

# MACROECONOMIC COOPERATION IN MERCOSUR

## AN INTERDEPENDENCE ANALYSIS AND A PROPOSAL OF COORDINATION

### EXECUTIVE SUMMARY

Mercosur is currently going through an intermediate integration stage in which macroeconomic interdependence acquires importance and the need arises to adopt strategic definitions with regard to the future of the process itself. Options cover a very wide range, from reversing previous steps to maintaining status quo or increasing integration by adding the macroeconomic dimension.

The purpose of this study is to assess, through several alternative approaches, the degree of integration achieved in Mercosur, as well as the need and possibilities for implementation of macroeconomic cooperation alternatives between the partners.

### EXTENT OF INTERDEPENDENCE

The increase in levels of interdependence, which is defined as “the degree of mutual influence between economies” (Cooper, 1985), is a natural result of integration and is directly proportional to the degree of progress in the process. For example, the influence of an economy on another one will be higher in a single market or monetary union than in a free trade area.

A key feature of macroeconomic interdependence is the high correlation in shocks experienced by economies, whether originating in the rest of the world or in one of the countries in the bloc.

There are two main channels for shocks to be transmitted and received between interdependent economies: i) the trade channel, which can be associated with trade in goods and services; and ii) the financial channel, which can be associated with foreign direct investment, financial investment, the position of assets in relation to the rest of the world, etc.

Three key channels of macroeconomic interdependence are: i) trade; ii) international capital

flows; and iii) the exchange regime. A detailed analysis of each of these key factors for Mercosur shows that the current degree of interdependence is high.

In short, the region's economies are fully interdependent, which means that there is a high correlation in reactions to both external as well as internal shocks.

Intra-Mercosur trade has increased remarkably since the early 1990s, following the Treaty of Asunción. Whereas in 1980 and 1990 intrazone exports had grown at a pace similar to that of extrazone exports (multiplied by 1.2 and 1.6), in the 1990s intra-Mercosur sales quadrupled (with most of the increase accumulating in the first half of the decade), whereas sales to the rest of the world only grew 60%.

Consequently, for the four Mercosur countries, the importance of the block as an export (import) destination (origin) increased considerably in the 1990s. By way of example, exports from Argentina (Brazil) to Mercosur grew from 14% (9%) of the total figure in 1980 to 32% (14%) in the year 2000.

Intrabloc industrial trade is associated with the existence of similar production structures which means that the economies face common shocks.

Due to their high volatility, capital movements have been the main source of common external shocks for the economies of Mercosur, transmitted through the financial channel. Whereas foreign direct investment appears as the most stable component of international financial flows, short-term capitals show high volatility and sudden capital flows reversals (“sudden stops”) have become the largest source of macroeconomic volatility for the region's economies, as well as the source of most crises in emerging countries.

Finally, when it comes to interdependence channels, currency exchange issues are not neutral in effect, due

to the different adjustment mechanisms used by economies with different exchange regimes to respond to common shocks. In view of the important effects of the exchange rate on the real economy in a context of high integration, real exchange rate stability around a point of balance is another necessary element in order to stop those negative effects that may call integration into question.

A study of the co-movement of the economies of the Mercosur countries leads to an analysis of the evolution of interdependence over time. Greater co-movement is a sign of common shocks, and points to the fact that macroeconomic cycles share the same dynamics. The higher the similarity of the cycle, the lower the cost of macroeconomic cooperation. In general terms, the cyclical component of GDP in Mercosur countries shows increasing correlation over time when looking at the period from 1955 to 2000, although with three clear-cut periods: whereas correlations for the four Mercosur countries taken in pairs for the period 1955 to 1975 are the lowest in the sample, they increase in the period from 1980 to 1990, but the great leap in correlation takes place in the 1990s, as from the implementation of Mercosur and financial globalization. There is also an analysis of the co-movement of other significant macroeconomic variables. As regards the cycle of foreign trade variables (exports and imports), the strongly positive correlation observed is a sign of common shocks in the trade channel. In the case of the cyclical component of capital flows, the existence of a strong positive correlation suggests that shock transmission through the financial channel is also important.

