Analysis of macroeconomic dynamics in Latin America and the Caribbean and its implications for regional economic integration. Current situation and prospects for macroeconomic coordination
CONTENTS

FOREWORD

INTRODUCTION AND SUMMARY 3

I. MACROECONOMIC DYNAMICS OF THE COUNTRIES OF LATIN AMERICA AND THE CARIBBEAN AND INTEGRATION PROCESSES: RECENT TRENDS 8
   1. The macroeconomic development in the region 8
   2. Macroeconomic dynamics and regional integration 19

II. EXPERIENCE OF LATIN AMERICAN AND THE CARIBBEAN IN SUBREGIONAL MACROECONOMIC COORDINATION 43
   1. Macroeconomic coordination, a requisite for advance in integration efforts 43
   2. The Latin American and Caribbean experience in macroeconomic coordination 53
   3. The prisoner’s dilemma as analytical reference 68

III. HOW TO GENERATE INCENTIVES THAT FOSTER MACROECONOMIC COORDINATION IN REGIONAL INTEGRATION 72
   1. Towards a new approach to macroeconomic coordination 72
   2. Specific proposals and subregional institutional mechanisms to favor macroeconomic coordination, according to the principles established in this work 83
   3. Expanding the method from subregional to regional level or to cooperation among the Latin America and the Caribbean subregions as an active complement of the subregional mechanisms set forth: specific proposals for the entire regional level (LAC) 88

IV. CONCRETE PROPOSALS 90

V. PRELIMINARY CONCLUSIONS 91

BIBLIOGRAPHY 95

ANNEX 99
FOREWORD

This document is the result of a preliminary analysis on the current situation and prospects in the area of macroeconomic coordination, being carried out by the Permanent Secretariat, as set out in the fundamental activities of Project 1.1.1. “Analysis of the macroeconomic dynamics of Latin America and the Caribbean. Possible implications for regional integration”, of SELA’s Work Programme for the year 2005.

The study begins with an analysis of the most recent trends surrounding the macroeconomic dynamics of the countries of Latin America and the Caribbean and of the four existing subregional integration institutions (CAN, MERCOSUR, CACM and CARICOM). The second section sums up the experiences gathered in subregional macroeconomic coordination, while the final section presents a number of proposals and institutional mechanisms that may be used to create incentives in order to promote macroeconomic coordination among the nations of the region.

This study, which is the basis for the debates of the regional meeting of SELA on this subject, (Caracas, 15 – 16 September 2005), also offers a number of key elements that will help to guide the work of SELA, as it follows up on viable proposals which, once jointly agreed upon our Member States, will encourage the implementation of mechanism aimed at promoting long-term macroeconomic coordination among the countries of Latin America and the Caribbean.

This paper was prepared by Dr. Christian Ghymers and Dr. Carlos Quenan, to whom the Permanent Secretariat of SELA expresses its deepest gratitude and appreciation.
INTRODUCTION AND SUMMARY

After the so-called “lost decade” of the 1980s, the countries of Latin American and Caribbean implemented major reforms which indirectly involved some degree of macroeconomic convergence in the region. Later, under the so-called “Washington consensus” of the 1990s, progress was made in fostering macroeconomic stability, and the economies gradually opened up. However, after some years of recovery and the so-called “Tequilazo” crisis, the region failed to achieve the high levels of sustainable growth that was expected. On the contrary, it was once again beset by macroeconomic instability spawned by a series of recurring financial and exchange crises, which culminated in the crises of 2001-2002 and in the stagnation of real per capita income levels. From a social and economic standpoint, all this added to yet another “lost half-decade” (1998-2002) for the large majority of countries.

While it is true that, overall, the reforms were indeed not fully implemented because of failure to strengthen the region’s institutional bases – except in the cases of Chile and Mexico, which are the two economies that best withheld the crises – Latin America and the Caribbean clearly seem to have failed to resolve their basic economic problems. Against this general backdrop of insufficient growth and of worsening social inequalities, the disproportionate benefits brought by the reforms versus the costs they entailed seem to have made the countries “reform-weary” and have cast doubt on the prospects that should be entertained. Internally, this trend has also hampered the continued implementation of institutional changes needed to ensure sustainable growth.

Yet, there is scant consensus as to the overwhelming need to remedy the shortcomings of governance by first strengthening basic institutions and democracy. This notion is based on theoretical teachings that attribute the varied development performance of the countries in the region mainly to institutional factors, a fact that tends to shift the emphasis of short-term political proposals to considerations dealing with the institutional framework in general and with the conditions for governance in particular.

Within this framework, the different regional integration processes, which witnessed a significant boom during much of the 1990s, were severely affected by crises, while the dynamics of these processes weakened in the late 1990s and at the beginning of the present decade. Accordingly, a debate has arisen with regard to the need to view the regional integration process as the result of an institutional building process aimed at furthering cooperation among member countries, which contribute to lessen instability and sustainability of economic growth.

In the current debate, which is vital in itself, the thesis this paper seeks to put forward is twofold:

(i) First, in view of the challenges and asymmetries posed by globalization, “regional cooperation” among neighbouring countries (or countries with common goals) may serve as an effective catalyst for reforms and as a guarantee to ensure that they are best internalised by economic players and by citizens on the whole. Regional integration has not been duly taken into account in terms of the concept it represents or in the implementation of economic reforms in Latin America and the Caribbean. It is interesting to note that national authorities in the countries of Latin American and the Caribbean have tended to ignore the numerous integration institutions located throughout the region. In fact, these authorities did not tap into solutions to be gained through cooperation, in order to work out orderly responses to the external shocks affecting their own interests.
Actually, as pointed out, regional integration in terms of real financial integration is not moving ahead - or is doing so at a snail’s pace - while the individual economies are becoming increasingly exposed to the external shocks.

(ii) Second, macroeconomic cooperation (and some form of coordination) among the sovereign authorities of a region is key to being able to go beyond the boundaries of a free trade agreement towards deepening regional integration, so that they may be able to use it as a tool with which to further governance and to achieve high levels of sustainable growth. Indeed, as integration processes are undertaken, countries tend to become increasingly interdependent, and both the economic cycles and policies implemented in the neighbouring states will have an impact on the performance of the other partners - through real and/or financial channels. Progress in any form of macroeconomic policy coordination appears, under certain conditions, to be one way of speeding up that “upward levelling” of national governance, by “internalizing” the effects of reciprocal interrelationships in the decision-making process of each economy, and by creating this counterforce mechanisms and incentives for policy-makers, which may be used to improve the overall result of each participant and of the region as a whole.

Although there is broad consensus surrounding the idea of regional integration, the integration processes implemented in Latin America and the Caribbean have failed to make any definite progress in macroeconomic coordination. This is why it is now so highly important to analyze the obstacles that must be surpassed and the conditions that must be fulfilled to ensure that the initiatives taken in this regard are indeed promoted by the countries of the region. This involves analyzing, among other factors, the intrinsic characteristics of the economic, financial and commercial interdependence between the economies of Latin America and the Caribbean, particularly from a historical, political and social standpoint. In addition, close attention must be paid to international experience gathered on this area, particularly the paradigmatic case of the European integration process. In this respect, the current regional reflection on this subject will be used as the basis, with special emphasis in the reflection recently conducted within the framework of the Macroeconomic Dialogue Network (REDIMA)\(^1\). This project was launched by ECLAC in the latter part of the year 2000 with the objective of creating a new space for dialogue among high-level officials responsible for defining macroeconomic policies in three of the subregions (MERCOSUR and associates, CAN and the CACM). The purpose of this effort was, actually, to set up an informal regional macroeconomic monitoring system that would not be dependent on institutional requirements or subject to the ups and downs of political or economic trends, but one that might be useful to each participant, by keeping it closely linked to its peers and by ensuring some degree of continuity in the common reflection undertaken by the subregion. Furthermore, REDIMA also organizes the same informal contacts among the three subregions, by fostering exchanges on issues of common interest to the three networks that have already been established. This provides an opportunity to build a Latin American consensus or to voice common strategies vis-à-vis other integrated regions or in multilateral institutions. This complementary informal space for the institutions or for existing mechanisms does not seek to serve as a forum for making decisions, establishing official positions, or promoting institutional changes. It is intended to serve merely as a tool with which to foster direct and continuous

---

cooperation among national experts, through dynamic exchanges and technical analyses of problems of common interest. The best mutual knowledge of experts may serve as a valuable tool with which to build a consensus around the contents of each country’s policies. The subregional network is thus a readily useful tool that may be used by all experts in their various areas of responsibility, and one that may therefore contribute macroeconomic convergence in the region. In addition, REDIMA serves as an effective channel for clarifying and supervising policies, which is one way of gaining support - and insight – from neighbours.

In economic literature, macroeconomic cooperation and coordination are analyzed in line with two approaches. The first of these two approaches is based on the theory of the optimum monetary areas and involves a cost-benefit analysis of macroeconomic coordination. Initially formulated to assess the possible interest of different countries in setting their own exchange rates and in forming a monetary union, this theory may be mobilized to study the interest that various countries may have in moving ahead with the coordination of their macroeconomic policies, on the basis of the fulfilment, or otherwise, of a series of conditions, including the similarity of economic structures, the flexibility of prices and wages, and the mobility of the production factors among associated countries, among others. If these conditions are not met, the costs of relinquishing monetary and exchange policies in order to address possible shocks to the economies might be greater than the benefits to be gained from association².

The second is a strategic approach to the “political economy” which, based on games theory, first defines a function of preferences for each of the countries and later evaluates the benefits to be gained from cooperation vis-à-vis a situation in which there is no cooperation whatsoever. From this standpoint, emphasis may be placed on the potential benefits to be gained with regard to governance and to credibility, if countries participate in an integration process and cooperate mutually in coordinating their policies. This approach – which will be promoted by this study – assumes that the advantages of integration lie in optimizing not only national policies but also the dynamics of improving decision-making at the national level so as to ensure regional cooperation through increased transparency and through the implicit counterforces that it introduces.

The central idea, which forms the thread of this study, may be formulated as follows: Without a paradigmatic change that involves focusing on the region as the lever for progress in the areas of governance and credibility to deal with globalization, regional integration will fail to be anything more than pure rhetoric. The new paradigm which SELA could promote involves focusing on the repercussions of globalization for the region, by underscoring the importance of regional and subregional macroeconomic cooperation as the condition and tool needed to revitalize the economic integration process which, in turn, is a basic pre-requisite for high, sustainable growth coupled with greater participation of the citizens of Latin America and the Caribbean.

Within this general context, the study has three specific objectives. First, it seeks to synthetically evaluate the macroeconomic dynamics of the countries of Latin America and the Caribbean in recent years, and the relationship between these dynamics and the actual and expected progress made in regional integration. Second, it aims to offer an

---

² This means the benefits of not applying these policies in order to address the shocks. It should be remembered that these may be different in nature: common, systemic or idiosyncratic (depending on whether they affect several economies or a single economy), relating to supply or demand (according to the economic source), symmetrical or asymmetrical (according to the effect or sign that the shock produces on each economy), external or internal (according to its geographical origin) or even permanent or temporary (according to whether or not it calls for a process of adjustment).
analytical summary of the experience gathered with respect to the efforts made by large subregional integration groups in the area of macroeconomic coordination. Third, it intends to propose mechanisms to promote and to optimize on the appropriate level of macroeconomic coordination both within subregional integration schemes and, wherever possible, in Latin American and Caribbean region as a whole.

**The first part** offers an up-to-date diagnosis on the macroeconomic dynamics of the countries of Latin America and the Caribbean in recent years and the relationship between this dynamics and the actual and expected progress made in regional integration. Specifically speaking, it highlights the factors which have trapped the region on a path of low, unstable growth marked by insufficient macroeconomic convergence that thwarts real integration and that, in many cases, threatens both national and regional cohesion. With unstable macroeconomic dynamics, globalization compounds the region’s exposure to external shocks and, through capital flows, reinforces the pro-cyclical nature of internal macroeconomic policies. This trends leads to increased financial weakness and generates exchange rates crises coupled with pro-cyclical destabilizing financial “spreads”, thereby producing attempts at competitive differentiation, which hinder or inhibit regional cooperation.

**The second part** of the text offers an analytical and comparative summary of the most recent experiences what have been gathered in the area of macroeconomic coordination and which involve the four most important subregional integration groups (the CACM, CARICOM, CAN and MERCOSUR). This section reviews the habitually acknowledged advantages of macroeconomic coordination, while also emphasising the relationship between the progress made in actual integration and the need for greater coordination. The comparative analysis of the macroeconomic cooperation schemes in the different subregional processes and of their truly weak performance throws light on the lack of an attitude of cooperation and provides the basis for a further analysis of this attitude. The analogical argument of the “the prisoner’s dilemma” helps to identify the concrete obstacles to macroeconomic coordination, as it seeks to provides an understanding of the rationale surrounding the lack of cooperation among regional partners or the so-called “lack of political will”, which actually stems from the fact that those responsible do not have sufficient incentives to cooperate, given the uncertainty and the risks (real or imaginary) that they face when engaging in commitments with their neighbours.

On the basis of the above, **the third part** proposes certain mechanism to optimize on macroeconomic coordination within subregional and several possible regional integration schemes. As has been mentioned, without a change in paradigm, Latin America’s regional integration process will fail to go beyond the rhetoric. It is therefore vital to highlight the need for an explicit analysis of the integration process as the result of an institutionalized building process whose broader objective is to include macroeconomic management in the activities of the region’s governments and in the predominant theoretical models. Such models tend to view the countries as autonomous entities without asymmetries or synergies among them. As a result, they do not take into consideration the capabilities of a regional response to the effects of the inconsistent pressures of globalization and to the low levels of convergence among economies seeking to integrate. At the same time, the “prisoner’s dilemma” scheme of games theory sheds light on the causal mechanisms of the lack of cooperation. Thus, it is possible to devise solutions to eliminate the reasons for the insufficiency or absence of coordination with the use of the appropriate solution. The most concrete and attractive strategy, in particular, involves creating the necessary incentives when extending the positive impact of the credibility effect that a visibly serious regional effort towards macroeconomic monitoring may have on country risk ("spreads" of sovereign bonds) and the perception
that national economic agents, financial markets and the external creditors may have of the region. In this regard, it is necessary to establish the principles of "regional political economy" which will gradually help the region out of the prisoner's dilemma without its having to go through former institutional changes but, rather, using existing schemes to foster a progressive dynamics of changes. This study establishes that regional integration should be undertaken by means of cooperative competition, or procedures which place the region at the service of national policies and of its political and social players, and which will succeed in improving governance in each economy. The idea is to identify the institutional mechanisms needed to ensure that concrete progress is made in getting national players to call for greater coordination in macroeconomic policies.

The proposals favoured by the study are rooted in a novel analysis of “regional political economy” which, nonetheless, uses the pragmatic method provided by the European experience to establish the principles of macroeconomic cooperation among national administrations without countries losing their sovereignty in the process. At the same time, a regional ad-hoc body plays a complementary role - and a non-competitive role with respect to local authorities - that leads to the creation of an added value which, if embraced by national participants, encourages their self-discipline.

The main idea is that, in the field of the macroeconomic policies, regional cooperation, does not allow governments to seek differentiation with respect to their neighbours in a non-cooperative fashion. However, without encouraging further institutional change and through transparent macroeconomic monitoring, it can allow members to channel the potential forces mobilized by Member States to protect themselves from the mistakes of their partners. Doing this requires organizing healthy competition among the Member States to ensure that they all respect the consensual rules set at the regional level. This, in turn, necessitates a regional body simply to provide technical and organizational support but one that is capable of performing a complementary role to guarantees a true mechanism of “checks and balances.” Indeed, such a "continuous game" is synonymous with protecting each one from their own mistakes, through the combined monitoring of the other players (and through dialogue between them), since the principle of competition makes the participants more demanding towards their neighbours than to towards themselves. For its part, the principle of regional cooperation makes it possible to create a regional added value in terms of transparency, credibility and diagnostics.

This dynamics may be “enticed” on the basis of an exercise in transparent and cooperative regional monitoring, with the implementation of an organized process of critical dialogue between the macroeconomists of the relevant administrative bodies (Central Banks and Finance Ministries) and independent macroeconomists (discussants belong to academe or to the specialized press). This ongoing evaluation process by professionals in a situation of "reputational" competition calls for a minimum degree of planning (which must, however, be conducted through the existing regional institutions) to draw attention, to ensure seriousness, and to put pressure on the market or on public opinion. In this manner, those responsible have a direct and personal stake in using subregional monitoring to win credibility and support, or to avoid market sanctions. And, in this manner, the added value of the region quickly becomes a reality for the macroeconomists in charge.

However, if this competition mechanism is to achieve its full effects, efforts must be made to prevent cooperation from leading to collusion between players (as sometimes happens in the EU. One recent example of this is the failure to strictly apply the Stability and Growth Pact for fiscal discipline). This necessitates not only that the monitoring exercise be transparent and simple but also that it be capable of generating sanctions and
incentives through the balancing of institutional and effective power. This analysis will show how the existing mechanism should be used and how it may be best complemented with a minimum degree of pragmatic organization.

I. MACROECONOMIC DYNAMICS OF THE COUNTRIES OF LATIN AMERICAN AND THE CARIBBEAN AND INTEGRATION PROCESSES: RECENT TRENDS

The first section analyses the main characteristics of the recent macroeconomic development of the countries of the region with the purpose of identifying common features, as well as the factors determining regional economic cycles that are extremely sensitive to the impact of different external shocks, particularly those of a financial nature. The second section presents, first of all, the main stylized facts surrounding the macroeconomic development of the different subregional integration groupings. This development is then scrutinised in terms of economic interdependence among the countries forming part of the various integration agreements that exist in the region and the degree of synchronization in the regional cycles assessed.

1. The macroeconomic development of the region

The region is trapped on a path of low, unstable growth that, through capital flows, is reinforced by the globalization process which compounds the region's exposure to external shocks. The progress made in recent years, with the economic recovery registered after the crises that beset the region in the late 1990s and at the beginning of the current decade, along with progress in macroeconomic governance, is still far from reversing the trend that has been underway for the past twenty years.

1.1 Main characteristics of regional macroeconomic development

Over the very long term, the Latin American and Caribbean region exhibited a respectable pace of growth; between 1960 and 2004, regional GDP increased five-fold, rising higher than that of the United States during the same period (Graph 1).

Graph 1
Latin America and the Caribbean: economic growth compared to other countries and regions
(1960-2004, index 100 = 1960)
However, this overall result is highly influenced by the performance registered in the 1960s and 1970s when, within the framework of the former import substitution and semi-closed economy “model”, the region’s GDP grew at an annual rate of 5.5 percent. In fact, if only the performance of the last 25 years is taken into account, regional growth, as is well known, is believed to have been extremely poor. The average annual GDP growth of Latin America and the Caribbean between 1980 and 2005, which barely rose above 2 percent, is not only far below that of China, the other rapidly developing Asian countries and India, but also lower than that of the United States, meaning that there has been no “catch-up” in the last 25 years. Among the large developing countries, only South Africa exhibits a performance similar to that of Latin America and the Caribbean.

Graph 2
Latin America and the Caribbean: economic growth compared to other countries and regions
(1980-2004, index 100 = 1980)

This poor performance in economic growth may be linked to weak investment and low productivity. The investment rate, which stood at around 25 percent of GDP in the second half of the 1970s, fell sharply during the 1980s and, during the 1990-2004 period, exceeded 22 percent of GDP only in 1997. As for total productivity of the factors, the growth rate fell slightly in the 1990s (1.6 percent), compared to the 1950-1980 period (2 percent)\(^3\), which was not enough narrow the gap between the region and the developed countries. In addition, a high percentage of the recovery registered in the 1990s may be ascribed to the reactivation produced following the deep recession of the 1980s.

\(^3\) According to the eight-year estimate for the region, conducted by Hofman, André, Growth and productivity in Latina America. A long-term comparative view, (LC/R. 1947), Santiago de Chile, ECLAC, December 1999 and updated by Ocampo, José Antonio, Reynaldo Bajrac and Juan Martín (coordinators), in A Decade of Light and Shade. Latin America and the Caribbean in the 1990s, ECLAC, Santiago de Chile, 2001.
Besides being meagre, regional growth is extremely volatile, and was particularly so in the 1980s and, most recently, during the 2000-2004 period (Chart 1). Indeed, the volatility of growth in Latin America and the Caribbean is, in many cases, lower than that of other developing countries and regions. Nevertheless, these regions, in most cases, are marked by higher levels of economic dynamism. As shown in chart 1, volatility in Latin American and the Caribbean is difficult to control because of a high frequency of years of negative growth or of less than 1 percent growth.

Chart 1

Latin America and the Caribbean and other countries and regions: compared volatility (in percentage points of GDP and in number of years)

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
<th>South Africa</th>
<th>India</th>
<th>NPI Asia</th>
<th>NPI2 Asia</th>
<th>China</th>
<th>World</th>
<th>Lat. Am. &amp; Car</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard deviation</td>
<td>2.0</td>
<td>3.6</td>
<td>3.0</td>
<td>3.1</td>
<td>3.0</td>
<td>7.7</td>
<td>1.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>1.8</td>
<td>2.3</td>
<td>3.3</td>
<td>2.0</td>
<td>0.8</td>
<td>14.9</td>
<td>0.8</td>
<td>1.9</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>2.7</td>
<td>4.4</td>
<td>4.3</td>
<td>3.2</td>
<td>1.9</td>
<td>3.8</td>
<td>1.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>2.3</td>
<td>4.1</td>
<td>1.8</td>
<td>2.3</td>
<td>3.6</td>
<td>3.9</td>
<td>1.3</td>
<td>2.6</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>1.4</td>
<td>2.1</td>
<td>2.1</td>
<td>3.2</td>
<td>4.6</td>
<td>2.5</td>
<td>0.9</td>
<td>1.5</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>1.8</td>
<td>0.4</td>
<td>0.6</td>
<td>1.8</td>
<td>1.5</td>
<td>0.3</td>
<td>0.7</td>
<td>2.7</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>1.9</td>
<td>3.2</td>
<td>1.7</td>
<td>3.1</td>
<td>3.6</td>
<td>3.0</td>
<td>1.1</td>
<td>2.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
<th>South Africa</th>
<th>India</th>
<th>NPI Asia</th>
<th>NPI2 Asia</th>
<th>China</th>
<th>World</th>
<th>Lat. Am. &amp; Car</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequency of years of negative growth: 1961-2004</td>
<td>5</td>
<td>9</td>
<td>4</td>
<td>1</td>
<td>2</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Frequency of years of less than 1% growth: 1961-2004</td>
<td>7</td>
<td>11</td>
<td>5</td>
<td>1</td>
<td>2</td>
<td>5</td>
<td>1</td>
<td>8</td>
</tr>
<tr>
<td>Frequency of years of negative growth: 1980-2004</td>
<td>3</td>
<td>6</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Frequency of years of less than 1% growth: 1980-2004</td>
<td>4</td>
<td>8</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>0</td>
<td>1</td>
<td>8</td>
</tr>
</tbody>
</table>

Source: Personally drawn up with ECLAC and Datastream data.

Another distinctive feature of the macroeconomic situation of Latin America and the Caribbean has long been high inflation accompanied by the significant acceleration associated with different processes of hyperinflation – or very high inflation - in the 1980s and early 1990 (Graph 3). Inflation, which stood at an annual average of 35 percent during the 1950-1980 period, sped up during the 1980s (at an annual average of over 400 percent) and part of the 1990 (at an annual average of over 100 percent from 1990 to 1997) 4.

However, the stabilization policies linked to an exchange rate, which appreciated in real terms, and implemented as of the late 1980s led to a significant slowdown in inflation from the mid-1990 (Graph 4). However, this trend did not remain undisturbed for long, given the inflationary pressures arising from the devaluations caused by the serious monetary crises at the ends of the 1990s and beginning of the current decade.

Together with reduced inflation, another major milestone of the last decade, from the standpoint of macroeconomic management, is the decrease in public deficits (Graph 5) while, in recent years, several countries in the region have achieved unprecedented primary surplus levels.

Thanks to this fiscal performance, the public debt/GDP ratio continued to shrink below the 50 percent level in 20045. All in all, this ratio is still high when compared to that of other

4 According to ECLAC data.

5 For the region as a whole, at the level of the public sector and on the basis of the weighted average, this ratio fell from 51 percent to 46.6 percent of GDP, according to ECLAC’s Preliminary balance of the economies of Latin America and the Caribbean 2004, Santiago de Chile, 2004.
developing regions: the public debt/GDP ratio stands at around 35 percent and at 25 percent with regard to the countries of Southeast Asia and of Africa, respectively⁶.

Graph 3
Latin America and the Caribbean: Inflation (1970-2004, in percentage terms)

Graph 4
Latin America and the Caribbean: Inflation (1995-2005, in percentages)

⁶ According to Datastream data.
1.2 Regional cycles and external financial flows

The fiscal progress made in fiscal management and in the struggle against inflation has been coupled with more dynamic growth linked to significant rises in national savings and in domestic investment. Thus, growth has been heavily dependent on access to external capital flows.

In actuality, the terms of trade and trade cycles naturally exert strong influence on the fluctuations experienced by the economies in the region, but financial flows have played a key role in determining the region’s economic cycle (Graph 6). Over the last 25 years, the only period in which the region witnessed higher growth than that of developed countries was between 1991 and 1997. Precisely during this period, there was a massive entry of external capital - with the most volatile flows linked to portfolio investments and with issue of debentures in international financial markets exercising considerable leverage. However, the Asian and Russian crises of 1997-1998, which were later accompanied by monetary and financial crises in a large number of Latin American countries, including Argentina, Brazil, Ecuador, and Uruguay, set off a period of contraction in external financial flows that precipitated a sharp slowdown in regional growth. Between 1998 and 2003, the period considered as the “new lost half-decade”, the region experienced average growth of just 1.5 percent. This figure represented a setback in per capita income in contrast with the average growth of over 3.5 percent of GDP registered annually during the 1991-1997 period.

