

# EXCHANGE RATE POLICY AND MONETARY INTEGRATION IN EUROPE AND MERCOSUR<sup>1</sup>

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## INTRODUCTION

Even through the stage of economic development, the degree of trade and financial integration, of macroeconomic coordination and the desire to move towards political integration are very different in Europe and MERCOSUR, there are some interesting comparisons that can be made and from which something may be learned.

One such comparison is how countries in the two areas have coped at one time or another with the problems caused by the **overvaluation of the exchange rate** and the ensuing loss of competitiveness for the export industry. The nominal exchange rate has been used as an inflation anchor both in the European Monetary System (henceforth EMS) by Italy, Spain and France in the 1980s and early 1990s and in Argentina and Brazil more recently.

Another interesting issue concerns the different consequences that financial and real shocks originating in the reserve currency country have had on the countries of the periphery and the role the exchange rate has played in limiting or magnifying the effects of these shocks. I am thinking here of the German 1990 reunification shock followed in 1992 by a interest

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rate shock originating from the BUNDESBANK's desire to bring inflation from about 5% per year to 2% as quickly as possible, and of the 1994 US long-term interest rate shock followed in 1995 by the Mexican crisis. I shall deal in this short presentation among other things with these shocks, focusing mainly on the consequences for the domestic economy of the exchange rate policy followed.

The structure of the paper is as follows. In Section 1, I shall discuss the reasons that led Europe to create the EMS in 1979 and to sign the Maastricht Treaty in December 1991 envisaging a common currency (European Monetary Union, henceforth EMU) by the year 2002 (and not by 1999, as is commonly believed) and discuss **what MERCOSUR could learn from the European experience** and whether some form of EMS or EMU could be adopted by MERCOSUR "when the time is ripe". In Section 2, I discuss the problems generated by an overvaluation of the exchange rate linked to exchange rate based stabilizations and discuss the EMS experience between 1983 and 1987 because I think it is an example that could be followed by MERCOSUR in the foreseeable future. The problem in Europe and MERCOSUR is that trade integration requires relatively stable real exchange rates as excessive changes in competitiveness have to be avoided. Excessive changes in competitiveness ("misalignments" of real exchange rates) increase the pressure for protectionism and endanger further trade integration. My view is that MERCOSUR countries will have to move better sooner rather than later towards a greater coordination of their exchange rate policy, both among themselves and *vis-à-vis* the US Dollar. They will therefore also have to move towards greater coordination of monetary and fiscal policies.

In Section 3, I discuss the social cost of an excessive rigidity of the nominal exchange rate and compare the recent experiences of Argentina and Brazil. However, I should state from the very beginning that I am not an expert on Latin America and I am therefore asking for forgiveness if I am not up-to-date and accurate enough especially on more recent developments in MERCOSUR. Data on Latin American developments are either not available or available with great delays in smaller provincial towns in Europe. My comments are often based on cursory evidence and my objective is more to raise issues and stimulate the discussion than reach firm conclusions.

In Section 4, I discuss the role of monetary anchors in a future economically and financially more integrated MERCOSUR and, in Section 5, I propose the introduction of a moderate Tobin tax on short term capital flows in this future MERCOSUR as an alternative to monetary union which seems to me politically much too premature and economically unwise for the reasons explained below.

One major concern which I had in the back of my mind while writing this paper is the still predominant role of Brazil and Argentina as



exporters of raw materials and agricultural products and their vulnerability to raw material price shocks. Asymmetric shocks hitting two countries which are on fixed exchange rates can be very dangerous in terms of employment and economic growth if labour market and wage flexibility are not high enough. In the case of the monetary union formed by Argentina with the US, because this is what the irrevocably fixing of the peso to the dollar almost amounts to, the likelihood of such asymmetric shocks is very high. Argentina has been relatively lucky so far. Should such a major prolonged shock occur, the exchange rate policy chosen could be very dangerous indeed. Section 6 contains concluding comments.

## **1 THE EUROPEAN MONETARY SYSTEM: WHAT IT WAS, WHAT IT IS AND THE POSSIBLE IMPLICATIONS FOR MERCOSUR**

### **a) A very brief description**

The EMS is an agreement to stabilize bilateral exchange rates of countries of the European Union and to create a zone of “monetary stability” (*i.e.* of low inflation) within Europe. The agreement came into effect in March 1979 among the general pessimism of academic economists (especially from North America). A central parity was fixed for bilateral exchange rates, but the Council of Ministers of Finance of the European Union can change the central parity. For the first time in history changes in central parities became a truly joint decision of the countries involved, contrary to the Bretton Woods agreements in effect from 1949 until 1971, which foresaw a joint decision but then all changes in central parities *de facto* taken unilaterally<sup>3</sup>.

In the EMS the allowed exchange rate fluctuation band around the central parity was set at  $\pm 2,25\%$  until August 1993 when it was broadened to  $\pm 15\%$ <sup>4</sup>. A rather generous mechanism of short term credit support was foreseen from the beginning for joint interventions in favour of weak currencies when they were hitting the margin of the band. This credit agreement was strengthened in 1987 (agreement of Basel-Nyborg) but some margin of discretionality remained on the part of the BUNDESBANK. In the context of this agreement the BUNDESBANK intervened heavily on

3 See for instance the devaluation of the British pound in 1967.

4 The lira was allowed to fluctuate within a band of  $\pm 6\%$  from March 1979 to the end of 1989. So were the pound and the peseta for much shorter periods (because they entered the Exchange Rate Mechanism of the EMS only in the late 1990s).

several occasions in support of the French Franc as it felt that the “fundamental” French economic developments and policies were “in order”. The help in favour of the lira and the pound was instead often less convinced, especially in September 1992, when the lira and the pound had to abandon the system. Despite this probably justified bias in favour of the French Franc, the speculation became so strong in mid 1993 that the band around the central parity of several currencies still participating in the system, including the French Franc, had to be widened on August 3 to  $\pm 15\%$ .

However, the August 1993 move to what may be seen as an almost flexible exchange rate system has not stopped the process of monetary integration in Europe, also thanks to the fact that the French Franc has remained almost all the time since then within the  $\pm 2,25\%$  band and thanks to the fact that the central rate has not been changed.

Before I come to the question of whether an EMS-like arrangement is exportable to the countries of MERCOSUR it is worth analysing why the EMS was created in the first place. The reasons were five:

- 1) Trade integration in Western Europe was very high and has been growing since 1979 (see Table 1) and the degree of openness of some countries, especially the smaller ones is very high indeed. Under such circumstances a high variability of the nominal and real exchange rates is damaging for the volume of exports and of GDP. Although the stability of the nominal exchange rate with the main trading partners does not guarantee the stability of the real exchange rate and of competitiveness, it was hoped that the former coupled with convergence of inflation would entail the latter.
- 2) The negative experience with flexible exchange rates of the 1970s led European leaders to seek more stable exchange rate arrangements.
- 3) The desire by strong currency countries (Germany in particular) to avoid excessive overvaluations of the effective exchange rate led Germany to seek a closer tie with the weaker currencies of the main European trading partners, while the higher inflation countries (Italy and France) had an interest in seeking a closer link with the Deutsche Mark (DM) in order to import credibility and reduce thereby the social cost of disinflation.
- 4) The management of the already complex common agricultural policy had become a nightmare with the advent of flexible exchange rates in 1973.



