Comment on "Financial Flows for Regional Integration," by Stephany Griffith-Jones

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Stephany Griffith-Jones' paper goes well beyond financial issues in posing a set of interesting policy questions regarding the prospects for greater economic integration in the Latin America and Caribbean (LAC) region. It may be thought of as consisting of three parts: (i) an objective description of the institutional base supporting regional integration in the LAC region; (ii) a review of foreign investment flows with emphasis on intra-regional foreign direct investment; and (iii) a list of questions regarding the design of a policy agenda aimed at deepening regional integration.

Since I am a believer in comparative advantage, I will leave much of the LAC-specific points to those who have a deeper knowledge of them. Instead, I will address several of the more general questions raised by the paper by considering some basic issues regarding the prospects for greater regional integration, including drawing on the experience of other regions. Needless to say, I will also pose some of my own questions.

My comments will in no way dispute the paper's conclusion – viz., "that the policy agenda for the financial aspects of regional integration is a rich and complex one, with very central issues for the success of the integration process." Indeed, this is a very difficult statement to counter. Rather, I will explore further some of the pillars of this policy agenda, placing particular emphasis on three aspects:

- First, the economic policy environment, including policy convergence and harmonisation issues;
- Second, the interaction between the role of public financial institutions and that of the private sector; and,
- Third, the relation between regionalism, multilateralism and bilateralism.

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1 The views expressed are those of the author and do not necessarily reflect those of the International Monetary Fund.

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The Economic Environment

Most studies of regional integration efforts – covering the relatively few successes and the more numerous failures – emphasise the role of economic policy convergence and harmonisation of regulatory and supervisory regimes. At a very basic level, progress in these two areas can be thought of as reducing the transaction costs and uncertainty which serve to inhibit regional activities. They are of increasing relevance the further one seeks to progress along the road of economic integration.

On the economic policy front, particular importance has been placed on relative financial stability between regional partners and the liberalisation of regimes governing trade in goods and services and capital flows. These are essential to the promotion of sustainable regional integration. Perhaps the most vivid illustration of this is in the European Union (EU) where, inter alia, emphasis is being placed on convergence criteria for the main macroeconomic variables associated with the transition to the third stage of economic integration. The criteria include inflation, fiscal deficit, government debt, long-term interest rates, and exchange rate stability.[2] The process is supported by strengthened macroeconomic surveillance which has accompanied the dismantling of barriers to trade in goods and service and capital flows.

Also of importance is the harmonisation of regulatory and supervisory structures – particularly in financial markets. Again, important insights are provided by the EU which has taken important steps in allowing for a "single financial passport" – i.e. enabling institutions licensed in one country to operate throughout the region, with clear delineation of the responsibilities of the host and home authorities. Thus, underlying the EU's regional finance is the harmonisation of regulations on a range of factors impacting credit and investment services. These include capital standards, safety net provisions, exposure limits, treatment of conglomerates, and other prudential and operational issues.

LAC countries have made considerable progress in recent years toward macroeconomic stability and liberalisation, notwithstanding recent developments in Mexico.[3] As Stephany Griffith-Jones' paper points out, this was an important factor contributing to greater flows of foreign direct and portfolio investments; the other being conditions in industrial countries, including

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2 For example, the convergence criterion on inflation is that consumer price increases should not exceed that of the three best performing countries by more than 11/2 percentage points. The quantitative convergence criterion on debt is specified as 60 per cent of GDP while that on the general government deficit is specified as 3 per cent of GDP.

3 See for example Sebastian Edwards, *Crisis and Reform in Latin America: From Despair to Hope*, Oxford University Press, Oxford, 1995.

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sharp decline in yields of US financial instruments in the early 1990s.[4] There has also been some progress in the harmonisation of financial regulation and supervision, particularly in the context of the multilateral initiative led by the Basle Committee on Banking Supervision.

In view of these consideration, it would be useful if the following questions were considered:

- Are the achievements in policy convergence and regulatory harmonisation sufficient?
- What are the remaining key policy priorities?
- What can and should provide the anchor for the convergence process?
- To what extent does further progress in these areas affect the arguments regarding the strengthening of the public financial institutions base and intervention vis-à-vis private capital flows?

Also, given the emphasis in the paper on foreign direct investment flows, there is a need to consider the role of taxation – particularly corporate taxation. Indeed, as recognised by the European Commission, the establishment of a common policy in this area is central to the effectiveness of investment flows in supporting integration at the enterprise level.[5] This, inter alia, brings out issues relating to efficiency in the allocation of resources and equity in the distribution of tax revenues across jurisdictions.[6]

Public and Private Institutions

Having considered the main prerequisites for a solid finance structure in support of regional integration, let me turn my attention to some of the issues raised by the paper concerning the structure itself.

The paper lists a host of policy questions regarding the strengthening of public and private finance for regional integration. As the experience of other regions indicates, the case for establishing and enlarging public institutions tends to boil down to political considerations and/or market failure arguments; the latter also provide a basis for interventions in capital markets.

