Floor Discussion of the Ffrench-Davis Paper

The paper by Ricardo-Ffrench-Davis and subsequent comment by Robert Devlin engendered a very rich discussion about the relations between finance and trade and how one could explain the rise of intra-regional trade in Latin America. But first Renato Baumann, economic affairs officer at ECLAC-Brazil, added some information on Mercosur.

The Case of Mercosur

Baumann highlighted the remarkable increase in trade within the Mercosur region. Exports of the four members (Brazil, Argentina, Paraguay, Uruguay) to the regional market increased from 4 billion dollars in 1990 to 11 billion dollars in 1994, augmenting the share of Mercosur in total exports of the four countries from 9 per cent in 1990 to 19 per cent in 1994. Imports rose from 4 billion dollars in 1990 to 9.6 billion dollars in 1993, increasing the share of Mercosur in total imports from 14.5 per cent in 1990 to 20 per cent in 1993. According to Baumann it is, however, difficult to assess how far these increases in intra-regional trade can be attributed to the existence of the Mercosur integration agreement. At least four specific explanations could be given, he said.

"First, there is the effect of some specific protocols, of which the protocol on wheat is the best example. This made Brazil import wheat from Argentina, even when the Canadians and the Americans had been trying to supply the same product more cheaply. Second, there is the effect of exchange rate differentials – exchange rates moving sharply – between the member countries of Mercosur. The overvaluation of the Argentinean peso, for instance, explains to a large extent why Brazilian exports to Argentina increased substantially in 1992-1993. Third, there is the effect of intra-industry trade. Intra-industry trade between Brazil and Argentina accounted for 23 per cent of total bilateral trade in 1986 and rose to 38 per cent in 1990, and a similar increase in intra-industry trade has occurred between Uruguay and Brazil. Fourth, there is a conjunctural factor. This has to do with the point stressed by Robert Devlin, that in the analysis of the regional experience one should take into account what is going on at the global level. A good deal of Brazilian exports of automobiles to Argentina, for instance, had to do with one specific car manufacturer which traditionally had a sort of market reservation in its home country – which is not Brazil but the home country of the transnational

From: Regionalism and the Global Economy: The Case of Latin America and the Caribbean
FONDAD, The Hague, 1995, www.fondad.org

company. The company lost it due to multilateral negotiations and had to divert the sales of certain products that were produced in Brazil to Argentina."

Given these specific explanations Baumann warned against drawing general conclusions from aggregate trade figures. "You have to get into details to know exactly what is going on. Probably one of the conclusions from a closer look at the Mercosur experience is that it is too recent a phenomenon to allow definite, affirmative statements with regard to exchange rate movements and so on. It certainly calls for a differentiated analysis of the specific role of the exchange rate."

Baumann observed that, in a similar way, more detailed analysis would be needed if one tried to explain the increase in intra-regional direct investments. "As Stephany Griffith-Jones' paper shows, foreign direct investment among Latin American partners is increasing and this is true for Mercosur as well. The anecdotal information in the press is that today there are 400 Brazilian enterprises in Argentina with investments coming close to 700 million dollars. It seems that Brazilian companies are investing in Argentina because of differences in tax structure, which is an aspect we have not dealt with in our discussion. Probably there is a new phenomenon here which has to do not exactly with tax evasion but with the treatment of income taxes, tax on production factors, and so on. Anyway, this example also points to the need for a more specific analysis," Baumann said.

Regarding Mercosur's relations with other regions Baumann noted that other Latin American countries may join Mercosur in the near future. "Brazil has a geographic frontier with ten other Latin American countries, which prompted the country in October 1993 to propose the creation of a South American Free Trade Area (SAFTA) and this was formally adopted as a Mercosur proposal in May 1994. Apart from that, Chile, Bolivia and Venezuela, among others, have manifested interest in joining Mercosur and having some sort of specific, differentiated participation in it. In parallel, negotiations have been held with other LAIA members to establish by the end of June 1995 the basis of a free trade area to be formed in 10 years. Preliminary contacts have been made also with the Australian-New Zealand Free Trade Area. The European Union approved in December 1994 a resolution to start negotiations with Mercosur for an inter-regional agreement. And last but not least, in the Miami Summit of 1994 it was agreed that by June 1995 there should be negotiations with NAFTA about the establishment of a Hemispheric Free Trade Area by the year 2005."

