A critique of the proposal of monetary union in Mercosur: a Post Keynesian view

Fernando Ferrari Filho *

Introduction

In 1961, Mundell, in an article which he develops a theoretical framework for analyzing optimal exchange arrangements, stated that “[t]he optimum currency area is the region” (Mundell, 1961, p.660). Since then, the idea of creating a single currency for two or more countries, considering that they have identical characteristics, has been part of the academic debate and international policy circles.

Recently the presidents of the countries of Mercosur – Brazil, Argentina, Uruguay and Paraguay - mentioned that the final step of an integration process in this region could be the adoption of a single currency among these countries. Based on the theory of optimum currency areas and on the experience of the European Monetary Union, the proposal of a currency union among the Mercosur countries aims at creating a new framework for economic management to (i) change the style of fiscal policies among governments of Mercosur, and (ii) modify the financial and monetary system of the member countries.

In general, the analysis concerning the theory of optimum currency areas shows that a country’s decision to join a currency area is determined by the difference between the monetary efficiency gain from joining and the economic stability loss from joining.

* Professor of Economics at the Federal University of Rio Grande do Sul/Brazil. The author would like to thank P. Waquil who presented some suggestions. Of course, he is not responsible for any remaining problem.

† The introduction of a single currency in the European Monetary Union is a strong example that the 1961 Mundell’s idea is not only academic, but it is a political issue, too.
Post Keynesians criticize the theory of optimum currency areas basically due to the fact that when countries decide to join the monetary union it means that they lose their economic policies to stimulate effective demand and, as a result, solve the unemployment problems.

Well, after presenting the main idea related to the theory of optimum currency areas, the paper aims at analyzing and criticizing, in a post Keynesian view, the proposal of a currency union among the countries of Mercosur, as the final step of an integration process in this region.

The article proceeds as follows: Section 1 briefly presents a survey of the literature on optimum currency areas. Based on the original work of Mundell (1961) and the contributions of Mckinnon (1963) and Kenen (1969), this section explores the arguments for and against that monetary authorities use to argue for supporting (or not) the idea that the countries have to adopt a single currency. Section 2 shows what are the requisites for integrating and coordinating a monetary union in Mercosur. Section 3 presents the (Post) Keynesian scenario for international monetary arrangement. In this context, the objective of the (Post) Keynesian proposal to reform the international monetary system is (i) to prevent international currency crises and (ii) to promote full employment and economic growth in a global economy. Thus, it shows that this objective depends on three important provisions: (i) the creation of an international central bank, with its own currency; (ii) a fixed but adjustable exchange rate system; and (iii) controls over capital movements to avoid speculative attacks on currencies. The final section summarizes and concludes.

The theory of optimum currency areas
In the beginning of the 1960s, the debate on optimal exchange rate arrangements was concentrated over the choice between fixed or flexible exchange rates. At this time, Mundell (1961) formulated a new conceptual framework for analyzing optimal exchange arrangements: optimum currency areas as an international monetary arrangement. Arguing that “periodic balance-of-payment crises will remain an integral feature of the international economic system as long as fixed exchange rates and rigid wage and price levels prevent the terms of trade from fulfilling a natural role in the adjustment process” (Mundel, 1961, p.657), he rejected the idea that flexible exchange rates were an efficiency system for stabilizing the economies – it means, to maintain, at the same time, the external balance and full employment - and concentrated attention to defining the structural characteristics in favor of an optimal exchange rate system in which two (or more) countries could fix the exchange rates between (among) their currencies. Thus, the theory of optimum currency areas came out.

Mundell’s analysis started from the assumption that the main goal of economic policy is to conciliate two objectives: (i) to maintain external balance and (ii) full employment. Considering this assumption, Mundell argued that the degree of factor mobility – capital and/or labor – was an important issue to determine the optimal choice of exchange rate regime. At this point, Mundell concluded that the limit of an optimum currency area would have to analyze the trade-off between factor mobility and the size of the area. According to him, “[t]he fault [would not lie] with the type of currency area, but with the domain of the currency area. The optimum currency area is not the world” (Ibid., p.659). Thus, it is possible to conclude that, in the limit, the optimum currency area would be the world.
McKinnon (1963) and Kenen (1969) presented important contributions to the Mundell’s theory.

