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# REGIONAL INTEGRATION IN SOUTH AMERICA*

Philip Arestis•
UNIVERSITY OF CAMBRIDGE, UK

Fernando Ferrari-Filho♦
FEDERAL UNIVERSITY OF RIO GRANDE DO SUL, BRAZIL

**Abstract:**

This contribution attempts to answer two specific questions: First, is the Union of South America Nations (UNASUR) the most viable institution to achieve a consistent regional integration process in South America? Second, what model of regional integration should be adopted in the case of UNASUR, which would ensure macroeconomic stability and avoid financial and exchange rate crises in South America? The answers to these questions rely on the following objectives: (i) it aims to show that the European Monetary Union is not a project suitable to prevent disruptive economic situations in the South American countries; and (ii) it presents a proposal for the UNASUR.

**Key words:** Economic integration, European Monetary Union and Union of South America Nations.

**JEL classification:** F5, F55.

#### 1. INTRODUCTION

The international financial crisis and the ‘great recession’ have substantially altered the dynamic process of the international economy. The effects of such a crisis and recession are not economically and socially neutral; as a result, the benefits of financial globalization have come to be called seriously into question. While this crisis is associated with an absence of regulation, particularly by the State, it has been action by ‘Big Bank’ and ‘Big Government’ that has prevented it from developing into a depression[1].

Moreover, the ‘great recession’ has generated a debate about the necessity of restructuring the international monetary system (IMS), a fundamental condition

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• pa267@cam.ac.uk / ♦ferrari@ufrgs.br

[1] We employ the wording of Minsky (1986, Chapter 13) in the text, according to which the failures of capitalism can be solved only by creating the ‘Big Bank’, a lender-of-last-resort function, to avoid financial system collapse, and ‘Big Government’, to assure fiscal stimulus and State intervention to stabilize output and employment.

for the world economy to return to stability and healthy economic growth. The provision of a possible 'new architecture' for the IMS has been on the agenda, so that financial markets could return to performing their primary function, which is to finance productive investment and consequently expand effective world demand. Also, and ever since 2007, the G-20 and other international organization meetings have proposed, in their attempt to avert any worsening of the 'great recession', the monitoring and regulating of the financial systems around the world. Unfortunately, the conservatism and conflicts of interest among the member countries of the G-20 have prevented any progress towards the possible restructuring of the IMS and other financial systems, at least for the present. In addition, the G-20 retreated from its initial position, preaching fiscal prudence.

In view of these developments, especially the pessimism about the progress of deeper reforms in the IMS, regional integration has become a second best strategy for the developing countries, especially so for South American countries. Since the 2000s, the South American integration process has experienced important changes, such as the stagnation of the Free Trade Area of the Americas (FTAA) negotiations, the creation of the Union of South America Nations (UNASUR) and the implementation of some 'institutionalities' in the Common Market of the South (MERCOSUR)[2].

Thus, the debate on the need to consolidate a process of regional integration more consistently and robustly in South America has come to be on the agenda. This point is corroborated by UNCTAD (2007), which argues that there is no better alternative available to the major emerging economies, including South American economies, than regional integration.

In this context and concentrating more closely on the UNASUR regional integration, two questions arise: first, is UNASUR the most viable institution to achieve a consistent regional integration process in South America? Second, what model of regional integration should be adopted in the case of UNASUR, which would ensure macroeconomic stability and avoid financial and exchange rate crises in South America? This contribution attempts to answer these questions by concentrating on the following objective: considering that academic debate on the future of possible regional integration of UNASUR is based on the European Monetary Union (EMU), it aims (i) to show that the EMU is not a project suitable to prevent disruptive economic situations in the South American countries. The EMU project has shown that their institutional and policy arrangements are inherently flawed; and (ii) to propose an alternative arrangement to

[2] In 1991, the Asunción Treaty, signed by Argentina, Brazil, Paraguay and Uruguay, created MERCOSUR. At that time, MERCOSUR was created to be *only* a Customs Union that came into effect on 1 january, 1995. For more details, see Arestis *et al*, 2003.

UNASUR to assure long-term economic growth and social development in the Region. The idea is that this regional integration proposal will become more consistent the higher the convergence of the macroeconomic policies is, simply because it can induce trade and financial cooperation[3].

After this short introduction we proceed as follows. Section 2 is concerned with the problematic nature of the EMU project. It examines the EMU simply because the UNASUR proposal is based on the EMU model. Section 3 presents a brief historical analysis of the economic integration in South America and analyses some selected macroeconomic variables of the member countries of UNASUR to examine whether some convergence has been achieved. Section 4 presents an alternative proposal for UNASUR, different from that of the EMU. Section 5 summarizes and concludes.

## 2. EMU: LESSONS FOR UNASUR

The euro area model is based on a monetary union with a common currency, the euro, but without the basis for an optimum currency area (Arestis and Sawyer, 2012). The European Central Bank (ECB) launched the single currency (euro) in 1999 alongside with the foundation of the EMU. The euro replaced the national currencies for all transactions at the beginning of 2002 for twelve countries, namely Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. This meant that three countries, namely Denmark, Sweden and the United Kingdom, of the then 15 members of the European Union (EU) did not join the euro. The EU expanded in May 2004 with ten new member countries, eight from Central and Eastern Europe countries (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia and Slovakia) and two more, Cyprus and Malta. There was a subsequent expansion with Bulgaria and Romania joining in January 2007. Of the new member states, five have since adopted the euro, namely Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009) and Estonia (2011).

The economics of the EMU is based on the 'New Consensus in Macroeconomics' (NCM) (see, for example, Arestis, 2009). The main elements of this framework are as follows (see, also, Arestis and Sawyer, 2012, for further details):

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[3] Despite the fact that this contribution emphasizes the main aspects of the relevant macroeconomic policies, it is important to emphasize that industrial policies, infrastructure investment and educational policies are key issues to reduce the asymmetries among the UNASUR countries. It is also important to emphasize the need for relevant political institutions as well a social and cultural integration, which are all relevant in the integration process. They are not discussed in the contribution in view of space limitation.

i. The NCM theoretical framework is based on the assumption that a market economy is essentially stable. As such macroeconomic policies would destabilize the market economy. This is due to the assumptions of rational expectations and of the Ricardian equivalence theorem, that imply that markets, and particularly financial markets, make well-informed judgments on economic events and the future of the economy. The global financial crisis of 2007-2008 has perhaps called some of that view into question.

ii. Monetary policy, however, is taken as the main instrument of macroeconomic policy. Indeed, since inflation is viewed as a monetary phenomenon, in the long run the inflation rate is the only macroeconomic variable that monetary policy can affect. Fiscal policy is no longer viewed as a powerful macroeconomic instrument. Monetary policy has, thus, been up-grated and fiscal policy has been down-grated to a balanced budget format. Further, monetary policy becomes identified with the setting of interest rates, rather than any other interventions such as money supply and/or credit controls or reserve requirements. Monetary policy can be used to meet the objective of low rates of inflation, which are desirable in this view, since low, and stable, rates of inflation are conducive to healthy growth rates.

iii. Monetary policy should not be operated by politicians but by experts (whether bankers, economists or others) in the form of an 'independent' Central Bank, and this is the precise set-up of the ECB. An 'independent' Central Bank would also have greater credibility in the financial markets and be seen to have a stronger commitment to low inflation than politicians do.

iv. Credibility of monetary policy is viewed as paramount in the successful conduct of monetary policy. Success is generally seen in terms of the achievement of the target inflation. It is argued that a policy which lacks credibility because of time inconsistency is neither optimal nor feasible.

v. The only objective of macroeconomic policy is price stability. This is often formalized in terms of setting an inflation target. Inflation targeting is neither a rule nor discretion (in practice only degrees of discretion prevail): it is rather a framework for monetary policy whereby public announcement of official inflation targets, or target ranges, is undertaken along with explicit acknowledgement that low and stable inflation is monetary policy's primary long-term objective. This improves communication between the public and policy-makers and provides discipline, accountability, transparency and flexibility in monetary policy. Inflation targeting has been described as 'constrained' or 'enlightened' discretion, in that inflation targets serve as a nominal anchor for monetary policy. As such, monetary policy imposes discipline on the central bank and the government within a flexible policy framework.

vi. The level of economic activity is taken to fluctuate around a supply-side equilibrium. The supply-side equilibrium here corresponds to a level of economic activity at which inflation would be constant: this is often formalized in terms of a non-accelerating inflation rate of unemployment (NAIRU), and unemployment below (above) the NAIRU would lead to higher (lower) rates of inflation.

vii. The essence of Say's Law holds, namely that the level of effective demand does not play an independent role in the (long run) determination of the level of economic activity, and adjusts to underpin the supply-side determined level of economic activity (which itself corresponds to the NAIRU)[4].

