Financial Aspects for Regional Integration;

Policy Suggestions

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I INTRODUCTION

Much of the focus of the discussion on both regional and multilateral integration rightly focuses on trade aspects. However, also crucial in the integration process - especially regionally but also multilaterally - are its' international financial aspects; even though crucial, these financial aspects tend to be insufficiently emphasised, in many of the studies on integration, as well as in policy discussions, on the subject.

There are at least three major aspects in which international financial flows and mechanisms play a very important role in regional integration:

1) Financial mechanisms are created explicitly with the purpose of enabling or facilitating trade integration. In the case of the Latin American and Caribbean region, these mechanisms include, for example, the LAIA payments and clearing arrangements, as well as BLADEX. The relevant question that needs to be addressed is whether the mechanisms created operate efficiently and whether they are sufficient and on appropriate terms (e.g. maturities) to meet the needs of integration.

2) Regional integration can be more or less spontaneously stimulated by intra-regional direct investment. Such flows have played a particularly large role in the market driven integration processes of Asia; they are also, however, playing a fairly important role in the move toward the policy driven process of Western Hemisphere integration. Insufficient research and data compilation hinders full understanding of this phenomenon.

3) Last, but perhaps most importantly, regional integration leads to a process of increased investment from outside the region. This dynamic effect of investment creation for the country or region relates to the additional flows of foreign investment from outside the region generated by three factors linked to regional integration; a) preferential and stable access to a significantly larger market; b) potential regional complementarities in terms of resources and productive capacity and c) a decline in uncertainty on economic policies which countries will follow. (This latter effect has been especially highlighted in the context of Mexico's entry into NAFTA[1]). The impact of flows from outside the region have positive effects in terms of growth (especially clear in the short-term), and hopefully on an increase in productive capacity in the medium-term, but may have very problematic effects, in particular on over-evaluation of the exchange rate, which may somewhat undermine a country's efforts at increasing exports, both within and outside the region.

Linked to strictly financial issues, are the issues of monetary co-ordination and harmonisation, which are important conditions both for successful financial co-operation and progress in trade integration, as the European

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[1] See, for example, J Ros "Beneficios comerciales y movilidad de capital: estudios recientes sobre las consecuencias de TLC "Comercio Exterior. México Junio 1994.

Community shows. Because of time limit, we will only refer briefly to this important topic here.

The next section (II), will describe, analyse and evaluate the financial mechanisms explicitly created to support regional integration within Latin America and the Caribbean. Section III will examine the scale and composition of intra-regional investment flows in the LAC region, and attempt to analyse their impact. Section IV will briefly analyse the impact of regional integration on flows from outside the region, as well as their effects. Given the importance of NAFTA, special, but not exclusive, emphasis will be placed on flows to Mexico. Section V concludes and draws policy implications.

II FINANCIAL MECHANISMS CREATED TO SUPPORT LAC INTEGRATION

Together with the initial regional agreements in the LAC region were created different schemes for collaboration in the financial and monetary field. These schemes have been mainly geared towards the creation of mechanisms that facilitate payments derived from transactions between countries in the region; some such schemes (and particularly the LAIA Clearing and Payment mechanism) have been modernised and revitalised, to better support the improved integration schemes. To a lesser extent, and relatively more recent, are efforts to create schemes to finance exports, both within and outside the region.

A. Latin American Clearing and Payments Arrangements

The effectiveness of a payment and clearing system is based on several factors: a) there must be a substantial demand for the use of the system for settlement of intra-regional trade; b) there must be an effective system in minimising the arrears problem and c) the majority of member countries should not be in a permanent debtor-creditor position. In Latin America, the LAIA Reciprocal Payments and Credit Agreement is not only the only mechanism that fulfils these conditions, but is also the only mechanism still performing payments arrangements in the region.

Since 1986, the LAIA payments arrangement has been recovering from the debt crisis and the consequent financial squeeze of the 1980's[2]. As can be seen in Table 1, since 1986 both LAIA imports and the total transactions channelled through the clearing system have increased significantly (except for 1993, when the level of transactions channelled through the clearing system fell fairly marginally). It is, however, interesting to note that the ratio of transactions through the clearing system to intra-LAIA imports has declined. The greater availability of foreign exchange, due mainly to the

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2 For a good analysis of the mechanism's problems during the years of debt crisis, see ECLAC "La Cooperacion Regional en las Campos Financiero y Monetario." Serie Financiamiento del Desarrollo, 5 Dec 1990. Santiago, Chile.

surge in private capital inflows in the early 1990's would seem to be the main explanatory factor.