It is clear from the paper's survey of existing institutions that there is already an extensive and functioning regional institutional base – a base that

4 Guillermo Calvo, Leonardo Leiderman and Carmen Reinhart, "Capital Inflows and Real Exchange Rate Appreciation in Latin America", IMF Staff Papers, March, 1993.

5 G. Fitchew, "The Single European Market and Tax Harmonisation", In: M. Gammie and B. Robinson (eds.) *Beyond 1992: A European Tax System*, Institute for Fiscal Study, London, 1989.

6 For an analysis of issues that influence the flow of foreign investment under alternative tax regimes, see Michael Keen, "Corporation Tax, Foreign Direct Investment and the Single Market", In: L. Alan Winters and Anthony Venables, *Economic Integration: Trade and Industry*, Cambridge University Press, Cambridge, 1991.

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goes well beyond what exists in other developing country regions. Of course, there is always room for adaptations to ensure greater effectiveness in promoting regional integration. However, such adaptations must be assessed in terms of complementarity with, rather than substituting for, private market functions. To this end, it would be interesting if the paper were to explore further the financing of regional projects. Some of these projects provide examples where, inter alia, difficulties in assigning clear property rights can serve to discourage the sufficient availability of private financing for what are economically efficient regional activities. Indeed, in some parts of the world, some of these projects have constituted challenges not only for private financing but also for official multilateral financing.

I would also take the opportunity to caution against oversimplifying the arguments for intervening in capital markets. I am thinking in particular of the paper's treatment of the adequacy of medium- and long-term financing of exports of capital goods. It is true that private capital inflows have not necessarily been aimed at promoting the finance of a particular type of activity. But this is not necessarily the indication of a market failure which warrants intervention to direct flows to particular uses. A key issue is the overall economic environment. As illustrated by the differing experiences of countries in Asia, Latin America and the Middle East, the macroeconomic policy mix itself can play an important role in promoting longer-term capital flow and limiting the share of more volatile short-term flows.

Bilateralism, Regionalism and Multilateralism

Let me now turn to the third and final issue – that relating to the question of "bilateralism versus regionalism versus multilateralism".

This issue has to be confronted very early on when discussing the economics of regional integration. By simplifying the vast amount of work done in this area, one can point to two general conclusions: first, multilateralism tends to dominate in an absolute sense; and second, regionalism is considered, in most cases, superior to bilateralism especially if it is based on an outwardly-oriented strategy and is a stepping stone to multilateralism (elements of the so-called "new regionalism").

Of course, there is a range of analytical complications. This is especially the case when the analysis has to deal not only with the existence of overlapping arrangements within the region, but also with the interdependence and game theoretics associated with the simultaneous formation of regional blocs in different parts of the world.[7]

7 See for example papers in Jaime de Melo and Arvind Panagariya (eds.), *New Dimensions in Regional Integration*, Cambridge University Press, Cambridge, 1993.

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It is also important to remember that there are different forms of regionalism. These range from a series of sub-regional groupings to a region-wide nondiscriminatory liberalisation. Indeed, the question is not just what form of regionalism but also the implications of the simultaneous pursuit by some countries of different forms of regionalism.

While not explicit, Stephany Griffith-Jones' recommendations on financial arrangements may be read as supporting the region-wide concept – thus her emphasis on broadening regionally the successful LAIA payments and clearing arrangement. I think that this is the correct approach, albeit the more difficult one to implement given the economic and financial divergences among some of the countries in the LAC region.

However, if one follows this line, it is important to also consider the role and effectiveness of potential compensatory financial mechanisms. The economic argument for these mechanism relies on two elements: the relative immobility of factors of production and the resource reallocations implied by the changing relative price structure inherent in a regional integration process.

OPEC is often viewed as a case where the lack of compensatory mechanisms has undermined at times the cohesive behaviour needed to achieve collective objectives. The EU, by contrast, has a number of such mechanisms. These range from Structural Funds – including the funding of mutually agreed-on projects in regions and countries below a specified income threshold – to balance of payments assistance provided on conditional terms and the operation of the Common Agricultural Policy.[8]

Of course, these mechanisms are not without problems. They raise issues of moral hazard and, if not effectively operated, can serve to retard the regional integration process. These risks are especially pronounced in the context of regional groupings that find it difficult, particularly for political reasons, to impose sustained discipline on their members.

Given its vision for financial structures supporting a region-wide integration process, perhaps Stephany Griffith-Jones' paper could be followed up by a discussion of:

- the role of compensatory financing arrangements in the LAC region;
- the potential for adverse incentives that result in a slower integration process; and,
- the policy implications.

Let me conclude by thanking Stephany Griffith-Jones for an extremely useful paper. My comments suggest that there is a need to build further on

8 An analysis of these mechanisms may be found in Charles Bean, "Economic and Monetary Union in Europe", In: *Journal of Economic Perspectives*, Fall 1992.

the analysis contained in the paper by looking at the importance for regional finance of four main issues:

- greater convergence in macroeconomic policies;
- progress in harmonisation of regulatory and supervisory regimes across the region;
- the complementarities between the role of private and public institutions; and,
- the role and design of compensatory financing mechanisms.

These essential building blocks are an integral part of any analysis of the case for and against creating and enlarging financial institutions, as well as intervening in the private capital markets.

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