duced wage indexation to the contemporaneous exchange rate, rather than to backward-looking inflation. From March 1994 to 1 July, 1994 the URV was in fact the US dollar unit of account, as the URV was fixed close on a one-to-one basis with the dollar. Although all wages and most prices were denominated in URVs by March 1994, prices in URVs could change both before and after the plan, but actual transactions continued to be made in "Cruzeiros Reais", based on the market exchange rate. Inflation in URVs (in dollars) could then be calculated and was around two per cent per month during the period March to May. The third stage (from 1 July 1994) introduced the new currency, the Real, which was pegged to the dollar from the start. All URV prices were to be converted (one-to-one) into Real prices, although some prices increases took place in the days prior to the plan's introduction. Inflation dropped immediately from the cruzeiro of approximately 50 per cent per month (June) to the URV rate of around two per cent per month after September and persisted roughly at that rate in the following year. The Real Plan produced, initially, favorable results within labor markets. Open unemployment fell to a 3.4 per cent average in Brazil's six largest cities, while average real wages of the employed labor force jumped by 4.9 per cent. In addition, as inflation declined production rises became increasingly generalized with an increasing share of output being directed towards low-income groups in response to their growing purchasing power. Within the balance of payments, the increase in domestic demand, coupled with the appreciation of the exchange rate and tariff reductions led to a 33.2 billion US dollar jump in imports. The drop in trade surplus was offset by a decline in the service imbalance, which was attributable to lower net interest payments. The Mexican crisis also imposed serious costs by slowing down economic activity and there were pressures in the exchange rate market. To deal with the decline in external competitiveness, the government introduced fiscal measures in January to abolish the 15 per cent reserve requirement on advances against exporters. Tariffs were also raised on automobiles and other consumer durable goods, which had accounted for a significant share of the rise in imports during 1994.

However, the economy remained overheated and the trade balance recorded a deficit of 1.1 billion US dollars. In response to this deteriorating situation, the authorities announced an important package of measures on 6 March, 1995. The Central Bank announced a new exchange rate policy, including fluctuation bands, and the real was effectively devalued by over 2 per cent over a two week period. Additional new fiscal measures were adopted with the objective of reducing the foreseen fiscal deficit in 1995. Five constitutional reforms relating to oil, natural gas, telecommunications and the abolition of the constitutional distinction between Brazilian and foreign investors were approved. New restrictions were placed on hiring at all levels of government, while public federal banks were ordered to reduce operating costs by 15 per cent. A

329 The Brazilian Constitution of 1988 constitutes the most serious obstacle to break with the import-substitution model and also interferes with the flexibilization of labor markets. It was the product of length and difficult negotiations within the Brazilian society and first of all in the Parliament. The Constitution guarantees the labor unionization by category instead of a firm basis, the right to strike, the right that civil servant cannot be fired. It discriminates between Brazilian and foreign investors as a basis for state support and establishes that certain areas can only be exploited by Brazilian capital. The Brazilian constitution is similar as the one introduced by Peron in Argentina in 1952.
new plan was announced to privatize financial institutions and one of the nations largest mining companies.

**Recent Developments**

Although there was a change of government during the aftermath of the implementation of the Real Plan, the new administration that came into office coincided with the achievement of consolidating the price stability that had been behind the Plan real. Thereafter, continued price stability could set the stage for sustained growth through sweeping fiscal reforms, economic liberalization and more rapid privatization. In order to achieve these objectives important key amendments to the 1988 Constitution are needed. With fiscal reforms progressing slowly the focus of macroeconomic management remained on a tight monetary policy with high interest rates and careful credit management within the economy. Although the policy of gradual devaluation of the currency tends to avoid further overvaluation and maintain balanced the external accounts, the main risks to the economy are a further deterioration in the fiscal balance a failure to pass reforms as well as reappearing inflation due to wage pressures. During 1996 only modest progress was observed with respect to the fiscal policy. Although inflation has been brought under control and indexation seems to be eliminated, there are some signs that reindexation may be re-entering the system. The new exchange rate policy of a quasi-crawling peg system can in itself be dangerous. On the one hand, it assures the sustenance of the exchange rate, avoiding overvaluation, while on the other hand it can become the element that fuels inflation and restores indexation. In Brazil it has taken a much longer time for society to recognize the necessity of starting with structural reform than has been the case in Argentina, and this is primarily due to the fact that it was the import-substitution model in Brazil which allowed the country to reach growth, and even during the debt crisis the Brazilian authorities could to some extent introduce some changes into the model. Whilst the Brazilian exchange rate policy grants some flexibility, as the central parity can be devalued, the degree of credibility is much lower than that of the currency board introduced by Argentina. Furthermore, fiscal austerity measures have been announced but the system does not provide for their enforcement.

