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Regional Interdependencies and Macroeconomic Crises Notes on Mercosur

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Abstract

In the relatively short history of Mercosur, the countries of the region have gone through wide macroeconomic fluctuations. Macroeconomic turbulence is not a novelty for Argentina, Brazil and their partners, but it has shown different features in recent years, particularly concerning the strength and nature of regional spillovers. Despite the asymmetries in size among the economies of the area and the low starting levels of trade, the rapid growth of intra-regional commerce until the last few years, and the feeling that there was a “Mercosur component” in the international demand for each country’s assets, increased the visibility of regional macroeconomic interdependencies. However, there was little movement in establishing concrete forms of macroeconomic cooperation.

These notes contain brief comments about the experience of Mercosur in macroeconomic matters, and some reflections about the possibilities for concerted regional actions. The paper quickly reviews aspects of the recent behavior of the economies of the area (focusing on Argentina and Brazil) and comments on the characteristics of macroeconomic interdependencies, and analyzes circumstances that have conditioned macroeconomic coordination within the region. Finally, it considers some policy options for regional cooperation in crisis situations.

I. Introduction

In the relatively short history of Mercosur, the countries of the region have gone through wide macroeconomic fluctuations (see the graphs in the Annex). Macroeconomic turbulence is not a novelty for Argentina, Brazil and their partners, but it has shown different features in recent years, particularly concerning the strength and nature of regional spillovers. Despite the asymmetries in size among the economies of the area and the low starting levels of trade, the rapid growth of intra-regional commerce until the last few years, and the feeling that there was a "Mercosur component" in the international demand for each country's assets, increased the visibility of regional macroeconomic interdependencies. However, there was little movement in establishing concrete forms of macroeconomic cooperation. Moreover, the macroeconomic disturbances of recent times (particularly the Brazilian currency crisis of 1999 and the long recession and deep financing difficulties of Argentina), instead of fostering coordination, have set in action strong centrifugal forces. By mid 2001, the prospects of Mercosur are in doubt, as the member countries reconsider their trade strategies and there is much public skepticism about the potential benefits of the integration project. But nonetheless, the economies are not likely to become isolated from the impulses originated by their neighbors. With due regard to national specificities, and whatever the outcome of the current discussion about the future of Mercosur will be, regional effects will continue to play a part in the macroeconomic performance of individual member countries. The management of macroeconomic interactions will remain present as a policy problem, although in quite different scenarios depending on how the present episode evolves and how the configuration of Mercosur as an integration agreement is determined into the future.

These notes contain brief comments about the experience of Mercosur in macroeconomic matters, and some reflections about the possibilities for concerted regional actions. In the next section, we quickly review aspects of the recent behavior of the economies of the area (focusing on Argentina and Brazil). The section considers instances where regional propagation effects seem to have been particularly significant, and discusses policy responses. Section 3 comments on the characteristics of macroeconomic interdependencies, and analyzes circumstances that have conditioned macroeconomic coordination within the region. Finally, we consider some policy options for regional cooperation in crisis situations.

II. Features of the regional macroeconomic experience

The integration process in the southern cone of Latin America started in a period of macroeconomic instability throughout the region. In the interval going from the first bilateral agreements between Argentina and Brazil (in 1985) and the signing of the Asunción Treaty (which formalized in 1991 the creation of the four-country Mercosur) the economies of Argentina and Brazil strongly felt the effects of the debt crisis of the early eighties and the difficulties faced by policy-makers in defining effective stabilization strategies. The very high inflation in Brazil and the hyperinflationary outbreaks experienced by Argentina in 1989 and 1990 were dramatic instances of that instability. The macroeconomic volatility did not prevent governments from negotiating measures to promote intra-regional trade, but it made agents (public and private) concentrate their attention on the short-run swings in the respective economies. The Mercosur project did not become at this point an important factor in economic decisions.

During the nineties, the economies of the area went through drastic changes. The period was marked by an international environment quite different from that of the eighties, and by reforms that governments implemented (each one with its own pace and characteristics) in policies and economic institutions[1]. Among these reforms, Argentina and Brazil liberalized their trade regimes (Uruguay

[1] A general discussion of the reform processes in Latin America can be found in CEPAL (2001) and Stallings and Peres (2000). The cases of Brazil and Argentina are studied, respectively, in Baumann (2000), and Heymann and Kosacoff, eds. (2000).

had already taken measures to that effect). Also, the countries of the region determined that Mercosur would move towards a customs unions, to be established (with some sector exceptions) after a few years of transition. The countries also made large-scale privatizations, especially in the case of Argentina, where most of the state enterprises were quickly transferred to the private sector. The concern for reducing fiscal deficits and ending high inflation was widespread throughout the region. However, the stabilization policies had different timings and features according to the country, and there remained substantial differences in the design of macroeconomic policies (in aspects as crucial as exchange rate regimes) and in the performance of the economies.

The scarce degrees of freedom of economic policies and the low levels of initial trade[2] strongly limited the willingness and the ability of governments to cooperate effectively in macroeconomic matters. Official pronouncements stated the intention to move towards a coordination of macroeconomic instruments, in the whole range of fiscal, monetary and exchange rate policies, but did not specify concrete actions in the macroeconomic field, although macroeconomic matters were to be periodically reviewed by groups of country officials. On the other hand, the initial Mercosur agreements were quite specific and detailed regarding the timetable of the integration of trade systems.

In the first part of the nineties, the macroeconomic performance of the countries differed widely. The output level fluctuated in Brazil, while inflation remained very high. In 1991, Argentina established its convertibility system (similar to a currency board), with a fixed exchange rate to the dollar (not modified since then). This was done at a moment where an urgent concern was to lend credibility to the stabilization program, and any form of monetary management was regarded with deep distrust. This strict regime became over time a focal point for economic decisions (especially in financial transactions), which strongly conditioned policy choices later on. A rapid disinflation was associated with a recovery in the supply of credit and more optimistic expectations, which fuelled a sharp increase in output and, particularly, in domestic demand. The trade balance quickly shifted from large surpluses to sizeable deficits, with a large increase in imports. In particular, the rapid rise in the value of imports from Brazil became a point of public attention. At the end of 1992 the Argentine government raised from 3 to 10% a fee applied on imports, including those from the Mercosur region. This measure generated discussions with the partners, but did not cause at that moment strong objections from Brazil. In any case, the use of tariffs for macroeconomic purposes indicated the limited range of the available instruments, and suggested the types of tensions the integration project may be subject to.

The issue of macroecomic coordination was widely discussed since the early period of Mercosur. According to some opinions, some type of regional agreement on macroeconomic policies was a condition for progress in trade integration. However, it was often stressed that the governments had few incentives to make regional commitments that would further restrict their margins of choice in macroeconomic management, or put into question existing policy institutions (like the Argentine monetary system). There were suggestions of schemes to moderate the fluctuations of inter-country relative prices and trade flows, like the possible application of safeguard clauses involving the imposition of tariffs on imports from within the region, or the use of tax-subsidy instruments to manage bilateral effective real exchange rates. In 1993, the Brazilian authorities proposed the definition of real exchange rate bands; in the case of divergence due to a devaluation in one country, the others would be authorized to raise tariffs on its goods[3]. The Argentine government

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[2] As an example, Argentine imports from Brazil were less than 650 million dollars in 1990. Four year later, those flows had risen to over 4 billion dollars.

[3] The proposal included the constitution of a regional intervention fund, although it was recognized that the amount of resources which could be contemplated for that purpose would be such that the fund would be mostly relevant for the smaller countries in the region.

rejected the idea, and in turn offered its own proposal which in practice would have made the Mercosur partners peg their currencies to the dollar as Argentina had done unilaterally.

This disagreement reflected different views in each country about the macroeconomic policies in the region. In Brazil, it was commonly argued that the Argentine policy of a fixed exchange rate system would induce an unsustainable real appreciation, which would likely lead to a devaluation. From the Argentine side, prior to the Real program, the main macroeconomic problem of the area was often perceived to be the instability in Brazil, manifested in a rapid inflation and a high real exchange rate (which the argument associated with lack of confidence in the prospects of the economy).

The divergences in macroeconomic policies and performance did not prevent a very large growth in intra-regional trade, while the operation of Mercosur seemed to become an increasingly important consideration in private investment decisions. Moreover, the governments were able to define comprehensive agreements on trade policies. Although there was some discussion (especially in Argentina) about the convenience of establishing a free trade area, rather than a customs union, it was decided that, since the beginning of 1995 a common external tariff would apply for a wide range of goods, and that national tariffs for the remaining items (like capital goods) would converge after a transition period[4].

In the mid-nineties, the macroeconomic behavior of the region varied substantially, as Brazil implemented its stabilization program (in 1994) and Argentina went through a financial crisis and a deep recession in 1995. The evolution of trade flows in this episode indicated the change which had taken place in the intensity of regional interdependencies.

The Brazilian stabilization package initially used a fixed exchange rate as an anchor, but this was meant as a short-term instrument, and no major reforms were introduced in monetary institutions, while measures were taken to discourage capital inflows. Such clear differences between its exchange rate policy and the convertibility system signalled the reluctance of the Brazilian government to lose monetary and exchange rate flexibility, in an economy which was much less dollarized than that of Argentina. But the specific design of the Real program did not cause much discussion in the other Mercosur countries. The much lower inflation and the demand expansion in Brazil created positive spillovers for its partners, precisely at a time where Argentina was showing a downturn in real activity.

The behavior of the Argentine economy until 1994 had generated different interpretations. Some analysts expressed concern about the current account deficits, particularly given the low levels of domestic savings; it was also pointed out that the pension reform (implemented since mid 1994), although it might reduce future government obligations by transferring pension liabilities to the newly created private funds, also caused an immediate fall in cash revenues and raised fiscal borrowing requirements. The authorities, on the other hand, maintained that the fiscal situation was under control; regarding the balance of payments indicators, they stressed the productivity gains that were being realized in various sectors of the economy, and argued that the large increases in domestic absorption which had been observed could be viewed as appropriate responses to a reasonable expectation of higher future incomes. Anyhow, it was clear that a continued expansion of spending and output required a fluid supply of international credit. The raise in the US interest rates in the first

4 The name itself of the trade area (Mercosur: Common Market of the South) already indicated that the ultimate aim of the participants was to achieve tight forms of integration (however, neither Brazil nor Argentina showed interest in establishing regional entities). It may be noted here that in its origin Mercosur had not only economic purposes, but was also intended to end the political rivalries between countries of the region which had been observed in the past.

part of 1994 already had an effect in slowing down spending; the turmoil caused by the Mexican devaluation at the end of that year triggered a deep financial crisis and a sharp recession.

The shock came as an unexpected event for much of the public and possibly also for the authorities (even if there had been indications of possible problems in Mexico, it does not seem that the prevailing modes of analysis led to anticipate so strong repercussions on Argentina). Preventing a crisis like the one that occurred in 1995 had not been a policy issue before the fact. Now, in a short period of time, there was a drastic fall in the demand for Argentine assets, soon followed by strong doubts about the solidity of banks, which resulted in a large decline in deposits and a drastic contraction of credit. This triggered an abrupt recession, while unemployment rose by 6 percentage points in about half a year.

Argentina's convertibility system was endangered, as reserves dropped and the authorities were required to sustain the liquidity of the banking system under attack. Actually, the Central Bank charter was modified to allow more freedom for lender of last resort operations. However, it soon became clear that the fixed exchange rate policy was not to be abandoned, and that this attitude had widespread support[5]. A large package of loans arranged by multilateral organizations eased tensions in the financial markets precisely at a moment when the run on the banks was speeding up. After some time, the demand for assets started to revive, and domestic spending recovered. The rapid increase in exports to Brazil, especially noticeable for manufactured goods, also had a non-negligible macroeconomic impact[6], and clearly contributed to the output recovery that was under way by the end of 1995. It was as if, from the Argentine perspective, a sort of "implicit" (and, certainly, fortuitous) coordination had operated, with Brazil expanding its purchases at a period when Argentina was absorbing a negative shock.

