

# On the economic desirability of a currency union between Argentina and Brazil.

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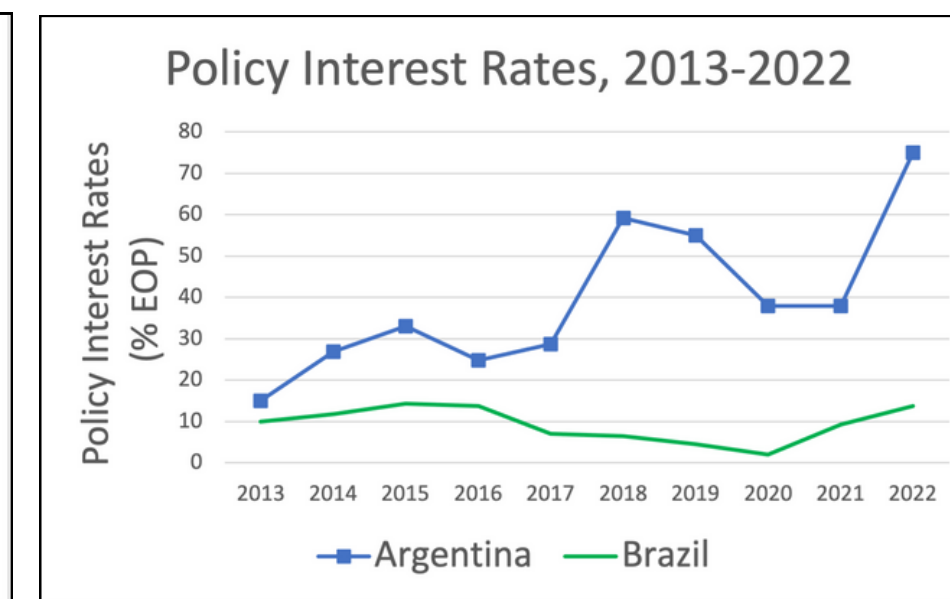
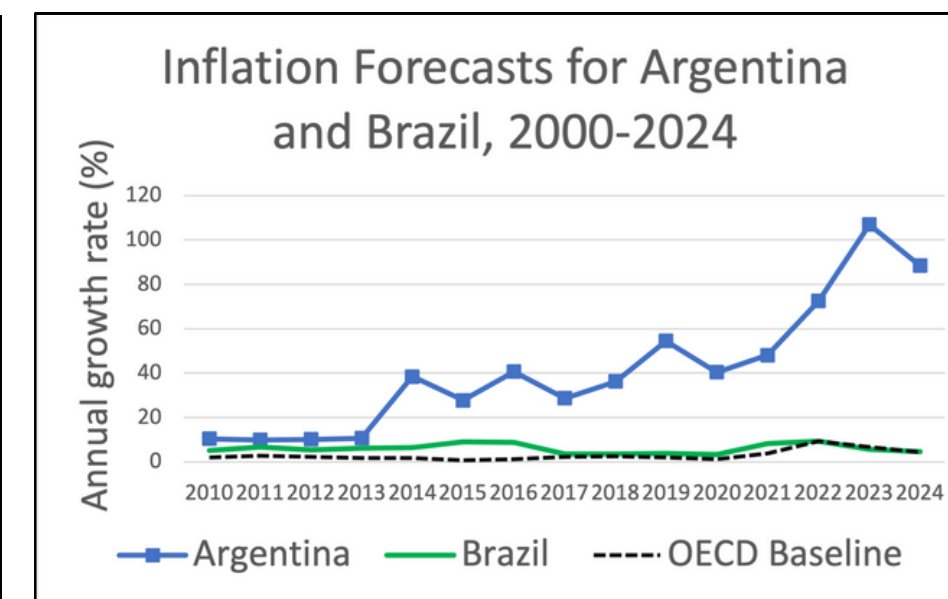
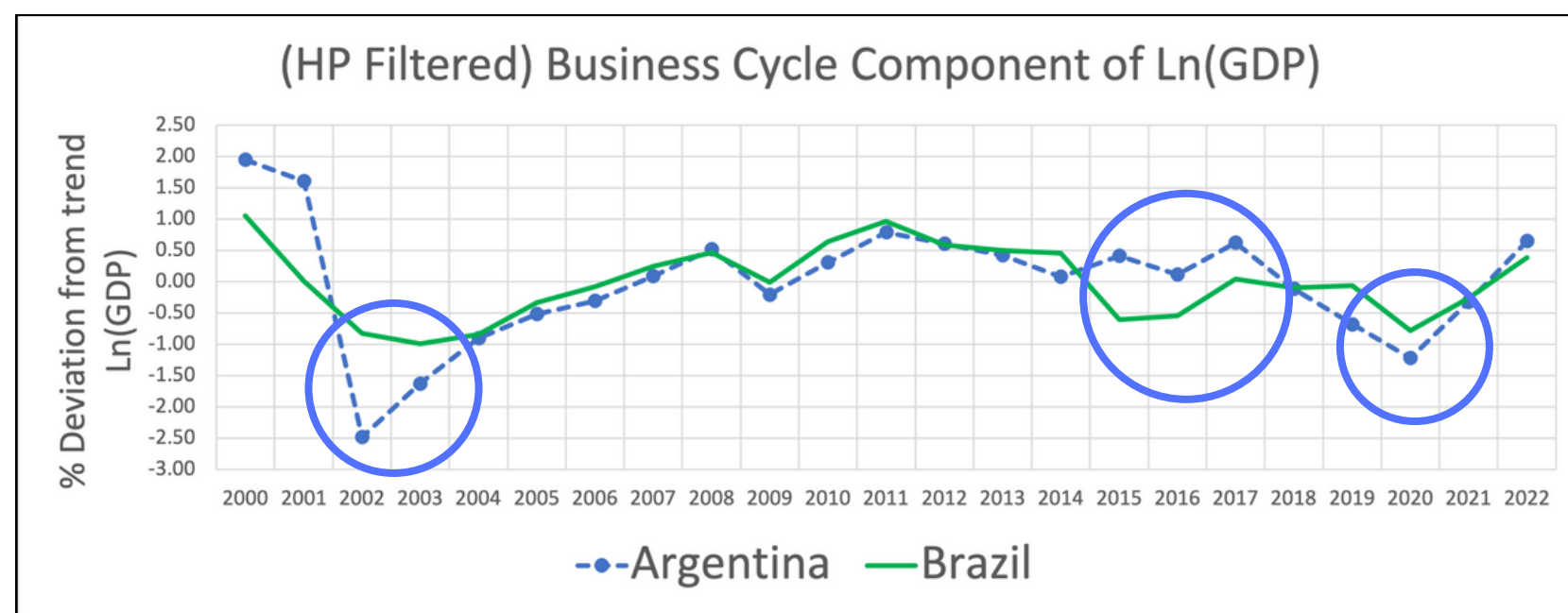
## OVERVIEW