Exposure to volatility and the transmission associated with the instability of “market financing” have become the main sources of external vulnerability for the region’s economies. Indeed, the risk premium of sovereign bonds, which reflects the general perception of financial agents as to the ability of the countries to fulfil their obligations, has become one of the major costs in macroeconomic terms.

---

7 ECLAC, Productive development in open economies (LC/G.2234 (SES.30/3), San Juan, Puerto Rico, 28 June - 2 July 2004.)
However, the novel development that occurred in 2004 is noteworthy. In this respect, economic growth took place side by side with negative net capital flows (Graph 6), which was matched by a substantial improvement in the current account balance of the region's balance of payments.

**Graph 6**

*Latin America and the Caribbean: Growth and net capital flow (1981-2004)*

*(in millions of dollars and in percentages)*

1.3 Economic dynamics and current account balances

The current phase of economic recovery in Latin America and the Caribbean (2003-2005) has been accompanied by the appearance of the existing current account surplus. Furthermore, this positive balance grew in 2004 – in relation to 2003 – in contrast with other similar phases of recovery in the recent past, as exemplified by the region’s ability to overcome the 1982-1983 and 1990-1991 recessions. These phases were marked by a sharp deterioration in current account balances and highlighted the classical “stop and go” phenomenon, whereby the recovery process inevitably led to a rapid deterioration of the external sector owing to a sharp rise in imports. Thus, if taken into account, the period running from the early 1980s to the present reveals that, of all the years in which relatively significant growth above 2 percent has actually taken place, only 1984 and the current triennium (2003, 2004 and 2005) show a current account surplus in the balance of payments (Graph 7).
With respect to the current phase of recovery and growth, the trade balance surpluses are largely responsible for the high levels of current account surplus. The recent dramatic world growth, particularly in the United States and China, the high costs of raw materials, which have led to considerable improvements in the region’s terms of trade, as well as the positive effects on competitiveness, produced at the beginning of the current decade by the depreciation in the real exchange rates of many countries in the region – primarily in South America - have been combined to produce a sharp rise in regional exports.

Graph 7  
Latin America and the Caribbean: Growth and current account balance  
(1981-2005)

Current account transfers have also played an important role in creating this current account surplus. This item consists mainly of migrant remittances, which climbed from a little under 30 billion dollars in 2002 to over 40 billion in 2004. Remittances make it possible to partially compensate for "structural" loss-making items in the current account balance, namely the real services account - which includes tourism and trade-related services - and net interest and dividend payments.

The recent performance of the region with regard to the growth and development of the external sector - negative net financial flows and surplus current account balances tied to a phase of economic boom – evidently does not mean that the dependence of Latin America and the Caribbean on external capital has come to an end. On one hand, the current account surplus is, at least, partially due to cyclical factors, such as the high price of, and strong demand for most of the raw materials of which the region is a net exporter. On the other hand, however, savings and domestic investment rates continue to be too
low to ensure sustained economic growth. Nevertheless, with respect to growth, the performance of the external sector allows for further progress in reducing the burden of the foreign debt. For example, the relationship between total gross external debt and exports fell from 200 percent in 1999 to around 140 percent in 2004, a trend that lessens the region’s vulnerability to external financial shocks.

1.4 Policies implemented: recent development

Following the foreign debt crisis in the early 1980s, which indisputably brought the era of import substitution and of semi-closed economies to a close, Latin America and the Caribbean proceeded to adopt a new development paradigm. Under the influence of the so-called “Washington Consensus”, the region embraced the promise and prospects of economic liberalization. Thus, in order to promote the emergence of more competitive economies to safeguard the external financial viability of the region, the Latin American and Caribbean countries decisively embarked on the path of structural and institutional reforms.

These reforms, which were undertaken throughout the region in the 1990s, led to a far-reaching process of commercial opening-up and of internal and external financial liberalization. This process was involved with the general folding of the state in many countries as a result of the mass privatizations undertaken. Nevertheless, the scant results obtained in terms of growth, together with the persistent financial vulnerability, have generated some frustration in relation to the liberalizing reforms and have opened up a debate as to the course that should be pursued. At the same time, however, detailed analysis will demonstrate that there are differences among the countries in terms of the scope, depth and pace of the reforms undertaken and that any attempt to get precise feedback on the outcome of the reforms or to propose a new development agenda for the region is will be met with a cleavage of views. What seems to be a general consensus on the need for a more balanced relationship between “state” and “market” after the “excesses of liberalism” in the 90, for increasingly stronger institution and for an improvement in the quality of public policies, actually conceals major differences with regard to the precise meaning of these issues, regardless of the fact that the cleavages seem more explicit when discussions are conducted on the importance of implementing active policies or on the precise way of protecting the economies from global financial instability.

Even so, one topic that has secured broad consensus is that of the need for wise macroeconomic management, as can be seen whenever a review is conducted of the performance of most of the countries in the region in the areas of fiscal policy and monetary and exchange policies.

1.4.1 Fiscal policy

As was seen, one of the most salient stylized facts of the last decade, from the standpoint of the region’s macroeconomic performance, is the reduction in public deficits (cf. Graph 5).

---

8 In this respect, see Kuczynski, Pedro Pablo and John Williamson (eds), After the Washington Consensus: Restarting Growth and Reform in Latin America, Washington Institute for International Economics, 2003, and French Davis, Ricardo, Macroeconomics, trade and finance to reform the reforms in Latin America, McGraw-Hill Interamericana, Santiago de Chile, 1999.
Various factors account for these results. First, in recent years, several countries in the region have achieved unprecedented levels of primary surplus while striving to increase fiscal pressure which, accordingly, has increased gradually since the early 1990s. Second, many countries in the region have clearly made major advances in developing a practice of "wise fiscal management." In many cases, such advances are demonstrated in terms of moderate increases in public spending, even during periods of vigorous economic growth, as was registered in 2004. Another sign of greater caution in the management of public finances is the spread of stabilization and savings funds used by many countries to administer the increased fiscal revenues obtained from the rise in the prices of raw materials which has taken place in recent years.

Nonetheless, it is still too soon to believe that the recent trend represents a reversal of one the core features of fiscal policy when its behaviour, that is its procyclicality, is analyzed in the long term. Broadly speaking, however, fiscal policy has acted procyclically, by serving as a soundbox for the fluctuations of private spending, and has failed to ensure macroeconomic stabilization.

1.4.2 Monetary policy and exchange regimes

As reduced inflation gradually became one of the main objectives of the economic policy implemented by Latin American and Caribbean countries, monetary and exchange policies have been geared toward the achievement of this objective.

During much of the 1990s, the consolidation of the nominal exchange rate, in line with intermediate exchange-rate regimes or on the basis of a relatively strict rate setting system, represented a decisive dimension of the policies to be used in the battle against inflation. Nevertheless, in many cases, the actual appreciation of national currencies, which took place during this period as a result of a massive inflow of capital, was one of the factors leading to the vulnerability of the countries in the region which, in the wake of the Asian and Russian crises, found it highly difficult to keep their exchange regimes in place. The serious monetary and financial crises of the late 1990s and at the start of the current decade led many countries to adopt the so-called "corner solutions" and, above all, flexible regimes (Chart 2).

\[9\] Even though the relationship between the tax income of the central government and GDP has exhibited an upward trend since the beginning of the last decade, regionally it is still below 20 percent and exhibits shows enormous disparities according to the countries of the region.

\[10\] See ILPES, Panorama of public administration (LC/IP/L. 243), Santiago de Chile, 2004.

\[11\] As seen in ECLAC, op. cit. (Productive development of open economies).
Chart 2

**Latin America and the Caribbean: Development of exchange regimes between 1996 and 2004**

<table>
<thead>
<tr>
<th>Regime</th>
<th>1996</th>
<th>2000</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dollarisation</td>
<td>Panama</td>
<td>Panama Ecuador</td>
<td>Panama Ecuador El Salvador</td>
</tr>
<tr>
<td>Governmental foreign</td>
<td>Argentina</td>
<td>Argentina</td>
<td></td>
</tr>
<tr>
<td>exchange</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed parity</td>
<td>El Salvador</td>
<td>El Salvador</td>
<td>Venezuela (Bolivarian</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Republic)</td>
</tr>
<tr>
<td>Sliding parity</td>
<td>Bolivia</td>
<td>Bolivia</td>
<td>Bolivia</td>
</tr>
<tr>
<td></td>
<td>Costa Rica</td>
<td>Costa Rica</td>
<td>Costa Rica</td>
</tr>
<tr>
<td></td>
<td>Nicaragua</td>
<td>Nicaragua</td>
<td>Nicaragua</td>
</tr>
<tr>
<td>Mobile bands</td>
<td>Brazil</td>
<td>Honduras</td>
<td>Honduras</td>
</tr>
<tr>
<td></td>
<td>Colombia</td>
<td>Uruguay</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Chile</td>
<td>Venezuela</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ecuador</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Honduras</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Uruguay</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Venezuela</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flexible</td>
<td>Guatemala</td>
<td>Brazil</td>
<td>Argentina</td>
</tr>
<tr>
<td></td>
<td>Mexico</td>
<td>Chile</td>
<td>Brazil</td>
</tr>
<tr>
<td></td>
<td>Paraguay</td>
<td>Colombia</td>
<td>Chile</td>
</tr>
<tr>
<td></td>
<td>Peru</td>
<td>Guatemala</td>
<td>Colombia</td>
</tr>
<tr>
<td></td>
<td>Dominican Republic</td>
<td>Mexico</td>
<td>Guatemala</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Paraguay</td>
<td>Mexico</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Peru</td>
<td>Paraguay</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Dominican Republic</td>
<td>Peru</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Dominican Republic</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: ECLAC (Information presented in different editions of the Preliminary Balance).

Meanwhile, as can be seen in this chart, there are currently different exchange regimes in place in each subregional integration grouping, except in the case of MERCOSUR which exhibits a process of convergence that is, nevertheless, incomplete. In the CACM, we have the case of El Salvador, with its dollarisation regime, while Guatemala, for instance, possesses a flexible exchange regime. For its part, the CAN includes Ecuador, with its dollarisation regime, Venezuela, which is governed by a fixed exchange rate, and other countries, which have more flexible regimes in place. CARICOM is also characterized by a variety of exchange regimes (Chart 3).
# Chart 3

**Exchange regimes in CARICOM (2004)**

<table>
<thead>
<tr>
<th>Exchange Regime</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governmental exchange</td>
<td>Antigua and Barbuda</td>
</tr>
<tr>
<td></td>
<td>Dominica</td>
</tr>
<tr>
<td></td>
<td>Grenada</td>
</tr>
<tr>
<td></td>
<td>St. Kitts and Nevis</td>
</tr>
<tr>
<td></td>
<td>St. Lucia</td>
</tr>
<tr>
<td></td>
<td>St. Vincent and the Grenadines</td>
</tr>
<tr>
<td>Fixed parity</td>
<td>Bahamas</td>
</tr>
<tr>
<td></td>
<td>Barbados</td>
</tr>
<tr>
<td></td>
<td>Belize</td>
</tr>
<tr>
<td></td>
<td>Suriname</td>
</tr>
<tr>
<td>Flexible</td>
<td>Guyana</td>
</tr>
<tr>
<td></td>
<td>Haiti</td>
</tr>
<tr>
<td></td>
<td>Jamaica</td>
</tr>
<tr>
<td></td>
<td>Trinidad and Tobago</td>
</tr>
</tbody>
</table>

Source: IMF data.

Together with the adoption of flexible regimes towards the end of the 1990s, the evolution of the real exchange rate for the region as a whole also reflects a trend towards depreciation between 1998 and 1999, which stands in contrast to the trend towards appreciation, prevailing up until 1998. It later shows a trend towards stabilization, lasting until 2002. This phase, however, was followed by another highly pronounced depreciation which gave way to a new stabilization phase in 2004\(^{12}\). As we will see, this overall evolution is the result of the specific performance of the different subregional integration groupings.

Most recently, a large number of the countries in the region have therefore adopted flexible exchange regimes and, in view of this, monetary policies have been geared towards inflation control through the implementation of inflation goal regimes (Chart 4). These regimes have nominally become the lifeline of the economies.

Indeed, from this perspective, the main tool of the monetary policy is the interest rate. In this sense, the management of the referential interest rate will impact on the growth of inflation, on the exchange rate and on the credit cost and will thereby affect the demand for money. Thus, controlling inflation to boost economic growth may prove to be a costly enterprise.

Furthermore, managing an inflation goal regime may prove to be more problematic to the countries with big public debts that are largely indexed to the referential interest rate. The most salient example of these countries is Brazil.

---

\(^{12}\) As a result of this evolution in the effective real interest rate of Latin America was equivalent to 117.5 in 2004 against 98.3 in 1998 (2000=100), which means a significant real depreciation. (ECLAC, op. cit., Preliminary balance …).
Whatever the case may be, the stabilization of internal prices has been a major achievement in recent years, in spite of the inflationary pressure caused by the sharp devaluations in the wake of the crises. The monetary and exchange regimes in force in the region have made a significant contribution toward this objective, but many problems persists, for example the difficulty of dealing with the volatility of external capital flows.

Chart 4
Monetary policy in Latin America (selected countries)

<table>
<thead>
<tr>
<th>Country</th>
<th>Situation</th>
<th>Instrument</th>
<th>Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Monetary growth objectives</td>
<td>Monetary base increased by quasi-currencies</td>
<td>4%-7% Inflation (2004)</td>
</tr>
<tr>
<td>Brazil</td>
<td>Inflation goal regime in force</td>
<td>Monetary policy rate (SELIC)</td>
<td>5.5% inflation (deviation of +- 2.5%) (2004)</td>
</tr>
<tr>
<td>Chile</td>
<td>Inflation goal regime in force</td>
<td>Monetary policy rate</td>
<td>2%-4% inflation in the centre of the band (2003)</td>
</tr>
<tr>
<td>Colombia</td>
<td>Inflation goal regime in force</td>
<td>Monetary policy rate</td>
<td>5.5% inflation (2003)</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>Mobile parity has increased dollarisation and has led to a loss in competitiveness</td>
<td>Introduce an inflation goal regime</td>
<td></td>
</tr>
<tr>
<td>Guatemala</td>
<td>Inflation goal regime in force</td>
<td>Monetary policy rate</td>
<td>The country will strive to use an objective interest rate (increased transparency)</td>
</tr>
<tr>
<td>Mexico</td>
<td>Inflation goal regime in force</td>
<td>Short</td>
<td>2.5% +-1.5% inflation</td>
</tr>
<tr>
<td>Paraguay</td>
<td>Intention of adopting a monetary policy based on controlling aggregates</td>
<td>Monetary base</td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>Inflation goal regime in force</td>
<td>Monetary base</td>
<td></td>
</tr>
<tr>
<td>Uruguay</td>
<td>Development towards an inflation goal system. Currently has monetary growth objectives</td>
<td>Monetary base</td>
<td></td>
</tr>
</tbody>
</table>

Source: Prepared with the use of ECLAC data, op. cit. (Productive development ...)

2. Macroeconomic dynamics and regional integration

2.1 Subregional macroeconomic development: main stylized facts

2.1.1 Growth, inflation and real exchange rate

A study of the performance of the different subregional groups reveals that, with respect to macroeconomic behaviour, none of these groups has remained unaffected by the regional trend. Thus, the four groupings surveyed were hit by recession in the 1980s, particularly during the first half of this decade and, in spite of the recovery which took place during the 1990s, the overall performance during the last 25 years has been poor (Graph 8).

Nevertheless, as may be seen in Graph 8, the most dynamic subregion is the CACM, whose average annual growth rate of 2.6 percent between 1980 and 2004 surpassed the average 2.3 percent achieved by the entire Latin America and Caribbean region. At the same time, the average growth rate of the CAN was equivalent to the regional average, while MERCOSUR –alone or including Chile - and CARICOM have been characterized by very scant GDP growth. MERCOSUR's annual average growth rate for this period stood at 2 to 2.1 percent – if we include Chile – while that of CARICOM was equivalent to 1.5 percent.

However, a study of the performance of these groups, with regard to inflation, reveals more pronounced differences. Indeed, as shown in Graph 9, the trend towards rising inflation has been underway since the 1970s, and all the subregional groups
witnessed an extremely rapid rise in prices during the 1980s. Yet MERCOSUR and, to a lesser degree, the CAN, have clearly been the least virtuous regions in this regard, with respect to prices levels to their ability to withstand inflationary trends. In fact, with regard to MERCOSUR, inflationary pressures tended to be extremely strong well into the 1990s, with inflation standing at three or four digits throughout the 1982 to 1994 period. For their part, CAN countries went through this kind of situation on five occasions during this sub-period.

Graph 8:
Growth of the different subregional integration groups
(1980-2004, 1980 = 100)
While the CACM does exhibit six years of triple-digit inflation, this loss of control in the movement of internal prices was more concentrated during the 1986-1991 period and was highly influenced by the hyperinflation experienced by Nicaragua. Meanwhile, although CARICOM experienced a rapid rise in inflation during the first half of the 1980s and the early 1990s, inflation levels were systematically lower than those of the other subregions. Of the entire period analyzed, the year which exhibits the highest inflation is 1992, when inflation stood at 28.1 percent.

It should be stressed that, in the long term, numerous countries in the region, regardless of their size or of whether they belonged to regional integration groups (Graph 10) were affected by the different phases of inflation. The countries most hard hit were Argentina and Brazil in MERCOSUR, Peru and Bolivia in the CAN, Nicaragua in the CACM and Suriname in the case of CARICOM. At the same time, the countries that were most successful in bringing inflation under control included members of all the subregional integration groups (Graph 11), such as Paraguay in MERCOSUR, Colombia in the CAN, Guatemala and El Salvador in the CACM, and Bahamas and Trinidad and Tobago in CARICOM.
Graph 10
Inflationary countries during the 1970-2004 period
(in percentages, annual variation)

Graph 11:
Less inflationary countries during the 1970-2004 period
(in percentages, annual variation)

*Fuente: CEPAL*
Recent behaviour of inflation control has pointed to a clear downward trend over the last ten years, although this trend was partially interrupted in the late 1990s and at the beginning of the present decade, above all in MERCOSUR (Graph 12). Yet, in line with this downward trend, which has been observed in the entire region in recent years during which inflation, as measured by the consumer price index, fell from 12.2 percent in 2002, to 8.5 percent in 2003 and to a further 7.7 percent in 2004, MERCOSUR has managed to curb the inflationary pressures unleashed in 2001-2002. Added to this is the fact that inflation has continued to decline in CAN, in spite of a rebound in 2003. However, while the CACM and CARICOM exhibit relatively low levels in relation to the historical parameters of the region, they have not been able to consolidate this downward inflationary trend.

A more in-depth analysis of the situation in MERCOSUR (Graph 13) shows that the reversal, at the beginning of the present decade, of the disinflation process registered in the second half of the 1990s was short-lived. Thus, the situation of MERCOSUR’s two major economies, namely Brazil and Argentina, which posted above-double digit inflation rates in 2002 (12.5 percent and 41 percent, respectively), has not been brought under control which, if the performance of the last ten years is carefully analyzed, is linked to a process of clear convergence. However, a rebound of this level of inflation may be perceived in 2005, especially in Argentina where inflation is expected to top 10 percent.

Graph 12
Inflation in the different regional integration groups (in percentages, 1995-2004)

\[\text{SOURCE: CEPAL, EIU}\]

\(^{13}\) ECLAC, op.cit, (Preliminary balance …)
In the case of the CAN, the downward inflation trend has been more noticeable than in the rest of Latin America and the Caribbean in recent years (cf Graph 12). However, this region is marked by a high level of dispersion caused particularly by the performance of Venezuela, which registered a significant increase in prices in 2002 and 2003 (and inflations rates of 22.4 percent and 31.1 percent, respectively) (Graph 14). Inflation is on the decline in Venezuela but, given the near-20 percent level registered in 2004, Venezuela stands in sharp contrast to Ecuador which, after the astronomical levels reached in 1999 and 2000, succeeded in significantly diminishing inflation to levels below 2 percent in 2004, the lowest rate registered in the Latin American and Caribbean region.

Graph 13
Inflation in MERCOSUR member countries
(in percentages, 1995-2005)

It should be pointed out that the advances made in inflation control have apparently enabled three countries in the subregion, namely Bolivia, Ecuador and Peru, to have maintained inflation levels at below 5 percent for an extended period of time, and three of them to fulfil the objectives set in 2004. The latter three include Ecuador, which made good on the objective envisaged in its economic program, and Colombia and Peru, both of which achieved the objectives set in their inflation goal regimes\textsuperscript{14}.

In the case of the CACM, the performance in inflation control is, as we have seen, relatively virtuous from the viewpoint of the regional parameters. Thus, the CACM stands out because, unlike the other subregions, it has exhibited single-digit inflation since 1998. However, over the last two years, it has failed to consolidate the downward trend. This is largely due to the rise in global prices, which have adversely affected the Central American countries, especially because of their dependence on imports of oil and other raw material.

Within this general framework, the dispersion of the inflation rates of the CACM countries\textsuperscript{15} is lower than that of CAN countries. Inflation in El Salvador, the most virtuous country, which also registered a slight rise in inflation in 2004, has hovered at around 2 percent in recent years while, at the other extreme is Costa Rica, whose inflation stands at approximately 10 percent. Of course, the level of dispersion rises substantially if the analysis includes the Dominican Republic which, owing to the banking and exchange crisis of 2003, has shown a sharp rise in inflation in recent years. This situation was again brought under control in 2005 (Graph 15).

\textsuperscript{15} These include the Dominican Republic, which is associated member of the CACM. Although it is not a member of the CACM, the Dominican Republic enjoys member status on the Monetary Committee (See 2.3. of the second part).
Graph 15
Inflation in CACM member countries
(in percentages, 1995-2005)

With regard to CARICOM (Graph 16), regional inflation has been affected by the rise in raw materials imported by numerous countries of the region. Otherwise, performance in inflation control has been quite varied between, on the one hand, Barbados and Bahamas, which are engaged almost exclusively in tourism and in other service sectors and which exhibit low inflation rates, and the larger countries which, like Trinidad and Tobago and mainly Jamaica show higher rates. The case of Haiti, which exhibits extremely high inflation rates – 40 percent and 22 percent in 2003 and 2004, respectively – is an exceptional one, since Haiti is a country that is marked by a serious and persistent social and political upheaval.

Another stylized fact is the one relating to the experience of each regional integration group in the area of effective real exchange rate (Graph 17).

The group that has been marked by the greatest volatility in recent years is MERCOSUR. This volatility has been coupled with sharp fluctuation and, particularly, with a strong depreciation, especially at the beginning of the present decade, which was followed by a significant effective real appreciation in 2003 and 2004. This same trend, though less severe, may be observed in the case of the CAN. It should also be added that, unlike the CAN, MERCOSUR currently exhibits a far more depreciated effective real exchange rate than the average registered in the 1990s.
Graph 16
Inflation in CARICOM member countries
(in percentages, 1995-2005)

However, with respect to both the CACM and CARICOM, which in recent years have shown a high degree of stability, compared with the CAN and MERCOSUR, the effective real exchange rate stands below the average of 1990s. In the case of several countries belonging to these subregional groups, the high and increasing revenues from migrant remittances may be one of the factors accounting for this real appreciation in their national currencies.
Beyond these developments surrounding the effective real exchange rate of each subregional group, real bilateral exchange rates within each group are marked by a high level of variability which affects the integration processes not only because of the likely impact of these rates on commercial flows but also because of their repercussions on the strategic performance of different sectors and interest groups.\(^{16}\)

This variability is clearly illustrated by the development of a bilateral exchange rate between Argentina and Brazil and between Venezuela and Colombia (Graph 18) which, in context of MERCOSUR and the CAN, respectively, are engaged in vigorous trade.

As can be seen, Argentina’s real bilateral exchange rate is marked by sharp fluctuations, particularly the abrupt swings occurring in the early 1999 with the appreciation of the Argentinean peso in the wake of the Brazilian crisis and the devaluation of the real, and in early 2002 with the depreciation of the peso after convertibility was brought to an end in Argentina. In spite of the absence of major crises and upheavals in the last two and a half years, the implementation of different monetary and exchange policies in MERCOSUR’s two main partners has, since April 2003, led to a real depreciation of the Argentinean peso by over 30 percent against the Brazilian currency.

As can be seen in Graph 18, the fluctuations are also significant in the case of real bilateral parity between Venezuela and Colombia. It is interesting to note that, despite the successive devaluations which the bolivar has undergone in recent years and the recent

appreciation of the Colombian peso, the Venezuelan currency seems to have appreciated in historical terms, with respect to that of the country’s main trading partner in the CAN.

Graph 18
Real bilateral exchange rate: Argentina-Brazil and Venezuela-Colombia (indexes, 100 = January 1995, 1995-2005)

Source: Datastream

2.1.2 Fiscal position and public indebtedness

With regard to the situation surrounding public finances within the general context of budgetary deficit reduction in the region, the most remarkable development is MERCOSUR’s success at significantly curbing this situation. Indeed, this regional grouping, which, in the late 1990s, showed the highest public deficits in the region, achieved the best results in this regard in 2004 (Graph 19). These results, which should be tested in 2005, are due mainly to the favourable performance of Brazil and Argentina in recent years (Graph 20) in terms of strong growth, particularly in the case of Argentina. The issue at this point is to test these advances by reducing dependency on “transitory” taxes and by improving the quality of budget institutions\(^\text{17}\).

The CAN is also benefiting from the regional trend towards decreased fiscal deficit (Graph). Nevertheless, the challenge of ensuring fiscal sustainability continues to be daunting. This mainly involves reducing the high procyclicality of public finances in the Andean countries, where fiscal policy appears as a domestic factor that has contributed to expanding external shocks. The procyclicality of fiscal policies is less marked in

\(^{17}\) For a presentation of the factors to be considered for building of a quality index of these institutions, see Alesina, Alberto, Rudolf Hommes, Ricardo Hausmann and Ernesto Stein, *Budget institutions and Fiscal Performance in Latin America*, BID, Working Paper N° 394, Washington D. C., 1999.
Colombia and Peru, but has proven to be particularly considerable in the oil countries, namely Venezuela and Ecuador\textsuperscript{18}.