The crisis of 1995 showed the sensitivity of the Argentine economy to the moods and attitudes in financial markets and it also revealed the importance attached by the public to the fixed exchange rate at a time of great economic tension. The policy responses to the observed fragility of the banking system consisted mainly in the reinforcement of prudential regulations. Regarding Mercosur, the episode generated a definitely positive perception about the consequences of integration. This view persisted in the following years, as the economies of the region went through a phase of expansion with rapidly rising trade among themselves, and a convergence in macroeconomic performance, featuring especially the drastic reduction of inflation in Brazil.

This behavior diluted worries about the macroeconomic functioning of the region. For Brazil, the spillovers from its partners lost visibility in the face of the improvement in its own economy, while the impulses transmitted by Brazil to the other countries were clearly favorable. In these circumstances, the parties of Mercosur felt no urgency in contemplating scenarios of regional economic disturbance. Some attention was given, however, to the issues of macroeconomic coordination over the long run, with an active discussion of the possibility of moving towards the constitution of a regional currency area. Still, it was clear that such a process could hardly be started in the immediate future, given the well rooted differences in monetary institutions and prevailing opinions about the regimes best suited for each country while, with a longer perspective, much would depend on the evolution of the real aspects of the integration project.

[5] The argument that the incumbent government was willing and able to guarantee the maintenance of the parity with the dollar probably played an important part in voting decisions in the 1995 presidential elections, particularly for the large number of individuals who had taken debts denominated in dollars.

[6] Between 1993 and 1995, Argentine exports to Brazil nearly doubled; the value of those additional sales approximately represented 1% of Argentina's annual GDP. It may be noticed that although very large, the increase in Argentine sales of goods to Brazil was proportionally smaller than the aggregate growth in Brazilian imports, which suggests that the driving effect came from the demand side.

In any case, the region was to show new instances of macroeconomic instability in the period that followed the Asian crisis. Independently of the variety of arguments that can be made about the specific nature of spillover and "contagion" effects, the rising trade flows and the perception itself that there may be common elements in the performance of the Mercosur countries generated interdependencies. The volatility of international financial markets could have induced the search for some type of common regional response. However, this did not happen. After the Russian crisis, which strongly affected the region, the concerns of Brazilian policies were centered on the fragility of its own financial situation, with very high interest rates (which reflected and aggravated fiscal problems), pressures in the exchange market and reduced levels of real activity. Meanwhile, the Argentine authorities made efforts to convince asset holders that they should "differentiate" their economy from that of Brazil, pointing to the robustness of the banking system due to the preventive measures that had been taken, and to their attitude of fiscal prudence (although the fiscal situation was showing weaknesses, with government revenues hit by the fall in output that started in late 1998). Thus, once again, the macroeconomic evolution of Brazil was typically seen in Argentina as a source of instability, which motivated attempts to signal the contrasts between the conditions of both economies. In turn, Brazil dealt with its domestic matters without showing much preoccupation with the effects on its neighbors, while the Argentine attitudes were often interpreted there as non-cooperative, and especially unwelcome in difficult times.

Mercosur experienced strong tensions after the attack on the Brazilian currency and its sharp depreciation at the beginning of 1999. That devaluation had strong effects on the other economies, which were already showing signs of recession. Initially, there was much concern in Argentina about the possibility that Brazil would enter a phase of strong financial instability and low activity. In fact, inflation in Brazil did not rise much and real output did not fall as feared, while interest rates gradually came down from very high levels. The Brazilian shock immediately induced a rise in the "country risk" indices for Argentine bonds, even if it was less sharp than in the Russian episode. Despite the big shift in relative prices, imports from Brazil declined together with total imports, but the devaluation of the Real had a strong effect on Argentine exports to Brazil. This impact (at a moment when Argentina was already facing a sharp fall in export prices) contributed to deepen the recession (and, thus, to worsen the fiscal situation), both directly and through its effects in asset markets.

The drop in exports to Brazil, the feeling that competition from Brazilian products was causing difficulties to several industrial sectors and worries that investments aimed at the regional market would now be localized in Brazil (even by closing production lines previously installed in the country) caused strong negative opinions in Argentina, and generated demands for applying restrictions to Mercosur trade. On its side, Brazil flatly rejected the application of commercial measures by its partners in response to its devaluation. Notwithstanding the statements of the authorities (in the Argentine case, including both those who ended their terms by the end of 1999 and those of the new government) in the sense that the progress of Mercosur remained a policy priority, the episode raised difficult questions about the prospects of the area, not only from the point of view of its macroeconomic functioning, but also regarding the future configuration of trade and investment policies.

After having shown a recovery in GDP already in 1999, the Brazilian economy continued to expand in 2000, with a moderate inflation and declining interest rates. This experience was widely interpreted as indicating that the depreciation of the Brazilian currency, although a traumatic event, had had favorable consequences in that economy, and that inflation could be kept well under control with a monetary policy that allowed for exchange rate flexibility. For many Brazilian analysts, those observations underscored by contrast the problems of a system like Argentinsa's currency board, and led them to see the difficulties of the neighbor economy mainly as the result of a stubborn insistence in maintaining that inflexible regime.

It was significant that the Argentine government chose not to consider a change in the fixed parity to the dollar at a moment when the main trading partner had sharply devalued its currency, the dollar was strong, export prices had fallen much below the levels of previous years and foreign financing was clearly much less fluid than some time before. This decision, which did not face much opposition within the country, signalled the very high costs that Argentines perceived a jump in the exchange rate would have in an economy with most of its financial contracts denominated in foreign currencies. Rather, influential opinion makers stated that a good part of "country risk" interest spreads (and not only yield differentials between dollar and peso assets) was due to fears of the turmoil that would emerge in case of a devaluation that the convertibility system did not absolutely rule out (since, in principle, there remained the possibility of modifying the law that had established the convertibility regime). In this view, convertibility was too flexible a regime in the Argentine circumstances, and one that disturbed expectations. The consequent proposal was to eliminate "escape clauses" altogether, and move to full, explicit dollarization. This suggestion was widely debated, although it did not become an actual policy project. One of the points that was raised in the discussion was that dollarization would close the option of having some sort of monetary cooperation with Brazil over the long run, and that it could be seen as contrary to the advance, or even the survival of Mercosur, taking into account the critical reaction that the proposal had induced in Brazil.

In any case, the Argentine economy confronted with its monetary system a variety of negative shocks, and suffered a long recession. This time, the banking sector did not show noticeable liquidity problems (and did not become object of distrust by depositors), although the supply of credit to private borrowers contracted as the growth in deposits slowed down and the public sector increased its demand for loans in the domestic market. In 2000, the government made strong efforts to control the fiscal situation: although higher tax rates and spending cuts managed to generate a non-negligible primary surplus, the larger weight of interest payments and the absence of sizable privatization revenues caused a rise in the central government's borrowing requirements. As the recession grew longer and economic policies were interpreted as signalling a continued need for adjustment, the public became increasingly pessimistic about income prospects, which weakened domestic demand and indirectly influenced tax revenues. The aggregate volume of exports had resisted the 1999 shock without a large fall, but the value of sales dropped, although the fall was reversed in 2000. Doubts about the ability of the economy to recover and a worsening of debt indicators contributed to strengthen the uncertainties incorporated in the prices of bonds. By the end of 2000, the government was practically cut off from international credit markets. A large emergency package of credits by multilateral agencies and local financial institutions caused a transitory relief, and a fall in interest rates. However, this effect was very short-lived. After some weeks, the indications that fiscal outcomes were definitely off-target made country risk coefficients shoot up again, and led to the resignation of the economic authorities. A new economic team proposed deep cuts in government spending, but the program caused strong opposition, and was not put into practice.

The economic authorities who came to office in late March 2001 stated their belief that the economy could start growing again in the near future. Among their immediate measures, a tax on bank debits and credits was imposed, and tariffs on consumption goods were raised, while those on extra-regional imports of capital goods were reduced (this was more or less reluctantly accepted by Brazil). The government also announced that it would establish sectoral "competitivity programs" with measures such as tax rebates. Reserve requirements were lowered so as to reduce the crowding out effect of government bond sales to the banks. A large swap operation with outstanding bonds was carried out, in order to cut financing requirements of the government in the following years. The authorities saw the swap as a crucial measure to dissipate the immediate fears of default on the part of asset holders, though the interests on the newly issued bonds were very high. Beyond the urgencies of financial management, economic policies faced the task of reinforcing the expectations that the economy could meet the conditions for external and fiscal solvency: while the demands for a prompt recovery were strong (not only from the public, but also from creditors, who stressed its connection with tax revenues), concerns about longer run sustainability were also very much present in the decisions of economic agents. In this regard, creating a positive prospect of the future course of the economy was part of the immediate policy problems.

In the changing economic conditions of the nineties, the currency board regime and Mercosur had been crucial "fixed points" of Argentine policies. Now they came under discussion. The authorities proposed to modify the exchange rate system, maintaining the features of convertibility (unrestricted conversion of the currency into some external unit and requirement of almost full backing of the monetary base), but pegging the peso to a dollar-euro basket (with equal weights) once the euro/dollar exchange rate reached the value of one. This reform was meant to provide more stability to the domestic price level (in this respect, the authorities stressed that the appreciation of the dollar had produced deflationary pressures in Argentina), and it meant a rejection of the alternatives of devaluation and dollarization. At the same time, the proposed modifications in the monetary system (which had to be sanctioned by law) posed questions about the transition (e.g., the incentives that agents may have to re-denominate dollar contracts in terms of the basket); their announcement induced noise in financial markets, although one of its purposes was to reject the possibility of a sudden shift in the exchange rate. With respect to Mercosur, its significance for Argentina was a matter of debate: some opinion leaders suggested trying to transform it into a free trade area, or indicated that the country may have an advantage in negotiating bilaterally a trade pact with the US (both proposals clearly regarded with disfavor in Brazil), while others kept the notion that Mercosur needed to go further in its economic integration, and act jointly in the negotiations for the Free Trade Area of the Americas (FTAA). But, clearly, the integration project had lost momentum and, in particular, seemed to have reduced its appeal for the private sector: in Argentina, voices demanding protection appeared to be louder than those stressing the advantages of producing for the regional market, especially at a moment where the Real was again experiencing a substantial depreciation (which some Brazilian analysts attributed in part to international uncertainties about Argentina).

While Mercosur was going through a period of trade frictions and uncertainty about its future as a trade area, the countries had taken steps to define some guidelines for macroeconomic convergence. These exercises recognized that, while it was difficult to expect that governments would put under regional scrutiny their basic policy criteria, or accommodate regional considerations in their day-to-day management, there were some general common views about the importance of running low-deficit fiscal policies and keeping inflation low. The parties accepted that there was an element of regional public good in the macroeconomic stability of each country. The guidelines had analogies with the targets that European countries established at Maastricht, but there was no presumption that the Mercosur economies were to unify their currencies, and exchange rates were not part of the set of guidelines. The numerical criteria were meant as indications of policy intentions, such that the parties could use as benchmarks in discussing the macroeconomic situation of the region. The agreement reached in December 2000 was that the countries would announce targets for inflation and the net deficit of the consolidated public sector (including subnational jurisdictions). Since 2002, there would be a 3% cap on the fiscal deficit (measured through changes in net debt), with Brazil being allowed a 3.5% level in the first two years. Also, starting in 2005, those countries with net public debts of over 40% of GDP would determine trajectories that would reduce them to that level. Inflation was to remain below 5% between 2002 and 2005; thereafter, an “inflationary core” would be defined, with an annual maximum of 4%. The guidelines were based on previous agreements about the definitions of the variables to be targetted in each country. It was determined that, in case a country deviated from the guidelines, it would be required to present to the partners a set of corrective measures it planned to apply, and that the presentation would be discussed by the economic authorities of the area. The contemplated enforcement mechanisms were clearly lax, although the exercises could possibly generate over time reputational effects that create incentives for individual governments to try to satisfy the guidelines (and to use them in their own internal bargainings in deciding domestic policies). However, the agreement came at a time of deep crisis, particularly in Argentina, and the regional targets have so far not resulted in visible effects.