The system was designed to have three parts. Firstly, the Multilateral Payments Clearing Mechanism compensates multilaterally the trade operations. This compensation is done every four months, for all direct transactions between persons or companies resident in the countries of the region.

At the end of each four month period, "multilateralisation" takes place, as bilateral positions are assessed and cleared, resulting in a single debtor credit balance for each central bank.

Secondly, LAIA also created reciprocal credit lines, between their central banks.

Thirdly, the LAIA payments agreement has a system of guarantees. The guarantees contemplated in the Agreement are those concerned with convertibility of national currencies into US dollars, transferability of the latter and reimbursement and payment of operation processed. The reimbursement guarantee is especially important because of the certainty it affords the exporter of timely collection of monies due, thus constituting a first supporting element of intra-regional trade[3].

Some recent modifications have reportedly[4] improved the operation of the LAIA payments system. To enlarge the scope of eligible transactions through the system, LAIA authorised in 1991 member countries to channel payments which originated from triangular trade. An additional mechanism recently introduced by LAIA is the Financial Discounting of trade documents originated in transactions previously channelled through the system. The mechanism provides funding for exporters with the guarantee of the LAIA Payments Agreement.

As can be seen in Table 1, the significant volume of transactions of the LAIA Reciprocal Payments and Credit System is an important achievement. During the period of its' functioning, the total transactions that went through the LAIA agreement reached US $155 billion; net settlements in foreign exchange reached $39 billion. As a consequence, there was a saving of use of foreign exchange reaching approximately 75%.[5] This important saving of foreign currency clearly is beneficial, as it allows them to be used for other purposes, hopefully developmental ones. Amongst other benefits from the LAIA Payments Agreement are: a) reduction of risk contingency and greater expediency on payments, b) reduction of the cost of commercial transactions, through the elimination of the traditional triangular banking process with

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3 For a clear detailed account, see ALADI. Reciprocal Payments and Credits Agreement. Jan 1993.

4 See, UNCTAD. "Regionalisation and integration into the world economy". Geneva - 31 Aug 1994.

5 Own estimates, based on Table 1 and LAIA data.

institutions outside the region, plus eliminating the need for credit insurance on exports; c) increased links between commercial banks as well as Central Banks of the region. The latter has facilitated the development of other financial integration mechanisms and d) the overall efficient operation of the guarantee mechanism has strengthened confidence in the regional commercial banking systems.

Table 1 LAIA Payments And Clearing Arrangements, And LAIA Imports 1966-93 (millions of dollars)

Year	Anticipated Payments	Number of Central Banks Participating	Total Transactions (1)	LAIA Imports (2)	% (1/2) (3)	Net Settlement in Foreign Exchange	% (3/1)
1966	0	7	106	985	10.76	31	29.25
1967	0	7	333	1008	33.04	94	28.23
1968	0	9	392	1062	36.91	130	33.16
1969	0	10	482	1301	37.05	81	16.80
1970	15	11	560	1354	41.36	110	19.64
1971	24	11	695	1485	46.80	136	19.57
1972	9	11	979	1664	58.83	189	19.31
1973	10	12	1398	2312	60.47	281	20.10
1974	78	12	2276	3930	57.91	387	17.00
1975	3	12	2385	4006	59.54	662	27.76
1976	105	12	2923	4641	62.98	652	22.31
1977	170	12	3936	5793	67.94	887	22.54
1978	56	12	4457	5772	77.22	1135	25.47
1979	300	12	6421	8439	76.09	1630	25.39
1980	682	12	8643	10529	82.09	2021	23.38
1981	869	12	9331	12199	76.49	2554	27.37
1982	633	12	7770	10620	73.16	2245	28.89
1983	309	12	6371	7711	82.62	1809	28.39
1984	155	12	6776	8533	79.41	2052	30.28
1985	62	12	6726	7533	89.29	1499	22.29
1986	14	12	6673	7674	86.96	1066	15.97
1987	65	12	7492	8496	88.18	1269	16.94
1988	61	12	8753	9914	88.29	1458	16.66
1989	162	12	10137	11147	90.94	2513	24.79
1990	472	12	10020	12381	80.93	3469	34.62
1991	769	12	11610	15620	74.33	2866	24.69
1992	2347	12	13772	19960	69.00	3845	27.92
1993	3293	12	13176	n.a		3824	29.02

Source: Compiled by the author, based on several LAIA publications and on UNCTAD. "Regionalisation and integration into the world economy: Latin American experience in trade, monetary and financial Cooperation" 31 Aug. 1994 Geneva.

