Introduction

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In the last few years, the integration process in MERCOSUR (Mercado Común del Sur – the Southern Common Market) has been characterized by economic turbulence: the devaluation of the Brazilian currency in January 1999 resulted in spillover effects in the MERCOSUR area, more specifically in Argentina. The 2001–2 crisis in Argentina has had a destabilizing impact on macroeconomic indicators in the MERCOSUR countries, particularly in Brazil. Since Brazil has a floating exchange regime, the demand for hedging caused more and more devaluation of its currency, with serious impacts on Argentina's trade, as this country had until recently a fixed exchange regime. After the collapse of Argentina's system of convertibility, the extreme macroeconomic instability has been a serious restriction to any growth-oriented policy, and as a result the re-starting and developing of the integration process may be harmed. Consequently, the optimism about the integration process, which prevailed in the mid-1990s, when the intra-regional flows of goods were expanding at a very fast rate, was changed later into deep scepticism.

Taking these turbulences into consideration, a question arises: what is the future of MERCOSUR? This question can be answered in different ways. On the one hand there are those who argue that MERCOSUR should only become a free trade area. In this context, the final step of the integration process in MERCOSUR would be the Free Trade Area of the Americas scheduled for 2005. On the other hand, there are those who maintain that nothing less than a monetary union should be the solution. This argument makes the following three points in favour of a monetary union: (i) it would provide a new framework for economic management: a new way of conducting fiscal policy would be introduced, and it would modify the financial and monetary system of the member countries in a way that would make policies a great deal more effective; (ii) it would prevent new currency crises in the region; and (iii) it would stimulate a definitive economic integration among the countries of the bloc.¹ Other authors, however, claim that it is too early to think of a monetary union for MERCOSUR and are in favour of macroeconomic policy coordination among the country members of the bloc.²

Until recently, there had been indications that the integration process in MERCOSUR was going in the direction of a monetary union. The most

important indicators were the following: in 1997 the former President of Argentina, Carlos Menen, proposed the ‘dollarization’ of MERCOSUR economies; in 1998 the annual regional summit of MERCOSUR indicated the possibility of having a single currency for the MERCOSUR countries; and in December 2000, the Presidents of the MERCOSUR countries declared their approval of macroeconomic convergence targets, namely inflation rate, fiscal deficit and net public debt. However, the adoption of a series of initiatives by Argentina’s government during 2001, aiming to improve the country’s competitiveness, seriously harmed imports of Brazilian products, and put at risk the very survival of the bloc. Since Argentina and Brazil had different currency regimes, and this difference was harming intra-MERCOSUR trade, the proposal of a MERCOSUR monetary union seemed to resurface in the debate as the unique solution to ensure the continuity of the bloc in the long term.

Economic and Monetary Union (EMU) is particularly relevant to the argument of the book, since it has been the main source of inspiration for the proposal to create a monetary union in MERCOSUR. It is for this reason that substantial reference is made to the EMU experience and institutional set-up in this book. The EMU experiment is also one of the very few examples of attempts of countries to unite under a common currency in the post-World War II era, an attribute that gives it added significance.

The principal aim of the book is to contribute to the academic debate on the future of MERCOSUR. Focusing on monetary unions, with particular reference to the EMU experience, and on the principles of economic policy coordination, the book addresses a number of questions, the most important ones being the following:

- Is it possible, or indeed desirable, to achieve monetary integration in MERCOSUR?
- What would the preconditions be for establishing such a union?
- What would the convergence criteria be for joining the monetary union?
- What are the expected economic consequences for the member countries of a MERCOSUR monetary union?
- Are there any other options than monetary union for MERCOSUR?
- What is the relevance of the EMU experience for MERCOSUR?

The book is divided into three parts for this purpose: the first part, entitled ‘Lessons from the Euro and EMU for MERCOSUR’, analyses the origins and dynamism of the monetary integration process in Europe, and the lessons for MERCOSUR. The second part, entitled ‘MERCOSUR Macroeconomic Policy Coordination’, contains contributions that present and discuss some of the necessary conditions for monetary union in MERCOSUR, such as the

issue of macroeconomic convergence. The third part, entitled 'Exchange Rate Regimes and Monetary Dilemmas for MERCOSUR', discusses some specific macroeconomic issues concerning MERCOSUR and their impact on the future of the bloc, such as the external financial integration between Latin American economies and mature economies, and the recent collapse of Argentina's monetary regime. Whenever possible, technical detail has been kept to a minimum in the hope that this text will also be accessible to students. Alternative solutions to the problem under scrutiny are also discussed, such as macroeconomic policy coordination among the member countries without a monetary union in place. We hope that the eight chapters in this volume will give the reader a fresh perspective of the issues concerning macroeconomic coordination in MERCOSUR. As nations are becoming more and more inter-dependent, the need for a serious analysis of the macroeconomic conditions of economic and monetary integration becomes more pressing. We believe that the best way to discuss these issues is to expose the problem in hand to different approaches. We hope that this volume will contribute to the debate.