As for the recent development in this respect, it should be noted that all the countries have contributed to the drop in overall deficit (Graph 21). The Andean countries, in particular, seem to have taken advantage of the growth achieved in 2004 - significant though lower than the regional average - to improve their public finance positions. However, it should also be observed that, with regard to Venezuela, which is characterized by a strong rise in economic activity and in fiscal revenues, this is not fully reflected in the fiscal balance owing to the expansive policies being applied.

That said, despite the gains made in 2002, Bolivia continues to be characterized by a delicate fiscal position, associated with extremely high levels of public indebtedness, in spite of the different initiatives undertaken to help this country to relieve its debt burden.

Graph 19
Fiscal balance of the different regional integration groups
(in percentages of GDP, 1995-2004)

\textsuperscript{18} Jaramillo, Fidel, Miguel Castilla and Osmel Manzano (Editores), \textit{Fiscal Sustainability in the Andean Region. Policies and institutions} Andean Development Corporation, Caracas, 2004.
Meeting on the “Macroeconomic Dynamics of Latin America and the Caribbean and Regional Integration”

Graph 20
Fiscal balance of MERCOSUR member countries (in percentage of GDP, 1995-2005)

Graph 21
Fiscal balance of CAN member countries (in percentages of GDP, 1995-2005)

Against this backdrop of moderate decrease in regional deficit in 2004, and of highly stable performance over the last ten years (Graph 19), the CACM, which is characterized by very low tax pressure, shows extremely different national situations (Graph 22).
“best students” in this respect, which include El Salvador and, to a lesser extent, Guatemala, have applied corrective measures to improve their situation following the deterioration in public accounts in 2003. In an intermediate position is Honduras, which lowered its own deficit on the basis of the fiscal adjustment programme underway, and Costa Rica. Nicaragua, the least virtuous country with regard to public finances and the one exhibiting the worst indicators of public indebtedness, has however been making considerable progress in recent years. This progress may be strengthened by the relief to be gained from the cancellation of a portion of its public debt, an opportunity that is due to the approval granted in 2004 for Nicaragua’s entry into the “Heavily Indebted Poor Countries Initiative.” For its part, the Dominican Republic, on the one hand, clearly shows signs for correction of associated fiscal imbalances in deterioration of the macroeconomic situation which led to the crisis in the year 2003.

Graph 22
Fiscal balance of CACM member countries
(in percentages of GDP, 1995-2005)

For its part, CARICOM, in 2004, witnessed an improvement (Graph 19) following the deterioration in its overall fiscal balance at the beginning of the current decade. All in all, the situation in this respect continues to be delicate owing to the abundant weaknesses of the countries belonging to this regional grouping, where direct taxation is weak while sales taxes or value added taxes need to be further developed. At the same time, adjustment margins are very low owing to the rigidity of expenses in most of the micro-states belong to CARICOM and, furthermore, the scheme’s fiscal situation is repeatedly affected by the natural disasters plaguing the region. Internationally, this trend is definitely less favourable to the raw material-dependent Caribbean countries than to the other countries in the region. Trinidad and Tobago finds itself in a more relaxed position, thanks to the importance of its energy sector (Graph 23).
The burden of public indebtedness has led to the need to consolidate fiscal sustainability in all the regional groups. Even though the different regional subgroups are benefiting from the trend towards the decrease in the relative burden of public indebtedness which, as we have already seen, is taking place throughout the region - except in CARICOM\(^1\) - the public debt-GDP ratio, which is calculated as the simple average of the membership of each subregional group or as an average weighted on the basis of the GDP of each member, produces extremely high results in all cases (Graph 24). Nevertheless, the public debt burden, even after the swap – which involved a strong deduction – that was conducted by Argentina following the default decided upon towards the end of 2001, is very high in the case of MERCOSUR. Yet, relatively speaking, the situation is less worrisome in the case of the CACM, especially if the calculation includes the Dominican Republic which, together with Guatemala, is the least indebted country in this subregional group.

---

\(^{1}\) In the case of the 14 member countries of CARICOM (all the members with the exception of Montserrat) according to data and estimates presented by Sahay, Ratna, *Stabilization, Debt, and Fiscal Policy in the Caribbean*, International Monetary Fund, Washington DC., June 2004, the Total Public Debt – GDP ratio (based on a simple average) jumped from 70 percent to 95 percent between 1997 and 2003.
Graph 24
Public debt / GDP ratio of MERCOSUR, the CAN, the CACM and CARICOM
(in percentages of GDP, 2004)1

1/ For Argentina, the Public Debt / GDP ratio was considered after the swap and restructuring conducted during the first semester of 2005. For CARICOM, the data relates to 2003.

Source: ECLAC, Datastream and estimates from Sahay, Ratna, op. cit.

2.2 Analysis of commercial and financial interdependence

With respect to growing internationalization, which is inherent in the globalization process, the levels of interdependence between the economies are also on the rise, not only in terms of the strengthening of commercial ties but also as a consequence of rising global financial integration.

Usually, two indicators are applied to measure the degree of commercial interdependence within a regional integration agreement. These include, on one hand, the proportion accounted for by intraregional trade in the overall external trade of the regional block and, on the other hand, the portion accounted for by intraregional trade in the GDP of each country and, consequently, in regional output. Interdependence therefore grows not only when the intra-regional trade segment of overall trade increases, but also when this is followed by a rise in the degree of economic openness, particularly the degree of openness in relation to intra-regional trade.

In the case of the countries of Latin America and the Caribbean, commercial interdependence has always been much lower than in the paradigmatic case of the European Union, which is characterized by an intraregional export versus total exports ratio of about 60 percent - even in the late 1980s, long before the consolidation of the monetary union - and by a total exports versus output ratio that, in the last fifteen years, has stood at over 15 percent of the GDP.

All in all, commercial interdependence in the Latin American and Caribbean region rose sharply during the 1990s, most specifically until 1997-1998, when the ratio of intraregional exports versus total exports20 peaked at 20 percent. This rise may be seen

in the different integration agreements (Chart 5). Between 1990 and 1998 the level of interdependence measured grew threefold or fourfold in the cases of MERCOSUR, the CAN and CARICOM, while the rise was more moderate in the case of the CACM, which, in 1990, was already showing a relatively high ratio of intraregional exports versus total exports, in relation to the regional parameters. Less affected by the crises of the beginning of the late 1990s and in the early part of the present decade, the CACM is the only subregional integration agreement in which the level of commercial interdependence has continued to rise during the current decade. Nonetheless, the other subregional groupings have witnessed a slight reduction in commercial interdependence. At any rate, in 2003 the percentage of intraregional trade rose above 1990 levels in all cases.

When intraregional exports are considered in terms of GDP (Chart 6), it will be seen that the rise in this ratio in the 1990s was counteracted by reduced dynamism in intraregional trade flows at the beginning of the current decade, so much so that the values definitely failed to increase in any substantial way between 1995 and 2003. The only case, in which the increase reached one point of regional GDP, during the period analyzed, is that of the CACM.

That said, with the regional economic reactivation of 2003-2004, intraregional trade has been given a major thrust. After the decline registered between the late 1990s and at the beginning of the current decade, the ratio between intraregional exports versus total exports of region as a whole reached 16 percent in 2004, thus highlighting the relative dynamism of intraregional trade among the Central American countries. Yet commercial interdependence continues to stand at relatively low levels.

### Chart 5

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>MERCOSUR</td>
<td>8.89%</td>
<td>20.50%</td>
<td>25.03%</td>
<td>11.99%</td>
</tr>
<tr>
<td>CAN</td>
<td>4.10%</td>
<td>12.12%</td>
<td>13.98%</td>
<td>6.10%</td>
</tr>
<tr>
<td>CACM</td>
<td>16.42%</td>
<td>20.73%</td>
<td>24.87%</td>
<td>26.35%</td>
</tr>
<tr>
<td>CARICOM</td>
<td>6.05%</td>
<td>12.35%</td>
<td>16.20%</td>
<td>14.92%</td>
</tr>
</tbody>
</table>

Source: IMF and Datastream.

---

Chart 6
Intraregional exports in percentages of GDP

<table>
<thead>
<tr>
<th></th>
<th>MERCOSUR</th>
<th>CAN</th>
<th>CACM</th>
<th>CARICOM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>1.5%</td>
<td>1.9%</td>
<td>3.5%</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>1.9%</td>
<td>1.9%</td>
<td>4.5%</td>
<td>6.0%</td>
</tr>
</tbody>
</table>

Source: IMF and Datastream

Nevertheless, as already pointed out, economic interdependence within the regional integration agreements is not channelled only through trade. The evidence contributed by different episodes of boom and crises that have occurred in recent years reveals that financial interdependence has grown as a result of the globalization of financial markets. Thus, a high level of interconnection may be observed between the financial markets of emerging countries, and this “contagion” is spreading among the different members of the same trade block through channels linked to the area of finance\(^{22}\).

Above all, as numerous studies have demonstrated, interdependence at the level of financial markets is dictated mainly by price variations rather than by changes in quantities\(^{23}\). In other terms, the “contagion” spreads less on the basis of substantial changes in capitals flows that on the basis of prices variations, particularly in terms of sovereign obligation spreads. REDIMA’s work in ECLAC has drawn attention to the relevance of interconnections of this kind\(^{24}\).

Indeed, the similarity observed in the way in which the spreads of the different Latin American countries have evolved quite independently of the basic macroeconomic situation, is a major sign of the effects of the basically financial exogenous shocks to which the region’s economies are exposed.

The evolution, over the past ten years, of the spreads of countries belonging to the different regional integration agreements is extremely illustrative. In the case of MERCOSUR, which shows the highest level of volatility in risk premiums, compared to the other integration groupings, all the crisis episodes (the Mexican crisis in late 1994, the 1997 Asian crisis, the 1998 Russian crisis and, of course, the 1999 Brazilian crisis…) have led to significant and widespread increase in the spreads (Graph 25).

\(^{22}\) Indeed, there are slight differences with regard to the assessment of the effects of this contagion among the members of a given integration agreement. Some authors do not think that, with respect to capital flows, “contagions” among emerging countries are influenced by membership in a given agreements. Other authors maintain that membership in a regional agreement increases the possibility of an exchange crisis if there is an exchange “gap” within the agreement (See Chapter 8 of the IADB, Inter-American Development Bank, Beyond Borders: The New Regionalism in Latin America, IPES 2002, Washington D.C., October 2002). For a truly exhaustive presentation on these debates, see Machinea, José Luis, op. cit.


\(^{24}\) See Escaith, Hubert, Christian Ghymers and Rogerio Studart, “Regional integration and the issue of choosing an appropriate exchange-rate regime in Latin America,” *Macroeconomics of development* series, Nº14 (LC/L.1732-P), Santiago de Chile, Economic Commission for Latin America and the Caribbean (ECLAC), August 2002, and Ghymers Christian, Fostering… op. cit.
More importantly, as can be seen in Graph 26, which shows the correlations and deviations of the spreads, it is logical to assume that when the deviation of the spreads diminishes (increases), the correlation of these spread rises (falls). Before 2001, the correlation was very high, at an average 0.88. Then, with the outbreak of the Argentinean crisis, the deviation of the spreads grew and the correlation fell. However, after the swap and restructuring of the Argentinean debt, the deviation of the spreads fell and the correlation rose again to high levels, but not to the levels registered during the 1994-2000 period. This could be interpreted as the persistency of the phenomena of contagion, coupled with a learning process for investors to enable them to identify different “risks” more effectively.

An analysis of the situation of MERCOSUR, with Chile included, does not reveal any substantial changes (Graphs 27 and 28): the trends are the same though less adverse.

Graph 25
Spreads of MERCOSUR countries (in base points, 1994-2005)

Source: Datastream.

---

25 With a 12-month delay given the calculation method chosen. In fact, it has been found that the ideal size of the mobile window for calculating correlation ratios is one year, because this method helps to prevent the these rations from being very volatile.

26 Contagion may be defined as a situation in which a crisis in one country raises the probability of a crisis in another country, once it has been economically brought under control. See Eichengreen, Barry, Andrew Rose and Charles Wyplosz, *Contagious Crises*, Working Paper 6370, NBER, Cambridge, MA, 1996.
Graph 26
Correlation of the evolution of spreads in MERCOSUR
(1994-2005)

Source: Datastream.

Graph 27
Spreads of MERCOSUR countries and Chile
(in base points, 1994-2005)

Source: Datastream.
Graph 28
Correlation of the evolution of spreads in MERCOSUR and Chile (1994-2005)

Source: Personally drawn up with Datastream data.

Because of the limited data available, it is not possible to make these calculations for CARICOM or for the CACM countries\(^\text{27}\). However, in the case of the CAN countries (Graphs 29 and 30), the pattern observed is similar to that of MERCOSUR, with lower spreads and, in general, less dispersion. The internal correlation is initially high, falling in 2000-2002 and registering sustained recovering since 2003. This is similar to the trends observed in case of MERCOSUR, but with a slighter adjustment in terms of the decline and recovery.

Graph 29
Spreads of CAN member countries (in base points, 1994-2005)

Source: Datastream.

\(^{27}\) In the case of this subregional integration agreement, there are adequate data only for two countries: El Salvador (only as of 2001) and the Dominican Republic.
Graph 30
Correlation of the evolution of spreads in the CAN (1994-2005)

Source: Personally drawn up with Datastream data.

2.3 Degree of synchronism in financial cycles and shocks

One major consequence of the increased or decreased level of economic interdependence among the members of an integration agreement is the impact of the costs and benefits of macroeconomic coordination and cooperation. As mentioned in the introduction of the study, the main cost, in the traditional approach to optimal monetary areas, lies in the loss of autonomy in economic policy to deal with the shocks that may affect the economy.

As is obvious, the higher the degree of interdependence, on the one hand, the more severely affected one country will be by whatever occurs in the others and, on the other, the more highly synchronized the cycles of the member countries of the block will be, in principle. Furthermore, as the growth of one partner exerts greater impact on another and as their respective situations become more similar or alike, the costs of coordination fall while the demand for regional economic cooperation rises.

However, it should be pointed out that greater commercial interdependence does not necessarily lead to increased levels of synchronism in the cycles among the countries in the same subregional group. This depends on the characteristics of the trade conducted among the partners: if the increase in trade flows involves a major and growing portion of intra-industrial trade, which leads to greater similarity in the respective production structures, the degree of synchronization in the cycles should likewise increase\(^\text{28}\). This characteristic, which is present in the European case, is not significant in the case of the

integration agreements of Latin America and the Caribbean\textsuperscript{29}, which, furthermore, as we have seen, do not show high levels of trade liberalization.

Within this general framework, it is discouraging to note that the empirical tests conducted demonstrate that the synchronism of the cycles of Latin American and Caribbean regional integration agreements is significantly lower than that of the European Union, as can be seen from the results of a study carried out by the IDB in the 1960-1999 period\textsuperscript{30}.

For their part, the calculations that we have made to gauge the level of synchronism in the cycles for MERCOSUR (MERCOSUR enlarged to include Chile), the CAN and the CACM\textsuperscript{31} for the 1960-2002 period (Chart 7) produce results similar to those the IDB study found for the 1960-1999 period. In addition, the hierarchy among the three subregional integration groups has remained the same: MERCOSUR exhibits the lowest of synchronism and the CACM the highest. The latter integration agreement, as we have seen, is the one showing the highest level of commercial interdependence. Moreover, its cycle moves like an “associate” of the cycle of United States\textsuperscript{32}.

However, it is interesting to note that the results tend to change whenever other periods, namely the 1970-2004, 1980-2004, 1990-2004 and 2000-2004 periods, are used to analyze whether there have been changes in the degree of synchronism in the cycles. However, in the case of the last period, results must be analyzed with care because of the very limited number of observations available.

Generally speaking, though, it is interesting to note that, in comparison to the most recent period - 1990-2004 - the synchronism of the cycles has tended to be lower in the case of the CACM. However, as we have seen, this subregional agreement is characterized by relatively high commercial interdependence. In any case, conclusions drawn in this manner must be viewed with caution since, as is well known, higher of lower degrees of synchronism in the cycles may be due to a variety of factors: differences in exchange-rate regimes, differences in economic policies, the existence of exogenous shocks that may not be simultaneous and/or asymmetrical.


\textsuperscript{31} The synchronism of the cycles is calculated as the correlation between the deviation of the GDP series of each country with respect to its trend which is calculated with the Hodrick-Prescott filter. In view of the lack of data, no calculations could be made for CARICOM.

\textsuperscript{32} This may be described as a sort of “external coordination” developed by the cycle of the United States, as mentioned by Panizza, Ugo, Ernesto Stein and Ernesto Talvi, \textit{Measuring Costs and Benefits of Dollarisation: An Application to Central America and Caribbean Countries}, Inter-American Development Bank, Washington D.C., 2000.
That said, when the calculation include only the last fifteen years, it can be observed that, in the cases of the CAN and the enlarged MERCOSUR, the level of synchronism is higher than during the 1960-2004 period. One factor which may have contributed to this and which may even be responsible for the extremely high correlation in the 2000-2004 sub-period is that the two South American integration agreements, particularly MERCOSUR, have exhibited, as we have seen, an intense phenomenon of financial contagion and a series of crises whose adverse effects targeted growth at the beginning of the current decade but which later gave rise to widespread recovery in 2003 and 2004. Nevertheless, it should be repeated that, because this is very short period, the conclusions drawn ought to be viewed with caution. In addition, the period used shows high variability with respect to MERCOSUR and, particularly, to the correlation between the cycles of the two main partners, Brazil and Argentina. With the use of quarterly data on the GDP of these countries, the above-mentioned CEI study found that, in the period running from the first quarter of 1991 to the first quarter of 2002, the correlation between the Argentinean and Brazilian cycles was weakly positive (0.22). However, when the three-year period running from the fourth quarter of 1994 to the fourth quarter of 1997 is used, the correlation was strongly positive (0.65), which the authors attribute to the greatest compatibility in exchange regimes.

This CEI study demonstrates the existence of significant and growing interdependence among the economies of MERCOSUR, by examining not only trade but also capital flows and exchange regimes and by showing that the shocks affecting MERCOSUR tend to be increasingly common to all its members.

In other words, these results, which are consistent with the hypothesis that shocks are increasingly more systemic and less and less idiosyncratic, seem to indicate that, where MERCOSUR is concerned, exogenous factors common to a given region might be generating higher levels of synchronism in economic cycles. The relevance of these factors to this subregional integration group is demonstrated, for example, by the strong negative correlation between the common cycle of the countries of MERCOSUR and the weighted country risk of this region. In other words, any deterioration (improvement) in the conditions of access to external credit will lead to recessionary (expansive) trends in the region as a whole, although, this is clearly not the only source of recurrent fluctuations.

One important corollary of this sort of financial globalization-induced phenomenon is that, because it is the source of the most generic effects and contagion which, in the end, affect integration groups as a whole and heighten the levels of synchronism in the cycles, it tends to reduce the asymmetries between smaller partners and larger ones. The latter, in fact, may intensify their call for coordination if they are concerned that their smaller neighbours do not create distrust among investors.

Chart 7

33 CEI, op. cit. (Macroeconomic coordination in MERCOSUR …)

34 Moreover, with the use of a general equilibrium computerized model, the CEI studies show that a shock which affects one member tends to generate major side effects on its trading partners. See CEI, op. Cit.

35 However, the synchronism of the cycle does not seem to be a growing one in the case of CACM, but quite the opposite.

Latin America: Correlation of cycles in different subregional integration agreements

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CORRELATION: MERCOSUR</td>
<td>0.275</td>
<td>0.284</td>
<td>0.249</td>
<td>0.272</td>
<td>0.358</td>
</tr>
<tr>
<td>CORRELACION: MERCOSUR + CHILE</td>
<td>0.203</td>
<td>0.211</td>
<td>0.241</td>
<td>0.284</td>
<td>0.462</td>
</tr>
<tr>
<td>CAN</td>
<td>0.293</td>
<td>0.274</td>
<td>0.232</td>
<td>0.356</td>
<td>0.249</td>
</tr>
<tr>
<td>CACM</td>
<td>0.352</td>
<td>0.365</td>
<td>0.311</td>
<td>0.244</td>
<td>0.094</td>
</tr>
</tbody>
</table>

Source: Estimates based on Base Chelem and ECLAC data.

II. THE EXPERIENCE OF LATIN AMERICA AND THE CARIBBEAN IN SUBREGIONAL MACROECONOMIC COORDINATION

As already indicated in the introduction, the first section of this part of the study examines the habitually acknowledged advantages of macroeconomic coordination. It will also emphasize the interaction between real progress in integration and the demand for greater coordination. The second section goes on to present a comparative overview of the macroeconomic cooperation schemes underway in different subregional processes and of their truly poor achievement, with the purpose of providing an analytical summary of experiences gathered in the area of macroeconomic coordination. Finally, the third section, which analyses the analogical argument of the “prisoner’s dilemma,” will provide insight into the rationality behind the lack of cooperation among regional partners.

1. Macroeconomic coordination, a requisite for advance in integration efforts

1.1 The advantages of cooperating in macroeconomic terms

While academic theories attempt to demonstrate (and measure) the benefits of coordination between authorities already applying first best policies, the world is leading us to consider the additional and much greater advantages of a coordination limiting the errors of individual policies and improving governance and institutionality in a globalized context where these factors are crucial for sustainable growth. This dimension of “political economy,” usually left out of the debates on coordination, is the central contribution of this document, which is in line with previous works made within the REDIMA Project. Therefore, the evaluation of the advantages of coordination should not be based on the weighting of the results of “individually” applying best policies and implementing them in a coordinated manner. It should rather compare the consequences of facing globalization without help – which combines our neighbors’ and our own governance errors – and collectively finding the way to reduce such errors, thus encouraging a regional response that assures progress in national governances.

As indicated above, because of the growing internationalization caused by the opening of the region’s economies in the broad environment of globalization, the interdependence between these economies exhibits an increasing trend. This is a result of the intensification of the traditional trade links, the development of the capital movements, the

37 Ghymers, C., op cit.
contagion effects, and the synchronization of economic cycles\textsuperscript{38}. With interdependence growing in the world, the economic policy decisions of each country have an indirect effect on the economies of the neighboring or partner countries, and these spillover effects tend to have an impact on the macroeconomic results of each economy\textsuperscript{39}. It then seems – and the theory confirms so – that these macroeconomic interactions, must be, as any other externalities, taken into account by decision makers, who need to avoid biased decisions that result in undersatisfactory situations for themselves.

When designing their own policies, each country’s government is interested in considering the indirect effects of such decisions on their neighbors and vice versa. The logical conclusion is that these interactions justify some extent of degree of cooperation between national authorities – even on economic policies of countries of a region intending to integrate. Although decisions are an exclusive responsibility of each sovereign authority, they should ideally be made after close consultations and exchanges or, at least, following previously agreed-upon rules, in order to either optimize the collective effects or mutually limit negative ones.

This very reasoning prevailed at the end of the Second World War and ensured the world an orderly and reciprocal access to the markets in a context of stability. Minimal rules were established both in trade (originally GATT, later the WTO) and in the monetary area (IMF, which allows orderly adjustments in the balance of payments, particularly with stable currency exchange rates). This objective of universal integration triumphed over the economic and political disasters caused by the opposed movement during the period between the two great wars of the 20\textsuperscript{th} century. The basic notion of these universal agreements is based on the fact that commercial and monetary policies of one country do affect those of others. As a result, the consensus on international integration admits no policies with negative effects that counteract them by threatening the stability of other economies. Access to external markets and monetary and financial stability are “international public goods” that become affected by the attitudes of different countries, especially the biggest ones. They may even be threatened by their policy errors. This is why the Group of Seven was created (as a supplement of IMF, which had no power against the biggest debtor countries). It was intended to make a coordinated correction (i.e., one not causing a financial crisis or a world depression) on the macroeconomic balances between the biggest industrial economies by gathering their decision makers for them to internalize the effects of the decisions of each one on the situation of the others. This very thinking also led the European Union to create convergence mechanisms for its national policies as a way to promote a higher level of integration among its markets into one single market. This resulted in the creation of one single currency, which implies a higher level of policy coordination.

These cases of effective cooperation tend to show the existence of significant advantages that serve as foundation to formulas of national policy coordination. Also, the cases of lack of coordination seem to demonstrate the same, but in the inverse way, as far as the lack of cooperation or coordination creates high costs for everyone.

Thus, in Latin America and the Caribbean and their subregions, the lack of an effective macroeconomic cooperation seems to be associated to the fragility and/or failures in regional integration. After the advances seen in the 1990s, the lack of cooperation has

\textsuperscript{38} Escaith, H., Ghymers, C., Studart, R. (2002), op. cit.

resulted in a recession which is now visible in the level of actual integration of the region’s economies.

The following hypothesis allows us to clarify the arguments favoring cooperation and/or policy coordination in the region:

- The weaknesses of regional integration processes and the lack of macroeconomic coordination seem to be associated to a “perverse circle”;
- Both expose their economies to the flaws and instability of globalization;
- This all damages their macroeconomic stability and growth;
- The resulting divergences represent an obstacle to the functioning of regional cooperation agreements and are a source of conflicts;
- This, in turn, hinders the progress of the actual regional integration and the cooperation efforts.