One important addendum to Baumann's presentation was made by Argentinean economist Roberto Bouzas. "In the case of the wheat protocol mentioned by Baumann the real issue is that in Mercosur a common policy is being developed of how to treat extra-regional subsidies. The issue goes

From: Regionalism and the Global Economy: The Case of Latin America and the Caribbean
FONDAD, The Hague, 1995, www.fondad.org

beyond the protocol and really is to develop a common way of dealing with subsidised imports, unfair imports, into the customs union. That is what is really at stake."

Exchange Rates, Intra-Regional Trade and the Rationale of Integration

Ricardo Ffrench-Davis' assertion that the depreciation of Latin American currencies in the 1980s had discouraged intra-regional trade aroused a variety of comments. Jaime Ros, a Mexican economist working at the University of Notre Dame in the United States, started off the debate by disputing the logic of Ffrench-Davis' argument.

"I don't follow the logic in Ricardo's presentation about the collective Latin American devaluation of the 1980s having a negative effect on intra-regional trade. Even though this collective devaluation did increase extra-regional exports it also decreased extra-regional imports. The effect on intra-regional trade vs. extra-regional trade seems to me ambiguous. The key issue is whether the collective devaluation was contractionary or expansionary vis-à-vis the region's level of economic activity. It may well be that the devaluation was initially contractionary vis-à-vis the level of intra-regional trade – similar to the contraction of economic activity brought about by the adjustment process. But it may well be also that, after these contractionary effects operated, we have entered a period of expansionary effects on intra-regional trade – some of which we may be still witnessing today. That is, some of the increases in intra-regional trade – intra-regional exports and imports – may well be still the last effects of the undervalued currencies that we had throughout the 1980s and early 1990s," Ros said.

Hector Assael, chief of the International Trade, Finance and Transport Division at ECLAC, followed up on the issue, arguing that one should also take into consideration whether the countries concerned were in the dollar zone or the non-dollar zone. "The devaluation of the 1980s occurred at the time of the strong dollar and the appreciation of the 1990s occurred at the time of the weak dollar. So it is important to know whether we are speaking in terms of devaluations or appreciations against the dollar or against a basket of currencies."

Assael further believed that one should distinguish between both the amount of loans received and the type of loans. "Because when you have a difficult period, you are receiving small amounts of loans and a lot of these loans – suppliers' credit and so on – are tied to buy imports in the developed countries. But when you receive a lot of loans, like in the 1990s, they are mostly private loans which are open to buy in any place you want. If in the future we will receive less loans and more of these loans will be tied to

From: Regionalism and the Global Economy: The Case of Latin America and the Caribbean
FONDAD, The Hague, 1995, www.fondad.org

importing from developed countries, you may see again a decrease in intra-regional imports."

A third observation by Assael was that intra-regional trade does not depend only on macroeconomic issues. "In the early 1990s we had a study made by a German economist and the explanation he gave for the rise of intra-regional trade between Argentina and Brazil was that it was affected not by differences in the exchange rate but mainly by the economic situation in both countries. We have to take into consideration not only macroeconomic explanations but also other kinds of explanations."

Shahen Abrahamian, officer-in-charge of the Global Interdependence Division at UNCTAD, supported Assael's view. "The macroeconomic factor has been very important, but the challenge is to break that macroeconomic link and not let intra-regional trade become the hostage of macroeconomic causes. I mean, one should try to detach it from the effects of financial sector movements as opposed to real sector adjustments. Robert Devlin was going in this direction: make Latin American trade more dependent on real competitiveness and mutual competitiveness, not relative exchange rates. I think Ricardo is right that in the future you are going to have a harder time generating intra-regional trade and you should do it with the governmental agreements to foster trade. It cannot be done through relative exchange rate movements. It cannot be done entirely through unilateral liberalisation. It cannot be done through the global system. Regional cooperation can do it, but it's going to be tough."