From a third complementary angle, the study examines macroeconomic interdependence with a macroeconomic model of computable general equilibrium. This enables an estimation of the sign and extent of transmission of shocks originating either in a Mercosur country or in the rest of the world<sup>1</sup>. The results of the model show that interdependence has important effects. For example, a reduction in capital flows to all Mercosur countries has a significantly greater negative effect on Argentina than a reduction in capital flows affecting Argentina alone. The different

results being attributable to macroeconomic interdependence. The results of the model also show that shocks originating in one of the bloc's economies significantly affect the other ones. In more technical terms, there is feedback from interdependence between all the economies.

#### COOPERATION: UTOPIA OR A NECESSITY?

With the generalization of floating exchange rate regimes in Mercosur in 2002, the increased exchange compatibility prevents the negative externalities resulting from different approaches to dealing with external shocks. However, the situation may still be far from ideal. In other words, there are no opposed regimes which as such could cause additional difficulties to the countries, but currency exchange flexibility is not risk-free. Should the countries not be prepared institutionally or go wrong in managing monetary policies, the results could be counterproductive. Therefore, the high level of interdependence is an additional warning sign against an irresponsible use of a flexible exchange regime where there are externalities or spillover effects on the partners. This means that in a context of interdependence it is not only domestic economic players that are interested in the country's monetary policy but also the economic players of the partner countries.

Accordingly, i) avoiding inflationary bias due to internal reasons damaging credibility and integration; and ii) avoiding competitive devaluation which may damage trade integration are important additional reasons that justify macroeconomic cooperation as a compromise technology.

However, cooperation should not stop only at fixing targets for fundamental macroeconomic variables, as proposed in the past (when Argentina had its currency board), nor should there be a hasty convergence towards intra-Mercosur fixed exchange rates or towards a single regional currency. There is a broad intermediate space for additional cooperation, which should be considered a priority and which relates to cooperation for a prudent regulation of external volatility sources.

However, in a context of interdependence it is not easy to achieve prudent regulation of capital flows individually. It can be shown, using game theory concepts, that a prudent regulation of capital flows in a context of high interdependence is effective only if the countries coordinate their actions.

#### A PROPOSAL FOR MACROECONOMIC COOPERATION

The high current levels of interdependence require that policymakers consider the position to adopt with regard to continuing the regional integration process. On the one hand, one may choose not to cooperate and to reverse the integration process. On the other hand, cooperation would minimize the risks of interdependence, but it requires great institutional effort.

Mercosur's common policy could seek to create a Macroeconomic Stability Area that would eventually lead to a single currency in the future; at the same time, it should focus on strengthening economic institutions, which determine the solidity of the currency, as well as reduce the effect of extra and intra-Mercosur volatility sources. Mercosur should basically work on three key aspects, considering its macroeconomic background: i) nominal stability; ii) fiscal solvency; and iii) sustainable long-term growth. Cooperation with regard to internal vulnerability

sources could be based on fiscal, monetary and current account targets and a commitment not to discharge negative shocks on partners. Cooperation in relation to external vulnerability sources should be based on the prudent regulation of short-term capital flows.

If countries cooperate they may avoid results from being less than optimum. At the same time, cooperation can be a long-term strategy reflecting a commitment that restricts opportunistic behaviour.

It remains to be considered whether Mercosur is an "appropriate compromise technology". In a way, most proposals are targets or objectives which countries should ideally achieve by themselves. However, international experience teaches that hands tied under an external commitment is often much more effective than a mere individual commitment. The best example of this is the European case. Mercosur has been a key instrument for consolidation and consensus with a view to a speedy and thorough opening up of trade in the bloc's economies. Without the regional bloc, commercial opening would have most likely suffered reversals and more volatility in regulations. Mercosur can therefore be an optimal instrument to consolidate the region's position in international financial markets and, above all, to consolidate the real and monetary stability of their currencies.

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