



**School of Business and Public Management  
The Institute of Brazilian Business and Management Issues**

Minerva Program

Spring 2004

***Mercosul:  
Has Political Will Proved to Be Enough?***

(WORKING DRAFT VERSION – NOT YET REVISED)

*Chamber of Deputies*

Author: *Márcia Azevedo*

Advisor: *Professor Thomas O'Keefe*

***“Politics takes both passion and perspective.”***

Max Weber

**ABSTRACT**

Since the Treaty of Asunción entered into force in 1991, Argentina, Brazil, Paraguay and Uruguay have been trying to show the necessary political will to promote economic integration within Mercosul. Nonetheless, political enthusiasm and commitment have varied widely. Domestic and international constraints have caused Mercosul members, mainly Brazil and Argentina, to shift their trade strategies away from Mercosul. In times of crisis, they unilaterally adopted policies that confronted the bloc's interests, reflecting the lack of a long-term operational approach. This paper analyzes how the political rationale has influenced the economic integration by examining the trade strategies and policies within Mercosul over its thirteen years.

# CONTENTS

<b>INTRODUCTION</b> .....	<b>5</b>
<b>INTEGRATION AS A VOCATION</b> .....	<b>7</b>
INTEGRATION AS A STATE POLICY: CONSTITUTIONAL PROVISIONS.....	7
THE ETHICS OF INTEGRATION.....	9
<b>A LOOK AT THE PAST</b> .....	<b>12</b>
THE BOLIVARIAN HERITAGE .....	12
THE LEGACY OF LAIA .....	13
COOPERATION BETWEEN BRAZIL AND ARGENTINA: THE ORIGINS OF MERCOSUL.....	14
THE TRANSITION PERIOD: SHAPING A FREE-TRADE AREA (1991-1994) .....	16
BUILDING A CUSTOMS UNION IN TIMES OF CRISIS (1995-1998) .....	20
<b>GETTING OVER OBSTACLES, FACING CHALLENGES</b> .....	<b>27</b>
THE LATE 1990S: EVEN HARDER TIMES .....	27
HARMONIZATION OF MACROECONOMIC POLICIES.....	30
<b>OUTLOOK AND TRENDS</b> .....	<b>33</b>
BUENOS AIRES CONSENSUS.....	33
THE DECLARATION OF COPACABANA.....	33
PHYSICAL INTEGRATION.....	34
PUBLIC PRIVATE PARTNERSHIP.....	36
<b>RECOMMENDATIONS AND FINAL REMARKS</b> .....	<b>37</b>
<b>CONCLUSION</b> .....	<b>39</b>

## **INTRODUCTION**

*“Mercosur cumple hoy 13 años”* (4/26/2004). With such a laconic headline the Paraguayan newspaper *ABC Color* recently referred to the 13th anniversary of the Southern Common Market (Mercosul), which was formally created in 1991 with the signature of the Treaty of Asunción by Argentina, Brazil, Paraguay and Uruguay. In briefly concluding its note, the newspaper remarked that *“as a less developed country, Paraguay depends on the goodwill of its neighbors Brazil and Argentina so that Paraguayan goods have more market access”*.

The headline is not exactly good news. After all, given its 13 year-history, Mercosul should be already resting on more solid basis rather than “goodwill”, which is not supposed to be the major pillar of regional economic integration. It is certainly necessary, but probably not sufficient.

Mercosul, a trading bloc created to be a common market, has so far become neither a complete free-trade area nor a perfect customs union. Mercosul member countries have not successfully enforced the common trade policy instruments required by the inherent characteristics of a common market. There has been no significant progress in the coordination of macroeconomic policies either. Moreover, the bloc still lacks a minimum degree of economic complementarity and infrastructure.

Fortunately, the reference to Mercosul’s anniversary also conveys good news. Despite its incomplete procedures, and all the controversies and setbacks the bloc has faced since 1991, Mercosul is a reality. It is regarded as the most successful experience of economic integration among developing countries since the resurgence of regionalism in Latin America, which dates back to 1960. This evaluation has a high significance taking into account the asymmetries of the four members, ranging from a basically agricultural country (Paraguay) to the largest economy in Latin America (Brazil).