In terms of policy implications there is an important difference between the NCM, which adopts inflation targeting, and the ECB, which allegedly does not pursue strict inflation targeting. The ECB, unlike the NCM, theoretical framework assumes a stable long-run demand for money. In the long run, inflation is strictly a monetary phenomenon. This leads to the adoption of a two-pillar approach to evaluating the prospects of achieving price stability in the ECB case. There is an economic analysis and a monetary analysis. The ECB economic analysis attempts to assess price developments and the risks to price stability over the short to medium term. This broad range of indicators includes: "developments in overall output; aggregate demand and its components; fiscal policy; capital and labor market conditions; a broad range of price and cost indicators; developments in the exchange rate; the global economy and the balance of payments; financial markets; and the balance sheet positions of euro area sectors" (ECB, 2004: 55).

The 'second pillar' is a commitment to analyzing monetary developments for the information they contain about future price developments over the medium and long term. It focuses "on a longer-term horizon, exploiting the long-run link between money and prices" (ECB, 2004: 55). This is a quantitative reference value for monetary growth, where a target of 4.5 per cent of M3 has been imposed[5]. Being a reference level, there is no mechanistic commitment to correct deviations in the short term, although it is stated that deviations from the reference value would, under normal circumstances, 'signal risks to price stability'. Monetary analysis is utilized by the ECB as a 'cross check' for consistency between the short-term perspective of economic analysis with the more long-term perspective that emanates from the monetary analysis itself.

[4] It should be noted that Keynes (1936) argued that Say's Law did not hold and that deficient aggregate demand (that is deficient with respect to productive potential) could and did exist in both the long term as well as the short term.

[5] The ECB definition of the M3 money supply is: currency in circulation, plus overnight deposits, deposits with an agreed maturity up to 2 years, deposits redeemable at a period of notice up to 3 months, repurchase agreements, money market fund (MMF) shares/units, and debt securities up to 2 years (see ECB, 2012).

Monetary policy, as justified and employed in the case of the euro area, suffers from what one might label as ‘the one size fits all policy’. It is applied throughout the euro area and in the absence of any other policy applicable throughout it, the ‘the one size fits all policy’ could present serious problem in a monetary union that suffers from economic and political integration. The experience of the ‘great recession’ and the euro crisis testify to this particular problem. There is, thus, a real danger of the euro area monetary union collapsing in view of the fact that neither political union nor economic convergence haven been achieved so far. And the history of currency unions in this respect is extremely relevant in this context (see, Arestis *et al*., 2003, for the relevant details). Furthermore, ECB’s M3 growth has been consistently above the 4.5 percent reference value and yet not much inflation has been produced over the period. It would also appear to be the case that the economic and monetary analyses are not always consistent (Arestis and Chortareas, 2006).

There is also another important dimension of the euro area. This is the Stability and Growth Pact (SGP), which was developed in the mid 1990s during the passage to the establishment of the euro area. It is important to note that there is a complete separation between the monetary authorities, in the form of the ECB and the national central banks of the EMU countries, which comprise the European System of Central Banks (ESCB), and the fiscal authorities, in the shape of the national governments comprising the EMU. It follows that there can be little co-ordination between monetary and fiscal policies. Indeed, any attempt at co-ordination would be extremely difficult to implement. For apart from the separation of the monetary and fiscal authorities, there is also the requirement that national governments (and hence the fiscal authorities) should not exert any influence on the ECB (and hence the monetary authorities). Any strict interpretation of that edict would rule out any attempt at co-ordination of monetary and fiscal policies.

There is no fiscal policy that can be exercised at the EMU level. The budget of the EU is relatively small (around 1 per cent of EU GDP) and cannot be used for fiscal policy purposes since it must always be in balance. The fiscal policy of national governments is constrained by the rules of the SGP. In this regard, the core elements of SGP are three: (a) to pursue the medium-term objectives of budgetary positions close to balance or in surplus; (b) the submission of annual stability and convergence programs by the member states; and (c) the monitoring of the implementation of the stability and convergence programs. The SGP also requires national governments to adhere to a 60 percent of government debt to GDP.

The SGP imposes an upper limit of 3 per cent of GDP on budget deficits, with the view that budgets will be broadly in balance or small surplus over the business cycle. The official rationale for the SGP is twofold. The first is that a medium-term balanced budget rule secures the scope for automatic stabilizers without breaching the limits set by the SGP. Second, since a balanced budget explicitly sets the debt ratio on a declining trend, it reduces the interest burden and improves the overall position of the government budget.

The SGP has not been a success story from the point of view of its objectives. The European Leaders agreed in principle at their meeting in Brussels on the 8th/9th of December 2011 to adopt tougher sanctions on the euro area countries that break the ‘new’ rules of the SGP, what is now called the ‘fiscal compact’ (FC) (European Council, 2011). Its main ingredients are three: a firm commitment to ‘balanced budgets’ for the euro area countries, defined as a structural deficit of no greater than 0.5% of gross domestic product, which should be written into national constitutions; automatic sanctions for any euro area country whose deficit exceeds 3% of GDP; and a requirement to submit their national budgets to the European Commission, which will have the power to request that they be revised. In effect the FC retains the principles of the previous ‘fiscal pact’ versions but with the added one that countries that break the deficit rules may actually be punished in some way. Even more, the FC requires countries to in effect run structural surpluses. It is clear that the major objections to the FC, and the old SGP, is that it seeks to impose without any justification a balanced budget and that it poses restrictions in the use of fiscal policy in the face of economic crises. In all these, though, there is no central power with sufficient discretionary means to organize some sort of fiscal transfer. Indeed, not only does the fiscal compact not provide a concrete answer to this question, but it does not even hint whether fiscal transfers are likely to happen or not. It is the case that proper fiscal union is the only way forward. This should be a very clear lesson and message to any attempt at any form of integration in South America.

## 3. UNASUR: BRIEF HISTORICAL ANALYSIS AND THE CURRENT STATE OF INTEGRATION

### *3.1 A Brief History of the Attempt at Economic Integration in South America*

The idea of economic integration in South American began in 1960 when some trade agreements were signed within the Latin America Free Trade Association (ALALC). ALALC was an unsuccessful attempt to create a free trade area in Latin America. The member-countries were Argentina, Brazil, Chile, Mexico, Paraguay, Peru and Uruguay. In 1970, Bolivia, Colombia, Ecuador and Venezuela became member countries of ALALC. In 1980, ALACL was replaced by the Latin America Association of Integrated Development (ALADI). At that time, Cuba also became a member country of ALADI.

Concomitantly to the proposal of having a wider regional integration in Latin America, such as ALADI, in the late 1960s and early 1990s two sub-regional blocs were created: the Andean Community of Nations (CAN)[6] and MERCOSUR.

CAN was created, in 1969, to achieve a sustainable and balanced economic and social development in the Andean region (CAN, 2012). The original member countries of CAN were Bolivia, Chile, Colombia, Ecuador, Peru and Venezuela. In 1977, due to political reasons, Chile decided to leave CAN and in 2006 Venezuela also left CAN to join MERCOSUR as an associate-member country[7].

In 1991 MERCOSUR was created to be an economic and political agreement among Argentina, Brazil, Paraguay and Uruguay. Its purpose was to promote free trade area in the region. Actually, it was meant to be a Customs Union, but since then some MERCOSUR Economic Authorities proposed a regional and common currency to MERCOSUR[8].

