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Economic integration without policy coordination: the case of Mercosur

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Abstract

This paper analyses the evolution of the South American Common Market, Mercosur. We show how the lack of coordination of macroeconomic policies, especially of the two major participants (Argentina and Brazil), had caused trade strains. Divergent macro-economic policies have had negative effects on bilateral trade due to the risk averseness (resulting from bilateral exchange rate volatilities) of exporters and importers, and due to the protectionist forces they have brought forth.

JEL classifications: F4; F42

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1. Introduction

The common market of Argentina, Brazil, Uruguay and Paraguay (Mercosur) was created in 1991 by the Asuncion Treaty. Trade within Mercosur increased substantially since that time. For instance, in the period 1990–1998 the share of intra-Mercosur exports rose from 9 to 25% of total Mercosur exports (Inter-

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American Development Bank, 1999, p. 25). This occurred while different stabilization programs were instituted in the region's largest economies, Argentina and Brazil. As the macroeconomic policies pursued to stabilize these two large economies were substantially different, they gradually threatened the existence of Mercosur.[1]

Excessive price and exchange rate fluctuations resulting from unco-ordinated macroeconomic policies affect international trade and the allocation of investments among members of a trade area. There are *two main channels* through which the lack of macroeconomic coordination affects international trade. First, there is an increased level of risk in international transactions (*risk channel*), which may induce producers to refrain from exporting or importing and therefore, causing an allocation of resources different than what would be suggested from comparative advantage. It also stimulates lobbying for protection from imports when there exists a substantial increase in the import penetration ratio (*lobbying channel*).

Thus, the expected expansion of regional trade, and even the formation of a common market,[2] may be hampered by the fact that the two main countries of Mercosur do not have their economic policies directed towards economic integration. The objective of this paper is to investigate whether un-coordinated macroeconomic policies of Brazil and Argentina can hamper the further expansion of trade flows in the region through the increase of risk involved in regional transactions and through the implementation of trade protection measures originating from the lobbying of interest groups.

Our work clearly relates to an earlier literature on Mercosur, in particular, to Bevilaqua (1997), Olarreaga and Soloaga (1998), Flôres et al. (2000). Bevilaqua emphasized the risk channel while neglecting the lobbying impact. The others concentrated mainly on the political economy aspect of protection (lobbying channel), while neglecting the results of the lack of macroeconomic coordination and the risk channel. Our contribution is to take all these variables into account in order to show the impact of the lack of macroeconomic coordination on bilateral trade between the two main economies of Mercosur.

The paper is presented in the following sequence. Section 2 describes the evolution of trade integration since the creation of Mercosur. It also describes how this period can be divided into sub-periods, depending on acute divergences of macroeconomic policies between Brazil and Argentina and presents some examples of trade strains between these two countries. Section 3 describes and tests how un-coordinated macroeconomic policies affect trade through risk and through the political economy of trade. In the latter case we focus on the description of what in

[1] The prioritization of stabilization programs instead of commercial integration may also produce a lack of tax harmonization between members of a trade area. The lack of tax harmonization may cause an excess flow of capital within and from outside the region to those countries with the lowest taxes. This is not necessarily the most efficient location, and it may also lead to confrontation among the members of the common market and result in controls over the free movement of capital within the region. See Brandão and Pereira (1997), Chapter 5.

[2] The formation of a common market was one of the targets of the Asuncion Treaty. See Averbug (1998, p. 3). Giambiagi (1999, p. 20), goes further and defend that Mercosur should move towards a monetary union in the long run.