More recently, for Argentina and Brazil, there was yet another episode of discussions for enhancing economic integration through the formation of a currency union. This report aims to examine the reasoning behind both the supporting and criticising views of such a monetary agreement between the two countries.



Presence of sources of potential asymmetries in output shocks, weighted against weak and uncertain economic integration benefits, make a currency union between Argentina and Brazil economically **undesirable**.

## WHY DO ASYMMETRIES MATTER?



$$PPIR (\%) = NI + \pi^T + \alpha(\pi^A - \pi^T) + \beta(Y^G)$$

*NI: Natural Interest Rate*  *$\pi^T$ : Inflation Target*  *$\pi^A$ : Actual Inflation*  *$Y^G$ : Output Gap*

Potential asymmetries during economic shocks (highlighted with blue circles in the first figure above) contribute to adjustment difficulties within a monetary union, where member countries no longer enjoy monetary autonomy, and are unable to use individual policy interest rates (PIR) to facilitate recovery from economic shocks. And so in cases of asymmetries, a common PIR set by the monetary union's central bank may result in variances in speed of economic recovery and sustainability of sovereign debt, for member countries, where the needs of one may be met at the expense of the other. This gap in PIR becomes more substantial for Argentina and Brazil, accounting for the divergence in price stability performance displayed in the latter two figures above.