In the 2000s, CAN and MERCOSUR, the main economic integration blocs of South America, went through periods during which questions were raised in terms of disappointing trade performance, as well as in terms of political and diplomatic experience. In this context, to avoid the weakening of these economic blocs, in 2008 UNASUR was created, from a treaty signed between the CAN and MERCOSUR members, to be an alternative and final project of economic integration in South America. The main objectives of UNASUR are: political coordination, free trade agreement, infrastructure integration –especially, in terms of energy and communications– cooperation in technology, science, education and culture, integration between business and civil society and integration and regional development (UNASUR, 2012). All countries of South America are members of UNASUR, which are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, French Guiana, Guyana, Peru, Paraguay, Suriname, Uruguay and Venezuela. In 2011, the GDP of UNASUR countries, at current prices, was around 4.2 trillion US Dollars (USD)[9].

At the same time, a set of institutional bodies were created to boost the economic integration in the Region, such as:

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[6] 'Comunidad Andina de Naciones' in Spanish.

[7] In 2012, Venezuela became a full member country of MERCOSUR.

[8] A critical assessment of the creation of a currency union in MERCOSUR can be found at Ferrari-Filho (2001-2002).

[9] The GDP calculation has been undertaken based on statistical information from UNCTAD (2012) and ECLAC (2012).

(i) Latin American Reserve Fund (FLAR): this is a financial institution created in 1978 whose main objective is to support its member countries (Bolivia, Colombia, Ecuador, Peru, Uruguay, Venezuela and Costa Rica) with balance of payments problems. It is considered the Andean version of International Monetary Fund (IMF).

(ii) Reciprocal Payments and Credits Agreement of ALADI: this is an agreement created in 1982 in order to allow the creation of a Reserve Fund to support the balance of payments, guarantee loans and improve the official reserves of the central banks of the member countries. In other words, its main objective is the establishment of a regional payment agreement.

(iii) Structural Convergence Fund of the MERCOSUR (FOCEM): this was created in 2004 and implemented in 2005 to operate "political and economic instrument[s] to reduce existing structural asymmetries among countries and promote competitiveness and social cohesion primarily in less developed countries and regions" (IADB, 2005: 3). Brazil is the largest contributor to the FOCEM, contributing 70% of its total resources. Argentina contributes 27% and Uruguay and Paraguay 2% and 1% respectively.

(iv) Bank of the South[10]: it was created in 2007 and its main objective is to finance and integrate the member countries of UNASUR. The task of this Bank is to lend money to the member countries of UNASUR for the development of social programs and construction of infrastructure projects[11]. In other words, the Bank of South is an alternative to the IMF and World Bank.

(v) The Payment System in Local Currency (SML): in October 2008, Argentina and Brazil launched a payment system for bilateral commercial operations with their local currencies, *peso* and *real*, respectively. SML aims at eliminating the US dollar as an intermediary of commercial relations between the two countries.

(vi) Single System of Regional Compensation Payments (SUCRE): in 2009, the governments of the Bolivarian Alliance for the People of Our America (ALBA), a political institution[12], decided to implement the SUCRE for trade relations among their member countries. SUCRE was launched in 2010 and, since then, it has allowed the offsetting of the liabilities and assets related to the commercial trans-

[10] 'Banco del Sur' in Spanish.

[11] It is important to mention that the Bank of the South is not yet in operation because Brazil and Uruguay have yet to ratify it.

[12] The member countries of ALBA are Antigua and Barbuda, Bolivia, Cuba, Dominica, Ecuador, Nicaragua, Saint Vincent, the Grenadines and Venezuela.

actions among the member countries. In other words, the SUCRE aims at reducing member countries dependence on the USD as a reserve currency.

To sum up, some integration process in South America became reality in the 2000s, especially after the implementation of UNASUR, due to, at least, two reasons: first, it created a set of institutional bodies that allow greater monetary, financial and fiscal cooperation among the South American countries; and second, policymakers and international institutions have argued for the restructuring of the global economic order once the 'great recession' has ended, which encompassed both restructuring of the IMS and the speed up of the regional integration process.

### *3.2 The Current State of Economic Integration of UNASUR*

As sub-section 3.1 shows, in South America, through UNASUR, the fiscal, monetary and financial integration is back to the negotiating agenda. It has created new mechanisms of cooperation, such as the FOCEM, the Bank of the South and the use of the Argentine *peso* and the Brazilian *real* as currencies to enable international transactions. Thus, in this new context, this sub-section aims to analyze the current stage of economic integration in UNASUR, in terms of monetary and financial integration, convergence of macroeconomic variables etc., in an attempt to ascertain what process of integration is more appropriate for UNASUR. For this purpose, our methodology consists of discussing the evidence on real and monetary-financial integration process among the countries of UNASUR. This will be undertaken in terms of some selected macroeconomic variables.

Before presenting and analyzing the current stage of integration in UNASUR, three clarifications on the methodology are in order: first, we will exclude from our analysis French Guiana, Guyana and Suriname, because the economic statistics for these countries are not fully available. Thus, for our purposes UNASUR will consist of Argentina, Bolivia, Brazil, Colombia, Chile, Ecuador, Peru, Paraguay, Uruguay and Venezuela. In fact, the exclusion of French Guiana, Guyana and Suriname does not make much difference, especially in terms of GDP: in 2011, the total GDP of these countries combined, at current price, was around 10.7 billion USD; this represents, approximately, 0.25% of total GDP of the other 10 countries of UNASUR. Second, the macroeconomic variables we have chosen are average GDP growth rate, average inflation rate, unemployment rate, real effective exchange rate (REER)[13], intraregional trade, current account/GDP, nominal fiscal outcome/GDP, gross public debt/GDP, foreign debt and foreign reserves. In other words, analyzing these variables, we are studying, directly and

[13] We also comment on the exchange rate and monetary regime of each country.

indirectly, the behavior of the main macroeconomic policies –fiscal, monetary and exchange rate[14]– and trade and financial cooperation; and third, the period analyzed is from 2000 to 2010.

We may begin with the evidence on GDP, inflation rate and unemployment rate among the countries of UNASUR.

Figures 1 to 4 show the economic performance of the UNASUR countries. These figures indicate that over the period:

The average GDP growth rate for all countries of UNASUR was around 3.8% per year[15]; and (ii) five countries (Argentina, Bolivia, Brazil, Chile and Colombia) presented an average GDP growth rate per year similar to 3.8% per year for all countries; two countries (Ecuador and Peru) had an average GDP growth rate per year greater than the average GDP growth rate of all 10 countries and the average GDP growth rate per year for three countries (Paraguay, Uruguay and Venezuela); it increased over the period less than the average GDP growth rate for all countries. Moreover, as Table 1 shows, the dispersion of the average GDP growth rate is very low (the exception is Peru).

The average inflation rate for all countries of UNASUR was 8.1% per year, relatively low considering the historically high inflation rates in South America during the 1980s and 1990s; and six countries (Bolivia, Brazil, Colombia, Chile, Peru and Paraguay) had an average inflation rate per year lower than the average inflation of all countries. Two countries (Argentina and Uruguay) had an average inflation rate slightly above the average inflation rate of 8.1% per year; and two other countries, Ecuador and Venezuela, had an average inflation rate per year greater than the average inflation rate of UNASUR countries (12.3% per year and 21.7% per year, respectively). Besides, and as Table 2 shows, the dispersion of the average inflation rate is low (the exception are Peru and Venezuela).

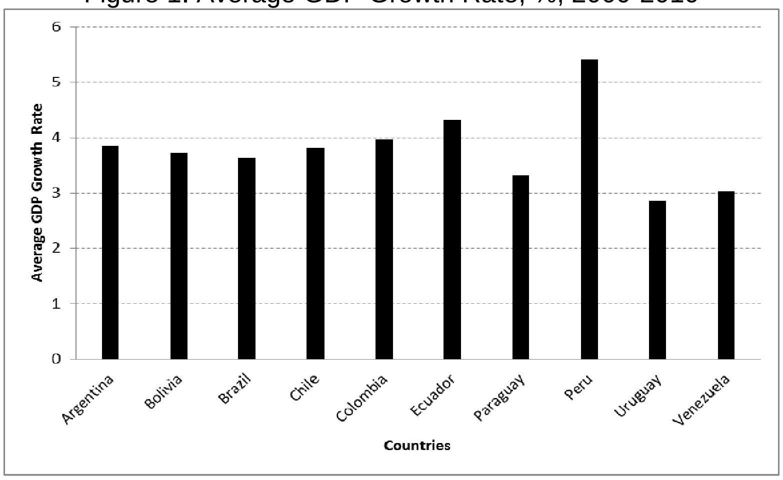
The unemployment rate was relatively high at the beginning of the 2000s, reaching double digits, for almost all UNASUR countries (the exceptions were Brazil and Paraguay). At the end of the 2000s the unemployment rate for almost

[14] It is clear that the macroeconomic policies and variables were affected by exogenous factors, such as the 'great recession'. However, for purposes of simplification, we will not analyze these issues in this contribution.