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330 The Real Plan was launched by Collor, whose political situation was extremely weak. Cardoso was elected president in 1994.
332 See Boletim Economico (1996).
333 There are some indications that indexation is taking place in part of the economy (informal rentals contracts). Additionally, the decision of a labor court of granting in 1996 an increase of 25 % to Banco do Brazil staff set a bad precedent for other state companies.
334 It takes a long time to eliminate the psychological effect of inflation. Backward looking adjustment is still present in mind of economic agents.
4.5 Summary and Conclusions

In this chapter, first I reviewed the previous agreements towards Latin American integration introduced during the past three decades. The integrationalist process in Latin America which dates from the 1960s, has seen several agreements enacted, (LAFTA, LAIA, Andean Group, and CARICOM) without success. None of them could reach the goal of significantly increasing trade and competition across the region. This has caused widespread skepticism towards the relevance of such agreements. Three decades have lapsed and new attempts now flourish, which have also attracted a great deal of interest outside of Latin America, MERCOSUR among them. This new integrationalist approach contrasts sharply with previous attempts not only as regards the institutional arrangements, but also in relation to political and economic factors. The underlying economic policies of both integrationalist processes are based on opposite development models. While the first attempt was part of an inward-oriented development strategy based on a structuralist development model, the import-substitution model, the new one is an example of an outward-oriented economic policy based on a neo-liberal model, "the so called Washington consensus" model. The debt crisis that started in 1982 constituted the inflection point between both models, by forcing Latin American countries to abandon the old structuralist model and to look for some alternative solutions to overcome the crisis. The results have been surprisingly optimistic; countries introduced important stabilization plans in order to reach price stability, but within the context of overall structural reform. Governments opened up their economies to foreign trade, privatized public sectors and introduced important measures in order to make labor markets more flexible and to maintain budget discipline. Growth rates were reversed from the years of stagnation and large capital inflows were attracted, an important part of them being foreign direct investment. Moreover, the most important challenge faced by these countries has been how to sustain the macro-economic stabilization and the structural reforms in the long term. In this sense, the MERCOSUR agreement offers a new "window of opportunity". In the real side it allows for the "conclusive" dismantling of the high level of tariff and non-tariff barriers introduced during the last decades. On the monetary side, it permits the countries to move towards further reforms in fiscal, monetary and exchange rate policies. Latin American countries need to rebuild credibility within their financial markets and in this sense an external agreement can act as a coordinating and enforcement policy instrument. Although, one of the explicit objectives of the MERCOSUR agreement is to "coordinate macroeconomic policies" among member countries, no concrete measure has been introduced concerning this issue. Furthermore, it is exactly in this area where most of the effort must be invested. While all the countries agree with respect to general principles, there are important differences in the management of budget deficits, monetary policy, size of the current accounts and real exchange rates. With the exception of Paraguay, one of the constant pressures on the MERCOSUR countries has been high inflation.

All the countries, in particular Argentina and Brazil, have attempted fighting inflation using the nominal exchange rate as an anchor within stabilization plans. Although there is a conformity across MERCOSUR countries with respect to the underlying rational behind the adoption of the exchange rate which relies on the credibility argument, no coordination among members has been introduced. In this sense, a movement
towards a fixed exchange rate linking member states would help to coordinate policy between them and could then act as an additional enforcement. I have also reviewed the last antinflationary experiences of Brazil and Argentina. Whilst the first adopted a fixed exchange rate with a band of fluctuation, Argentina introduced a currency board. The fixed exchange rate of Brazil does not introduce enough enforcement on the fiscal side because the central parity can always be readjusted. In fact, in response to the Mexican crisis, the Brazilian government introduced a small exchange rate correction. While the Brazilian exchange rate system allows sufficient flexibility, it does not introduce any constraint towards fiscal policies. On the other hand, the Argentinian system is extremely inflexible towards unexpected external shocks although it does provide a high level of credibility. Therefore both systems contain strengths and weaknesses. As a result, the design of a new system for the MERCOSUR region offers the opportunity of constructing a better system by introducing some flexibility while maintaining a high degree of credibility.
Figure 4.3.1

