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**MERCOSUR:
WHY DOES
MONETARY UNION
MAKE SENSE IN
THE LONG TERM?**

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This paper has originally been published by the Inter-American
Development Bank (IDB/Intal) in *Integration & Trade*, v. 3, nr. 9,
September/December 1999.

Rio de Janeiro, December - 1999

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Abstract

This paper adopts an encompassing approach to justify the long-term objective of currency unification among Mercosul countries. The risks of dilution of this agreement within a probable much more extended free trade area, that is from Tierra del Fuego to Alaska (Alca), are exposed. After drawing an analogy with the European integration, the requirements for a single currency and the increasing homogeneity of the economies of the region are described and the debate currency unification vs. dollarization is analyzed. The text ends with a proposition of an agenda for the 2000/2002 period. Although it is not an immediate goal, it is emphasized that the currency unification tends to be the natural consequence of advancements in the process of regional integration.

1. Introduction¹

In May 1997, Barry Eichengreen, one of the most important authorities on global monetary issues, wrote an article on free trade in which he refers, by the way, to the idea of creating a single currency in Mercosur. He states: “This is unrealistic... over any horizon relevant for policy planning” since, in contrast to the intensity of European integration, “*nothing similar is likely to occur in our lifetimes in South America*” (Eichengreen [1997] p. 31, emphasis added).

It is a common reaction to most observers when they first face the idea of monetary union in Mercosur. However, if the question is analyzed in great depth, the conclusions that emerge may differ greatly. In fact, even Eichengreen, in an article written specifically on this issue one year later, and interestingly called “Does Mercosur Need a Single Currency?”, expressed an opinion markedly different from the previous one. He acknowledged that “there is a coherent political-economy logic for why the members of the customs union might contemplate a common currency” (Eichengreen [1998] p. 4) and, in what concerns to the countries of the subregion, he stated that “if they intend to press on to deeper integration, then they, like their European counterparts, will also have to contemplate monetary integration” (p. 10). Moreover, after asserting that “the option of monetary union cannot be ruled out as infeasible a priori” (p. 25), Eichengreen concluded, in contrast to the totally skeptical view expressed a year before: “If [integration]... develops a readiness to transform Mercosur into a more far-reaching integration initiative, involving the creation of a true single, integrated South American market, then exchange rate swings will become more politically disruptive, and monetary unification becomes *not only feasible but essential*” (p. 33, emphasis added).

How did this idea emerge? In all processes of economic subregional integration there is a natural sequence to be followed. It begins with the establishment of a free trade area (FTA), then the introduction of a common external tariff (CET), and, finally, the creation of a common market. The common market is characterized by the constitution of a geographic area in which the countries, while preserving their own laws and political organization, agree to harmonize their respective legislation in certain areas, coordinate their macroeconomic policies and, in general, allow the “four freedoms”: the free circulation of goods, services, labor and capital. At a later stage, the common market could also include monetary union. Western Europe, or at least for the most part of it, is about to start this “fourth stage” of integration – that

1 Some of the issues discussed here, based on the idea of “shared sovereignty”, first presented in Araújo (1992), although the issues have not been examined closely.

is, the establishment of monetary union. This will take place after the physical substitution of the national currencies of the countries involved by the currency of the European Monetary Union (EMU) – then “euro” – in 2002.

The Treaty of Asunción, which gave rise to Mercosur, anticipates a sequence of events similar to that discussed above, although there is no reference to monetary union. Article 1 of Mercosur’s founding treaty thus states that “the member states agree to create a common market that ... will be called the ‘Southern Common Market’ (*Mercado Común del Sur*, Mercosur). This common market implies: the free circulation of goods, services, and productive factors between the countries ...; the establishment of a common external tariff and the adoption of a common trade policy in relation to third countries ...; macroeconomic and sectoral policy coordination between the member states, including foreign trade, agricultural, industrial, *fiscal, monetary, exchange rate, and capital policy* ...”(emphasis added). However, despite the treaty had been signed and the FTA and CET defined and initiated many years ago, although with some problems, little or no progress has been made toward to the creation of a common market.²

This loss of dynamism in regional integration implies two types of problems for the future of Mercosur. First, “in a competitive and dynamic world where productive investment is in dispute, by not *advancing or advancing quickly the process is reversed*” (Lavagna [1996] p. 2, emphasis added).³ Second, if Mercosur limits itself to an FTA with a CET, its strength will be significantly diminished when the Free Trade Area of the Americas (FTAA) is established. This is because, once tariffs disappear in the Americas, the ability of the subregion to distinguish itself from the rest of the countries will naturally be undermined. In other words, *for Mercosur to conserve its strength once the FTAA is established, the former should be far more than a free trade area with a common external tariff.*

Taking these arguments into consideration, a discussion about the possibility of establishing a single currency for the Mercosur countries, perhaps in the second decade of the twenty-first century, began in 1997. For this to occur, however, the countries would have to make arrangements in advance (Giambiagi [1997, 1998]; Lavagna and Giambiagi [1998]; Rigolon and Giambiagi [1999]). This idea was first raised in a press article published in the *Estado de São Paulo* on 8 April 1997 (“A Proposal for Mercosur”), which summarized a purely academic article by Giambiagi [1997]. This idea gained political momentum when it

2 See IPEA [1997] for a strictly commercial analysis of initial developments in Mercosur and its prospects.

3 In employing a metaphor used by a diplomat active in the integration process between countries of the region, Mercosur’s dynamism can be compared to water skiing, since “if the boat stops, the skier falls”.

was included in Mercosur's diplomatic agenda after being mentioned by Argentine President Carlos Menem in a press interview on 27 April 1997. Menem made further references to the proposal on numerous occasions. The idea thus began to be identified as an Argentine proposal. The Argentine government even held an international seminar on the issue in Buenos Aires in June 1998.⁴ At the same time, the Mercosur authorities began to discuss the issue, although informally, after it was mentioned in statements made by some Argentine authorities.⁵ Examining this issue so much in advance may appear rather surrealist, but taking global geopolitical considerations into account, such anticipation is reasonable and makes part of the countries' strategic vision in this respect.⁶

In a certain way, this type of logic has also influenced European integration *vis-à-vis* the creation of the euro. It was seen as an incentive for the EMU member states to make greater efforts to advance in areas where progress had been slow – such as in cooperation and mutual understanding – despite Europe's long history of integration. This was acknowledged by Jaques Delors, one of the mentors of monetary union: “In the longer run, *European Monetary Union should also promote the partial harmonization of national tax and labor policies*. In other words, the virtuous cycle now underway should lead, via a single currency, to still further economic integration” (Delors [1997] p. 17, emphasis added).

