Policy harmonization in MERCOSUR

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ABSTRACT

Despite its general character, the harmonization of economic policies presents two problems that need to be considered. One is the initial degree of uniformity in the behavior of the economies involved in the economic integration process. The other, the way the policies have to be implemented in the view of the whole. This paper provides a brief overview of both problems in MERCOSUR.

Key words: MERCOSUR, economic integration.

RESUMO

A despeito do seu caráter geral, a harmonização de políticas econômicas apresenta dois problemas que precisam ser considerados. Um, é o grau inicial de uniformidade no comportamento das economias envolvidas no processo de integração econômica. O outro diz respeito às formas como as políticas têm que ser implementadas tendo em vista o todo. Este artigo fornece um breve panorama de ambos os problemas no MERCOSUL.

Palavras-chave: MERCOSUL, integração econômica.

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Recebido em abril de 1997. Aceito em agosto de 1998.

1 Introduction

As it is well-known, the first purpose of economic integration in the form adopted by MERCOSUR is to facilitate and increase the flow of goods, services and capital within the region. To attain this goal, the four member countries eliminated tariffs and other barriers to trade between them, and established a uniform external tariff with third countries. Furthermore, they declared their willingness to relinquish part of their individual policies aimed at the domestic welfare function (e.g. preferences about inflation and employment, labor market institutions, growth rates, social security, etc.), to take into account the economic situation in other member countries.(Gretschmann, 1994; Schwidrowski, 1991)

Economic integration takes place gradually. In general, the process starts slowly and involves a small amount of the economic transactions. Later, as economic integration matures, trade expands and larger quantities of goods and services flow among members countries. For instance, ten years ago, intra-trade among countries belonging to the European Union (EU) accounted for more than 50% of total EU's trade (approximately 50% of EU's total GDP). In the case of MERCOSUR, although intra-trade made up less than 12% of total trade (or one third of GDP), it has fortunately been increasing rapidly (Schwidrowski, 1991). In addition, the growing interdependence among the economies makes the harmonization of the domestic policies crucial. In a non-integrated environment, any country will be reluctant to follow domestic policies that are detrimental to its economy; however, it may potentially agree on some common policies on an integrated environment.

The paradigm of integration is the individual country, where most economic policies carried out by Governments are homogeneous among the various regions. Similarly, when different countries have integrated, they become more economically interdependent because domestic policies now affect other members′ economies. Therefore, domestic policies turn out to be somehow restricted; they no longer remain determined by individual (in occasions, selfish) interests; they have to take into account policies of other members countries.

The harmonization of economic policies, despite its general character, may take two different forms: convergence or coordination. Convergence is the alignment of the policies implemented by member countries to attain similar goals, e.g. stabilization, employment, growth. Coordination takes place when individual policies are made compatible for the achievement of common goals.

Above all, harmonization presents two problems that need to be solved, one being the initial degree of uniformity in the behavior of the economies, as synthesized, for instance, by the short-term fluctuations in GDP. And the other, the way the policies are to be harmonized after the union is in operation, in particular whether they have to be convergent, coordinated, or subject to some other alternative.

In other words, these two questions are important because, on one hand, the feasibility of harmonizing policies in the case of independent countries would be determined exclusively by the conditions in each country. After integration, on the other hand, the country belongs to a group and therefore domestic policies have to be implemented in view of the whole. The first problem is discussed in Section 2, the two main policies (monetary and fiscal) in Section 3, and conclusions are summarized in Section 4.

2 Initial degree of uniformity among the MERCOSUR countries

Assume a group of countries to be integrated which initially do not have any strong economic link among them. Up to the moment of integration, the economic performance of each country depends on domestic and external variables. In the case of external variables, however, they might not be significantly related to the later-to-be member countries. This period previous to the integration will be identified as the "initial situation" or "zero intra-country relations", opposite to the time when the integration process is taking place.

This partition may be applied to the countries now joining MERCOSUR, an institution created after many unsuccessful attempts in the past to integrate all or a group of Latin American economies. On legal grounds, the date of the Tratado de Asunción should be taken as the boundary between the two periods, marking the performance of the economy in the past and its likely behavior in the future. The results of the integration, however, took time to emerge; their first evidence may have occurred in the early 1990s. Therefore, it seems more appropriate to take this latter time as the dividing point.

