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Economic policy Co-Movement in Latin America and the Caribbean

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Abstract

There have been numerous attempts at the formation of regional policy groupings within Latin America and the Caribbean (LAC). This paper analyses the similarities in macroeconomic policies pursued by member countries using realised correlation analysis on 26 LAC countries and observations covering the period 1970–2005. The study finds evidence of co-movement in monetary, fiscal, trade and capital account policies, with the strength of association rising over time. The main determinants of the strength of co-movement were similarity in economic size, economic shocks, transportation costs and population size.

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1. Introduction

There has been renewed focus on forging greater links within Latin America and the Caribbean (LAC) in recent years by means of facing the changes that are taking place in the international arena and crises that afflicted the region during the 1980s and 1990s (ECLAC, 1994). There are four main regional groupings: (1) the Southern Common Market (MERCOSUR), consisting of Brazil, Argentina, Uruguay, Venezuela and Paraguay; (2) the Andean Community made up of Bolivia, Colombia, Ecuador, Peru and Venezuela; (3) the Central American Common Market

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(CACM) comprising Guatemala, El Salvador, Honduras and Nicaragua; and (4) the Caribbean Community and Common Market (CARICOM) which embraces 15 Caribbean countries.

One of the essential elements of furthering the goal of regional integration is policy co-movement or convergence. Policy convergence occurs when the macroeconomic policies pursued by countries move toward being identical. On the other hand, policy co-movements reflect the degree of similarity in macroeconomic policies. Drezner (2001) contends that policy convergence in a regional grouping can occur either through structural factors or the power of self-directed agents. Structural theories argue that external pressures on states constrain countries to pursue one universal policy, while agent-based models assume that countries choose to implement some acceptable bounds on macroeconomic policies, but not necessarily identical rules or regulations.

The pressure to implement similar policies can either be due to economic or ideological factors. Most regional groupings explicitly attempt to remove restrictions on the free flow or movement of goods, services and capital across borders. This increased mobility, however, can itself lead to convergence as non-converging states are penalised by capital flowing to more competitive territories (Fischer, 1998; Stiglitz, 2000). Alternatively, demands for policy convergence can occur for ideological reasons, as countries fear that if they do not adopt similar policies they may be viewed as laggards (Drezner, 2001).

Theoretically, policy convergence should increase trade and economic growth. McCallum (1995) contends that policy convergence can reduce 'border effects' and lead to fewer trade disputes and thus lower transactions costs. Similarity in macroeconomic policies should also lead to greater economic integration as it should increase intra-regional trade in goods, services and investment, as economic agents in two or more countries will receive the same treatment from governments.

Economists have long been intrigued with the topic of convergence. As such, there is a burgeoning body of theoretical and empirical literature that focuses on this issue. In Europe, studies on monetary policy convergence have emerged as the most popular type of policy convergence research. The early literature dealt primarily with the performance of the European Monetary System (EMS). These studies (for example, Hagen & Fratianni, 1990; McDonald & Taylor, 1991; Orlowski, 2004) sought to determine whether the EMS countries were capable of maintaining the necessary currency peg by following similar macroeconomic policies. As noted by Brada, Kutan, and Zhou (2005), the test of this hypothesis was usually framed in the convergence between the monetary policies of various EMS countries and the Federal Republic of Germany where the existence of cointegration between the series served as a test of the convergence hypothesis. The rationale was that the Bundesbank had the most credible monetary policies and in order for EMS member countries to maintain the peg, their policies would have to converge towards those of the Bundesbank. Soukiazis and Castro (2005), in contrast, note that the Maastricht rules and the Stability and Growth Pact have not had a significant impact on convergence in Europe. The authors attributed this finding to differences in the cyclical positions of countries in the area and inflexibility of fiscal policies.

This paper contributes to the existing literature in a number of ways. First, the study employs statistical tests for policy co-movement and second, an empirical assessment of the potential determinants of the strength of policy co-movements is provided. The results provided in the study should be of interest to policymakers and researchers since it provides an assessment of the key factors that are likely to determine the success of attempts at regional integration.

The remainder of the paper is structured as follows. After the introduction, Section 2 gives a review of previous research on policy convergence. Section 3 presents estimates of policy