III. Interdependencies and policy options

The channels of macroeconomic transmission between the countries of Mercosur have changed over time in their nature and intensity. There is some evidence of increase in the correlation of the output fluctuations of Argentina and Brazil, although the cycles in both countries have historically been quite distinct, and the economies have had different performances in recent periods. Thus, the movements in output in both economies appear to have responded to impulses specific to each country, and regional effects have not had a decisive influence. However, this observation (which is not applicable for Uruguay and Paraguay) does not mean that interdependencies have been irrelevant, particularly with regard to the impacts of Brazil on Argentina.

The volume of bilateral trade between the two largest countries of Mercosur is small compared with the size of the respective economies (and, in particular, the trade/GDP ratios are much lower than in the European case). This results from the fact that the economies are still rather closed and, in the case of Brazil, the share of the regional partners in its total trade is quite low. However, trade flows have shown a high variability, so that changes in bilateral trade have been quite large. On several occasions, the shifts in trade with Brazil have had macroeconomic effects on Argentina; the impulses in the other direction have been smaller, but not insignificant (in particular, the increase in intra-regional sales represented a significant fraction of the total growth in Brazilian exports during the nineties).

The available evidence about the determinants of trade flows between Argentina and Brazil indicates that there is an asymmetry in the effect of the macroeconomic variables (real output and exchange rate) of the buyer and the seller. Roughly speaking, the influences on the demand side have been more important, both for the Argentine sales to Brazil and for the flows in the opposite direction. This feature was again observed in 1999 when, given the devaluation in Brazil and the recession in Argentina, there was a sharp fall in the bilateral exports and imports. Another salient characteristic of trade between the two countries is that, although exchange rate effects are sizable (with long run elasticities of the order of 1), there is a particularly large response to the level of activity in the economy of the importing country. The fact seems important when studying the causes of the volatility of trade flows: this appears to be generated in part by shifts in real exchange rates, but particularly by the fluctuations in real output.

The perspective of an easy access to the regional market and the expectation that this would be a growing one were probably important factors in investment decisions during the nineties, and in particular induced FDI to the area (some of it originating from firms of the region). By contrast, uncertainties about Mercosur had a negative effect on investment in the last years, especially in Argentina. The regional effects on real investment, even if hard to quantify, have been a source of interdependence. However, the external financing of each country has proceeded through international markets, and the credit movements between the economies (leaving aside those directly connected with trade) seem to have been quite small. Accordingly, the transmission of impulses through financial channels has worked through the perceptions and decisions of international operators.

Contagion effects on asset demands may be induced by a variety of mechanisms. Establishing the relevance of each one in concrete instances is not a trivial matter, and prediction is even more difficult. Still, there is some evidence of correlation between the prices of assets of different "emerging markets", which may increase during crisis episodes (Calvo and Reinhart (1995), Eichengreen, Rose and Wyplosz (1996), Ganopolsky and Schmuckler (1998), Rigobon (1999)). In the case of Argentina and Brazil, inspection of "country risk" indicators shows an association in their movements, but also wide shifts in the differential interest rate spreads of the two economies. For instance, while by late 1996 the yield of Argentine bonds was somewhat higher than that of their Brazilian analogues, by the end of 1998 the Brazilian risk factor had risen substantially above that of Argentina, and the gap further increased in early 1999; by contrast, in the recent period, the Argentine spread was clearly larger. This indicates that the specific conditions of each economy have a definite influence on the price of bonds, and that there is a certain "differentiation" such that the financial interdependence is neither automatic nor necessarily tight. At the same time, however, there are concrete reasons why the valuation of assets of both economies do indeed depend on one another. It seems unlikely that the supply of credit to each country would become de-coupled, especially at moments of uncertainty about the macroeconomic stability of one of the neighbors.

The regional interactions in Mercosur have been variable, and they have had quite different impacts from country to country. However, in one way or another, all economies have experienced the transmission of macroeconomic effects from others in the region, and this appears to have been especially relevant in periods of turbulence. Although it may be difficult to anticipate the characteristics that macroeconomic interdependencies will take in the future, it seems that countries (including Brazil) will remain subject to regional influences. There appears to be a common interest (likely to persist in the future) in avoiding large swings in economic performance in individual countries, which may become a source of "excess volatility" in the fluctuations of the region as a whole. But this general argument for recognizing the regional aspect of economic conditions and economic policies does not determine by itself a concrete set of actions that the parties may be willing and able to undertake. The options depend on specific features of the economies, and on policy choices resulting from them. Moreover, the forms in which macroeconomic policies can interact will be determined to a considerable extent by the long-run perspective in which the countries view the integration process.

The Mercosur economies have wide differences in size. Brazil is large for regional standards, and perceives itself as such. A Brazilian economy that generates the expectation of steady growth and low inflation may naturally evolve into a regional "focal point" regarding the configuration of economic policies and the response to shocks. But that expectation is yet to be firmly established. Argentina has a particular pattern of economic relations, with Brazil as its main trading partner, a good part of FDI coming from the EU and a dollarized financial system, while a group of influential opinion makers sees a trade association with the US (possibly with dollarization) as the best alternative available. Those facts appear to create a potential for tensions, especially at times of uncertainty about the macroeconomic performance of the economies, as the parties seem to be in doubt about the significance they assign to the integration project, and tend to view with concern the attitudes of the partners.

The macroeconomic policy regimes have shown some convergence over time, but also clearcut contrasts. After the breakdown of its pre-determined exchange rate scheme in 1999, Brazil moved to a policy of monetary management aiming at establishing an inflation targeting system, and has shown to value the option of keeping flexibility in the exchange rate. Argentina, as previously discussed, has revealed a strong reluctance to allow changes in the parity of its currency and to exercise discretion in monetary policies: the recently proposed reforms that would peg the peso to a basket maintain central features of the convertibility regime and explicitly avoid an initial jump in the exchange rate to the dollar. The reasons for this resistance to changes in the peso-dollar rate can be found in the effects of a hypothetical devaluation on dollar-denominated debt contracts, with a high risk of financial disturbances and depressive consequences for real activity. In this regard, it may be argued that the exchange rate instrument has been "assigned" in Argentina to the (certainly non-standard) role of providing stability to the contractual system, in an economy where agents find too risky the use of domestic units of account to determine future payments. This implies that the instrument has been unavailable for dealing with shocks (which clearly has shifted the burden of adjustment to other variables), but the consequent cost has been perceived as smaller than that of a disruptive depreciation. The differences in the approach to monetary policies in Argentina and Brazil can be ascribed to a great extent to specific conditions of each economy (particularly concerning the degree of financial dollarization), although at times it seemed that the analytical views have also been quite dissimilar. In any case, from a practical standpoint, the exchange rate policies have been placed "out of discussion" when considering current macroeconomic cooperation in the region.

It has often been recognized that the interaction of policies in Mercosur would likely follow a sequence: arrangements that require a strong degree of commitment by the participants may hardly be contemplated before having previously established a practice of working together through relatively lax schemes of exchange of information, consultation and joint discussion of economic projections and policy criteria. Such routines do not have a firm tradition in Mercosur. But they would have a non-trivial content in making it easier for partners to predict the behavior of others and to consider opportunities for common action. In this respect, the existence of an expectation of repeated interaction would help in creating incentives for the participants to establish "mutual confidence", and these incentives would be stronger the more the countries value the maintenance of fluid relations with the others. While it is clearly conceivable that exercises of macroeconomic cooperation may be undertaken by countries that do not participate in a trade area, in the case of Mercosur it seems that progress in dealing jointly with macroeconomic issues requires that the partners perceive regional integration as a convenient long-term project. By mid 2001, this is an open question. At the same time, the controversies that have been raised in recent years about the trade and investment policies of the countries of the region underscore the influence of macroeconomic conditions on the attitudes concerning intra-regional commerce. The implication that trade and macroeconomic matters should better be considered in conjunction, and with a long-run perspective, does not make the problem easier, particularly when turbulences shorten decision horizons.

Still, Mercosur was launched during a period of much uncertainty (and it has continued since with governments belonging to different political parties). Over time, it has become a visible part of the economic environment for agents and policy makers. It is unlikely that the strengthening of the economic relations between the countries that took place during the nineties will be wholly reversed, even if Mercosur does not develop institutionally, and even if it regresses in that respect, or in the case that the area somehow becomes part of a larger trade zone (FTAA). Again giving due consideration to asymmetries, the regional performance will probably remain as a permanent concern for agents in each economy. There would then be concrete arguments for the countries of the region to invest in establishing practices of cooperation, in macroeconomic matters in particular. The gains to be obtained from those regional activities would depend on the intensity of interdependencies, and therefore on the size of the economies of the regional partners and their potential volatility. In this respect, the likelihood of large shocks, but also the expectation of long-run growth of the economies of the region would provide an incentive for some type of regional approach to macroeconomic problems. It seems difficult to envisage closer or relatively demanding forms of coordination (understood simply as an "exchange" of actions between the parties, with an immediate *quid pro quo* or the anticipation of a future one) for purely "defensive" reasons, in fear of negative spillovers from neighbors that are assumed to have bad prospects. The variability of regional macroeconomic conditions (especially if it manifests itself in crises) generates a demand for coordination, but the option of considering tighter commitments between the participants seems to be encouraged in particular by contemplating of longer-term scenarios with a strong common performance.

IV. Regional cooperation in crisis prevention

The region is presently in a crisis. Prevention is easier to contemplate in times of relative calm: the urgent matter is how to face current disturbances. The existence of regional spillovers is recognized in general terms, and there have been instances of dialogue between the economic authorities. However, macroeconomic policies have followed a strictly national approach, and this will probably remain so. Regional policy interaction can possibly perform limited but important roles in dealing with the incentives to use trade frictions as demand-shifting devices, and in signalling that Mercosur will continue to provide the framework for regional trade in the future, if governments do maintain that position. Continued joint monitoring of the macroeconomic evolution seems particularly relevant: although there may be differences in opinion, it matters greatly to have available settings to conduct an active evaluation of scenarios and policy options, and to consider responses (even if "ad-hoc") in the event of "bad news", or measures to help sustain recoveries, as it may turn out. The regional guidelines on public finances and inflation that were established recently have had little immediate impact, and clearly they do not operate as actual restrictions for the decisions of each country, but they have served to indicate a common attitude regarding central aspects of policies, and accordingly continue to have a meaning as indicators of objectives and triggers for discussions.

The way in which the economies get through the current episode will probably condition their behavior and opportunities for the years to come, in matters as significant as their access to credit markets. The international economy is undergoing changes. Any projection of what form future macroeconomic fluctuations may take in a national and regional context would be subject to much uncertainty. But the countries in the region have gone through episodes of currency crisis or sudden output contractions associated with credit disturbances, in very different circumstances and time periods. If there is any guidance in past experience, countries like Argentina and Brazil are likely to remain subject to economic shocks and crises.

Economic crises have been much discussed in recent literature. Much of the analytical effort has been directed to modelling large currency depreciations or abrupt falls in spending and credit flows within a framework that assumes that agents understand the workings of the environment (although they may be surprised by the realization of random exogenous shocks, from known probability distributions). The approach allows for coordination failures (in the form of "bad collective choices" among multiple equilibria, perhaps triggered by a realization of some extraneous "sunspot variable"), but always maintaining the presumption that individual plans are consistent with one another, and that expectations are "as good as can possibly be" given the information available. Quite apart from the usefulness of the results of that work, the expectational assumptions contrast with the common observation that crises tend to motivate agents (and analysts) to "rethink" the models (implicit or explicit) that they had been applying in order to make interpretations and forecasts[7].

Leaving aside the cases where, for example, a clearcut inconsistency between monetary-fiscal and exchange rate policies can be identified as the reason behind a crisis, large disturbances often seem to happen in economies where, previously, income prospects had been viewed with optimism (so that the supply and the demand for credit expanded rapidly) and where, for some reason or another, that expectation is put into question. This type of crisis appears to be associated with revisions of beliefs about the trend of incomes, with consequences for the anticipated solvency of debtors and the willingness of agents with access to credit to enter into debt[8].

