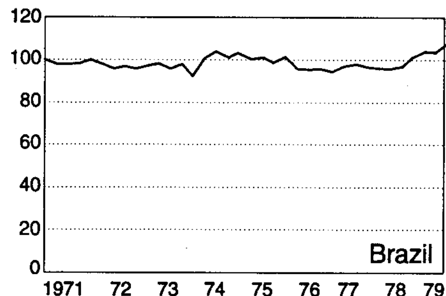
	Argentina	Brazil	Chile	Colombia	Mexico	Venezuela
1970	13.5	22.3	33.3	9.1	5.0	3.4
1971	34.8	20.2	19.4	13.3	4.8	2.8
1972	58.4	16.5	79.1	20.9	13.6	4.3
1973	61.3	12.7	351.9	24.3	24.0	8.2
1974	23.5	27.6	506.0	22.9	16.1	10.4
1975	182.3	28.9	374.2	20.2	13.9	7.4
1976	443.2	41.9	211.8	33.1	29.3	7.7
1977	176.1	43.7	91.9	17.8	18.9	7.2
1978	175.5	38.7	40.1	24.7	17.5	12.5
1979	159.5	77.2	35.7	26.5	25.7	21.4

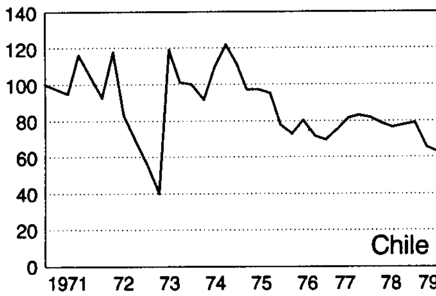
Source: International Financial Statistics, IMF.

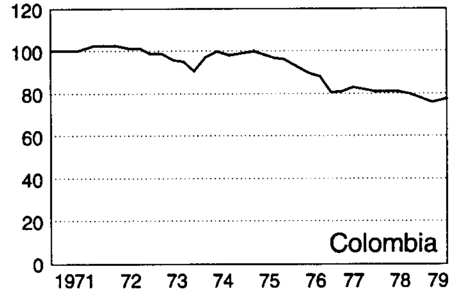
From the outset, a well known fact should be remembered. For several decades, Latin-American foreign exchange markets have been submitted to pervasive governmental controls. According to the IMF's annual reports on the subject, these restrictions may include: special regimes for capital transactions and services, multiple exchange rates, bilateral payments arrangements, import surcharges, advance import deposits, surrender of export proceeds etc. Within this array of *ad hoc* interventions, there is, at least, one enduring feature: the clearing system of the Latin-American Integration Association (LAIA), known by its Spanish acronym CCR (Convenio de Creditos Reciprocos). Created in 1965, it consists of a set of reciprocal credit agreements among central banks. Every four months, the member countries settle imbalances in their trade accounts on a bilateral basis through the Federal Reserve Bank of New York. After a quarter century in operation, the CCR is perhaps the most successful experiment ever accomplished within LAIA's framework. As argued below, this clearing system could be the starting point for a more sophisticated set of regional arrangements that would sustain the Latin-American exchange rate regime after the end of inflation.