Mercosul has created significant trade flows both within the member countries and externally, bringing greater dynamism to the region’s commercial relations. It is the world’s fourth largest market with more than 200 million consumers, and a GDP of more than US\$ 1 trillion (after Nafta, European Union and Japan), covering an area of 11

million kilometers. The bloc represents more than 50% of Latin America's GDP, 46% of inter-regional trade - within the scope of the Latin American Integration Association (LAIA), this would be 58% including Bolivia and Chile -, and around 10% of Latin America's total trade with the rest of the world. The bloc also attracts 80% of the investments made in South America.

Since the creation of Mercosul, Argentina, Brazil, Paraguay and Uruguay have been trying to show the necessary political commitment to the integration of the Southern Cone sub-region as a means of lessening their asymmetries and enhancing overall welfare. As a matter of fact, from the very origins of Mercosul, politics has been a distinguishing feature within the bloc. It was the political will of Argentine and Brazilian governments to overcome their differences that launched the bilateral cooperation initiatives leading to the formation of Mercosul.

Nonetheless, political enthusiasm and commitment have varied widely since 1991. Domestic and international constraints have caused Mercosul members to shift their trade strategies towards a not necessarily more efficient or profitable direction, but often to one that could improve their current account and balance of payments in the short run.

In times of crisis, Mercosul countries' leaderships have managed to keep their political rhetoric favorable to the bloc "priority", whereas in practical terms, the procedures they unilaterally adopted would undermine the possibility of intra-bloc policy convergence. Indeed, it is ironic to remember, for instance, that former President Raul Menem, the same who signed the Treaty of Asunción on behalf of Argentina, has also made decisions that did drive that member country away from Mercosul, posing a threat to the bloc's cohesion and, therefore, to its future.

The key question seems to be: is it possible to foster trade flows and economic integration on the basis of political will? Is it enough? This paper analyzes how the political rationale has influenced the decision-making process regarding the economic integration, specially the trade strategies and policies within Mercosul over its thirteen years.

## **INTEGRATION AS A VOCATION**

### ***Integration as a State Policy: constitutional provisions***

As this paper will discuss further, there is an undeniable historic underlying trend to (or vocation for) regional integration in South America dating back to the 19<sup>th</sup> century. Regional and sub-regional integration have long been defined as a main concern by Southern American countries' highest authorities (presidents, ministers, ambassadors, congressmen, among other public officials).

On his taking office as Brazil's Minister of Foreign Relations, in 2003, Celso Amorim stated that South America is a priority for Brazilian government. Likewise, his predecessor Minister Celso Lafer used to say: "*Mercosul is a natural path to follow*". More recently, Argentine Minister of Finance, Roberto Lavagna, referred to Mercosul as a "*State policy, not only a government policy*", and "*Argentina's most important project*".

A State policy, not a merely a government policy. This key distinction implies that integration must be embraced as a non-partisan and unavoidable project by whoever rules each of Mercosul's countries.

In this regard, it is worth considering the Constitutions of Argentina, Brazil, and Uruguay, that provide a general legal framework for regional integration, as follows:

### ***Constitution of Argentina (1994)***

*Section 75 - Congress is empowered:*

*22 - To approve or reject treaties concluded with other nations and international organizations, and concordats with the Holy See. Treaties and concordats have a higher hierarchy than laws.*

*(...)*

*24 - To approve treaties of integration which delegate powers and jurisdiction to supranational organizations under reciprocal and equal conditions, and which respect the democratic order and human rights. The rules derived there from have a higher hierarchy than laws.*

***Constitution of Brazil (1988)***

*Article 4 – The international relations of the Federative Republic of Brazil are governed by the following principles:*

*(...)*

*Sole paragraph: The Federative Republic of Brazil shall seek the economic, political, social and cultural integration of the peoples of Latin America, viewing the formation of a Latin American community of nations.*

***Constitution of Uruguay (1967)***

*Article 6 – (...) The Republic will seek the social and economic integration of the Latin American States, specially regarding the common defense of their products and raw materials. Likewise, it will tend towards the effective complementation of their public services.*

Accordingly, to be in compliance with the national positive law of each country (represented by its Constitutions, their supreme law) and the international law (represented by the Treaty of Asunción<sup>1</sup> and its Protocols), executive authorities, lawmakers and policymakers must acknowledge that it is mandatory, not discretionary, to coordinate efforts aiming at a comprehensive integration. Those who are empowered to plan governmental programs must demonstrate both political will and commitment to economic integration and its related areas (foreign trade, agriculture, industry, capital, services, customs, transportation and communications). It is necessary to turn commitment into concrete procedures through the adoption of coordinated macroeconomic policies, namely exchange, fiscal, and monetary policies.