The other two major Clearing Facilities in the Latin American and Caribbean region, (the Central American Clearing House, - CACH - and the Caricom Clearing Facility) had a problematic history and are in practice not operating at present.

CACH had been forced to suspend its' operations in 1983, as its' resources were exhausted when intra Central American trade fell and when major Balance of Payments disequilibria occurred. At the end of 1990, the members of CACH reached an agreement on arrears and started to revitalise the clearing house. This was to an important extent supported by a credit line from the European Union. The new Clearing House, having learned from past problems, implemented special safeguards against the accumulation of arrears. Since July 1991, net debtor positions in the clearing house had to be settled in full in foreign exchange. In spite of such changes, the CACH again suspended its' operations in 1992. In contrast to the crisis of the CACH in the 1980's, which was due to imbalances and decline in intra-group trade, that led to the accumulation of intra-Central American debt, the suspension of activities this time reportedly resulted from the unsatisfactory level of savings in hard currency. According to UNCTAD data,[6] only a small part (around 20%) of intra-group trade was channelled through this mechanism in 1992. Also, because of the imbalances in intra-group trade, a high proportion of transactions through the system had to be settled in hard currencies.

The Caricom Clearing Facility also ran into problems in the 1980's. The accumulation of arrears by Guyana, and the Balance of Payments problems of Jamaica, forced the Caricom Clearing Facility to suspend activities in 1983 - after six years of operation. Member states use instead a system of bilateral arrangements established in 1987.

To conclude, there is a sharp contrast between the - on the whole - successful LAIA mechanism and the Central American as well as the Caricom mechanism. The failure in the 1980's of the latter two mechanisms seems to an important extent linked to the fact that in these, each country gave global credit lines, without bilateral limits. In contrast, the LAIA mechanism was based on many bilateral credit agreements, which limited the maximum debtor position of one country with another; this prevented resources being concentrated in a few countries which then may be unable to pay back, disrupting the operation of the whole mechanism.

The main challenge now is either to revitalise the Central American and Caricom mechanisms, drawing on the lessons of their own experience and of the far more successful experience of the LAIA mechanism, or alternatively - which may become increasingly relevant in the medium-term as regional integration hopefully broadens to include an ever growing number of countries in the region - is to increasingly broaden the LAIA mechanism to

6 UNCTAD. "Clearing and Payments Arrangements among Developing Countries: Recent Developments, Long-Term Policy Considerations" 4 Feb 1994. Geneva, and UNCTAD, op.cit.

include the Central American and Caribbean countries, as well as others in the region.

A further step would be to expand LAIA financial and monetary co-operation much further, to include links with developing countries in Africa and Latin America. Such a multilaterlisation of LAIA arrangements would be desirable[7].

B. Mechanisms for intra-regional trade and investment financing

Latin American regional trade financing has been carried out, traditionally, by five main institutions: the Latin American Export Bank (BLADEX), the Central American Bank for Economic Integration (BCIE), the Andean Development Corporation (CAF), the Latin American Reserve Fund (LARF) and the Inter-American Development Bank (IADB). Of these institutions, BLADEX (see below) specialises solely in trade financing; the other also cover other fields, such as investment financing.

Latin American Export Bank (BLADEX)
The Latin American Export Bank (BLADEX), started operating on January 1979. The driving force behind the creation of BLADEX was the growing recognition among the Latin American Governments of the need for the promotion and diversification of Latin American exports. BLADEX responded to the rationale that an active financial mechanism was needed in order to provide additional finance that matched the growing exports of manufactures and semi-finished goods that already had relevance in the total aggregate of Latin American production.
The creation of BLADEX was encouraged by the Inter American Development Bank (IADB) and supported by the World Bank's International Financial Corporation which actually invested in the capital of the new institution.
The Bank mainly provides short term pre and post export financing at competitive rates, mainly to shareholder banks for on-lending to exporters. It also finances imports originated within and outside the region, provided they contribute to generate future Latin American exports.