From this point of view, the emergence of crises would be related to difficulties in projecting the future value of "fundamental variables", which in turn may induce agents to form incoherent expectations and make decisions that depart from a "sustainable path". Such difficulties are likely to be particularly relevant in economies that are undergoing transitions in their configuration or performance, and where past patterns of behavior do not form a sound basis for making forecasts. "Model uncertainty" would then seem an integral part of the process leading to a crisis, although, once this happens, the features of propagation and amplification mechanisms (through credit channels, for example) may show recurrently observed features.

If relevant, the previous argument has concrete implications. First, crises would typically be (almost by definition) hard to anticipate since, in order to identify, say, a situation of excessive spending, the actual evolution of the economy would have to be compared to a reference path, which cannot be determined unless by making some conjectures about the economy's future opportunities and performance. This does not mean that current variables should not be watched closely, but does imply that pre-determined numerical criteria that try to distinguish between

7 In this connection, the attempt to extract lessons from crisis episodes presumes that there are new elements to be learned from such phenomena, which were not already incorporated in existing models. It seems paradoxical that much of this work is carried out under the methodological assumption that the beliefs of agents have already "converged to the true model", and according to which the new data that the analyst uses to consider alternative hypotheses would add nothing to the knowledge of the decision makers in the system.

8 The argument refers to the traditional macroeconomic theme of intertemporal coordination (cf. Leijonhufvud (1981)). The connections between expected trends, wealth perceptions and fluctuations in credit and aggregate spending have been explored in Heymann and Sanguinetti (1998), Heymann (2000) and Heymann, Kaufman and Sanguinetti (2001).

sustainable and unsustainable behavior on the basis of "thresholds" for some variables would be at best rough rules of thumb that may be qualified or modified by informed judgments. Being alert to the possibility of crises would require an active work in interpreting data and analyzing potential future scenarios. In a regional setting, this again draws the attention towards a routine of joint monitoring of the economic evolution where, at some point, the opinions of the partners may gain increasing importance for each of the policy-makers, and eventually lead to actions decided by consensus.[9] Second, it is analytically appealing to contemplate the determination of economic policies through a set of "contingent rules", which serve to guide expectations and, at the same time leave flexibility to react to shocks. For various reasons (imperfect knowledge of the model being probably among the most important), actual policies are typically set either through more or less strict rules, or in a rather "open ended" way (and the preferred combination of both types of policy scheme, and the institutional "level" at which actions should be taken seems the outcome of informed groping, rather than the result of a grand exercise of once-and-for-all optimization). Possibly, preventive measures would take these two forms. For example, prudential regulation of banks, through well-defined restrictions on the portfolios of intermediaries seems to have had effects in preventing the propagation of shocks through the banks (although, clearly such prudential considerations face tradeoffs with objectives regarding the cost and segmentation of credit). Fiscal management on the basis of cyclically-adjusted variables can be envisaged, although estimating the trend-cycle decomposition is precisely a big difficulty in transitional situations. In any case, there would be room for more or less "flexible" policies (within the restrictions imposed by the availability of instruments) which contemplate that the risk of crisis would call for "precautionary savings" (or the search for instruments of insurance), with a magnitude that depends on the estimates of the odds by the decision-maker. In these fields there are possible opportunities for regional cooperation, such as movements to coordinate (or reconcile) bank regulations, and the establishment of instances to analyze common projections and policy alternatives. "Mutual insurance" schemes may be considered, although they appear in principle difficult to design and implement.

Crises are likely to combine doubts about a country's solvency with strong liquidity constraints. Although it may be difficult to discriminate the causes behind actual financial restrictions, access to credit may be tightened to an extent that does not correspond to the debtor's capacity to repay in "normal times" and with a more adequate provision of funds. This point has been recognized, and in recent years there have been several large international operations (done on a case-by-case basis) to provide liquidity assistance to "emergent" economies. There have been proposals for setting regional funds, that may do part of that work and "constitute a link between individual countries and a strengthened and reformed IMF" (Agosín (2001); cf. also Griffith-Jones *et al.* (2001)). These may possibly act as "first line of defense" in case of liquidity shocks on some countries (especially if they are of comparatively small size). Their operation would require the establishment of criteria for lending, which can be a useful exercise in a regional context, particularly if it can result in a common set of views. In the case of Mercosur, however, it seems unlikely that the larger partners would consider devoting liquid resources to such a fund in the immediate future, since in the current crises they have shown reluctance to make strong regional commitments, and credit constraints are tight. In any case, it is to be expected that the current experience will lead to a substantive discussion of the role that the participants plan to give to Mercosur in the future. In that discussion, the treatment of regional macroeconomic spillovers will be prominent parts of the agenda.

[9] Such exercises of joint monitoring can lead to more formalized schemes of "peer review" (cf. Ocampo (1999)), with a potential signalling effect on third parties.

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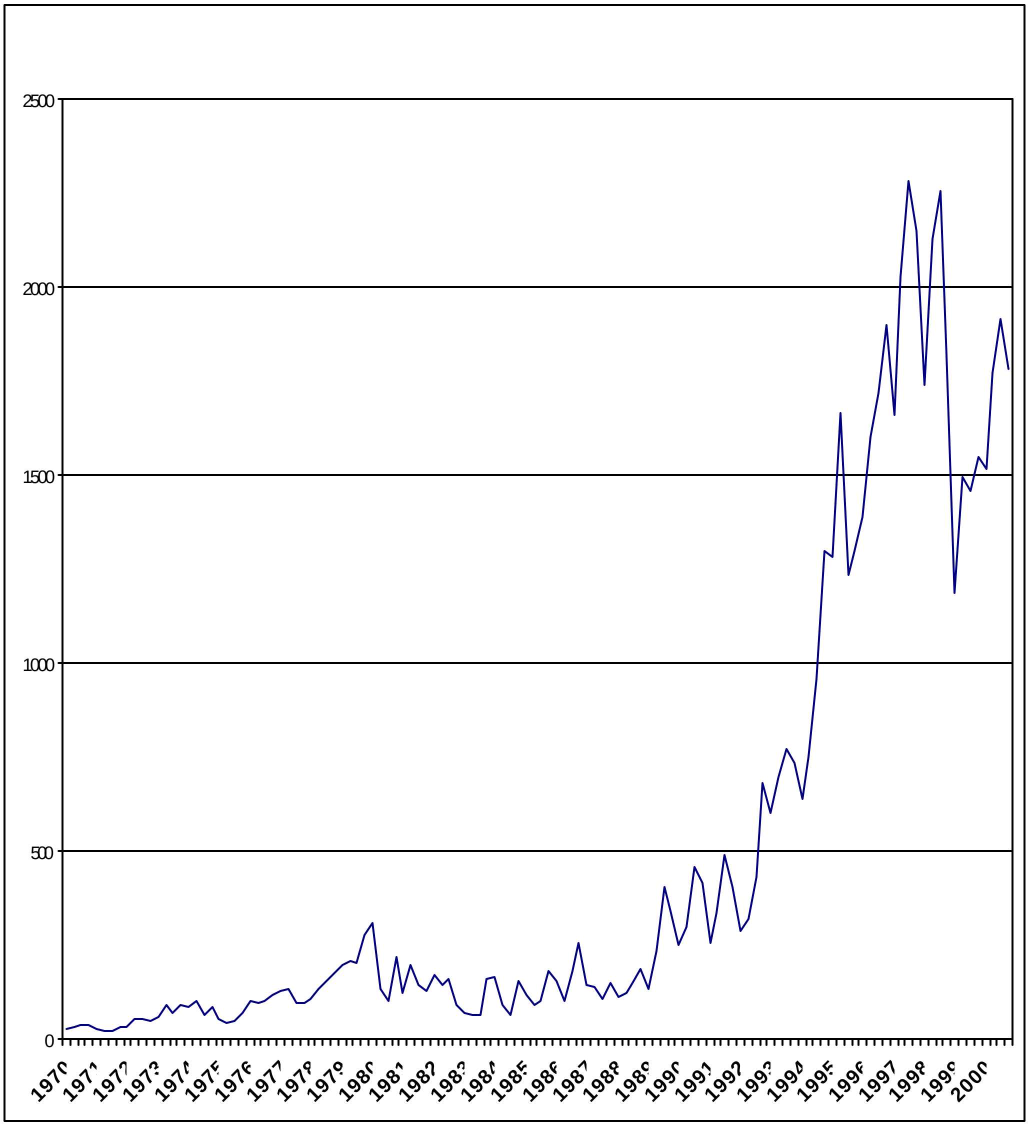
Annex

Figure 1
ARGENTINA: EXPORTS TO BRAZIL
(millions of current dollars)

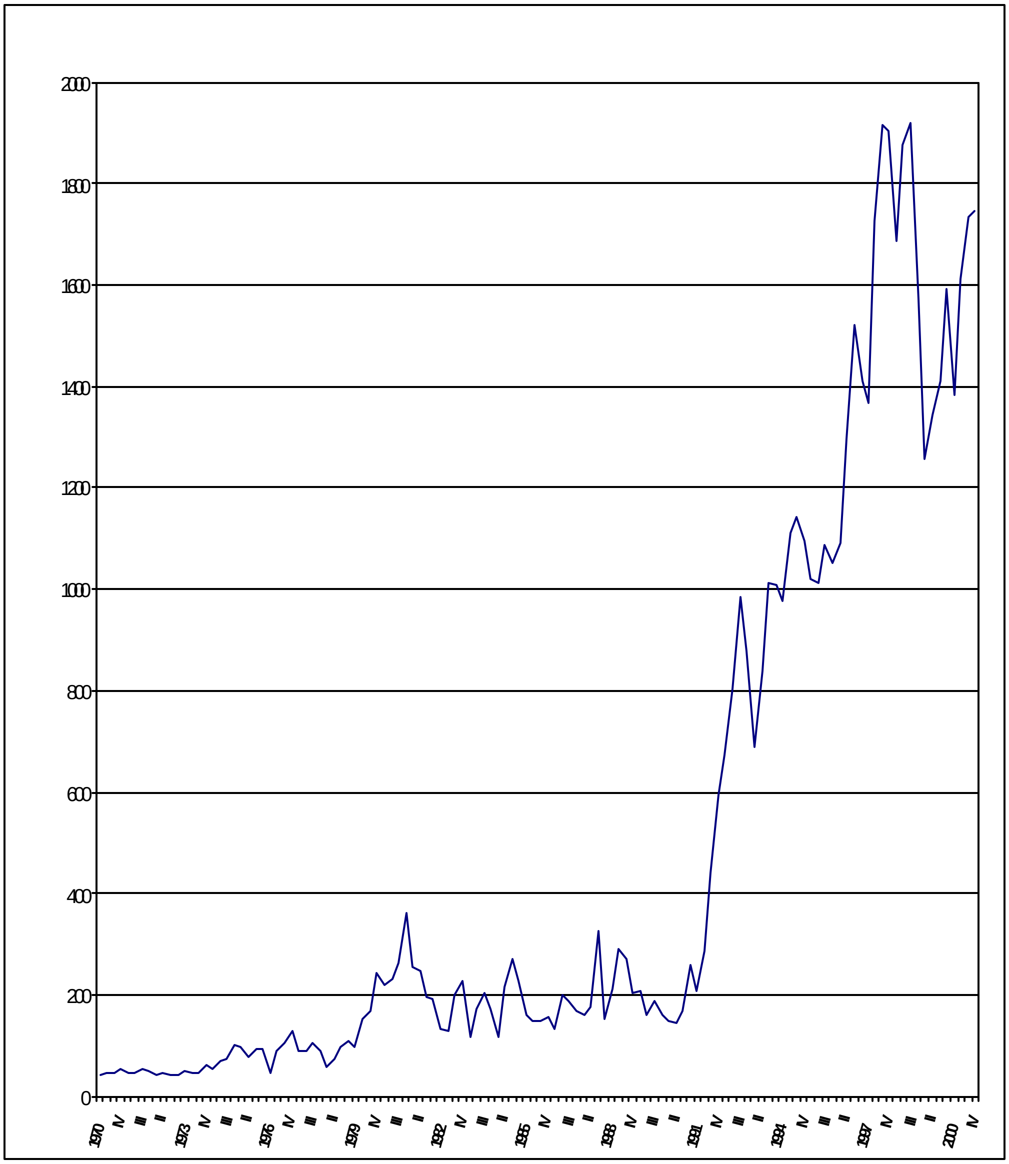


Source: ECLAC, on the basis of official figures.