Nevertheless, the decision-making process is not that simple. In the case of Mercosul, it reflects domestic and external interests that are not always convergent. On the contrary, many of them collide with each other. That is when political will is at stake, and maybe some sort of ethic of integration is required.

---

<sup>1</sup> The Treaty of Asunción in its Article I: “The States Parties hereby decide to establish a common market, (...). This common market shall involve: (...) The commitment by States Parties to harmonize their legislation in the relevant areas in order to strengthen the integration process.

### ***The Ethics of Integration***

From the standpoint of policymakers, regionalism seems to be politically preferable to multilateralism because a State member has more control over the distribution of gains among sectors, and that makes it easier to protect less competitive industries. However, this is more likely to be true when regional trading blocs<sup>2</sup> are relatively less institutionalized, and nations can negotiate specific terms separately based on their own hierarchy of objectives and their perception of the international scenario. In economic terms, however, this approach does not always seem to be the optimal path toward maximum efficiency and economic growth. (VAZ, 2001)

In the case of Mercosul, this political preference seems even contradictory because the bloc's broader project goes beyond free trade. It is expected to reach a deeper level of economic integration, not simply a free-trade<sup>3</sup> area, since it has been conceived to become the common market<sup>4</sup> of the Southern Cone, with cooperation and articulation of different domains (including the political itself), and plans to mould South America into a single bloc.

In the view of these facts and given the complexity of the integration process, involving convergent and divergent interests, as well as public and private agents, there should be an ethics of integration, so that the logic of integration is not broken, and the bloc is successful in accomplishing its common goals. The ethics herein suggested is not related to a moral code. Instead, it is related to the Mercosul countries' capability of holding to a commitment, thus generating, to a certain extent, a sense of accountability among them, to allow more efficiency and prevent deadlocks from happening.

For this reason, the ethic of integration is not that different from the "ethos of politics as a 'cause'" introduced by the German sociologist Max Weber in 1918. In his famous lecture called "Politics as a Vocation", Weber argued that "*he who lives 'for' politics makes politics his life, in an internal sense.*"

---

<sup>2</sup> The theory of economic integration categorizes regional trading blocs at different levels according to how extensive the integration of national economies becomes. A trading bloc may be a free-trade area, a customs union, a common market or an economic union.

<sup>3</sup> A free-trade area is an arrangement under which tariffs and other barriers to trade among the members are removed, according to a defined schedule. (DUNN, 2004)

<sup>4</sup> According to the trade theory, a common market is a third step in regional integration, after a free-trade area and a customs union. A common market is a customs union that allows the free mobility of capital and labor among the member countries. (DUNN, 2004)

Weber further added that *“passion does not make a politician, unless passion as devotion to a 'cause' also makes responsibility to this cause the guiding star of action(...) - a sense of proportion is needed. “Politics takes both passion and perspective”.*

Following this rationale, Weber pointed out two “sins” against vocation, in the field of politics: lack of objectivity and irresponsibility. Finally, he concluded that a political conduct can be oriented to an “ethic of ultimate ends” (principles or conviction) or to an “ethic of responsibility” (obligation), which are no absolute contrasts, but rather supplements.

By the same token, integration takes both passion and perspective, for it takes more than sharing common beliefs and values or cherishing an old dream. However, it also does take more than protecting one economic sector or another because, in a given period of time, it has more power to influence the decision-making process.

The passion (“ethics of ultimate ends”) is represents the close social ties, cultural values, history, and traditions. In other words, it is the self-perception of the bloc as a unity. The perspective (“ethics of responsibility”) is related with the pragmatism, the commitment to national interests, the prevalence of sovereignty. The blending of passion and perspective should provide sustained political will.

But what is it that we call political will? How can it be defined? It is definitely not a predictable, nor a measurable variable. It cannot be measured or depicted in graphs, although it is undoubtedly one distinguishing feature considered by political economy studies, since political economy is concerned with the relationship between politics and economics with a special emphasis on the role o power in economic decision-making (SMITH, 2003).

Political will can be defined as “a determined effort by persons in political authority to achieve certain economic objectives, through various reforms of social, economic and institutional structures” (ibid). The definition may be clear, but the concept seems to be too fragile in practical terms. As a matter of fact, lack of political will is often said to be one of the main reasons for the failure of economic programs.