The Bank is focused on short-term business, therefore its medium-term lending activities have had a modest growth since its establishment. Nevertheless, according to its' 1993 report, there is increasing demand for the financing of exports of capital goods which usually requires medium term financing. Indeed, it would seem worth stressing that one of the main (if not the main) gap in intra-Latin American financing is for medium-term lending, to support exports of capital goods and development of infrastructure. BLADEX could play an important role here, by expanding into this important area.

During 1993, the Bank's lending activities continued to achieve consistent growth, reflecting a strong demand for trade finance in all Latin American

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7 For further discussions, see UNCTAD Secretariat "Enlarging and Deepening Monetary, Financial and Investment Co-operation among Developing Countries." April 1995. TD/B/CN3/13.

markets. Total loans grew 35%, reaching over $3 billion. This fact can largely be explained by the improving economic performance of most Latin American countries, coupled with free trade agreements.

Central American Bank for Economic Integration

The Central American Bank for Economic Integration (BCIE) finances investment projects, especially sub-regional infrastructure programmes, and funds projects that create economic complementarity and expand intra-regional trade.

The scale of its' lending has been relatively modest, as from its' inception (in 1961) till the end of 1992, the Bank has lent US $1.7 billion. Recently, the Bank's financial situation was strengthened thanks to external support.

Andean Development Corporation

The Andean Development Corporation (CAF) has provided support to the Andean region. It grants medium and long-term credits for investment and pre-investment projects; it also finances non-traditional exports amongst Andean countries, and towards other countries; it also facilitates imports from third countries into the Andean region, whereby the CAF assures the risk taken by the bank, via the Mechanism for Confirmation of and Financing of Letters of Credit and Imports (MECOFIN). In 1993, reportedly the institution committed loans of US $2.1 billion.[8] Also, in 1993, CAF launched its programme of share participation in private enterprises of member countries and the guaranteeing of bond issues. Thus, CAF seems to be adapting flexibly to countries' new needs and to changes in the international financial environment.

Latin American Reserve Fund

The Latin American Reserve Fund (LARF), available to all LAIA member countries was created in March 1991, on the base of the Andean Reserve Fund.

The main objective is to provide balance of payments credits for the financing of member countries' adjustment policies. For this purpose, total financial support amounting to US $3.7 billion was extended over the 1978-91 period, with the largest part granted in the form of 6 months short-term credits and the rest going to medium-term Balance of Payments credit support. The main benefit that member countries obtain from the LARF seems to be that it grants member countries rapid access to credit, at levels well above individual contributions.

Another important function that LARF performs is to provide an attractive alternative for countries to invest their reserves. As CEPAL, op. cit., shows -

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8 See UNCTAD, Regionalisation and integration into the world economy,..." op.cit.

in most years - the yield in assets invested in this institution was significantly higher than in US Treasury Bills.

Inter-American Development Bank

The Inter-American Development Bank is a major financing institution in the region, with its' total lending in recent years almost as high as World Bank lending to the LAC region.[9] To the extent that a fairly important proportion of its' loans go to fund infrastructure, it has very directly supported both regional integration and integration with the world economy.

In the field of trade finance, the IADB has approved 43 export financing loans of a cumulative total portfolio of US $1.6 billion; these were granted both from the Bank's ordinary resources and from the Venezuelan Trust Fund.

The IADB has recently launched a "Proposal for the establishment of a Regional Network of Export Credit Rediscount Facilities", to provide pre and post shipment export financing for the short, medium and long-term. Both the IADB in Latin America and other regional development banks in other continents could play an important role in strengthening trade financing in their region; technical assistance from institutions like UNCTAD would be very valuable, in bringing together regional development banks to foster inter-regional trade and provide support in specific aspects.

Besides its' fairly limited role in funding trade, the IADB will play an important role in supporting the regional integration process. An obviously key area is the financing of inter-national transport and communications networks, with special emphasis on investment in the connection between networks existing at a national level.

To conclude this section (B), it seems worthwhile stressing that the different institutions that fund trade and investment within the LAC region have on the whole performed fairly well, meeting important needs, and have adapted rather well to changes in those needs.
However, two caveats need to be made: 1) <u>There are important gaps in the provision of trade credit</u>. Perhaps the largest gap is insufficient medium-term financing, to fund exports of capital goods, both within the region and outside it,[10] as well as to fund large inter-regional infrastructure projects. As regards the latter, given its' important expertise in the area, clearly the IADB should play a key role, where possible supplemented by private capital. As regards the funding of exports of capital goods, it would seem important to define what institutions at a regional level should take a lead in this important area, as well as to what extent such funding would most efficiently provided by regional institutions, and / or by national export credit agencies, as occurs in all developed countries, and as exist (in the region) for Mexico and Argentina.