[15] We may also cite the average GDP growth rates of NAFTA and EMU, from 2000 to 2010, for comparative purposes; they were, respectively, 1.9% per year and 1.4% per year (average rates calculated by the authors based on IMF (2012).

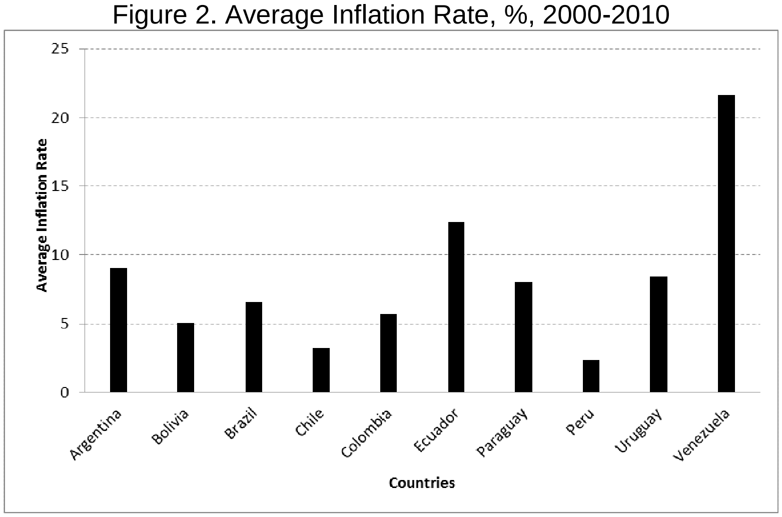
all countries, with the exception of Colombia, dropped to figures around a 7.4% per year (average rate).

Figure 1. Average GDP Growth Rate, %, 2000-2010



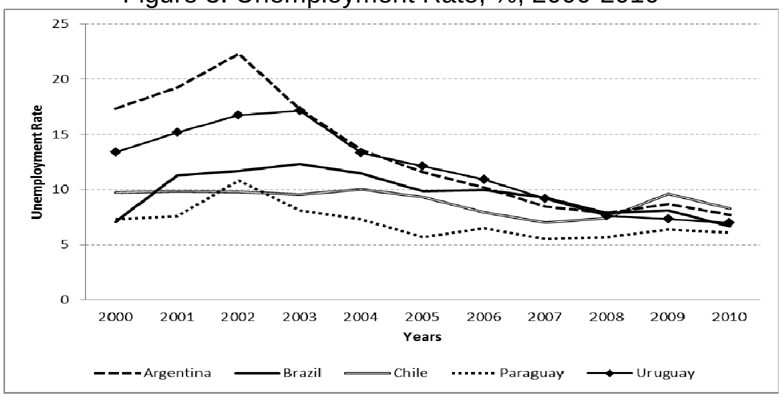

Source: IMF (2012).

Figure 2. Average Inflation Rate, %, 2000-2010



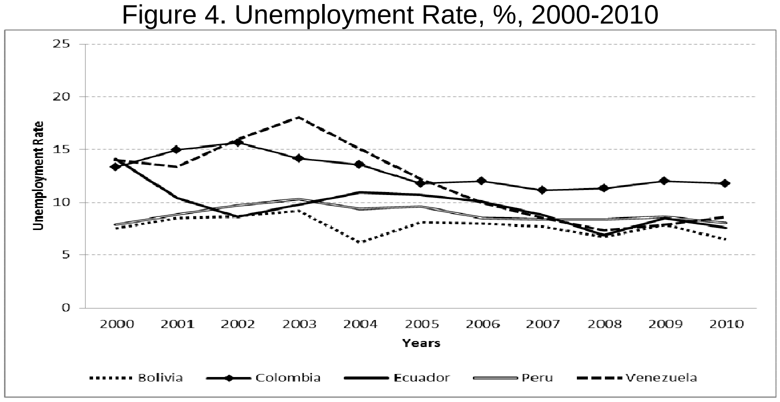

Source: ECLAC (2012) and IMF (2012).

Figure 3. Unemployment Rate, %, 2000-2010




Source: ECLAC (2012) and IMF (2012).

Figure 4. Unemployment Rate, %, 2000-2010




Source: ECLAC (2012) and IMF (2012).

Table 1. Dispersion to the Average Growth Rate

| *Period* | *Argentina* | *Bolivia* | *Brazil* | *Chile* | *Colombia* | *Ecuador* | *Paraguay* | *Peru* | *Uruguay* | *Venezuela* |
|---|---|---|---|---|---|---|---|---|---|---|
| 2000-10 | 0.04 | -0.05 | -0.10 | 0.01 | 0.12 | 0.35 | -0.31 | 1.08 | -0.62 | -0.51 |

Source: Author's elaboration based on Figure 1.
Note: The average GDP growth rate for UNASUR countries was 3.8.

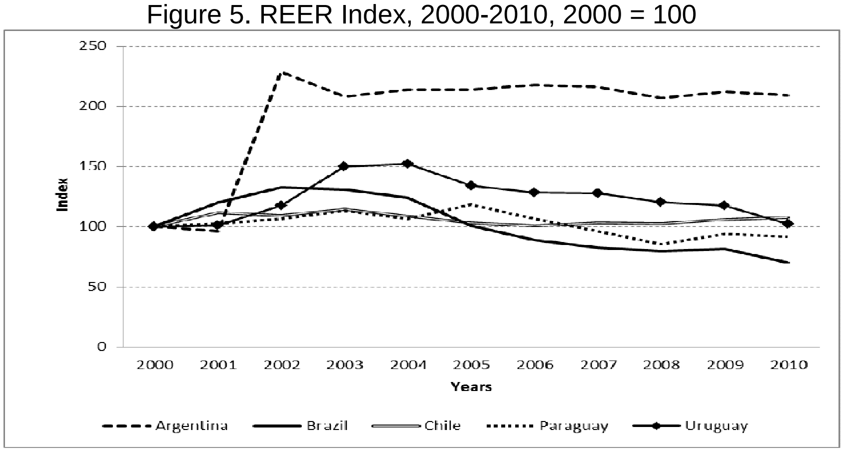
Table 2. Dispersion to the Average Inflation Rate

| *Period* | *Argentina* | *Bolivia* | *Brazil* | *Chile* | *Colombia* | *Ecuador* | *Paraguay* | *Peru* | *Uruguay* | *Venezuela* |
|---|---|---|---|---|---|---|---|---|---|---|
| 2000-10 | 0.18 | -0.57 | -0.29 | -0.90 | -0.45 | 0.78 | -0.02 | -1.06 | 0.05 | 2.52 |

Source: Author's elaboration based on Figure 1.
Note: The average inflation rate for UNASUR countries was 8.1.

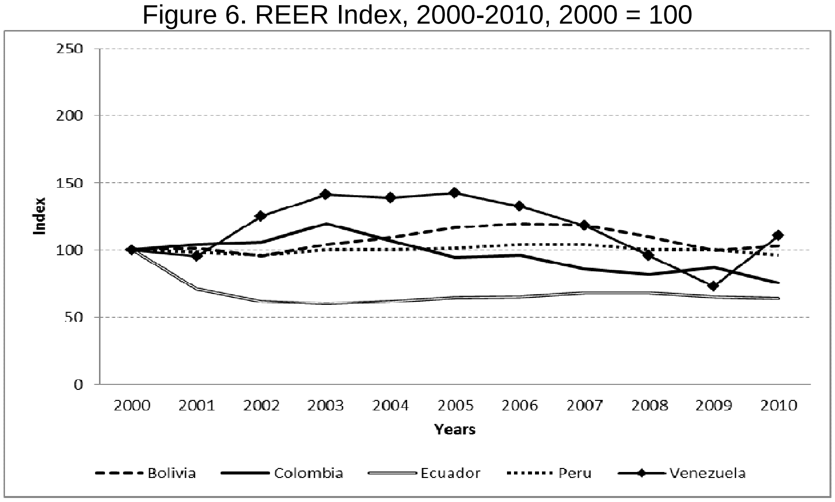
In terms of the REER, Figures 5 and 6 show that: (i) in 2010, the ERERs of Bolivia, Chile, Paraguay, Peru and Uruguay remained relatively stable and presented a convergence process; (ii) the Argentinean *peso* since 2002, after a strong devaluation, has remained stable; (iii) Brazil, Colombia and Ecuador experienced an overvaluation process. The REER overvaluation was stronger in Ecuador; and (iv) the REER of Venezuela experienced high volatility. It is important to emphasize that in Venezuela the high level of inflation has contributed to the volatility and the appreciation trend of REER.