The opening chapter, by John Flemming, seeks to extract some lessons for MERCOSUR by focusing on the EMU experience. In his short note, Flemming first shows that since the process of EMU is not complete, it is too early to draw definitive conclusions from this experience. One of his fears for EMU is related to the possibility that its 'one-size-fits-all' monetary policy might leave some countries with untreated depression, but this has not happened. What has happened is a number of booms in certain peripheral countries, Ireland and Portugal in particular. But this peripheral boom has its counterpart in a relatively sluggish core of France, and particularly Germany. The effect of EMU on the peripheral countries has been virtually to diminish the risk premium reflected in their interest rates, since it eliminated the exchange rate risk. Since MERCOSUR does not have a core and a periphery, it is doubtful whether there is a useful lesson in this particular context. On the other hand, despite the ten-year-old single market and the two-year-old euro, the European market in corporate control is far from being free and unified. Germany has just blocked a directive on European takeovers. Consequently, mergers that create national champions do little to take advantage of any potential improvement in the scale/competition trade-off.

In the second chapter of the first part, Philip Arestis, Fernando Ferrari-Filho, Luiz Fernando de Paula and Malcolm Sawyer discuss whether the EMU mould of monetary union is appropriate and feasible for MERCOSUR. Three lessons are derived for MERCOSUR from the euro and the EMU experience. First, the adoption of the EMU model of monetary union would imply deflationary policies; there is little coordination of monetary and fiscal policies, and the deflationary policies, due essentially to the primacy of monetary policy over fiscal policy. The latter is guaranteed by the institutional structure and

rules of the European System of Central Banks and the Stability and Growth Pact. Second, there is a dilemma of sequencing between political union and economic integration, since the formation of the EMU was not much influenced by economic convergence and political union considerations. Third, it is necessary to account seriously for the concerns of the optimal currency area (OCA) literature, factor mobility and openness of markets, relative price flexibility, and fiscal transfers within the monetary union. These considerations appear to have played little role in the formation of the euro zone. In the case of MERCOSUR, the area has only minimally achieved some basic criteria defined by the OCA literature. The chapter concludes by suggesting that one lesson that can be extracted from the EMU experience is the avoidance of using this model as the benchmark for a possible MERCOSUR monetary union. Since the countries of MERCOSUR have more social problems than the countries of the EMU, the cost of adopting a MERCOSUR monetary union on the euro pattern would probably be greater than in the case of the EMU. So, it would be necessary to have much more flexible mechanisms of compensation in terms of fiscal transfers in order to tackle the socioeconomic problems of the MERCOSUR countries.

The second part of the book unfolds with a contribution by Fabio Giambiagi, who puts forward a proposal for a MERCOSUR monetary union in the long term. He adopts an encompassing approach to justify the long-term objective of currency unification among MERCOSUR countries. The theoretical advantages of a monetary union are: (i) more guarantees for stability ('tying one's hands'); (ii) stimulus for investment, related to the reduction of uncertainty and discretion; (iii) reduction of interest rates, as a consequence of the decrease in the exchange risk and regional risk; and (iv) elimination of transaction costs in the product, capital and labour markets. He presents further arguments in favour of a monetary union for MERCOSUR, such as the strengthening of the bloc in international negotiations, the advantages of the creation of an effective common market, and the creation of an intermediary regional power. MERCOSUR has some advantages over other regions that include democratic institutions, economies with capitalistic tradition, relatively sophisticated financial markets, recent economic stability, lack of conflicts (religious, ethnical, geographical, historical, external), and cultural identity. The next step in the argument describes the requirements for a single currency and the increasing homogeneity of the economies of the region. The chapter concludes by suggesting that this proposal can provide for a possible transitory agenda to 2002/2004 in order to reach a macroeconomic convergence in the region. This agenda includes an annual inflation target of 5.0 per cent, a 3.5 per cent ceiling on the ratio of the current account deficit to GDP, and a 3.5 per cent ceiling on the nominal public sector deficit to GDP. The chapter also emphasizes that currency unification tends to be the natural consequence of regional integration.