Based on the following factual observations, this hypothesis turns into a plausible description of the Latin American and the Caribbean case:

- Thanks to a minimum convergence and stability in the macroeconomic parameters during the last decade, it was much harder to negotiate and implement preferential trade agreements, both at subregional and Latin American/Caribbean levels. This convergence did not result from any voluntary coordination but from the simultaneousness in the application of reforms and adjustment policies imposed by the previous crises and/or debtors.
- Inter-regional trade exchanges and the net capital income have increased significantly, developing a growing interdependence between the economies of the region.
- This means that the efficiency of each country’s policies became more dependent of the policies applied by their neighbors and the stability of each economy turned into a regional public good. This wider interdependence of the macroeconomic conditions between the countries shows progress in the regional integration.
- For this reason, as a result of the contagion effect and because of the gregarious nature of globalized financial markets, the perception of external and financial sustainability of an individual economy has become more dependent on the macroeconomic conditions and policies of their closest neighbors, while the changes in these perceptions on one economy affect the main macroeconomic parameters of other economies in a region in the path to integration.
- This results in a phenomenon of crossed and amplified externalities among neighboring economies and their independent macroeconomic policies. A manifestation of this phenomenon is the existence of a common “risk premium” for the region in the assessment made by financial markets. A certain regional correlation affects two key parameters of the macroeconomic evolutions – the interest differentials (spreads) over the bonds issued by countries in the same region and the fluctuations of the currency exchange rates of that region. These two parameters share a component, a common label that, for good or bad, the markets “stick” to the countries in the same region. The movements in both the interest and currency exchange rates show a partial parallelism regardless of the macroeconomic situation of each economy.
• This phenomenon produces relevant pro-cyclical effect that amplifies the destabilizing nature of globalization for the management of national policies. In the booming periods, the reductions in spreads and the pressures of real currency appreciation generalize in the region, tend to validate themselves and reinforce among them, which notoriously amplifies the cycle of internal expenditure in relation to the productive potential. Meanwhile, during the periods of crisis, the contagion effect exaggerates financial punishments and depreciations, with negative, destabilizing effects especially on the intra-regional trade and the application of integration agreements. In brief, neglecting these externalities does not contribute to regional integration but rather tends to exacerbate the conflicts of interest among the countries and their different sectors and groups.

• However, the absence of cooperative or regional response from the national authorities is evident. The result is that both risk premiums and monetary depreciations tend to be excessive, as they incorporate an uncontrolled regional factor that transmit and amplifies the regional cycle in a perverse circle which can potentially destroy the regional cohesion obtained in the previous phase. Although involuntary, these market reactions are comparable to the beggar-my-neighbor policies to the extent that the depreciation of a currency arithmetically implies an appreciation of the others. This induces compensatory depreciations, causing in turn a reduction in the initial depreciation, which, therefore, must be higher if it must be effective. The final effects are deeper depreciations with greater volatility and uncertainty for the economic operators, which have a negative impact on growth and inter-regional exchanges.

Although interdependence is inherent to the globalization of economies, its existence shows it is necessary to consider the possibility of internalizing it at a regional level through cooperative options between the affected authorities. It is an obvious case of coalition of interests both between countries and between groups of social players in conflict within each country – national decision makers, companies, workers and all citizens of the affected countries are directly interested in the development of a regional institutionalized response devise improving the credibility of national policies and integration agreements.

**Excessive fluctuations in currency exchange rates are a fatal threat on the credibility of commercial integration agreements.** For instance, the price or cost variations in South America between 1999 and 2003 reached proportions that disturbed the logics of schemes negotiated in the past and, notably, jeopardized the profitability of many reciprocal investments. Additionally, the potential instability of relative prices prevents any rational economic calculation for the future. The damage caused by uncertainty over the evolution of the relative prices is an important obstacle to investment and sustained growth.

The only way to reach a reasonable stabilization in mutual currency exchange rates among commercial partners is obtaining it from a predictable convergence of the macroeconomic policies of the region. Although this regional convergence will result only from the respect to national stability policies adopted according to the interest of each country, some modalities of duly institutionalized and transparently controlled regional cooperation could undoubtedly increase the credibility and predictability of national measures, as well as promoting and facilitating the progress of governance in each country. A mutual and regular monitoring based on objective criteria that evaluate the formal and detailed self-commitments of the national authorities will increase the
transparency and credibility of policy contents. It will also capitalize powerful actions of the financial market expectations and from other economic operators, as well as a better democratic support.

In this view, it is dramatically clear that the Latin American commercial integration schemes require effective mechanisms to promote macroeconomic coordination and convergence. In other words, something is not working in Latin America and the Caribbean, as they have regional and subregional institutions explicitly devoted to cooperation and coordination.40

Given that, considering the number of countries involved, the hypothesis of mere irrationality or systematic errors committed by decision makers does not look plausible, we must find a serious explanation for this absence of an effective demand for coordination.

1.2 The concept of coordination in its two opposing meanings: Federal and sovereign coordinations

The first step to clearly understand the problem of the lack of coordination in the region and conceive realistic solutions is to clarify the concept of coordination and its basic components. While the notion of coordination is generally considered vague, there are two opposing models of coordination. The first one, present in the collective unconscious of Latin cultures, is known as federal coordination. This model implies a supranational (exogenous) authority and corresponds to the cooperative games in the theory of games; it is binding and includes compulsory institutional mechanisms and legal sanctions. The opposed model, called sovereign coordination, consists of varied formulas that generate cooperation in an endogenous fashion. In other words, cooperation is encouraged by the interest of each participant (incentives or market sanctions) in solving externalities in “non-cooperative games” situations (situations of sovereignty and uncertainty about the future behavior of the players).

In the previous section, we have come to the first logic conclusion: A cooperative formula between regional partners brings them advantages and might encompass a certain coordination for the optimization of polices and the improvement of national governances. However, this stage, yet necessary, is not much worthy in the real world of the economic policy if the operational scope of the cooperative formula is not accurately defined. In fact, the debates on policy coordination are very ambiguous and usually ignore operational details related to the type of coordination, as they are generally considered obvious and limited to a particular case. Thus, accepting to limit the discretionary power of each participant is admitted as an implicit starting hypothesis. However, the true problems and obstacles are precisely in this strong hypothesis: Combining coordination and surrendering of sovereignty is not always desirable or positive when the underlying model is uncertain (the limits of our understanding of reality). Even in such a situation there is a high risk of moral hazard, which generates opportunities for the use and abuse of the regional level to blame coordination on the unsolved errors of conflicts at a national level.

The same happens in the economic theory: Accessing to a Pareto superior solution while taking the externalities generated among the economies into account is an evidence of the application of a static model with complete and symmetric information between

---

40 In fact, Latin America and the Caribbean’s institutional development in the area of integration is much vaster than that of other regions of the developing world. Goldstein, Andrea and Carlos Quenan, Regionalism and Development in Latin America: What Implications for Sub-Saharan Africa?, in Regional Integration in Africa, J. Braga de Macedo and Omar Kabbaj (ed.), OECD, 2002.
players. On the contrary, as ECLAC points out, even with more realistic hypotheses, uncertainty on the underlying reality and future behaviors of the players (who lack complete or symmetric information), these models do not lead to any clear or irreversible solution (multiple balances), and become too complex and dependent on hypotheses of specific (case-on-case) behaviors. Therefore, the lack of coordination in Latin America and the Caribbean might be a radical (yet not optimal) response to the restrictions of reality, rather than the result of a “lack of vision” or “political capacity.”

While it is better for the region to establish a coordination that is able to “internalize the externalities,” this is not enough to obtain clear prescriptions on the how to measure and resolve such externalities and, particularly, distribute the benefits of the coordination formula in the real world – with all the uncertainty and asymmetry of economic policies, which prevent, in advance, a trustable observance of the rules by all players. The real problem, then, is not to determine the advantages of an ideal coordination, but rather to configure, from a political-institutional point of view and depending on the type of realistic modalities, a cooperation that is advantageous for all the participants. It may be demanded and function in the subregions of Latin America and the Caribbean – known for their governance deficiencies.

This stage allows us to identify the key point of the problem – the ambiguity in the concept of coordination, or rather what it covers exactly. Behind this ambiguity, those who defend coordination tend to excessively simplify the complexity and difficulties of collective decisions, putting the problem aside without solving it. Coordination is often implicitly understood as a high degree of centralization in decision making. In our typology, this interpretation is called federal coordination to indicate that it has a certain degree of federal authority as opposed to national sovereignties. It is a coordination formula that partially removes sovereignty from the authorities in charge of the policies. It may be applied either indirectly, that is, through previously agreed-upon supranational rules – or tacit ones imposed by a hegemonic leader from his power position – whose mandatory nature limits the (other) national policy makers, or directly, that is, by replacing the decisions of the national authorities with those of a supranational organization under defined circumstances (a “federalization” that may be total, as in the case of the Central European Bank for monetary policies, or partial, as in the case of the Stability and Growth Pact of the European Union for a specific aspect of the budget policies).

Anyway, externalities disappear when decisions (binding nature and guaranty of observance by all players) are centralized, which leads to the disappearance of uncertainty about the future behavior of no longer autonomous players. In the theory of games, these are, by definition, cooperative games and their solutions are single, simple and automatic. However, accepting and effectively practicing this type of coordination means that, in political and institutional terms, the problem was solved in advance. The “political will” existed under the form of a strong demand for federal coordination that made the negotiated loss of autonomy desirable and advantageous for the national authorities. Moreover, this implies that the coordinating group is the “owner of the truth” (that is, it owns the true underlying model). As a consequence, the solution will be simple: The problem solves itself through the surrendering of a part of the sovereign by the players because they all agree that this is convenient for all, both individually and collectively. If the problem of coordination was this simple (in other words, if it could disappear with more centralization), we would have to think that the world is masochistic, because it is not demanding for it more insistently. And we would all be thinking that it is

---

41 Cárcamo, R. (2005), op. cit.
better to be ruled by a *Big Brother* in one single worldwide State, putting national autonomies, the origin of deep insufficiencies, aside!

Therefore, the absence of coordination in Latin America and the Caribbean as a result of their lack of “political will” is not necessarily a negative fact. It means that there is no demand for coordination of the federal type. Adopting this type of binding coordination schemes, which takes responsibilities over, would be equivalent to imposing a disguised change in the political regime through inadequate means. It would give rise to more serious errors and conflicts. This is why such an approach is wisely ruled out by all governments. Besides, reality shows that very few cases of federal coordination have been successful, as the existence of national sovereignties loses all economic justification. However, in Latin America and the Caribbean, the alleged “lack of political will” is not positive either, because it also reveals other obstacles to the development of a coordination of the sovereign type.

In the European Union, although the euro zone exceptionally implies a partial demand for federal coordination because of the existence of a single currency, centralized decision making covers very few areas – only the monetary policy (full federalization) and some common rules governing budget deficits, which have a binding nature according to Article 104 of the Maastricht Treaty (complemented by the Stability and Growth Pact (managed financial sanctions of the federal type). Additionally, the events of the years 2003 to 2005 show that these rules could not be applied effectively\(^{42}\), which means that cases of true cooperative games in the international scene, that is, with sovereign players, are just an exception. And this happens even in the European Union, considered the most advanced experience of regional integration. The failure of the first Stability and Growth Pact\(^{43}\) demonstrated that centralized solutions are illusory when externalities are induced by sovereign decisions. Indeed, establishing rules or creating strong regional institutions remain insufficient measures if their legitimacy and respectability are firmly ensured, which is impossible when national budgets are decided by sovereign national parliaments. Even in the case of the European Union, the political regime would need to be changed, transforming the Union into an authentic federal state or subjecting the national budgets to a community authority. Moreover, there is no political demand for a federalization in Europe. As a result, the only solution is the opposite type of coordination, the sovereign type, that is, the demand for self-interest from the autonomous players. This consists of a non-binding coordination, based on incentives (or financial market and national political opinions) for its participants, as implemented in the European integration and its Economic and Monetary Union.

In conclusion, the solution for Europe and, *a fortiori*, for Latin America and the Caribbean (regions with a lesser degree of integration and institutionality) is to seek for sovereign coordination. Also known as the self-motivated type, this coordination responds to the interests of each participant, is demanded for as such, and does not implies any transfer or loss of sovereignty (it rather strengthens it and improves national governance). In fact, it is the sole sustainable form of coordination today (and it will remain so for a long time).

\(^{42}\) In November 2003, the Council of Economy and Finances Ministers of the European Union decided not to apply the Pact to France and Germany, rejecting the coordination mechanism in force within the Economic and Monetary Union. In June 2005, it also agreed on changing the rules to make the autonomies of national policies more flexible.

\(^{43}\) In fact, the June 2005 decisions may be considered a “new” Pact that corrects some imprecise points of the original one and reduces its “federal nature” to return to the internalization through self-interest.
The European process in search for formulas of collective governance is a very good illustration of the so-called “paradox of coordination” – coordination presupposes the existence of autonomous players and protects the autonomy of each one. Etymologically, coordination is the opposite to centralization. It works as a limit to centralization and defends the sovereignty and interests of individual players when an interaction exists. However, coordination is implicitly linked to autonomy, rather than opposed to it, as usually stated by those who use the term with an authoritarian or hierarchical connotation. From this point of view, coordination is described as a situation in which a “coordinator” imposes its own rules on other players, or as the illusory coordination of the cooperative games in the economic bibliography, where regional optimization is sought through the imposition of formal commitments on the members.

“Sovereign cooperation” is related to the natural selection in successive attempts and reflects a great deal of the political reality of Latin America and the Caribbean. This observation (which, seen from outside, might be considered an example of collective lack of ambition, or even a sample of institutional mediocrity) contains the key to understand the challenge of coordination and its complex balance.

In its broadest sense, the Latin tradition is more exposed than the Anglo-Saxon tradition to dangerous illusions in the area of coordination. The countries with a Latin culture have greater expectations from the so-called coordination, as they consider it an initiative imposed from above, which ignores the principle of subsidiarity. In other words, we tend to forget that a higher degree of centralization would imply significant changes in our constitutional systems and would require conditions that do not exist in Latin America and the Caribbean or even in Europe (actually, they are still to appear anywhere in the world). National governments cannot legitimately sacrifice their own objectives “for the sake of the others”. For definition, decisions made by one sovereign national authority may not be abolished by another authority without having modified its institutional system and established a federal regime, that is, a centralized decision-making authority. Member states can not be required to accept or meet commitments that imply the modification of decisions made by their autonomous parliaments, except in the case of specific and exceptional proceedings adopted through a supranational treaty in limited areas and with the approval of the sovereign national authority. However, this requires, as the European Union and its crisis show, a long process of progressive consolidation of the community and national institutions.

This confusion emerges form the Jacobin illusion that centralized (“enlightened”) decisions are superior to those made by local authorities, deemed to have a shorter vision of future. This type of coordination is inconsistent not only with the democratic institutions of the present time but also, in general terms, with globalized markets. Furthermore, it presupposes the existence of a perfect regional integration and a solid consensus on the underlying economic model. Reality, though, is very different from that. Economic uncertainty, the diversity of the nations and the absence of a regional cohesion create a variety of intermediate (national or subnational) states which, to some extent, compete among themselves and against the centralized decision-making process. In this context, a “strong” formal coordination would expose the region (or the subregion) to the considerable risk of losing legitimacy (because some nations might find themselves

---

44 Ghymers, C. See Fostering Economic Policy Coordination in Latin America: The REDIMA Approach to Escaping the Prisoner’s Dilemma, ECLAC, UN, N° 82, Santiago de Chile, April 2005.

exploited or marginalized by their partners) and efficiency (by eliminating the balance resulting from the competition between the various levels of power). This strong coordination might also lead to conflicts between the levels of authorities arising from liability damage or moral hazard situations caused by the mere existence of an authoritarian coordination. Exposed to the pressures of “internal demands in term of economic policy,” national authorities might attempt to blame their neighbors or the very coordination scheme on the problems. This inevitable bias tends to favor a “free-riding” behavior and discourage internal initiatives, leading to a loss of efficiency in the national policies and creating confusion about responsibilities.

These developments lead to two fundamental conclusions for the definition of an efficient and practicable coordination:

1) A coordination of the federal type based on a pre-established “cooperative game,” one solving the problem of externalities in advance, is a risky illusion. However, sovereign coordination stimulated by self-interest, corresponding to the non-cooperative games, which may only lead to very “light” (i.e., non-binding) categories of coordination, yet much less ambitious, opens a more realistic and democratic way and is based on an open and evolving process of collective governance.

2) In the real world, the best advantage of coordination is probably the limitation of errors in national economic policies, using the problem of the externalities to establish a reciprocal control over individual errors. Academic theory, on the contrary, attempts to get only advantages from a joint optimization of supposedly correct policies at a national level. This aspect of “economic policy” is essential to understand that the only practicable formula of sovereign coordination for the improvement of governance is the voluntary or indirect type, that is, sovereign coordination, because a sovereign government will never willingly accept to subject itself to a foreign authority just to correct its wrong practices. That is, at least, what history has taught us. History also shows that it is possible to correct wrong practices by indirect means (for instance, through a formula of reciprocal control). Actually, a principle of political economy states that all governments – good and bad ones – tend to be more demanding with their neighbors than with themselves.

1.3 Real integration, demand for coordination and globalization

Regional integration is successful when sovereign nations involved show a minimum degree of cooperation. In the previous section, we have established that this type of cooperative attitude is sustainable and successful when it is possible to perceive that the cooperative behavior of the participants benefits the superior interests of the individual nations. This perception is founded on a demand for regional cooperation manifested by political leaders, economic sectors and even common citizens. In turn, the demand for cooperation rests on the perception of interdependence among economies of the same region. Obviously, intra-regional commercial relations are the most visible source of awareness about economic interaction and the mutual effects of the policies adopted by each country. The higher the degree of commercial integration in a region, the more intense the demand for cooperation and coordination between authorities, at least when the partners are of similar size.

When the sizes of the participants are too different (Brazil within MERCOSUR, for instance), this principle becomes asymmetrical: The smaller partners, which receive the stronger impact from the decisions of the bigger one, show more interest in making coordination agreements with it. The most important partner does not share this interest, and the demands for coordination from the smallest countries tend to privilege federal
coordination formulas that compensate the effects of the difference in size. Thus, the demands for coordination become twice as asymmetrical. There are difference in effects – the intensity of demands between partners – and, also, in the formulas, and this is a double hindrance (even a fatal obstacle) to coordination. In this case, though, the asymmetry may be less significant if the small partners limit their demands for coordination to the sovereign type. This reduces the risks of “loss” for the bigger partner, while the advantages for the small partners grow, making agreements more feasible.

Besides, as indicated above, when coordination brings improvements in the governance of the neighbors and prevents serious errors in a globalized world (which may lead to a contagion effect), the big partner will potentially obtain the most benefits, as a result of the consolidation of its institutions and reputation. However, the sole coordination formula allowing the accomplishment of such benefits is the sovereign one. We have also demonstrated that commercial ties are not the only form of interdependence. Financial globalization has widely expanded the nature of macroeconomic interactions, even reducing the importance of the size of the economies, depending on the contagion effects, given that they are more generic and do not discriminate countries. For this reason, globalization tends to reinforce the role of regional integration by curbing asymmetries between regional partners. Brazil should not be interested in one of its neighbors unchaining a wave of mistrust in the region’s investors, because this would increase the probability of more asymmetric demands for coordination, particularly of the sovereign type.

That is how globalization tends to balance and reinforce the demands for coordination between regional partners while expanding the importance of the regional context in Latin America and the Caribbean. The growing weight of the international context and the increase in the pressures on foreign competition are promoting the development of complementarity among national markets and the elimination of transaction costs between neighboring economies. The strategies of transnational corporations, financial markets and local exporter tend to take regional elements (suppliers, size of the market, macrofinancial conditions, political and social events) into consideration when making decisions. Besides, globalization imposes a temporary macroeconomic convergence, a sort of implicit coordination, by restricting the available options and making common interests more obvious to neighboring countries. Also, the asymmetric and destabilizing nature of capital movements counteracts individual efforts for convergence, and emphasizes the importance of institutional and governance factors. This enhances the specific role of the regional level, which may serve to improve rationality and credibility of the national policies in absorbing external impacts amplified by globalization.

This is another important conclusion drawn from the observation of the regional dynamics allowing Europe to strengthen its cooperative response to globalization. The European Union is the only example of regional construction that has been respectful of the national sovereignties and enjoyed success during a sufficiently long period. In the European Union, the pressure made by the external competitors and the growing instability created by financial turmoil in an incipient globalization bore the conditions for integration. The already existing regional institutionalization managed to orient the reactions to globalization pressures toward a methodical and progressive regional response. This is how the European Union advanced in an accumulative process toward the deepening of its integration. The increase in the external competition of globalization promoted the internal demand from the players – both economic and political ones – for more integration reducing of transaction costs derived from the existence of borders (achievement of the single market). At the same time, external financial impacts provoked costly speculative attacks against the currencies of member states, putting both the
growth and functioning of the market at stake. This intensified efforts to reach a durable monetary unification. The process was sustained by a demand for institutionalization of the macroeconomic convergence through the coordination of policies, which captured the attention of the financial markets and the public opinion, and led to both positive and negative “market sanctions.”

The subregions of Latin America and the Caribbean could take this experience as an inspiration to develop the same type of process. As we shall demonstrate in the next section, an incipient demand for coordination has, slowly, grown in Latin America and the Caribbean too. However, it cannot be considered as an effective influence on convergence, integration and growth.

2. The Latin American and Caribbean experience in macroeconomic coordination

2.1 The CAN case

After a profound crisis in the 1980s, the Andean Community of Nations (CAN) saw a revival in the past decade, as a result of the signing in March 1996 of the Trujillo Protocol, which modified the Cartagena Agreement that had created the organization (initially called Andean Pact) in the late 1960s. Thus, the CAN, which now groups Bolivia, Colombia, Ecuador, Peru and Venezuela, established an organizational system with several bodies to govern, control and manage the subregional integration and specific duties in the financial and social management areas. This system, called Andean Integration System (AIS), encompasses the Andean Presidential Council, the Andean Council of Foreign Ministers, the Commission and the General Secretariat of the Andean Community. In 1997, the organization also created the Advisory Council of Treasury or Finance Ministers, Central Bank Presidents and Economic Planning Officers (those in charge of decisions on economic policies). Other bodies must be taken into consideration during the process of configuration of commercial and integration policies, including the Tribunal of Justice of the Andean Community, the Andean Parliament, the Andean Business Advisory Council, the Andean Development Corporation and the Latin American Reserves Fund.

In the area of coordination of economic policies, the organization conceived harmonization mechanisms for the achievement of the treaty’s common objectives. Article 54 of the Cartagena Agreement foresaw the “harmonization of foreign exchange, monetary, financial, and fiscal policies, including the treatment of subregional or foreign capital.” However, nothing was done between 1989 and 1990 (Fourth Andean Presidential Council), when presidential directives were adopted to “intensify the harmonization of macroeconomic policies.” Although this allowed the approval of some rules to regulate competition, macroeconomic matters were once again postponed. Only when the Presidential Council decided to create the Advisory Council in 1997, did the process finally start, as it actively and regularly involved national macroeconomic authorities. There were nine formal meetings from November 1998 and June 2005. In May 1999, the Advisory Council adopted the fundamental principle that the stability of one member states is in the interest of the whole community and, besides, is essential to maintain coherence with the project of Andean integration.” The members have also acknowledged the inherent community solidarity with the Andean process and the growing interdependence between the economies of their partners.

2.1.1 Approach and privileged variables

In this environment of strong institutional development and with the perspective of reaching the status of common market by 2005, the Advisory Council of
54
Treasury or Finance Ministers, Central Bank Presidents and Economic Planning Officers undertook the task of harmonizing and converging macroeconomic policies in the Andean Community. The Advisory Council is convened by the finance minister of the country occupying the presidency of the Andean Presidential Council. It has been meeting since 1998, and its advances have come from its efforts to achieve macroeconomic convergence among the countries of the region, financial integration and harmonization of indirect taxes.

In its third meeting, which took place in May 1999, the Advisory Council adopted the first convergence criteria dealing with inflation, and established the goal of gradually push inflation down to one-digit rates annually.

Starting in the first half of 2001, the project of Macroeconomic Dialogue Network (REDIMA), launched by ECLAC in 2000, initiated its informal technical meeting with the assistance of the General Secretariat of the CAN. The work with experts from the member states, the General Secretariat, the CAF and the FLAR, reinforced this activity and encouraged the macroeconomic convergence agenda.

In the fifth meeting, in June 2001, the Council went through crucial stages in the creation of a formal coordination devise. First of all, It approved two additional criteria in the tax area, and improved the existing inflation criterion. Second, it formalized a working method based on recent experiences of the CAN and the work team of REDIMA. The group of experts (including one delegate for each institution participating in the Advisory Council and one representative of the General Secretariat of the Andean Community, the FLAR and the CAF) started to work under the denomination of Permanent Technical Group (PTG). Its main objective is to follow up the convergence goals in the area of inflation and taxes. This group of experts also forms the REDIMA-CAN network, organized with the assistance of ECLAC with the commitment that the network will be aimed, specifically, at supporting the work agenda of the Advisory Council, and, generally, at promoting the harmonization of macroeconomic policies of the subregion. This flexible formula was thus adopted to simultaneously work, in an informal fashion, with REDIMA-CAN in the preparation of the agenda and, officially, with the PTG – with the experts “changing hats” – when the consensus achieved with the informal level allowed to report to the Advisory Council and take official positions. Third, the convergence actions programs were established to allow each member state to formally announce the goals and policies to which it commits itself for the following year. They include standard modules under which the PTG may monitor the goals and convergence criteria.

Regarding tax criteria, the CAN decided, on the one hand, that the non-financial public sector deficit, starting in 2002, should not exceed 3 percent of the GDP starting in 2002, although this limit was transitoriely extended to 4 percent for the period 2002-2004. On the other hand, they approved the goal that the public (foreign and domestic) debt balance of the consolidated public sector should not exceed 50 percent of the GDP at the end of an economic year, starting in the year of each country’s choosing but no later than 2015. Moreover, the first convergence goal was modified to set December 31st, 2002 as deadline for all the member states to achieve the objective of reporting an annual one-digit inflation rate.

---

While the CAN lacks criteria on foreign exchange rates, the Cartagena Agreement includes an safeguard clause on currency exchange in its Article 110, included under Decision 406 of the Commission of the CAN. In its Sixth Meeting, which took place in Bogota, Colombia, on June 26, 2003, the Advisory Council requested the PTG to evaluate the possibility of applying such a clause. This was also discussed, informally, in the REDIMA-CAN workshop in September 2003 in Quito, Peru. Making a community monitoring of the foreign exchange rates of the members of the CAN is, then, institutionally possible.