Figure 5. REER Index, 2000-2010, 2000 = 100




Source: ECLAC (2012).

Figure 6. REER Index, 2000-2010, 2000 = 100



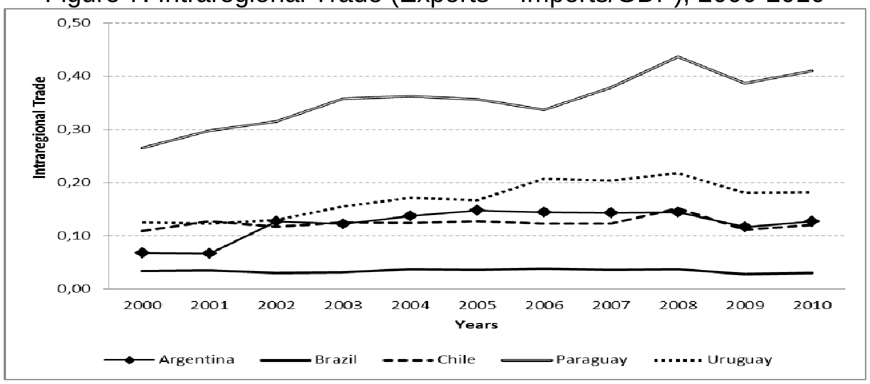

Source: ECLAC (2012).

In addition, the exchange rate regimes of the UNASUR countries are the following: Argentina in 2001 had a currency board regime and since 2002 it has adopted a managed exchange rate regime[16]; Bolivia has a flexible exchange rate regime; Brazil operates a dirty floating regime in the context of an inflation targeting monetary regime; Chile, like Brazil, operates a dirty floating regime in the context of an inflation targeting monetary regime; Colombia adopts a dirty floating regime and its monetary regime is based on inflation targeting; Ecuador is 'dollarized' and adopts a flexible exchange regime with free convertibility; Paraguay has a dirty floating regime; Peru also operates a dirty floating regime in the context of an inflation targeting monetary regime; Uruguay adopts an inflation targeting regime and has a flexible exchange rate regime; and Venezuela, at the beginning of the 2000s, ran a managed exchange rate regime, and, more recently, decided to control the exchange rate to avoid the 'exchange rate pass-through' mechanism, and continued as the only country to control its foreign currencies and manipulator of this devaluation experience. In summary, seven countries 'manage' their exchange rates, one country adopts USD as legal tender and two countries operate a flexible exchange rate regime.

The intraregional trade (exports and imports) among the UNASUR countries increased 176.1% between 2000 and 2010: in 2000, the intraregional trade was around 73.1 billion USD and in 2010 it reached a total of 201.8 billion USD. However, its importance compared to GDP is still very low, as Figures 7 and 8 show, and this intraregional trade expansion, in terms of UNASUR GDP, has remained relatively stable. In 2000, the ratio of total exports plus imports to UNASUR GDP was 5.5%, while in 2010 it increased to 5.8%. As the figures show, the intraregional trade of UNASUR is more important for Bolivia and Paraguay. Moreover, the share of UNASUR exports in world trade is still relatively low; it increased from 2.5%, in 2000, to 3.4%, in 2010.

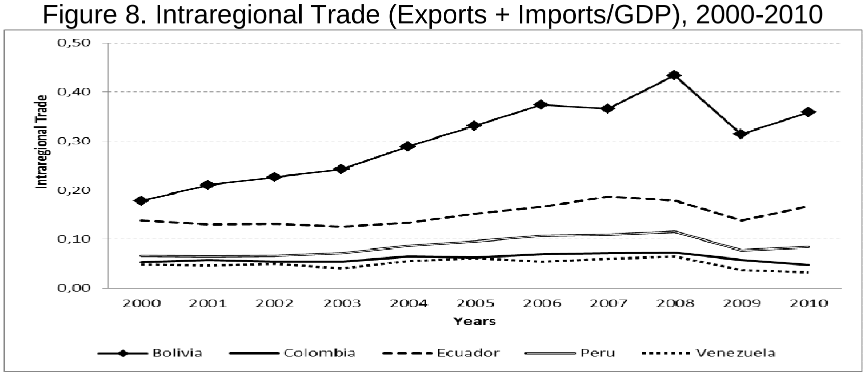
[16] The stable and competitive real exchange rate strategy was a result of the exchange rate administration by the Central Bank of Argentina and its intervention in the monetary market to control the interest rate. However, since the international financial crisis, due to the deterioration trend in the trade surplus, Argentina's government has responded by implementing administrative controls in the foreign exchange market, in order to seek to avoid a further deterioration of its exchange rate.

Figure 7. Intraregional Trade (Exports + Imports/GDP), 2000-2010




Source: ECLAC (2012).

Figure 8. Intraregional Trade (Exports + Imports/GDP), 2000-2010



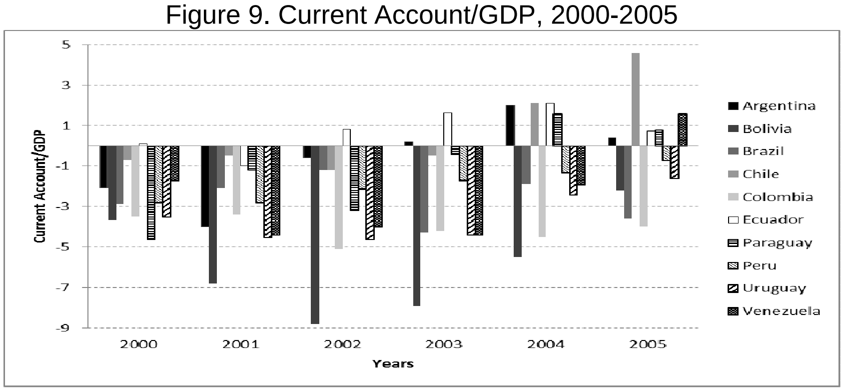

Source: ECLAC (2012).

We look at the figures next that relate to the current account deficit. Figures 9 and 10 reveal the following:

- At the beginning of the 2000s, all UNASUR countries had high current account deficits to GDP. In our view, at least three reasons explain this performance: first, the Argentinean and Brazilian exchange rate crises, respectively in 2001-02 and 2002, ended up affecting the economic dynamics of other countries in the region; second, the slowdown of the world economy, particularly the United States, reduced the demand for South American products; and third the commodity prices (agricultural and mineral –especially copper and iron) of the UNASUR exports fell, basically from 2001 to 2003 (UNCTAD, 2008).

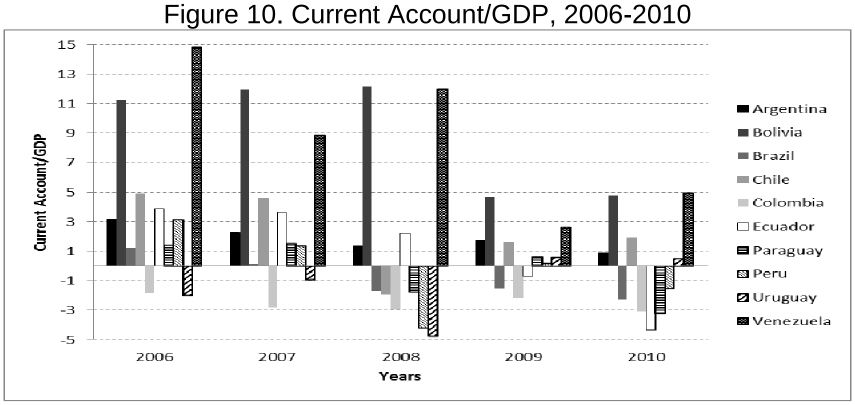
- In 2005 the current account deficits were reduced and in 2006 and 2007 the current accounts of almost all UNASUR countries (the exceptions were Colombia and Uruguay) turned positive. During this period, the world economy showed high growth and the commodity prices increased considerably.
- From 2008 to 2010, the current account deteriorated due to the 'great recession'. Despite this deterioration, the current account deficits were still better than those observed in the beginning of the 2000s.