**Table 1**  
 OPENNESS:  
 IMPORTS AS A SHARE OF GDP

	(1960)	(1987)
Belgium	39,3	75,6
Ireland	37,2	60,0
Netherlands	45,9	59,3
Denmark	33,4	36,7
Germany	16,2	28,5
United Kingdom	22,4	28,2
France	12,9	25,0
Italy	12,5	23,4
EC12	10,4	12,3
United States	4,4	10,1
Japan	11,0	11,4

Source: *European Economy*, n. 34, nov. 1987.

- 5) There was still is, especially after the signature of the Maastricht Treaty, a political objective of greater European Unity behind all projects of greater exchange rate and monetary coordination in Europe. I feel that in the minds of the key French and German politicians of the last decades (Giscard d'Estaing, Mitterand, Delors, Helmut Schmidt and Kohl) this political objective was the main driving force behind the process of monetary integration in Europe. The EMS and EMU are in their minds the horses of Troy to get to closer political unity.

Especially after the fall of the Berlin wall in 1989 the powerful German financial community led by the BUNDESBANK may have seen the immense opportunities opening up in the East of Europe and may have felt the temptation to move freely, (that is without the ties and constraints stemming from closer monetary, financial and political links with Western Europe), towards the economic conquest of the East, a conquest which had failed by military means almost 60 years earlier. Hence the urgent need felt also by enlightened Germans to tie in forever Germany into a web of close and irreversible political alliances with Western Europe, before Germany overcomes the economic problems caused by the German reunification. If Europe waits 5-6 more years, it will be too late to proceed towards more political integration. This at least is the thinking of the former German

Chancellor Helmut Schmidt and I tend to agree with him (see his book "Handeln fuer Deutschland", Rowohlt, 1994).

## **b) Is the EMS exportable to MERCOSUR?**

If we now ask ourselves which of these five reasons could be valid for MERCOSUR to create an EMS like arrangement we see immediately that the political objective (point 5) is lacking and that the degree of openness of Brazil and Argentina is quite low compared to European Union members (point 1). In 1994 imports of goods were only 5.8% of GDP in Brazil and 7.6% in Argentina (cfr Table 1). In addition as Tables 2 and 5 show, at least large MERCOSUR countries are not as important in each other's trade as their geographical proximity would suggest<sup>5</sup>. However, the degree of trade integration is to a large extent endogenous. When a group of countries decide to form a customs union and to reduce tariffs and quotas among themselves, trade integration can increase very rapidly. This has happened in MERCOSUR countries in the last years (see Tables 2 and 5). For the Central European countries the degree of trade diversion away from Russia towards countries of the European Union with which they signed trade agreements in 1991 has been even more remarkable and fast (see Tables 6 and 7).

Furthermore MERCOSUR is lucky enough not to have the monster of the European Common Agricultural Policy (point 4). Finally no country in MERCOSUR has such a good and long standing inflation record as Germany that the others may want to choose its currency as the anchor for inflation (point 3). Argentina has chosen the US Dollar and Brazil also, albeit in a more flexible way.

Yet, a properly functioning trade area like MERCOSUR needs to set up sooner or later a common exchange policy *vis-à-vis* each other's currencies and *vis-à-vis* third currencies. The reason being that excessive changes in real exchange rate and competitiveness have to be avoided if trade integration is to continue. In the next section I shall argue that an EMS-like arrangement of the type that was in operation from 1983 to 1987 would be very useful and to be recommended for MERCOSUR. I realize that the time may not be ripe enough for such an arrangement, but that's where MERCOSUR should be heading in its own interest.

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5 It is worth noting, however, that Brazil has a much higher share in Argentinian imports, (19% in 1994) than Argentina in Brazilian imports (11% in 1994, see Tables 2 and 3). This may contribute to explain why in early 1998 Argentina was worried that Brazil would devalue its currency, after the East Asian crisis which started in July 1997 had already weakened both South American countries.



Table 2

## DIRECTION OF TRADE – ARGENTINA

	%								
	1988	1989	1990	1991	1992	1993	1994	1995	1996
<b>EXPORTS</b>									
Germany	5,30	4,32	5,26	6,11	5,97	4,76	3,66	3,10	2,37
Italy	3,72	3,03	4,25	4,79	4,30	3,84	3,96	3,51	3,03
France	1,60	1,52	1,90	2,07	2,18	1,58	1,31	1,52	1,25
UK	0,93	1,21	1,50	1,64	1,38	1,23	1,34	1,48	1,50
US	13,3	12,4	13,75	10,39	11,02	9,74	10,50	8,60	8,30
Japan	3,64	2,82	3,19	3,79	3,06	4,67	2,69	2,18	2,15
Other ind. countries	20,84	19,59	19,84	20,55	18,43	17,99	15,68	13,45	12,14
Russia	9,41	8,67	4,03	1,87	0,87	1,10	0,24	0,43	0,63
Brazil	6,65	11,75	11,51	12,43	13,65	21,45	22,11	26,17	27,80
Chile	2,83	3,66	3,73	4,07	4,74	4,51	6,04	7,04	7,42
Uruguay	2,04	2,17	2,12	2,59	3,13	3,90	3,93	3,16	3,05
Other developing countries	29,74	28,86	28,92	29,70	31,27	25,23	27,97	29,02	29,81
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>
<b>IMPORTS</b>									
Germany	11,39	9,38	10,00	7,86	7,28	6,10	6,04	6,21	6,00
Italy	5,80	5,78	4,95	4,52	5,12	5,84	6,26	6,26	6,33
France	4,28	4,45	3,53	3,61	3,86	4,40	4,68	5,17	4,97
UK	0,02	0,02	1,02	1,32	1,32	1,53	1,55	2,05	2,37
US	17,25	21,23	21,48	18,03	21,70	23,00	21,54	20,90	19,99
Japan	6,56	4,30	3,26	7,24	4,68	3,98	2,71	3,53	3,05
Other ind. countries	13,75	14,50	14,63	10,54	10,33	10,10	14,10	13,78	12,41
Russia	0,34	0,54	0,29	0,30	0,20	0,27	0,25	0,43	0,41
Brazil	18,25	17,16	17,60	18,44	22,46	21,27	18,74	20,75	22,42
Chile	2,76	2,64	2,74	2,84	4,29	4,18	3,63	2,55	2,35
Uruguay	2,46	2,35	2,84	1,99	2,36	3,40	3,45	1,43	1,26
Other developing countries	17,14	17,65	17,66	23,31	16,40	7,66	16,74	16,80	18,41
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>

– Data for 1996 are provisional.