In June 2005, ECLAC’s Project REDIMA-CAN resumed with the direct support of the Secretariat of the CAN and the European Commission, which initiated a second stage devoted to concrete advances in the harmonization of national policies and macroeconomic convergence, following a two-year program.

2.1.2 Follow-up Mechanism

In it Decision 543 of April 13th, 2003, the Commission of the Andean Community defined modalities for the follow-up of convergence advances.

The follow-up mechanism for convergence goals works based on a yearly evaluation of the achievement of community goals. Such an evaluation is practice according to the goals stated in the convergence actions programs (backed by the finance minister and central bank president) that the member countries must submit to the General Secretariat at the start of every year. The PAC of each member country is based on a standard format that later becomes a model for their respective reports. The opinion of the PTG must take into account the follow-up reports presented by the countries themselves. The PTG must issue its reports, at least, once a year to inform the Advisory Council of Treasury or Finance Ministers, Central Bank Presidents and Economic Planning Officers. The PTG report is accompanied by “the opinion of a group of economists from the private sector about the CAN’s follow-up report.” This critical complements is honorific and independent from the bodies of the CAN and the member states, as part of the promotion of debate, guarantee objectivity and increase credibility of the monitoring. The autonomous group was created by the General Secretariat of the CAN based on three-candidate proposal made by the CAN members.

In its sixth meeting, in June 2003, the Advisory Council requested the Permanent Technical Group to make a proposal to review the current criterion for inflation convergence, in an attempt to reduce the level and volatility of inflation and curb its dispersion/propagation among the member countries.

Besides, the Council extended the community follow-up mechanism to similar national goals when they are established in the constitution or the law and are stricter than the community rules.

The full implementation of this follow-up mechanism has been made in the last two years, with the presentation of the Follow-up Reports on the 2003 and 2004 convergence goals, including analysis, observations and recommendations by the Group of Economists of the Private Sector. Apart from the above mentioned analysis, these reports contain the follow-up reports presented by each country.
56

The latest macroeconomic convergence report\textsuperscript{47}, in particular, underscores the importance given by the General Secretariat of the Andean Community to regular follow-up activities. The report reviews the achievement of the goals, points out the need of a wider involvement of the FLAR, and lists topics that should be deepened in the next few years.

Thus, the current objectives related to the three convergence goals for the CAN are:

- **Goal 1. One-digit inflation.** The 5-percent inflation goal will come into force in 2006.
- **Goal 2. Public sector deficit.** Up to 3 percent of the GDP (non-financial public sector); maximum for the 2002-2004 transition period: 4 percent of the GDP.
- **Goal 3. Public debt.** No higher than 50 percent of the GDP, starting when each country decides, but no later than 2015.

In fact, the degree of achievement of these goals in 2004, according to the independent Group of Economists, is rather high (see table 8).

**Table 8**

<table>
<thead>
<tr>
<th></th>
<th>Bolivia</th>
<th>Colombia</th>
<th>Ecuador</th>
<th>Peru</th>
<th>Venezuela</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Convergence criterion</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflation</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Public sector deficit</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Public debt</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**Source:** General Secretariat of the Andean Community, op. cit.

**Note:** The Peruvian goals in the Convergence Actions Program are more ambitious than the community goals of the CAN.

Finally, the main work guidelines of the PTG for the period 2005-2006\textsuperscript{48} include recommendations complementing the follow-up reports with, for instance, analysis of the sustainability of the macroeconomic indicator related to the achievement of community goals, and suggestions about the improvement of these goals. Among them are the following:

- evaluate, on the base of a document presented by the FLAR, the proposal of the Group of Economists of the Private Sector on the establishment of a limit to the growth of the public expenditure to make a final decision on the convenience of adopting this type of goal; if not adopted, consider other options, such as proposed ways to reduce the public debt in the region, according to the specificities of each country;
- expand the analysis on the convenience of the current community goal about the level of debt as independent of the primary fiscal balance, instead of a goal separating these results;


\textsuperscript{48} General Secretariat of the Andean Community, op. cit, pp. 171-174.
• analyze how the establishment of these goals will impact the perception of the international markets about the CAN countries;
• promote the exchange of experience among the countries (of the Andean and other regions) about inflation goals management, and
• share views on convergence and macroeconomic coordination with MERCOSUR’s Macroeconomic Monitoring Group through high-level technical meetings.  

The CAN represents a clear example of a balanced institutional devise intending to develop a sovereign coordination formula through an institutionalized process of collective macroeconomic monitoring. Discussed in terms of economic policy, it evaluates the degree of achievement of the defined goals based on convergence actions programs conceived by the national authorities. Although the mechanism is still in its initial stages, its organization offers much flexibility and possibilities of adjustment during its development. Its double level of statutes for the experts’ meetings (the informal REDIMA-CAN group freely exchanges out of official negotiations, while the PTG processes official decision projects) and its exposition to critical opinions from independent economists is an interesting systemic advantage.

2.2 The MERCOSUR case

As a continuation of the process initiated with the signing of the Brazilian-Argentine Integration Act in 1986, the Asuncion Treaty, signed in March 1991, created the Southern Common Market (MERCOSUR), which grouped Argentina, Brazil, Paraguay and Uruguay. The commercial treaty established the rules and deadlines for the elimination of tariff and non-tariff barriers and the adoption of a common tariff.

Marked by a rather “light” institutional development, MERCOSUR has an organizational structural that separates bodies with decision-making power from those that only have an advisory or deliberating nature. The Asuncion Treaty created two decision-making bodies – the Common Market Council (CMC, the top political body formed by ministry representatives) and the Common Market Group (CMG). In 1994, with the adoption of the Ouro Preto Protocol, the MERCOSUR Trade Commission (MCC) joined the structure. The advisory bodies are the Joint Parliamentary Commission (a body of legislative representation), the advisory economic and social forum, and the Administrative Secretariat of MERCOSUR. Initially, this Secretariat was explicitly marginal, but it has been evolving in such a manner that the latest reform sought its transformation into a technical body with operational capacity.

MERCOSUR saw a fast progress in its first years, between 1991 and 1998. The goals for the commercial liberalization were met almost totally within the established agenda. In December 1994, the Ouro Preto inaugurated a customs union, while the inter-zone trade continued to grow vigorously. However, the crises that hit Brazil, Argentina and Uruguay in the late 1990s meant a recession for integration.

Thus, the MERCOSUR crisis provoked the stagnation of the negotiations in 2000 and 2001. In that period, MERCOSUR’s political bodies with decision-making power only met to attempt to solve the recurrent crises, while the ad hoc commissions and groups tried to

49 General Secretariat of the Andean Community, op. cit, pp. 2-4 (presentation by Allan Wagner Tizón).

50 The Brazilian-Argentine Integration Act, which established the fundamental principles of the Integration and Economic Cooperation Program (PICE), pointed to the creation of a common economic area through the selective opening of the markets between both countries.
analyze the various controversies between the four members. However, the crises neatly showed the need to harmonize and coordinate macroeconomic policies.

### 2.2.1 Approach and privileged variables

The idea of coordination emerged with the creation of MERCOSUR. Article 1 of the Asuncion Treaty mentions the need of “coordination of macroeconomic and sectoral policies among the member states.” However, the organization started to advance in that direction only after Brazil’s 1999 crisis. Certainly, the urgency of applying Article 1 became most evident when in 1997 Brazil adopted conflicting commercial restrictions with its regional partners in order to counteract the consequences of its macroeconomic policies. Although informal contacts and discussions intensified with the devaluation of the real and Brazil’s adoption of a floating currency exchange – which made exchange regime divergences a more serious concern – the support to macroeconomic convergence and a more explicit cooperation grew.

A new stage started for MERCOSUR when the Buenos Aires Ministerial Declaration, signed on April 29, 2000, clearly stated that macroeconomic convergence and coordination were crucial to the future of the agreement, and dialogue and cooperation between the national authorities were necessary if they needed to agree on the best way to face external impacts. The Declaration established the Macroeconomic Monitoring Group (MMG) with the mission of initiating a process of non-binding coordination (of the sovereign type, according to the terminology explained above), and the capacity to make peer pressure to internalize the mutual macroeconomic effects in the interest of each of the participant authorities. The MMG, which includes Chile and Bolivia as associated members of MERCOSUR, was created as an advisory teamwork without formal organization or regular meeting calendar but applying in advance the new method proposed by ECLAC’s REDIMA Project. In just a few months, this method allowed experts and national policy makers to take off successfully. Between August and November 2000, the MMG made a huge technical work, with a high level of quality, a good rhythm in the harmonization of concepts and tax statistics and a rich exchange of policy information.

The results of the new method were presented in the meeting of Florianopolis, Brazil, held between December 13 and 15, 2000. The encounter, which the media dubbed “Mini-Maastricht,” agreed on the macroeconomic convergence goals for three variables: Inflation, tax deficit and public debt.

In the first stage, considered a transition period (2001), the members decided that they must jointly announce their specific objectives on inflation, variation of the fiscal debt of

---

51. ECLAC, which made contacts with the European Commission requesting technical contributions on the experience of coordination and convergence, considerably favored these informal discussions. As a result, a document was presented to the Tenth Regional Seminar on Fiscal Policy, organized with the cooperation of Brazil’s Finance Ministry and held in Brasilia in January 1999, when the real was devaluated: Ghymer, C. Economic Policy Coordination in the Euro-area: Origins, Development and Challenges with some possible lessons for Latin America. The REDIMA Project derived from the conclusions of this document. It also favored the initiative of creating the Macroeconomic Monitoring Group of MERCOSUR, which was finally formed in the year 2000.

52. Created by the Decision CMC N° 30/00, the MMG must be formed by the high-level representatives of the finance or economy ministries and central banks of MERCOSUR and its two associated members, Chile and Bolivia. Its original objectives include the harmonization of macroeconomic statistics, the monthly publication of fiscal indicators and the setting of common goals for inflation, deficit, debt, as well as the revision of national legislations about financial and capital markets. The basic idea is that the collective works generate a mutual knowledge in a confidence environment. It should also be capable of creating common interests and peer pressure to exchange technical aspects of the policy initiatives.
the consolidated public sector and net debt of the consolidated public sector (after deducting the international reserves) for the year 2001. Starting in 2002, such announcements had to be consistent with the common goals agreed upon.

In 2002, in the so-called stage of common goals, the following objectives were established: Inflation must not exceed 5 percent during the period 2002-2005, and later seek convergence at 3 percent; the top for tax deficit was set at 3.5 percent of the GDP for the transition period up to 2003, with a goal of 3 percent for the following period; an indicator was defined for public debt that is the three-year average of the quotient between the net debt of the consolidated public sector (without international reserves) and the GDP, using the period 2002-2004 as a reference. The objective in this area is to observe a declining trend from 2005, and a common top of 40 percent of the GDP for all the member states from 2010.

2.2.2 Follow-up mechanisms

The mechanisms for the correction of goal deviations were also decided in Florianopolis. When one country loses track of the established goals in one year, it must explain, in the first meeting of the following year, what correction measures are needed to return to the community goals. These measures should bear results at least at the end of the following year after from the presentation of the MMG indicators. The correction measures are to include, at least, the following points:

a) macroeconomic projection for the period of return to the goals;

b) macroeconomic policies measures, and

c) structural measures, when applicable.

The MMG will technically analyze the presentation of the country and remit the evaluation to the Advisory Council of Treasury or Finance Ministers, Central Bank Presidents and Economic Planning Officers.

The crises in Argentina and Uruguay in 2001 and 2002 meant a disturbance in the convergence process, interrupting the work of the MMG and making REDIMA more difficult to implement in South America. However, after the depreciation of the Argentine currency, the cooperation efforts resumed informally, and REDIMA-SUR was used to keep a minimum technical dialogue in a period of serious crises. These efforts led to new meetings of the MMG in 2002 as a preparation to the 23rd Meeting of the Council of the Common Market and finance ministers and central banks presidents in December of that year. This summit, which took place in Brasilia, reaffirmed the commitment to the convergence process and updated the goals together with the Macroeconomic Monitoring Group.

In 2003, the Argentine government undertook diplomatic initiatives to explore the creation of a monetary institution for MERCOSUR. The long-term objective of this institution would be the establishment of a single currency for the common market. However, because it was launched prematurely and by ways other than resorting to the specialized teams of the central banks and experts in macroeconomics of the MMG, the initiative did not succeed.

Finally, when the presidents of the member nations of MERCOSUR signed the Joint Communiqué of the 28th Meeting of the Council of the Common Market of MERCOSUR, held in Asuncion, Paraguay, in June 2005, they underlined the existing need to reach deeper understandings on the coordination of macroeconomic policies in the region, and
took note of the results of the Meeting of Finance or Economy Ministers and Presidents of Central Banks, which had been held days before.

After a period of macroeconomic instability exacerbated by the crises, the growing level of macroeconomic convergence is visible now, in spite of the problems that some countries are having in controlling their inflation rates in the long run.

With the experiences accumulated by the MMG and REDIMA, the strengthening of the Secretariat of MERCOSUR and the good perspectives of growth, the new developments toward a sovereign coordination formula – especially if conceived through a more permanent or regular organization of the teamwork meetings – are likely to bring palpable advantages to all members.

2.3 The CACM case

Created by Guatemala, Honduras, El Salvador, Nicaragua and Costa Rica in 1960, when the Managua Treaty was signed, the Common Market of Central America (CACM) was intended to establish a free trade zone, a customs union and a common market.

The Central American economic integration process has gone through several periods during its long life. The first one comprised the 1960s and the 1970s, when the economic integration was closely associated to the import substitution process. The second period spans along the 1980s, when the main objective was to reach peace in the region and, therefore, politics dominated the agenda, while trade matters were left in the background. The third period covered the first half of the 1990s, but experienced a bright moment in December 1991, when the Tegucigalpa Protocol modified the Charter of the Organization of Central American States (ODECA), creating the Central American Integration System (SICA). The Guatemala Protocol, the 1993 modification to the General Treaty of Central American Economic Integration of 1960, proposes an integration agenda that is both intense and profound. The forth stage of the process started in the second half of the 1990s and reaches our days. In this latest period, the discourse on the intensification of integration efforts persists, but it now has a tendency to deepen integration by subgroups. This fragmentation is associated to the existence of a new integration axe between Guatemala and El Salvador, which count on the support of Honduras and Nicaragua in some instances and projects. Costa Rica has a lesser presence in the process.

However, the efforts for the deepening of the Central American integration persist with plans and policies aimed at establishing increasingly strong institutional links between the member countries. Among these efforts are the Action Plan for the Economic Integration, based on the general objective of consolidating the process for the definitive establishment of a customs union; the Amendment to the Tegucigalpa Protocol in the points governing the controversies solution mechanism, and the Central American Migratory Integration Plan, signed by El Salvador, Guatemala, Honduras and Nicaragua in February 2004. The latter represents a decided support to integration by the Central American presidents and means free transit for the citizens from each of the countries of the region to all the others.

While the periodical presidential meetings have been strongly oriented to the integration process, the CACM has a well developed institutional structure, which includes the

---

53 Beside the five members of the CMCA, the SICA includes the governments of Panama and Belize, covering the whole isthmus. Also, in the monetary and financial areas, the Monetary Council was widened to comprise the Dominican Republic and Belize (which only participates as an observer).
Council of Integration Ministers, the Executive Committee of Economic Integration, the Secretariat of Central American Economic Integration (SIECA), and the Central American Monetary Council. The Central American Bank of Economic Integration (CABEI) is a supporting body with a solid tradition.

2.3.1 Approach and privileged variables

Since its creation in 1960, following Article 10 of the General Treaty of Central American Economic Integration, the CACM has also pursued the complementary objective of establishing a monetary union based on the Central American peso, the regional currency unit. Economic and other difficulties in the 1980s stopped this project, but the economic reactivation, the figures of intra-regional commerce in the 1990s and the political stabilization have reanimated the regional dynamics of initiatives and perspectives in the area of macroeconomic convergence.

According to its Article 1, the Central American Agreement regulates coordination, harmonization, convergence or unification of the monetary, credit, currency exchange and financial policies of the Central American states within their economic integration process. The purpose is to carry out this monetary and financial integration process in a gradual manner. The agreement’s objectives include the promotion of a stronger autonomy for the central banks of the region and the encouragement of the regional convergence in macroeconomic policies. It dedicates a special attention to the convergence of monetary, credit, currency exchange and financial policies, emphasizing internal and external factors that have an impact on the goals. However, the approach adopted in the practice suggests that the regional integration and the macroeconomic convergence depend solely on the monetary, financial and currency exchange policies. Although the Charter of the SICA established the Sectorial Council of Finance Ministers and Central Banks, it was never activated. This means that these policies, which are part of the competences of the central banks, must be dealt with, regardless of the existence of budget and tax policies in hands of the governments and parliaments. Convergence is, above all, a matter of policy mix. As a result, the CACM is in charge of the execution of the agreement only, although it also has competences on issues related to tax policies. That is one of the main causes of the difficulties that the Central American process of integration has faced in coordinating policies and strengthening its integration.

Thus, despite its many efforts and sophisticated institutional structure, the region still suffers a serious structural lack – a functional body capable of gathering all the experts and macroeconomic decision makers in a regular base to work together and deal with issues that are important for all. Unlike MERCOSUR and the CAN, the CACM has been unable to establish an effective group allowing to sit monetary and fiscal policy makers around the same table. Concrete proposals on the matter have been repeatedly presented with the REDIMA Project. In Central America, this experiment benefited from co-organization efforts with the Executive Secretariat of the Monetary Council and clearly showed the interest in teamwork formulas for macroeconomists from the central banks with their counterparts from the economy and finance ministries. However, these initiatives are still under discussion.

---

54 Recent works by the Executive Secretariat of the Monetary Council show that the proposals for the creation of a Committee of Macroeconomic Policies are gaining relevance, in line with the works of REDIMA-CA, which included both instruments of macroeconomic policy.

55 The REDIMA Project, as indicated above, resumed activity in June 2005, opening a second two-year stage.
The CACM was created by the Agreement for the Establishment of the Central American Monetary Union, signed by the central banks of the region on February 25th, 1964. The agreement was totally reformed on January 22, 1999 to be updated and adjusted to new legal instruments of the Central American integration, especially the Guatemala and Tegucigalpa protocols. The CACM is a body of the Subsystem of Economic Integration of the System of Central American Integration, with the category of Sectorial Council of Ministers. Its members include the presidents of the five Central American central banks and the governor of the Central Bank of the Dominican Republic. One of its faculties is to periodically evaluate the advances of the process of regional macroeconomic convergence.

Additionally, Article 15 of the Agreement states that the central banks of Central American must closely cooperate with the Council in the achievement of the Agreement's objectives. The central banks will provide the Executive Secretariat with as much information and statistic data as may be required for the development of its tasks. According to Article 50 of the Guatemala Protocol, the Executive Secretariat has its own legal status and is both a technical-administrative body of the Council and its regular communication channel. Confidential information and data must be kept as such by the Executive Secretariat. The Executive Secretariat must also periodically publish an economic report and a statistic bulletin with monetary, exchange, credit and fiscal data, such as results of the balance of payments and foreign trade of the Central American countries. The Monetary Agreement establishes the Central American peso as the region's currency unit with a value equivalent to one United States dollar. With the consensus of all its members, the Council has the power to modify the region's currency unit, its use, denomination, value and convertibility to other currencies.

The 1993 and 1994 technical works served as base to decisions on macroeconomic convergence criteria by the CACM. These criteria included eight parameters: Growth rate of 5 percent of the GDP, index of the real bilateral exchange rate with the dollar between 90 and 110 (1997 = 100), integral covering of the monetary base with net international reserves, deficit of current account of the balance of payment lower than 3.5 percent, deficit of the consolidated public sector lower than 2.5 percent of the GDP, total public debt lower than 50 percent of the GDP.

### 2.3.2 Follow-up mechanism

Given the Council’s limited competence, although the follow-up shows a high level of technical quality and pertinence, it only has an informative value, and lacks mechanisms to involve fiscal authorities or to make peer pressure, as equivalent bodies in other subregions are allowed to. In November 2002, the Central American Monetary Council agreed to modify some of the current convergence parameters to make them appropriately represent the recent evolution of the Central American economies and the consolidation of their economic stabilization processes. This modification also took into account the effect that the incorporation of the Dominican Republic had on the level of the convergence parameters in 2002.

The evaluation parameters are:

- annual variation of the real GDP: 5 percent is the most recommended level, but figures above 4 percent are estimated satisfactory;
- annual inflation rate: 6 percent;
- Index of the real effective exchange rate (ITCER) with the United States: 95 to 105;
• average reference passive interest rate in real terms up to December of each year: \(0\% \leq \text{ir} \leq 5.0\%\);
• ratio between the net international reserves of the Central Bank and the monetary base: \(\geq 100\);
• ratio between the deficit in the current account of the balance of payment and GDP: \(\leq 3.5\%\);
• ratio between the deficit of the public sector and the GDP (includes non financial public sector and the central bank): \(\leq 2.5\%\), and
• ratio between the total public debt and the GDP (includes domestic and foreign debt of the public sector): \(\leq 50\%\).

In order to implement the analysis on the meeting of the various parameters associated to the eight convergence variables, the CACM incorporated in 2002 a mechanism to evaluate the individual effort of the countries based on the measuring of the impact of every variable in the previous three years. The methodology is applicable to all the variables, except those having convergence ranges, such as the inflation rate (which ranges from 0 to 5) and the ITCER (which varies between 95 and 105).

A graphic presentation prepared by the Executive Secretariat of the Monetary Council summarizes the achievement of the criteria (see annexed graphics).

Up to May 2005, according to the available information and the annual goals, the degree of meeting of the convergence indicator in the region was established at 50 percent, which exceeds the 38 percent reported in December 2004.\(^{56}\) Inflation was left out of the recommended parameters because the prices of the hydrocarbons continued to grow. The interest rates stayed within the suggested band mainly as a result of the Dominican Republic recently controlling inflation. The bilateral real exchange rate exceeded the recommended range, particularly because several countries appreciated their nominal exchange rates. From this point of view, the relation of the net international reserves of the Central Bank surpassed by far the suggested limit.

According to the criteria approved by the CACM for the follow-up of the macroeconomic convergence parameters based on the 2004 results, the group evaluation of the member countries of the CACM indicate a low level of criteria observance. It was below 50 percent for Nicaragua (13 percent), the Dominican Republic (25 percent) and Guatemala (38 percent). Costa Rica and Honduras, however, reached 50 percent, while El Salvador managed to hit an exceptional 63 percent.

The work made by the Monetary Council and its Executive Secretariat had a high level of quality. This effort cannot be valued unless there is an instrument allowing to involve the main parties of the macroeconomic policy mix in a collective process of exchange. It needs to create peer pressure to be capable of internalizing externalities and improving the rationale of the policies of each participant.

2.4. The CARICOM case

The Community of the Caribbean (CARICOM) currently comprises 15 states and territories.\(^{57}\) The CARICOM was established by the Chaguaramas Treaty, on

---


\(^{57}\)
July 4th, 1973. This treaty was revised in the light of many protocols signed at the end of the 1990s. It was the base for the creation of the Community of the Caribbean and the Common Market. The CARICOM was the successor of the Caribbean Free Trade Association (CARIFTA), created in 1968.

The CARICOM pursues three main objectives. The first one is to promote the trade integration between their members by creating a common market. A common market entails free circulation of goods, services, capitals and people throughout the region. In 1991, the members of the CARICOM assumed a more ambitious goal, the establishment of the Caribbean Single Market and Economy (CSME), which implies seeking for a deeper integration. A second aim is to strengthen the external stance by coordinating the external policies of the member countries, particularly the main trade partners. Third, the limited resources of the member countries in realms such as health, education, environment, communications, science and technology, meteorology and response to natural disasters, need to be combined in a functional cooperation.

The appendix of the Treaty establishing the CARICOM includes the creation and operation of the Common Market of the Caribbean. It has its own international legal status and three main objectives: (1) a reinforced coordination and regulation of the economic and trade relationships between its members; (2) a sustained expansion and integration of the economies of the member countries, and (3) a greater independence and effectiveness in the relationships with states, groups of states and entities.

Characterized by a significant development in the institutional sphere, the deepening of integration from the perspective of the CSME must result in the development of economies of scale, the increase of the competitiveness of member states in the global economy, and the strengthening of the negotiating position of CARICOM countries in the multilateral trade forums of the WTO and in FTAA negotiations. This implies the expansion of the Caribbean geopolitical space by incorporating new members, an active support to the creation of new spaces, such as the Association of Caribbean States (ACS) and a greater efficiency of trade negotiations through the Regional Negotiating Machinery (RNM).

57 The CARICOM is composed by Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Lucia, St Kitts-Nevis, St. Vincent and the Grenadines, Suriname and Trinidad and Tobago. Haiti joined the CARICOM on May 13th, 2002. Anguilla, the British Virgin Islands, Turks and Caicos Islands, Cayman Islands and Bermudas are associate members. Fourteen of the 15 member are independent countries; only one, Montserrat, is an overseas territory of the United Kingdom. Meanwhile, the Dominican Republic has recently expressed interest in joining this level of integration. In 1998, this country signed a free trade agreement with the CARICOM that includes 400 products.

58 The organizational-institutional structure of the CARICOM includes the Conference of Heads of Government (the supreme body), the Council of Ministers of the Community, the Board of the Conference, the Council for Economic Development and Trade, the Council for External and Community Relations, the Council for Human and Social Development, and the Council for Finance and Planning. Additionally, it includes the following committees: Legal Affairs, Budget, and Central Bank Governors. Likewise, there are several institutions: The Caribbean Disaster Emergency Response Agency, the Caribbean Meteorological Institute, the Meteorological Organization of the Caribbean, the Food Corporation of the Caribbean, the Health Institute of the Caribbean, the Parliamentary Assembly of the CARICOM, the Caribbean Center for Development Management, and the Caribbean Institute for Food and Nutrition. There are associated partners: The Caribbean Development Bank (CDB), the University of Guyana, the University of West Indies, the Caribbean Legal Institute, and, the Secretariat of the Organization of the Eastern Caribbean States. Finally, the CARICOM Secretariat is the organization’s consulting and proposing body.
2.4.1 Approach and privileged variables

Meanwhile, CSME aims at advancing in the coordination of macroeconomic policies in the framework of a highly ambitious perspective. In fact, in 1992, the heads of government of the CARICOM decided that the region needed to initiate a convergence towards a monetary integration. The argument in favor of the monetary union was based on a greater national macroeconomic stability and a greater regional capacity to face external perturbations (using common international reserves), and, also, on the increase of intra-regional trade and investment flows. Additionally, the monetary integration should promote a greater competitiveness and the international insertion of the Caribbean countries.