This study is divided into nine chapters. After this introduction, prospects for Mercosur after the possible establishment of the FTAA are examined. Interpretations of the origins and logic guiding the European unification proposal, via the 1992 Maastricht Treaty – which influenced Mercosur's proposal for monetary union – will then be analyzed. Chapter Four highlights the prerequisites that are generally viewed as fundamental for the creation of a monetary union. Chapter Five analyzes recent trends towards greater macroeconomic convergence in the Mercosur countries. Chapter Six examines developments since 1997, when the first informal discussions on the idea of monetary union began. This chapter is followed by a defense of this unification

4 See Nofal [1998] for a critique of the proposal.

5 Menem's first reference to the issue, at the end of April 1997, was made soon after his bilateral meeting with his Brazilian counterpart Fernando Henrique Cardoso. In a subsequent press conference, Menem said that “we should begin to think about a common currency”. This statement was supported by the Brazilian president who said that “the moment for a common currency and for the convergence of macroeconomic policy will come (*Gazeta Mercantil*, 28 April 1997). Subsequently, Argentine Economy Minister Roque Fernández said in a statement made in that country that “in the future, we are going to focus on integrating the capital and financial markets, which will directly point towards a single currency. If we can commit ourselves to integrate the capital markets, making progress on a single currency will only depend on fiscal coordination in the different countries” (*Gazeta Mercantil*, 29 April 1997).

6 See an article published in 1997 by President Carter's former advisor on National Security Affairs (1977-1980) on the United States' geopolitical strategy towards the countries of Eurasia, which examines possible scenarios involving the countries of the former Soviet Union in the 2005-2010 period (Brzezinski [1997] pp. 1924).

proposal, in the context of Mercosur, as a long-term project for the subregion. Chapter Eight examines the dollarization proposal as an alternative to the abovementioned proposal for unification. Finally, a working agenda for the 2000-2002 period is examined.

2. Mercosur and the Challenge of the FTAA

In the last few years, the unity of Mercosur has been undermined by events such as, for example, Argentina's opposition to Brazil's candidacy to a place on the UN Security Council; the criticism of prominent Brazilian political leaders of what they saw as closer ties between Argentina and the United States, to the detriment of its regional partners; the Argentine Congress's approval of a law preventing the application of preferential tariffs on Brazilian sugar imports to Argentina; the retaliatory measures of Brazilian political leaders, through an initiative by the President of Mercosur's Parliamentary Commission, consisting of a legislative decree bill that banned the import of Argentine wheat and so forth. It is highly unlikely that these problems would have had the fertile ground to flourish had Mercosur been in a phase of continuous progress, as in the first half of the 1990s. *These issues suggest the existence of an "adolescent crisis" in Mercosur, which should define what future it wants.*

The succession of frictions and the increasing unwillingness to make any concessions towards integration highlight the need to discuss the future of Mercosur once an FTA and a CET are established among its member states. The fact that these frictions occurred emphasizes the need to upgrade Mercosur in such a way that it ceases to be a mere trade agreement and, continuing to deepen integration, makes progress towards the creation of a truly common market.

To a certain extent, Mercosur is at a crossroads.⁷ One possibility, alternative A, would be to view the progress made thus far as satisfactory and in which *no further progress should be made*. In this respect, alternative B would consist of making a *leap forward* and of identifying new areas of integration, with the underlying advantage of definitively consolidating trade integration.

Alternative A implies adopting a passive approach, although there are serious problems associated with it: *if Mercosur is limited only to a free trade area with a common external tariff, its strength would be severely diminished once the FTAA is established, because as soon as tariffs are eliminated in the three*

7 See Almeida [1998] for a more detailed examination of the future of Mercosur.

Americas – North, Central and South – the ability of the subregion to distinguish itself from the rest of the countries in the continent will naturally be undermined. That is, for Mercosur to maintain its strength once the FTAA is established, it should become far more than an FTA. In other words, if its member states are incapable of deepening the agreement, the creation of the FTAA represents, in practice, the death of Mercosur. Under this first alternative, Mercosur would be a bloc with scant supranationality, diluted in a larger free trade area. Mercosur would thus be left with few policy-making powers vis-à-vis the large multinationals and the hegemonic global centers.

Alternative B, associated with a more dynamic approach, implies that Mercosur would still play an important role characterized as: (i) a response to the question of what its global role would be in 10 or 20 years time; (ii) a medium-sized economic power vis-à-vis the large blocs consisting of Nafta, the European Union and the Asian countries, with a consolidated supranational dimension, representing one kind of power in the new world order; and (iii) an affirmation of regional identity, in all its aspects – economic, geopolitical and cultural. This alternative would be far more arduous, since it would demand negotiations in a number of areas and the development of an extensive working agenda, as well as the diplomatic effort implied by the FTAA process. However, it would avoid the risks associated with alternative A.

This dynamic approach in favor of integration, regardless of whether a single currency is introduced as the final stage of the process, should result in concrete progress being made over the next few years, such as (a) establishing mechanisms for macroeconomic coordination between countries, without which the barriers to intra-subregional trade integration could proliferate; (b) further studies of the creation of a common citizenship, through the introduction of a Mercosur passport; (c) a joint effort by the countries of the subregion to harmonize, for example, their tax, labor and capital market legislation.

If this more dynamic approach is not adopted, in an extreme case, as Argentina, Brazil, Paraguay and Uruguay eventually decide to join the other parallel processes of trade liberalization that are making good progress, the question “what is Mercosur for?” will become unanswerable and the bloc will lose its *raison d’être*. The next section will examine the conditions that Mercosur must meet to continue as a separate entity in the context of the new global environment of the next few decades.

3. The Parallels with Maastricht: a Taxonomy of the Interpretations of the Validity of the European Single Currency

The natural source of inspiration for the proposal concerning monetary union in Mercosur is Europe, which introduced the euro as a fiduciary currency in 1999. The euro will become an exchange mechanism, substituting national currencies, in 2002. In respect to the process of European integration, Schweickert, Zahler and Jessen indicated that, "the early start of the Economic and Monetary Union and the creation of a single currency serves as a splendid *learning opportunity* for Latin American and Caribbean countries engaged in regional or subregional integration schemes" (Schweickert, Zahler and Jessen [1997] p. 30, emphasis in the original). Therefore, it is useful to identify the factors that determined this process and the parallels that can be made with the Mercosur countries. There are several interpretations in relation to the reasons behind the agreement to establish monetary union that resulted in the 1992 Maastricht Treaty.

a) A Solution for the Inconsistencies Associated with Incomplete Integration

According to this interpretation, monetary union is the natural solution for the problems arising from incomplete integration – that is, without monetary integration – and a mechanism for improving the efficiency of the economies that constitute an FTA. According to Giavazzi and Giovannini, "... the survival of the current system of fixed but adjustable parities must be ascribed to the operation of capital controls. However, capital controls prevent financial integration. Thus, *financial integration requires that European countries give up realignments altogether, moving toward a system of credible, and thus irrevocably fixed, exchange rate. This is a monetary union*" (Giavazzi and Giovannini [1991], emphasis added). At the same time, according to this view, monetary union would be nothing more than the logical outcome of the prior process of integration. This is the origin of the "*one market, one money*" principle set out by the European Economic Community a few years before Maastricht (ECC [1990]).⁸

b) A Mechanism for Preventing Reverses in the Integration Process

This view is supported by, among others, Collignon, Bofinger, Johnson and De Maigret: "In the long run, distortions in the structure of relative prices misdirect the use of resources and

8 See Hoekman and Leidy [1993] for an analysis of the origins of and a discussion on some of the problems associated with European integration.