– Figures may not add up exactly to 100 due to rounding errors.

Table 3

## DIRECTION OF TRADE - BRAZIL

	%								
<b>EXPORTS</b>	<b>1988</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Germany	4,21	4,84	5,64	6,82	5,59	4,70	4,70	4,63	4,36
Italy	4,07	5,06	4,94	4,27	4,27	3,38	3,77	3,67	3,21
France	2,51	2,80	2,76	2,73	2,27	2,03	2,06	2,23	1,91
UK	3,15	3,15	2,89	3,34	3,47	2,93	2,82	2,85	2,77
US	25,80	24,63	23,68	20,19	19,11	20,69	20,56	18,88	19,50
Japan	6,73	7,07	7,19	8,08	6,22	5,96	5,90	6,65	6,38
Other ind. countries	18,70	20,04	20,96	17,92	19,18	15,94	17,29	17,13	17,35
Russia	0,68	0,93	0,63	0,27	0,28	0,02	0,39	1,22	0,97
Brazil	2,88	2,17	1,97	4,66	8,20	9,43	9,48	8,67	10,82
Chile	1,60	2,12	1,48	2,14	2,49	2,86	2,29	2,60	2,21
Uruguay	0,95	1,02	1,20	1,06	1,38	1,99	1,68	1,74	1,70
Other developing countries	28,72	26,17	26,66	28,52	27,54	30,07	28,14	28,75	28,00
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>
<b>IMPORTS</b>	<b>1988</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Germany	9,52	7,33	8,95	8,74	9,24	8,58	10,25	9,54	8,92
Italy	1,95	2,33	3,22	3,64	4,01	3,57	6,23	5,77	5,43
France	3,82	2,82	2,79	2,80	2,84	2,62	2,61	2,80	2,51
UK	2,68	2,33	2,02	2,10	1,97	1,98	2,30	1,97	2,33
US	20,85	20,90	19,83	23,24	24,52	23,49	20,57	21,12	22,2
Japan	6,59	6,60	7,09	5,81	5,59	5,90	7,29	6,62	5,15
Other ind. countries	12,13	13,43	11,17	12,95	11,72	12,60	11,10	12,3	12,12
Russia	0,19	0,20	0,56	0,61	0,88	0,18	1,32	0,80	0,72
Brazil	4,60	6,47	6,66	7,52	8,37	9,97	11,07	11,25	12,65
Chile	2,28	2,74	2,31	2,27	2,32	1,67	1,79	2,21	1,72
Uruguay	1,96	2,99	2,61	1,92	1,65	1,56	1,72	1,49	1,74
Other developing countries	33,43	31,86	32,79	28,40	26,89	27,88	23,75	23,66	23,80
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>

- Data for 1996 are provisional.

- Figures may not add up exactly to 100 due to rounding errors.



Table 4

## DIRECTION OF TRADE - URUGUAY

	%								
<b>EXPORTS</b>	<b>1988</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Germany	8,29	7,99	7,63	8,62	8,14	6,27	9,78	5,61	4,71
Italy	3,80	3,53	4,33	3,90	4,62	2,95	3,13	3,11	3,54
France	2,90	2,85	3,00	2,58	2,34	1,75	1,72	1,13	1,13
UK	4,01	3,96	4,10	3,77	4,07	3,92	3,76	4,19	3,59
US	11,20	10,97	9,47	10,13	10,67	9,05	6,26	5,94	7,10
Japan	1,31	1,17	1,21	1,25	1,23	0,84	1,09	0,89	1,04
Other ind. countries	20,19	8,46	8,87	8,79	9,05	7,68	8,30	8,48	7,84
Russia	5,67	4,09	5,08	3,14	na	na	0,47	0,33	0,58
Brazil	16,32	27,34	29,24	24,18	17,53	22,08	25,70	33,09	34,66
Chile	0,82	1,05	0,98	1,38	3,08	3,13	2,14	1,88	1,79
Uruguay	7,26	4,83	4,73	10,26	15,43	19,07	19,95	12,63	11,35
Other developing countries	18,23	23,76	21,36	22,00	na	na	17,70	21,92	22,07
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>
<b>IMPORTS</b>	<b>1988</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Germany	6,37	6,09	6,90	4,89	4,52	3,90	3,63	3,63	3,00
Italy	2,46	2,58	3,64	2,96	3,43	3,94	4,85	5,16	5,14
France	4,41	3,09	2,88	3,35	3,03	3,00	3,09	3,49	3,55
UK	3,05	2,84	2,96	2,38	1,94	1,75	1,47	1,43	1,56
US	7,90	9,52	10,47	9,85	9,30	9,64	9,33	9,90	12,22
Japan	2,97	2,84	3,26	3,80	4,97	5,48	2,84	2,55	2,16
Other ind. countries	9,54	7,54	4,81	7,17	7,13	8,65	9,91	9,21	8,12
Russia	1,78	0,33	3,34	0,19	na	na	0,78	0,38	0,54
Brazil	26,08	26,73	23,00	24,03	23,63	27,48	25,46	24,38	22,45
Chile	1,95	1,67	1,51	1,67	1,69	1,62	1,58	1,71	1,65
Uruguay	15,20	15,70	16,85	17,52	17,21	30,32	23,45	21,24	20,79
Other developing countries	18,29	21,07	20,38	22,19	na	na	13,17	16,32	18,26
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>

- Data for 1996 are provisional.

- Figures may not add up exactly to 100 due to rounding errors.

Table 5

## DIRECTION OF TRADE – PARAGUAY

	%							
<b>EXPORTS</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Germany	2,27	4,58	4,88	3,04	0,82	1,59	1,71	1,40
Italy	2,37	2,71	5,29	3,34	2,34	2,94	3,13	2,03
France	0,79	1,14	1,49	2,13	1,65	1,47	2,42	1,33
UK	0,49	0,52	0,54	0,76	1,93	0,61	0,71	1,87
US	4,16	4,27	4,74	5,32	7,31	6,97	4,23	3,35
Japan	0,19	0,31	0,54	0,30	0,13	0,12	1,21	6,40
Other ind. countries	32,91	28,07	24,58	26,81	31,47	22,64	18,38	16,07
Russia	na	na	na	na	0,13	-	-	-
Brazil	32,50	32,53	27,54	26,02	29,65	39,65	40,26	44,23
Chile	4,85	5,73	6,10	9,74	8,96	11,14	8,07	11,00
Uruguay	1,09	1,25	1,49	1,67	0,96	1,22	3,03	2,26
Other developing countries	na	na	na	na	5,96	11,62	16,85	10,06
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>
<b>IMPORTS</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Germany	4,53	4,94	4,20	4,08	3,57	3,48	2,64	2,70
Italy	0,90	1,92	2,41	2,08	1,28	1,81	2,11	1,97
France	1,51	2,76	1,63	1,76	1,41	1,39	1,21	0,94
UK	4,08	3,93	4,44	4,49	3,50	2,69	3,18	2,03
US	14,67	12,74	14,80	13,95	14,30	11,70	12,33	16,91
Japan	12,40	15,67	12,86	11,30	11,53	8,96	8,44	4,13
Other ind. countries	3,66	2,88	3,07	3,39	3,74	3,85	3,18	9,49
Russia	na	na	na	0,48	0,26	-	-	-
Brazil	26,77	17,35	18,23	21,09	22,94	25,77	23,06	29,95
Chile	10,28	12,65	11,84	16,11	14,23	14,30	17,55	13,90
Uruguay	0,90	0,75	0,77	0,88	1,28	1,35	1,21	1,49
Other developing countries	na	na	na	20,39	21,96	24,71	25,06	16,42
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>