McKinnon emphasized the relevance of size and openness of an economy – that is to say, the relation between tradable production and non-tradable goods production of a country - to determine the efficiency or not of the exchange rate system. According to him, the greater the size and openness of an economy, the greater would be the answering of internal wage and price levels to a change in the exchange rate. Based on this premise, McKinnon concluded that the greater the size and openness of an economy, more efficient would be a fixed exchange rate to restore the external balance and maintain internal stability. In his own words, “if we move across the spectrum from closed to open economies, flexible exchange rates become both less effective as a control device for external balance and more damaging to internal price-level stability” (McKinnon, 1963, p.719).

Kenen (1969), arguing in favor of a fixed exchange rate regime, emphasized Mundell’s idea related to the degree of geographic factor mobility as an important condition to the optimal choice of exchange arrangement. According to him, the optimal exchange arrangement would depend on the degree of inter-industry factor mobility. How? Kenen argued that the greater the diversity of an economy’s production, the less persistent would be the unemployment or inflationary costs to the economy.

To sum up, according to the theory of optimum currency areas, (i) factor mobility, (ii) size and openness of an economy, and (iii) diversity of production are considered the structural characteristics in the choice of exchange rate arrangements.

In this “environment”, what are the advantages and disadvantages to a specific country when it decides to join a monetary union, according to the theory of optimum
currency areas? Bringing back Mundell’s analysis, a country would have the following reasons to join a monetary union: (i) the inflation rate in the monetary union would be lowest; (ii) the transaction costs would decrease and/or be eliminated; (iii) the purchasing power parity of the country would be stable; (iv) the uncertainty related to exchange rate would disappear; and (v) the regional integration would be stimulated. On the other hand, the main reason that a country would have to consider to avoid joining the monetary union is the following: the country prefers to operate the exchange rate as an instrument of economic policy.

As a final reflection, the above discussion shows that a currency area will be optimum if the relations between a specific country and its partners follow the basic principles: (i) the integration process is dynamic; (ii) the factor mobility is high; and (iii) the main economic variables – such as inflation rate, interest rate, and fiscal deficit – have to converge. Moreover, it is important to emphasize that, under a monetary union, the monetary authorities and/or governments lose their power to operate monetary, fiscal and exchange rate policies.

The basic fundamentals for a monetary union in Mercosur and the economic consequences of monetary union

Assuming that the final step of an integration process in Mercosur will be, long time from today, the adoption of a single currency among the countries of Mercosur – that is to say, a monetary union will be created in the future - at least two questions come out: (i) what must be the conditions for convergence? (ii) what are the economic consequences to the member countries of Mercosur monetary union?
First of all, it is important to say that a monetary union in Mercosur means that all participating countries have to accept a total financial liberalization, adopt a fixed exchange rate regime and lose their fiscal and monetary instruments. Only in this context, an independent regional central bank can be created to complete the harmonization of financial liberalization and to print a single currency.

There are a number of convergence criteria that reflect certain aspects of economic behavior that must be similar among countries to enable them to join a monetary union. Based on the European Monetary Union experience, it is possible to say that the conditions for the entry of any other South American country in the Mercosur must be the following: (i) the countries cannot devaluate their exchange rate as well as they have to maintain their exchange rate within the normal margins determined by regional central bank; (ii) the inflation rate in a specific country cannot be, for instance, 1.5% higher than the countries with the lowest inflation rate; (iii) the individual interest rates cannot be, for example, 2.0% higher than the countries with the lowest inflation rate; (iv) any country cannot have an excessive fiscal deficit – for instance, the budget deficit should not exceed 3.0% of GDP; and (v) the gross national debt of any country cannot exceed, for example, 60.0% of GDP².

