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IMPLICATIONS OF ECONOMIC AND MONETARY UNION ON EUROPEAN UNION-MERCOSUR RELATIONS

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The external value of the euro in the medium and long run

The euro has determined four major structural and institutional changes in international monetary and economic relations:

1) a substantial elimination of international trade (intra-European Union trade will become regional trade);

2) the elimination of a significant number of national currencies and their respective markets;

3) the introduction of a totally new currency;

4) the introduction of a new major institution, the European Central Bank (ECB).

These four major innovations will interact with the policy followed by the ECB. The dynamic evolution of the euro/dollar exchange rate – the key exchange rate in international relations – will reflect this complex interrelation.

The implications of the euro for Mercosur will depend largely on the evolution of the euro/dollar exchange rate and on the degree of transatlantic monetary cooperation. This paper discusses the evolution of the euro, and its implications for transatlantic cooperation and for Mercosur.*

Different views have been expressed about the likely evolution of the euro/dollar exchange rate in the initial phase of the Economic and Monetary Union (EMU). According to one of them, the single currency will go through an initial devaluation given the credibility problems associated with the reputation building process of the European Central Bank, as well as structural problems spurring from the fact that the EMU is assumed to be lacking the requisites of an optimum currency area. An alternative view predicts an initial appreciation of the euro given the structural elements leading to an excess demand for euros in the international markets which is related to the role of the euro as a "key currency". A third view argues that the emergence of the euro will result in the bilateral instability between the two currencies. The first few months following the launching of the single currency apparently suggest that the first view is the correct one. It is still too early, however, to judge which trend will prevail over the medium term.

We know, from the theory of international transactions, that it may exist multiple equilibria for the relative position of key currencies due to the presence of network externalities associated with the role of vehicle currencies. The equilibrium share of a currency in international reserves and in private portfolios as well as its detention for transaction purposes may either be "low", signalling a "regional" role for the currency, or it may be "high", signalling a "global" role for the currency. As of

* I would like to thank Enrique Barón-Crespo, Sheila Page, Álvaro Vasconcelos and Roberto Zahler for many useful comments on a previous version of this paper.

now it is safe to say that only the dollar plays a truly global role and that the German mark, while being the second most important international currency, is closer to a regional role. At its starting life point, the euro will probably inherit the German mark position in international markets, although a somewhat larger role for the European currency may be expected.

Different equilibria imply both a different share of the euro as an international currency and, possibly a different long run equilibrium level of the euro/dolar exchange rate to the extent that different demands for euros are accommodated by different supply behaviours. The possible shift between equilibria is largely a function of the policies that will be followed with respect to the external value of the euro. An increased role of the euro and its shift from a low share to a high share equilibrium, is likely to be associated with the perception of a stable currency. The international demand for euros would rise and lead to a (temporary) appreciation of the single currency. Policies not perceived by the market as stability-oriented would, on the contrary, decrease the desirability of the euro, leading to a long run decline of its international status.

More importantly, the desirability of the euro would be enhanced by the perception that, following its introduction, the European Union economy is finally phasing out of its low growth and high unemployment performance and resuming on a path of sustained expansion. In this perspective policy choices that reinforce growth and sound development of the European Union, will feed back on the role of the euro in international markets much in the same way as the performance of the United States economy supports the desirability of the dollar. A desirable currency opens the way for the opportunity of making the European Union economy extremely attractive for international capital much in the same way the United States economy is able to do.

Alternative currency behaviours can be coped differently according to the degree of cooperation that will be established between the European Union and the United States. Two extreme cases can be considered: full cooperation or bilateral benign neglect. In order to assess this aspect one must first consider the alternative exchange rate policy options for the euro, the evolution of the euro from a regional to a global role and the likely evolution of international cooperation between the United States and the European Union.

2
Exchange rate policy options for the euro

If multiple equilibria are possible, then transition management is crucial in determining not just the smooth convergence to the new equilibrium but the equilibrium itself. As mentioned previously, the direction that this path will take is a function of the polices that will be implemented to manage the euro.

During the initial stages of the EMU project, there was a debate about the appropriate exchange rate policy for the euro. Two views have emerged. According to the "stability view", given that monetary stability is the main goal of EMU, the external value of the single currency has to be consistent with that target. According to the "growth view" the heavy constraints on EMU fiscal policy required by the Stability Pact and the low inflation commitments of the ECB leave the exchange rate as the only policy instrument for growth.