- Data for 1996 are provisional.

- Figures may not add up exactly to 100 due to rounding errors.



**Table 6**  
DIRECTION OF TRADE – HUNGARY

	%							
<b>EXPORTS</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Germany	11,87	20,21	27,47	27,69	25,30	28,50	28,67	29,00
Italy	4,65	5,89	7,73	9,51	8,30	8,55	8,52	8,03
France	2,37	2,70	2,93	3,20	3,58	3,58	4,03	3,70
UK	1,82	2,04	2,08	1,99	2,36	4,39	3,05	3,00
US	3,30	3,56	3,24	3,20	4,35	4,07	3,21	3,53
Japan	1,15	1,16	1,76	0,91	1,00	0,87	0,60	0,77
Other ind. countries	15,20	17,26	22,22	22,30	21,09	21,57	22,34	22,00
Russia	24,99	20,24	12,03	13,08	14,00	7,62	6,40	6,00
Other developing countries	34,65	26,95	20,55	18,12	20,03	20,86	23,19	24,00
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>
<b>IMPORTS</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Germany	15,88	23,36	21,83	23,46	21,50	23,55	23,43	23,57
Italy	3,33	4,05	7,50	6,28	6,05	7,04	7,88	8,10
France	2,18	2,05	2,75	3,05	3,37	3,44	3,95	4,24
UK	2,18	2,12	2,54	2,89	2,58	3,95	3,09	3,26
US	2,50	2,64	2,70	2,90	4,04	3,13	3,12	3,51
Japan	1,59	2,10	2,83	2,37	2,79	2,72	2,19	2,23
Other ind. countries	18,76	20,78	25,73	24,76	24,50	26,60	26,04	23,29
Russia	22,05	19,07	14,35	16,75	20,93	12,08	11,88	12,47
Developing countries	31,52	23,83	19,77	17,54	14,25	17,49	17,64	19,33
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>

– Data for 1996 are provisional.

– Figures may not add up exactly to 100 due to rounding errors.

Table 7

## DIRECTION OF TRADE - POLAND

	%							
<b>EXPORTS</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Germany	14,16	25,11	29,43	31,34	36,36	35,67	38,34	34,44
Italy	2,30	2,95	4,09	5,52	5,23	4,96	4,91	5,55
France	2,43	3,22	3,78	3,63	4,19	4,00	3,58	4,40
UK	6,48	7,12	7,10	4,30	4,31	4,54	4,00	3,93
US	2,80	2,76	2,48	2,35	2,90	3,44	2,72	2,31
Japan	1,40	0,81	0,57	0,51	0,34	0,22	0,19	0,21
Other ind. countries	18,28	22,72	25,76	20,71	21,45	22,20	21,17	20,77
Russia	20,79	15,27	10,97	5,48	4,56	5,42	5,56	6,77
Other developing countries	31,35	20,02	15,81	26,16	20,66	19,19	19,3	21,36
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>
<b>IMPORTS</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Germany	15,73	20,11	26,53	23,89	28,07	27,47	26,63	24,68
Italy	4,14	7,47	4,46	6,90	7,79	8,41	8,55	9,93
France	3,12	3,01	3,62	4,43	4,26	4,51	4,89	5,46
UK	4,64	5,64	3,97	6,64	5,75	5,28	5,17	5,89
US	1,36	1,62	2,26	3,43	5,18	3,90	3,92	4,43
Japan	1,36	2,30	1,61	2,10	1,75	1,63	1,65	1,63
Other ind. countries	22,34	23,56	26,25	22,12	23,08	23,6	23,02	21,13
Russia	18,09	19,83	14,11	8,50	6,74	6,74	6,75	6,80
Developing countries	29,22	16,46	17,19	21,99	17,38	18,12	19,24	19,89
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>

- Data for 1996 are provisional.

- Figures may not add up exactly to 100 due to rounding errors.

## 2 HOW TO AVOID EXCESSIVE CHANGES IN COMPETITIVENESS WITHOUT RENOUNCING TO AN EXTERNAL (EXCHANGE RATE) INFLATION ANCHOR

Four periods can be distinguished in the history of the EMS. Although only during one period the system was managed in such a way that it may represent an example for MERCOSUR to follow, all periods are nevertheless instructive.

**The first period** goes from March 1979 to March 1983. It was characterized by the adjustment of member countries to the second oil shock, different monetary and fiscal policies followed by individual member countries and hence frequent “realignments” of bilateral exchange rates<sup>6</sup>. In the EMS, realignments were common decisions of all Ministers of Finance. Ministers of Finance of the EMS countries meet regularly every month (ECOFIN meetings) and on special request of countries hit by a currency crisis and demanding a realignment. The ECOFIN meetings to discuss realignments are preceded by technical meetings of the “Monetary Committee” (composed of high officials of the Central Banks and the Ministries of Finance) which analyses if the developments of “economic fundamentals” justify a realignment and proposes the amount of the realignment to the ECOFIN. The devaluation of the central rate requested by countries were sometimes denied and frequently reduced in amount. The nominal exchange rate did exercise to some extent the role of inflation anchor for higher inflation countries, as the nominal devaluations granted were usually inferior to the accumulated inflation differential since the previous realignment. It followed that the real exchange rates of higher inflation countries tended to appreciate, making inflation costly in terms of competitiveness lost. This provided an incentive for governments to try to reduce inflation to German levels.