An interesting theoretical exercise would be to determine the feasibility of policy harmonization before the countries have started the integration process, that is, what was formerly called the initial situation. Moreover, the analysis could be focused on the behavior of short-term disturbances in each country's GDP. A practical rule might be the following: if disturbances are distributed symmetrically among countries, common or convergent policies are possible; otherwise, if they are perfectly asymmetrical, policies may be coordinated so that no country is following a policy opposite to that of another member. In practice, the experience of MERCOSUR shows that the situation is somewhere in between these two extremes.(Bayoumi and Eichengreen, 1992; Funke, 1997)

Hence the exercise entails the examination of short-term deviations of the individual countries' GDP from a trend line. Before going ahead with the analysis, the effects of domestic policies need to be discussed. One may assume that no policy was implemented, or that it was irrelevant to influence the level of economic activity, or that it had a perverse effect on it. However, these alternatives could be rejected.

It would be better to assume that policies are partially effective in compensating cyclical disturbances; otherwise, i.e. if they were completely effective, the GDP would exhibit anything but a trend line. To disentangle the specific effects of policies when every disturbance is presented looks impossible. For example, how to determine what part of a disturbance is due to fundamentals and what part is compensated with a successful policy. Consequently, the analysis of the disturbances implies that they are not purged of the effects of policies.[1]

The analysis of the simultaneity of GDP expansions and contractions allows the computation of the number of coincidences among the four countries. Were the fluctuations simultaneous, the number of years when they occur would be equal to the number of years in the sample; on the contrary, if they were in opposite directions, such number would be zero. Finally, if the fluctuations were distributed randomly, it would be reasonable to think that the number of years when they occur is close to half the total number of years. Given that the number of years in the sample is 25, the latter would be 12 or 13.

The top figures in Table 1 record the number of coincidences of GDP fluctuations for every pair of countries. This number is relatively high in the case of Argentina and Brazil, indicating that their economies have followed quite uniform paths. The fluctuations of the Paraguayan economy register a low simultaneity with the other countries; in the case of Uruguay, that number is even lower.[2]

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1 Under this assumption, one can benefit from the findings of a pervious work by the authors (Arnaudo and Jacobo, 1997) on the macroeconomic homogeneity of MERCOSUR countries for the period 1970-1994.

2 The coincidence of fluctuations have been checked with CEPAL's annual reports for the Latin American and Caribean countries. There is no way to make it directly because of methodological aspects (fluctuations respect to the previous year and fluctuations around a trend line), but a table similar to Table 1 may be constructed for comparison, taking expansions and recessions

Table 1
Simultaneity of Economic Fluctuations
(Years and Correlations)

Countries	Argentina	Paraguay	Uruguay
Brazil	21	14	11
	0,38	0,50	-0,25
	0,39	0,32	-0,31
	0,07	-0,05	-0,41
Paraguay	15		15
	0,16		-0,39
	0,52		-0,06
	-0,19		-0,20
Uruguay	12		
	-0,20		
	-0,29		
	-0,34		

Source: Arnaudo and Jacobo (1997, Tables 3-4).

However, this analysis only focuses on the number of years when the economic conditions were similar, disregarding the size of the fluctuations. This difficulty can be overcome by looking at the temporal correlations of the fluctuations. The next three figures record, for each country mentioned in the upper part of the Table, the cross-correlations in the same period, and the lagged (one year) and leaded (one year) periods.

According to the temporal correlations, the two largest economies of Argentina and Brazil do not show a similar strong relationship with respect to their magnitudes, even though the fluctuations are in the same direction. The presumption is that the magnitude of the fluctuations is very significant: when one country confronts a considerable expansion (contraction) the other experiments only a weaker one.

The case of Brazil and Paraguay seems to be the opposite. The coincidence of fluctuations is taking place just over half of the 25 years under analysis, but the magnitude of the relationship is substantial.[3] Such situation is not observed in the case of Argentina.