The second chapter of the second part, by Arturo O'Connell, examines some issues concerning the macroeconomic coordination in MERCOSUR. First, he shows that, even after almost a decade of a long process of integration and opening up of the MERCOSUR economies, their commercial dependence on each other was slim compared to that of the EU countries presently undergoing a process of monetary unification. Furthermore, liberalization of labour flows has hardly made any progress. Therefore, on the 'real' side, there is little that could be argued for macroeconomic coordination, let alone for a currency union among MERCOSUR countries. On the other hand, volatility in relative exchange rates has not necessarily had serious impacts on trade flows in the region. In fact, some studies on determinants of trade flows between Argentina and Brazil have shown a large response to changes in levels of activity in the destination country and a very small one to changes in exchange rates. O'Connell concludes that obstacles for MERCOSUR progress, therefore, have more to do with some microeconomic issues than with macroeconomic issues of relative exchange rates or coordination of fiscal and monetary policies. He suggests that for MERCOSUR countries to start on a new phase of sustainable development, it would be essential to overcome both their specific and more general weakness in their pattern of trade and external relations with the world at large. Only in this way could some degree of autonomy be pursued and achieved in terms of the policy aims of the member countries. So the question arises as to which policies would be instrumental in achieving those aims by overcoming what may be seen as obstacles to further development of MERCOSUR. According to O'Connell, the only way to gain more autonomy and be able to practise growth policies is through the development of competitiveness that could lead to a less vulnerable position, integrated in the world economy not only as a receiver of financial flows but as a dynamic exporter.

In the following chapter, Maria Luiza Silva, Joaquim Andrade and Hans-Michael Trautwein analyse some issues concerning the macroeconomy of MERCOSUR countries, in particular Brazil and Argentina. The coexistence of a fixed exchange rate regime within a currency board arrangement in Argentina and a more flexible exchange-rate system with strong sterilization policy in Brazil have challenged the sustainability of MERCOSUR regional integration. Even when both countries had fixed exchange rates in terms of the US dollar, domestic policy shocks tended to produce asymmetric adjustments, because Brazil largely neutralized the impact of intra-regional capital flows, whereas Argentina did not. In this constellation, trade integration would be favoured only by monetary expansion in Brazil or by fiscal expansion in Argentina; the difference in the monetary policy regimes may nevertheless have helped to buffer external shocks, as in the case of the Mexican crisis. However, the underlying asymmetry was exacerbated when Brazil switched to

floating in 1999. Now even external shocks had clearly adverse effects on trade integration and on the synchronization of economic development in the region. Therefore, the differences in monetary policies have contributed to the asynchronization and asymmetries in the cyclical fluctuations of economic activity in Argentina and Brazil. Through the interaction between the different regimes, the impact of common external shocks to the region has been dampened in Brazil, whereas it has been amplified in Argentina. The monetary policy asymmetry is likely to have produced adverse long-run effects on the trade pattern and other target variables of economic integration in the MERCOSUR, thereby limiting the sustainability of regional integration. The authors conclude that the puzzle could be solved through a macroeconomic coordination arrangement. The lack of macroeconomic policy coordination in MERCOSUR has led to serious setbacks in the process of trade integration.

In the last chapter of the second part, Adriana Amado and Luiz Afonso Simoens analyse the perspective of monetary integration within MERCOSUR. The chapter is based on the Post-Keynesian tradition and points out some problems associated with monetary integration in economies that are structurally different. It also examines whether these differences are relevant to the MERCOSUR case. A theoretical framework is developed which emphasizes the point that to the extent that financial systems from integrated economies are structurally different, the 'logic of the market' tends to imply inequality, instead of convergence, in growth trajectories. It follows that financial systems with very different structures tend to reinforce the regional imbalances in terms of development. Consequently, it is necessary for regional blocs to adopt suitable institutional mechanisms to avoid the concentration and unstable tendencies of the market. The banking sectors of Argentina and Brazil are compared to show that: (i) in both countries the penetration of foreign banks has increased a great deal recently, but Argentina's is a more internationalized financial system than Brazil's; (ii) the indicators of financial deepening show that Brazil has a more developed financial system than Argentina; (iii) productivity is higher in the banking sector in Argentina than in Brazil; and (iv) both countries have concentrated financial systems both in absolute and in regional terms. Two conclusions are derived from this comparison: first, in the case of financial integration, it would imply a flux of liquidity from Argentina to Brazil that would benefit the Brazilian banking sector; second, since both countries have concentrated financial systems, financial integration would also generate a tendency to exclude peripheral regions from the possible benefits of the process of integration. This issue could be aggravated by the fact that both countries have increasingly internationalized financial systems. Furthermore, since there are great differences in the degree of dollarization between Argentina and Brazil, the adoption of a single currency would be more problematic than otherwise. The chapter concludes that market forces