## INSURANCE MECHANISMS

Full integration of financial markets and budgetary unification within an MU would prominently reduce the opportunity cost by providing a strong insurance mechanism in face of asymmetric shocks. However, the formation of these mechanisms would require collaboration on multiple aspects of political economics, including economic institutions, public policies, and legal frameworks.

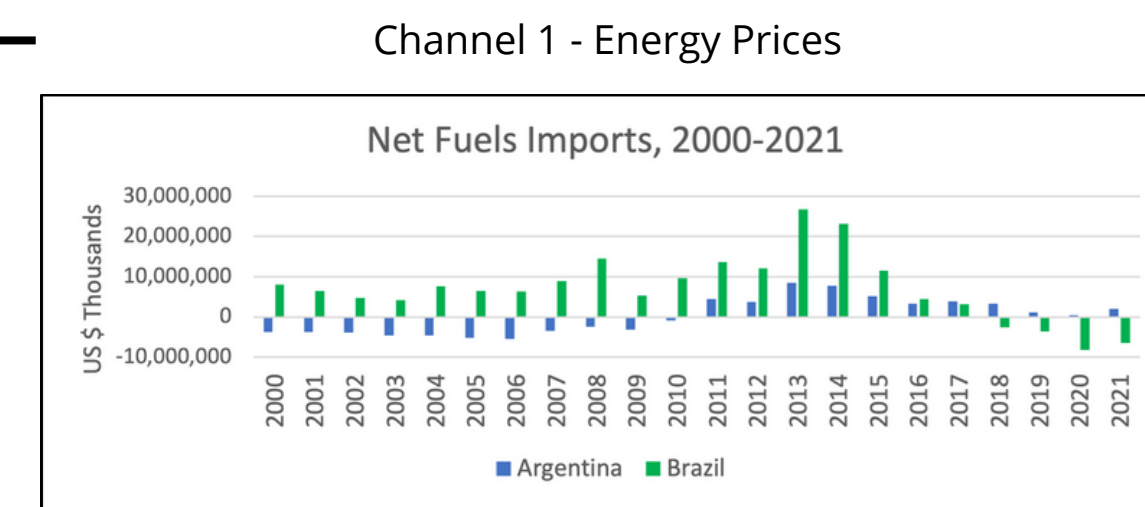


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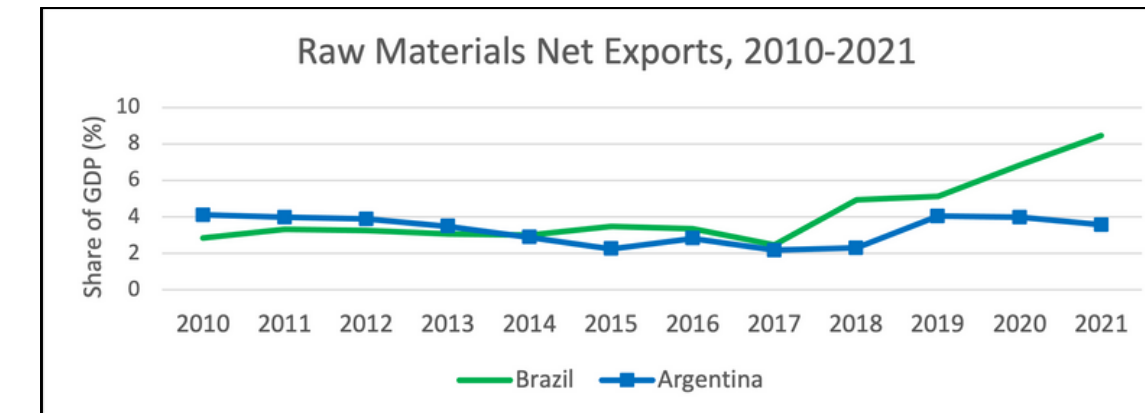
FULL REPORT & REFERENCES

