

The Clearing Mechanism of the Latin American Free Trade Association*

At a September 1965 meeting in Mexico City, central bank governors of the nine nations then belonging to the Latin American Free Trade Association (LAFTA)¹ agreed to establish a limited clearing mechanism for facilitating intraregional payments. The basic agreement provides for the negotiation of bilateral (and reciprocal) credit agreements between each pair of participating central banks and for the multilateral clearing of balances which arise from each individual bilateral credit agreement clearing. The mechanism went into operation in mid-1966 among only six countries, but since then more countries have joined and actively participated, while the number and size of underlying bilateral credit arrangements have been expanded. By reducing the magnitude and frequency of cash transactions among countries, the clearing facility has helped economize on their convertible foreign exchange and has made payments easier and less costly. LAFTA's clearing arrangement has become an important step toward financial integration among LAFTA countries. This article describes the evolution of this mechanism and the ways in which it serves the participating countries.

BACKGROUND

For decades, Latin American governments, central bankers, and regional organizations have been discussing possible means for achieving a greater degree of financial integration within the region and have considered numerous proposals for intraregional credit and clearing of balances. Establishment of intraregional clearing came slowly, however, because clearing proposals were combined with automatic credit, and some countries were

reluctant to extend such credit to intraregional deficit countries. Under some proposals, creditor countries within the region would not have been able to use their regional surpluses to settle extra-regional deficits, and this appeared to them as a backward step, away from free convertibility. Furthermore, smaller and poorer surplus countries felt it unreasonable that they be forced to extend credit to larger and wealthier deficit countries, and surplus countries did not always approve of the economic policies of debtor countries.

The problem of Latin American payments was discussed at the first meeting of the United Nations Economic Commission for Latin America in 1948. At that time, bilateral agreements covered about half the area's intraregional trade as well as some extra-Latin American trade. It was hoped that multilateral arrangements could be developed to improve and eventually replace the network of bilateral agreements. Discussions continued, and in 1958 a working group of central banks proposed an agreement to create a multilateral clearing system for bilateral balances. Although the draft scheme was rather similar to the system now in force, it was not implemented at the time.

By 1960 the Latin American integration movements were becoming institutionalized, as evidenced by the establishment of the Inter-American Development Bank, LAFTA, and the Central American Common Market. Other regional organizations, such as the Center for Latin American Monetary Studies (CEMLA) and various committees of the Organization of American States and the Alliance for Progress, actively studied the financial aspects of integration. These aspects of clearing arrangements received new emphasis, as ways were sought to smooth out possible balance-of-payments difficulties arising from the lowering of intraregional trade barriers. While discussion proceeded, emphasis shifted again from this objective to that of providing incentives to facilitate the growth of intraregional trade. The example of the Central American Clearing House, which began operations in 1961 as part of Central American integration efforts, contributed to this shift. The Clearing House made intra-

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¹ The original signatories were the central banks of Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, and Uruguay. Bolivia and Venezuela joined later.

regional payments easier and reduced the use of scarce foreign currency for such purposes without large mutual credit facilities. It became evident that a payments or credit system need not involve extension of sizable and long-term credits, and support developed for an arrangement whereby the maximum amount of such credit would be specified in advance and its term would be held to a very short period.

The decisive impetus to establish the present mechanism was given at the first meeting of commercial bankers of LAFTA. In their report of March 1965 to their central banks, the commercial bankers suggested the signing of a complementary agreement to the LAFTA treaty, establishing guarantees of free convertibility and the transferability of exchange used in transactions among LAFTA countries. The bankers also recommended the creation of correspondent relations among the commercial banks, whose clearing payments would be expressed in United States dollars and settled through arrangements made by the central banks. In June the Advisory Commission on Monetary Affairs of LAFTA drafted the documents, and on September 22, 1965 the governors of the LAFTA central banks signed a general agreement establishing the clearing mechanism.

THE AGREEMENT

The preamble to the general agreement makes clear that the system was conceived as the first step toward the long-run goal of financial and monetary integration. The more immediate aims, however, were to provide a stimulus to financial and trade relations within the region and to foster systematic consultations on monetary, exchange, and payments matters.

The agreement calls for the establishment of bilateral (and reciprocal) lines of credit, expressed in United States dollars, among all participating central banks. The channeling of payments through the system is entirely voluntary, thus allowing each country to maintain its trade and exchange practices. (In reality most central banks have made it compulsory for payments among addressees of signatory countries to go through the mechanism.) Article 7, however, requires the central banks to guarantee the convertibility of the currencies used in the final settlements with each other, a feature reinforced by Article 8 which specifies that settlements must be made in United States dollars.