Besides, considering the literature related to the optimum currency areas, there are some requisites that countries have to present before entering the monetary union: (i) trade and financial integration process among countries must be intensified; (ii) factor mobility – labor and capital mobilities – must also be intensified; and (iii) the convergence of macroeconomic figures of the member countries is a necessary precondition.

² The figures are based on the criteria concerning the European Monetary Union.
Analyzing the convergence criteria as well as the necessary requisites for the entry of any country to Mercosur Monetary Union, an important reflection is that some problems come out in this puzzle.

Considering the necessary requisites for creating the Mercosur Monetary Union, at least three points must be analyzed. First, the evidence shows that trade and financial integration process among the countries of Mercosur is so incipient. Looking at the export figures of Argentina, Brazil, Paraguay and Uruguay related to the Mercosur area, these countries export, in average, less than 2.0% of GDP\(^3\). Secondly, labor mobility practically does not exist, as well as the financial liberalization – so important to promote capital mobility – is so incipient. Instead of having convergence of macroeconomic figures among the member countries of Mercosur, the statistical data show that inflation rates, interest rates, economic growth rates, and so on, are moving in different ways\(^4\).

Concerning the convergence criteria – once again, the figures above are just a supposition based on the European Monetary Union case – there is no doubt that since the countries decide to join the Mercosur Monetary Union they lose the power of operating economic policies – basically, monetary and fiscal policies – to promote stability and economic growth.

\(^3\) In 1997, for instance, the relation between total fob exports of Argentina, Brazil, Paraguay and Uruguay related to the Mercosur area and total GNP of these countries was 1.99% (US$ 20.5 million over US$ 1,028 million). This relation, elaborated by the author, was based on the figures of CEPAL/ECLAC (1999:196-7) and Ministério das Relações Exteriores/GETEC (1999:200).

\(^4\) For example, looking at inflation rate (\(\%\)) and interest rate (i) in Argentina, Brazil, Paraguay and Uruguay the figures show how divergence are the economic variables in these countries. Considering the last 12 months, the inflation rates and interest rates in the member countries of Mercosur are: Argentina = - 1.1% (\(\%\) - March 2000) and 9.2% (i - April 2000); Brazil = 12.9% (IGP-DI, FGV – March 2000) and 18.5% (i/Selic – April 2000); Paraguay = 9.6% (\(\%\) - March 2000) and 11.0% (i – April 2000); and Uruguay = 4.5% (\(\%\) - March 2000) and 33.9% (i – April 2000). The source of these figures was Gazeta Mercantil (2000:20).
On the other hand, there are some economic advantages to Mercosur that must be emphasized: (i) a common currency facilitates the elimination of border taxes on trade as well as it eliminates other transaction costs; (ii) a currency unification eliminates the foreign exchange risk; (iii) a single currency can reduce domestic prices due to competition; (iv) an independent central bank can discipline low inflation with low interest rate; and (v) the Mercosur currency can “challenge” other international currencies as the world’s leading currency.

Of course, these arguments must be debated for some time before the presidents of Brazil, Argentina, Uruguay and Paraguay (and whatever country decides to join the Mercosur zone) decide to present a real proposal to create a currency unification for Mercosur.

The international monetary reform: a (Post) Keynesian alternative

Since the collapse of the Bretton Woods system in the early 1970s, the increased of international mobility of capital and financial liberalization, i.e., the globalization process, has substantially altered the dynamic process of international economy. In other words, the globalization process has limited the actions of macroeconomic policies and National States to stimulate effective demand and, as a consequence, increase the level of employment. Besides, in the absence of government macroeconomic policies to stimulate economic growth and to limit the movements of capital flows, the international speculative capital flows has created serious monetary problems, such as European monetary crisis in 1992/93, Mexican peso crisis in 1994/95, Asian crisis in 1997, and, recently, Russian crisis
in 1998, provoking high rates of unemployment, exchange rates disequilibria, persistent balance of payments imbalances, and so on.