Source: Anuario Estadístico de América Latina y El Caribe, 1995. CEPAL

Figure 4.3.2

Source: Anuario Estadístico de América Latina y El Caribe, 1995. CEPAL
Figure 4.3.3

Public Sector: Overall Balance

Source: Anuario Estadístico de América Latina y El Caribe, 1995. CEPAL

Figure 4.3.4

Monetary Sector: Domestic Credit

Source: Anuario Estadístico de América Latina y El Caribe, 1995. CEPAL
**Figure 4.3.5**

Source: Anuario Estadístico de América Latina y El Caribe, 1995. CEPAL

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**Figure 4.3.6**

Source: Anuario Estadístico de América Latina y El Caribe, 1995. CEPAL
Figure 4.3.7

Source: Anuario Estadístico de América Latina y El Caribe, 1995. CEPAL

Figure 4.3.8

Source: Progreso Económico y Social de América Latina. BID (several issues)
Figure 4.3.9

Source: Anuario Estadístico de América Latina y El Caribe, 1995. CEPAL

Figure 4.3.10

Source: Anuario Estadístico de América Latina y El Caribe, 1995. CEPAL
Appendix
Protocols

a) 29 July 1988
1-Good of capital
2-Wheat
3-Cooperation for food shortage
4-Trade expansion
5-Binational enterprises
6-Financial affairs
7-Investment Funds
8-Energy
9-Biotechnology
10-Economic Studies
11-Nuclear assistance and radiological emergencies
12-Aeronautic cooperation

b) 10 December 1986
13-Iron and Steel industry
14-Transport
15-Maritime transport
16-Communications
17-Nuclear cooperation

c) 15-17 July 1986
18-Cultural
19-Public Administration
20-Currency

d) 7 April 1988
21-Automobile Industry
22-Food Industry

e) 29 November 1988
23-Common Frontier

f) 23 August 1989
24- Economic and Social Planning
Chapter 5

Conclusions and Economic Policy Recommendations

MERCOSUR, the common market of the South, was created through the signing of the Treaty of Asuncion in 1991 and went into effect in January 1995 for Argentina and Brazil and in the following year for Uruguay and Paraguay. It produces 40 percent of Latin American GDP and comprises two of the most industrialized countries of the region, Argentina and Brazil. Despite the initial turmoil regarding macroeconomics imbalances, trade and intra-industrial relationships have been growing strongly. This new integration scheme has also attracted interest among non-Latin American countries, with new free trade association agreements having been signed with other economic areas such as the European Union, NAFTA and ASEAN. After two years of the agreement's full functioning, many Latin American countries have shown growing interest in participating in it and have presented application for full membership, and Chile (although initially it had rejected an invitation to join it) and Bolivia both have joined the club as associated partners. The objective of the MERCOSUR agreement consists of the free mobility of goods and productive factors and the establishment of a common external tariff. Experience has demonstrated that the implementation of agreements on commercial policy is not in itself sufficient to reap the full benefits of integration if it is not followed by coordination on exchange rate policies. Competitive devaluations implemented unilaterally by the member countries are very dangerous and can provoke the failure of the agreement. In this sense, the European Union provides a good example on this matter. Although the difficulties implied by the coordination of exchange rate policies have been recognized, it has proceeded in this direction, through the introduction of the EMS, and it is ready to move further towards monetary union.

Violent shifts in currency parities between Argentina and Brazil during recent years have induced sharp changes in trade balances among member countries and have delayed the process of eliminating all tariff and non-tariff barriers among them. It thus becomes imperative to analyze what kind of exchange rate agreement would be appropriate for the MERCOSUR case. The aim of this study is to seek some answers to the question: what would be the optimal exchange rate policy for the MERCOSUR countries? My study approached that question from three different though related angles: a theoretical analysis, a review of the European experience with exchange rate agreements, and finally a review of the Latin American experience.

Chapter 2 introduced the theoretical analysis. First, within a two-country Mundell-Fleming-Dornbusch model, I compared the effects of monetary and fiscal shocks in the short and in the long run and the dynamic adjustments of two opposite exchange rate systems, fixed and flexible. I concluded that in both cases spill-over effects from one country to another are observed. Additionally, I found that fixed exchange rates reduced nominal and real exchange rate variability. However, the adoption of a fixed exchange rate system implies completely relinquishing an autonomous domestic monetary policy, with the monetary base thus becoming fully endogenous. Second, I introduced a time inconsistency approach, which suggests the convenience of adopting
strict rules regarding monetary policy: such strict rules permit the time inconsistency problem to be overcome. Furthermore, a fixed exchange rate regime represents a "monetary rule" and thus could be a desirable arrangement. However, an extremely rigid rule may induce serious problems in the presence of severe shocks, and in extreme situations it might even force the authorities to abandon the adopted rule. Hence some degree of flexibility as an escape clause should be available. Yet escape clauses could present some problems in that, if policymakers have used them extensively in the past, credibility could be reduced.