The alternative between an exchange rate policy targeted at European internal price stability ("strong euro") and one targeted at competitiveness ("weak euro") is largely a false problem. It can be argued that the most appropriate policy is one of external stability of the euro/dolar exchange rate. The following considerations may be offered in support of this view. A stable euro/dollar exchange rate will favour the stabilisation and will perspective a lowering of the real interest rate in Europe, thus supporting a much needed investment upturn in the European Union economy. The latter will also be sustained because of lower financial uncertainty that will accompany the elimination of national currencies. On the contrary, the gains of a "weak euro" in terms of exports and growth are bound to be limited because of the decreasing role of export-led components in the European Union growth mechanism and, more importantly, because of the decreasing role of price competition in European Union foreign trade, especially transatlantic trade.

As it is well known, in Europe, over the past two decades, substantial public deficits have been offset by private sector surpluses, pointing at weak performance of private demand and unsatisfactory real investment growth, itself feeding negatively on the long run growth potential of the European economy. A different story can be told for the United States economy, where the saving-investment gap is far from equilibrium over the 1980s and 1990s only in recession years, and the fiscal gap, which has been narrowing considerably, is financed by the current account deficit.

The differences between the European Union and the United States support the idea of long run benefits of coordinated fiscal consolidation under EMU. Price stability and lower interest rates would lead to smaller fiscal deficits, thus leaving room for expansion of private (and public) investment. In addition, a stable exchange rate/low interest rate policy would strengthen the global role of the euro, increasing its attractiveness in international markets for both private and public investors.

3
The euro: from a regional to a global role

The euro comes to light as a regional currency with a slightly larger domain than that of the German mark. Such a domain is likely to be extended beyond the boundaries of the European Union, in the first place towards the next candidates for European Union membership, the Central and Eastern European Countries (CEEC) and the Mediterranean. Secondly, the euro region will include countries that are now tied to currencies which will be replaced by the euro, such as African countries belonging to the French franc zone. More generally, one can consider the benefits deriving from the establishment of a large euro currency "region" (which is not to be understood as a currency area). These benefits are increasing with the extension of the region (i.e. the use of the currency in different countries in terms of lower transaction costs and scale effects) and decreasing with the diversity in policy propensities (i.e. the use of "active" monetary and exchange rate policies to support growth). The fact that the euro starts off with a large membership and on the sound base of the fiscal convergence process – hence with a very strong convergence of national policy preferences towards stability – points to the existence of positive net benefits from its creation.

The establishment of the euro will accelerate the process of eastern enlargement of the European Union, which is the next important step of the process of European integration. This effect will work through several channels:

1) an area of monetary stability in Europe will (further) increase capital mobility thus facilitating the process of integration through the reallocation of the production process in European industries;

2) the euro will represent a natural monetary anchor for Eastern European Countries. Pegging to the euro will facilitate the macroeconomic adjustment process in these countries in an environment of low inflation and low interest rates;

3) a (hopefully) new phase of growth and resumed investment in Europe will speed up the process of trade integration in the region.

The presence of a "natural" euro zone will not be enough, however, to allow for the shift to a "high" equilibrium, i.e. to a global role of the European Union currency. This will be definitely achieved only when a full international financial market in euros will be established. This process will be accelerated by the integration of European national financial markets (although the process might be slowed down by a late entry of the pound in the EMU).

In summary, it is likely that in the medium term the euro will slowly evolve from a regional role towards a global role. Once this will be fully established the euro will place itself on a equal footing with the dollar. This process will be strengthened by a stability-oriented euro policy.

4
Macroeconomic cooperation and transatlantic relations

Once the EMU will be in place in the reasonable future what will be the implications for transatlantic relations? Two opposing views can be considered. According to one view a major institutional change – such as the establishment of the EMU and of a supranational monetary authority in Europe – will increase the amount of transatlantic cooperation, especially by strengthening other supranational institutions such as the G7. The opposing view maintains that a lower amount of transatlantic cooperation will develop – and will be needed – as the two regions, European Union and North America, will be more interested in their domestic affairs and will seek more inward looking strategies. A tendency towards bilateralism rather than multilateralism in monetary and macroeconomic relations will develop.