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9 For more details, see, for example, S Griffith-Jones et al. <u>An Evaluation of IDB Lending, 1979-1992. IDS Research Report</u>. 1994.

10 Interview material.

Indeed, the provision, - at a country and / or regional level,- of sufficient credit and / or credit guarantee, especially of a medium-term and long-term nature, seems currently an important gap in the financing of trade in LAC countries.[11] Similarly, there seems to be insufficient credit for financing of exports, by small and medium enterprises. In this context, the creation of agile and appropriate mechanisms for funding non-traditional exports could represent a large potential for the region, and especially exercise an important effect on intra-regional exports.

2) A second caveat is that the number of institutions providing finance for trade in the region is fairly large, and seem to have some overlap of functions. Particularly when and if trade integration progresses towards a truly regional or hemispheric scale, some streamlining of institutions that finance trade within the region may be desirable. However, such streamlining should be carefully carried out, so that no important functions or country links are cancelled, unless it is clear that they will be adequately performed amongst the remaining institutions, either public or private

III INTRA-REGIONAL FOREIGN INVESTMENT FLOWS

An important distinction made in the literature on economic regionalism is that between market-driven (or de facto) versus policy-driven (or de jure) regionalism.[12] The classical example for policy driven regionalism is European integration, whilst the main example for market-driven or de facto regional integration is the Asian experience. Within this latter process, intra-regional foreign direct investment has played a key role in supporting both rapid economic growth in that region and stimulating rapidly growing intra-regional trade. Indeed, while in the 1980's, 70% of investment flows from underdeveloped countries were channelled to the developed world, the majority of Asian FDI flows went to developing countries in Asia, mainly for investment in export-oriented manufacturing.[13]

The Latin American and Caribbean regions seems to be in an intermediate position. Though to an important extent integration within the LAC region and with the US, is policy driven, there is emerging an increasingly dynamic undercurrent of largely de facto or market driven investment flows which encourage integration. As the growth of these intra-regional investments is a new phenomena, information on them is still quite patchy.

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[11] Interview material; see also, CEPAL El regionalism abierto en América Latina y el Caribe. 1994. Santiago, Chile.

[12] See, P Mistry "Regional Integration and Development: Panacea or Pitfall?" Paper prepared for FONDAD Symposium, September 1994. Mimeo; World Bank, "The New Regionalism and its' Consequences Mimeo. March 1994. International Economics Department; C Oman Globalisation and Regionalisation: The Challenge for Developing Countries. OECD, 1994.

[13] See, W Peres (1993) "The internationalisation of Latin American industrial firms" CEPAL Review 49. April; P E Tolentino Technological Innovation and Third World Multinationals. London. Routledge. 1993.

According to UNCTAD data (see Table 3), average annual outflows of FDI from countries in the LAC region (excluding Mexico) reached $ 610 million in the 1990-91 period, a level almost four times higher than during the 1975-77 period.

Table 2 FDI outflows, annual averages (millions of dollars)

Country / Territory	1975-77	1978-80	1981-83	1984-86	1987-89	1990-91
LAIA	169.0	686.5	272.5	276.3	392.7	605.1
Argentina	-0.3	-192.0	-45.0	-	-	-
Bolivia	-	0.5	0.1	-	1.5	1.6
Brazil	147.0	687.0	256.7	88.7	278.7	332.5
Chile	1.7	15.0	-	-	-	-
Colombia	12.3	171.0	56.7	20.7	33.0	20.0
Paraguay	8.3	5.0	-	-	-	-
Uruguay	-	-	2.7	3.0	-0.9	-
Venezuela	-	-	1.3	164.0	80.3	251.0
Central America	-0.4	7.2	3.7	4.1	3.8	3.3
Costa Rica	-0.4	7.2	3.7	4.1	3.8	3.3
Caribbean	1.4	8.1	3.0	8.3	4.0	1.4
Barbados	0.7	0.8	1.0	2.1	2.1	1.4
Netherlands Antilles	0.7	7.3	0.7	-0.2	2.5	-
Trinidad & Tobago	-	-	1.2	6.3	-0.6	-
Total	170.0	701.8	279.2	288.7	400.4	609.7

Source: UNCTAD, Division on Transnational Corporations and Investment. World Investment Directory Vol. IV. Latin America and the Caribbean. 1994 New York

Though data available from other sources indicate somewhat higher outflows, the trends shown in Table 2 are the same ones as those given in other sources. The key point is that a recovery of growth in the region, the prospects of increased integration, the opportunities offered by privatisation and greater availability of foreign exchange, due mainly to a massive surge in capital flows from abroad, has increased the propensity to invest abroad in the early 1990's of the countries in the region.