In Chapter 3, I reviewed the European experience with monetary agreements. I analyzed in what context the discussion about exchange rates agreements arose. I observed that, after the breakdown of the Bretton Woods system, the European integration process was accompanied by strong fears about exchange rate variability and thus the European countries devoted significant effort to designing monetary agreements that could moderate such variability. The debate concentrated on two issues across the years: initially, exchange rate variability constituted the main issue of concern; then, during the 1980s, the discussion shifted much more towards price stability. The European Union has implemented several exchange rate agreements, first the Snake, which allowed relatively high variability, and later the EMS. The EMS constitutes a fixed exchange rate regime with escape clauses under which a band of fluctuation was allowed, as well as realignments. My analysis therefore focused on the ability of the EMS to achieve price and exchange rate stability. The simple observation of descriptive statistics reveals that the EMS has been able to achieve some convergence among European prices towards lower inflation, although the costs in terms of unemployment have been significantly high. Afterwards, I performed an econometric analysis in order to study the dynamic behavior of exchange rate variability in response to nominal and real shocks. I observed that the EMS has reduced the responses of both nominal and real exchange rates concerning monetary shocks. Moreover, no significant influence with relation to fiscal shocks has been observed.

In Chapter 4, I focused on the Latin American experience towards integration. After several decades of import-substitution policies and budgetary inconsistencies that led to high inflation, all MERCOSUR countries agreed upon the need to introduce price stability and austerity measures. At least during the last years, efforts have been made in this direction and countries have observed important improvements in GDP growth rates. The MERCOSUR agreement has thus played an important role in this transformation process. It constitutes an instrument not only to achieve integration among the countries themselves, but also into world markets. However, violent movements in the exchange rates of the MERCOSUR countries introduce high uncertainty and affect exports and investment rates. Unilateral exchange rates policies lead to beggar my neighbor effects. I reviewed the use of a fixed exchange rate as an anchor in stabilization plans, as it has been in constant use in MERCOSUR countries with the objective of coordinating expectations and generating sufficient credibility in the system. However, a fixed exchange rate regime cannot substitute for the introduction of austerity measures necessary to correct fiscal imbalances nor can it obviate the implementation of global structural measures such as privatization, opening up the market to world trade, and flexibilization for goods and labor markets. The experience of Argentina and Brazil showed that both countries have used the exchange rate to anchor their stabilization plans, although in different degrees. While Argentina chose an extreme case of
the fixed exchange rate, a "currency board", Brazil followed a relatively more flexible version: a fixed exchange rate with bands. The choice was based on the respective historical experiences of the two countries. While Argentina has undergone an hyper-inflationary process, Brazil had suffered chronically high inflation and this constitutes an important difference as it defines different preferences of policymakers towards credibility and flexibility. Thus, every hyperinflationary process introduces a break in history and destroys the former preferences of economic agents and policymakers as well.\footnote{A similar effect is observed in Europe in the case of Germany. Germany constitutes the only member country that has suffered a hyperinflationary process and therefore it reveals a much stronger aversion towards inflation than other European countries such as France or Italy.} Nevertheless, all exchange rate arrangements that MERCOSUR countries established have been related to the US dollar and no relationship between their own currencies has been explicitly established. This constitutes a problem because, so long as trade flows among MERCOSUR countries increase, the variability of exchange rate becomes a matter of concern. Violent shifts of exchange rate parities introduce "noises" within the markets, distorting competitive advantages. Additionally, at least the two main members of MERCOSUR, Argentina and Brazil, have experienced destructive inflationary processes and there is some kind of consensus as to the necessity to achieve price stability in order to achieve economic growth. In this sense, once all MERCOSUR countries agree upon the introduction of stabilization programs anchored on fixed exchange rates, the natural question is whether it would be convenient to coordinate stabilization plans among them. An important difference from the European case is that none of the MERCOSUR currency can work as an anchor and thus an external hard currency must be chosen for this purpose.

