Fiscal Convergence Within A Customs Union: The Case of MERCOSUR
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Abstract
A real dynamic multi-country general equilibrium model is built to analyze the effects of ceilings imposed on the share of deficit to GDP and total public debt to GDP established in the Declaration of Macroeconomic Convergence signed by the Presidents of MERCOSUR countries in December 2000.

In the absence of monetary policy and under the assumption of fixed exchange rates, our results indicate that MERCOSUR's output would be lower as a result of the restrictions imposed on the fiscal indicators. At the aggregate level, the results suggest that the loss of economic activity would be most marked when the debt ceiling is lower. Without an output growth target and in the presence of rigidities – both on the exchange rate and the government spending - the countries would have to reduce overall economic activity in order to reach and maintain the fiscal targets. Overall, the positive effect on investment generated by lower domestic interest rates is exceeded by the negative effect on output required to prevent a breach of the fiscal ceilings.

By using the discounted stream of consumption, we find that MERCOSUR as a whole experiences a welfare loss. The results obtained in this study indicate that a higher ceiling on the stock of total public debt as a percentage of GDP would cause a smaller loss of welfare both on MERCOSUR as a whole and each country's welfare as compared to welfare changes resulting from a lower debt ceiling.

From the current account data, our results indicate that MERCOSUR would experience deterioration in the foreign borrowing position in the periods prior to the enactment of fiscal ceilings which would be reversed in the long run. We find that although the region would still be credit-constrained, in the long run it would be facing less negative – more sustainable - levels of debt after the fiscal ceilings are imposed. The reversal of the borrowing position is largely due to the improvement of the trade balance with the rest of the world. Trade among member countries changes unevenly as Brazil improves its intraregional trade balance while Argentina intraregional trade balance worsens.