Latin American outward FDI tends to be fairly heavily concentrated in the secondary and tertiary sectors, with a fairly important concentration in certain sub-sectors. Over 95% of Venezuela's investment in the US is in petroleum refining, and related industries; Mexican investment is heavily concentrated in non-metallic minerals industries, mainly in glass (Vitro) and cement (CEMEX). Brazilian investment was heavily concentrated in the production of motor vehicle cars, wearing apparel and marketing.

For the most advanced economies, in the region, the late 1980's and early 1990's have seen increasing outward FDI in the tertiary sector, particularly in banking and financial services, as well as wholesale and retail trade. These outflows have been directed to less industrialised countries within the region, stimulated by regional economic integration and the removal of FDI barriers. More generally, one of the main factors that has encouraged an important surge in intra-regional investment was the privatisation of state companies.

Reportedly, Chile has in recent years become the most active Latin American country undertaking FDI in the region. By October 1994, the stock of Chilean FDI in the region amounted to more than $1.1 billion, of which almost $700 million (over 60%) was in Argentina; indeed, in Argentina, there are more than 50 companies owned by or linked to Chilean corporations.

A very interesting feature in the process of outward regional investment by Chilean companies (which may well be relevant for the case of other developing countries) is that this outward regional investment is to an important extent funded by resources obtained on the international capital markets[14], and especially those obtained by placement of Chilean shares on the New York stock exchange, via ADR's.[15] Furthermore, it would seem that an important part of the financial resources obtained by Chilean companies via ADR's and also via other mechanisms, such as international loans have been dedicated to - and were obtained specifically with the purpose of - the financing of their outward regional FDI, especially in investments in privatisation's in Argentina and Peru. It could indeed be argued that on a fairly limited scale Chile becomes a "recycling centre" for financial resources, which come from the international capital markets (especially the US ones) and are then channelled towards Chilean outward regional investment.

A second important feature of much Chilean outward foreign investment to the region, (which may be also important for other countries) is that outward investment seems often to be association with export of "know-how" in management and technical aspects, to an important (though not exclusive) extent linked to the fact that economic reforms began significantly earlier in Chile[16] than in neighbouring countries, and to the fact that the economic reforms (in aspects such as privatisation) follow very similar patterns to - and are to a certain extent modelled on - those carried out earlier in Chile.

It is the link between these aspects - the renewed access on an important scale to international capital markets in the early 1990's of Chilean companies, the expertise previously acquired by Chilean companies related, to a fairly important extent, to early privatisation, and finally the opportunities

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14 El Mecurio, Edición International. 17-23 Nov 1994. These figures are based on Central Bank data; other estimates are fai higher. For more details, see A Calderón and S Griffith-Jones "Los flujos de capital extranjero en la economía chilena: renovado acceso y nuevos usos". CEPAL, Documento de Trabajo, 37. 1995.

15 See, A Calderón and S Griffith-Jones, op. cit., especially Table 8, and case studies.

16 Interview material.

offered by the recent processes of privatisation in neighbouring countries - which provided important incentives for the rapid growth of Chilean regional outward FDI. The liberalisation by the Chilean Central Bank in 1991 of the mechanisms through which outward investment could be carried out significantly facilitated the process. That this liberalisation was to an important extent spurred by an important increase in foreign reserves, also linked to the beginning of the surge of capital flows to Chile[17].

IV THE SURGE OF PRIVATE FLOWS INTO THE REGION; ITS' LINK WITH REGIONAL INTEGRATION

As is well known, there was a major surge in private capital flows into the LAC region[18] in the 1990's. An important proportion of these flows came into Mexico.

A number of reasons, both domestic and international, explained this surge of capital flows to the LAC region. These include, on the international side, very low US interest rates and recession in the industrial countries in the early 1990's and changes in US capital market regulations. On the domestic side, they include far greater macro-economic stability, the elimination of the debt overhang via Brady deals and other mechanisms as well as profitable opportunities provided by the development of domestic capital markets, privatisation programmes and relatively high real interest rates.