Figure 9. Current Account/GDP, 2000-2005




Source: ECLAC (2012).

Figure 10. Current Account/GDP, 2006-2010

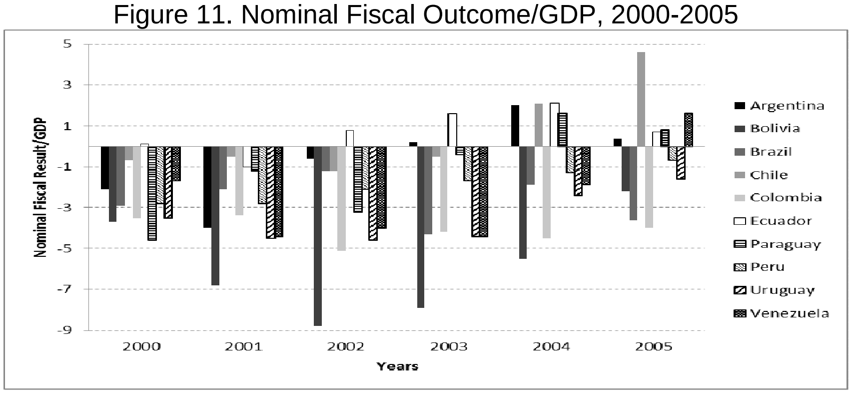



Source: ECLAC (2012).

Figures 11 and 12, which display the fiscal deficits of the UNASUR countries, show that: (i) from 2000 to 2003, in general, the ratio of nominal fiscal outcome/GDP had a bad performance; (ii) in 2004 and 2005, the nominal fiscal outcome became a little bit better for some countries, especially Chile; (iii) from 2006 to 2008, it improved for almost all countries (the exception was Uruguay);

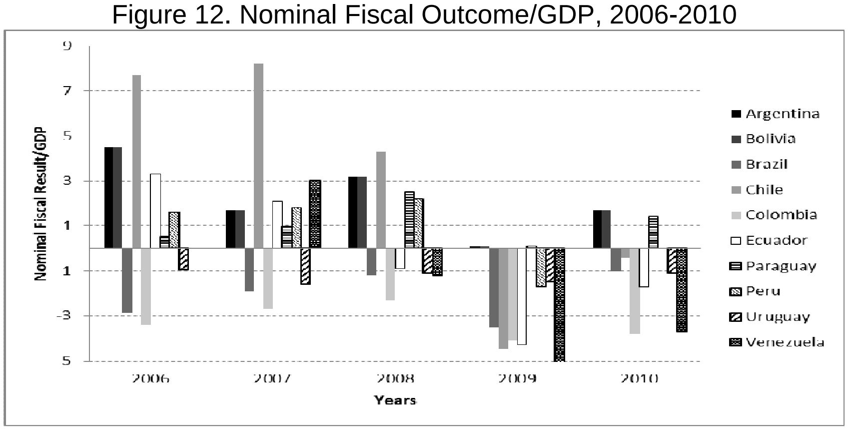
and (iv) in 2009 and 2010, there was great deterioration in the ratio of nominal fiscal outcome/GDP. This deterioration can be explained by the countercyclical fiscal policies implemented by the monetary authorities in response to the 'great recession'. For instance, Brazil and Chile reduced the taxes to stimulate consumption and Argentina, Brazil and Colombia increased their public expenditure. Thus, the combination of short recession and some expansionary fiscal policy produced a reduction in the fiscal balance, in 2009, that quickly improved further in 2010 (Jará, Moreno and Tovar, 2009).

Figure 11. Nominal Fiscal Outcome/GDP, 2000-2005




Source: ECLAC (2012).

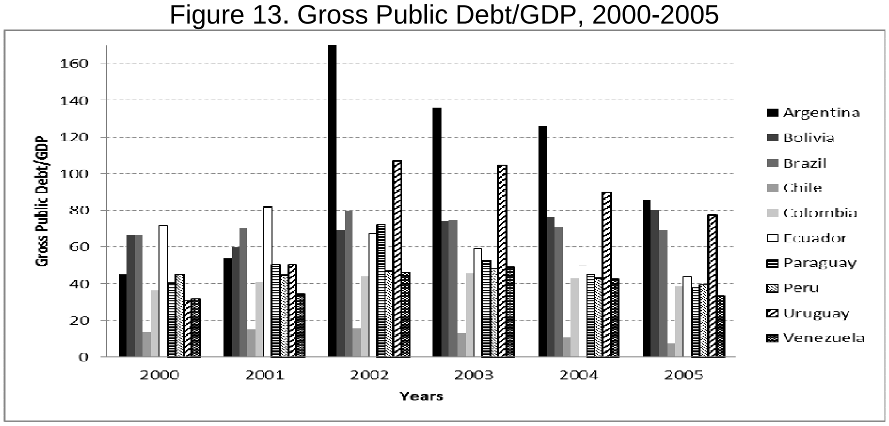
Figure 12. Nominal Fiscal Outcome/GDP, 2006-2010




Source: ECLAC (2012).

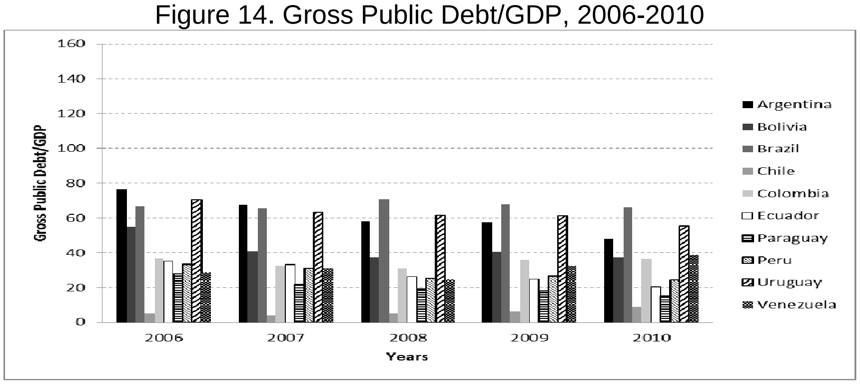
In terms of the ratio of gross public sector debt to GDP, Figures 13 and 14, we may observe that: (a) after reaching 170.0% of GDP, the Argentinean gross public debt dropped, year after year, to 48.0% by 2010; (b) the Bolivian gross public debt was relatively stable, around 60.0%, from 2000 to 2005, and after 2006 it dropped considerably; (c) the Brazilian gross public debt remained, during the period, around 65%; (d) Chile presented the lowest ratio of gross public debt to GDP. Its gross public debt ranged between 15.0% and 20.0%; (e) the Colombian gross public debt ranged between 30.0% and 40.0%; (f) Ecuador, at the beginning of the 2000s, had a high gross public debt. However, after 2006 the gross public debt dropped rapidly, reaching 20.0% in 2010; (g) the gross public debt of Paraguay increased from 2000 to 2002 and, since 2003, has declined, year after year; (h) the Peruvian gross public debt ranged between 20.0% and 30.0%; (i) from 2000 to 2003, the Uruguayan gross public debt increased rapidly and after 2004 it declined and remained stable around 60.0%; and (j) the Venezuelan gross public debt, during the period, ranged between 30.0% and 40.0%.

Figure 13. Gross Public Debt/GDP, 2000-2005




Source: IMF (2012) and ECLAC (2012).