In order to achieve this goal, the authorities decided to implement a logic sequence of stages towards the economic convergence. This is the reason why, in 1992, the governors of the central banks presented the criteria for convergence, known as criteria 3-12-36-15, which propose: (1) Countries need to maintain international reserves equivalent to three months of imports for, at least, 12 months; (2) the foreign exchange rate needs to remain stable against the dollar during a period of 36 consecutive months, without incurring in arrears in the foreign debt service, and (3) this service needs to be lower than 15% of the value of goods and services exports. In 1996, the criteria were adjusted to make reserves cover three months of imports or 80 percent of the current liabilities of the Central Bank.

The rule for the exchange rate was later relaxed in the cases of countries that had left their currency to float. This floatation was limited to a total range of 3 percent in order to integrate all the member countries of CARICOM under the Caribbean Monetary Authority in the year 2000, after a transition period. The monetary and macroeconomic balances were complemented thanks to the efforts to accomplish the harmonization in the tax area, the standardization of the tax structure of the member countries, the establishment of a tax incentive policy respecting international rules, and the avoiding of competition between countries to attract investment. However, the implementation of this ambitious program found several obstacles. Particularly in the monetary field, the currency convertibility agreements were very difficult to apply in national banking practices, in especially with floating currencies.

Anyway, there is an important element in the approach adopted by the CARICOM. The criteria 3-12-36-15 integrate rules related to exchange rate, like the CACM case but different from the situation of the other two subregional groups. This integration brings the CARICOM closer of the European Union experience. Besides, other variables have been submitted to monitoring, including growth rate, inflation, unemployment, fiscal balance rates (consolidated fiscal balance as GNP percentage), and interest rates.

2.4.2. Monitoring mechanism

In this framework, mechanisms, functions and responsibilities have been developed to monitor national economic policies to ensure a greater coordination of monetary and currency exchange policies. The Council for Finance and Planning (COFAP) was created to favor macroeconomic coordination and promote a more stable and secure economic environment.

From the operational point of view, the Group of Presidents of Central Banks monitors the convergence process. They are supported by the Caribbean Centre for Monetary Studies (CCMS). The CCMS, created in 1995 by the University of West Indies and the central banks of the region, provides relevant information and researches for analysis of the convergence process in seminars, conferences such as the Annual Monetary Studies
Conference, and, above all, the CARICOM Economic Performance and Convergence Report. This report, presented in the meeting of the COFAP and used in the deliberations of the Committee of Presidents of Central Bank, contains a diagnosis on the situation of the economies of the region (growth, inflation, fiscal situation, balance of payments, etc.), with a particular emphasis on the convergence goals. For example, the summary on the convergence criteria of the 2001-2002 report pointed out the following:

- Criterion about reserves and covering of imports: The average covering of imports by reserves during the period improved, rising from 4.4 months to six months. Every country but Belize respected this criterion.
- Stability of the exchange rate: A relative currency exchange stability was observed, although none of the countries fully complied with the criterion about floating into the established range.
- Foreign debt service: In average, there was a moderated increase of the rate of debt service, from 8.9% to 9.3%, in five of eight countries (those with available information). Only Belize and Jamaica did not respect this criterion.

In general terms, great efforts to progress towards a more convergent and dynamic integration have been made since the launch of the objective of moving towards a “single market and economy,” the CSME. However, advances are slow to materialize and the results of the economic convergence leave a lot to be desired. Although several countries have been able to respect the criteria on covering of imports by reserves and debt service, the rule regarding the exchange rate has created more difficulties due to the persistent imbalance in current account, particularly in countries with relaxed exchange regimes. Among the most conflicting aspects are, precisely, the problems caused by convergence when different exchange regimes are involved in the integration process.

2.5. Comparative analysis of the various subregional experiences and diagnosis on their difficulties

The four instruments present common characteristics and differences linked to subregional peculiarities.

The positive side. A salient common element is the overall minimal demand for coordination, which has resulted in a progressive creation of institutional mechanisms to take the decisions at a subregional level. Although those mechanisms are still fragile or preliminary, in the recent past all of them have proven to be enough to support collective actions at a subregional level, in the context of a sovereign coordination, as defined above. Indeed, these cooperation mechanisms cover both the decision-making level (finance ministries and presidents of central banks) and the technical level (high-level experts in charge of macroeconomic policies), however incomplete in two subregions (CACM and CARICOM). These two subregions still lack a common committee of national


experts with the capacity to combine the two instruments of policy mix (the finance ministries and central banks). Though this institutional deficiency represents an obstacle, in the practice it does not prevent the Monetary Council in the CACM or the Group of Presidents of Central Banks of the CARICOM from calling ad hoc meetings of finance ministry and central bank experts. It is highly valuable for Latin America and the Caribbean – actually much more than generally estimated in the region – to have the essential practical instruments. The advantages are direct and significant. Coordination experiences may begin today or, rather, improve after showing their results, in the existent institutional framework and without negotiating new agreements.

The negative side. The possibility to apply the existent mechanisms seems to be paralyzed. At least, it only shows convergence progresses resulting from other processes rather than from coordination efforts, which, in turn, are limited. Such efforts do not represent a driving force, but only a passive (and, by the way, very useful) lateral role. Despite of the existence of tighter international links and more noticeable effects of domestic policies beyond the border lines, the formulation of economic policies still ignores the “spillage effect” between regional partners. All of the subregions share this contradiction between the existence of sufficient mechanisms and the deficiency in their effective implementation in order to influence national policies. Although all of the subregions express a certain demand for coordination in their political and institutional speeches, this demand does not reach a real development of a dynamic cooperation and the reinforcement of credibility. This contradiction is clearly represented in the common statement about the “lack of political will” of the region.

As mentioned above, this statement covers a very widespread illusion. In the name of a regional Deux ex-machina (the regional ideal), “supranational” solutions could be imposed from above (heads of state) in order to solve disagreements between sovereign policies of these individual heads of state. This confusion, shared by all subregions, is not uncommon at all, nor does it reflect an inferiority or backwardness complex, as many Latin-American and Caribbean people usually say. Instead, it reveals a universal process observed in all the attempts of international coordination, both in Europe and in the G7. It is, then, the typical paralysis of the cooperation – a “prisoner’s dilemma” situation in the sense that no national authority will rationally tie its own hands before the uncertainty about the behaviors and policies of their neighbors. The importance and concrete usefulness of this concept to organize a workable coordination effectively demanded by national authorities brings us to the point number 3 of this analysis.

From a more factual point of view, the comparison of the four existent mechanisms allows us to draw the following conclusions:

1. None of the instruments has a binding mechanisms or criterion based on peer pressure at the technical and ministerial levels.
2. However, these pressures do not seem to be active yet. In theory, only two of the subregions (CARICOM and the CAN) have a minimal system of pressure activation, such as a widespread or public debate about the accomplishment of the announced or engaged objectives. The CAN’s system is very recent and CARICOM’s seems to be deactivated. On the other hand, none of the existent systems involves national parliaments in the follow-up or evaluation processes.
3. The goal-criteria are relatively “soft”. They contain minimal objectives that can be accepted by all the members. Nevertheless, the CAN managed to incorporate national objectives to its community monitoring when they are stricter and defined by national laws.
4. All of them are based in the monitoring of the main macroeconomic parameters: Inflation, public deficits and debt. Two subregions, CARICOM and the CACM, have criteria about exchange rates and two criteria about international reserves. The CACM also has criteria about current balance and interest rates.

5. Two subregions, CARICOM and the CACM, also have a monetary agreement, which falls within the competence by their central banks. However, the agreement has been difficult to implement, and the two subregions lack of a common decision-making body allowing them to involve the fiscal and economic authorities with the monetary authorities.

6. Even tough these mechanisms have produced a cooperative dynamism in all of the subregions; none of them seems to have achieved enough force to have a crucial influence on the national policies.

7. Thanks to its method of direct and informal technical exchanges, the ECLAC’s REDIMA experiment has allowed to respond to the existent demand for cooperation and encourage initiatives in the three subregions where it was launched (only CARICOM could not participate).

3. The Prisoner’s Dilemma as Analytical Reference

The prisoner’s dilemma, as follows, does not intend to explain or describe reality rigorously, because it formally corresponds to a simple and static model. However, the analyses developed in the works of ECLAC for REDIMA (see Ghymers [1999, 2001 and 2005], Escaith [2002 and 2004], and Cárcamo [2005]) allow to determine the approach and limits of an operational method for macroeconomic coordination. In this work, this dilemma is used mainly as a pedagogical metaphor to identify key components in a process of interactive decisions among policy-makers, according to the method developed in the framework of REDIMA.

Regional integration is successful when a minimal degree of cooperation exists among sovereign nations. This kind of cooperative attitude is sustainable and successful only if the cooperative behavior of the participants is perceived as beneficial to the highest interests of each country individually. The metaphor of the prisoner’s dilemma helps to understand why this apparently obvious behavior is not the general rule in the real world and allows to identify tangible obstacles, thus opening the door to possible solutions.

The prisoner’s dilemma is an ideal example of a basic “game” which is recurrent in several political, social and economic contexts, where the general rationality of the preferences in conflict prevents cooperative actions and causes losses to all the “players”.

The title was taken from the pedagogical anecdote used by A.W. Tucker to illustrate it. Two people are accomplices in a crime. Police arrests them by a minor felony and under strong suspicion, but without solid evidence for conviction. The alleged criminals were placed in separate rooms and could not communicate with each other. Each one is offered to confess and to incriminate the other: i) if both confess, they will receive the same reduced sentence for pleading guilty (for instance, five years in prison); ii) if only one of them accuses the other with evidence, the accuser will go free, while its accomplice will receive the maximum punishment, a twelve year sentence; iii) if none of

them confesses, both will be accused for a minor felony and both will serve a year in prison.

Consequently, both accused men find more attractive from an individual point of view not to cooperate with his partner (receive a shorter term) and to accuse him (that is, defect): each one will obtain the best individual result by betraying the partner, regardless the actions of the latter. If one of them cooperates (that is, does not accuse the other) while the other deserts (accusing his accomplice), the deserter goes free and the naïve cooperator is punished even harder receiving a maximum sentence (12 years). If the partner accuses him, the cost for him is even lesser if he does not cooperate (five years) than if he does not accuse his accomplice. The worst result is obtained whenever one of them cooperates while the other defects. *The structure of relative incentives turns cooperation impossible*. Isolated individual rational decisions (that minimize the own risks or maximize the benefits of acting in isolation) do not lead any of the accused to cooperate. In fact, each one of them is led by the rational fear of falling into the worse case: not accusing his partner (cooperate with his accomplice) while his partner defects and accuses him (that is, he chooses not to cooperate), and therefore taking the risk of receiving the most severe sentence. In this example, the prisoner receives a twelve-year sentence if he decides to cooperate by not accusing his partner. Even if his partner cooperates (does not defect), he also receives a one year sentence and loses the opportunity to obtain the best individual option, which he would obtain by acting isolatedly (freedom or not being sentenced to prison). In any case, desertion permits each one of them to get a comparatively better individual result, although such result is not the best in collective terms (five years for both partners is not a “Pareto optimum”). It is clear that both partners would be in a better position if both cooperate (1 year for both) and decline to confess accusing the other. In terms of the Game Theory, this is known as the “prisoner’s dilemma”: each player has a “dominating strategy” when pursuing its individual and rational interest. This dominating strategy prevents the player from cooperating and, if seen from the collective point of view, it encloses both players in a suboptimal equilibrium.

Therefore, those decisions that are rational from the perspective of a unique decision-maker (a national government) become irrational from the collective (regional) point of view.

In spite of its simplistic character, this example of a clear divergence between individual and collective rationality that leads to an actual loss of well-being, allows to draw attention on the conditions required for the results of cooperation to be viable. It is evident that this (static) case, with an immediate and single interaction between players (game of one turn only) is the simplest. In addition, it is clear that the dilemma ends once the players can negotiate an obligating agreement that is reliable and prevents the emergence of a detrimental “dominating strategy”. In our simplistic case of two accused men, the simple fact that they communicate would be enough for them to “cooperate”.

However, in the real (dynamic) world of international relations, communication is far from being enough or possible, specifically due to the uncertainty about the future (particularly, on the potential benefits and losses derived from the cooperation that depend on the effective behavior of the partners in the future), on the actual underlying model (limits of knowledge) and on the credibility of international agreements as obligating instruments of future national decisions that none can predict with certitude, since they are the result of changing coalitions among interest groups, whose demand for international cooperation varies in time. The simplistic model reflects though an important reality: the risk of any cooperation among sovereign authorities. In a game where the players are sovereign
potencies and therefore, where the opportunity of connivance among them is very limited by definition, the probability of desertion by one of the partners makes that the individual behavior is markedly biased against cooperation. In this case, the potential for individual losses that the risk of desertion by one of the partners creates, leads necessarily to the selection of noncooperative strategies, with extremely negative consequences for all the players. In an economic region where the players are decentralized and sovereign – precisely due to the impossibility of a viable connivance – the internal decisions on economic policies, which have important reciprocal external effects, are destined to be prejudicial for the region (and lead to a “suboptimal” equilibrium). Further, the theoretical models of “negotiation” show that exclusively restrictive hypothesis are required to reach feasible solutions for cooperation, such as a very peculiar weighing of the objectives of the responsible individuals, in case that total symmetries among players exist.

However, a way out of the dilemma stays open if the international cooperation is conceived within a more dynamic frame. The inclusion of a dynamic dimension that takes into account the links between the decisions adopted through successive negotiations or contacts along a period of time ("multi-period" or "dynamic" games) makes possible to consider an important aspect of reality: the interaction of the expectations generated by the mutual learning experience of those who formulate the economic policies. If this occurs in a continuous process of successive decisions, response strategies are developed among the players that are incorporated into their respective behaviors (the "Tit for Tat" behavior) and schemes of evolving cooperation may arise (Axelrod, 1984). This means that the individual incentives of the players can evolve to favor cooperation, making possible to overcome the individual stagnation of the "prisoner's dilemma" implied in the hypothesis of rejecting a cooperating attitude. This important contribution – which seemed explicitly or practically unexplored practically before the REDIMA Project – is the basis for the formulation of the specific proposals contained in part III.

The partners located in a subregion face a "continuously iterated game", i.e. they do not meet once for a specific matter, but they have to play in perpetual sequence (or during an unspecified period) to deal with several important concurrent topics. As Robert Axelrod explained, this dynamic dimension modifies the behavior at long as future results have enough weight on current decisions. In fact, when the game is iterated, the players learn from the behavior of the others and obtain the capacity to create and develop their own incentives (or dissuade) to cooperate (or refrain from cooperating). Hence, effects can be developed in terms of reputation, reasons for credibility and of "political economy" which makes cooperation spontaneously attractive and generates opportunities to create new incentives derived from cooperation itself. This means that the benefits of cooperation become endogenous. These benefits could be fostered by means of "Technologies of Compromise", such as tying the hands of a government with regional institutional agreements that increase the cost of desertion (according to the definition of Persson and Tabellini, 1990) and creating important incentives for individual players (following the approach of rewards and sanctions imposed by the market, as observed in the EU convergence process before adopting the Euro).

In the basic case of the dilemma (the static example of the two prisoners), the endogenous nature of the potential benefits of cooperation is the pragmatic form of untying the dilemma, as long as the dynamic (potential) benefits that will be harvested in the future clearly surpass the immediate benefits derived from desertion. In this case, the dominating strategy is no longer to defect, but to cooperate and at this point, the prisoner’s dilemma is, by definition, solved.
In spite of the fact that the prisoner’s dilemma does not constitute an operational model in itself, it is clear that it offers to the economists and individuals in charge of formulating economic policies, general categories of assumptions that decompose a complex matter into simpler elements and allow to identify the basic relations and their intrinsic mechanics. This leads in turn to count on evaluations and insights that allow to find a probable exit to a noncooperative status quo.

This approach to political economy is the method chosen by the ECLAC’S REDIMA Project and it is inspired by the European experience. This European experience shows that acting at regional level is an effective means to consolidate the institutional progress and to generate a common response before the asymmetries or the external differences that may affect national economies. More concretely, regional cohesion can offer a solution to the prisoner’s dilemma by combining two elements:

1. The gradual development of **personal contacts and cooperation initiatives** between those in charge of decision making and the experts of the member countries of the region, aimed at encouraging a common culture, a basic consensus and a collective trustworthy environment. Since the “prisoner’s dilemma” depends on the uncertainty about the behavior of the rest of the players, improving the communication among them and asking them to express their collective opinions clearly increases their possibilities of finding a way out to the suboptimal regional situation by means of cooperation.

2. The rules implemented at regional level and the objective procedures for **mutual monitoring** enable the generation of individual incentives for the players by directing the attention of the markets and the public to the performance of each government. In this way, coordination becomes a directly useful and desirable instrument for the individuals in charge of national decision making, since it increases the credibility of their policies and helps them to fulfill their duties. This ensures congruency between the national and regional interests: regional cooperation is based on the own national interest. To use a terminology inherent to the Game Theory, this increases the probability that all the players develop dominating strategies that coincide with the optimal social objective. Particularly, an important element of any successful macroeconomic monitoring plan is the inclusion of fiscal rules with numeric references and clear agreements in terms of procedures that can draw the public attention and produce political incentives.

In the European case, this combination really lead to the spontaneous development of individual incentives for the participants to cooperate (as recommended by Triffin, half a century ago) by creating a non-zero sum game in which positive results are increased when the game is repeated. Consequently, the prisoner’s dilemma was resolved by means of the game dynamics: the fact that the players have to meet again during a long and undefined period; that they could not avoid the consequences of their decisions on the rest of the participants; that the incentives to defect decreased inversely to the strengthening of integration as time elapsed; that each one of them learned more on the others every time; that rewards and penalizations were managed progressively and allowed to identify an equilibrium between costs and benefits, reducing the uncertainty on the cooperation results- all were factors implying that the cost of not cooperating increased quickly as time passed by, while positive results were higher as long as the game was iterated.

Due to the endogenous nature of the benefits of cooperation (and integration), the important lesson in this case is that the more time passes and greater the interaction among countries becomes (and the more interdependency relationships are created), the greater the benefit of coordination and the lesser the interest on deserting will be (Escaith
Further, as explained by Axelrod (1984), “the most promising result is that, if the participants know the rules of the theory of cooperation in advance, it will be possible to accelerate its evolution”. Therefore, considering the dynamic dimension of cooperation, the incentives for its application will emerge as long as this cooperation is efficient, visible and credible, i.e. that these positive incentives have a higher weight as compared to the disincentives found in a static analysis.

III. HOW TO GENERATE INCENTIVES THAT FOSTER MACROECONOMIC COORDINATION IN REGIONAL INTEGRATION

Based on the ideas above, the third part of the work includes proposals on mechanisms to optimize macroeconomic coordination within the integration schemes at subregional level, and some proposals of possible regional projection. In the first section, the basis for a new approach to the macroeconomic coordination are examined, insisting on the importance of a vision in terms of “regional political economy” emphasizing the “cooperative competition” among national administrations as a means to implement an operational subsidiarization in Latin America and the Caribbean. From this perspective, the importance of regional macroeconomic monitoring is underlined as a self-motivated cooperative process – with the monitoring of exchange rates as catalyst of this process – and as generator of an added value that stimulates institutional strengthening. In the second section, a series of specific proposals to favor the macroeconomic coordination are outlined, according to the approach adopted in this work.

1. Towards a New Approach to Macroeconomic Coordination

1.1. The Regional Level as a Complement and Non-Competitor of the National Level: Towards a Latin American Version of an Operational Subsidiary

The most known vision of the regional integration is the one that suggests that the national States will slowly lose prerogatives and powers in the benefit of a supranational structure at regional level, although in all integrationist schemes along history, the tendency towards centralization of decision making has resulted into a series of deep failures, not only in Europe but also in Africa and Latin America and the Caribbean (for instance, in the first version of the Andean Pact). As previously analyzed, this ambiguity reaches the concept of coordination of economic policies that is generally confused with requiring nations to subordinate their responsibilities before supranational entities or before more powerful neighbor countries (coordination of federative type).

Macroeconomic coordination can be only of “sovereign type”, i.e. does not imply imposing decisions, but an improvement process of decision making at national level, in the benefit of the interests of each country. Therefore, the conflict of interest not only disappears, but it can be transformed (with the adequate operational modalities) into a force that favors cooperation and directly benefits national leaders. Therefore, Latin American actors must capture the concept of subsidiarization and translate it operationally into the search of their own path towards regional integration and towards reforms to ensure “good governance”.

---

64 Escaith Hubert (2004) “La integración regional y la coordinación macroeconómica en América Latina” [Regional Integration and Macroeconomic Coordination in Latin America], *Revista de la CEPAL*, n° 82, Santiago de Chile, April 2004.
As indicated by the etymology of the **subsidiarity concept** ("subsidium" means help), the upper authority level (the state versus the individual citizen, the central power vs. local power, federal power or the region versus their member states) finds its reason in the fact of being of at the service for the attainment of the goals of its components (individual, locals and nationals, respectively). The attainment of the goals of the national parts of a federation or an integration region is the only justification for a federal or regional power to exist: to make possible what would be impossible or inefficient in the case of being in the hands of the national powers (the same is valid for a state in relation to its citizens), but without unnecessary interventions at inferior levels. The definition of the necessity of such “regional” interventions is evolutive and relies on the combinations of the principle of efficacy and the principle of full respect of the sovereign goals of the national States as long as these are compatible with the objectives of regional integration. As a rule, this means that the regional power cannot oppose to the functioning of the national power, unless national sovereignty provokes severe mistakes for regional objectives, not only from the regional partners’ point of view, but also for the national State itself and its own citizens. An example would be the case of unsustainable macroeconomic policies of one State (inflation or excess public deficit), which constitutes a severe mistake, not only due to its spreading effects on its neighbor countries (instability and contagious effect), but also due to its consequences on the country’s inhabitants (The State will not attain its national or regional goals, not to mention the intertemporal and intergenerational injustice resulting from future adjustment costs).

Deviated by conservative currents, the principle of subsidiarity was reduced first to the mere defense of the individual versus the power of the state, and more recently, in the case of the European integration, it was circumscribed to the defense of the national powers versus the tendency to centralism (or central federalism). However, subsidiarity clearly offers a double dimension: to the defense of the lower levels, we must add (even against its own severe mistakes) the justification of a federal or regional power when a net added value is added, i.e. by discounting its costs and under the condition that it does not reduce the national possibilities, except when they commit severe mistakes.

Subsidiarity, so defined, is a universal condition necessary to good governance and a regulating principle of any attempt of regional integration. We must emphasize that a centralist (or “Jacobin”) conception of integration is an obstacle in itself, because it tends to reinforce the lack of trust towards regional entities, and to an excessive formality in the contacts among governments and administrations of the member countries that are seen as “negotiations” in which the national interests are being confronted or risked. This prevents the development of a cooperative environment and the information and knowledge exchange between countries, so intensifying the "prisoner’s dilemma". When a remarkable absence of regular communication among high Latin American and Caribbean economic officers is admitted (except when it is considered a “diplomatic negotiation”), the damage of the myth of a centralist integration is perceived. Despite the availability of several official institutional communication and negotiation channels among the countries in the subregion, there is a need for a real technical interchange, without a nuance of negotiation, to reduce the uncertainty and lack of trustworthiness and to work towards the development of a community culture and a collegial task. In Europe, this deficiency, which was stimulated by the individual interest of every national administration, afraid of losing power, explains the very long road and the slow development of macroeconomic cooperation.

Consequently, it is convenient to translate the subsidiarity into operational modalities for Latin American and the Caribbean subregions, and to limit some practical aspects of what could be a Latin American version of operational subsidiarity that adapts to its
regional reality and that is not an inadequate import of foreign models. While it is convenient to learn from models of other regions by drawing useful methods and principles, the summary and operational modalities must be found and experimented by stages by the Latin American responsible individuals in a collegial process.

Within the boundaries of this analysis, the basic guidelines of the modalities would be the following:

On the one hand, - as underlined several times – it is convenient to prevent the threat of centralism that is present in the collective unconsciousness and in the traditions dominating the region. On the other hand, this same bias prevents the efficacy of the intergovernmental method and demands that the regional level is duly respected. These contradictory demands generate the risk of falling into any of these two opposite types of error: to decide not to trust on a regional institutionalization (importing reflections from Anglo-Saxon tradition) and to opt for the “intergovernmental formula” that prevents the performance of a regional power (interpretation of subsidiarity biased to favor the national sovereignty) or to build a strong judicial and administrative power to compete with the national powers (biased interpretation in favor of supranationality), which prevents the necessary neutrality to generate an effective cooperation among national administrations.

The underlying problem to an operational subsidiarity for Latin America and the Caribbean revolves around an organization of the “regional level” with respect to the national powers. This topic has not been very much discussed or prepared in Latin America and the Caribbean, where the regional level is often seen as a potential competitor of the national administrations not only in terms of decisory power, but also in terms of budget. Therefore, it does not receive the corresponding means for its inherent tasks. In fact, there is a high risk that the resources for the regional level are considered as subtracted resources, which impairs national administrations.

Nevertheless, the concrete organization of a macroeconomic coordination in Latin America and the Caribbean presupposes a solution to the operational tradition of subsidiarity.

According to the previous analysis, the following concrete guidelines allow the definition of the type of solution that is developed in point 1.2:

• The creation of an institutional regional level is a need to overcome the limits of the mere “intergovernmental” relationships and to give consistence to regional objectives, thus slowly creating a community culture. This implies having minimal own resources to ensure independency, continuity and technical competence.