MERCOSUR states can discover in the agreement a "window of opportunity". Its member countries are, on the one hand, unilaterally seeking enforcement commitments that allow them to achieve price stability, and to regenerate a friendly environment towards investment. On the other hand, especially Argentina fears the trade balance effect of unilateral devaluation introduced by the Brazilian government. A global agreement could help to achieve intra-MERCOSUR exchange rate stability and at the same time could work as an external commitment with enforcement power that would contribute to overcome time inconsistency problems.

Summarizing, the three approaches utilized in the analysis lead to the following conclusions: first, some kind of fixed exchange rate agreement is highly desirable. Second, there are several kinds of fixed exchange rate agreements and different degrees of flexibility and there exists a trade-off between credibility and flexibility: the greater is the fixity of an exchange rate agreement, the larger will be the effect on price stability, and the less will be the flexibility that is permitted in response to shocks. Taking into account all these elements of analysis, the economic policy recommendation are as follows:

a) A Currency board for the MERCOSUR region. In chapter 3, I demonstrated that the Argentinian experience with the currency board has been quite successful not only in the monetary but also in the fiscal sphere, because it also compels fiscal discipline to be pursued. Thus, in a currency board system the central bank is not allowed to finance any budget deficit. Because countries have in the past abused monetary policy, it becomes important to introduce institutional constraints that act as an obstacle to...
wards discretionary policies. Governments themselves design strongly institutional arrangements because, in adverse economic conditions, they have more power than a simple commitment by individual governments to keep their promises. Governments can abandon institutional arrangements, but this becomes more costly. In this sense, an international monetary agreement reinforces the commitment since the costs of leaving the club once it has been formed become too high.

With respect to the design, since none of the MERCOSUR currencies can behave as an anchor currency, all currencies must be fixed to an external hard currency such as, for example, the US dollar. The central banks of the individual countries will remain in existence and thus act as individual currency boards, and no central MERCOSUR monetary authority would be needed. Furthermore, this alternative is, in my view, the first best towards credibility, although it implies high costs in the presence of negative shocks because it is an extremely rigid rule and will therefore probably generate some resistance from other MERCOSUR countries. Especially from Brazil, whose demand for credibility is probably not as high as that of Argentina.

b) A fixed exchange rate with a band of fluctuation, which could be initially relatively large (+-10 per cent) and would be reduced over time. Member states would fix their national currencies to the US dollar, and thus cross-rates between them will be indirectly fixed. This system presents the advantage of being compatible with the currency board working in Argentina as well as the real plan working in Brazil. The currencies could fluctuate inside the band but interventions must be compulsory once currencies have reached the upper and lower limits of the band. Although this system has some similarity to the EMS, each central bank must intervene unilaterally. Since all the countries are fixing to the US dollar, the system presents some peculiarities, i.e. that none of them has an unlimited amount of the hard currency (the US dollar). Realignments will be possible but they should not be made unilaterally, but in a coordinated way with the agreement of all member countries. This constitutes the main difference with the present unilateral fixing of the nominal exchange rate by the individual countries, and it permits beggar my neighbor policies to be eliminated.

Moreover, because a fixed exchange rate only can allow monetary policies to be coordinated, some additional measures should be introduced with respect to fiscal policies. The MERCOSUR countries should agree not to exceed some limits upon fiscal deficits and government debt ratios. In this sense some punishment procedure should be introduced in case some of the countries do not fulfill this condition. It could work like the European "stability pact" (The Economist, 1996). Member countries would agree to maintain low budget deficits and debt ratios, and those countries which did not follow the rule would be penalized and be forced to pay some fines.

c) A fixed exchange rate to a basket currency with a band of fluctuation. This represents a variant of the previous case, where instead of the US dollar being the anchor currency, a basket of hard currencies would be introduced, e.g. the US dollar, the Yen and the Euro. Taking into account that in 1999 the EMU will start (with a larger or a smaller group of member countries) and that an important part of the extra-MERCOSUR trade is orientated towards the European countries, it becomes an attractive alternative to define the basket according to the average of trade proportion of the individual countries.

This alternative has the advantage that it lessens dependency upon the monetary policy of a third country, since it is not very probable that the monetary policy conducted by
the European Central Bank, the Federal Reserve and the Bank of Japan will move in exactly the same direction at the same time. Thus, this policy will soften the impact of external monetary policies. Concerning the rules for intervention, realignments and a common central bank, they remain as previously presented in the alternative b.
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Herausgegeben von Rolf Hasse, Wolf Schäfer, Thomas Straubhaar, Klaus W. Zimmermann