Abrahamian also dwelled on the logic of Ffrench-Davis' statement – contested by Jaime Ros – about the link between exchange rates and intra-regional trade. "There may be a link between exchange rates and the net inflow of resources. You may have decade-long movements of financial glut followed by financial shortage, each of them associated with an exchange rate movement. The point is that when there is a lot of money coming in, your currency appreciates. But when everybody's exchange rate in the region is appreciating, no one is becoming less or more competitive with the others. What does promote your exports is the aggregate growth of imports of your neighbours in Latin America. Conversely, when the money is going out, or not coming in, there is a devaluation which doesn't affect your relative competitiveness but does affect the demand pull from your neighbours. So if you were to have a world without capital movements, just exchange rates and trade balances, Jaime Ros would be right: you could get a devaluation and, at the same time, an aggregate increase in imports which would not necessarily reduce intra-regional trade. But in practice that is not what happens."

Claudia Schatan, economic affairs officer at ECLAC-Mexico, noted that the recent devaluation of the Mexican peso demonstrated that diverging exchange rate movements within a region do matter. "Perhaps in the future exchange rates will converge again, but as it is now – with an extremely devalued currency in Mexico – we have very different kinds of exchange rate movements, in part of the region at least, and overlapping trade agreements. We can start seeing the effects of the rush there has been recently for signing these trade agreements between Mexico and the US and between Mexico and the smaller countries of Central America. The US is suffering some effects of the tremendous contraction of the Mexican economy, but the Central American countries are really scared by the situation. Because there is a free trade agreement between Mexico and Costa Rica, the Costa Ricans are frightened that they will be invaded by cheap Mexican products. More generally, the Central Americans are worried that some of the products that cannot be exported from Mexico to the US – not because of prices but because they are not competitive in terms of quality – will be dumped in the Central American region through Costa Rica. Costa Rica has this free trade agreement with Mexico and from there there's nothing that will stop Mexican products from going to the rest of Central America because there is the free Common Central American Market. The possibility of getting a very unfair trade practice through this new exchange rate is very worrisome."

Cristian Ossa, a Chilean economist and director of the Department of Economics and Social Information and Policy Analysis at the UN in New York, returned to basic underlying assumptions and questioned the rationale of integration put forward by Ffrench-Davis.

"The strategic decision of countries is to integrate into the world economy and regional integration should be part of that process. But what I see in Ricardo's approach to regional integration is that it is meant to reduce the costs of integration into the world economy rather than to assist in the process of integrating into the world economy. In a sense, Ricardo's approach is back to the 1960s rather than looking at the 1990s and into the next century. It is too much of a defensive approach. Compensating unilateral import liberalisation with regional integration might be a second best, but why not opt for an approach à la Korea, Taiwan, Malaysia, Thailand, Indonesia, or, if you wish, Chile, where the emphasis is not on regional integration but on opening up? The Asian NICs have growth rates of 6, 7, 8 per cent. Latin America in the 1980s had barely 1 per cent, and now it has 3 per cent and we seem to be satisfied."

Finally, Percy Mistry, an Indian economist engaged in finance and policy research, said he had the impression that – even in the 1990s which began so optimistically – Latin America seemed to remain extraordinarily prone and vulnerable to macro-financial shocks, whether caused by inflows or outflows.