Figure 2

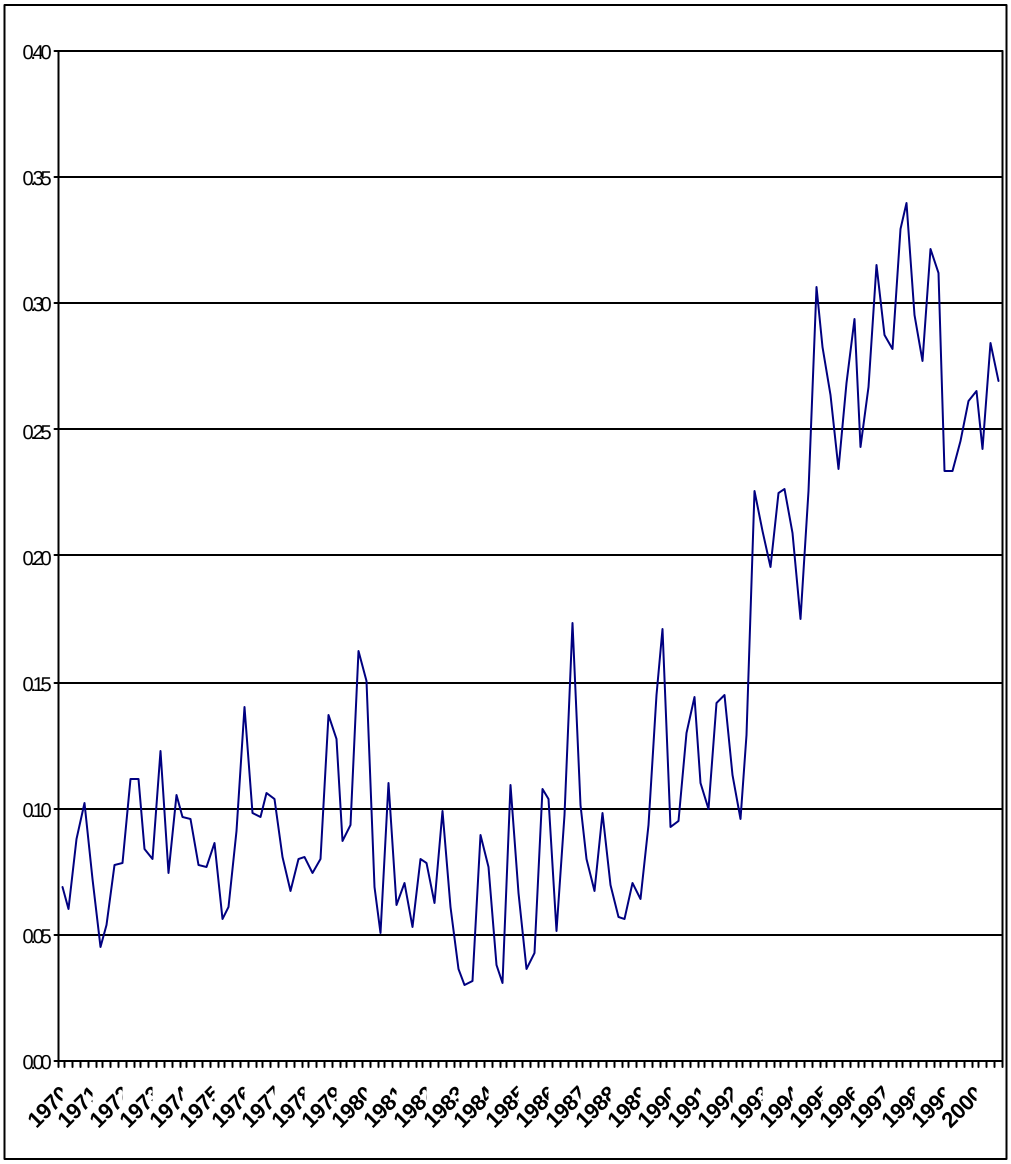
ARGENTINA: IMPORTS FROM BRAZIL

(millions of current dollars)



Source: ECLAC, on the basis of official figures.

Figure 3
ARGENTINA: EXPORTS TO BRAZIL AS A SHARE OF TOTAL EXPORTS
(percentage)

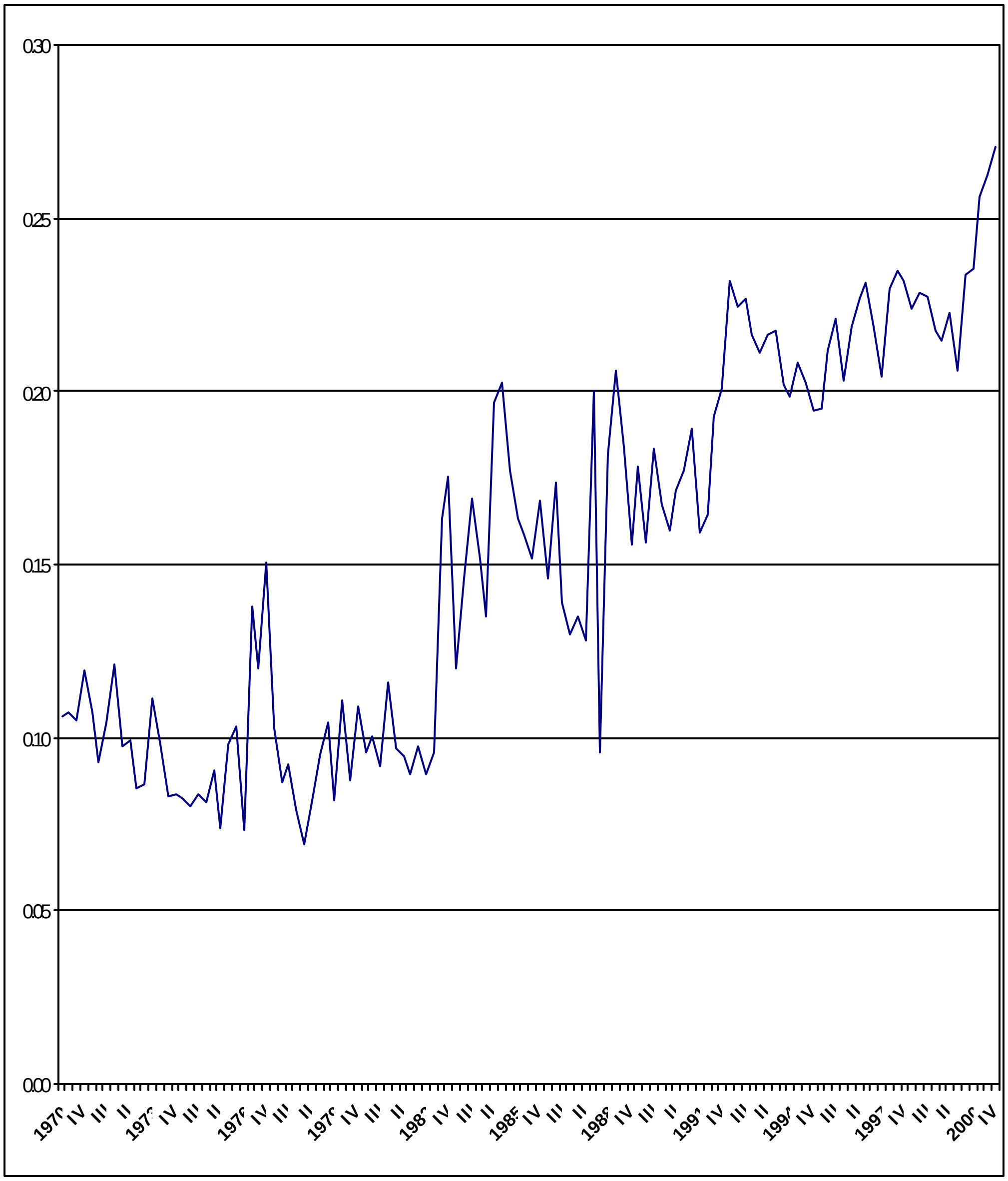


Source: ECLAC, on the basis of official figures.

Figure 4

ARGENTINA: IMPORTS FROM BRAZIL AS A SHARE OF TOTAL IMPORTS

(percentage)

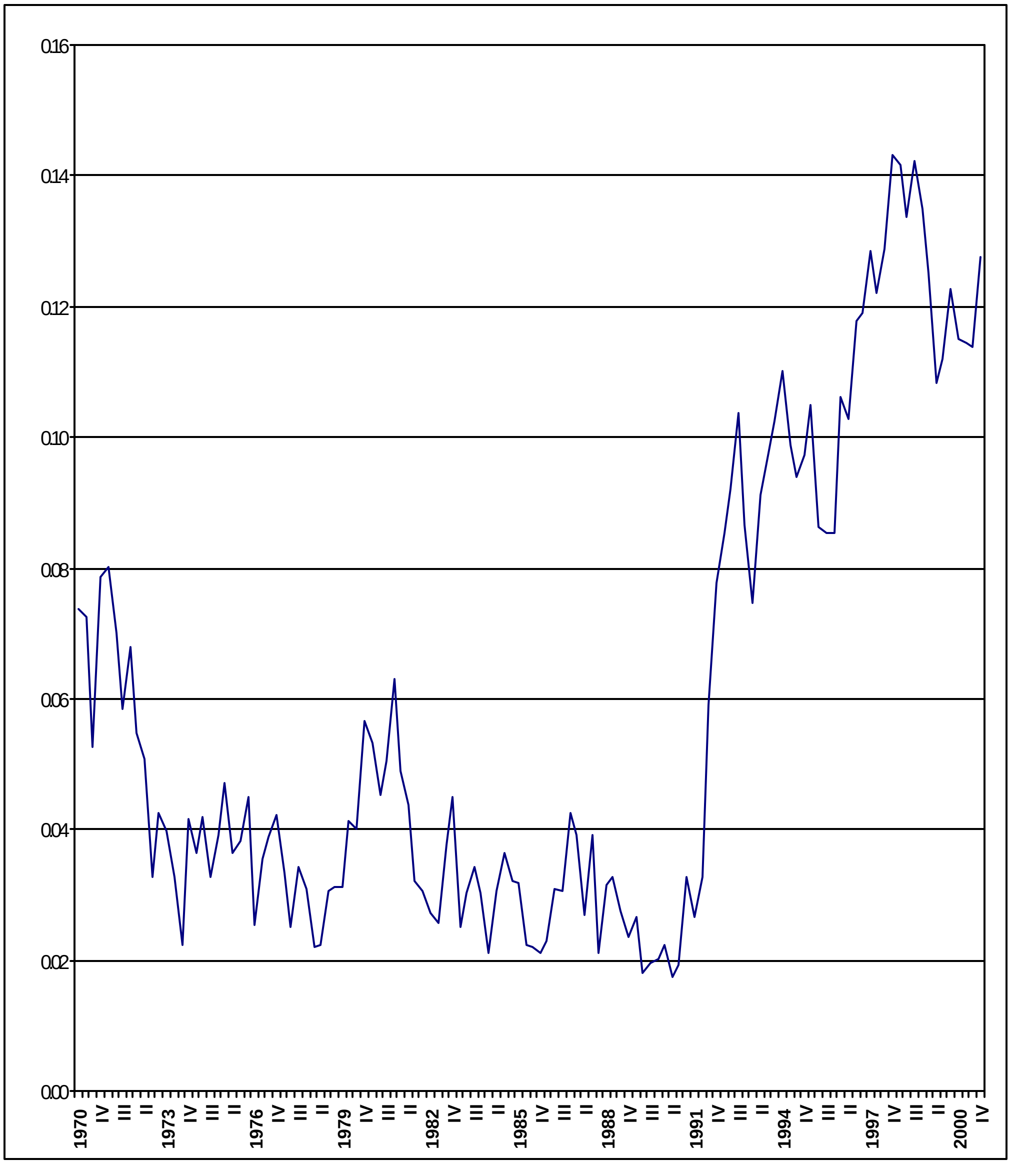


Source: ECLAC, on the basis of official figures.