## SOURCES OF COSTS

### Differences in Exposure to External Shocks



### Channel 2 - Commodity (Raw Materials) Prices



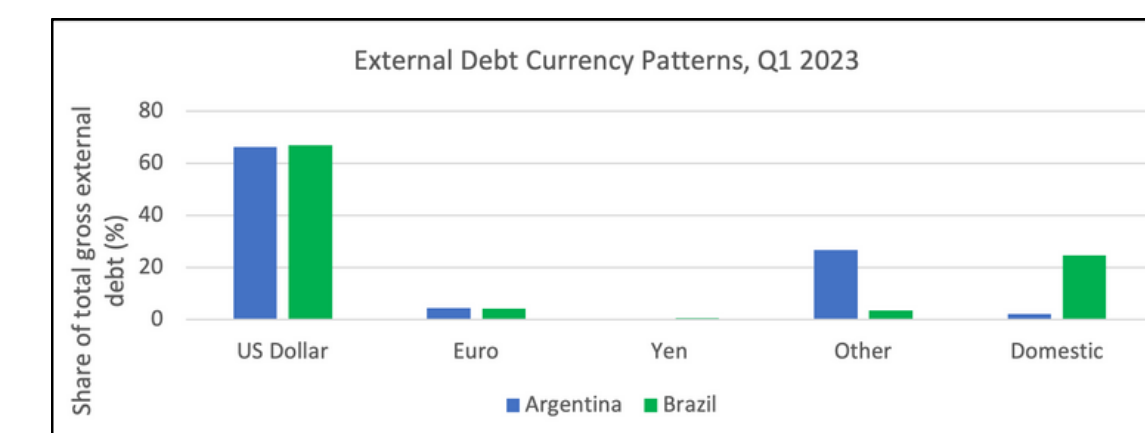
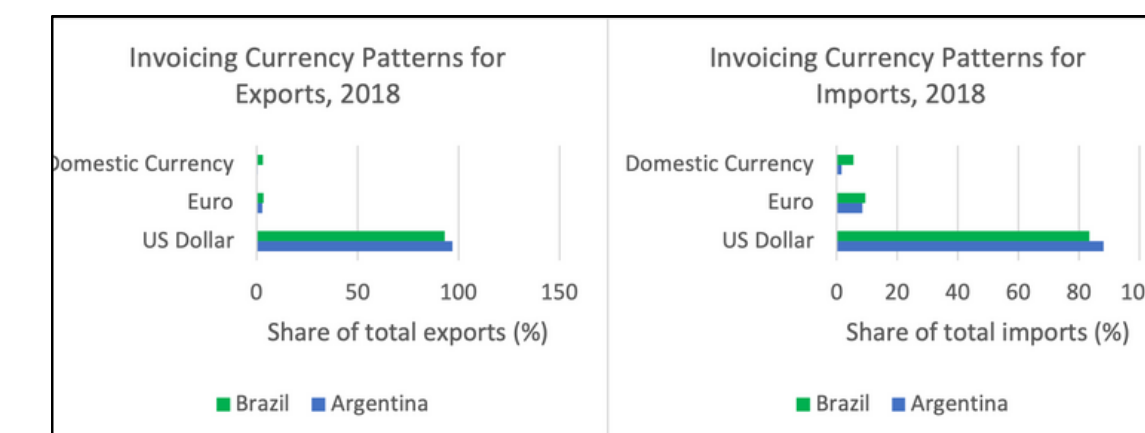
### Channel 3 - Weightage of Short Term Debt