"There is a feeling that both seem to be bad, and that there is somewhere a right amount in between which one must try to find, while I think that the real question may very well be: Why is it that a region which is so incredibly

From: Regionalism and the Global Economy: The Case of Latin America and the Caribbean
FONDAD, The Hague, 1995, www.fondad.org

rich in capacity still finds it elusive to achieve the kind of durable real sector adjustments where things like exchange rates, deficits etc. are driven by real sector movements and not continually derailed by financial sector movements? It is a rather fundamental issue; it is just as simple as the fact that these problems would be solved if the domestic savings rate would go up to 30% and remain there thereafter. Why is Latin America, after 30 years, still so prone to macro-financial shocks? What the implications of that are for durable vs. non-durable integration, or whether people see integration as a soft option to moderating the financial shock effect as opposed to looking at domestic responses which anchor these economies much more solidly, one does not know. But it is certainly an issue that ought to be looked at."

Reply by Ricardo Ffrench-Davis

First, on the issue of exchange rates and intra-regional trade, what I tried to emphasise was that the exchange rate – the devaluation of Latin American currencies in the 1980s – has been an important factor. If we look at exports we see that a country that devalued in the 1980s was changing not only one price relation, but two price relations, because there are tradeables – and that has to do with the first comment by Robert Devlin – with the world, tradeables with the region and non-tradeables. Some tradeables with the world are also tradeables with the region but some are not. In some cases the one has helped the other, in other cases the one has substituted for the other or they have been completely separate. But in broad terms we have seen the phenomenon that if two Latin American countries devalue, they improve competitiveness with the rest of the world, but they don't improve competitiveness with one another. Looking at it from the export point of view, this means that the composition of non-tradeables vs. reciprocal, regional tradeables is affected. Then, in the 1990s, we experienced the opposite: we improved competitiveness within the region and, because of an appreciating currency, we became less competitive with the rest of the world. So today it is more difficult for Latin America to sell in Europe and the US than to sell within Latin America.

Hector Assael raised the point of different exchange rate markets. However, I always try to talk in terms of real exchange rates which are determined by a basket of currencies. In the case of Mexico the basket is mostly the US dollar; in the case of Brazil, Argentina or Chile, the US dollar is only one component and the Deutsche Mark and the Yen are also important – as well as the exchange rates of Argentina, Brazil and so on – in affecting average relative prices. This explains some differences among countries, but the big trend has been that Latin America appreciated in the 1970s, depreciated in the 1980s, appreciated in the 1990s, and in all cases very

From: Regionalism and the Global Economy: The Case of Latin America and the Caribbean
FONDAD, The Hague, 1995, www.fondad.org

strongly. Today the appreciation may not be as strong as in the 1970s for the total region, but for several countries the appreciation is as large as the one suffered in the 1970s.

Hector Assael and Shahen Abrahamian questioned the role of macroeconomic factors. I fully agree with them and wished that from now on macro would be less relevant. In the 1980s, however, it was a very strong factor explaining many things that happened, and in the early 1990s it remained a strong factor explaining what happened. The recovery of GDP of Latin America was macro, it was not the creation of capacity, the expansion of the productive frontier – that was moderate, close to the growth of population. A significant component of moving from below up to the production frontier was the macro situation, led by capital flows. Argentina was 40 per cent below the production frontier and moved to the frontier, Brazil will be approaching the production frontier fairly soon, and Chile approached the production frontier already five years ago and stayed there. Obviously, the increase of GDP was led by real growth, by the creation of new capacity, by increased investment and productivity. It is also clear that the creation of productive capacity is more important than macro events in the financial sphere. In that sense Hector is very much right. But, in the end, it all depends on how one creates capacity, how the increase of productivity is distributed and how the market signals are directed towards domestic markets, intra-regional markets and extra-regional markets. It may well be that in the future we will be somewhat less dependent on the overall macro situation than we have been in the 1980s and early 1990s. I hope so.

To take the point raised by Claudia Schatan, indeed, Mexico has had a very significant effect in the neighbourhood, because of vicinity and because of the integration agreements – not only on trade but also on investment. There is going to be a diversion of investment toward Mexico. For investors with a long-term horizon Mexico is going to be profitable in the next 15 years. There may be problems for 1, 2, 3 or many years, but with the present low exchange rate it is very profitable to go into Mexico. In Central America the effects will be important, maybe also in Venezuela, Colombia and Chile.