The balances resulting from the utilization of the bilateral lines of credit are to be cleared periodically and multilaterally. (Originally the period between settlements was two months, now it is quarterly.) The agreement calls for

the immediate settlement of any balance exceeding the set credit limit, but the central banks are allowed to negotiate additional extraordinary credits. Furthermore, the agreement requests the central banks to encourage intraregional correspondent relationships among their commercial banks, so that the latter may clear their net balances through the system. The clearing operations, including the computation of the net balances at the end of the period, are carried out by an agent bank, a task which has been given to the Central Reserve Bank of Peru.

The procedures are simple: on the bases of accounting information cabled by each of the central banks within forty-eight hours after the end of the last working day of the settlement period, the agent determines the balances between each pair of central banks and also the net balance of each central bank in relation to all the other banks together. By the following day the agent must notify every central bank of its net position, and this information is also sent to the designated common correspondent bank—the Federal Reserve Bank of New York. Within the next twenty-four hours the debtor countries must make their payments, in dollars, to the special LAFTA account of the correspondent bank, which then proceeds to pay the creditor banks. If a bank does not provide the required information within the stipulated forty-eight hours, the agent will compute the net balances among the other banks, with which the tardy bank will have to settle its accounts directly. Furthermore, if a debtor bank does not pay the correspondent bank within twenty-four hours of being notified, the agent will annul the clearing by ordering the correspondent bank to return the amounts received and will proceed to settle the accounts again, excluding the delinquent bank.

DEVELOPMENT OF THE SYSTEM

Immediately after the system started operating, problems became evident. The central banks authorized every payment, cabled payment orders were confirmed by air-mail, and in some cases payment data were cabled daily. There were serious questions as to how to treat expenses and commissions regarding payments and how to resolve conflicts of national holidays falling on settlement dates. Credit limits in many cases were insufficient, frequently making extraordinary settlements necessary—a problem which plagued the system in its first years. In addition, as any pair of participating banks could establish their own operating techniques by setting them forth in a bilateral agreement, until recently no two bilateral credit agreements were completely alike. For example, there were significant differences regarding the amount of documen-

Table I
BILATERAL CREDITS
UNDER AGREEMENTS NEGOTIATED BY THE END OF MARCH 1969

In millions of dollars

Country	Argentina	Bolivia	Brazil*	Chile	Colombia	Ecuador	Mexico	Paraguay	Peru	Uruguay*	Venezuela	Total
Argentina.....	—	2.0	†	15.0	3.0	†	1.5	1.0	17.0	†		39.50
Bolivia.....	2.0	—	†	.5	.1		.2		.45			3.25
Brazil*.....	†	†	—	5.0	†		3.0	†	3.0			11.00
Chile.....	15.0	.5	5.0	—	.75	†	5.0	.2	4.5	.5	1.8	33.25
Colombia.....	3.0	.1	†	.75	—	.8	3.0		1.0			8.65
Ecuador.....	†			†	.8	—			.5			1.30
Mexico.....	1.5	.2	3.0	5.0	3.0		—	.2	1.0		1.5	15.40
Paraguay.....	1.0		†	.2			.2	—	.2			1.60
Peru.....	17.0	.45	3.0	4.5	1.0	.5	1.0	.2	—		†	27.65
Uruguay*.....	†			.5						—		.50
Venezuela.....				1.8			1.5		†		—	3.30

* The agreements have been signed but are not in operation.

† Agreements being negotiated.

Source: *Boletín Mensual* (CEMLA, February 1968), page 102, (July 1969), page 318, and *Síntesis Mensual* (LAFTA, May 1969), page 188.

tary credits to be authorized, the limit at which excess balances would require immediate settlement, the extent of the guarantee to be given on currency convertibility and transferability, and the option of channeling some or all payments through the system.² The general agreement, however, sets forth simple provisions for revising the system, and amendments soon solved many problems.

Last year most improvements were incorporated in a uniform text for bilateral credit agreements and a technical procedures annex, drafted by LAFTA's Advisory Commission on Monetary Affairs, to which all countries adhere today.³ The uniform text provides that all payments between addressees of the two signatory countries are allowed to go through the mechanism. Payments are to be expressed in dollars, are subject to the foreign exchange regulations of the countries, are to be effected under most-favored-nation terms, and are to be made by the central banks or their authorized institutions. Those payments arising from trade in merchandise originating outside the

two countries, as well as services and capital transactions with nonresidents, are excluded from the bilateral agreements.

A major improvement in the system, which had been discussed since 1966, is formalized in the uniform text by a "payments guarantee" clause. Each central bank guarantees the settlement of payments going through the agreement. Most of these payments arise from the letters of credit, documentary credits, certified drafts, and payment orders drawn or issued by its own commercial banks, and the guarantee provides that each commercial bank of the other country must declare "in writing and under its absolute responsibility" that it has made the payment according to the instructions of the drawer bank. Prior to this guarantee, commercial and financial transactions between commercial banks were routed through the central banks; now such transactions can be made directly between commercial banks.