To put things in a slightly different perspective, the first scenario will increase the "demand" for international cooperation while the second scenario will decrease it. If the first scenario prevails, however, the question remains as whether a larger demand for cooperation will be matched by an increase in the "supply" of cooperation, i.e. if international institutions will accommodate demand by adjusting to the new situation.

On the one hand this point may be particularly worrying given that historical experience seems to suggest that, in the international system, supply of cooperation usually falls short of demand. However, this need not necessarily be the case if one considers that a larger supply of cooperation does not necessarily imply stronger (or larger) international institutions but, in many cases, more flexible institutions.

To look further into this issue one must consider the possible United States reaction to a successful EMU. It should be recalled that the first American reaction to the Single Market initiative was one of suspect, to say the least, as the perception of a "Fortress Europe" mounted on the wave of fear that a stronger European Union would accelerate the decline of United States economic (and political) power in the global system. While the fear of a protectionist stance in Europe soon proved to be unrealistic, it is sometimes argued that the launching of the Single Market has accelerated NAFTA and has strengthened the tendency towards trade regionalism. It is not surprising, therefore, that the first reaction of the United States administration to the launching of the euro in May 1998 has been the invitation to the European Union not to pursue inward looking policies.

Accordingly, it could be that a single European currency will reinforce the tendency of international investors to diversify away from the dollar, thus weakening the United States currency, and possibly increasing monetary instability. On the other hand, also as a consequence of the EMU, a dollar currency region might develop (or, rather, receive a boost) in Latin America, not so much as a precise integration project but by reinforcing the tendencies of some Latin American countries to take further steps towards a full dollarization along the lines of currency board experiments such as the one in place in Argentina. This point will be taken up later.

Would such developments strengthen or weaken cooperation in other areas, especially in trade relations? One could recall that, as protectionist pressures mounted in the United States in the 1980s, when the strong dollar appreciation hurt United States competitiveness, a similar reaction might develop in Europe in case of a strong euro appreciation. Deep financial, trade, and investment integration across the Atlantic, however, makes this an unlikely scenario.

The evolution of the euro/dollar rate will also depend on the attitude followed by the European Central Bank. Opposing views on how to manage the euro exchange rate are present in Europe. We have discussed the point in the previous paragraph, here we note that a cooperative management of international relations along these lines would call for arrangements to stabilise the real exchange rate between the two regions. A different approach would instead stress the need to stabilise the euro nominal exchange rate on the argument that the ECB should target monetary stability and that, especially in its early life, the ECB might use the exchange rate as a suitable intermediate target for monetary policy given that other intermediate targets, such as aggregate money supply, might be much more difficult to monitor.

In the longer run, once two key currencies such as the dollar and the euro will be established, the well known "n-1 problem" in monetary relations will take a different perspective since it will not be obvious (as in the past) that, because of the sheer economic size of her economy, the United States could substantially ignore the gyrations of the dollar. The establishment of a European economy operating with a single currency will largely equalise the economic dimension of the two regions. As a consequence, the "neglect option" that has so far been a prerogative of the United States will be available to Europe as well. This obvious consideration can be stated differently. Neither of the two regions will be really in the position to ignore the other.

A stable euro/dollar exchange rate would greatly help transatlantic economic relations. It would be favoured by all those actors involved in global activities, multinational firms and sectors exposed to international competition in the first place, and it would represent a major prerequisite for future initiatives such as a New Transatlantic Market Place. In addition, insofar as the medium term will see more of sectoral or specific, rather than general issues on the transatlantic negotiating table – such as standards, property rights, market access, public procurements, R&D cooperation, etc – exchange rate manipulation would not be the appropriate policy response by either of the two sides.

One provisional conclusion on this point may then be the following. While the incentives to increase cooperation in the macroeconomic area may be weak, a single European currency might make it easier to pursue the more modest, yet relevant, goal of monetary stabilisation in dollar/euro relations – which implies flexibility even in the case of target zone type arrangements. Because of globalisation, the incentives for aggressive exchange rate manipulations may be substantially weaker as weaker are, for the same reason, serious protectionist threats. However, this requires that cooperation in other areas be reinforced.