Cristian Ossa has raised several questions which go much beyond my paper. They touch on what I was doing until a month ago, but I closed that and I will not repeat what I was doing before. So I omitted things on which I have been working before. I agree that it is crucial to take into consideration where one places the analysis. Import liberalisation is given, is there. We are not replacing it, we are living with it. So the real question is: What do we put together with it? One thing is real cooperation or preferences for reciprocal trade. This should be accompanied by more effective export promotion policies and more effective systemic policies, that is policies which improve systemic productivity. We have a very poor record on that in Latin America.

From: Regionalism and the Global Economy: The Case of Latin America and the Caribbean
FONDAD, The Hague, 1995, www.fondad.org

Reforms have been weak and in some cases they have destroyed more than created during the transition. I recall that in Chile 8 or 10 years ago most people were saying that the economic situation was bad, because the costs had been very large in the process and costs always have to be counted. We must not omit them, we have to consider benefits and costs and try to make the transition better. And for that, we need, for instance, better export promotion policies. We have to improve policies in Latin America including exchange rate policies and many other things that will improve the investment climate for private economic agents. We should be doing that – with or without intra-regional cooperation – but we are doing very little. We did import liberalisation without many of the other things to complement the efficiency of import liberalisation.

Given this situation, intra-regional cooperation is not defensive, is not inconsistent with growth of exports to the rest of the world. It is inconsistent with the philosophy that exports to the rest of the world should be the only driving force. On average, if we use the right prices and the right policies, intra-regional preferences have a lot to offer, given that external tariffs in Latin America are relatively low, already much lower than the East Asian tariffs in the 1950s, 1960s, 1970s and early 1980s, and even lower than the Japanese tariffs until a few years ago, or the European or US tariffs in the 1930s, 1940s, 1950s and early 1960s. The costs of a too expensive trade diversion, I think, are rather limited and the space for improving efficiency through economies of scale, economies of specialisation and completing markets are significant.

Focusing on the case of Chile I think it is crucial to consider how long it took to reap the net benefits. It took a very long time. Only in 1992 average wages reached again the level of average wages in 1970. It was a very long process, because reforms were incomplete, naive, based too much on the belief that the market would solve everything. So they did not contribute to completing markets – in some cases they created markets, but they also destroyed several markets. Technology weakened, labour training weakened, people went into many years of unemployment or self-employment, and so on.

Now the situation in Chile might look good, but it took 22 years and that is very long. We can do things faster and we can improve a lot in the process of adjustment in Latin America by doing better export promotion, better labour training, improving education, and so on. Education is very weak in Latin America: there is more quantity, more years, but lower quality. Or take labour capacity: labour training is minimal compared to what happens in Korea, Taiwan, Japan or Malaysia. We are weak in all these things and that affects systemic productivity. So we need to improve systemic productivity and introduce some additional elements, one being intra-regional cooperation.

From: Regionalism and the Global Economy: The Case of Latin America and the Caribbean
FONDAD, The Hague, 1995, www.fondad.org

I would like to add a small exercise that we did in table 7 of the paper; it deals with the relationship between the growth of GDP, on the one hand, and the growth of intra-regional and extra-regional exports, on the other. It starts in 1990, though, ideally, we should have started in 1980 in order to see what is recovery and what is creation. This table introduces the macro element that Robert said I had not put enough in my paper. If we look at what happened in effective demand – the demand for natural resources, labour and capital – there have been changes in real terms between 1990 and 1994. We can see in the table that exports have had a positive effect: they contributed to 40 per cent of the increase in GDP, and of this growth of exports about half was accounted for by intra-regional exports. So my conclusion is that, together with the other things – capital flows, economic reform, discipline, democracy, etc. – these intra-regional exports have contributed significantly to the recovery of Latin America, with the qualification that after 1994 the contribution is probably going to be smaller and more complicated.

From: Regionalism and the Global Economy: The Case of Latin America and the Caribbean
FONDAD, The Hague, 1995, www.fondad.org