Two other major improvements, which were introduced in May 1968 by the Council on Financial and Monetary Policies of LAFTA, are incorporated in the uniform text. First, interest is charged on debit balances at a rate 1½ percentage points below the discount rate of the Federal Reserve Bank of New York in effect at the beginning of the settlement period. This makes the mechanism more attractive to net creditor countries. Second, the central banks are authorized to use multilaterally, with the permission of all the parties concerned, the unused credits

² For a more comprehensive description, see Appendix 1, "Características Comunes y Aspectos Divergentes de los Convenios de Crédito Recíproco en ALALC", in "Ampliación y perfeccionamiento de los mecanismos de compensación en América Latina", *Boletín Mensual* (CEMLA, April 1968), pages 195-99.

³ See *Boletín Mensual* (CEMLA, September 1968), pages 478-82 for text of the bilateral agreements and technical procedures.

that are available to them bilaterally. This enhances the usefulness of the system as a multilateral instrument. Until recently, the credits were compartmentalized by the bilateral agreements: a country could exhaust its credit with one central bank and not be able to make use of the credits available under the remaining individual bilateral agreements. In August 1968 the new option was used for the first time by Chile, which settled \$1.5 million with Mexico by utilizing its credit balances with Colombia, Peru, and Venezuela.

The uniform text provides for variations in the size of the basic credit that can be extended under each agreement (see Table I) as well as in the percentage of the basic credit to which balances may expand before immediate settlement of the excess is required. (These

percentages presently run from as low as 5 percent to as high as 333.33 percent of the basic credits.) This provision regarding excess balances acts as a secondary line of credit and was introduced with the objective of eliminating, as far as possible, settlements before the end of the settlement period. It also gives the central banks time to adopt measures to reduce excess balances and takes into account legal restrictions on the granting of unlimited credit by some central banks.

Increasing participation of signatory countries in the system has been an important development. To be sure, the central banks are far from having concluded all the bilateral agreements possible, but it should be recalled that they are not compelled to do so and, what is more important, that some countries have virtually no trade

Table II
LAFTA CLEARINGS
In millions of dollars

Settlement date (end of period)	Argentina	Bolivia	Chile	Colombia	Ecuador	Mexico	Paraguay	Peru	Venezuela	Total*
1966										
June.....	1.8		— .5	— †		— 1.1	— .1	— †		1.8
August.....	.6		.2	— †		— 1.1	— .8	1.1		1.9
October.....	8.5		— 7.1	— .9	— .1	3.4	1.2	— 5.2		13.2
December.....	9.4		— 10.2	— 1.9	— †	4.0	1.2	— 2.6		14.7
1967										
February.....	12.5		— 10.7	.6	— .5	3.8	.4	— 6.0		17.3
April.....	16.0		— 10.1	.3	— .7	2.9	— †	— 8.3		19.2
June.....	11.2		— 7.5	— .5	†	3.0	— .6	— 5.6		14.3
August.....	13.2		— 8.7	— .1	— .2	.9	.2	— 5.3		14.3
October.....	10.8		— 9.8	— 3.6	.1	3.4	.2	— 1.1		14.5
December.....	10.6		— 6.8	— 1.9	— .2	3.7	— .1	— 5.3		14.3
1968										
February.....	22.1		— 11.0	— 3.1	.2	2.6	— .3	— 10.4		24.9
April.....	21.2	— .4	— 12.0	— 2.8	— .5	4.4	— 1.3	— 8.7		25.7
June.....	16.8	— .8	— 14.7	— 2.8	.9	5.8	1.1	— 6.2	— .2	24.7
September†.....	25.4	.2	— 22.3	— 4.0	— .5	9.6	.5	— 8.9	— .1	35.7
December.....	13.3	— .5	— 8.9	— 4.0	— .4	4.3	.9	— 4.7	— †	18.5
1969										
March.....	14.0	— .9	— 8.2	— 1.7	— 2.1	7.6	— .1	— 8.5	— †	21.6
June.....	21.8	— 2.3	— 17.7	— .3	— 1.4	7.3	— .2	— 7.1	— .1	29.1

Note: Minus figures represent net payments; other figures are receipts. Because of rounding, figures do not necessarily add to totals.

* Total receipts and total payments.

† Less than \$50,000.

‡ Since July 1, the clearings have taken place quarterly.