According to the Post Keynesian view, these monetary crises have resulted from an unprecedented volatility of financial and foreign exchange rate markets that have increased the liquidity preference of economic agents. Moreover, the recent international experience has showed us that the current international institutions, such as IMF, have not been able to monitor and solve the financial crises in today’s global economy.

In this context, what can be done to avoid the instability of financial and exchange rate markets and, as a consequence, to face the financial crises in global economy? At this point, Keynes’s revolutionary analysis provides a starting point for designing a new international monetary system that can be able to resolve the current financial crises and at the same time to promote full employment and economic growth in global economy. Thus, bringing back Keynes’s ideas and proposals about international monetary system, the Post Keynesian theory, basically in Davidson’s works, have built a proposal for reforming the international monetary system.

In many of his writings, Keynes discussed and suggested schemes to reform the international monetary system, such as: in *A Tract on Monetary Reform*, 1923, he proposed the abandonment of gold-standard regime; in *A Treatise on Money*, 1930, Keynes outlined a proposal for the operation of a Supranational Central Bank to maintain the stability of international price levels; in *The Means to Prosperity*, 1933, he presented an international agreement under fixed, but alterable, exchange rate; and in his proposal to an *International Clearing Union*, 1944, Keynes developed a scheme based on an international currency,

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5 This section was originally presented in Alves, Ferrari Jr., & de Paula (1999-2000).
However, it was in the *International Clearing Union* that Keynes’s revolutionary analysis deserves especial attention.

The main idea of Keynes’s *International Clearing Union* was “the substitution of an expansionist, in place of a contractionist, pressure on world trade” (Keynes, 1980:176). Thus, Keynes suggested a scheme set out in an international agreement as follows:

“We need an instrument of international currency having general acceptability between nations (...) We need an orderly and agreed method of determining the relative exchange values of national currency units (...) We need a quantum of international currency, which is *neither determined in an unpredictable* and irrelevant manner (...) *nor subject to large variations depending on the gold reserve policies of individual countries*; but is governed by the actual current requirements of world commerce, and is also capable of deliberate expansion and contraction to offset deflationary and inflationary tendencies in effective demand world. We need a system possessed of an internal stabilising mechanism, by which pressure is exercised on any country whose balance of payments with the rest of the world is departing from equilibrium in *either* position, so as to prevent movements which must create for its neighbours an equal but opposite want of balance (...) We need a central institution (...) to aid and support other international institutions” (Ibid.:168-9, italics added).

Moreover, Keynes, aiming at reducing entrepreneurial uncertainties, proposed (i) an international agreement under fixed, but alterable, exchange rate, and (ii) the control of capital movements. In his words,

“The proposal is to establish a Currency Union (...) based on international bank money, called (let us say) *bancor*, fixed (but not unalterably)” (Ibid.:170).
“The system contemplated should greatly facilitate the restoration of international credit loan for loan purposes (...) distinguishing (a) between movements of floating funds and genuine new investment for developing the world's resources” (Ibid.:186).

Going in this direction, Davidson (1994) develops a Post Keynesian proposal for reforming the international monetary system. After defining a specific taxonomy to explain the economic dynamism of an open unionized monetary system (UMS) and an open non-unionized monetary system (NUMS), Davidson aims at presenting the rules required to operate an international monetary agreement according to an UMS, due to the fact that this system can “(1) prevent a lack of global effective demand (...) (2) provide an automatic mechanism for placing a major burden of payments adjustments on the surplus nations, (3) provide each nation with the ability to monitor and, if desired, to control movements of capital, and finally (4) expand the quantity of the liquid asset” (Ibid.:268).