5
The driving forces behind stronger cooperation

Market forces, and especially those associated with the globalisation of capital markets and the activities of multinational enterprises, will do much to increase transatlantic economic integration. Private pressures – such as those emanating from the Transatlantic Business Dialogue – will push towards the establishment of tighter formal relationships and regulations. It is also true, however, that such pressures will probably be resisted by those actors, such as trade unions, who – on both sides of the Atlantic – might consider further integration and openness as a threat to the standard of living of their constituencies.

The nature and intensity of the political response to these opposing pressures will determine the future scenario, as it can be doubted that market pressures alone will lead to the establishment of a new economic order in the transatlantic region. Even intermediate targets and deadlines, however, may fail to appear in the agenda of transatlantic relations in the near future, in spite of pressures coming from the markets and from the private sector. Such a scenario might develop if both North America and the European Union will give priority to their intra (rather than inter) regional problems. It may be argued that Europe is facing more severe problems in coping with her regional integration process, given the challenges posed by enlargement, but that such problems are likely to rise with the process of Latin American integration as well.

Economic trends alone will not produce enough pressure to move ahead in transatlantic integration but one may argue that the required political momentum is likely to come from two other areas of concern to both European Union and the United States: security (in Europe) and the evolution of international financial instability. It is often argued that a common monetary policy in Europe will be fully credible and effective, possibly only with political unification and with a common foreign and security policy in place. It is also argued that a more liberal trade policy in favour of former communist states and Mediterranean countries will provide additional security benefits to Europe and to the international system. A common European Union-United States goal of providing a global security framework would represent an additional incentive to transatlantic cooperation as both European Union and the United States view a stronger and more integrated European economy as a prerequisite for a more efficient security burden sharing. The developments of the international financial crisis may also strengthen the pressure towards deeper European Union-United States cooperation for the support of global financial stability.

6
Can the European experience help integration in Mercosur?

In order to assess the implications of EMU for Mercosur it is useful to first have a look at the perspectives of trade and monetary integration in Mercosur in the background of the European experience. Two issues are of relevance here: the role of monetary integration in providing a useful disinflation mechanism and the co-evolution of trade and monetary integration.

The European Monetary System (EMS) experience which started in 1979 can be considered a successful experiment of a monetary coordination mechanism established with the main purpose of bringing inflation to very low levels in European countries. This was achieved through a "diffusion of discipline" from the nominal anchor country, Germany, to the other countries, including such large economies as France, Italy and Spain. Success of disinflation was confirmed in the aftermath of the severe crisis in 1992 when inflation did not resume, even in countries that experienced large devaluations (Italy, Portugal and Spain). One of the major costs of disinflation was, in some cases, a large and prolonged real appreciation in inflation prone countries which, to a large extent, harmed trade performance. In spite of this, however, and even after the large real devaluations after 1992, trade integration in Europe was not disrupted. This is a very encouraging experience that Mercosur can take into consideration: monetary stabilisation and trade integration can indeed proceed together. The point can be further developed by noting that the EMS has also produced increasing cyclical convergence between countries participating in the exchange rate agreements (with the notable exception of the United Kingdom). Somehow, this result has made one of the crucial conditions for the success of a monetary union in Europe – cyclical convergence – endogenous and self-reinforcing.

It may, in this respect, be argued that Brazil and Argentina are large commodity exporters and hence they may be exposed, more than European Union countries, to asymmetric shocks, thus suggesting lower reliance on fixed exchange rates. On the other hand, the very process of Mercosur integration will strengthen other forms of trade – manufacturing and intra-industry trade – which will increase the benefits of monetary integration.

Another aspect makes Mercosur clearly different from the European Union: the widespread phenomenon of dollarization. The use of the United States currency in the domestic Latin American economies has two distinct aspects, which also have different implications for the choice of the external peg: currency substitution and asset substitution. Currency substitution refers to the use of the dollar as a unit of account (and therefore as a medium of exchange). If currency substitution is prevailing then the appropriate policy is pegging the domestic currency to the dollar as this increases domestic monetary stability. Asset substitution refers to the role of the dollar as a store of value (and therefore as an investment instrument). If asset substitution prevails, portfolio diversification is enhanced and a flexible exchange rate may increase domestic monetary autonomy.

Trade integration, monetary stabilisation and dollarization issues lead us to the major problem faced by Mercosur in deciding forms of monetary integration: the choice of the nominal anchor. This aspect is made both more problematic and amenable to different solutions with the establishment of the euro.