• This regional level must be a complement and be to the service of national administration without relationships of power or subordination, but of cooperation, by acting as catalyst and not as a competitor, which implies a neutral, light and flexible administration.

• This regional administration must privilege the collegial work with its peers of the national administrations (expert committees by topics).

• It is possible to avoid the development of bureaucracy by using contractors and even individuals of the national administrations that perform precise tasks to serve a
reduced number of permanent regional officers and under the monitoring of its peers of the national administrations.

- The experiences from the European Union and Latin America and the Caribbean (and also from other regions) lead to understand that there are some aspects of the diplomatic relationships that seem obsolete and could become obstacles to regional integration. Foreign Ministers, as expressed by their names, generally place integration with neighboring countries in the same category as the formal diplomatic interactions with real “foreigners”. While an integration process implies by definition to transform what was used to be consider as foreign into internal, the nature of such integration and of the procedures to achieve it depend on the specific development of goals and common interest in economic, financial and monetary matters. According to the principle of the competitive advantage, it would be more rational and coherent (but perhaps “politically incorrect”) to transfer the matters related to regional integration or at least their technical and strictly economic aspects, to the ministries of economy and finances before being considered by the Foreign Ministries for a final decision. This is not a minor topic. Regional integration cannot be originated in an intergovernmental frame, as shown by the repeated European attempts in non-community areas (such as the second and third pillars of the European Union). Regional integration demands a context and procedures of “community” basis. If a more efficacious distribution among the ministry departments is not produced in favor of the macroeconomic experts, that permits that the economic integration becomes an internal affair, the “prisoner’s dilemma” will continue to frustrate or even nullify any genuine initiative to approach common interests.

1.2 Regional Political Economy: “Cooperative Cooperation” among National Administrations as a Way to Implement an Operational Subsidiarity in Latin America and the Caribbean

The solution to contradictory demands that are to be conciliated in Latin America and the Caribbean to define the adequate formula of regional power seems to rely not much on a precise judicial or institutional option, but on a dynamic option of political economy that we will call “cooperative competition”. Defining an adequate institutional formula beforehand is impossible: it is a process in which national actors must develop a demand for integration and coordination. This does not make any sense without a progressive practice to leave the prisoner’s dilemma behind, by means of learning about regional cooperation. Fortunately, all the subregions of Latin America and the Caribbean have the minimal regional institutional structures to launch such process of “political economy” without undergoing a diplomatic negotiation or institutional modification.

The purpose is that the regional level serves the national policies and its political and social actors for them to (better) reach their own national goals. If the regional level generates an “added value” (by reaching these goals), the perception of a competition between the two levels of power could be put aside and this would favor the cooperation between each national administration and the (reduced) regional administration. Nevertheless, national governments would compete to capture that added value, as they now do in view of globalization. However, the essential difference relies on that the regional level generates added value only when the cooperation principle is respected. As previously analyzed, in view of globalization, governments look for a differentiation from its neighbors in a noncooperative way, while the same competition can be organized in a minimal competitive frame. The novelty that could change the orientation of the same forces is very simple: to show that the regional level can create a precise and directly beneficial added value for the national levels. In this case, the huge force of competition among countries and administrations can be channeled and the initial mutual mistrust
that blocked cooperation can be transformed into mutual monitoring, the moving force of a cooperation that becomes necessary to protect from the neighbors’ mistakes and ultimately, as further explained, it serves to discipline all the parties following objective rules, whose respect precisely generates the regional added value (credibility).

The mechanism of “political economy” that permits to change a non-cooperative balance into a self-motivated cooperation (i.e. without centralization) rests on the combination of the tremendous force of competition among countries (and among sovereign national administrations) and the creation of a collective “carrot” by means of the cooperation among national administrations and with the regional administration. It is clear that such a “cooperative competition” cannot be created without the initiatives of a neutral competent referee (the regional administration) that allows to organize this cooperation (transparent game rules creating credibility effects). Its neutrality is guaranteed in turn by the competition among national administrations, which also guarantees the respect of the game rules and outcome, which is constituted by the powerful effects of credibility (mutual monitoring, whose effectiveness creates the “carrot”). The complementary and non-competitive character of the regional level is so established on a very clear basis. Also, a demand for cooperation and coordination appears for the sake of each participant: it is the application of our own paradox of the coordination that reinforces the autonomy of the participants in a self-motivated cooperative game that also includes the referee. The regional administration finds its limits in the defense of the national rights and its compatibility with common interests.

Then, the formula consists in organizing a healthy competition among member States to make that all respect the consensual rules set at regional level. This requires of a regional entity that constitutes only the technical-organizational support, under complementary title that guarantees a true mechanism of check and balances. In fact, such “continuous game” is equivalent to protect everyone from its own mistakes but through the collegial monitoring of the other players (and the dialogue among them). As already discussed, the principle of competition makes participants be more demanding with their neighbors than with themselves, while the principle of regional cooperation permits to create a regional added value, in terms of transparency, credibility and diagnoses.

The field of macroeconomic stability is particularly suited for this form of cooperation: The authorities are in competition and they are only competent to decide on their policies with legitimacy and efficacy; only the type of cooperation promoted by a complementary regional authority allows to organize the objective information based on which cooperation among participants permits to draw the attention not only on the spreading effects but also on the advantages (costs) of (unsustainable) sustainable policies for the national authorities.

We must underline the importance of this complementation among national and regional administrations and the fact that this is only possible if the regional administration does not impose anything else to the national administrations but respect of the rules set under the pressure of the peers in competition vis a vis the financial markets and their own public opinions.

This leads us to determine the specific modalities that can be recommended for the Latin America and the Caribbean subregions.
1.3 Regional Macroeconomic Monitoring as a Self-Motivated Cooperative Process

It is convenient to summarize some ideas and conclusions already explained. Only a sovereign coordination can be successful, since it is the only one based on the individual interests of the autonomous participants. This makes it particularly useful for the participants, as shown by the experience of the EU. The European Union member states managed to maintain an effective coordination and they accept the application of formal procedures because this serves to their own interests; national administrations take advantage of coordination as an instrument that is directly useful to their decisions and to the credibility of their economic policies. They also obtain information and contributions from their partners, thus reducing the uncertainty that characterize the economic processes. The willingness to disclose their politics and even their future intentions turns into a game without losers whenever minimal confidence exists. Participants benefit from the critical comments of the group that, within a continuous game, do not have any interest in creating problems within the group or bother their neighbors, unless their interest are being directly threatened. On the contrary, the countries share the interest in helping each other so that their economies are solid and prosper as much as possible. In this kind of game, conflicts are reduced due to the participation of each member to supervise the others and to ensure that common rules are respected. There is no police or supreme authority; each actor simple maintains a strict monitoring on its partners. Reaching common good depends on every party following the rules established.

Under the condition of making it adequate to the realities of Latin America and the Caribbean, a similar process is at the reach of the rest of the different subregions without other institutional or political requirements than the activation of a regional mutual monitoring on national policies, which is effective and transparent. To start a similar dynamic process, it is necessary that a regular monitoring is available, upon which subregional neighbors have agreed, according to objective and transparent rules.

Following the components required to start:

1. Availability of a reduced regional professional team (regional administration) and of regional evaluating procedures in two stages: committee of high officers (non-political experts) of national administrations in charge of macroeconomic policies (monetary and fiscal) and committees at ministry level (ministers and presidents of central banks).

2. Publication of data, diagnosis and evaluations agreed at regional level and promotion of political (national parliament) and public (national press) debate on the conclusions.

As already said, uncertainty on the attitudes of regional neighbors (the “prisoner’s dilemma”) and the behavior reinforcing the formality of the contacts among administrations of countries located in the same region, generally through foreign ministers (the sovereignty “complex”) can be overcome by implementing two main guidelines:

1. Clarifying that viable and realistic monitoring for Latin America and the Caribbean does not imply a loss of sovereignty, but a strengthening of the autonomy for each participant at long term (the paradox of coordination, as previously seen) and;

2. Permitting that national high macroeconomic officers create their own direct network to share information, knowledge and technical evaluations, in which they do not
negotiate on behalf of their respective authorities, so that a greater mutual confidence is generated when working together behind closed doors. This reduces uncertainty and leads to targeting the differences and to awareness on common interests among participants. Another advantage of this specific type of network is the longest continuity of the technical teams, if compared to the political responsible individuals or officers directly linked to changing minister cabinets.

1.4 Exchange Rate Monitoring; a Catalyst to Effective Monitoring

The exchange rate schemes and policies represent the most visible external part of national options. Therefore, mutual monitoring is also the best mechanism to catalyze the regional technical dialogue and deepen cooperation among those individuals responsible for the formulation of economic policies in interdependent economies. Of course, we must clarify from the beginning, that the purpose of such monitoring or of our proposal is not to "omit stages" and to propose a specific foreign exchange rate regime (ERR), but to analyze and shed some light on the technical implications of the existing or alternate ERR and on the exchange policies of each economy and each regional context, considering the highest interests of each participant. Therefore, in the application of what we have named the paradox of coordination, the technical analysis of the exchange policies and options among regional peers should not be interpreted as a restriction of national autonomy or sovereignty, but a useful and necessary step towards a complete legitimacy and respect to the right to a political account rendering from the national authorities, which is responsible and efficient at the same time. More precisely, this step is the most rational form of giving meaning to the fundamental reality that "the exchange rate is a matter of common interest" for regional partners.

The appearance of mutual monitoring in previous experiences with industrial nations (G-7 and EU) and of the exchange control evolution as effective mechanism to consider and organize a cooperative option, evidences the importance of our argument in favor of an explicit exchange rates monitoring. More concretely, the EU coordination scheme was gradually built on the attempts to reduce the volatility of the exchange rates among community partners, as one of the pillars of regional integration. The European experience, which accumulated mainly during this intense phase of foreign exchange rates monitoring (through the European Monetary System – EMS. and later, during the first two stages of the Economic and Monetary Union – EMU-), indicates the possibility of foreseeing a realistic process in the Latin American and Caribbean subregions. The starting point consists in exclusively concentrating on the evolution of exchange rates of the partners’ currencies, which inevitably leads to the technical analysis of the need for convergence and compatibility of the national macroeconomic policies and creates an opportunity to institute a technical dialogue to examine the internal economic policies of each country. The process of dialogue will offer progressive important advantages to the participants and will lead the individuals responsible for the economic policies to consider a greater formalization of their performances. In this subsequent process, several options arise.

The inclusion of obligating rules could be considered only if a firm consensus is reached among all the authorities involved, starting by organizing a directed cooperative flotation, and later passing to a progressive imposition of disciplines on the monetary and fiscal policies. The recent crises recorded in Latin America are a negative confirmation of the validity of this principle, by showing that insufficient dialogue and absence of cooperation on exchange rates policies contribute to the meaningful retrogression of integration.
As underlined, this does not mean that Latin America and the Caribbean must apply exactly the same formula as Europe, regarding an exchange rate control system; for instance, EMS and its particular parity exchange mechanism related in itself between fluctuation bands, or regarding monitoring and supervision of other dimensions of economic policy, as established in Maastricht with respect to fiscal discipline. The model of the European Union cannot be imported by Latin American and the Caribbean, although the European experiment includes important methodological aspects that are especially useful for Latin American and Caribbean economies.

In Europe as well as in any other part, the evolution of exchange rates control is basic to macroeconomic cooperation and coordination and therefore, its supervision could be the potential key to the launch and organization of macroeconomic cooperation in Latin America and the Caribbean. The need to strengthen convergence and compatibility among the economic policies of autonomous partners that attempt to integrate is not related to whether they share the same ERR or not, or that they have a unique monetary project. Cooperation and coordination at regional level are the result of a search of credibility in a common attempt to deepen integration and to be competitive in a global scenario.

The European Union experience shows that it includes all possible exchange rate systems: while 12 currencies have already fused into the floating Euro, the United Kingdom and Sweden have kept their currencies in a pure floating scheme and Denmark has linked its currency closely to the Euro in a fixed exchange rate, through the Exchange Rate Mechanism II (ERM II). This evidences that regional cooperation or coordination are perfectly compatible with different schemes, but not with macroeconomic divergence or exchange rate instability. Consequently, precise schemes of regional cooperation and mutual surveillance were introduced to avoid such divergences and exchange instability.

Therefore, the purpose of the conclusions presented is not to promote a debate on an optimal exchange rate control for Latin America and the Caribbean or their subregions, but to concentrate the attention on a pragmatic form of adopting the foreign exchange control issue as a trigger for a cooperating attitude among national authorities, avoiding unnecessary costs or instability. In the reality, the optimal limits of a ERR are relative and depend on the temporary horizon, the circumstances and national structures. Academic models and formulas can be pertinent or inappropriate, depending on the circumstances and the kind of shock that affects the particular economy. In fact, all main academic approaches that concentrate on the partial determining factors involved have some truth. In this case, the problem does not rely on the details but on the conditions for implementation in the real world and the praxis. Our objective is to offer methods to avoid doctrinal rigidity to those individuals responsible for formulating economic policies.

1.5 Incentives for the Actors of National Policies

This monitoring creates a group dynamics through which participants compete in strengthening their respective roles, their managing capacity and their knowledge to show the professionalism of their respective administrations. This induces to a process of “competition to improve” and of creative initiatives. With the use of new information, important tasks can be implemented that could not have been planned- not even at national level- if they have to be channel through a full official program before being able to hold formal regional negotiations. Therefore, sharing the analysis and the information about difficulties stimulated the gradual creation of a spirit of corps among macroeconomic experts. This particular group identity acts as a catalyst on cooperation among participants, because the group helps participants in their daily tasks. Hence,
macroeconomists obtain a greater margin for maneuver and contribute with higher efficacy to the decision-making process and this allows them to reinforce their actual participation in the formulation of internal economic policies. A higher number of external contacts and a greater participation in collegial activities also intensify internal contacts in the administrative-technical teams of each country. The final receivers are the authorities (ministers) who profit from the information received as well as from the motivation of their experts, who, in turn, experience a personal growth through their role in the regional group. This leads to a dynamic process, that as the governance in each country improves, also accelerates the process to reach a regional consensus on the necessary measures.

As explained when analyzing the “prisoner’s dilemma”, the challenge consists in making tangible the dynamic benefits that each participant expects to obtain by taking advantage of the regional level, its rules and collective monitoring. The basic channel to grant incentives is the process of credibility generation. This can be obtained through the organization of this type of regional monitoring on national economic policies. The existence alone of an effective system of rules and monitoring must offer individual advantages to its participants. Certainly, this system allows to fortify the credibility of their economic policies and to support their attaining their national goals more easily. Credibility also influences investment and savings directly, and in general terms, it has impact on growth, by reducing the uncertainty and increasing the expectations on the performance of those decisions adopted by the economic agents.

1.6 Macroeconomic Monitoring Generates an Added Value that Fosters Institutional Strength

It could be argued that institutional weaknesses, which already constitute an important deficiency at national level in several countries in Latin America and the Caribbean, could become an even greater obstacle at regional level, where its reputation is even lower. The answer to this logical objection is a reflection of the European counter-experiment that shows that the regional level—which is weaker institutionally speaking—has been able to contribute with considerable improvements to the already good functioning of the national institutions. Incentive mechanisms that have worked out in Europe should be even more powerful in those countries that face greater governance difficulties. This argument revolves around the possibility of exploiting – under strict conditions – the dynamic added value of the regional level to solve certain internal problems.

It is necessary to present more explicitly the basic principles that transform this added value of regional monitoring into a realistic possibility for the purposes of showing that there is not any logical a priori objection that may hinder its implementation in Latin America and the Caribbean. On the contrary, the less credible the national economic policy, the greater the net potential benefits are for a country to participate in the monitoring game with its regional peers and the more power the “group dynamic” will have among them.

Consequently, this point describes the creation and exploitation of the **regional added value**, by making reference to the series of arguments stated above.

- In view of the existing interdependencies among regional partners, the potential added value in general is not exploited due to the consequences of the “prisoner’s dilemma”, generated by the uncertainty regarding future behaviors and the specific benefits that each partner will receive.
• Mutual regional monitoring of macroeconomic policies makes common added value more tangible, because of its greater credibility and more solid control mechanisms, at the same time as it generates a self-gratifying mutual knowledge, a better communication and a greater confidence among autonomous participants. This first step is necessary to reduce the uncertainty regarding the existence and individual identification of potential benefits.

• The temptation experimented by each player of capturing those benefits to satisfy its own interest implies the emergence of an endogenous game based on cooperation, which tends to self-discipline, as long as an adequate combination of competition and cooperation among players exists. As pointed out, this emulation among group members ensures an upward leveling to reach higher standards, by creating, even for the best ones, a net increase of credibility nurtured by the improvements attained by their partners.

• By gradually drawing the attention of national public opinion, creditors and markets to the performance and commitments of national policies, monitoring generate market sanctions and rewards (effects on credibility) that permit to identify and understand the added value of regional cooperation. This modifies the perception on the importance of the future advantages of macro regional cooperation regarding the individual and unilateral actions. From the point of view of the game theory, this process leads to each actor to assume dominating strategies, so improving the convergence between an optimal national level and the regional level. The dynamic benefits of regional monitoring reverts the incentive structure to those in charge of formulating national economic policies and lead to a progressive cooperation based in the own interest.

• The foregoing corresponds to a game without losers, where the positive result increases and the incentives to defect tend to decrease as time passes. As cooperation develops, the game is repeated and it starts to be considered as a continuous process (the endogenous nature of the benefits at regional level in a continuous process).

• This endogenous game of non-zero sum is even more accelerated by the effect of the expectations (as Axelrod pointed out; see section 3 of part two), which creates the need for establishing cooperative actions and which points the way out of the “prisoner’s dilemma”.

The central element of the proposed method to allow that the Latin American and the Caribbean countries resort to the regional level to improve its national governance consists in the referred emulation process among players, which emerges from group pressure and is supported by the sanctions imposed by the markets. This emulation is generated by a peculiar combination of competition and collaboration which is the result of the mutual method: participants compete for getting credibility to the eyes of the international financial markets or creditors, but also for cooperating both to strengthen their common credibility capital generated by monitoring, and to capture that credibility part that is proportional to the individual efforts made to present and to fulfill their individual commitments (plans of adjustment and convergence). The interest of each member of the competing group is to be rigorous with its partners and to oblige them to respect the rules of cooperation in the monitoring game (to ensure the regional added value and to protect its own interests). However, an important condition to permit this combination is the adequate implementation of the subsidiarity principle in its two dimensions: not only to ensure that the sovereign national authorities are the only responsible for their national economic policies (given that they compete to apply the rules of the game and to have a better performance under the supervision of the group,
subject to the sanctions of the market), but also to permit this periodical regional monitoring (since that they cooperate to permit the exploitation of a net added value that they intend to capture or preserve by competing with the others). While national administrations can not be asked to sacrifice their own national goals for the benefit of their neighbors or the region, the force that moves their own and legitimate interests could be channeled to protect them from the errors of their neighbors and so create a solid competition where the respect of some rules shared in the regional game would be accomplished.

To initiate this added value process is not necessary to wait until mature institutions with good credibility emerge, but the contrary, since individual benefits are directly proportional to the initial lack of credibility of the weakest. This also applies to those who show the best performance from the beginning, since the systemic consolidation resulting from their neighbors’ progress would also benefit them. The result is the creation of a true added value for all the participants or the generation of net wealth as a result of transforming better governance into better sustainable growth (for instance, by means of lower risk primes). In contrast to the zero sum game in the prisoner’s dilemma, the reputation of the average credibility of the individual countries does not determine the credibility of regional monitoring, but it tends to take it to an upper level, even to the best group performance level, originating positive spreading effects in terms of regional growth and integration (a non-zero sum game).

Furthermore, the incentive mechanism is very simple, since it is exclusively based on the universal principle of the own interest of the individuals responsible for the economic policies. It does not depend on the initial quality of governance but on the rigorousness of the supervision. In view of the growing importance of the teams of first-level macroeconomists, who manage the technical aspects of the combinations of national economic policies, the incentive mechanism activated through regional cooperation could be particularly convincing, if compared to less effective incentives and means that these macroeconomists have to apply to cause some impact in their own countries.

Definitely, this section leads to two important results:

1. The possibility that the Latin American and the Caribbean countries obtain their own regional approach from the European Union experience seems attractive and viable. This approach will accelerate their capabilities of institutional strengthening by means of an appropriate combination of competition and cooperation among national administrations and economic policies. Some forms of subsidiary regional supervision could compensate national institutional weaknesses, as long as they offer tangible benefits that invert the incentive structure against cooperation, to participating individuals who are responsible for the national economic policies.

2. This work that follows the line of REDIMA, is based on the idea that it would be simpler and faster to establish a regional monitoring scheme rather than leaving the countries trying to reach equivalent results in terms of a better credibility and governance, using their own mechanisms. This approach is not a substitute of solid national institutions and economic policies; on the contrary, its purpose is to catalyze or even accelerate the strengthening of such policies and the reform of national governance.

However, the regional option demands a careful and progressive approach that would be precisely one of the results of the “learning by doing” process that would lead to the kind of periodical macroeconomic dialogue proposed by our approach. The adequate
management of this regional dimension, yet insufficiently explored, could open a new dynamic approach for the countries of Latin America and the Caribbean.

Nevertheless, this option is implicitly based on assumptions that can only be verified by means of a self-validating process, which consists in quickly fortifying the credibility of the national economic policies to escape from the “prisoner’s dilemma”.

What are the conditions and precise forms of this cooperation oriented by the participants’ individual interests? The answer relies on the design of operational formulas for organizing periodic monitoring or activating the existing mechanisms. This is a task for the Latin American and the Caribbean responsible individuals and macroeconomists, but it could be useful to establish a starting point by means of two types of complementary mechanism (one for the subregions and the other for the Latin American region as a whole). Of course, the concrete proposals presented in the two following sections are examples, which are open to scrutiny.

2. Specific Proposals and Subregional Institutional Mechanisms to favor Macroeconomic Coordination, according to the Principles established in this Work

These proposals retake the ideas already exposed in the REDIMA networks. They are based on transparency, on a deliberately organized mechanism for creating consensus and on the simplicity of determination and application of the rules. Contrary to the appearances, the proposal does not imply revolutionary changes or even institutional transformations, but the introduction of a new method, not very expensive, to institute the necessary political balance and open public debates that could support the responsibilities and credibility of those who formulate the economic policies on their own benefit.

This method implies only a minor institutional change – the creation of a reduced group of independent macroeconomists for technical evaluation in each region as a counterpart of the official groups or subcommittees. With the particularities evidenced all the Latin American and the Caribbean subregions count on the technical and institutional basis to organize the monitoring on national economic policies at two levels: the collegial group of high officers in charge of the fiscal and monetary policies; and the Committee of Ministers and Presidents of the Central Banks.

The basic idea to quickly strengthen and guarantee the credibility of the economic policies consists in supporting the subregional level with a new and independent tool that can draw the public attention to technical supervision and collegial evaluation of foreign exchange rates and national macroeconomic policies. Regarding macroeconomic policies, the lack of credibility and transparency points to the need for a radical and “fresh” approach, giving priority to open debates among professionals, to independent evaluations and to sovereignty and local susceptibility. This proposal is similar to the proposal of Eichengreen, Haussmann and von Haguen (1999) in the sense that it creates national independent fiscal councils, but it introduces two major improvements: these councils are not only national but also regional and their scope is widened so that the formula of supervision of the monetary and foreign exchange policies can be applied as well.

Specifically, this implies the creation of a two-level subregional system aimed at increasing credibility by generating a positive dynamics of open debates that creates incentives for the responsible individuals of the national economic policies, through the market and the public opinion whose reactions constitute rewards or sanctions.

1. At official level, the agents in charge of formulating the economic policies meet as a collegial group of policies: first, the preparatory and advisory groups that include high governmental officers, i.e. “Official Group of Macroeconomic Monitoring” (OGMM). Its members are the macroeconomists of the national entities in charge of economic policy, in general, first level experts of the finance ministries and national central banks; second, the regional decisory entity at the level of ministers and presidents of central bank, for deciding on proposals or on technical advise received from the OGMM;

2. As technical compensatory power and direct spokesmanship of the OGMM, the Autonomous Group of Macroeconomists (AGM) includes a few and prominent independent macroeconomists, who are in charge of exercising a periodical supervision on foreign exchange and macroeconomic policies of the countries of the particular region; this group acts not only as a supporting element of the OGMM, but it also cooperates actively in order to create a technical dialogue.

The independent AGM would be in charge of proposing methods, criteria and subregional goals and of issuing periodical reports on the evolution of the regional foreign exchange and macroeconomic indicators and the corresponding components and measures of economic policy at national level. The OGMM would be the first to receive the results of the AGM and it would discuss its proposals and evaluations. It would elaborate in the presence of the AGM, its own recommendations for the consideration of the Council of Ministers and authorities of Central Banks (CMCB), a decisory entity, which would issue its recommendations in the matter of economic policies.

To ensure a reasonable balance of powers, the AGM would be granted the use of two specific instruments: 1) The publication of an attachment (or parallel document) with its own recommendations and comments on the recommendations issued by the Council and 2) the organization of expert “public hearings” with the participation of the media and the international macroeconomic and financial community.

Within this light institutional framework, the interaction among governments and independent macroeconomist would produce “controls and account rendering”, which are more systematic in professional terms, and an automatic and credible monitoring. It could be foreseen that this regional approach gives a high degree of credibility to decision-making, as well as flexibility and stability to the eyes of the national economic actors, of the public, of the regional neighbors, the international financial institutions (IFI) and the creditors.

We propose suggesting to every subregion to adapt its regional mutual monitoring two-level system by performing two basic and interrelated activities:

1) The design and implementation of a rule-based regional plan for macroeconomic convergence, with a view to establishing of a Regional Monitoring Mechanism (MMR). The supranational rules would be gradually discussed and established, in particular those related to quantitative convergence criteria (priority fiscal rules to reach sustainability adapted to each economy, but according to common principles) and;
2) The supervision and evaluation of foreign exchange aimed at establishing a common framework for follow-up, analysis and, if possible, a future agreement on foreign exchange regimes or policies for each participating country at subregional level, according to the general regional principle of common interest in credibility and stability of foreign exchange, i.e. a Regional Exchange Rate Monitoring (RERM).