As Keynes, Davidson argues that the international monetary system must be rooted in the following basic points: a new international currency to regulate the international liquidity, a stable exchange rate system to protect the exchange rates from speculation activity and an agreement currency clause to eliminate the balance of payments disequilibrium in either position. Thus, Davidson’s proposal must have some provisions, such as: (i) an International Money Clearing Unit (IMCU) as a reserve asset for international liquidity; (ii) a mechanism to permit that the IMCUs can be held only by the national central banks; (iii) a system of fixed, but adjustable, exchange rate between the

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6 According to Davidson (1994, Chapter 12), in an open unionized monetary system (UMS) the contracts are expressed in the same monetary system - *i.e.* the exchange rate is fixed -, while in an open non-unionized monetary system (NUMS) the contracts are expressed in different currencies and, as a consequence, the exchange rate is flexible.
national currency and the IMCU to help countries to solve balance of payments troubles; and (iv) a “trigger mechanism” to allow to put much more pressure of balance payments adjustments on the creditor countries than on the debtor countries - *i.e.*, according to this mechanism a creditor nation would be encouraged to spend its excessive credits in three ways: buying products of any other country of the international payment system, investing capital in deficit countries (direct foreign investment projects), and providing foreign aid to deficit countries (Ibid.:268-72).

The provisions (i) and (ii) are precondition to reduce and/or to avoid people hold the international asset, IMCU, as a store of value. As a consequence, the IMCUs would be used only for international financial and commercial transactions. In other words, the national central banks and the governments have power to control the quantity of liquid asset to expand the global effective demand. The provision (iii) is a necessary condition to stabilize the long-term purchasing power of the IMCU. At the same time, it restricts private speculation regarding the IMCU; that is to say, there is no possibility of the IMCU loses its international purchasing power. Finally, the “trigger mechanism” is the main instrument to guarantee that “export-import imbalance is eliminated without unleashing significant recessionary forces” (Ibid.:272).

Thus, (Post) Keynesian proposal creates conditions to alter the current logic of financial globalization - that is to say, it can substitute the process of international production for the dynamic of international speculative capital - and, as a consequence, to reduce the entrepreneurs uncertainties, so necessary to expand global effective demand. As Keynes points out, an international monetary system built like that “could use its influence and its power to maintain stability of prices and to control the trade cycle” (Keynes, 1980:190-1).
Conclusion

Davidson (1997:672), considering the possibility of having another Great Depression at the end of the 20th century due to the international financial crises in the global economy, stated that “what is necessary is to build permanent fireproofing rules and structures that prevent ‘beauty contest’ induced currency fires. Crisis prevention rather than crises rescues must be the primary long-term objective”. This quotation expresses the main idea of the previous section: despite the fact that, in these days, the international monetary problems are more difficult than those faced in Keynes period, bringing back Keynes’s revolutionary analysis to reform the international monetary system can help governments to understand the necessity of creating an international standard currency to promote full employment economic growth as well as to maintain long-run price stability.

Going in this direction, the proposal to create a monetary union in Mercosur is open to a range of objections, as it was observed in the Section 2. Moreover, the experience of the European Monetary Union provides some validation of the views expressed in this paper. Why? With the introduction of the Euro, the member countries of European Monetary Union have to accept the idea (i) that individual countries lose their policy instruments – specifically, those related to fiscal policy - to stimulate effective demand and, as a result, to reduce high unemployment, and (ii) that the creation of an European Central Bank does not provide the necessary finance for full employment in Euro zone as well as it does not provide an anti-speculative mechanism to control movements of capital.

Considering these arguments, instead of proposing a monetary union for the Mercosur in the future, based on the theory of optimum currency areas, the presidents of
Brazil, Argentina, Uruguay and Paraguay could concentrate their efforts in creating an international arrangement to the global era for reducing the real disruptive outcomes derived from the speculative activity in financial markets. This international arrangement could be rooted in the following basic points: (i) the international monetary system would be based on the objective of expanding world effective demand and promoting full employment; (ii) the creation of an international central bank to regulate the international currency, issued by the same international central bank, and provide long-term lending; (iii) a system of fixed, but adjustable, exchange rate; and (v) the establishment of some sort of control on capital flows to mitigate instability and fragility in the global economy.

References