cannot lead to monetary and financial integration. Instead, MERCOSUR's national governments must create institutions and financial mechanisms that favour a model of integration that stimulates social and economic growth.

In the first chapter of the third part, Rogério Studart analyses the effects of external financial integration between Latin American economies and mature economies. In the last two decades financial integration between these two groups has been rapid and significant. It has also been quite traumatic, because often followed by macroeconomic instability – exchange rate instability, poor growth performance and domestic financial crises. In the case of the MERCOSUR bloc, this associated macroeconomic instability has been a major obstacle to sustained trade integration among the four economies of the bloc. According to Studart, some analysts blame the volatility of capital flows for such perverse destabilizing effects, while others (mainly mainstream economists) centre their criticisms on the inconsistent domestic policies and lack of appropriate financial regulation and supervision in domestic Latin American economies. This chapter claims that this debate is missing the main issues behind such instability; these are (i) financial integration of Latin American economies in the 1990s has been the 'integration of uneven partners', that is, the integration of rapidly expanding capital-market-based systems with relatively stagnant bank-based systems; (ii) the consequences of such integration are destabilizing due to the volume, type and volatility of capital flows *vis-à-vis* the size and capacity of Latin American domestic financial markets to absorb such flows. The chapter concludes that the Latin American experience of the 1990s is not the first traumatic experience of financial opening and liberalization, and is unlikely to be the last. Two lessons can be drawn from this traumatic experience. First, if MERCOSUR or any other trade bloc in the region is to be sustainable in the future, one crucial target should be to avoid processes that lead to financial vulnerability of the economies. Second, and as a consequence of the first lesson, the deregulation of the capital and financial account should always be very gradual, respecting the structural asymmetries that exist between financial systems of developed and developing economies.

Finally, José Maria Fanelli and Daniel Heymann examine some causes of the collapse of the Argentine system of convertibility with a hard peg to the dollar and its consequences for the future of MERCOSUR. To begin with, they deal with the literature on monetary and exchange rate policies and show that even though there is no first best in the case of the choice of an exchange rate regime, in the context of open capital accounts credibly fixed rates may not be a viable long-run option for most countries, given the pervasive possibility of speculative attacks. This seems to be the case of the Argentine experience. It has been a feature of the Argentine economy that most assets of more than a few months' duration have been denominated in dollars. The diffusion of

dollar contracting increased the costs of leaving convertibility. This characteristic, which derives from the uncertainties of agents with respect to monetary management, has implied that an expansion of longer-run credit carried with it the risk of currency mismatches if the exchange rate varied significantly. As a macroeconomic result economic downturns are associated with pressures on both financial and foreign exchange markets. There was thus a lock-in effect, derived mainly from the financial behaviour that had been induced under the monetary regime. Persistent fiscal deficits, especially after the 1994 reform of the social security system, caused a continuous increase in public debt. Further, when the economy went into recession, fiscal policies were burdened with a variety of demands, such as to contemplate increasing scepticism of creditors and claims for social spending, while tax revenues were falling. According to the authors, the 'internal drain' of deposits, combined with the 'external drain' of foreign reserves, the extreme difficulties of fiscal policies and the deepening recession acted jointly to generate explosive economic and social conditions in Argentina. They conclude that given the increased importance of exports for Argentina, it may be argued that the possibility of restarting and developing integration may have a high cost. So, if Argentina manages to define a viable monetary-fiscal regime policy, and moves towards a normalization of the economy, a gradual process of macroeconomic coordination with Brazil may appear a distinct possibility.

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NOTES

1. See, for instance, Chapter 3 of this volume.
2. See Chapters 5, 7 and 8 in this volume.