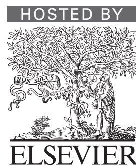

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Regional economic integration in Mercosur: The role of real and financial sectors

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Abstract

This study explores economic interdependence in Mercosur by examining common trends and common cycles among key macro-variables representing both the real and financial sectors of the economy. The serial correlation common features test reveals that the key macroeconomic variables (real output, investment, and intra-regional trade) share common trends in the long run suggesting that macroeconomic interdependence in the Mercosur economies is strong. The exchange rates demonstrate co-movement in the long run as they share a single common trend. These finding suggests that these economies cannot swing away from long-run equilibrium for an extended duration; they will be brought together by their common trends. Similarly, each variable under consideration shares common cycles lending support to the notion of short-run synchronous movement. The trend-cycle decomposition results reveal that the cyclical movements of real output and trade are synchronized with a high degree of positive correlations. Our overall findings thus provide justification and optimism for deeper economic integration among Mercosur countries.
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1. Introduction

Recent decades have witnessed regional economic integration gaining momentum in many parts of the world. Since 1990, there have been more than 14 agreements pertaining to free trade areas and custom unions. By lowering trade barriers and fostering greater mobility of human and physical capital, regional trading arrangements provide many benefits and may contribute to economic growth in member countries. These benefits include reduced transactions costs, lower prices for consumers, more efficient use of resources, scale economies, enhanced competition among firms, greater certainty and investment, technological improvements, and increases in productivity. Regional integration can also lead to deeper assimilation and may complement multilateralism by setting a precedent which other nations will follow (Carbaugh, 2015). Given these potential advantages, it is not surprising that many countries around the world have continued to pursue greater economic integration. On the other hand, regional trade agreements are also discriminatory in that some nations are treated differently than others. Further, they may decrease incentives for nations to pursue multilateral agreements because trade bloc members may not gain additional economies of scale through multilateralism. Finally, as the recent experiences of some members of the European Union such as Greece and Spain have demonstrated, integration is no panacea. The loss of independent monetary and exchange rate policies can pose serious limitations in tackling economic crises. And as is also apparent from the recent exit of the United Kingdom from the European Union, non-economic factors, particularly the role of special interest politics, can be crucial.

The main objective of this paper is to investigate the economic interdependence of the economies of Mercosur (Southern Common Market). Established in 1991 between Argentina, Brazil,

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Paraguay, and Uruguay,[1] Mercosur is one of the largest regional trade blocs in Latin America. The main goal of Mercosur is to eliminate barriers to facilitate the free movement of goods, people, and currency among member countries. The formation of Mercosur was inspired by the success of the European Union and represents a first step toward greater regional integration. The member countries decided to adopt a gradual approach toward deeper integration, starting with a free trade area to an eventual customs union, and from a contractual agreement to a structured international organization (UNCTAD, 2003). Although Mercosur has a long way to go to achieve its goals, member countries have agreed to set up an institutional framework to foster economic policy coordination. In 2000, a high level monitoring body (equivalent to the Economic and Financial Council in the European Union) was created to implement agreements and treaties among member countries with regard to the convergence of public deficit and debt ratios. The process of deeper integration in Mercosur appears to be steadily gaining momentum.

In light of these efforts toward economic integration, this study examines the degree of macroeconomic synchronization (i.e., the co-movement of macroeconomic variables) among the member countries of Mercosur. For this purpose, we make an attempt to identify the number of common trends and common cycles. We also separate permanent and transitory components from the original variables which will allow us to identify the degree of co-movement in the long run and short run, and measure the degree of interdependence among the economies under consideration. For this purpose, we examine key macroeconomic variables in the Mercosur countries—real output, investment, intra-country trade, exchange rate, and interest rate, representing both real and financial sector of the economies. Studies suggest that a high degree of macroeconomic synchronization or business cycle co-movement is a necessary condition for promoting economic cooperation among countries involved in an economic integration process (Christodoulakis et al., 1995; Fiorito and Kollintzas, 1994). If business cycle fluctuations are synchronized, harmonized policies to cope with these cycles across countries can be effective (Sato and Zhang, 2006). Likewise, exchange rate dynamics often remain at the core of monetary policy discussions. In an open economy, the monetary authority needs to respond to exchange rate movements which work as shock absorbers. After the collapse of the Bretton Woods system, monetary authorities in developing countries began to emphasize exchange rate stability and correct exchange rate alignments to improve economic performance.[2] One of the reasons for establishing the European Monetary Union was to promote exchange rate stability among member countries and to encourage trade inside the European Union (Dell'Ariccia, 1999). Acknowledging the importance of exchange rate movements, Basnet et al. (2015) examine exchange rate movements to assess monetary policy coordination in the ASEAN nations. The results of their study lend support for monetary policy coordination between some but not all ASEAN nations. The effect of exchange rates on macroeconomic stability is linked to interest rates and other macroeconomic variables. International shocks are also transmitted through, among other variables, interest rates.

The existence of long-term common trends and short-term common cycles in a set of variables indicates that these variables do not swing for an extended period of time, ultimately move together, and share similar cyclical fluctuations in the short run. We submit that if member countries share synchronous long-term trends and short-term cycles in their key macroeconomic variables, these countries may find it mutually beneficial to strengthen their integration process. Eventually, these countries could potentially even move toward a monetary union, the highest level of economic integration. Such a union would be characterized by, among other features, a common currency, common fiscal and monetary policies, and free mobility of goods, services, labor, and capital. On the other hand, if the impact of a shock is not symmetric across countries seeking deeper integration, harmonized monetary and fiscal policies are unlikely to benefit these countries. That is, non-synchronized movements in macroeconomic variables may indicate weak interdependence which may require different policy prescriptions, and in turn, lower the prospects for integration. Therefore, an examination of the costs and benefits of integration must include a careful and rigorous investigation of the behavior of macroeconomic variables. The common feature analysis has been extensively used in the literature (e.g., Sato and Zhang, 2006; Abu-Qarn and Suleiman, 2008; Castillo Ponce and Ramirez, 2008; Adom et al. 2010; Weber, 2012; Basnet and Sharma, 2013), especially to assess the feasibility of higher levels of policy coordination involving an economic or monetary union. However, Mercosur has been largely exempt from this kind of analysis. Utilizing a variety of methodologies and hypotheses, studies have examined business cycle synchronization (Allegret and Sand-Zantman, 2009), labor market interdependence (Caceres, 2011), and convergence and inequality (Blyde, 2006) in Mercosur. To the best of our knowledge, no study has explicitly analyzed the real and financial sectors of Mercosur countries to explore the possibility of greater economic alliance, particularly from the perspectives of common trends and common cycles. We hope that our findings will provide helpful information as to how favorable the economic conditions are to expedite the process of economic integration in Mercosur. As a corollary, we hope to determine whether these countries require different policy adjustments to internal and external shocks.

The rest of the paper is organized as follows. The next section provides a brief economic background of the four Mercosur countries. Next, we describe the data and methodology used to analyze macroeconomic interdependence and business-cycle synchronization. In the following section we discuss the empir-

[1] Venezuela is a recent member of Mercosur. Even though Venezuela signed the membership agreement with Mercosur in 2006, full membership was not granted until 2012. Therefore, we have opted to include only the founding members in our study.

[2] For details: Ann Krueger, Exchange rate determination, Cambridge University Press 1983.

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