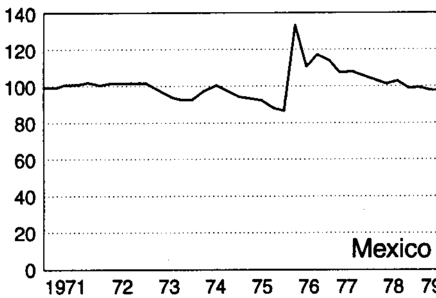
Real exchange rates

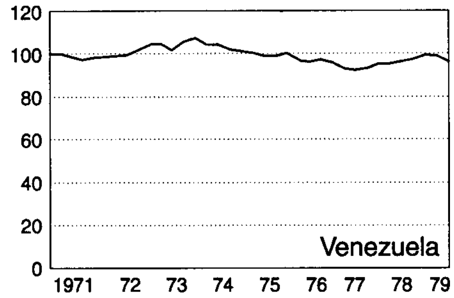












Under that collection of regulations, many types of correlation were established between exchange rate and inflation during the 1970s. For instance, Brazil, Colombia, Mexico and Venezuela, despite their different inflation levels, were able to keep fairly stable real exchange rates for several years. The contrast between Brazil and Venezuela is interesting. In Venezuela, there was practically no exchange restriction, the few exceptions were import and export licenses for certain agricultural products, and some controls over foreign investment, technology transfer and financial flows. The nominal exchange rate was fixed at 4.20 bolívares per US dollar and stability of the real rate resulted from the fact that domestic inflation remained similar to the American levels until 1978. Brazil was at the opposite extremity: with virtually all types of restrictions in place, rising two digit inflation, and foreign exchange stability obtained through crawling peg devaluations.

The combination of crawling peg with moderate inflation did not always lead to amenable results, but to pronounced overvaluation, as in the cases of Argentina, in 1971-1974, and Colombia, in 1975-1979. These examples reveal how fragile the crawling peg can be as a monetary arrangement. Likewise, abrupt exchange rate movements resulted not only from sharp increases in inflation levels, but also from changes in the rules of the game, as the devaluation of the Mexican peso in 1976, the Chilean reform of the exchange regime in 1973 and the successive Argentine reforms in 1975-1977 indicate.

In sum, the Latin-American monetary performance in the 1970s had two features that could be instrumental in the quest for a new exchange rate regime. The first is the possibility of a transitory compromise between moderate inflation and some exchange

rate stability. This means that the coordination of macroeconomic policies in the region could be started before the ending of inflation, thus reinforcing both processes. "In the extreme view", as Marcus Miller and associates noted, "stating that national economic policies should be coordinated and that exchange rates should be stabilized are two ways of making the same point (1989, p. 1)". The second feature is the familiarity created among the central banks by the experience of managing the CCR. This will be valuable for overcoming the inevitable turbulence during the initial phase of the new regime, as discussed in the next section.

3. POLICY HARMONIZATION AND THE ROLE OF CENTRAL BANKS

There are three main obstacles for the foundation of a monetary system that would ensure, simultaneously, long run macroeconomic stability and international competitiveness for Latin-American economies. The first is the use of exchange rates as nominal anchors when implementing stabilization programs. Without discussing the possible merits and limitations of this strategy[4], it should be recalled that a fixed nominal rate implies, obviously, a volatile and overvalued real exchange rate during the whole stabilization period. This precludes, at least momentarily, a consistent search for international competitiveness. A way to circumvent this contradiction is by entering into a credible supra-national exchange rate arrangement that would gradually replace the domestic nominal anchor.[5] As Miller and associates observed, "an agreement to cooperate will not be credible in the absence of an enforcement mechanism. Negotiating exchange-rate rules or a formal exchange-rate arrangement can be understood as an investment in credibility. Nations invest political and economic capital when they join an exchange-rate arrangement like the European Monetary System. If they fail to coordinate their policies so as to maintain their membership, that investment is lost, generally at the expense of the politicians responsible. Hence establishing an exchange-rate arrangement can be understood as a precommitment to policy coordination" (1989, p. 2).

The second obstacle is that a monetary area where the United States is the "center country" can be highly asymmetric, given the disproportionate size of the American economy and the unwillingness of the US government to coordinate its macroeconomic policy with that of Latin-American governments. This means that the "periphery countries" should surrender completely their monetary sovereignty and support alone, whenever required, the burden of international adjustment. However, these conditions could be relaxed by two parallel strategies led by four countries: Argentina, Brazil, Canada and Mexico. On the one hand, a basket composed of their currencies, floating in relation to the dollar, would provide the nominal anchor for a stable but adjustable system of exchange rates among Latin-American countries. On the other hand,

[4] On this, see Edwards, 1993.

[5] For a discussion on reasons why countries cannot afford to start an exchange rate union with overvalued real exchange rates and large initial inflation differentials, see Cardoso and Klein (1993).

profiting from their roles in Nafta and Mercosur, those countries could generate a complementary channel for consultations between the US government and the region, which gradually would allow the long-run convergence of macroeconomic policies.