Since MMR and RFEM support each other, every subregional macroeconomic monitoring plan would greatly depend on the foreign exchange regimes applied in the corresponding subregion. The dynamics of the supervisory process would be subject to the accumulation of what is being “learned by doing” as a result from the collegial interest on the reciprocal exchange rates or the implementation of the RERM. Understanding foreign exchange fluctuations demands a close supervision on each national combination of economic policies; consequently, it is inevitable that these activities complement each other.

Therefore, the initial stage of this “monitoring” would merely consist in a common framework to initiate a technical dialogue on the foreign exchange types and policies. It would constitute the basic plan to initiate an operational macroeconomic dialogue that could lead the countries to align “upwards”, by adopting the best of all dynamic contributions that the creation of powerful efforts for critical analysis, peer pressure, a better mutual knowledge, the interchange of optimal practices and a more explicit consensus on economic governance could generate.

Since the proposal is based on the gradual strengthening of mutual confidence and its associated benefits, it would not demand previous intense negotiations or any formal commitment, but to start as a continuous process of self-validation that would imply the complete protection of the national sovereignty. Therefore, it is more realistic and politically acceptable than other formulas.

If this example is taken only as a possible future scenario and not as a necessary result, it could be imagined that this process could open a door to a wider cooperation in later stages.

As long as the group formed by the individuals in charge of formulating the economic policies reaches a consensus, an intensification of cooperation could occur by raising the issue before the regional decisional entities, according to the existing procedures.

1) In some subregions, the following step could consist in the use of the RFEM to reach a common position on sustainable foreign exchange goals or fluctuation bands between partners to strengthen their mutual stability. The authorities would contribute to model the expectation of the markets, by showing collectively agreed signals on the foreign exchange types established as goals. In this stage, the purpose would not be to determine bilateral parities, but to avoid evident disparities within the subregion. Clearly, this is only feasible if the public willingness exists to advance towards this form of implicit monetary cooperation. In that case, the process to generate consensus on each foreign exchange type should start in the first level of the OGMM, with the technical opinion and possible support from the AGM. Once this first technical stage is covered, if the OGMM and the AGM reach a common position on sustainable common foreign

---

66 This dialogue should include the discussion on all the aspects of the foreign exchange, including the issue of pegging Latin American currencies to one or several reference currencies, in particular the case of those countries that are characterized by a high diversification degree in their international commercial and financial relationships. See Miotti, Pilhon and Quenan (2002) and Escaith and Quenan (2003).
exchange goals, the best would be that the CMCB announced the **recommended bands** for the foreign exchange types that are compatible with the national economic policies set and foreseen. This concept of recommended bands does not imply a fixed bilateral parity system or obligatory limits, because it would also apply to floating foreign exchange. At the beginning, these bands would be wide and not compulsory, and they would only serve to alert the markets on the existence of an agreed orientation of the national economic policies.

2) A complementary tool to exercise influence on market expectations would be to entrust the RERM the creation of a mechanism for making *(obligatory)* **formal consultations** in the scope of the OGMM and ultimately of the CMCB, in those cases where the limits of the agreed bands were narrowing. These obligatory consultations would foster the design and implementation of rules and procedures established in the regional monitoring mechanism (RMM). This consultation system would work by consent; therefore, each member, even an individual national central bank would be granted the power of absolute veto, in an attempt to reach consensus on the adjustments to economic policies to be presented to the national authorities. The more obvious tool for the second stage is the publication of a “joint communiqué” which publicly expresses a degree of consent on the basic indicators of the region and its policies.

3) The next cooperation level would consist in deciding on **common actions** to be adopted beyond the limits the adjustments to national economic policies and joint communiqués. These actions and tools include a wide range of options, such as the application of common criteria and the implementation of compulsory game rules with gains or sanctions and ad hoc cooperation actions, common interventions in favor of specific currencies, the announcement of new bands fixed by consensus or coordinated adjustments of economic policy to support the accomplishment of the bands agreed. Once a trial period has elapsed, the system would probably be in the conditions to design a common procedure of foreign exchange orientation by means of pegging market expectations through precise criteria and formal procedures. This would provide transparent information on the respective positions on economic policies that justify the determination of bands and the rhythm of adjustment required.

4) Gradually and if participating members could reach an actual degree of consensus and cohesion shown by their respect to the common criteria and rules established in the RMM, the option of **experimenting an actual or nominal band** could be analyzed, revolving around a network of parity relationships. Given the continuous strengthening of consensus in the context of an actual consolidation of integration (greater reciprocal trade and nominal convergence), the following steps could transform the MCR into a Regional Monetary System (RMS) and ultimately, into a Regional Exchange Rate System (RERS). Clearly, this type of directed flotation based on rules demands a solid agreement among central banks and other national authorities and it could be reached once the MMR and its common rules were sufficiently developed and their credibility is demonstrated.

The example of the possible orientation of this approach tries to show that national administrations could reach a consensus to elaborate common rules and criteria and to apply them to the appropriate regional level, i.e. through the supervision of the group under the control of the economists and the market. This transparent approach would

---

67 Theoretical background on the approach of recommended bands, for example, can be found in Williamson (2003) and Krugman (1991).
become a powerful catalyst of the reforms and an adequate mechanism for supporting institutional capacity. The majority of the reforms that each economy requires could be conceived in this way. The reforms could be promoted and supervised by applying this collegial method based on regional cooperation and by originating scale economies as well as endogenous incentives and the social support of a skeptical public. This is a responsibility that deserves confidence and a real “upward regional alignment”. In particular, the macroeconomic and foreign exchange stability could become easier and, prudently, a common regional matter; this contributes to a democratic participation and to molding a regional identity. Clearly, as mentioned above, if parasitism or moral risk is to be avoided, all this dynamic must presuppose the existence of a non-centralist, non-bureaucratic regionalism (strict subsidiarity and transparency) and the permanent possibility of taking the way out (self-exclusion in case of deep disagreement).

Therefore, it must be clear that our proposal to advance towards the creation of a SMR does not require the establishment of a unique currency or the use of fixed bilateral parities at subregional level, but a system to strengthen the macroeconomic stability by means of an agreement for the explicit and collegial treatment of foreign exchange policies. If compared to the system implemented in Europe, this system would have a different nature: it would not be limited to a configuration in which the countries opt to relatively fixed foreign exchange types, but it would also encompass numerous cases of free floatation and the dollarization cases. This would allow the collegial analysis and diagnose of the implications of foreign exchange regimes and the role of the foreign exchange type in the combination of economic policies and the development strategy.

Consequently, the method previously described is much wider than the current IFI approaches, which tend to privilege the “extreme solutions” in foreign exchange matters and are only discussed with the individual national authorities on a bilateral basis. In particular, an effective system with rules and application power would have the capacity to act as a real regional peg. In a similar situation, it is possible to foresee important implications in promoting the debate on the most adequate foreign exchange types for the Latin American countries.

Although this suggestion is purely speculative, the following aspects should be considered in future debates:

An ideal macroeconomic scheme at subregional level can reflect a greater credibility than the purely national rules (as those related to fiscal responsibility or monetary independence) or the dollarization. Simultaneously, it could adopt the rules and positions of economic policies, according to each situation or particular position of a country in particular. With the regional macroeconomic cooperation, the ERR problem changes radically: The regional monitoring system (RMM and RERM) can activate the same type of mechanism for “importing credibility” as dollarization by limiting discretion, but in this case, in terms of monetary and fiscal policies, although it does not necessarily restricts its flexibility.

This combination of advantages means that it would be possible to obtain benefits of credibility that are equivalent to those of dollarization, without supporting its disadvantages of rigidity and its exogenous nature, and also reaching the flexibility that flotation brings without being exposed to the same instability risk and excessive adjustments.

Consequently, this subregional scheme could:
1) Simultaneously offer the advantages of both poles of ERR, flexibility and credibility;

2) without imposing its costs (rigidity or instability);

3) internalize the spreading effects of the national economic policies and make possible to conceive a common and coherent response in terms of policies regarding the challenges of globalization;

4) actively promote regional integration and identification.

More specifically, this means that the subregional option would have the “alchemist power” of combining the advantages of both extreme solutions without imposing its costs, which would grant a greater freedom to the national individuals in charge of formulating the economic policies.

Clearly, it does not mean to ignore the obstacles that the regional integration groups in Latin America and the Caribbean should face to advance in this regard. It is true that, as stated in point 1.6, the mechanisms of incentive that have worked in Europe should be even more powerful in countries facing greater governance difficulties. But the regional lack of reputation is high and the absence of a “peg” (Germany in the European case) should not be underestimated. However, the deficit and the absence of a peg is exactly what leads toward a subregional mechanism which is capable of compensating what no country in the region can offer by itself without passing many years of testing. Definitely, with or without cooperation, the deficit of reputation is a fact and the regional cooperative method presented cannot make it worse: on the contrary, all indicates that it could solve the situation with a lesser individual cost. On the other hand, the current context of growth reactivation in a rather favorable international scenario offers more adequate conditions for the development of cooperative attitudes and consequently, for activating the dynamics explained.

3. Expanding the Method from Subregional to Regional Level or Cooperation among the Latin American and the Caribbean Subregions as an Active Complement of the Subregional Mechanisms set forth: Specific Proposals for the Entire Regional Level (LAC)

The foregoing (including the generic word “regional”) refers to the “subregional” stage, that is to say, it deals with the specific framework of the four existing schemes of economic integration, since it is the most adequate form to initiate and develop the dynamic explained by using the existing institutional mechanism and completely respecting the particular characteristics, different rhythms and the historical links of each region.

However, the whole regional level, i.e. Latin America and the Caribbean, has its own tasks in the development of the dynamics explained as well as in its institutional existence as such.

3.1 Functions of the Entire Regional Level

The dynamics explained and the proposals above would be reinforced if an adequate form of cooperation among subregions could be reached. The experience of
the first phase of REDIMA\textsuperscript{68} showed the existence of a demand and a function proper of the regional level that stimulated the activities of each subregional network. As foreseen and implemented in REDIMA, it is convenient to ensure cooperation among subregions by means of the regular interchange.

In fact, the interest of this regional dimension is to promote the exchange of experiences and difficulties among participants of the various subregions, generating learning and emulation effects among them that reproduce and widen the mechanism of “cooperative competition” explained previously. Moreover, this type of cooperation allows to reach greater and essential objectives in terms of information and strategy for national participants and for those who are members of subregional entities. Both similarities and differences in economic policies along the subregions deserve to be treated in a collegial form as a basic stage to create a common culture and generate a regional identity in certain key fields so that the challenges of globalization can be faced. As pointed out, globalization tends to reinforce the importance of the regions. A straight interest of the countries – regardless their size – consists in being able to benefit from a higher weight in the international scenario. Considering the enormous difficulties and high costs that reaching agreements or regional common positions takes at traditional international forums, it is obvious that expanding the method proposed in this work, from subregional to a whole regional level, offers crucial advantages to reach a regional consensus in specific topics of macroeconomic policies with a lower cost: it does not need institutional changes, but use the existing entities (see 3.2) without new mandates or negotiations. Thanks to plenary meetings in which the countries would not have further commitment but to be a participant for their own subregion, progress can be made towards a deeper knowledge of regional realities and of the strategies of their actors, paving the way towards the concrete Latin American and the Caribbean consensus, i.e. the formulation of common positions vis à vis third parties or at international institutions.

\section*{3.2 Proposals for Assigning Regional Responsibilities}

As known, there are regional institutions that embody all the countries of the region. Particularly in the matter of policy coordination, we can mention two: ECLAC and SELA. On the one hand, the ECLAC exercises its mandate of informing and fostering of cooperation and integration among all the Latin American and Caribbean countries in the economic and social fields. In this framework, it supports the self-managed REDIMA networks, which work mainly at subregional level but with a regional cooperation that spreads the results among the subregions. Also, the mandate of the Office of the Executive Secretary of ECLAC stipulates that it coordinates “ECLAC activities with those of the major departments and offices at the United Nations Headquarters, specialized agencies and intergovernmental organizations with a view to avoiding duplication and ensuring complementarity”.

On the other hand, SELA was precisely created as an intergovernmental agency in 1975, to “promote intraregional cooperation” and “promote a permanent consultation and coordination system for the consensus on joint positions and common strategies on economic and social issued, vis-à-vis international organization and fora and before third countries and groups of countries”. This function offers an interesting complement to the ECLAC mandate to implement solid regional cooperative mechanisms in the field of coordination of macroeconomic policies. This could reinforce the initiatives already in

\textsuperscript{68} REDIMA 1 held an annual plenary session of its three networks in 2001, 2002 and 2003, as well as its own web site with possibilities of holding permanent electronic conferences among different subregions (CEPAL’s WebBoard system). REDIMA 2, which started in 2005, organizes its first plenary session in November 2005, in Santiago de Chile, and has also plans for an interactive web site.
progress within the framework of phase 2 of REDIMA, especially to act on more political areas where ECLAC has more limitations than SELA, for being part of the United Nations system.

In fact, the specific proposals made in 1.6 have been conceived to be applied in each subregion and according to their particular characteristics. Although ECLAC also ensures a regional coverage in the frame of REDIMA (the Caribbean is to be incorporated yet) complementary initiatives on the part of SELA’s Permanent Secretariat would be beneficial for the political dynamics of the process in progress, if certain conditions are respected: mainly, the application of the adequate method and non duplication of the efforts.

The method developed in this work is aimed at creating a subregional added value, by means of the dynamics of an endogenous game of “cooperative competition”, as discussed earlier, (point 1.2) among national administrations that improves governance and growth (point 1.5). This subtle combination between competition and cooperation depends on the rigorousness and credibility of subregional macroeconomic monitoring, which requires broadening the professional debates and having autonomous counter-powers such as Autonomous Groups of Macroeconomists (AGM, point 1.6). For these mechanisms to be reinforced by means of a complementary cooperation among subregions, it is also necessary to transfer counter-powers and professional debate to the regional level as a whole and in complete independence. This type of “surveillance” could be reinforced by cooperation among regional entities, such as the ECLAC and SELA, each one according to their comparative advantages. The ECLAC on the one side, both in its role of technical and financial responsible of the REDIMA networks and its mission of promoting integration and regional and subregional cooperation, is in the right position to ensure a dynamic of professional interchanges at Latin American and Caribbean level. SELA, on the other side, in its mission to promote cooperation among subregions and foster common positions, is in the position to support the ECLAC and complement it in the political field to ensure the “internalization” of the technical debates in the governments, parliaments and civil societies of the member countries. Consequently, there is an objective justification for the ECLAC, following its mandate of coordinator with other intergovernmental regional entities, to procure cooperative synergies with SELA in the regional organization of professional and political debates and the macroeconomic coordination among Latin American and Caribbean countries. Of course, this proposal makes sense only as long as the formula is consented by the two regional organisms so that both can get full benefit from their competitive advantages. A *sine qua non* condition is, and it is convenient to reiterate, that no task is duplicated and that the missions and efficacy of both institutions are reinforced.

IV. CONCRETE PROPOSALS

1. SELA should propose the ECLAC to organize a regional forum with the four Latin American and Caribbean subregions, on the results of macroeconomic monitoring and the scope of the coordination elements for subregional macroeconomic policies.

2. For instance, SELA could particularly contribute to divulge the information and both the professional and political debates about the scope and the result of the cooperation initiatives in the different subregions, and possible initiatives among subregions or at Latin America and the Caribbean region as a whole.

3. Among others, SELA could consider the autonomous organization of “*hearings*” of international specialists on the respective works of the OGMM and AGM, as well as of
international seminars with the specialized press and the IFIs, to evaluate the effects of
the efforts made and of the advances on reputation.

4. At political level, SELA could (an arduous but crucial task) involve civil society and
especially, national parliaments (in cooperation with subregional parliaments), as well as
the social spokespersons, in macroeconomic cooperation, so that awareness on the
regional problems is raised in the national decision-making.

This series of measures implies the creation of a stimulating pressure on both technical
(OGMM and AGM, ECLAC, SELA) and political participants (ministers and presidents of
central banks), which will activate the process of “account rendering” for each responsible
individual or institution involved.

Thus, the dynamics created could favor that the Latin American and Caribbean countries
make progress in the improvement of governance, at the same time as integration
recovers a more relevant role and permits the construction of a regional operational
identity in the international scenario.

V. PRELIMINARY CONCLUSIONS

From the analysis developed in this work, a series of operational conclusions are
drawn, as follows:

1. The globalization context, the “tiredness regarding reforms” and the current
conjunctural phase that Latin American and Caribbean economies are experiencing, are
reinforced to implement novel initiatives in cooperation and the macroeconomic
convergence at subregional and regional level.

2. The Latin American and the Caribbean countries have an important advantage to
move forward in that sense: all the integration subregions have – although in a
differentiated and sometimes incomplete form – the minimal institutional mechanisms to
launch cooperative initiatives among its members and to take decisions at subregional
level to support the macroeconomic convergence.

3. However, all the subregions share a contradiction, on one side between the
existence of sufficient mechanisms and on the other side, a lack or insufficiency in
effective use of these mechanisms to influence on national policies. Although all
subregions show a demand for coordination at political and institutional speech, in the
reality, this demand does not manage to develop a real dynamic of cooperation and
reinforcement of credibility. This contradiction can be summarized in the common
statement of the “lack of political willingness” existing in the region, that unveils a typical
cooperation paralysis in a situation of the “prisoner’s dilemma”: it would not be rational
for national authorities to tie their hands before the uncertainty on the effective capacity of
the neighbors to accomplish or follow the policies agreed.

4. Based on an analysis of the mechanisms of “political economy” that allow a non-
cooperative balance in a self-motivated cooperation (i.e. without centralization), a method
is established to implement a kind of “subsidiarity” which is adequate to the Latin
American and Caribbean case: the “cooperative competition” among national
administrations. Under certain conditions, the subregional level can create a precise
added value, which is directly beneficial to the national levels. In this case, the enormous
strength of competition among countries and national administrations can be channel
through the subregional cooperation motivated by the creation of this common added value, and the initial mutual mistrust that inhibits cooperation, becomes an active mutual monitoring on cooperation. Cooperation, then, becomes a need in order to protect from the neighbors' mistakes and ultimately, it serves to discipline all, according to objective rules that can generate a regional added value (credibility) if they are respected.

5. This dynamic process can be supported by means of a progressive learning process that is at reach of all the subregions by the effective implementation of a dialogue based on a collegial (already existing) macroeconomic monitoring on the part of high level technicians in charge of the national policies. This dialogue should also include, with strong emphasis, the analysis of the foreign exchange rates and their determinants. In this process, the interest of each member of the competing group consists in being rigorous with its partners and this obliges them to respect the rules of cooperation of the monitoring game (to ensure that the regional added value is attained and therefore to protect its own interests). Thus, the fast and spontaneous creation of counter-powers can be reached, which improve the transparency and quality of the national governance and contribute to guarantee a higher level of sustainable growth.

6. As a starting point of a debate among Latin American and Caribbean responsible individuals, a group of solid proposals allows to underline two types of complementary mechanisms to further implement macroeconomic cooperation and convergence:

- First, at subregional level and using the existing or REDIMA’s devices, the activation of a subregional two-level system (technical and ministerial) aimed at strengthening credibility by generating a positive dynamics of dialogues and open debates to create incentives to the responsible for the national economic policies, through the markets and public opinion, whose reactions constitute gains or sanctions, and;

- Second, at full regional level, the creation or activation of a forum, which would include the four subregions and would open cooperation among them. This would be very beneficial for the dynamics of each subregion, since it broadens the interests of its own national participants. However, this type of cooperation requires of “prime mover entities” that are neutral and that include all the countries of the region. In this case, it seems obvious that the ECLAC, since the second stage of REDIMA, can foster that regional level completely. However, a cooperative participation of SELA – whose specific mission consists in the intraregional cooperation and the search of common positions and strategies in the region – would offer complementary advantages to activate the counter-power mechanisms and to value the REDIMA’s subregional works at regional level. This would contribute to accelerate the impact of this process on the effective policies of the regional member states.

7. No doubt, the concrete examples of operational proposals presented in this work can be object of critiques or objections. But it is to underline that the principles of political economy (the “Latin subsidiarity” and the “cooperative competition”) that are the basis to the election of formulas for “sovereign coordination” have shown their validity in the experiences (including failures) Developer in Europe and in G-7, as well as in the most recent collaborations from the game theory.

It is our conviction that the individuals responsible for the macroeconomic policies in the Latin American and the Caribbean countries count on all the elements to successfully find the adequate modalities to move forward macroeconomic cooperation in each region and at regional level as a whole.
In this context, the new paradigm - that an organism such as SELA, which strives for consensus in the subregion and the Latin American and Caribbean countries could promote - consists in focusing on the effects of globalization at regional level and emphasizing the importance of regional and subregional macroeconomic cooperation as a precondition and a tool for an emergent economic integration. This would be in turn the condition for a sustainable and elevated growth with a more active participation of the citizens in Latin America and the Caribbean.
BIBLIOGRAPHY


CEI, Cooperación macroeconómica en el MERCOSUR, Un análisis de la interdependencia y una propuesta de coordinación [Macroeconomic Cooperation in MERCOSUR: An Analysis of Interdependence and a Proposal for Coordination], Estudios del CEI N° 4, Ministerio de Relaciones Exteriores, Buenos Aires, April 2003.


Escaith Hubert, “La integración regional y la coordinación macroeconómica en América Latina y el Caribe” [Regional Integration and Macroeconomic Coordination in Latin America and the Caribbean, ECLAC Magazine, n° 82, Santiago, Chile, April 2004.
Escaith Hubert and Paunovic Igor, “Regional Integration in Latin America and Dynamic Gains from Macroeconomic Cooperation”, serie *Macroeconomía del desarrollo*, Nº 24 (LC/L.1933-P), Santiago de Chile, Comisión Económica para América Latina y el Caribe (ECLAC), July 2003.


Fanelli, Jose María, “Coordinación” macroeconómica, competitividad y crecimiento” [Macroeconomic Coordination, Competitiveness and Growth], en Kosacoff, Bernardo (Coord.), *Evaluación del desempeño y aportes para un rediseño del MERCOSUR. Una perspectiva desde los sectores productivos argentinos* [Performance Evaluation and Contributions for a Redesign of MERCOSUR], ECLAC, Oficina de Buenos Aires, September 2004.


Ocampo, José Antonio, “Pasado, presente y futuro de la integración regional [Past, Present and Future of Regional Integration], presented at the INTAL Conference: 35 years of Commitment to Regional Integration], November 27-28 2000, Buenos Aires.

Ocampo, José Antonio, Reynaldo Bajrac y Juan Martín (coordinadores), *Una Década de Luces y Sombras. América Latina y el Caribe en los años noventa [A Decade of Lights and Shadows. Latin America and the Caribbean in the Nineties]*, ECLAC, Santiago, Chile, 2001.


EVOLUTION OF MACROECONOMIC CONVERGENCE IN THE CACM

Costa Rica

El Salvador
<table>
<thead>
<tr>
<th>INDICATOR</th>
<th>Convergence Criterion</th>
<th>Costa Rica</th>
<th>El Salvador</th>
<th>Guatemala</th>
</tr>
</thead>
<tbody>
<tr>
<td>PIB</td>
<td>4.0</td>
<td>4.2</td>
<td>3.2</td>
<td>1.8</td>
</tr>
<tr>
<td>P^6</td>
<td>6.0</td>
<td>13.1</td>
<td>13.7</td>
<td>5.4</td>
</tr>
<tr>
<td>Ir</td>
<td>0-5</td>
<td>1.0</td>
<td>1.2</td>
<td>-2.0</td>
</tr>
<tr>
<td>ITCER/USA</td>
<td>95-105</td>
<td>103.8</td>
<td>104.0</td>
<td>96.9</td>
</tr>
<tr>
<td>RIN/BM</td>
<td>100</td>
<td>147.0</td>
<td>167.0</td>
<td>106.7</td>
</tr>
<tr>
<td>RCC/PIB</td>
<td>-3.5</td>
<td>-4.8</td>
<td>-4.2</td>
<td>-4.4</td>
</tr>
<tr>
<td>RSP/PIB</td>
<td>-2.5</td>
<td>-2.6</td>
<td>-3.0</td>
<td>-1.4</td>
</tr>
<tr>
<td>DPT/PIB</td>
<td>50</td>
<td>59.0</td>
<td>55.1</td>
<td>47.0</td>
</tr>
<tr>
<td>% of Compliance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>INDICATOR</th>
<th>Convergence Criterion</th>
<th>Honduras</th>
<th>Nicaragua</th>
<th>Dominican Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td>PIB</td>
<td>4.0</td>
<td>5.0</td>
<td>4.3</td>
<td>5.1</td>
</tr>
<tr>
<td>P^6</td>
<td>6.0</td>
<td>9.2</td>
<td>9.4</td>
<td>9.3</td>
</tr>
<tr>
<td>iR</td>
<td>0-5</td>
<td>1.8</td>
<td>1.3</td>
<td>-0.7</td>
</tr>
<tr>
<td>ITCER/USA</td>
<td>95-105</td>
<td>97.2</td>
<td>96.9</td>
<td>107.0</td>
</tr>
<tr>
<td>RIN/BM</td>
<td>100</td>
<td>173.6</td>
<td>189.3</td>
<td>83.2</td>
</tr>
<tr>
<td>RCC/PIB</td>
<td>-3.5</td>
<td>-5.2</td>
<td>-2.7</td>
<td>-18.0</td>
</tr>
<tr>
<td>RSP/PIB</td>
<td>-2.5</td>
<td>-4.4</td>
<td>-4.7</td>
<td>-5.6</td>
</tr>
<tr>
<td>DPT/PIB</td>
<td>50</td>
<td>71.0</td>
<td>77.1</td>
<td>122.0</td>
</tr>
<tr>
<td>% of Compliance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| | 50% | 63% | 13% | 13% | 25% | 50% |