Source: *Sintesis Mensual*, LAFTA.

relations with certain other LAFTA members. All things considered, the growth in the number of agreements signed and in the volume of final settlements has been extremely rapid. In May 1966 the clearing mechanism started operations with six central banks—out of nine original signatories to the general agreement—and nine bilateral agreements, totaling \$17.8 million. At that time, five other bilateral agreements totaling \$5.6 million had been signed, but balances were not cleared through the mechanism. By December 1967, ten banks had signed the general agreement, with seven taking part in the clearing through sixteen bilateral agreements totaling \$25.7 million. Venezuela, the new member, settled balances under its two bilateral agreements outside the mechanism. By the first quarter of 1969, eleven banks had signed the general agreement, and nine of these were actively participating in the system through twenty-three bilateral credit agreements amounting to \$61.2 million.⁴ Brazil and Uruguay, original signatories of the general agreement, have signed four bilateral agreements totaling \$11.5 million, but they have yet to start operations. Thus, out of a possible total of fifty-five bilateral agreements within LAFTA, twenty-seven have been signed, eight are being negotiated, and another twenty remain to be negotiated. As a result of one early revision of the agreement allowing the central banks of Latin American countries outside LAFTA to participate in the clearing mechanism, the Dominican Republic concluded a bilateral credit agreement with Venezuela and apparently intends to negotiate others in order to participate in the system.

Progress toward attaining other goals of the system has been mixed. "Triangulation"—the utilization of the services of a common correspondent commercial bank outside the region, usually in the United States, to make payments among commercial banks in the LAFTA countries—has been almost totally eliminated. Some banks, however, find lines of credit in hard currencies with banks outside the region, especially in the United States, to be useful in the financing of intraregional transactions. The development of correspondent relationships among commercial banks has been uneven. While the more aggressive LAFTA banking systems have been quite successful in establishing correspondent relationships among themselves, others are required to transact all foreign exchange operations through their central banks.

⁴ Part of the \$61.2 million resulted from the extension of the settlement period to three months and the subsequent increase in the amounts of the reciprocal credit agreements.

A major immediate objective of the clearing system—the saving of foreign exchange—has been successfully achieved. Foreign exchange transactions going through the system have been curtailed by almost three fourths: 65 percent to 75 percent of the transactions are cleared internally by the netting of claims against liabilities, and only the remaining 25 percent to 35 percent are settled in United States dollars. Thus, in June 1966, the first clearing, covering balances totaling \$6.3 million, was settled by payments of only \$1.8 million (see Table II). Recent figures indicate that between \$70 million and \$100 million in balances is now being cleared quarterly, with final settlements averaging \$26 million. Savings have also resulted for the commercial banks. They can keep smaller balances outside the region and do not have to pay the commissions and cabling expenses entailed in the clearing of transactions through third countries.

While the system cannot claim to have increased LAFTA's trade, it has clearly expedited payments and lowered their costs.⁵ Formerly, payments delays of over six months were not rare. Today, it is claimed that these delays have been reduced substantially, while the costs of bank commissions and fees have been considerably reduced in most cases. Moreover, it is reported that total payments going through the system exceed commodity trade payments, indicating the increased utilization of the mechanism for nonmerchandise purposes. For example, Argentina and Peru channel all payments through the system; on the other hand, Chile and Venezuela do not allow the payment of their main exports, copper and petroleum, to go through the system.

While problems have not disappeared, the central banks are gradually solving them. For example, some central banks are having difficulties in receiving data on payments from others, there are no uniform criteria as to the effective date for applying interest rates on the central

⁵ Several studies have analyzed and evaluated the operations and achievements of the clearing system. Enrique Angulo, "Los acuerdos de créditos y compensación en Centroamérica y en la ALALC", *Boletín Mensual* (CEMLA, August 1966), pages 369-83, and "Integración financiera Latinoamericana en 1968", *Boletín Mensual* (CEMLA, July 1969), pages 311-23. Comité Técnico Especial sobre Mecanismos de Compensación, "Informe", *Boletín Mensual* (CEMLA, February 1968), pages 95-103. CEMLA, "Ampliación y perfeccionamiento de los mecanismos de compensación en América Latina", *Boletín Mensual* (April 1968), pages 188-200, (May 1968), pages 263-79, and (June 1968), pages 342-53. Felipe Pazos, "Mecanismos multilaterales de pagos en América Latina", *Temas del BID* (Inter-American Development Bank, September 1968), pages 1-18.

bank debits, and commercial banks still occasionally forget some of the routine formalities embodied in the technical procedures.

Despite these problems, the system's immediate goals have been, for the most part, achieved. Through their close cooperation, the central banks have developed more understanding of each others' difficulties, a stronger mutual confidence, and a greater willingness to work together in solving common financial problems. This new attitude has been quite evident in the system's rapid shift from very re-

stricted operations under detailed instructions to a more relaxed, decentralized, and multilateral method of operating under the bilateral credit agreements. It has also been evident in the continuous efforts to strengthen the institutions of financial integration. This strengthening was evident in September, when the Council on Financial and Monetary Policies of LAFTA reportedly approved the establishment of credits to cover balance-of-payments difficulties—a further step toward the common utilization of the area's financial resources.