draw capital and labour into uses which remain profitable only so long as inflation accelerates. This effect is damaging for the functioning of the economy... The same applies to instability resulting from exchange rate instability in the Single Market. The uncertainty which dominates market relations based on different currencies introduces the need for hedging operations and drives a distorting wedge between prices, which leads to a misallocation of resources. *An integrated market, where goods and services are allowed to circulate freely and information is readily available, but where the value of commodities is expressed in separate currencies, is therefore necessarily suboptimal and could disintegrate again* if distortions turn welfare gains into losses... Only with full economic and monetary union and a single currency will the informational distortions that are implicit in a multicurrency standard be eliminated... [for]... achieve a truly efficient and Single Market” (Collignon, Bofinger, Johnson and De Maigret [1994] p. 8990, emphasis in the original). With the development of the European “snake” mechanism of exchange rate parities in the European Community at the end of the 1980s, the latter reached a crossroads, since the internal logic of unification required the abolition of capital controls. However, this would have caused greater exchange rate volatility in Europe. Thus, Western Europe had to choose between exchange rate flexibility or monetary union. Even the early critics of EMU thus recognized that “... wider exchange rate swings would compound the adjustment difficulties associated with completing Europe’s internal market. If national industries – under pressure from the removal of barriers to intraEuropean trade – find their competitive position eroded further by a sudden exchange rate appreciation, resistance to the implementation of the Single European Act (SEA) would intensify. The SEA might be repudiated. *In this sense and this sense alone, monetary unification is a logical economic corollary of factor – and product – integration*” (Eichengreen [1993] p. 13211357, emphasis added).⁹

c) An Opportunity to Secure Greater Credibility

This interpretation is based on the following premises: (i) low inflation is a positive long-term condition for economic growth; (ii) the aim of achieving and maintaining low inflation requires consistent fiscal and monetary policies; (iii) the success of such policies is associated with an institutional environment that allows economic policy decisions to be isolated from the demands of the political cycle. EMU is thus a mechanism that “ties the hands” of the countries of the agreement. It even serves as an “alibi” when these adopt unpopular measures, since the “blame” falls on an external agent of that country. In certain respects, this is equivalent to “exporting” the Bundesbank’s

9 The Single European Act of 1986 represented a commitment of the countries of the European Economic Community to create a common market totally free of barriers to the free circulation of goods, capital and labor within the member states of the agreement by the end of 1992.

credibility to the other countries that, together with Germany, make up the monetary union. This point of view is held by, among others, Giavazzi and Pagano [1988] (before the Maastricht Treaty), as well as by Sandholtz [1993]. In respect to the increase in credibility conferred on those national policies direct toward fighting inflation – understood as the most efficient basis for long-term growth – Sandholtz notes that “... European governments favored European Monetary Union because it would provide the highest possible level of credibility;... monetary union would be more credible than unilateral pegging to a strong currency because the latter could be undone at any time, even in response to temporary electoral concerns. In fact, monetary union would provide price stability for governments that would be unable, for domestic policy reasons, to achieve it on their own” (Sandholtz [1993] p. 35). This view was subsequently backed up by the following: “For governments that found it difficult domestically to achieve monetary discipline, European Monetary Union offered the chance to have it implemented from without. *Governments could even escape the blame when tight monetary policies pinched*” (Sandholtz [1993] p. 38, emphasis added).

d) A Combination of Complementary National Interests

This interpretation highlights a combination of complementary national interests that led to the decision to create EMU. On the one hand, a group of European countries, led by France, were interested in weakening the domination of Germany in the economic decision-making that affected their economic performance. In practice, in the period of the Maastricht agreement, all of the countries of Western Europe were subordinate to German monetary policy. Establishing an EMU in which all the countries affected by this policy would be represented was a way of sharing responsibility for European monetary policy. In parallel (and this helps to understand not only the support of these countries, but principally German backing for the agreement), monetary union – after the fall of the Berlin Wall and specifically in the context of German unification – was a mechanism for guaranteeing European peace and unity and of assuring the rest of Western Europe that Germany would continue to be part of the same bloc and would preserve the communitarian spirit that marked the post-war European integration process. At the same time, Germany’s loyalty to the integrationist philosophy during the initial negotiations on EMU obviated the danger that France would use its political veto to block German unification. The then President of the Bundesbank, Helmut Schlesinger, acknowledged that EMU would not have significant economic benefits for Germany and that German support for the project was strictly political in nature.

Some of the incentives evident in the European experience are not present in the case of Mercosur, although others assume greater importance. In particular, the problems associated with

incomplete integration did not have the same consequences as outlined in point (a) and there is nothing that comes close to matching the concerns in Europe over German expansionism, as mentioned in point (d). However, the risks of an incomplete integration process reversing itself, as described in point (b), are real and the commitment to stability associated with institutional change, as highlighted in point (c), has potentially many more benefits – in terms of a reduction of interest rates and the creation of a favorable environment for investment – for Latin America countries, which struggle against a track record of high inflation, in contrast to Europe’s decades-long history of low inflation.

4. The Necessary Conditions for Introducing a Single Currency¹⁰

The introduction of a single currency should be associated with a *latu sensu* single market. This means, among other things, that the labor market formed by the geographic space using the same currency is characterized by mobility of factors, thus avoiding differences in unemployment rates. In practice, however, this is difficult to achieve, and sometimes even within countries it is possible to find markedly different regional unemployment rates. Nevertheless, in theory, the literature on optimum currency areas (OCAs) emphasizes the following necessary aspects to justify the creation of a single currency:¹¹

i) Free movement of labor factors between countries. This makes it possible to react to external shocks in a uniform manner. The constraints to this mobility include legal, economic and cultural factors, such as, for example, language. The most important economic factor concerns the difficulty of harmonizing national pensions systems and validating in the other countries the contributions made by each worker in their country of origin.

ii) High level of intra-regional trade. Countries that do not trade with each other have no incentive to adopt a single currency. By contrast, if 100% of the trade of a group of countries is intra-subregional, monetary union is practically a precondition. After decades of integration, Europe has increased its intra-subregional trade, this being one of the most important factors in favor of integration.

10 Apart from the general questions examined in this chapter, a process of unification implies resolving a series of operational issues relating to, among other things, the way in which financial markets operate. See Mc Cauley and White [1997] for a detailed analysis of the European case. See Begg [1997] for an examination of the specific issues of monetary policy in a process of unification between national currencies, also in reference to the European case.

11 See Masson and Taylor [1992] for a survey of this literature, especially section III of these authors’ study.

iii) Similarities in the types of shock that affect a group of countries. A region which, for example, consists of large oil importers as well as important oil exporters is not a good candidate for monetary integration, since variations in the price of oil affect these countries in opposite ways. On the other hand, countries with similar features tend to confront shocks in the same manner and are therefore, according to this point of view, good candidates for monetary union.¹²

Therefore, an optimal exchange rate area – defined as a geographic space well suited to adopting a single currency – is one in which the countries that are included in it share characteristics that make them vulnerable to the same types of shock, “... so that policies that are generally appropriate in one country are also appropriate for other member countries” (Englander and Egebo [1993] p. 11).