Bringing the debate back to the Mercosul's scenario, political will has proved to be a key variable of the national governments in defining priorities and strategies, and thus explaining the dynamism of Mercosul (ROETT, 1999) It is possible to recognize that, on the one hand, the bloc has benefited from its inherent vocation for integration, a general legal framework and converging interests bringing its State members together and leading them to integration. On the other hand, there are conflicting interests that reflect the inherent asymmetries of the bloc. Such conflicts are not a new neither an exclusive feature in the integration process. Conversely, they are very common and probably the reason why there have been hitherto so many attempts of integration in South America.

## **A LOOK AT THE PAST**

### *The Bolivarian Heritage*

Once upon a time there was a large continent that had been divided into colonies and kept under the rule of ancient powers for over 300 years. Then a man who was inspired by revolutionary ideas from overseas fought bravely for the independence of those colonies. He knew that, though free, the newborn countries would still be vulnerable. So the “Hero of Independence” tried to bring the former colonies together, united as a single, sovereign nation, but his efforts were in vain. One after another they split into independent states. That was when *El Libertador* realized that politics is no fairy tale.

The continent was South America, in the 19th century, the dominating powers were Spain and Portugal, and the man was Simón Bolívar (1783-1830), who won the independence of Bolivia, Colombia, Ecuador, Panama, Peru and Venezuela. Born of a wealthy family in Caracas, Venezuela, Bolívar had been educated by tutors under the influence of European Enlightenment.

As of 1810, the struggle for independence among the Spanish (and Portuguese, in the case of Brazil) colonies in Latin America evoked a sense of unity, especially in South America.<sup>5</sup> The pioneer Panama Congress (1826) convened representatives of the new republics, but separatist movements kept undermining Bolívar’s attempts of integration. His proposal – a Spanish America united, starting with the region he had freed - was rejected by the regional elites leaders. The largest countries in South America, Brazil and Argentina did not join the continental political integration (the beginning of Pan-Americanism) as proposed by Bolívar.

Albeit the Bolivarian dream did not come true and seemed to be a utopia rather than a feasible project, the trend towards regional integration endured in South

---

<sup>5</sup> Amid the separatist and integrationist movements, a series of inter-American conferences were held in Panama (1826), Lima (1847 and 1864), Santiago (1856), Santiago (1856), and Washington (1889-1890).

America. The past forty decades have proved that there is a historic vocation for regionalism in South America.

### ***The Legacy of LAIA***

The formal integration process in Latin America began in 1960 with the signature of the Treaty of Montevideo, creating the Latin American Free Trade Association (LAFTA/ALALC), providing for a free-trade area within twelve years, negotiated by individual member states. LAFTA was based on the premise that the integration project, by expanding markets, would prove positive for the import-substitution model. The scheme did not live up to expectations. The inherent contradiction between trade liberalization to boost exports and the protectionist logic of the import-substitution model undermined the LAFTA system. At that time, governments used to defend protectionism as a stimulus to growth, and were not willing to offer long lists of goods for liberalization. (ROETT, 1999) Such an unfavorable political and economic environment led to LAFTA's failure.

In 1980, the Latin American Integration Association (LAIA/ALADI) replaced the LAFTA, establishing economic preference areas under more flexible time lines than its flawed predecessor had established. The objective was to arrange preferential tariff agreements among the member countries that agreed to do so, aiming at a Latin-American common market (the same as Mercosul).

The 1980 Montevideo Treaty is the legal framework that constitutes and rules the ALADI. Its general principles are pluralism, convergence, flexibility, differential treatment and multiplicity. The member countries of ALADI are Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela. Any Latin-American country can join the 1980 Montevideo Treaty.

It is interesting to take into account that the main influence on regional economic integration frameworks in Latin America comes from Western Europe. Such was the case for the LAFTA, as well as for the LAIA. Later, in 1991, the Treaty of Rome would also be a source of inspiration for the drafters of the Treaty of Asunción. Nevertheless, the European influence was not the sole or the main one, since the drafters also borrowed guiding lines from the General Agreement on Tariffs and Trade (GATT).