The third obstacle is the fiscal challenge faced by every contemporary government, namely, how to reconcile the imbalance between the demand upon public resources and the State taxation power. As bluntly put by Sven Steinmo, there is a "conflict between the demand for revenue, the desire not to impede economic growth within a capitalist system, and broad public resistance to taxes in general..." (1993, p. 19). The capacity to meet this challenge is, nowadays, a fundamental attribution that differentiates advanced from developing countries. "In the late twentieth century, every OECD democracy relies on a small number of taxes with which to generate the vast bulk of government revenues. Just five taxes (personal income, corporate profits, general consumption, property and social security charges) today contribute an average of 79.5 % of total government revenues in OECD nations. Most of these taxes did not exist a hundred years ago. Modern democracies not only rely on broadly similar types of taxes, but have also tended to change, adapt, and reform their tax systems at almost exactly the same times and in roughly similar ways throughout the twentieth century" (Steinmo, p. 14).

Like the exchange rate, the tax system also plays a dual role in the promotion of international competitiveness and macroeconomic stability. The latter role is well known and non-controversial: an adequate flow of fiscal revenues is the backbone of sound public finances and low inflation. The former role is perhaps less evident. The tax system not only supports the basic sources of long run competitiveness, through public investment in education, science and technology, health and infrastructure, but also provides competition rules, through the distribution of charges among domestic and imported goods. Accordingly, OECD governments have abolished all kinds of taxes that were biased against local activities, such as cascade taxes on sales, on money orders, and other oddities that are still popular in many developing countries.

Thus, expanding the tax base, reducing the tax rates and improving the mechanisms of tax collection were utmost priorities of the tax reforms implemented by OECD governments in the 1980s. These changes were framed by a passionate debate on the role of the State in modern democracies, that generated some consensus on the desired profiles of public investment, allowing, *inter alia*, innovative health care programs and new arrangements for R&D activities; but also reopened the time honored quarrels on transparency, accountability and efficiency of public expenditures. Indeed, that debate is yet to be settled and, everywhere, still produces the watershed between Left and Right.

In Latin America, the failure to meet the fiscal challenge has been, for many decades, a common trait of the region's economies, given the contrast between the aspirations for economic development, which amplified the demand upon public resources, and the restricted size of the tax base. Not by chance, import substituting industrialization strategies had a long-lived popularity in the region, since they generated innumerable stratagems for circumventing the fiscal challenge. To begin with, a major part of the rents received by the protected industries came from quantitative controls that redistributed resources inside the economy without affecting

the fiscal budget; and the continual creation of hidden, but short-lived, taxes were complemented by other procedures that disguised the real dimension of the public expenditures. Among the most usual: conceding apparent fiscal incentives that were canceled by other government programs, launching projects that were latter informally discontinued, overestimating revenues, miscalculating costs etc. Through these incongruent actions, governments artificially enlarged their accomplishments, managed the postponement or the downsizing of certain programs and implemented their favorite targets within the limits of available resources. The final outcome of this process was overregulation, large bureaucracies and, very often, fragile governments dominated by special interests.

Several years after abandoning import substitution policies, and despite severe fiscal adjustment programs that included privatization, public sector restructuring and trade reforms, most Latin-American and Caribbean countries are still far from the contemporary standards of public finance management. However, there are some promising trends in motion. Table 2 presents the 1993 profile of the region's central banks, which reveals a recent, but radical, improvement in monetary policy instruments, initiated in 1990 by the newly elected Chilean government of president Patricio Aylwin, followed by Cavallo's 1991 Plan in Argentina, and the central bank reforms in Colombia, Mexico, Peru and Venezuela in subsequent years. In the late 1980s, only Belize and Guyana had central banks exclusively devoted to monetary policy, while today, among the region's seven largest economies, Brazil is the single exception.