**The most interesting period** and the period during which the EMS worked best was the period from March 1983 to January 1987. In March 1983, the French government decided to start coordinating monetary and fiscal policy much more closely with Germany and to follow more orthodox policies. The socialist government of President Mitterand reneged on its 1981 electoral campaign promises: it stopped nationalizations, it reversed fiscal policies and became much tougher on wage policy. This change in attitude which had strong effects also on the behaviour of other countries like Belgium and Italy is called the French U-turn. After March 1983 the realignments within the system became more rare, but central rates were still changed when the accumulated inflation differentials had become significant in order to avoid excessive changes in competitiveness. In other words, the system was managed flexibly enough to strike a reasonable

6 Realignment are changes in the central rate with the Deutsche Mark and the ECU.



balance between the objective of reducing average inflation in Europe (letting the nominal exchange rate with the DM play the role of inflation anchor) and the objective of preventing the accumulation of excessive losses of competitiveness for weak currency countries or gains for Germany and the Netherlands.

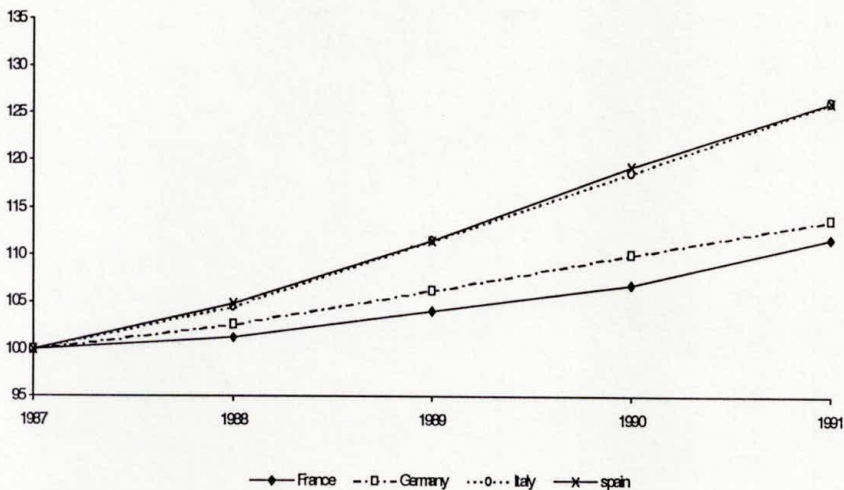
**The third period** goes from January 1987 to September 1992. In January 1987 the last general realignment of the system occurred and until September 1992 no general realignment took place<sup>7</sup>. In September 1992 the system almost broke down with the exit of the Italian Lira and the British Pound. The problem with how the system was managed from January 1987 to September 1992 was that exchange rates were kept too rigid, considering the lack of sufficient convergence in fiscal policy and the very large shock caused by the German reunification, a shock which initially helped nominal exchange rates to remain stable by increasing inflation in Western Germany to almost 5% in 1991 and removing very rapidly the huge German current account surplus (almost 4% of GDP in 1989). But when at the end of 1991 the BUNDESBANK started to increase in successive steps the degree of restrictiveness of monetary policy, despite the approaching European slowdown, the system came under heavy pressure. The problems for the system had already begun in April 1992 after the Danes had voted against the Maastricht Treaty in a referendum. When on July 16 the BUNDESBANK further increased the discount rate the strain on the system became unbearable. In addition, the Italian fiscal restriction of July 1992 was considered insufficient by the markets to allow Italy to join EMU prevailing at the central rate.

As the system had become a system of perfectly fixed exchange rates without sufficient convergence, excessive changes in the real exchange rates had been allowed to accumulate. Fig. 1 shows that the real exchange rates of the lira and the peseta with the DM had appreciated between 1987 and 1991 by about 15%. The real exchange rate of the French Franc had appreciated by much less but at a high cost in terms of unemployment. Fig. 2 shows that there had been in the period a substantial convergence of inflation which gave to many the illusion that everything was fine with existing central parities. The inflation convergence was, however, hiding large accumulated losses in competitiveness, as shown above in Fig. 1. Brazil and Argentina may be experiencing a similar problem at the time of writing (December 1996), as suggested by Fig. 3 and 4 and Tables 9 and 10<sup>8</sup>.

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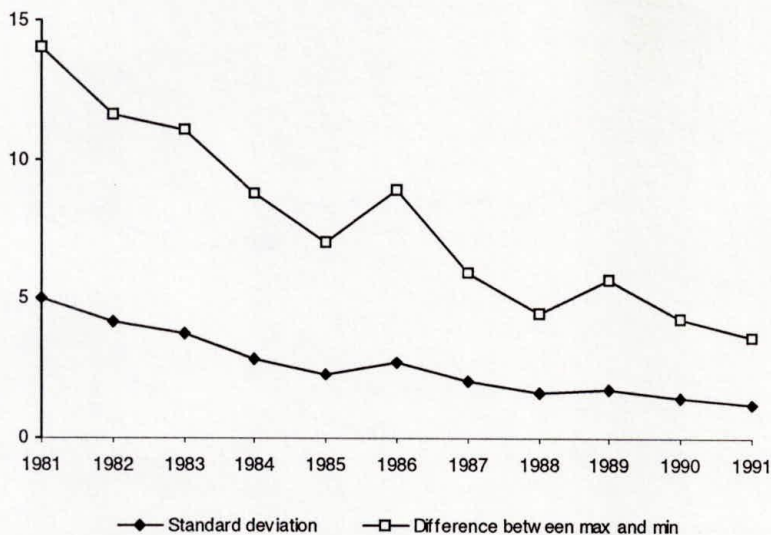
7 For the sake of completeness we should report that the lira's central rate was devalued slightly at the end of 1989 when the band was also reduced from  $\pm 6\%$  to  $\pm 2.25\%$ .

8 By March 1998 the real effective exchange rate of the Argentinian peso had appreciated by another 7.6% with respect to the average of 1996. The Brazilian "real" had appreciated by another 8.1% in the same period. (World Financial Markets, J. P. Morgan, 2<sup>nd</sup> quarter, 1998)



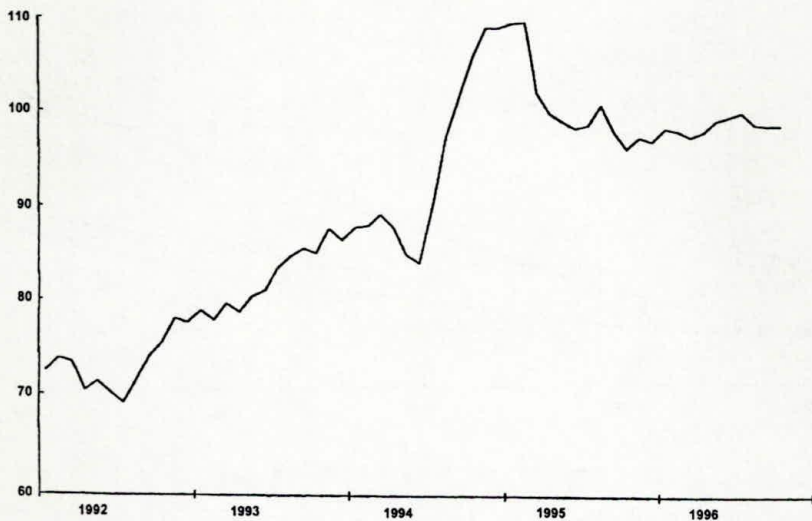
Source: International Monetary Fund. *International Financial Statistics*: reproducer from De Graue, Micossi, Tullio (eds.) 1996.