It is precisely this factor that makes labor market flexibility in the countries involved in monetary union especially important. As Englander and Egebo again stress “with exchange rates fixed, the option of changing relative prices quickly via nominal exchange rate changes is not available. Hence, real exchange-rate adjustments, when needed, must be achieved through changes in relative costs and prices. However, if wages and prices are not flexible internally and credibility effects do not greatly affect wage and price decisions, such adjustment may require large shifts in capacity utilization and employment. In general, *the greater the degree of wage and price rigidity, the more the output and employment response that would be needed to alter relative prices*” (Englander and Egebo [1993] p. 9, emphasis added).

At the same time, as highlighted by Bovenger et al, the fact that the mobility of the labor factor is limited, and that there is a certain rigidity of prices and wages, implies that once the possibility of changing intra-subregional exchange rate parities disappears – from a group of countries in a monetary union – the member countries of the agreement need to have some flexibility in their respective fiscal policies. They can thus combat future shocks that could affect them in different ways. (Bovenger et al [1991]).

In this context, what is the situation of the Mercosur countries? The motives behind their possible adoption of monetary union lies fundamentally in the strengthening of an institutional environment that nurtures long-term price stabilization – including a single and independent central bank; the setting of limits on the relationship between the fiscal deficit and GDP; and in having low inflation targets. Regardless of this, however, there is evidence that certain conditions necessary for the creation of a monetary union are gradually being met, while others are not.

12 These three points, points (i) to (iii), are based in part on Schweickert, Zahler and Jessen [1997].

After 1991, intra-subregional trade grew more rapidly than trade with the rest of the world. In particular, Mercosur's two largest economies, Brazil and Argentina, have an external sector with relatively similar characteristics in terms of their dependence on external capital flows. They thus tend to be equally sensitive to fluctuations in the international prices of their export goods, to world economic growth, external interest rates and/or the liquidity conditions of the international financial market. There are also many issues on which Mercosur must make progress. These will be discussed in a subsequent chapter of this article.

5. Macroeconomic Convergence in the Mercosur Countries

In the last few years, the process of macroeconomic convergence of the Mercosur countries – understood as the increasing similarity in the performance of the various economies of the subregion – has deepened. This is an important factor when considering the unification of their currencies.

Table 1 supports what was previously noted on the growing similarity of certain performance indicators in the Argentine, Brazilian, Paraguayan and Uruguayan economies. These figures show GDP growth rates over the last five decades and, in the last line, their standard deviation (SD) in each year.¹³ Graph 1 was drawn up on the basis of the last line of this Table.

This graph presents the running mean – for 10-year periods – of the SD in the GDP growth rates of the Mercosur countries. Therefore, the values included in these correspond to the arithmetic mean, for 10-year running periods of the standard deviation of the last line of Table 1. The numbers of the graph, in each year, refer to 10-year periods ending in the reference year – for example, 1980 should be interpreted as the average of the SD of the last line of Table 1, for 1971-1980. The graph shows the SD trend between the total growth rates of the four countries. A fall in the indicator means that the GDP growth rates of the four countries tend to differ less between them in the longer term. The graph *shows a clearly downward trend in the standard deviation*. This points to a greater degree of similarity in the behavior of the economies of the region. This trend is reflected in the following elements:

i) the average SD between 1989 and 1998 is the lowest in the series under consideration;

13 The last line therefore corresponds to the standard deviation of the four values presented in each column.

ii) on the basis of the means of the last line of Table 1, for fixed 10-year periods, there is an average fall in the SD of 4.7 in 1971-1980, 4.1 in 1981-1990 and 2.8 in 1991-1998 (eight years in the latter);

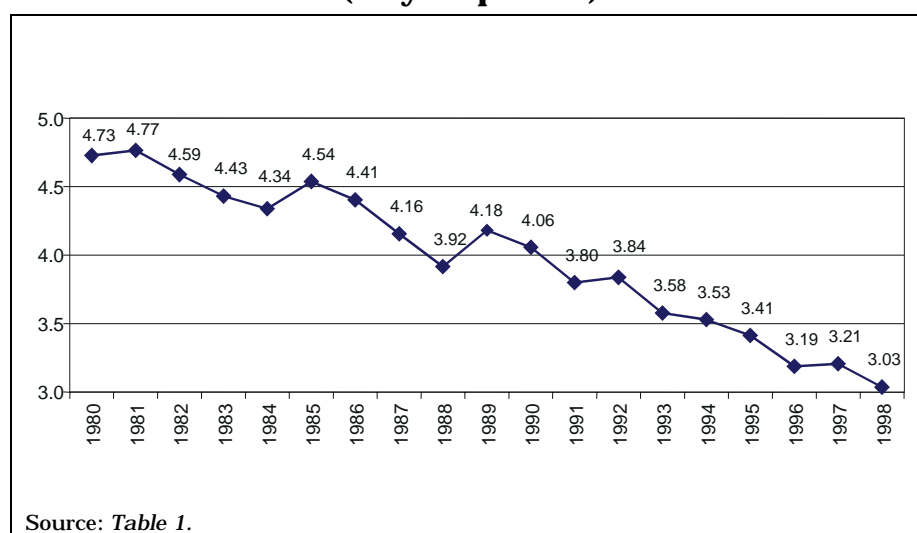
iii) the average SD fell consecutively during the last five observations.

Table 1
GDP Growth Rates of the Mercosur Countries
(percentages)

	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	
Argentina		3.7	1.2	-4.6	1.6	3.9	-5.1	5.4	4.1	7.1	2.8	5.1	6.1	-6.4	7.8	7.1	-1.6	-2.4	10.3
Brazil		2.4	7.4	6.6	6.5	5.9	8.7	2.5	10.1	6.9	3.1	8.1	7.7	5.5	9.8	10.3	5.2	1.6	2.9
Paraguay		-13.1	1.1	16.8	-1.7	1.9	-1.7	2.8	1.7	4.6	4.2	4.6	5.7	0.4	0.1	4.8	7.0	2.7	4.3
Uruguay		6.7	2.6	3.7	3.1	8.2	-0.4	6.5	5.7	1.6	1.7	1.0	-3.6	-2.8	3.5	2.9	-2.2	0.5	2.0
Standard deviation		8.87	2.96	8.83	3.40	2.70	5.89	1.96	3.54	2.56	1.03	2.91	5.12	5.05	4.35	3.19	4.68	2.19	3.74
	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	
Argentina		9.1	0.6	2.7	4.3	8.6	5.4	4.8	3.1	6.1	6.5	-1.4	-2.9	6.4	-3.4	6.7	0.7	-6.2	-4.2
Brazil		2.7	3.8	4.9	11.2	9.9	8.8	13.3	11.7	13.9	9.8	5.7	9.2	4.7	5.0	6.4	7.2	-1.6	0.6
Paraguay		5.7	1.1	6.3	3.6	3.9	6.2	4.4	5.1	7.8	8.3	4.8	7.1	12.7	11.3	11.4	11.4	8.7	-1.0
Uruguay		1.1	3.4	-4.1	1.6	6.1	4.7	-1.0	-3.3	0.9	1.6	3.6	2.8	1.2	5.3	6.2	6.0	1.9	-9.4
Standard deviation		3.53	1.61	4.61	4.18	2.67	1.79	5.91	6.18	5.36	3.57	3.17	5.34	4.81	6.04	2.49	4.41	6.28	4.41
	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998			
Argentina		3.0	2.7	-4.4	7.3	2.6	-1.9	-6.2	0.1	10.0	8.9	5.8	8.3	-3.1	4.4	8.4	4.0		
Brazil		-3.4	5.3	7.9	7.5	3.5	-0.1	3.2	-4.4	1.0	-0.5	4.9	5.9	4.2	2.8	3.7	0.2		
Paraguay		-3.0	3.1	4.0	0.0	4.3	6.4	5.8	3.1	2.5	1.7	4.0	3.0	4.5	1.1	2.6	0.0		
Uruguay		-5.9	-1.1	1.5	8.9	7.9	0.0	1.3	0.9	2.9	7.4	3.1	5.5	-2.0	5.0	5.1	2.5		
Standard deviation		3.77	2.66	5.16	4.01	2.32	3.64	5.16	3.15	4.02	4.49	1.16	2.17	4.01	1.75	2.52	1.92		

Source: ECLAC.