7
The euro and Mercosur: problems and opportunities

Ruling out the possibility of full monetary cooperation between the European Union and the United States, the most likely scenario for the medium term is an unstable euro/dollar behaviour, i.e. a scenario characterised by "mutual benign neglect". Consequently, the establishment of the euro might force Mercosur countries to face problematic choices. One of the basic factors supporting economic integration in Latin America is macroeconomic stabilisation. Notable examples are the currency board in Argentina and the stabilisation program (*Plano Real*) in Brazil. The success of these programs was based on a solid linkage with the United States dollar, chosen to fulfil the role of nominal anchor. Such a choice was also dictated by the fact that a large share of Mercosur international trade is in commodities, whose prices are set in dollars.

As discussed above it remains unclear what will be the future evolution of the euro/dollar exchange rate. With the exception of the stability scenario, which implies at least some degree of European Union-United States cooperation, one can expect different trends, as well as short term volatility in transatlantic currency behaviour. In all cases, problems for Mercosur would arise in order to maintain the dollar-peg policies. In case the dollar would appreciate *vis a vis* the euro, Mercosur countries would gain in terms of stabilisation (antinflation) benefits but would loose competitiveness in European Union markets (including the markets of the "euro region"). In case of dollar depreciation *vis a vis* the euro, the opposite would hold, i.e. increased trade competitiveness and weaker and possibly adverse stabilisation effects. Finally, larger euro/dollar volatility would most likely depress trade perspectives with the European Union and increase trade integration with the dollar area without adding to macroeconomic stabilisation gains.

In all cases, the direction and possibly the intensity of the Mercosur integration process would be significantly affected, given that the European Union and the dollar region are the two most important trading partners for Mercosur. The trade shares with the two regions would determine the relative importance of the effects. The current Mercosur trade pattern indicates that both imports and exports of Mercosur from (to) the European Union are marginally larger than those with the United States and that trade is relatively more balanced with the European Union – as the normalised trade deficit is negative in both cases, but smaller for European Union trade, implying a smaller financial dependence from the European Union (1991-1996 data). Such a trade pattern must be considered in the context of increasing trade diversion that has occurred between 1990-1991 and 1996-1997. This process has hit proportionally more the exports to the European Union than those to the United States. Over that period, the share of exports to the European Union has decreased from 32% to 24%, while exports to the United States have only marginally decreased from about 22% to a little over 20%. Mercosur exports to Latin America have increased from 19.6% to 33.6%, and Latin American exports to Mercosur have more than doubled (from 10% to 23%). Imports from the European

Union, however, have increased from 23.5% to 26.2%, imports to the United States have increased from 20% to 21.6%, while imports from Latin America have increased from 27% to 29%. Given the still predominant currency substitution effect as far as dollarization is concerned, the first of the two possibilities discussed above – a weaker euro – would add monetary stabilisation gains while strengthening the process of trade diversion towards a deeper internal Mercosur trade integration.

A third scenario, an unstable euro/dollar relationship, would produce increasing pressures for Mercosur countries, which would have to choose a reference currency (either the dollar or the euro) to act as a nominal anchor. A case of clear predominance of trade with one of the two regions (which is not the current case, however) would obviously make things easier; in other words, the geography of trade patterns would dictate macroeconomic priorities. In the longer term the choice would increase the regional orientation of trade, strengthening the initial ties (e.g. with the dollar region) and weakening the incentives to strengthen ties with the other region (the euro region). Instability in the euro/dollar exchange rate would further increase the asymmetrical regional pattern also possibly increasing intra-Mercosur trade. In this respect, somewhat paradoxically, the establishment of the euro might increase rather than decrease the distance between the European Union and Mercosur.

The choice for Mercosur countries will also depend, however, on the expected policies of the two regions, the European Union and the United States, in terms of macroeconomic performance and market access. Growth oriented and open market access policies will act as a major determinant of choice for Mercosur. In this respect Mercosur choices are, to some extent at least, a function of the policies the two northern regions will carry out, both in their own sake (as far as growth orientation is concerned) and with respect to Mercosur.

To conclude this paragraph one may object that the natural choice for a reference currency is neither the dollar nor the euro but both, i.e. a basket pegging. This option, while certainly possible and reasonable, may turn out to be difficult in practice if we assume that, at least in the medium run, the euro/dollar exchange rate is likely to exhibit a large instability. On the other hand such an option would become highly feasible if a cooperative scenario between European Union and the United States develops.