### ***Cooperation between Brazil and Argentina: the Origins of Mercosul***

Unlike its predecessors, Mercosul is the result of a bilateral process initiated by Argentina and Brazil in the mid-eighties. It had first been set up in July of 1986 with the implementation of a Program for Integration and Economic Cooperation (PICE), signed by Presidents José Sarney of Brazil and Raúl Alfonsín of Argentina. Two years later, the positive outcomes from the implementation of the first stages of integration led to the signature of a Treaty on Integration, Cooperation, and Development in 1988.

That bilateral initiative had a political scope, namely the consolidation of democracy, the promotion of regional stability, and the overcoming of suspicion and rivalry in the sub-region, a feeling particularly dominant during the military dictatorships that had ruled the Southern Cone during the sixties and seventies.<sup>6</sup> At that time, intra-regional trade was in decline, and protectionism was the main instrument of foreign trade policy. To illustrate the collapsing trade flows previous to the Argentine-Brazilian rapprochement, it is worth noting that whereas Brazilian exports to Argentina peaked in 1979 at US\$ 1.1 billion, during the first half of the 1980s exports never topped US\$ 880 million and reached a dismal low of US\$ 612 million in 1985. (Manzetti, 1990)

From the beginning, the PICE initiative was clearly state led. Only when economic sectors were put on the agenda by official trade negotiators was the private sector involved in the early negotiations.

Despite the centralized negotiations, the integration program was expected to shape a common economic space, by promoting economic interdependence between Brazil and Argentina. At that time, the main objective was to stimulate a balanced and managed growth of trade flows. Trade was approached very selectively and carefully, by lowering tariffs in specific industries.

---

<sup>6</sup> The authoritarian regimes had followed the paradigm of Realism, which places great stress upon military power. Realism can be seen as the conservative ideology whereby sovereignty represents the ultimate legal authority over a given territory; therefore, the nation-state is primary and central to any developments in international relations.

The scope of the sectoral agreements was limited to three basic goals: to stimulate bilateral trade on the grounds of economic complementarity and political symmetry; to foster changes in the efficiency of production in key economic sectors through the expansion of bilateral investment flows; and to promote cooperation in areas of critical importance for joint economic development such as energy, transports and technology. Capital goods were then regarded a core sector.

The great change in the development strategies of Argentina and Brazil would come to pass only after 1990. The selective economic opening both countries tried to pursue in the late eighties was gradually replaced by a liberalizing approach. The political agenda was not dismissed, but trade liberalization became the main driving force of the integration process. The objective of a common market gave way to some operational definitions of the settlement of a free trade area and a customs union in the short term. And that laid the groundwork for integration, paving the way for Mercosul to take shape.

Unlike the previous bilateral integration initiatives, the new strategy was not the outcome of a deliberate and jointly defined approach to common political and economic challenges. Rather, it evolved from the convergence of liberal economic policies pursued unilaterally by both countries. It aimed at the establishment of a trade liberalization program that could eventually serve as a leveling platform in other international trade negotiations<sup>7</sup>. The selective approach was replaced by a broad trade liberalization program through automatic, linear tariff reductions. Instead of limited lists of specific goods, trade liberalization should encompass the entire universe of tradable goods, allowing each country to keep a small number of products under a temporary exceptional regime.

This program was originally agreed to bilaterally in 1990, when the Buenos Aires Act was signed by Presidents Carlos Menem (Argentina) and Fernando Collor de Mello (Brazil). The program was incorporated into the Economic Complement Agreement no. 14, subscribed by both countries under the Latin American Integration Association

---

<sup>7</sup> Some international analysts see the creation of Mercosul in 1991 as a response to the “Initiative for the Americas” announced by the United States under George H.W. Bush Administration in 1991. (VAZ, 2003)

(LAIA). The new integration strategy introduced strict commitments to tariff reductions and the establishment of a free trade regime within five years.

When Paraguay and Uruguay decided to join the bloc, they were encouraged by the commitments undertaken by the two major countries in the Southern Cone, as well as by the possibility of creating a trade bloc to negotiate collectively with the United States within the framework of the Initiative for the Americas (the Free Trade Area of the Americas - FTAA). Such a bloc would grant credibility to the efforts of domestic economic reforms. Moreover, it would prompt economic opportunities and favorable conditions for market access on preferential basis. (VAZ, 2003).

On March 26, 1991, the Argentina, Brazil, Paraguay and Uruguay signed the Treaty of Asunción. The Treaty of Asunción is considered ambitious because it aimed at building a common market in a very short time frame (before December 1994).