Figure 5

BRAZIL: EXPORTS TO ARGENTINA AS A SHARE OF TOTAL EXPORTS

(percentage)

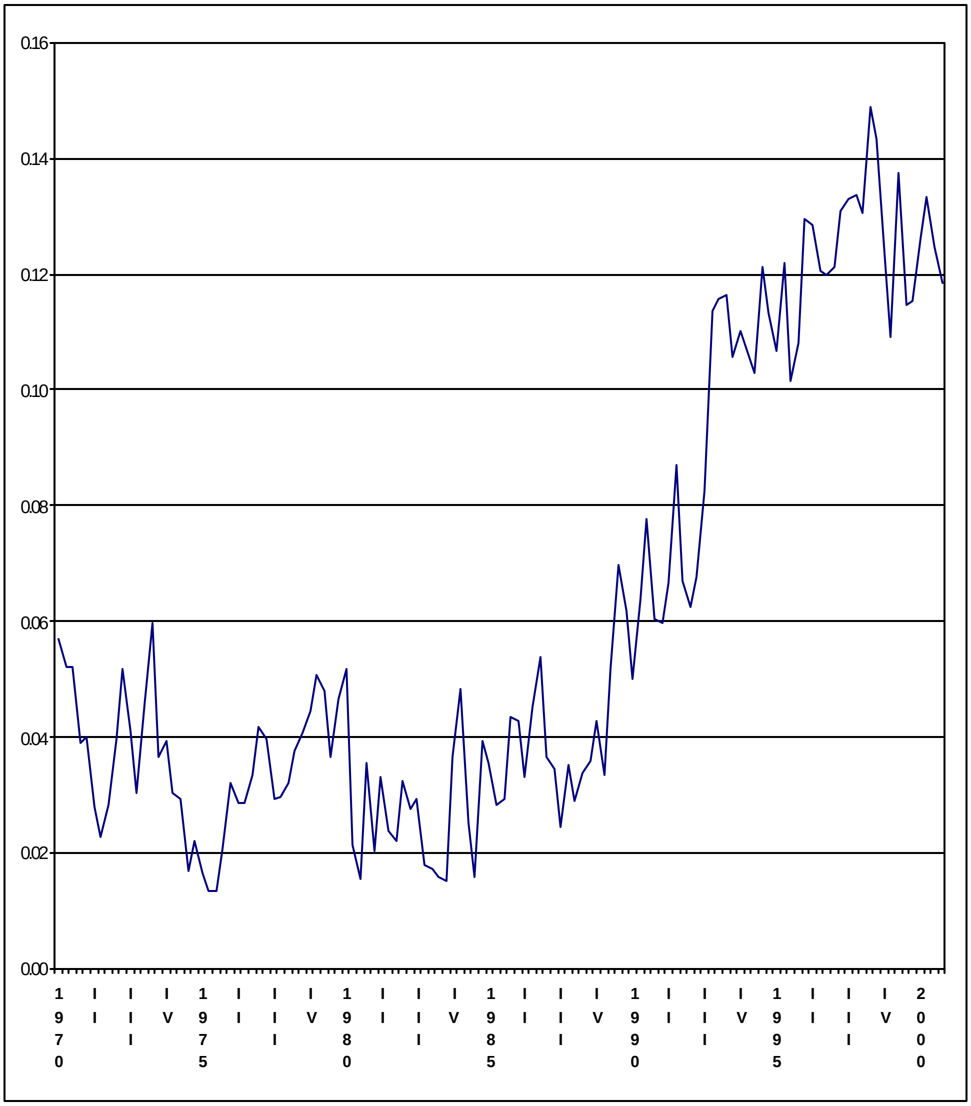


Source: ECLAC, on the basis of official figures.

Figure 6

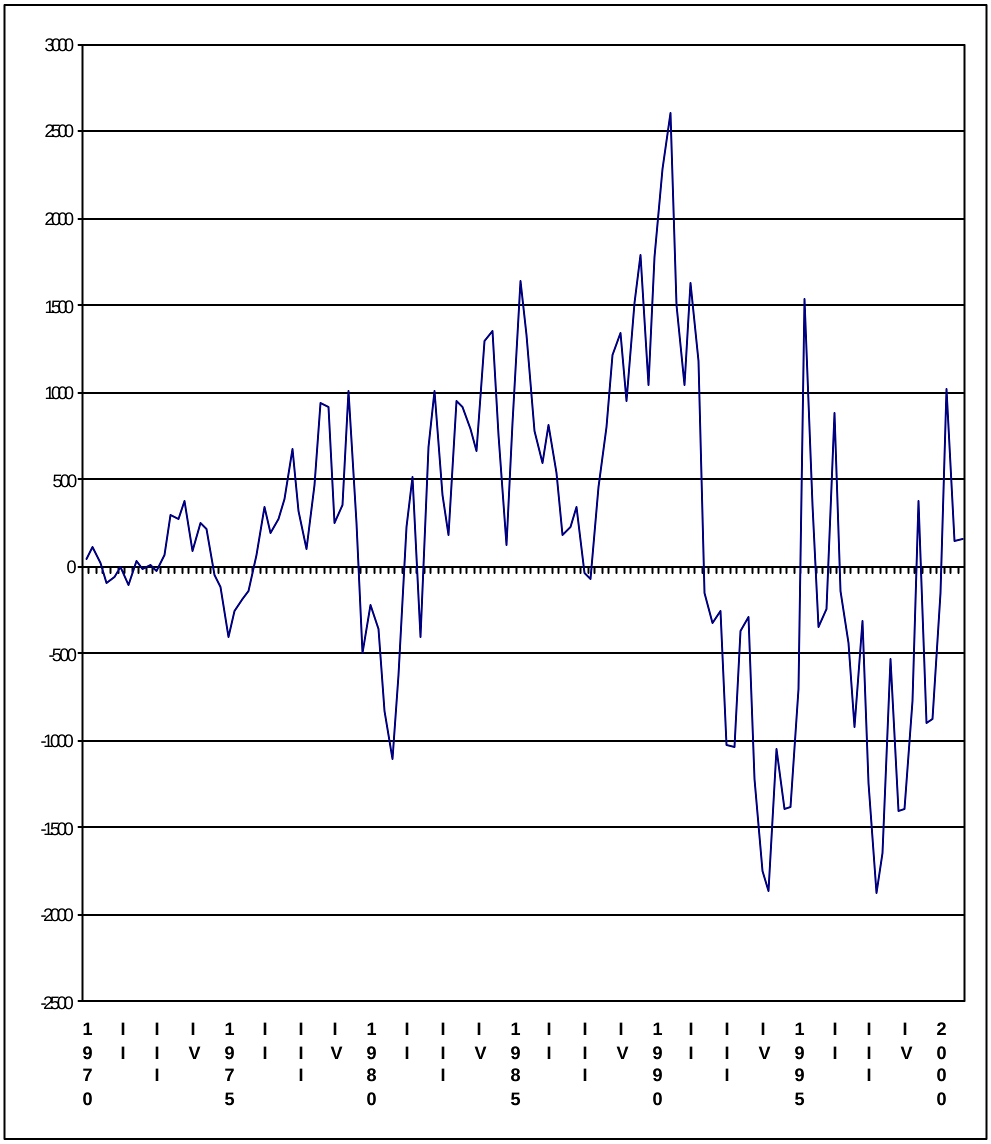
BRAZIL: IMPORTS FROM ARGENTINA AS A SHARE OF TOTAL IMPORTS

(percentage)



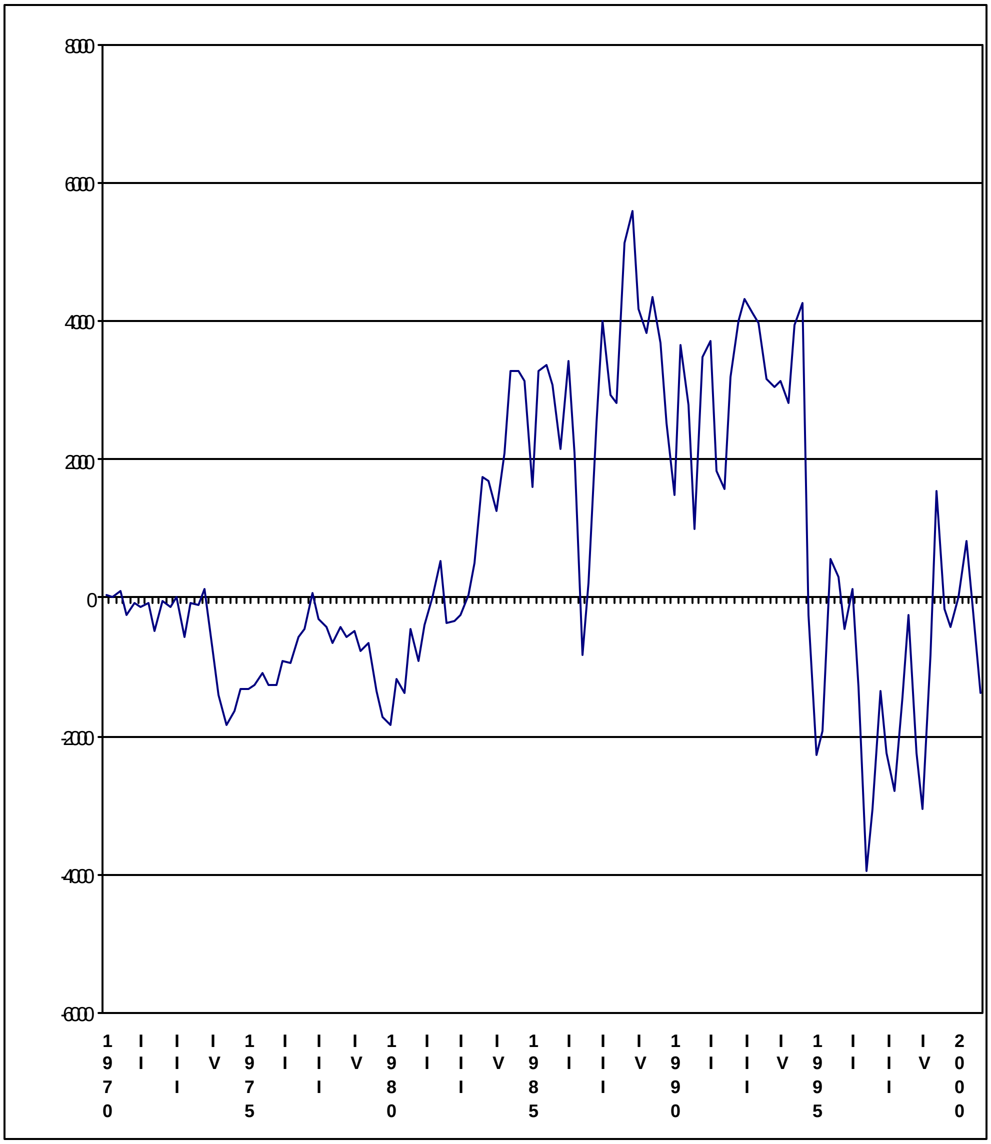
Source: ECLAC, on the basis of official figures.