The points raised in the previous paragraphs do not exhaust the implications of the euro for Mercosur. The euro will force Mercosur to make possibly painful choices about the future of its integration process but it will also offer new opportunities.

In the first place Mercosur, like other countries and regions, will benefit from a new large area of monetary stability in terms of lower interest rates and larger and deeper financial markets to tap from. Secondly, the presence of a new large financial area will offer new opportunities for international investment diversification. In the third place, for any given amount of trade with the European Union, transaction costs related to trade with EMU countries will be lower, and exchange risk will be reduced; i.e. the benefits accruing to EMU members will be shared with their trading partners.

From the Mercosur perspective the establishment of a wide euro market will increase the weight of the asset substitution component of dollarization as foreign currencies, both the dollar and the euro, will be held for investment rather than for transaction purposes. This effect will be stronger the faster the progress towards macroeconomic stabilisation and financial market integration in Mercosur and will increase the range of monetary policy options open to Mercosur.

The above reasons will make the option of stronger ties with the euro more attractive for Mercosur countries. The euro-Mercosur relationship, however, will largely depend on the expected behaviour of EMU authorities *vis a vis* Mercosur. This includes financial support and possible lender-of-last-resort action that EMU authorities will be willing to grant to Mercosur countries. The Mexican crisis, to some extent the South East Asia crisis, and to a larger extent the Brazilian crisis, have shown that the United States is firmly committed to support the economy of a country with which it is closely related and, at the same time, that large European countries will not necessarily share the same policy priorities as the United States. Given the ever pending possibility of local and global financial crises, the expectation of financial support from a regional leader will clearly matter in the strategies of third countries and would-be peggers. In other words, the attractiveness of the euro region as a nominal anchor will, as in the case of trade policy, also depend on the perceived policy orientation of EMU authorities in the case of financial distress facing countries belonging to the EMU region. In this respect however, it may be reasonable to expect that, at least in the medium run, priority in support would be granted to geographically closer countries such as the Central and Eastern European ones. This should, however, reinforce rather than weaken the effort the European Union should direct towards deeper integration with Mercosur in the form of increased trade opening and investment initiatives. Such a process would "naturally" increase the attractiveness of the euro for Mercosur.

In the end, however, the above dilemma would be largely eliminated to the extent that international institutions such as the International Monetary Fund (IMF) will be strengthened by a new and more authoritative role played by the new European institutions. A more independent and politically accountable IMF, for instance, would be able to act as a true lender-of-last-resort to cope with future crises. Such a model – i.e. stronger international institutions backed, on an equal footing, by both the United States and Europe – would represent a major step forward towards a more cooperative and stable environment (a new financial architecture) which would make the options open to Mercosur less conflicting.

9
Monetary regimes and Mercosur integration: longer term implications of the euro

Given the balance between costs and benefits in the longer term, the major impact of the euro on Mercosur might well be that of speeding up the Mercosur integration process in a direction of greater independence from both the United States and the European Union, so as to strengthen the triangular relationship with both areas. From the point of view of monetary relations this perspective might sound highly unrealistic. A bipolar – or even tripolar – monetary system would seem to leave very little room for an independent Mercosur monetary regime. In other words, it would appear inevitable for Mercosur to choose between the dollar and the euro although a more stable euro/dollar relationship would facilitate the adoption of a basket-peg option. Prior to that choice, however, something else will have to be settled: the form of monetary regimes that Mercosur countries will adopt.

At present, as it is well known, the two major Mercosur countries have similar, yet different, regimes. Argentina has adopted a currency board which implies a fixed, one to one, conversion rate with the dollar as well as a *de facto* loss of monetary sovereignty. Brazil has, more recently, adopted a fixed peg with the dollar for the purpose of disinflation, but has maintained some control over its monetary policy. As the Brazilian crisis shows these two systems cannot coexist in the long term and, at the same time, their coexistence does not support the process of Mercosur financial convergence, adding to centrifugal rather than centripetal forces in the region. Argentina's currency is exposed to the consequences of a real appreciation with respect to the real, severely hurting competitiveness and disrupting the trade integration process. The Brazilian economy is simply too large and diversified for the adoption of a currency board, which entails loss of monetary sovereignty. Higher exchange rate flexibility will undermine Mercosur trade integration even more seriously. In the medium to long run, taking into account deeper financial globalisation, intermediate forms of exchange rate regimes, such as pegged exchange rates, are likely to prove unsustainable. In other words, in the long run the only feasible arrangements are flexible exchange rates or monetary unions. Of the two alternatives, monetary union is the only arrangement consistent with deep integration.