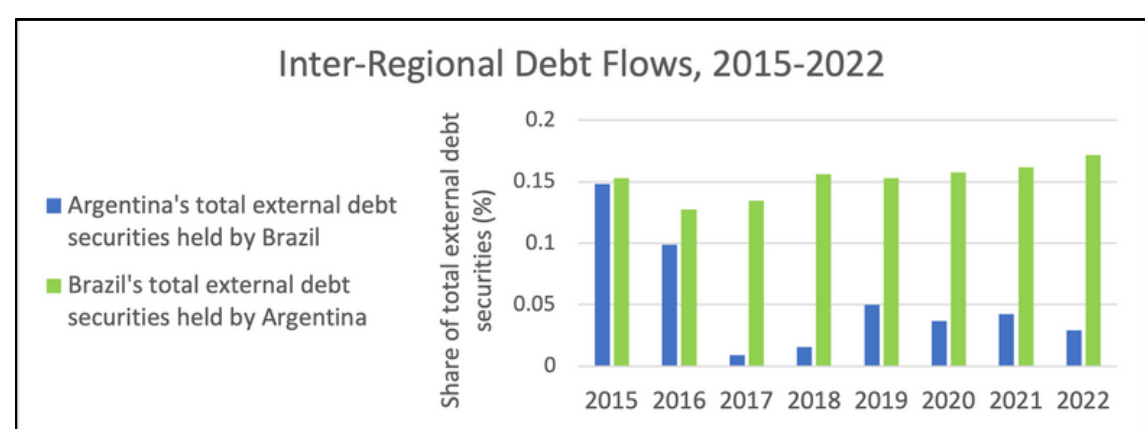
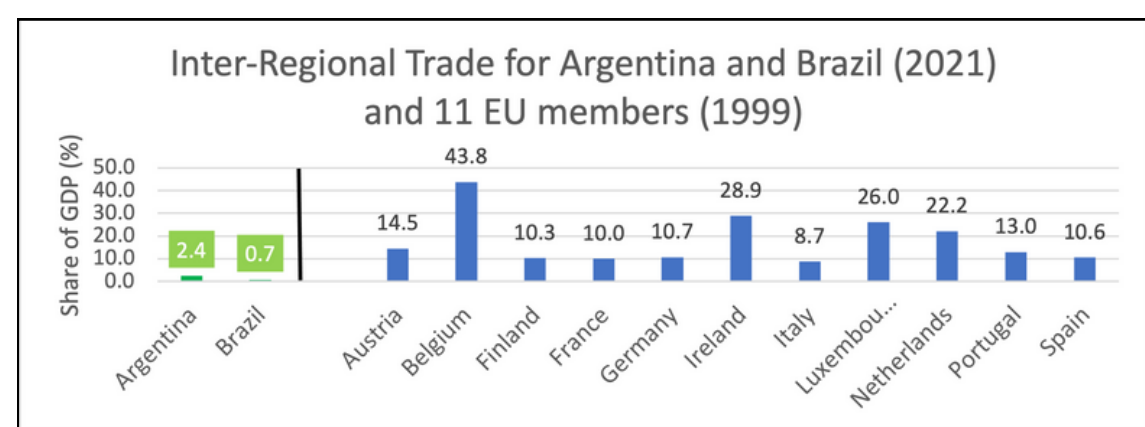
1. **ASYMMETRIES** in magnitude of negative spill overs
2. **ASYMMETRIES** in societal consequences following negative spill overs

### Exposure to USD Appreciations

The above trade and debt asymmetries and subsequent negative spill overs can also be brought about by USD appreciations, given dominance of the USD in trade invoicing and debt denominations for Argentina and Brazil.



## SOURCES OF BENEFITS



**LOW** levels of inter-regional trade flows **LOW** levels of inter-regional debt flows

**WEAK** gains following elimination of transaction costs and exchange rate volatility within a monetary union (MU)

### Impact of an MU on Trade Integration?

**POSITIVE** impact with magnitude of 5% to 20% based on the EU experience.

### Impact of an MU on Financial Integration?

**POSITIVE** impact on deal flows while magnitude & impact on welfare remain **UNCERTAIN** given budgetary and institutional asymmetries.