Clearly the prospects of regional integration - and especially integration into NAFTA - have been an important factor encouraging such inflows, especially into Mexico. This seems to be particularly the case for foreign direct investment flows. Indeed, shorter term profitability factors are key to the very rapid growth of portfolio flows to the LAC region in general, and to Mexico in particular, even though the prospect of "locking" structural reforms and macro-economic stability via NAFTA reduces perceived country risk for Mexico, and therefore also contributes to increase its' attractiveness for portfolio flows; so do the signing of memoranda of understanding and co-ordination of efforts with US regulators, efforts facilitated by the prospects and reality of NAFTA. However, it is FDI flows which would seem to respond more strongly to longer term considerations; in this context, Mexico's entry into NAFTA provides a more reliable access to the huge North American market. Reportedly, the rules of origin and local content negotiated within NAFTA afford enough flexibility to enable the participation of investors from all over the world.[19] This was largely because the opinions of companies already operating in Mexico - especially that of automotive companies - prevailed in the discussions.

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17 See, for example, S Griffith-Jones et al "The return of private capital to Latin America" in J Williamson et al. Fondad.

18 See R Ffrench-Davis and S Griffith-Jones (Ed) Coping with capital surges: the return of finance to Latin America. Lynne Rienner and FCE. 1995.

19 See A Gurría "Capital flows: the Mexican case" in R Ffrench-Davis and S Griffith-Jones, op. cit.

Indeed, though foreign direct investment in Mexico by US and other multinational companies was already important preceding NAFTA (de facto integration), NAFTA increased Mexico's appeal to investors of diverse origins as a platform for exporting manufactured goods, particularly to the North American market. Volkswagen and Nissan have taken important decisions in this regard; it is expected that increased integration could also lead some North American subsidiaries in Asia to transfer their operations to Mexico.

There was also the spectacular rise in portfolio investment flows during the 1988-93 period (even though these fell very dramatically in 1994). As the Mexican crisis illustrated dramatically, portfolio flows respond mainly to short-term factors, and may be extremely volatile.

The link between integration with a major market and increased FDI seems also to be shown by other experiences. After Portugal and Spain joined the EC, FDI to those countries increased very significantly, apparently showing the close link between increased FDI and regional integration with a very important market. However, it should be stressed that participation in a regional market is not a sufficient condition for a developing country to attract FDI. After Greece joined the EC, it did not experience a large increase in FDI inflows. However, the Southern Enlargement of the EC does show on balance a net important positive effect of integration on FDI flows.

A final point needs to be made here. Additional FDI and other capital flows, linked to regional integration, have important economic benefits, both of a macro-economic kind (by providing foreign exchange that allows higher growth) and a micro-economic kind (by facilitating improvement of technology and management). However, there are also risks in capital flows, especially clear in non-FDI flows. Thus, surges in capital flows can - and recently have - led to overvaluation of currencies, which discourages exports, even though increased exports are precisely a key aim of regional integration. Increased capital inflows may also partly replace domestic savings, and therefore lead only partly to increased investment. If insufficient capital inflows are channelled into increased investment in tradeables, the country could be creating Balance of Payments problems for the future. If inflows are in an important proportion devoted to increased investment in tradeables (more likely in the case of FDI), their long-term effects are more likely to be beneficial. Above all, as recent events in Mexico have shown, portfolio and short-term capital flows can be incredibly volatile, with very negative effects on countries' economies.

We therefore can conclude that the main welfare effects of regional integration (and especially of NAFTA) are related to the impact of increased foreign inflows. Though there is evidence of such an impact, its' magnitude is somewhat unclear, as are its' long-term effects. However, as regards the latter cautious optimism seems justified by preliminary evidence, though euphoric conclusions clearly are not. Unfortunately, events in Mexico since December 1994 confirm many of the concerns of more pessimistic analysts.

V CONCLUSIONS AND POLICY ISSUES

Financial mechanisms and flows play a key role in supporting economic integration.
In the case of Latin American and Caribbean integration, a number of institutions were explicitly created to facilitate trade (payments and clearing arrangements) and finance it (e.g. BLADEX). Most of these mechanisms and institutions have functioned fairly effectively, even though the 1980's put special pressure on them; unfortunately, payments and clearing arrangements in Central America and in the Caribbean have not been able to recover from their crisis in the 1980's, whilst the LAIA mechanism clearly has. As integration becomes increasingly regional (and probably hemispheric), it may be appropriate to think in terms of a regional payments and clearing arrangement, based for example on the broadening of the successful LAIA mechanism. Such a payments and clearing mechanism could both sustain and encourage full regional integration. As discussed above, there is also a case for broadening such multilateral payments still further, to include increased links with African and Asian countries. Technical assistance from institutions like UNCTAD could play an important role.