Figure 7
ARGENTINA: TOTAL TRADE BALANCE
(millions of current dollars)



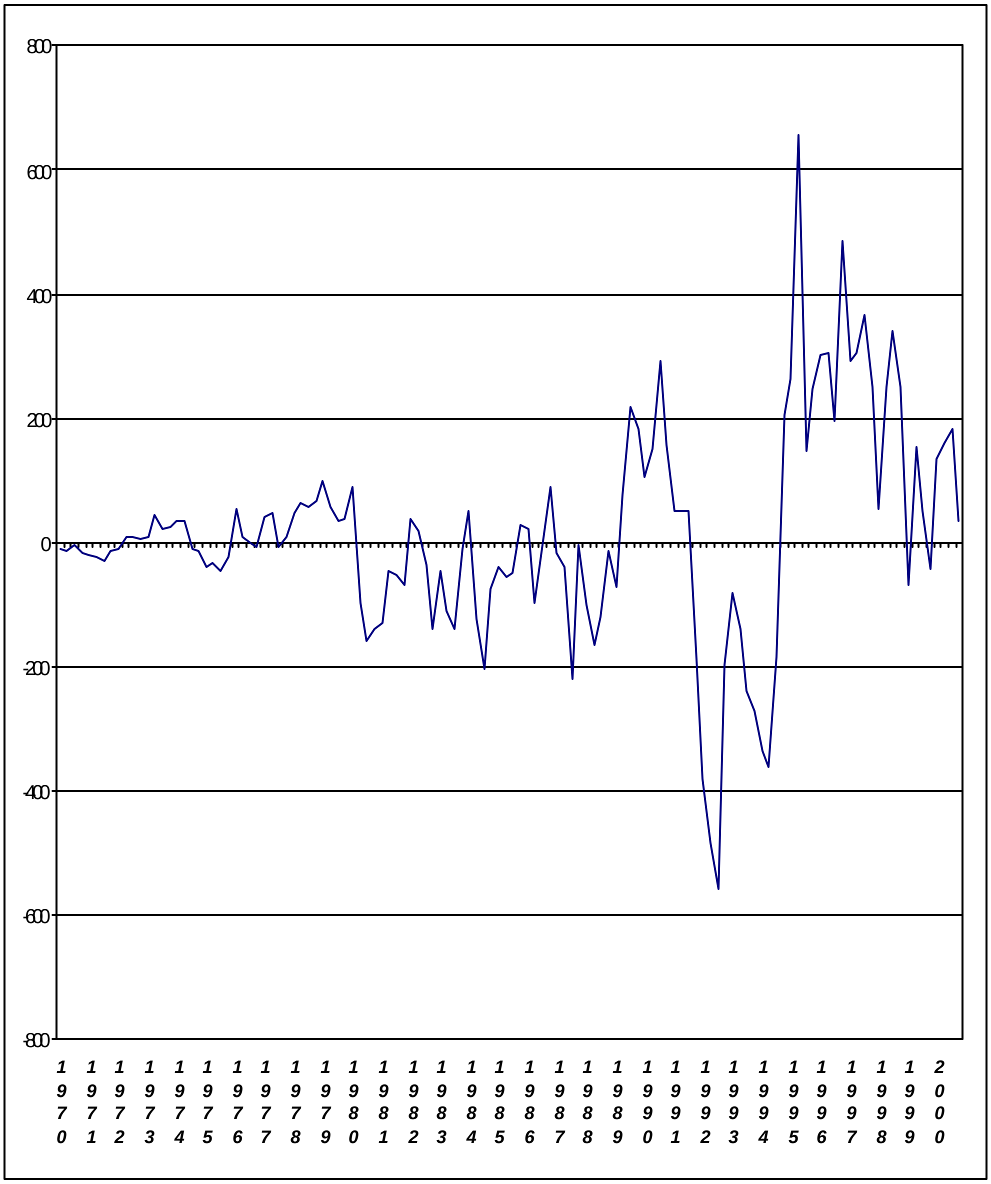
Source: ECLAC, on the basis of official figures.

Figure 8
BRAZIL: TOTAL TRADE BALANCE
(millions of current dollars)



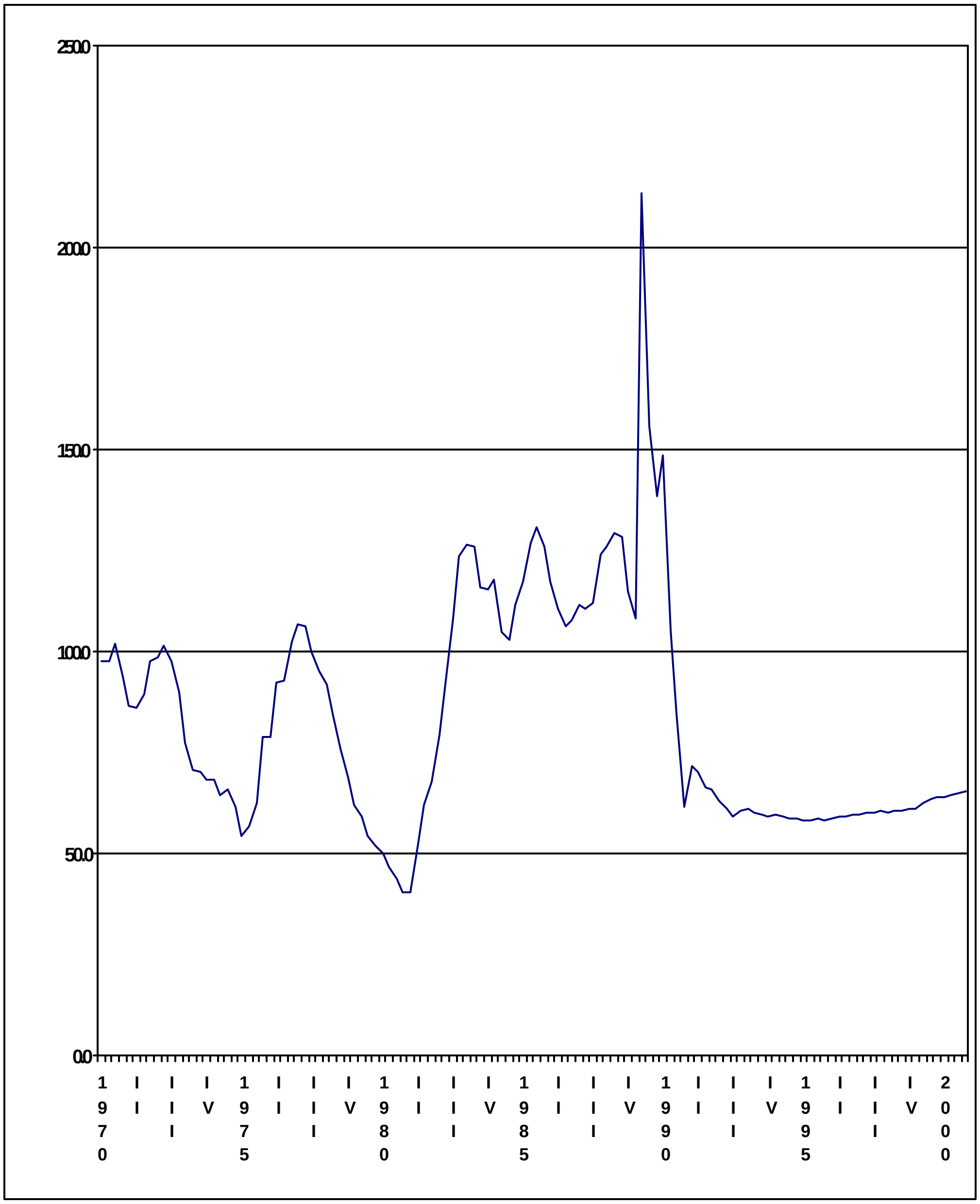
Source: ECLAC, on the basis of official figures.

Figure 9
ARGENTINA-BRAZIL: BILATERAL TRADE BALANCE
(millions of current dollars)



Source: ECLAC, on the basis of official figures.

Figure 10
ARGENTINA:REAL EXCHANGE RATE WITH THE US DOLLAR
(1990=100)

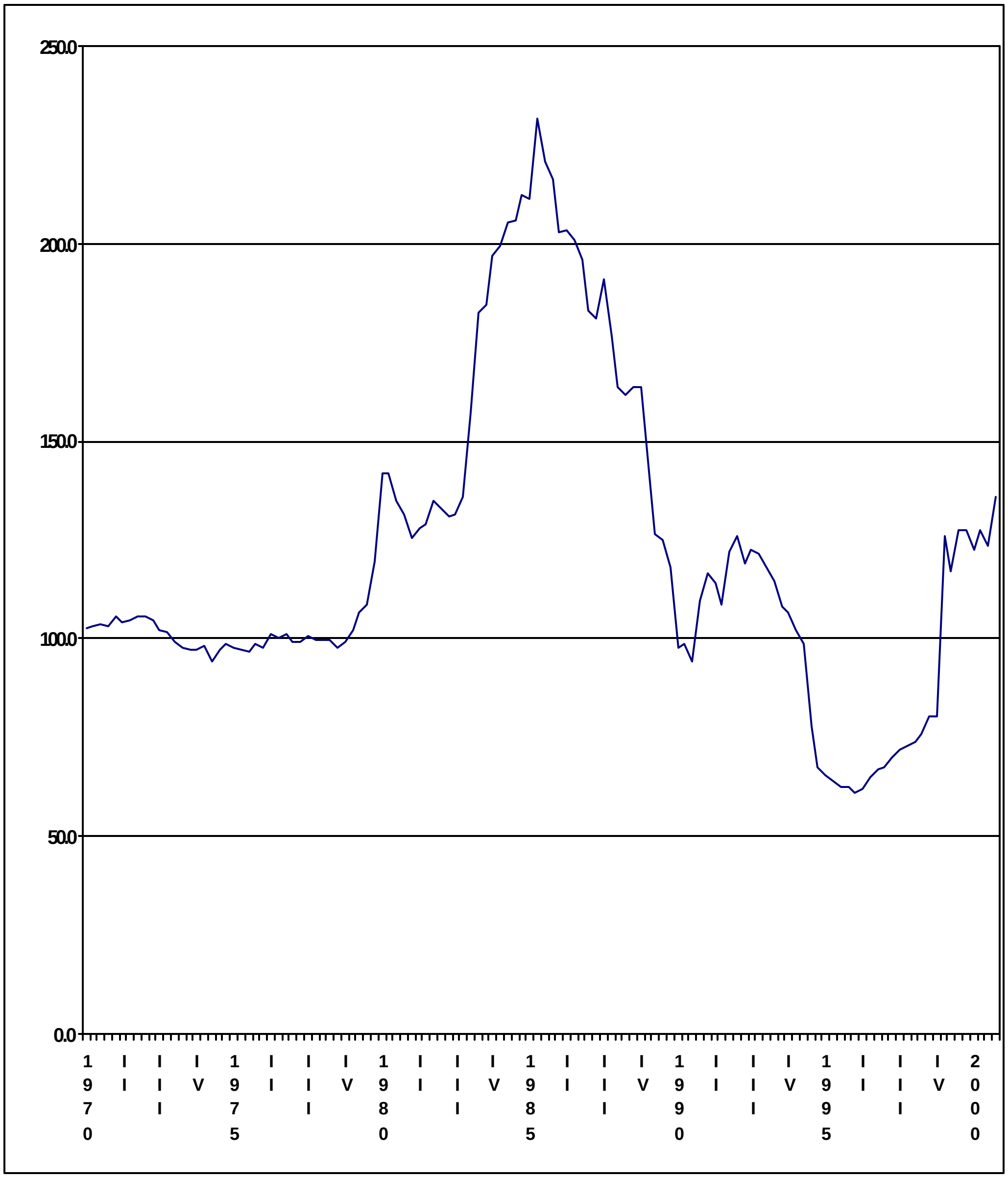


Source: ECLAC, on the basis of official figures.