**Figure 1: PRICE INDICES IN 4 EMS – COUNTRIES SINCE 1987**

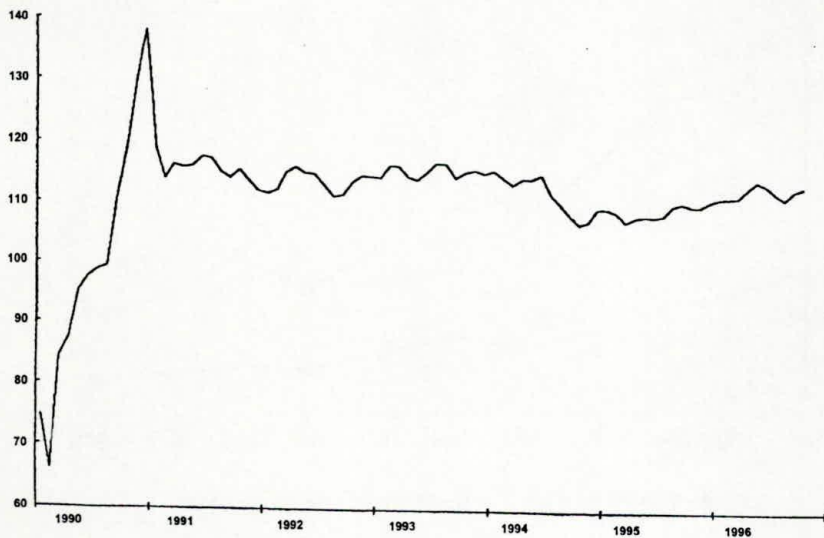


Source: International Monetary Fund. *International Financial Statistics*: reproducer from De Graue, Micossi, Tullio (eds.) 1996.

**Figure 2: NATIONAL DIFFERENCES IN INFLATION: 1981-1991 IN EMS CONTRIES (%)**



**Figure 3: REAL BROAD EFFECTIVE EXCHANGE RATE – BRASIL**  
*Index 1990=100*



**Figure 4: REAL BROAD EFFECTIVE EXCHANGE RATE – ARGENTINA**



**Table 8**

**ITALY, CURRENT ACCOUNT BALANCE  
AND REAL EFFECTIVE EXCHANGE RATE, 1990-1997**

	Current account in % of GDP	Real effective exchange rate (1993 = 100)	Nominal effective exchange rate (% change)	Consumer price inflation
1990	-1,3	121,2	1,5	6,5
1991	-1,9	124,1	-1,4	6,3
1992	-2,2	118,5	-3,5	5,2
1993	1,2	100,0	-16,7	4,5
1994	1,5	95,0	-4,6	4,0
1995	2,5	84,6	-10,0	5,2
1996	3,4	96,6	9,4	4,0
1997***	3,6	n.a.	n.a.	2,0

Source: Banca d'Italia, Annual Reports, various issues.

\* Based on unit labour costs; a decline in the index indicates a depreciation.

\*\* With respect to previous year, annual averages; a - sign indicates a depreciation.

\*\*\* Forecasts.

**Table 9**

**ARGENTINA - SUMMARY MACROECONOMIC STATISTIC**

	1991	1992	1993	1994	1995	1996e	1997f
Inflation (%)	172	24,6	10,6	4,3	3,4	0,2	0,5
Real GDP (%)	8,9	8,7	6,7	7,4	-4,4	4,3	7,6
Real exch rate (1990 = 100)	115,4	113,5	117,6	113,9	111,1	115,1	122,8
Current account/GDP				-3,5	-0,9	-1,3	-2,8

Sources: IFS (IMF), World Financial Markets (J. P. Morgan), estimates for 1996 and forecasts for 1997 are from J. P. Morgan.

**Table 10**

## BRAZIL - SUMMARY MACROECONOMICS STATISTIC

	1991	1992	1993	1994	1995	1996e	1997f
Inflation (%)	414,7	991,4	2103,7	2669	84,4	15,5	6,0
Real GDP (%)	0,3	-0,8	4,2	5,8	4,2	2,9	3,5
Real exch. rate (1990 = 100)	80,4	73,1	83,0	94,7	101,7	99,1	105,3
Current account/GDP				-0,3	-2,6	-3,3	-4,4

Sources: See Table 9.

**The fourth period** starts in September 1992 and is marked by frequent and large realignments of the central rate of most of the currencies which remained in the exchange rate system (The Spanish Peseta, the Portuguese Escudo and the Irish Punt), the enlargement of the band from  $\pm 2.25\%$  to  $\pm 15\%$  in August 1993 (which became necessary in order to allow the French Franc not to abandon the system and not to realign in the face of large speculative attacks), a large overshooting of the lira and the peseta, fiscal and monetary restriction in most countries in preparation for the European Monetary Union.

Three facts are worth mentioning concerning this period. First, the progress in the important institutional changes required by the Maastricht Treaty in order to join EMU has not stopped. For instance, the French and the Italian central banks are now completely independent from the government. Second, the large real depreciation of the peseta, the pound and especially of the lira became a threat to free trade within the European Union. Particularly the French were very upset and requested that European Commission Structural Funds be used to help French enterprises in difficulty because of "unfair" competition from Italian and Spanish firms.

Third, a remarkable fact which may have important implications for MERCOSUR is that the years from 1992 to 1996 have shown that even very large nominal depreciations of the exchange rate have had virtually no impact on inflation in Sweden, Finland, Italy, the UK and Spain, contrary to the expectations of most. In other words, even for very open economies, significantly more open than Brazil and Argentina, the pass-through from exchange rate depreciations to inflation can be very small if the monetary and fiscal policies followed are appropriate to combat inflation or to keep it low. Table 8 shows that despite a cumulated depreciation of the nominal effective exchange rate of the lira of over 35% from 1992 to 1995, inflation did not accelerate. In short, from this point of view, European countries have



turned out to be much “larger” than most scholars thought (De Grauwe and Tullio, 1994 and Amitrano, De Grauwe and Tullio, 1997). On the contrary, the impact of the large depreciations on the current account have been remarkable and long-lasting. For instance, Italy’s current account turned from a deficit of 2.2% of GDP in 1992 to a surplus of 3.5% on average in 1996 and 1997 (Table 8).