Graph 1
Running Mean of the Standard Deviation of the GDP
Growth Rates of the Mercosur Countries
(10-year periods)



In addition, Table 2 shows:

(a) in general terms, the trend towards lower inflation in the region, close to international levels;¹⁴ and

(b) fewer differences between the inflation rates of the four countries.

Table 2
Mercosur Inflation (CPI) January/December
(percentages)

Country	1993	1994	1995	1996	1997	1998/p
Argentina	7.4	3.9	1.6	0.1	0.3	0.9
Brazil	2,489.1	929.3	22.0	9.1	4.3	2.5
Paraguay	20.4	18.3	10.5	8.2	6.2	16.0
Uruguay	52.9	44.1	35.4	24.3	15.2	9.4

Note: /p Provisional.
Source: ECLAC.

Finally, it is worth noting the similarities in the public debts, measured as a percentage of GDP, of Argentina and Brazil. These two economies are clearly the strongest in the subregion and their public debt, excluding the monetary base, accounts for some 40% of GDP (slightly less in Argentina and slightly more in Brazil). This point is especially important for the implementation of a successful monetary union. If debt levels had been very different *vis-à-vis* GDP, it would have been necessary to generate compensatory primary results in those countries with higher debt levels and, in that case, the taxes introduced with this aim in mind would have hindered the entry of capital and/or prompted capital flight. This would have reduced the internal consistency of policies in the subregion and made it more difficult to administer exchange rate and monetary policies in the monetary union. The similarities in the respective public debt levels of the biggest members of that possible union is, therefore, a positive factor for its success and for its unification.

6. What has Changed Since 1997?

As stated above, the idea of establishing monetary union in Mercosur was first mooted in 1997. What has changed since this idea emerged two years ago? Or, to put it differently, has the idea of monetary union really strengthened in the 1997-1999

14 This trend will be negatively affected in 1999 by a rise in inflation in Brazil, the result of the devaluation of the real. However, the trend is likely to resume in 2000. In the case of Argentina, the modest increase is simply the consequence of natural fluctuations in the CPI variation, when this fell sharply to nearly zero.

period. In this regard, seven important elements should be taken into account, all of which point towards monetary union:

a) The deterioration in relations within the bloc *owing to a series of trade frictions*. Curiously, this could be viewed by some skeptics as a clear sign that monetary union is nothing more than a utopia. However, the opposite is true, since the fact that integration has until now been limited to trade has prevented the member countries from adopting commitments associated with greater integration (commitments which invariably imply concessions, choices and sacrifices on the part of the members). This has left room for protectionist lobbies of all types proliferate. Although the metaphor cannot be sustained academically, it is valid to compare Mercosur to a pair of lovers who continue their relationship without committing themselves to marriage. This relationship is marked by minor conflicts. The point comes, therefore, when the only way to put an end to these conflicts is for the couple to commit themselves to deepening the relationship and, consequently, to agree to make compromises that will benefit the union. Similarly, problems such as those that affected the sugar sector in Argentina, or the protests against Brazilian phytosanitary controls, will likely be solved only when the sectors involved realize that these commitments are essential to make progress in more important areas.

b) The *devaluation of the real*. Sharp fluctuations in the real parities between currencies in one area, within which there is free trade, are obviously a worrying factor that works against intra-subregional trade. It is not a coincidence that after the devaluation of the lira in 1992 some European member states demanded retaliatory measures against goods imported from Italy. Similarly, after the devaluation of the real, Argentine producers made similar demands, such as the introduction of a specific tariff against Brazilian goods, safeguard measures, and the establishment of quotas. Although these measures were temporarily justified, they ran against the spirit of free trade that has marked Mercosur since its creation. In the last resort, monetary union is the only decisive way to end these types of problems and risks, as well as to avoid a reverse of all subregion achievements in respect to strictly trade related matters – which is related to point (a) above.

c) The *consolidation of the euro*. In 1997, Luxembourg was the only country complying, *strictu sensu*, with the Maastricht criteria, as distinct from the fiscal problems that affected the “patrons” of the euro – France and Germany – and doubts over the introduction of the euro as a fiduciary currency on 1 January 1999. Two years later, the euro was adopted as a fiduciary currency in 11 of the 15 members of the European Union. It is conceivable that once the euro begins to operate as a physical currency in 2002, the “euro zone” will be enlarged to include 15 countries – with the inclusion of the United Kingdom, Sweden,

Denmark and Greece. Most experts believe that, if the negotiations for the accession of six new members to the European Union – involving those countries in the old Eastern European bloc that made successful transitions to capitalism – are concluded satisfactorily, it is likely that in the next decade the euro will become the currency of an even larger bloc, which could include 21 countries.

d) The *change in world perception* after the crisis that affected the emerging economies in 1997/1999. Until recently many authorities and scholars, especially in the United States, had reservations about European monetary union. In this context, any proposal for monetary union in Mercosur, with a much more recent integration history than Europe's, was seen as something that was simply unattainable and not even worth discussing. However, after the crises and devaluations in South-East Asia (1997), Russia (1998) and Brazil (1999) the key idea that there should be fewer currencies – as one of the mechanisms that would help avoid future crises – became increasingly popular in different fora and gained a certain academic respectability. The idea of monetary union in Mercosur, therefore, was no longer seen as a simple utopia.

e) The *favorable evolution of the situation in Brazil*. It is clear that, if the integration process is to be deepened, it is essential that Brazil achieve macroeconomic balance. In 1997, there was serious concern about the increasing external and fiscal deficits posted by Brazil until then and in 1998. However, data for 1999 suggest an improvement in the next few years in the relationship between: public sector borrowing requirement/GDP and current account deficit/GDP. This is the result of fiscal adjustment measures, on the one hand, and the devaluation of the real on the other.