Figure 11

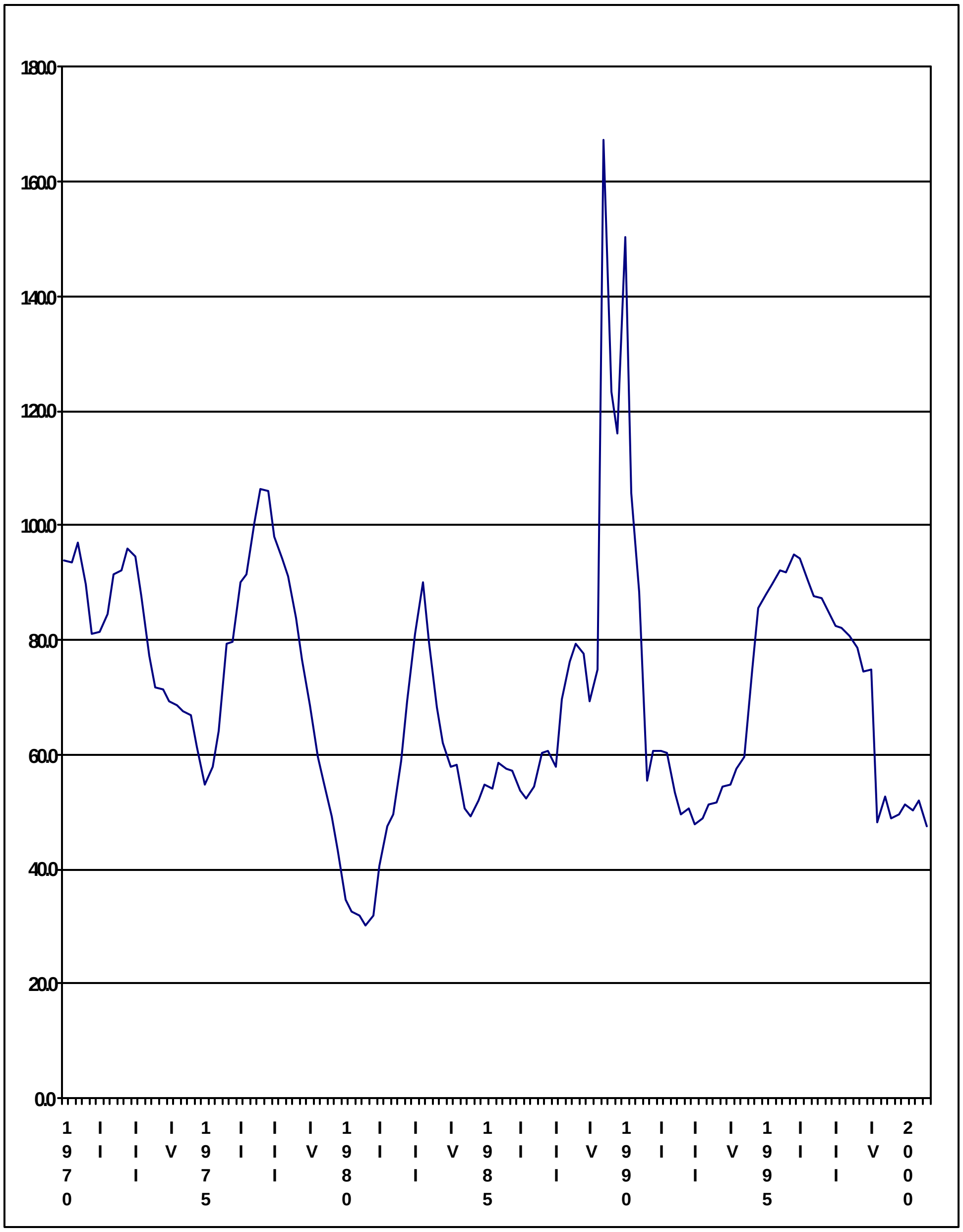
BRAZIL: REAL EXCHANGE RATE WITH THE US DOLLAR

(1990=100)



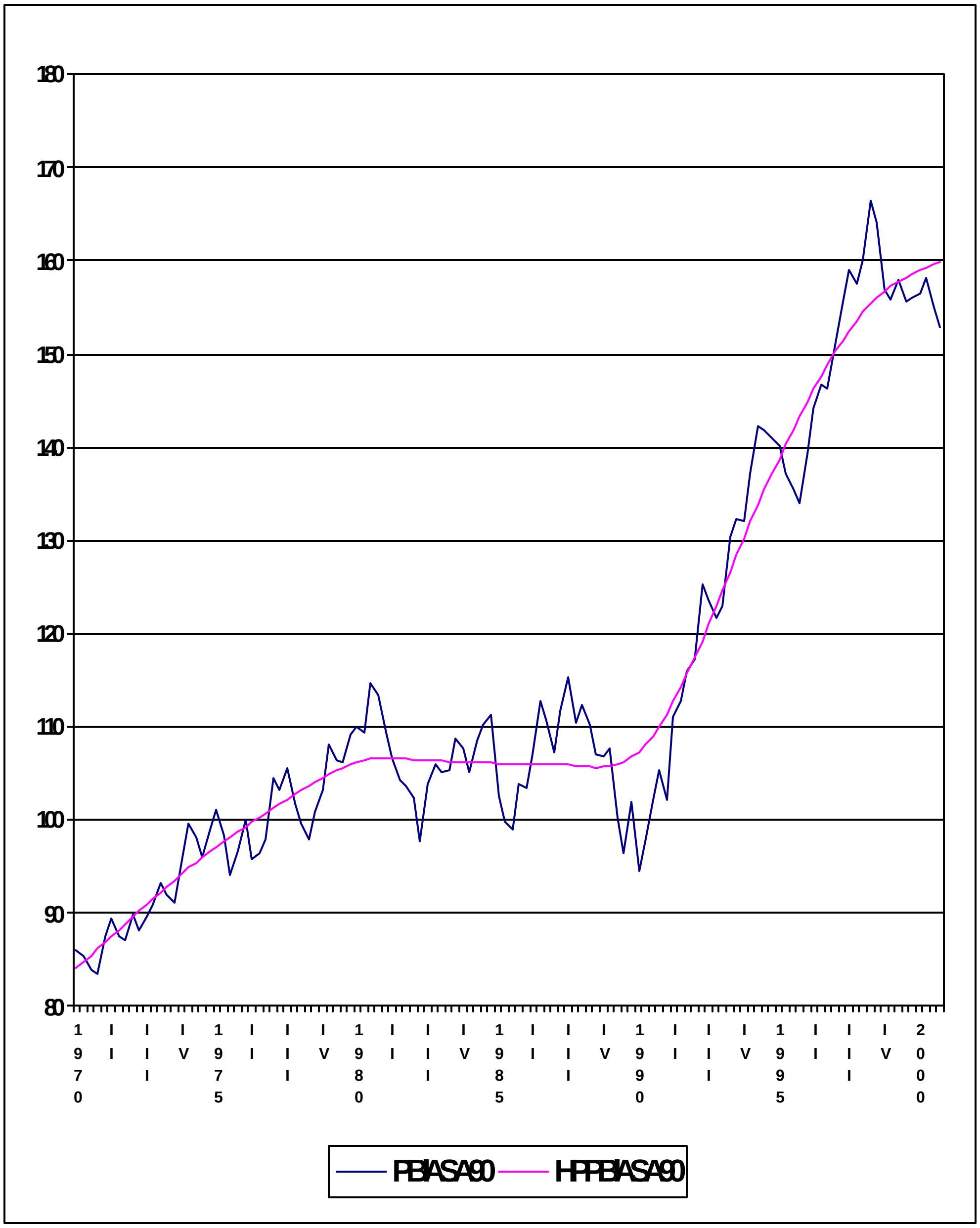
Source: ECLAC, on the basis of official figures.

Figure 12
ARGENTINA-BRAZIL: BILATERAL REAL EXCHANGE RATE
(1990=100)



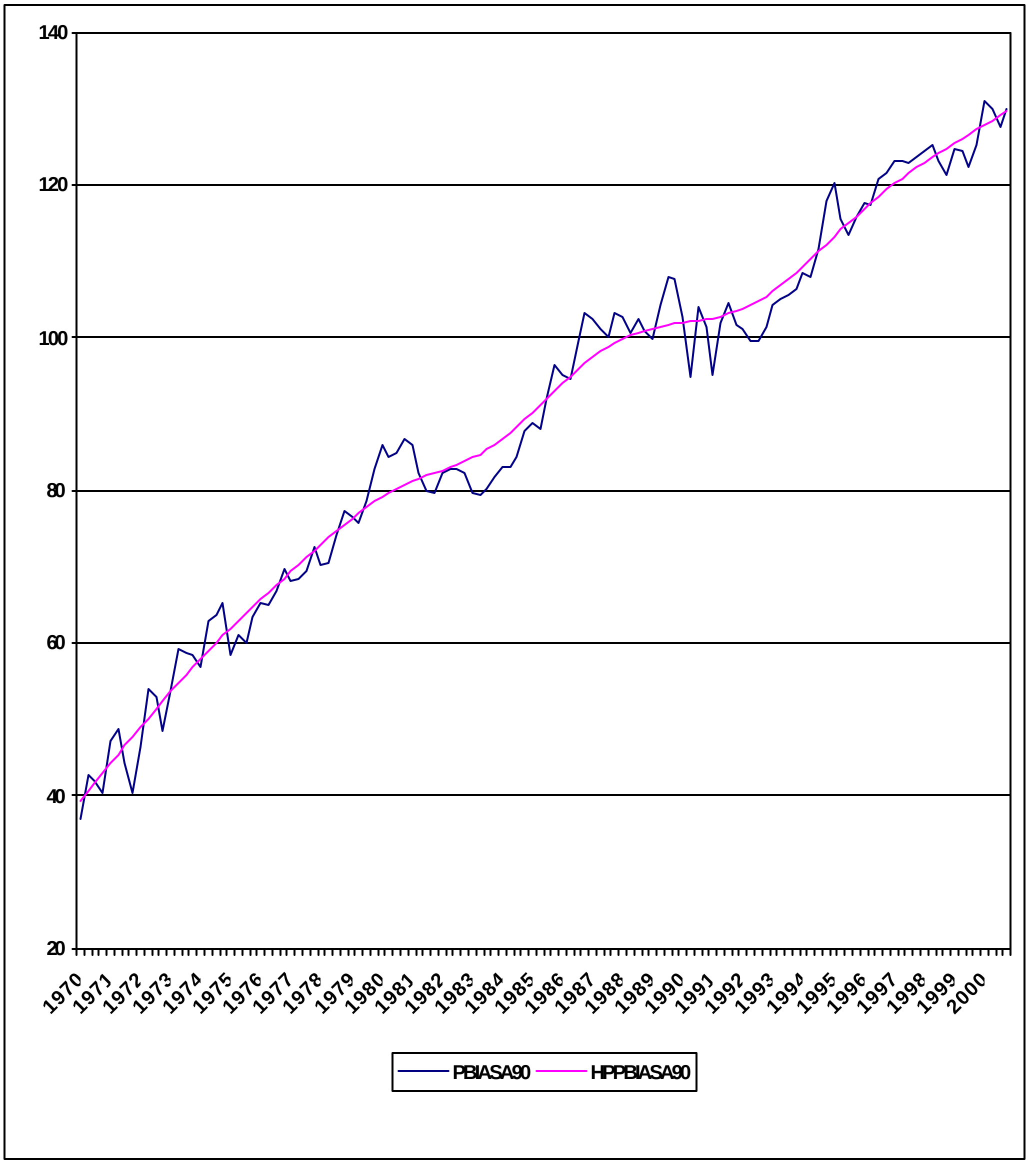
Source: ECLAC, on the basis of official figures.

Figure 13
ARGENTINA: GDP (QUARTERLY, SEASONALLY ADJUSTED) LEVELS AND HODRICK-PRESCOTT TREND
(1990=100)



Source: ECLAC, on the basis of official figures.

Figure 14
BRAZIL: GDP (QUARTERLY, SEASONALLY ADJUSTED), LEVELS AND HODRICK-PRESCOTT TREND (1990=100)



Source: ECLAC, on the basis of official figures.

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