This raises the issue of whether internal anchors (the right monetary policy) may not at times be better than external anchors (the fixing of the nominal exchange rate) to combat inflation. The choice of the anchor depends crucially on the degree of openness of the country, on the probability of the occurrence of external shocks and (in particular of asymmetric shocks) and on the degree of credibility which governments have. As the European experience after 1992 has shown that the pass-through was substantially smaller than we thought, it follows that the usefulness of an external anchor may be less than we imagined. I will treat these issue in more detail later when I draw the conclusions for MERCOSUR.

The main message I want to draw from this brief history of the EMS is the following: if MERCOSUR countries want to move towards closer trade and financial integration they have to avoid large changes in competitiveness among themselves. They will have to think about coordinating exchange rate policy. A system like the EMS from 1983 to 1987 is something they may want to consider, sometime in the future. They could also draw some lessons from the excessive rigidity of central parities within the EMS from 1987 to 1992. Especially Argentina ought to think very carefully about the very high social costs of an inflexible exchange rate policy. Apart from the interest rate and capital outflow shock of 1995, the severity of which has certainly been magnified by the exchange rate policy followed, Argentina has been lucky enough not to experience so far in the 1990s any serious and long-lasting shock in raw material prices, nor any serious slowdown in world economic activity. An inflexible exchange rate policy can be very costly for a well diversified industrial country which is well integrated with the partners with which it fixes the exchange rate. It can be many times more costly for a less diversified country like Argentina, relying heavily on raw material exports and in addition burdened by a non-negligible foreign debt.

This arguments hold for Brazil as well, although to a smaller degree, first because it has adopted a more flexible exchange rate policy since the July 1994 monetary reform, second because it is more closed and more diversified.

Another reason for needing some exchange rate flexibility is that productivity growth and economic transformations in general are going to be very substantial in the years to come in MERCOSUR and certainly larger than in the country chosen as the anchor, the US. In addition, these transformations will not proceed at the same pace in MERCOSUR members.



### 3 REAL EXCHANGE APPRECIATIONS IN MERCOSUR AND THEIR SOCIAL COSTS

Argentina and Brazil, much like the “weak” currencies of the EMS between 1987 and 1992, have also experienced a real exchange rate appreciation since the stabilization of inflation which started in 1991 in Argentina and in July 1994 in Brazil (see Fig. 3 and 4 and footnote 9). The competitiveness indices shown in Fig. 3 and 4 are based on wholesale prices which contain a higher share of traded goods than consumer prices and therefore are more influenced by the exchange rate. Measures of competitiveness based on consumer prices or calculated as the ratio between prices of non-traded goods and traded goods show even larger appreciations of the real exchange rate for both countries. Real exchange rate appreciations are of course compatible with long run equilibrium if productivity growth in the appreciating countries is higher than abroad. However, if productivity growth occurs at the expense of a substantial increase in the rate of unemployment one cannot really talk of an appreciation which is compatible with long run macroeconomic equilibrium. Similarly, the stability of the real exchange rate achieved at the expense of increased unemployment and deflation like in the case of Argentina in the last years could indicate that the nominal exchange rate is out of line.

In order to assess the consequences of exchange rate based stabilization in Argentina and Brazil, we present in Tables 9 and 10 some key macroeconomic variables for these two countries. In Argentina the appreciation of the real exchange rate as measured in Fig. 4 has been prevented by deflation and an unsustainable increase in unemployment. In addition, the exchange rate policy followed has probably made real GDP in Argentina more vulnerable than in Brazil to the 1995 Mexican shock (real GDP fell by 4.4% in Argentina and increased by 4.2% in Brazil (see Tables 9 and 10). One could of course argue that the 1995 slowdown in Argentina was to some extent also the natural outcome of a remarkable four year economic expansion which followed the 1991 stabilization, while in Brazil the end of hyperinflation in 1994 did not bring about the astonishing growth rates observed in Argentina.

However, it could also be that the strategy followed in 1995 by Brazil may contribute to explain the better performance in that year, as the nominal and real exchange rate of the Brazilian currency were allowed to depreciate at the beginning of the crisis. The advantages of this more flexible exchange rate strategy may become even should raw material or financial shocks occur or should the world economy slow down. These advantages will be larger the more the Brazilian Central bank is able to gain credibility.

In conclusion, there is a problem with the exchange rate policy followed by Argentina since about 1994 and the more flexible policy followed by Brazil seems to me superior. In addition, a 2-3% consumer price inflation for a country undergoing rapid transformations is too low because large relative price changes occur and the cost Argentina is paying for such a low inflation seems to me too high. And imagine how much larger the costs could have been if an adverse major raw material shock had occurred between 1991 and 1996 unless one is convinced that prices and wages are very flexible downwards, which does not seem to be the case in any country of the world, including Argentina. This is the main conclusion of the theory of *optimum* currency areas. The US and Argentina are by no means an *optimum* currency area. Argentina has just been quite lucky so far in the 1990s when the business cycles of the major countries in the world (the US, Japan and the European Union) were largely out of phase with each other. Let's hope that Japan and the European Union will take over from the US the function of keeping the world business cycle on a steady path when in a year or two the US expansion come to an end! Only god knows what the future has in store and it is better for countries to be ready for any event much like airplanes whose structures should be such as to resist even the worst of possible storms.

The imperfect mobility of labour between the countries of the European Union in the face of possible asymmetric shocks and the downward rigidity of prices and wages in Europe are the main arguments against EMU. Yet the structure of production, exports and imports of European Union countries are rather similar and certainly much more similar than between the US and Argentina. Argentina and the US have *de facto* formed a monetary union and the likelihood of asymmetric macroeconomic shocks hitting the US and Argentina is therefore much higher than for most of the countries that are candidates of EMU. There may be some problems for the UK and Norway because they are both oil exporters and for Greece, Portugal and Southern Italy because their structure of production is somewhat different. However, asymmetric relative price shocks like oil shocks are best dealt in Western Europe by favouring relative price changes rather than exchange rate changes. In the early 1980s the increase in the price of oil after the second oil shock led to a large appreciation of the British Pound which had dramatic consequences for the competitiveness of British industry. The United Kingdom would have been better off with fixed exchange rates within the ERM.

For Argentina and Brazil instead a generalized fall in prices of the raw materials they export would amount to a macroeconomic shock because of the greater importance raw materials and agricultural products have in their exports and in the economy as a whole. This holds especially for Argentina.



## 4 WHAT INFLATIONARY ANCHOR FOR MERCOSUR COUNTRIES

In the previous Section we have talked about the dangers of keeping the exchange rate of the peso with the dollar fixed in the face of any external circumstance. Similarly, there are dangers involved in reducing too much the exchange rate flexibility of the Brazilian Real. Let's assume that the main advice I give in this paper is followed and that MERCOSUR adopts sooner or later an EMS like arrangement of the type we experienced in Europe from 1983 to 1987. How would inflationary expectations in MERCOSUR countries be stabilized and how could one substitute the role the US Fed is playing now in Argentina, since no government or central bank within MERCOSUR has achieved yet the reputation and credibility of the BUNDESBANK or of the US Fed. Three things should be done.