In short, over the medium term the emergence of a bi(tri)polar monetary system would force Mercosur to face problematic choices, while offering at the same time opportunities for diversification. In the longer term, however, the dilemma might be bypassed by the evolution of Mercosur into a full economic and monetary union. The (hopeful) success of EMU will represent a very clear guide in this respect.

10
Perspectives for the transatlantic triangle after the crisis of the real

The introduction of the euro will, by definition, establish a triangle in transatlantic relations. The real issue is whether this will be a stable relationship or not. A tentative answer must distinguish between medium and long run perspectives.

In the medium term, over the next five to ten years, two of the three poles of the triangle – EMU and Mercosur – will be undergoing deep transformations. The EMU will be developing towards full economic and (possibly) political union in a context of monetary and financial stability as the ECB will establish a strong reputation, and the euro will slowly increase its role as an international currency for both trade and investment purposes. The process will be fully completed only when all fifteen members of the European Union will join the single currency. During this period the main policy concerns in Europe are likely to be inward looking, i.e. an attitude of "neglect" with respect to the external value of the euro will prevail. To the extent that the United States attitude will also be one of "neglect", i.e. no serious bilateral cooperation framework will be established, the variability of the euro/dollar exchange rate is likely to increase, making the basket option a less attractive one.

The crisis of the real has not changed dramatically the perspectives discussed above. It has, if anything, accelerated the process towards the adoption of new monetary regimes in Mercosur. At the time of writing, the option followed by the two major countries – deeper links with the dollar for Argentina, a float for Brazil – dramatically highlight the need for Mercosur to decide for her future as an integrating region. It cannot be ruled out that, for the sake of medium term monetary and financial stabilisation, the two major countries will decrease rather than increase reciprocal integration by choosing different monetary arrangements. Their hard choices are not made easier by the very slow process made in the implementation of the new financial architecture.

In the medium run, while little progress in transatlantic monetary cooperation can be expected, a crucial role will be played by trade and investment policies. Further trade opening towards Mercosur from both NAFTA and the European Union would help stabilise the triangle. In such a perspective, the relative role of the euro and of the dollar will largely depend on market behaviour, as markets will choose between the two key currencies on relative efficiency and profitability considerations. Under conditions of financial stability such a process would gradually increase the relative importance of the asset substitution motive with respect to the currency substitution motive in dollarization, i.e. foreign currencies in Mercosur would be held relatively more for the investment than for transaction motive. Monetary policy options open to Mercosur would increase as a dollar-peg would not necessarily remain the only realistic strategy. Persistent financial instability in the region, however, is likely to put the process back onto a currency substitution rather than on an asset substitution path.

If one assumes financial stability in the long run, however, one can foresee three regions: NAFTA, EMU and a well developed Mercosur possibly with a robust macroeconomic framework to support trade and investment integration. What would make the triangle really stable would be deep integration both in trade and in investment within and, more importantly, between regions, as deep integration would make the costs of intra-regional conflict simply unbearable for all parties concerned.

Of course, the long run scenario can follow a different path if Mercosur and NAFTA merge into a larger American economic region. This would inevitably substitute the triangle with a bipolar framework.

In conclusion, the introduction of the euro will lead to a bipolar (if not tripolar) international monetary system. This will offer Mercosur both problems and opportunities. Problems will arise from the apparent need to "take sides" either with the dollar or with the euro. Opportunities will arise from the possibility of diversification away from the dollar in currency invoicing, portfolio and investment denomination, etc. The desirability of closer monetary and financial integration with the EMU will be enhanced by the perception that European Union authorities are prepared to provide financial support (such as lender-of-last-resort intervention) to countries outside the euro region, as well as larger market access. In the longer run, the dilemma of choosing between the euro and the dollar might be overcome by the establishment of a full economic and monetary union in Mercosur, thus "completing the triangle" between Europe, Latin America and North America.