3 Keep in mind the negative values arising from the products in correlation.

Apart from the relationship just mentioned, the two smallest economies of Paraguay and Uruguay do not show much coincidence with those of the other two countries or between themselves. Neither the direction nor the magnitudes of the fluctuations are significant.

As a result, the case for a coordination of policies is weak. The smallest economies are economically independent and behave in a way quite different from the other two; therefore, any uniform policy should be initially discarded for this group. However, a case could be risen for the two largest economies. Similar policies could work both in expansions and contractions, but their strength should be completely different: very high in one country, very small it the other.

Even if the relationships between the Argentine and Brazilian economies are accepted and thus the policy coordination is considered possible, there is still an additional requirement that ought to be fulfilled: the shocks to the economies should show some parallelism.[4] The methodology of Blanchard-Quah looks appropriate to cope with this problem. It considers a time series as formed by the sum of a transitory short-term shock and a long-term one. GDP fluctuations around the trend are separated between those producing a permanent change, and those lasting for a period of time.

This method requires that changes be explained by the incorporation of a shock variable influencing directly the GDP, and an additional variable also influencing the GDP but subject to its own shocks. In practice, the latter is associated with monetary policy. The shocks of monetary policy (demand shocks) are transitory, coming from the rigidities existing in every economy and some other minor causes. On the contrary, permanent shocks to the aggregate real economy (supply shocks) have effects remaining forever. It has been suggested that positive demand shocks increase inflation and output in a transitory way without taking the economy to a higher level of capacity Positive supply shocks, on the contrary, increase permanent output and reduce inflation temporarily.

If demand (or monetary) shocks are measured by the difference between the rate of inflation and the rate of change of an adequate monetary stock,[5] the paper mentioned above (Arnaudo and Jacobo, 1997) gives some indication for the economies of Argentina and Brazil. Argentina´s GDP has been affected primarily by supply shocks, whereas Brazil's by demand shocks. The conclusion is that the possibilities of coordinated policies are not enhanced.

4 Some view of the shocks may be observed in Table 2 of Arnaudo and Jacobo (1997).

5 Hyperinflationary periods are not considered.

3 Policies implemented after the MERCOSUR Treaty

The policies implemented after the integration process began can be divided into two categories: those policies aimed at increasing the degree of homogeneity in commercial relations, and those to attain a higher degree of homogeneity in the operation of their economic systems. The two categories are not exclusive, and there may be policies to get both goals; in practice, the implementation of policies that fall in the first category are good in obtaining the second goal. There seems to be no contradiction in the fact that a country can follow a selfish policy in the integration process and at the same time aims to a higher level of homogeneity.

The most common sort of policies within the first category are those related to the exchange rate. If the exchange rate is unstable and subject to wide fluctuations, the elimination of tariffs may not contribute to increase trade. The resulting beneficial effects of integration are therefore eliminated or deteriorated by a greater variability of the real exchange rate. It is obvious that intra-regional trade may be arranged taking the currency of another country as a kind of unit of account; but finally transactions have to be arranged in the local currency. The more it fluctuates, the more trade is discouraged.

Therefore, in matters of exchange rate, countries in general give a special treatment to the other members. This might take the form of a special exchange rate regime, or a particular exchange rate, or modifications to exchange rate regulations, which put the other members in a favorable situation with respect to third countries.

3.a Monetary policy

A coordinated monetary policy involves the creation of a kind of currency area. A currency area is an arrangement made by a group of countries to peg their exchange rates. In practice, a currency area is the next step after a custom union; however, it may not be beneficial for members in all cases. There may be situations when a common currency is advisable for economies sharing similar characteristics, for example, underdeveloped countries exporting a good which market they monopolize.

The establishment of a currency area implies the successful implementation of three phases in every member country, each one taking its own time. First, the fixing of the exchange rate and the adoption of credible mechanism of adjustment. In some cases, exchange rates may be rigidly pegged, but in others may be allowed to fluctuate within narrow bands. Second, the compromise to a thigh monetary arrangement with respect to foreign currencies, as in a currency board. This arrangement involves a much stronger political and institutional commitment than the fixing of the exchange rates; it implies a single currency functioning as the monetary standard for the group. Third, the replacement of the domestic currency by a common or foreign currency, and the creation of a monetary authority on a union-wide basis.