### ***The Transition Period: Shaping a Free-Trade Area (1991-1994)***

The so-called “transition period” ranges from the signature of the Treaty of Asunción on March 26, 1991, to December 31, 1994. That was supposed to be the easiest phase in Mercosul integration, since the main objective was to become a free-trade area.

The bloc’s internal agenda for its first four years included: the implementation of the trade liberalization program, the settlement of trade disciplines in non-tariff areas, and the establishment of a common external tariff.

Mercosul’s strategy in its first years was relatively successful in promoting trade liberalization. There were positive results in the performance of intra-Mercosul trade in its first four years (which grew from US\$4.2 billion in 1990 to US\$12 billion by the end of 1994). These outcomes were closely associated with political and economic factors: the strong political commitment by national governments to market-oriented economic reforms, with Mercosul as a forefront initiative to support and promote them; a favorable

external economic environment which stimulated the emergence of outward-driven trade strategies notably in Argentina and Brazil; and the methodology applied to promote the phasing out of tariffs and settlement of the basic instruments of a customs union.

However, divergent political preferences between Brazil and Argentina as to the form and levels of coordination of trade policies to be achieved, and differences in degrees of macroeconomic stability led to mounting disagreement between the two most important partners in Mercosul. Differences in their trade and industrial policies influenced the trade strategy pursued by Mercosul during the transition period.

It is important to take into account the different perspectives of Brazil and Argentina in relation to trade policy within Mercosul, which grew increasingly contradictory.

Brazil had begun to shift its trade policy towards liberalization, which means away from a managed trade strategy, which for decades had focused on the development of its large domestic market through imports substitution. The challenging Brazilian strategy in the early nineties was to pursue trade liberalization and, at the same time, preserve some key industrial sectors and exploit market opportunities for those sectors within and out of Mercosul. As a result, Argentina, Paraguay and Uruguay had the perception that a protectionist bias still persisted in Brazil's trade policy.

Argentina, on the other hand, aimed at redefining its economic outlook and its international insertion, by trying to develop a privileged relationship with both its main economic partners and with the United States. Its agenda also included the commitment to trade liberalization and obtaining concessions in terms of market access from its main trade partners, including Brazil.

That initial framework, in which Brazil maintained a limited protectionism while Argentina tried to exhibit deep commitment to the liberal agenda, changed significantly when considered from the perspective of the intra-Mercosul negotiations in the first half of the nineties. In Argentina, rising commercial deficits with Brazil reflected microeconomic imbalances. Pressure increased from domestic economic sectors that bore the costs of unilateral measures of economic adjustment and liberalization, as well as those derived from integration within Mercosul. Argentina's trade policy within Mercosul

gradually incorporated some elements of managed trade. Brazil, in turn, sought to promote, consolidate, and lock in its economic reforms through Mercosul. In order to safeguard its interests in Mercosul as a privileged space for preparation for wider economic opening, Brazil needed to reject several proposals and unilateral measures proposed by Argentina with the purpose of regulating the process of trade liberalization within Mercosul. (VAZ, 2003).

At the end of the transition period, Brazil emerged as a more open economy in relation to 1991. Argentina, even if it were not the original intention of the government, emerged as an economy in which several limits to trade liberalization had been introduced. For several economic sectors in Argentina, those limits meant a setback to the implementation of a liberal trade agenda. The regime of convergence toward a common external tariff (which was the core aim of the transition phase), the lowering of Brazilian tariffs, and the upward trend of Argentine tariffs, reflected an inversion of the trade policy orientations of both countries within Mercosul.

The trade strategy aimed at generating preferential market access for goods among the four member countries by phasing out tariffs and establishing common trade disciplines in relation to non-member countries. An important feature of that strategy was to grant priority to the negotiation of less controversial issues and to build on successes achieved there to deal with more controversial and complex ones. Therefore, efforts concentrated on the phasing out of tariffs, while non-tariff issues and the disciplines required to build a free trade regime or a customs union remained unfinished. Progress in negotiations in these areas demanded the accommodation of divergent interests and priorities through political and technical tradeoffs and side payments.

Trade-offs were vital to overcome specific stalemates and to achieving the basic objectives of the negotiations within the defined time framework. The fundamental and most important trade-off involved in Mercosul's commercial profile was of a political nature.