The heading "fiscal activities" in Table 2 includes a series of central bank assignments that go far beyond collecting seigniorage, such as implementing selective credit policies, supporting insolvent financial institutions, manipulating multiple exchange rates, setting interest rate ceilings, operating export promotion programs etc. According to Maxwell Fry, "central banks in some countries produce revenues equal to the government's explicit tax revenue" (1993, p. 1). But these revenues do not appear in tax codes, nor do they appear in the government's budget. Moreover, "tax rates are not specified and, in some cases, can be estimated only after the revenue has been collected" (p. 2). In short, central bank "fiscal activities" are just another way of keeping public finances apart from citizens'control.

There is no straightforward relationship between these distortions and macroeconomic performance. In the 1980s, Bolivia, Costa Rica, El Salvador, Guatemala, Haiti, Honduras, Jamaica, and Trinidad and Tobago had low or moderate inflation while assigning fiscal activities to their central banks. Yet, the stubbornness of most Latin-American inflationary processes resulted from this seasoned habit of concealing the real magnitude of the economy's fiscal imbalances. In Brazil, for instance, an apparent fiscal deficit of just 1,7% of GDP generates over 1000% of annual inflation, as Edmar Bacha (1993) well explained. It also should be noted that central banks will not necessarily be independent from the central government after the abolishment of their fiscal activities.[6] The issue of independence is part of the already mentioned debate on rules and discretion, wherein the transparency of government procedures is taken for granted.

[6] On this, see Swinburne and Castello-Branco (1991) and Goodman (1992).

TABLE 2

The 1993 profile of Latin-American and Caribbean central banks

Country	Established since	Fiscal activities	Other activities
Argentina	1935	—	—
Bahamas	1973	Y	—
Barbados	1972	Y	Y
Belize	1982	—	—
Bolivia	1928	Y	Y
Brazil	1965	Y	Y
Chile	1926	—	—
Colombia	1923	—	Y
Costa Rica	1950	Y	Y
Dominican Republic	1947	Y	Y
Ecuador	1927	Y	Y
El Salvador	1934	Y	Y
Guatemala	1946	Y	Y
Guyana	1965	—	—
Haiti	1911	Y	Y
Honduras	1950	Y	Y
Jamaica	1960	Y	—
Mexico	1925	—	—
Nicaragua	1961	Y	Y
Panama	—	—	—
Paraguay	1952	Y	Y
Peru	1922	—	—
Suriname	1957	Y	—
Trinidad & Tobago	1964	Y	—
Uruguay	1967	Y	Y
Venezuela	1939	—	Y

Source: Inter-American Development Bank.

To dismiss superficialities like imputing this problem to ignorance of economics or lack of political will, it should be remembered that central banks are highly respected institutions in Latin America. In many countries, such as Argentina, Bolivia, Colombia, Ecuador, Mexico, Haiti and Peru, they have been established since the beginning of this century. More than a curiosity, the fact that Raul Prebish was the first president of the Argentine Central Bank is among the events that created the image of these institutions, which are, in general, equipped with trained professional staff and responsible management. Thus, the column "other activities" in Table 2 is both an anomaly and an indirect sign of central banks' respectability. It refers to tasks like the management of museums, the production of socioeconomic indicators, input-output tables, price indexes, households surveys etc., that distract the bank from its main duties, in order to compensate for deficiencies in other areas of the public sector.

4. CONCLUSION

In the 1980s, the European Monetary System, the Single Market Project and the Maastricht Treaty represented major innovations in the search for institutional arrangements that would allow the survival of national governments within the context of a global economy. In the 1990s, the US government is gradually taking the lead in that search, by signing the North American Free Trade Agreement, concluding the Uruguay Round, initiating the Asia Pacific Economic Cooperation forum, and keeping alive the idea of a Western Hemisphere Free Trade Area. These events superseded a controversy that had been fashionable until recently in Latin America: whether trade liberalization should be multilateral, regional or sub-regional. Indeed, all three routes are mandatory.

The monetary system that will sustain such diversified trade policies will require Latin-American central banks to be exclusively focused on the management of monetary policy instruments, not just because the region's macroeconomic policies should be convergent, but also for an operational reason. Ultimately, exchange rate stability is an outcome of coordinated procedures among central banks that have similar controlling power over their respective economies, since those arrangements are not feasible otherwise.

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