



# Disintegrating effects of monetary policies in the MERCOSUR

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## Abstract

This paper shows that differences in the monetary policies in Argentina and Brazil have produced adverse effects on the structures of intra-regional trade and other target variables of economic integration in the MERCOSUR. The long-lasting coexistence of a strictly reserve-restrained monetary regime in Argentina with more flexible policies in Brazil has led to the development of a fundamental asymmetry in the adjustment mechanisms of both economies to common shocks. In several steps of modelling and econometric analysis the paper provides evidence for economic disintegration that has been caused by this lack of monetary integration.

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## 1. Introduction

The year 1991 marked the beginning of two policy experiments in South America that were to have far-reaching consequences for the economic development in the region. On 26 March 1991, Argentina, Brazil, Paraguay and Uruguay signed the Treaty of Asuncion by which the four countries created the institutional framework for MERCOSUR, the Common

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Market of the South. A few days later, on 1 April, Argentina's Congress approved a law to guarantee the full convertibility of the peso, the newly created currency, to the US dollar at the rate of one-to-one. Since the law confined the issue of pesos almost exclusively to the official dollar reserves, monetary policy in Argentina was subject to a (quasi-)currency-board rule.

The formation of MERCOSUR was based on the idea that economic integration would foster economic growth in South America by intensifying trade and financial relations between Argentina and Brazil, the two dominant economies in the region.<sup>1</sup> The Argentinian currency board was declared to be a precondition for macroeconomic stability and growth, because it was aimed at curbing the hyperinflation that had plagued the country throughout the 1980s. By the mid-1990s, both reforms were deemed to be successful. Argentinian inflation was under control and the growth rates of Argentinian GDP and intra-MERCOSUR trade rose faster than expected. At the same time Brazil had succeeded in getting rid of hyperinflation by pegging its new currency, the real, to the US dollar. Referring to Europe, where the 1991 Treaty of Maastricht had set monetary union on the agenda, politicians and economists began to speculate about combining economic integration in the MERCOSUR with monetary integration in the not too distant future.

A few years later such speculations looked absurd. In January 2002 the Argentinian currency board collapsed in the middle of a deep and protracted crisis whose beginnings date back to the Asian crisis in 1997 and the Brazilian currency crisis in early 1999. With hindsight it seems almost trivial to say that the two experiments of the 1991 vintage—MERCOSUR and the Argentinian currency board—proved to be incompatible with each other. After the currency crisis Brazil had gone over to inflation targeting and floating exchange rates. Together with other factors the strong depreciation of the real against the dollar and the peso contributed to a catastrophic decline of industrial production in Argentina. This undermined the credibility of the currency board rule and created, at the same time, tensions within the MERCOSUR that threatened to halt the whole project of creating a common market in the region. In the end the “boarded peg” of the Argentinian peso to the dollar had to be abandoned.

Yet it would be misleading to consider the period between 1999 and 2002 as an *exceptional* episode of inconsistent macroeconomic policies in an otherwise consistent story of economic integration. In our paper we show that fundamental differences in the monetary policies of Argentina and Brazil have existed even at the times when both countries had their currencies pegged to the dollar. We argue that the policy differences have led to asymmetries in the mechanisms by which the Argentinian and Brazilian economies adjust to common shocks. When Brazil was forced to abandon the dollar peg, these asymmetries generated adverse effects on real income convergence and trade integration in the MERCOSUR.

The general idea behind this “joint hypothesis” can be described with reference to the recent discussion about the endogeneity of Optimum Currency Areas (OCA). In the tradition of Mundell (1961), there are two alternative OCA criteria for successful monetary

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<sup>1</sup> The GNPs and populations of Argentina and Brazil amount to more than 96% of the total figures for the MERCOSUR. In 1999, Argentina's GNP share was 26.5%, its population share 17.3%. The figures for Brazil were 70.8 and 79.0%, respectively. Due to this dominance, MERCOSUR will henceforth largely be taken as synonymous with Argentina and Brazil, neglecting the other two member countries, Paraguay and Uruguay.

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