f) The *fall in subregional inflation*. Monetary union will not be possible without harmonizing the inflation rates of the countries in the subregion and, preferably, lowering these to the rates of the industrialized countries. In this respect, inflation was still high at the beginning of 1997, with inflation in Brazil and Paraguay standing at close to 10% in 1996 and above 20% in Uruguay. Two years later the outlook turned more favorable although, strictly speaking, there were reverses in Paraguay and inflation in Brazil rose again in 1999. The fact that the exchange rate in Brazil devalued by 80%, in the peak of the overshooting period, and will probably end 1999 with a devaluation of 45%, with a pass-through of some 0.15, and with consumer inflation of under 7%, clearly shows that stabilization in the country is a stronger phenomenon than at first thought, with inflation likely to fall again in 2000 and possibly reaching OECD convergence in 2001. At the same time, the success of the Uruguayan government's anti-inflation policy has been notable, with a similar convergence likely to occur in the next few years.

g) *The change in the situation in Uruguay and Paraguay.* In 1997, if the subregional initiatives in favor of monetary integration had proved successful, it would have been highly likely that this would have consisted of a bilateral initiative between Brazil and Argentina, with the subsequent inclusion of Mercosur's smaller members. At that moment, high inflation in Uruguay and doubts over Paraguay's status in the bloc – threatened by the risk of institutional breakdown because of the political conflicts in the country – would have made it difficult for these two countries to join the project. Meanwhile, the fall in the inflation rate in Uruguay and the resolution of the Paraguayan crisis, which culminated in the formation of a coalition government, helped make Mercosur a more coherent and homogenous bloc, both economically and politically.

7. The Viability of Monetary Union as a Long-Term Project

The natural objection to the adoption of such an ambitious proposal as the monetary union of a group of countries is based on the view that, in the case of Mercosur, the necessary conditions for such a project do not exist – that is, the development of a common market that goes beyond a CET, specifically the coordination of macroeconomic policy and the harmonization of national tax, labor and financial legislation. In short, this objection could be expressed in the idea that “Mercosur cannot achieve in 10 years what it took Europe four decades to build”. There are, however, four key arguments to consider:

a) The intellectual idea behind European monetary union was the famous 1970 Werner Report, presented 13 years after the 1957 Treaty of Rome, which gave rise to the European Economic Community. The recommendations of the report, however, were dropped after the 1973 oil shock and, specifically, because of the subsequent rise in inflation. Similarly, although Mercosur dates back to 1991, its origin lies in the 1986 bilateral agreements between Brazil and Argentina. Therefore, *the view that Mercosur is advancing more quickly than the European Union with respect to the unification project is erroneous*: the most serious discussion of monetary union took place in 1999, 13 years after these agreements were signed. Coincidentally, this is exactly the same length of time that separated the Treaty of Rome (1957) from the first formal mention of monetary union in the Werner Report.

b) No one views monetary union as a short-term project. All the member states acknowledge that *this is not a proposal that can be implemented immediately* but one that, after all the stages

have been completed, could probably become a reality within 10-15 years.

c) In 10-15 years time, Mercosur will be younger than the European Union, *but the historical environment is different*. In the 1990s, the world economy underwent a more rapid process of transformation than that experienced from the 1960s until the 1980s, and this trend will probably continue in the coming decade. If Europe had four decades to reach the point at which it is today, within a world that moved more slowly, it is unlikely that Mercosur will have the same opportunity without running the risk of missing the train of history.

d) Although monetary union can include Uruguay and Paraguay, it is clear that the main difficulty lies in reconciling the interests of Brazil and Argentina. However, the economic, political and diplomatic engineering required for integrating the economies of only two countries such as Brazil and Argentina, although difficult, is simpler than the integration of the 11 countries that form the "euro zone", including the latecomers of the "Club Med". Taking into account the blocs as a whole and considering the number of countries participating in Mercosur (4) and the European Union (15), it is clear that it is easier to *reconcile the interests of four members than of 15*.

In effect, eventual monetary union, so long as it meets a series of prerequisites, could provide benefits for all the Mercosur countries. Independently of this, however, it could have a significant impact on the bloc, specifically on the two largest members.

Monetary union would have four main benefits for the subregion as a whole:

a) The transformation of the subregion into an *export platform towards third countries*. It is necessary to take up again the original aims that motivated the creation of Mercosur. These included transforming the bloc into an export platform, based on a market that guaranteed those companies based in the subregion a scale of production sufficiently large to enable them to enjoy benefits of scale that would allow them to operate at reduced costs. This project was frustrated; Mercosur continues to be a marginal exporter in global terms, in part because it is an incomplete market, since exchange rate instability continues to be an economic factor in subregional investment decisions. The creation of a *single market worth US\$ 1 trillion*, including the four economies of the subregion, would be an extremely important factor in persuading those large business groups that wish to meet world demand to invest in the subregion.

b) *Reduction of risk*. A commitment to satisfy minimum prerequisites of macroeconomic stability would contribute, *per*

se, to reduce “country risk”. As the countries of the bloc each begin to assume the same kinds of commitments, investors would begin to view the still negative Latin American “brand” more positively, thereby reducing Mercosur’s “region risk”. Finally, once exchange rate policy is perceived as being managed by an independent subregional central bank, the discretionary component associated with political interference in exchange rate policy would disappear. This would, in turn, reduce the subregion’s “exchange rate risk”.

c) A *fall in interest rates*, in relation to the above: since the basic interest rate of an economy is affected by external interest rates and by the risk components mentioned above. Once these are overcome the interest rate would fall dramatically over time, coming close to those rates prevalent in the more advanced economies, as a result of lower risks in the subregion.

d) An *increase in new investment*. Greater confidence about long-term stability and a reduction in interest rates would serve to promote investment in the subregion by groups that operate on a global scale, which would begin to show greater interest in the subregion. Similarly, the new environment would help stimulate domestic investment.

This last point would be particularly important in the case of Brazil and Argentina, where monetary union would increase their investment potential, since local investors would probably be those that would most benefit from an investment boom in the subregion.

As the main member of Mercosur, Brazil would be the natural beneficiary of the political strengthening of the bloc – for example, in negotiations and international fora – that monetary union would imply. Rather than being an isolated voice, without power to impose itself in difficult multilateral external negotiations, it would be the spokesman of a bloc that is increasingly important on the world stage.

On the other hand, monetary union would benefit Argentina by ending the uncertainty over Brazil’s exchange rate policy, reducing the impact of the so-called “Brazil dependency”. Although 30% or more of Argentina’s exports will continue to be directed towards Brazil, it would no longer suffer the internal problems associated with a unilateral devaluation by Brazil since, once there is monetary union, bilateral parity would, by definition, remain frozen after the respective national currencies disappear.

8. Monetary Union, Dollarization and Currency Board

It is important to differentiate between the proposal that is being made here – monetary union in Mercosur – and the idea of dollarization of the economies of the subregion or the countries of Latin America as a whole, that is being discussed in some international circles (Hausmann et al [1999]). In fact, the same logic that is used to advocate monetary union can be used to support the proposal to dollarize the economies of the region. However, the implications are completely different.