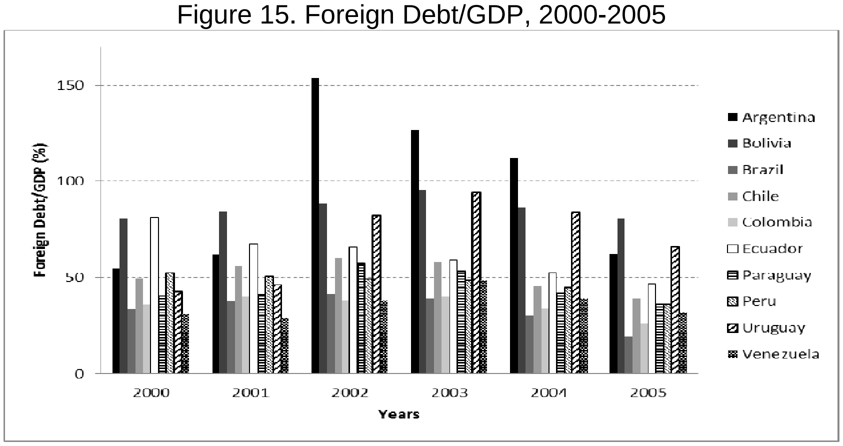
Figure 14. Gross Public Debt/GDP, 2006-2010




Source: ECLAC (2012).

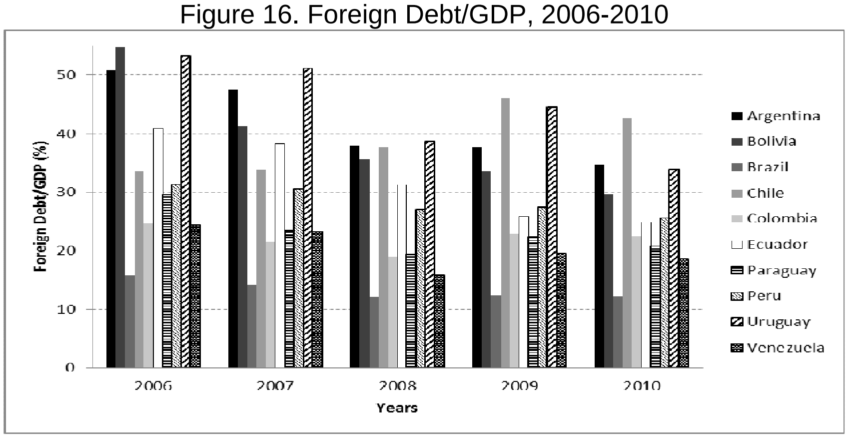
Figures 15 and 16 show the relationship between foreign debt and GDP. In the beginning of the period, 2000, this relationship used to range between 30.0% and 80.0%, while in 2010 it ranged between 12.0% and 43.0%.

Figure 15. Foreign Debt/GDP, 2000-2005




Source: ECLAC (2012).

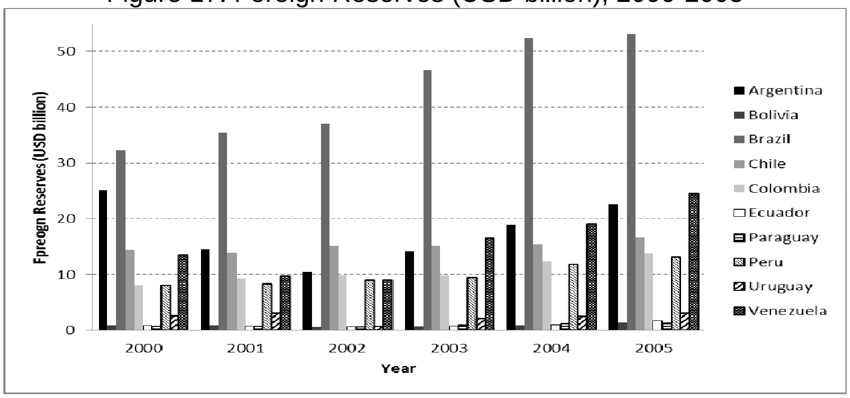
Figure 16. Foreign Debt/GDP, 2006-2010




Source: ECLAC (2012).

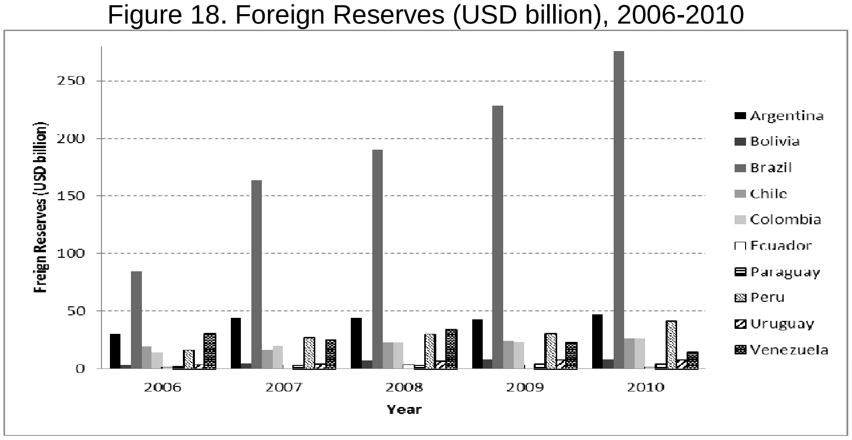
Finally, Figures 17 and 18 show that the foreign reserves of the UNASUR countries, from 2000 to 2010, increased substantially: the total amount of foreign reserves in 2000 were around USD 106.9 billion, while in 2010 they reached USD 451.0 billion. With the exception of Venezuela, in which the total amount of foreign reserves became stable from 2000 to 2010, the total amount of foreign reserves of the other nine countries of UNASUR increased significantly. The amount of foreign reserves of Bolivia and Brazil, for instance, increased seven times in the period.

Figure 17. Foreign Reserves (USD billion), 2000-2005




Source: ECLAC (2012), Brazilian Central Bank (2012) and Central Bank of Ecuador (2012).

Figure 18. Foreign Reserves (USD billion), 2006-2010




Source: ECLAC (2012), Brazilian Central Bank (2012) and Central Bank of Ecuador (2012).

Summarizing the macroeconomic variables for UNASUR countries as discussed in this sub-section, we observed that: (i) average growth rate and inflation rate have been relatively similar for all countries. The exception was Venezuela, basically in terms of the inflation rate; (b) the unemployment rate decreased and converged, over the period, for all countries; (c) despite the difference in the exchange rate regimes, the REER became relatively stable for all countries. Moreover, the range of the REER was relatively close, with the exceptions of Argentina, Brazil and Ecuador; (d) the volume of intraregional trade among the UNASUR countries is still low, but it improved from 2000 to 2010; (e) the relationship between current account and GDP, for all countries, was volatile over the period, showing a slight improvement in the last years of the series, despite the 'great recession'; (f) after 2005, the nominal fiscal result/GDP ratio, for all countries, improved considerably, even with the problems arising from the 'great recession' that forced countries to adopt countercyclical fiscal policies, deteriorating, thereby, the primary fiscal surplus; (g) the gross public debt/GDP ratio showed different performance for the UNASUR countries. However, the trend in the gross public debt/GDP was falling and tending towards stability; (h) the foreign debt/GDP ratio dropped, substantially, for all countries (this relationship dropped slightly in Chile), from 2000 to 2010; and (i) the total amount of foreign reserves increased, from 2000 to 2010, around 320.0%.

To conclude this section, it is important to mention that at the end of the 2000s, a set of factors contributed to the 'convergence' of the macroeconomic performance and to face the contagious of the international financial crisis in the main South America countries: (i) lower interest rates; (ii) public accounts in general improved with low level of indebtedness; (iii) inflation stopped rising (Argentina and Venezuela were the exception); (iv) current account deficits were reduced; (v) competitive exchange rates emerged; (vi) high level of foreign exchange reserves; (vii) reduced short-term external liabilities; and (viii) capital account regulations in place (Cunha, Prates and Ferrari-Filho, 2011; Ocampo, 2012).