The institutions, such as BLADEX, CAF, the BCIE, CAF and LARF, which provide credit for intra-regional trade have on the whole worked well, as have export credit agencies in individual countries, the most important of which is BANCOMEXT.

Relevant policy issues are: 1) Is there a gap, with insufficient medium and long-term finance, provided either by these institutions and/or private capital markets to fund exports of capital goods? Is it necessary to complete private financial markets in this field? If there is such a gap, what institution/s should best increasingly focus on these financial activities, which will help fund intra-regional trade, that is more technology and skill-intensive? What modalities of collaboration between public and private institutions/mechanisms would best suit these needs and be the most cost effective from the point of view of using public funds? To what extent should regional financial institutions undertake such tasks, or would they be better achieved via national export credit agencies, as occurs in the industrial countries; 2) Should existing regional and sub-regional credit institutions possibly be streamlined to avoid overlap in certain functions, and also to increasingly sustain a more regional - and hopefully - a more hemispheric integration process. However, any streamlining would have to be carefully studied and carried out, to avoid disrupting any essential functions.

Again in the area of trade finance, a need arises for technical assistance from institutions like UNCTAD, for functions such as training, support for design of export financing institutions and for creation of joint guarantee networks by national and / or regional institutions.

Four other important policy issues arise. Firstly, how should the rapidly increasing needs to fund intra-national infrastructure to include sectors such as telecommunications and "information superhighways") essential to support trade integration be best met? In this context, it should be remembered that to an important extent the European Investment Bank (created at the same time as the European Community was formed) was largely geared to funding infrastructure to support European integration. It would seem that regional development banks - possibly with the support of the World Bank - should take a leading role in such funding, given its' expertise in the field. Again, creative forms of collaboration and co-financing with private capital flows need to be found; again, the European Union experience, with the recent creation of a 3 billion ECU European Investment Fund, to guarantee private investment in very large intra-national infrastructure projects, provides an interesting precedent, which could be adapted to the needs of Western Hemispheric integration.

Secondly, should further measures be taken to encourage intra-regional FDI and investment from outside the region? To what extent are these flows increased by the prospect of increased integration? To what extent are their effects welfare enhancing in the medium to long-term? To better answer those questions, a fuller understanding of the scale and the impact of such flows seems essential, careful evaluation needs to be undertaken by national governments as well as institutions like UNCTAD. A related area of work concerns the development of regional capital markets, which includes standardisation of aspects such as regulations and tax systems and facilitation of cross-border trading of government and private securities. Again UNCTAD could provide valuable technical assistance.

Thirdly, what measures can realistically be taken to achieve progress in monetary co-ordination and harmonisation? Though full monetary union may be too ambitious a short-term goal, co-ordination and policy convergence should play an increasing role. It is crucial. as the European experience shows, to develop an appropriate institutional structure for such co-operation. Both this European experience, and the more limited progress made in several regional groupings of developing countries deserve careful study dissemination and discussions, institutions like UNCTAD could play a useful role in carrying out such work.

Last, but not least, there is the forgotten financial agenda, in the Western Hemisphere integration process, which may need to be brought into the discussion. Should financial compensatory mechanisms (used for example for labour retraining) be designed on a significant scale to compensate sectors and regions which suffer dislocation from trade integration? Even further, should certain financial mechanisms be created which support integration by reducing extreme inequalities between countries? This may sound radical or even utopian in the context of today's discussion in the Western Hemisphere, but it was - and still is - a central part of the West European integration process, implemented both through credit mechanisms (e.g. the EIB) and through fiscal mechanisms (e.g. the Structural Funds).

It seems that in the context of Western Hemispheric integration, compensatory mechanisms operate mainly via differential schedules in the liberalisation of trade. Though valuable, a question that needs addressing, is whether that is enough to provide long-term support from all sectors and social groups for the integration process?

We can conclude that the policy agenda for the financial aspects of regional integration is a rich and complex one, with very central issues for the success of the integration process.