MERCOSUR countries currently show some degree of convergence, as evidenced by key economic variables moving in the same direction. However, they have hardly fulfilled the first stage. Table 2 includes a very brief account of what happened during the last years. Argentina was the exception; it adopted a convertibility plan fixing the exchange rate between the peso and the dollar, with the subsequent stabilization of nominal prices and salaries. The other three countries adopted less rigorous policies in the same direction; fortunately however, those policies were far from the inflationary policies followed in the 80s and early 90s.

Table 2
Exchange Rate Provisions

Item	Argentina	Brazil	Paraguay	Uruguay
Regime	Fixed	Bands	Pegged	Pegged
Adjustment		→0	Prices	Prices
Year of Adoption	1991	1994	Existing	Existing
Rate of Change and Direction (% quarterly average)				
Period	92-96	95-96	91-96	91-96
Exchange Rate		2,6	2,2	7,5
Prices	1,5	4,5	3,6	3,4
Level of Nominal Interest Rate	11,2	28,3	21,0	44,5

Source: IMF *International Financial Statistics*, and NU-CEPAL *Anuarios Estadísticos para América Latina y El Caribe*, various issues.

In 1994, Brazil implemented a stabilization plan that should progressively lead to zero-inflation; the plan has been quite successful until now. The exchange rate experienced a decreasing rate of change, but was not fixed as in the case of Argentina. This would have not been feasible because the central bank did not have enough international reserves to convert the monetary base. Paraguay and Uruguay underwent a decreasing inflation without committing to a specific program; therefore, the exchange rate had to be adjusted to the level of prices.

All MERCOSUR countries have abandoned the inflationary policies that substantially modified the real exchange rates, requiring periodic adjustment in the nominal exchange rate. Voluntarily or not, it should be counted as a way to coordinate policies in the monetary area. Moreover, the exchange regimes seem to have also evolved in the same direction. A question remains to whether they will proceed in the future with the second and third phases. If the member countries were to implement them, more restricted exchange rate regimes should be needed; for instance, the establishment of a band for the exchange rate to fluctuate within it. According to an interpretation, the Treaty of Asunción, paves the way for a common currency. Notwithstanding, many economists have doubts about the convenience of such an arrangement.(See for example Martirena-Mantel, 1997)

3.b Fiscal policy

It is usually argued that a common currency imposes strong constraints on domestic fiscal policies.(Dornbusch, 1997) An independent central bank issuing currency with disregard to the situation of other member's economies will not be willing to finance the deficit incurred by any Government. The country having a fiscal deficit or facing the services of the Government debt has to resort to the market, to pay a higher interest rate and to suffer an increasing country-risk; these three elements act as sufficient constraints for the fiscal policy. This connection introduces monetary policy as a constraint to fiscal policies.[6]

However, if the system of a common currency were implemented, it would hardly work in such an easy way. In the absence of such system, similar fiscal policies may be convenient for their own sake or to complement monetary ones. Limits to the budget deficits, at least in the long-run, may be coordinated formally or informally - in order to restrict or eventually eliminate the deficit. Bear in mind that in the past MERCOSUR countries recurred to inflationary financing to pay for their expenditures. Now they have decreased the magnitude of their fiscal deficit, as well as the recurrence to their central banks; a fact most probably due to seize the benefit of stable prices and salaries. Notwithstanding, such alignment could be accounted as a measure of coordination among the member countries.

Finally, some coordination and possibly unification in tax matters would be needed if taxes are used as a substitute for changes in the exchange rate.

6 The conditions referring to fiscal deficits and debt imposed by the Maastrich Treaty would be unnecessary.

5 Conclusion

Previous to the MERCOSUR arrangements, there were no grounds to expect a strong coordination of policies among the four countries because their economies were basically unrelated. After the Treaty, however, as commercial trade began to grow, the relationships among member countries increased, and some degree of policy harmonization was needed.

The overall convergence of economic policies was mainly due to the abandonment of inflationary finance. However, it is expected that the unseen coordination of specific monetary and fiscal policies will hopefully be reversed in the future.

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