#### 4. AN INTEGRATION ARRANGEMENT PROPOSAL FOR THE UNASUR

The previous section shows that some degree of economic integration in South America seems to have become a reality. However, there are still some economic and social problems to be overcome in the South America countries. This is that a growing disparity of the most dynamic countries, such as Brazil, Argentina and Chile, in comparison with the less dynamic countries, for instance Bolivia and Paraguay is present. We may refer to a few examples to make the point. The less dynamic countries seem to suffer from perverse consequences in the sense that the financial system is not developed, the intraregional trade is still low, the industrial system is not diversified and complete, the infrastructure conditions are poor and the income distribution is highly concentrated. Moreover, and as section 2 shows, in the absence of strong economic integration, political integration becomes paramount. Unfortunately the political integration in South America is far from even discussing it, let alone being at some advanced stage or even happening. Two reasons may explain the remote possibility of political integration in South America, at least in the short-run: (i) the colonization and independence processes and the consequent culture of the people, which are all still very far apart; and (ii) the democratic system in the Region, which is by far very recent (1980s and 1990s); it is also the case that the concept of democracy has been used in different ways from country to country. There is, thus, very little chance of achieving healthy monetary union with a common currency. In any case, the EMU model is not the ideal model for South America.

Despite the fact that South America is not economically and politically integrated, starting from the assumption that the process of economic integration in South America can be consolidated by UNASUR, this section presents a relevant proposal for UNASUR. Unlike the original proposal for the creation of UNASUR, which is based on EMU, our proposal would suggest the following: (i) that the EMU is not a relevant arrangement to be adopted by the South American countries, because, as section 2 shows, the EMU institutional and policy arrangements are inherently flawed; and (ii) that our proposal focuses on the creation of a Regional Market Maker that is capable of boosting trade and financial relations, discipline and standardize macroeconomic policies and prevent any disruptive situation resulting from financial and exchange rate crises.

As it is well-known by now, the financial and currency crises in the global world show that the real disruptive outcomes derived from speculation in liberalized financial markets should be reduced, if not eliminated, under certain conditions. The most important condition is the presence of a relevant institution able to (i) prevent the capital volatility, (ii) assure market price stability and (iii) promote full employment economic growth.

Based on this idea we propose an alternative arrangement to UNASUR. The alternative is to assure macroeconomic stability, understood as sustainable economic growth, inflation under control, fiscal adjustment and external equilibrium. To address this objective, it is necessary to create a UNASUR Supraregional Board (USB), with similar characteristics to a Regional Monetary System, with sufficient powers to establish (i) the adoption of common countercyclical macroeconomic policies[17]; (ii) joint programs for removal of trade barriers; (iii) the use of national currencies for intraregional transactions; (iv) a stable exchange rate system; (v) conditions for eliminating the external imbalances; (vi) the management of foreign reserves; (vii) mechanisms of capital controls; (viii) fiscal transfer to reduce structural and economic disparities among the countries; and (ix) conditions to monitor and to prevent market failures (Ferrari-Filho, 2001-2002, 2002).

[17] It is important to mention at this stage that we are not proposing targets for macroeconomic policies nor do we suggest the same macroeconomic policies for countries that have distinct characteristics. In other words, this is not the same as the idea of a 'one size fits all' type of the EMU monetary policy, as argued in section 2 above.

In other words, the idea is that the USB can be an institution able to regulate and stimulate the monetary, financial and trade relations of the UNASUR.

It should be noted that the USB does not necessarily require the establishment of a single currency in the UNASUR area. Instead of adopting a single currency and, as a consequence, the domestic central banks losing monetary policy autonomy, what is required, besides the institutional bodies created in the last three decades to boost the economic integration in the Region, is to embrace under the auspices of the SML all trade relations of the UNASUR countries. The SML should enable foreign trade to take place in domestic currencies and, as a result, there is no need to operate export and import trades among countries in the USD. Moreover, it is necessary to design some rules for the governments and central banks of the UNASUR countries, which would enable them to manage effectively aggregate demand in the South America, as occurred in the 1990s and 2000s, especially in Argentina, Brazil and Uruguay.

In order to achieve its objective, the USB should concentrate on pursuing creative policy options to reduce the real disruptive outcomes that emanate from speculative activity in financial and exchange rate markets. Thus, the USB should attempt the following policy objectives:

(i) To coordinate the macroeconomic policies among countries. It means that monetary policy should be employed to control the rate of interest, instead of controlling the stock of money to keep inflation under control, and fiscal policy should be discretionary to support aggregate demand and, by a transfer mechanism, to reduce economic and social differences and integrate among countries' infrastructures[18]. Furthermore, it is vital for a satisfactory co-ordination of fiscal and monetary policies by the member countries as recently argued, for example, by Arestis (2012).

(ii) To assure that central banks act as a lender-of-last-resort to avoid bankruptcy of banks and financial collapse, as well as government default. Thus, disruption in the credit system that would not support the real sector's productive capacity should be fully discouraged;

(iii) To implement a common trade policy and distribute the costs of achieving balance of payments equilibrium among the two groups of countries, those in deficit and those in surplus. The idea is similar, but on a large scale, to those existing in FLAR, as section 3.1 shows;

(iv) To consolidate the free trade area in the UNASUR, which means to eliminate tariffs, import quotas and preferences on goods and services traded among the UNASUR countries. Currently, most trade relations among countries of the Re-

[18] The proposal is similar to that of the FOCEM.

gion, for instance inside the MERCOSUR and the CAN, are determined by the principles of the Common External Tariff –that is, a standard trade duty adopted by a group of countries.

(v) To manage an exchange rate regime based on a fixed, but adjustable exchange rate system. As it is well-known massive capital inflows as a consequence of large capital inflows in the form of both foreign direct investment and portfolio investment, fuelled by interest rate spreads between markets in the region and in developed economies, have produced macroeconomic problems in the main emerging countries of the region, including exchange rate appreciation and quick increase in domestic credit. Thus, the objective is to reduce the volatility of capital flows and to mitigate instability and fragility related to the speculative attacks on domestic currencies. In this context, on the one hand, reserve accumulation policies can be seen as insurance against negative shocks and speculation against domestic currency. On the other hand, another possibility is the use of capital management techniques, which include capital controls, prudential domestic policies etc. (see, for more details, Ferrari-Filho and Paula, 2008-2009)[19];

(vi) To promote a system of local currency payments to boost the trade and financial relations among countries. The idea is to generalize the SML system.

It should be emphasized at this point that a lesson from the current 'euro crisis' is evident. Namely that in any integration, and the South American integration as discussed in this contribution is no exception, it is very important to have common countercyclical policies of the type of the United States of Europe for example, rather than of the EMU. A single policy based on a single objective of economic policy as in the EMU, with no other policy, is based on the wrong macroeconomic model. Further policies, and fiscal policy in particular, are paramount. This is particularly important in view of the existence of more than a single objective of economic policy as the 'great recession' has taught us recently. Coordination of policies across the regional integration is also important (see, for example, Arestis, 2012).

In other words, our proposal removes all constrains on national-level fiscal and monetary policies, stabilizes the exchange rate, stimulates the trade rela-

[19] Considering that five countries of South America have adopted the inflation targeting framework, a question that is raised is the following: how could inflation targeting and exchange rate targeting be compatible? Frenkel and Rapetti (2011) suggest a mix of administered exchange rate flexibility with active foreign exchange reserve accumulation, regulation of capital inflows and active sterilization of international reserves, combined with low domestic interest rates and fiscal restraint. To evaluate deeply the macroeconomic problems, and their consequences, to identify the trade-offs in economic policy, and to choose the right economic strategy, is the main challenge to economic policies in the South American countries.

tions, imposes limits on capital mobility, and encourages, through SML, intraregional trade and cooperation and preserves foreign reserves. In sum, it reduces the entrepreneurial uncertainties and develops an institutional arrangement to assure full employment economic growth and to mitigate the regional inequality among the UNASUR countries.

### 5. SUMMARY AND CONCLUSIONS

We have argued in this contribution that regional integration in South America is the way forward. Should this be economic integration or political integration along with a monetary union is the really relevant question. We have suggested that the latter is rather premature and regional integration is more appropriate. In pursuing this objective, though, it is of paramount importance that the EMU model is avoided.

The proposed regional integration should involve the creation of a Regional Market Maker in the form of a USB. We have highlighted the policy options of such a board. We believe that a proposal for the UNASUR built like that "could use its influence and its power to maintain stability of prices and to control the trade cycle [in the UNASUR area]" (Ferrari-Filho and Paula, 2008-2009: 190-191). In other words, our proposal suggests a new regional arrangement for UNASUR to promote 'full employment, growth and stability' and to reduce the real disruptive outcomes derived from the speculative activity in financial markets in the South America.

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