**First** of all, monetary and fiscal policy within MERCOSUR should be coordinated more than at present. This is a precondition for the smooth functioning of an adjustable exchange rate peg of the type I am proposing.

**Second**, central banks in MERCOSUR should be made more independent from the government and be assigned an inflation target which should be coordinated among them as argued under point I above. It need not be the same across members for a long time since MERCOSUR countries will undergo in the next years transformations of different speeds and will experience different rates of economic and productivity growth.

**Third**, the exchange rate with the dollar should not be allowed to fluctuate freely. The Central Bank of Brazil will continue to announce a corridor of the "real" with US Dollar and keep it within the corridor. As a result, all member currencies will have a corridor with the US dollar. This way some credibility will continue to be imported from the US for the system as a whole and the anchoring of inflationary expectations will not rely only on announced internal inflation targets. At the same time central rates should be set for the four MERCOSUR currencies *vis-à-vis* each other, with a reasonable band around the central rate. The central rates should be adjustable. The Ministers of Finance of the four countries will convene on a regular basis (and whenever required) to discuss bilateral exchange rates among each other and their common exchange rate with the US Dollar. No bilateral rate will be allowed to change without an unanimous vote or without qualified majority<sup>9</sup>.

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9 See the role of ECOFIN and of the Monetary Committee in the European Union, described above in Section 2.



If it is politically unfeasible to attribute to the Brazilian Central Bank the duty to manage on a day-to-day basis the exchange rate of the Real with the US Dollar, following the monthly or bi-monthly instructions of the Council of the four Finance Ministers, one can alternatively create a Common Foreign Exchange Board which manages the exchange rates of the four currencies *vis-à-vis* the US Dollar. However, as Brazil is the largest country in the group it would be much simpler if it took care of dollar interventions following the instructions of the four Ministers of Finance of the member countries as suggested above<sup>10</sup>.

The adoption of a 1983-87 type of exchange rate system in MERCOSUR would also have two further advantages. First, unpopular fiscal measures that may have to be taken in member countries may be politically easier to justify if the severity is imposed by MERCOSUR Finance Ministers in the name of closer integration and coordination among members and more economic growth in the long run, than if the imposition comes from monetary policies of the US Fed, (which cares, anyway, very little about the negative consequences of its actions on other countries) or from the IMF. Second, in the name of further integration of MERCOSUR countries and hence of higher economic growth, it may be politically easier for Argentina to change its current exchange rate policy, both internally and *vis-à-vis* world financial markets. For Argentina, the political cost of abandoning the fixed exchange rate with the US dollar and substitute it with the Brazilian Real in the name of MERCOSUR integration is likely to be rather small.

In conclusion, as trade and financial ties within MERCOSUR expand, monetary, fiscal and wage policies will have to be coordinated to some extent and above all the inflation anchor will have to be sought more within the system than externally among in order to allow enough flexibility of the exchange rate both with the dollar and among member countries. The experience of Europe in 1992-96 shows that even for very open economies large depreciations of nominal exchange rates do not necessarily cause inflation if the right monetary and fiscal policies are followed. The pass-through of exchange rate changes to inflation must be even lower for MERCOSUR countries and therefore the exchange rate must be a powerful tool to adjust the current account balance also in MERCOSUR (see De Grauwe and Tullio, 1994, and Amitrano, De Grauwe and Tullio, 1997, and Table 8).

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10 Within the EMS, the BUNDESBANK took over the responsibility of carrying out most US Dollar interventions, while other members mostly intervened in DM. See Giavazzi and Giovannini (1989).

## **5 ADJUSTABLE PEGS, HIGH CAPITAL MOBILITY AND THE USEFULNESS OF A TOBIN TAX ON CAPITAL FLOWS**

There is, in my opinion, another aspect of the history of the EMS from which an interesting implication for the future of MERCOSUR may follow. During the period 1983-87, when according to my judgment the EMS worked satisfactorily, controls on capital outflows were still severe in France, Italy and Spain. This protected to some extent also Germany, which had no capital controls, from excessive speculative capital inflows, especially when realignments were expected by the markets. Capital controls made the management of the EMS and of realignments easier. In the late 1980s and early 1990s, capital controls were abolished also by France and Italy, because the European Union had set itself the objective to create a truly "internal market" characterized by the free mobility of labour and capital and by the right of establishment of European Union banks, financial institutions and insurance companies in any member country. Fixed exchange rates and adjustable exchange rates are more difficult to manage under perfectly free capital mobility than with capital controls. This is one of the many economic reasons behind the idea of establishing a monetary union in Europe. It was preferred to give up forever national monetary independence rather than renounce to fixed exchange rates and/or free capital mobility.

Coming to MERCOSUR, if sometime in the progress towards the establishment of closer trade and financial ties my proposal to consider an EMS like exchange rate arrangement of the 1983-87 type is accepted, the management of the exchange rate system could be facilitated by the introduction of a moderate Tobin tax on short term capital flows. Such a tax would also have the advantage of protecting, at least to some extent, the areas' international reserves in case of sudden panic withdrawals of funds (like in the case of the Mexican crisis of December 1994). A moderate Tobin tax would be less damaging for the member countries' financial integration with each other and with world financial markets than direct controls on capital flows or the sudden introduction of restrictive measures against withdrawals of funds in the face of financial panics or large gyrations in nominal and real interest rates.



## 6 CONCLUSIONS

The main conclusions of this paper are:

- 1) Asymmetric shocks do occur, especially in large raw material exporters like MERCOSUR countries. The exchange rate as a means to cope with such shocks should not be given up forever. Argentina should give up its rigid link to the US dollar. Brazil should also not base too much the credibility of its anti-inflation policy on too rigid a link with the US dollar.
- 2) The role of nominal anchor for inflation should be progressively moved away from the exchange rate towards an anchor which is internal to each country or to MERCOSUR as a whole. Central banks should all be made independent from the government and they should adopt inflation targeting in a coordinated way.
- 3) The reduction of tariff barriers and freer trade within MERCOSUR requires the avoidance of large real exchange rate and competitiveness changes. They require also a relatively stable system of bilateral exchange rates with not too frequent realignments and some coordination of macroeconomic policy. I propose to adopt an EMS type arrangement, like the Europe had from 1983 to 1987.
- 4) The pass-through of exchange rate charges to domestic inflation is much lower than normally believed, especially if domestic aggregate demand policies are right. In addition, the exchange rate is a very powerful tool to adjust current account imbalances and foster economic growth. The experience of Italy after 1992 is relevant for Brazil and Argentina.
- 5) Since Monetary Union is not yet viable, MERCOSUR and free capital mobility is important for the area, a moderate Tobin tax on capital flows can make it easier to manage the adjustable peg system I propose and reduce at the same time, at least to some extent, the danger of sudden capital outflows.



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