Dollarization is not an advisable strategy, since there are five types of problems associated with it. These problems are acknowledged even by its proponents:¹⁵

a) The *difficulty of absorbing real shocks*.¹⁶ Monetary union “freezes” the “relative parity” within the subregion, but is perfectly consistent with the possibility of modifying the exchange rate of the subregion in case of external shocks, such as those involving prices, interest rates or international liquidity conditions. This is not possible with dollarization. Eichengreen’s (1998) particularly rigorous observation, originally presented as a criticism of the idea of a regional currency board, is also applicable *ipsis litteris* to the issue of dollarization, “...pegging each of the Mercosur currencies to a common external numeraire like the US dollar is an extremely indirect way of solving the problem of intra-Mercosur exchange-rate variability. *It forecloses not just intra-Mercosur exchange-rate changes as an instrument of adjustment but also, in effect, changes in the exchange rate vis-à-vis the rest of the world*” (Eichengreen [1998] p. 24, emphasis added).

b) The *lack of a “lender of last resort”*. There is apparently little possibility of a financial crisis hitting the Mercosur countries in the near future. If this were to occur, however, both under the present system of multiple currencies and in the system of monetary union, the monetary authorities could act as a lender of last resort in order to inject liquidity into the system. On the other hand, and given that the Mercosur countries do not issue dollars, this would not be possible in the case of dollarization. Although it could be possible in the context of an agreement with the United States, it is unlikely that the US authorities, especially the Federal Reserve, would approve such action.

c) The *loss of income from seigniorage* – emission of money – and from the interest of international reserves. In a situation in

15 See Larraín [1999] for a balanced critique of the dollarization proposal.

16 Some of the critical comments made against the dollarization thesis are also applicable to the currency board system. However, given the limits of this article, it is not possible to make any comments over the validity of such a system in the case of Argentina. What concerns us is simply to defend the arguments in favor of monetary union visàvis the arguments in favor of dollarization.

which national currencies are substituted by a foreign one, the concept of international reserves would become meaningless. These losses, especially those associated with interest based on reserves, would be significant for the countries involved. In this case, an international treaty with the United States could lessen the impact of the problem, through some kind of financial compensation for the countries of the subregion. However, as in the aforementioned case, it is doubtful whether this support, which would be provided by US taxpayers, would be so easily forthcoming.

d) The *difficulty of sharing sovereignty*, or what Hausmann et al [1999] refer to as “governance structure” – that is, the resistance to US institutions being “absorbed” by other countries or, alternatively, to the United States sharing sovereignty with neighbors that, in its view, are not trustworthy. In concrete terms, it is difficult to imagine the Federal Reserve agreeing to having a director on its board nominated by, for example, one of the Mercosur countries.

e) The *lack of political support* for the proposal. Despite the problems highlighted above, situations may arise where the relationship between a country and the United States is so close that the benefits of creating a monetary union with it are greater than the costs. However, for this to occur, several factors should be taken into account, such as public opinion and the view of political leaders. In this respect, it is reasonable to affirm that the dollarization proposal has been embraced by certain small Central American countries and even in Mexico. The latter has already developed very close ties with the United States, has a vast common border, and has historically been the source of mass labor migration to the United States. Therefore, a significant section of Mexican society has relatives resident in the United States and many Mexicans receive remittances from families that have emigrated to the United States. On the other hand, it is unlikely that the proposal would be embraced by Argentina, much less by Brazil, whose ambitions to become a leader in the region and to differentiate itself from the United States are well known.

In general, it is valid to assert that in Europe the euro has been associated with the creation of *new* institutions – particularly the European Central Bank – to support a *new* currency. This implies the definition of *supranational sovereignty* in which all members have a voice and a vote. In the case of the dollarization of one or more Latin American countries, however, these would probably be *adhering* to the institutions, currency and sovereignty of another country, the United States. Dollarization would, therefore, result in geopolitical circumstances completely different from those in Europe.

Among the various possibilities associated with the adoption of monetary union based on a new currency and dollariza-

tion, an alternative has been presented by the former Argentine Economy Minister Domingo Cavallo, who proposed that Argentina and Brazil adhere to a currency board system (Cavallo, 1999). This alternative, however, has not only been criticized on the same grounds as dollarization, but is not supported by Brazil. Regardless, if a single currency is adopted in the subregion and Argentina continues to apply its fixed exchange rate system, it would be necessary to develop a transition mechanism to minimize the likelihood of a speculative attack prior to defining the conversion rates between one currency and another. A mechanism could be introduced whereby the bilateral peso/real parties would be maintained rigidly during a certain period of time prior to the two currencies disappearing.

9. A Proposal for a Working Agenda

The basic proposition of this study is that the coordination of macroeconomic policy – essential for the viability of monetary union – is necessary to avoid reverses and to promote new advances in the Mercosur integration process. It is also vital to prevent the integration process – hereto limited to intra-subregional free trade, with a common external tariff – from stagnating. An empirical analysis of Mercosur makes it impossible to reject the hypothesis that there is an inverse relationship between the variability of the intra-subregional exchange rate and the intensity of trade flows within Mercosur. This hypothesis was apparently confirmed by the recent experience of the devaluation of the Brazilian currency. Consequently, the stabilization of the exchange rate parities between the member states, through greater macroeconomic coordination, could have a positive impact on intra-subregional trade flows (Abreu and Bevilaqua [1995]). This could eventually lead to monetary union, which is in effect an extreme form of stabilization of these parities.

For such an ambitious proposal to have any chance of success, the Mercosur countries obviously need to make considerable progress towards harmonizing their respective national legislation, principally in the areas of tax, labor and capital markets.¹⁷

However, it is first necessary to define a three-year (2000-2003) *working agenda*. This would operate on different levels and consist of a time period during which the principal members of Mercosur would not be subject to the discontinuities associated with presidential elections. The objective would be to achieve the

17 In respect to tax harmonization, for example, see González Cano [1996], Gandra [1997] and Gómez Sabaini [1999]. For an excellent but relatively skeptical analysis of the lack of financial integration in Mercosur see Abreu [1997].

necessary conditions to be able to sign an agreement in the final year of the present Brazilian government (2002). This agreement would set the final year of the subsequent government (2006) as the deadline for establishing a date for monetary union.¹⁸ At present, the steps required are so many and so large that the definition of dates is still premature; thus the proposal to work towards a position in which these dates can be defined more precisely within a few years.

It is worth noting that 2002 is not being presented as the year in which this process will begin, but rather as the year in which the Mercosur countries will commit themselves to define, in 2006, the date of monetary union, which would probably not take place before 2010. In this case, 2006 would represent for Mercosur what 1992 represented for European unification – a kind of “initial sprint” in the race towards unification. However, given that the process involves a small group of countries with certain “know-how” in currency exchange rates, it may not be necessary to wait 10 years between this start up and the onset of the physical circulation of a new currency, as occurred in Europe – where this stage will only start in 2002, a decade after the Maastricht Treaty. In Mercosur, it could happen in a shorter period. *A realistic date for introducing a single currency in the subregion would be between 2010 and 2015.* If this process is completed near to this latter date, then monetary union would have been achieved three decades after the start of Argentine-Brazilian integration in 1986 – when the seed of Mercosur was first sown – a time period that is not much shorter than the four decades in Europe that separated the 1957 Treaty of Rome from the recent adoption of the euro as a fiduciary currency.

Monetary integration would thus include some key dates. The first is 1998, when the Mercosur countries, through their presidents, signed the Act of Ushuaia at the XIV meeting of the Common Market Council in which “... the Mercosur leaders announced that the process of deepening the customs union should be completed through new measures capable of: (a) defining fiscal and investment disciplines, (b) working towards the harmonization of macroeconomic policies and (c) *considering other aspects that could in the future facilitate the establishment of a single currency in the Southern Common Market*” (emphasis added). Although the declaration is ambiguous, it was important in that it was the first explicit, official and joint mention of monetary union as a long-term aim. The second key date is 2002, when this article suggests the countries should formally commit themselves to define before 2006 – the third key date – the date

18 The importance of Brazil's political calendar lies in that, since the country is obviously the key to the success of the negotiations, it is vital that the terms of what is agreed are extensively discussed by its authorities in the years prior to their conclusion so that any final decision does not have to be taken by a recently elected government that has not participated in previous debates. This strategy is also relevant in the case of Argentina, whose president takes office in December, at the end of the first year of his counterpart in Brazil, where the presidential mandate begins in January.

for monetary union, establishing an agenda on the progress that has to be made in the 2003-2006 period. A date for unification would be fixed once this agenda was successfully completed.

In the 2000-2002 period specifically, it is suggested that the working agenda focus on *three fronts*:

a) *The unresolved agenda.* The long list of strictly trade-related conflicts must be resolved, including those relating to the automobile sector, the inclusion of the sugar sector in the negotiations, and the criteria for phytosanitary controls. The aim would basically be to “clean up the guidelines” on trade issues; create a “pure” free trade area; and avoid “perforations” in the CET. In this way, the discrepancies in relations within the bloc would be reduced, current differences would be eliminated and the road towards a “pure” CET would be defined before 2002. Thus, it is expected that the negotiations could make progress beyond mere trade issues from 2003. In this case, in the 2003-2006 period, the negotiations would involve the so-called “new issues”, such as consumer rights, fair competition, government procurement, and the concept of “national treatment”, which are complex issues but in certain respects they are under the jurisdiction of the executive. It would also include legislative harmonization in the three areas already mentioned – tax, labor and capital markets – which would imply a greater parliamentary participation in the negotiations.

b) *Statistical standardization.* The decisions adopted at the 15 June presidential meeting on standardizing the criteria for defining and measuring the main macroeconomic variables in a more homogenous manner was an important step forward. The aim would be regularly to publish a series of economic indicators that would: (i) make comparisons; and (ii) define a subregional measure for each of these indicators, which lays the foundation of any ambitious integration effort.

c) *Macroeconomic coordination.*¹⁹ It is proposed that in 2000 the Mercosur countries negotiate and approve a “Protocol of Macroeconomic Coordination”, through which they commit themselves to put into practice, by 2002, a “three 3% ceilings” rule, establishing:²⁰

- a 3% ceiling on inflation;
- a 3% GDP ceiling on the nominal deficit of the consolidated public sector; and

19 See StraussKahn [1997] for a discussion on the different alternatives for coordination.

20 This focus is consistent with the caution that has characterized the initial negotiations in the bloc on the proposal for monetary union. This caution was highlighted by Brazilian President Fernando Henrique Cardoso when he said: “Without fiscal responsibility healthy integration cannot be achieved. A common currency will never be introduced without very serious prior efforts which economists call fundamental... Without solid fundamentals, the single currency [is] an illusion” (*Jornal do Brasil*, 16 June 1999).

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- a 3% GDP ceiling on the deficit of the current account of the balance of payments.

It is important to note that these parameters represent, as stated above, *ceilings*, not *goals*, since some countries currently register better indicators than these. In other words, the aim is that in around three years the four Mercosur countries would: first, have an inflation rate close to international levels; second, respect the same public sector deficit established in Maastricht for the euro countries; and third, have certain modest external disequilibria goals, which is particularly important owing to the crises that affected Mexico in 1994-1995, the South-East Asia countries in 1997, and Brazil in 1999. *However, nothing will prevent each country from eventually deciding to adopt more or less rigid goals than the aforementioned ceilings.*

The benefits of a gradualist strategy, *vis-à-vis* a more rapid integration strategy, are twofold. First, it allows *sequential consensuses to be constructed* – that is, to establish successive agreements leaving particularly difficult issues to one side, so long as the issue is not of vital importance. A common exchange rate policy is one example. In particular, it is an issue that will have to be discussed in the future but that today is “taboo” subject in the negotiations – because of the differences between the exchange rate regimes in Argentina and Brazil, which neither country is willing to abandon – and it makes little sense to discuss it in the current stage of Mercosur’s development. Second, the strategy is *consistent with the respective national agendas* – that is, it seeks to define macroeconomic policies that will benefit the integration process but that will also help improve each country’s economy.²¹ Brazil, for example, will benefit greatly if it succeeds in lowering its fiscal deficit, in the same way that Argentina will benefit if the trend there towards external disequilibria is reversed.

By 2003, therefore, the Mercosur economies should become more homogeneous and share what is generically understood as “macroeconomic equilibrium”. This would allow them to develop into attractive centers for foreign or domestic investment. The risks of speculative attacks against their national currencies should also diminish. In turn, this would induce the countries to speed up the integration process, advancing beyond the progress made thus far. In this context, a new working agenda for the 2003-2006 period would be established, and a date for monetary union could finally be defined by 2006.

In this respect, it is worth examining the essential condition for the success of any ambitious integrationist initiative: the

21 At the same time, it is assumed that each country makes important progress in its respective reform agenda, but could contribute towards greater harmonization of the respective macroeconomic situations and legislation, such as tax reform in Brazil; reform of the labor market in Argentina; or the ongoing policies towards gradually reducing inflation in Uruguay.

political will of governments, which need these initiatives to succeed – despite the fact that the “ideal” conditions for monetary union are still absent. Otherwise, in the absence of such a will, progress will simply not be made. As Mintz states, “It has often been argued that the conditions under which monetary integration might reasonably be expected to succeed are very restrictive. In fact, these conditions appear no more restrictive than the conditions for the establishment of a successful common market. *The major, and perhaps only, real condition for the institution of either is the political will to integrate on the part of prospective members*” (Mintz [1970] p. 33, emphasis added; quoted in Cohen [1993] p. 200).

The importance of a gradualist approach is underlined by the latest events that have affected Mercosur and, specifically, the bilateral relationship between Brazil and Argentina. In view of the arguments presented here, the answer to the question “Does monetary union in Mercosur make sense?” is “Yes”. However, the answer to the question “Is this a viable option in the short term?” is obviously “No”, if one takes into account the long list of unresolved issues that still need to be settled before an official calendar towards monetary union can be defined. An example of the type of problem that needs to be resolved is that of the non-tariff barriers (NTBs) that the Mercosur countries have been increasingly introducing since 1996. The NTBs, which numbered 285 when the Protocol of Ouro Preto was signed, reached 350 in 1998.²² Consequently, completing the free trade zone and the customs union is the first step to be taken if more ambitious integration proposals are to succeed. Once this stage is complete, and once the Mercosur economies become increasingly harmonized, with more adjusted and relatively homogeneous macroeconomic indicators, the issue of monetary union will feature more naturally on the agenda, following an evolutionary path very similar to that adopted by Europe over the last 40 years.

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22 The figure is from Felipe de la Balze.

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