Brazil conceded preferential access to its large domestic market, in exchange for the establishment of common trade disciplines in the context of a customs union. Several other trade-offs at the technical level were equally important, because they

allowed the definition of the structure and levels of the common external tariff, as well as the regime for the exemption of sensitive sectors, in time for the free trade regime and the customs union to be enforced from January 1, 1995 onwards.

The strong political commitment of the four countries to the integration process was essential for the harmonization of conflicting particular interests and the creation of a minimally coordinated strategy of internal development. Mercosul's limitations were compensated for by the political commitment of national governments to economic reform and the favorable external economic environment. Both these elements, however, would be severely affected starting in 1995 by the rising instability of international financial markets, which brought about the need to adjust the bloc's trade strategy to an increasingly unstable external environment, and by dramatic changes in both countries' domestic situations.

In Argentina, those changes were associated with the gradual erosion of the underpinnings of the economic stabilization program set forth in April 1991. In Brazil, however, the most important change was associated with the successful enforcement of the monetary reform and stabilization program initiated in 1994. In both cases, although for different reasons, a conjunction of external and domestic factors led governments and corporations to divert their attention from Mercosul's internal agenda. A shift in the trade strategy of the transition period became inevitable.

By the end of the transition period, there were still some important issues upon which no agreement had been reached: harmonization of non-tariff measures, liberalization of the trade of services, disciplines against unfair trade practices of third states, safeguards and customs valuation.

### ***Building a Customs Union in Times of Crisis (1995-1998)***

The customs union<sup>8</sup> of Mercosul was created on January 1, 1995, when the Common External Tariff (CET) entered into force. Today, Mercosul is still an incomplete customs union for it was agreed that the Common External Tariff to be applied to capital goods should converge to the 14% level until January 2001; for technology (informatics) and telecommunication sectors, a 16% level would be reached in 2006.

In this period the Protocol of Ouro Preto, that had been signed in December 1994, entered into force. The Protocol provided for the international juridical personality of Mercosul and its institutional structure, whose bodies have inter-governmental status (not supranational). The three bodies with decision-making power are the Common Market Council, the Common Market Group and the Mercosul Trade Commission. The Joint Parliamentary Commission is regarded as an embryo to a future Parliament of Mercosul.<sup>9</sup> The other two bodies are the Economic-Social Consultive Forum and Mercosul Administrative Secretariat.

In December 1995, the member countries also approved the Mercosul's Program of Action to Year 2000 (or Agenda 2000). In general terms, it provided for the consolidation and solidification of Mercosul, giving high priority to the improvement of the customs union. In the consolidation phase the primary aim was to extend the application of the Common External Tariff to the entire tariff range, eliminating exclusion lists. In addition, it sought to define agreements on common trading policy in order to both encourage the adoption of common commercial defense mechanisms (safeguarding measures, special importation regimes) and increase competition within the integrated area for the benefit of consumers (protection of competition, consumer protection).

At international level, the period from 1995 to 1998 was marked by the negative externalities of successive financial crises that affected Mercosul's internal performance. The period began with the Mexican crisis (*tequila* effect) in late 1994. Such

---

<sup>8</sup> A customs union is a free-trade area in which external tariffs and other barriers to imports coming from nonmembers are unified. (DUNN, 2004)

<sup>9</sup> In 1995, some Workers' Party congressmen voted against the Protocol of Ouro Preto because the Joint Parliamentary Commission would only be entitled to make non-compulsory recommendations, which means that Deputies and Senators would keep little power in decision-making process within Mercosul.

unfavorable economic conditions required more cohesion and identity from the bloc so it could project itself internationally, and to address issues related to market access and the enforcement of multilateral trade disciplines.

Besides, a framework agreement with the European Union was signed in December 1995. In 1996, Mercosul signed the so-called 4+1 agreements with Chile and Bolivia, in a clear movement to widening the scope of the bloc.

During this period, Mercosul shifted its focus to the external attainment of market access through the negotiation of trade agreements with neighboring countries. After the negotiations with Chile, Bolivia, the European Union, the United States, as well as within the framework of the Free Trade Areas of the Americas (FTAA). Negotiations with the Andean Community and Mexico followed as part of the renegotiations of the preferences granted under the Latin American Integration Association (LAIA).

The achievements of the transition period as to trade liberalization had referred strictly to goods, since negotiations on services had not reached any sort of agreement. At the domestic level, domestic regulations in this area were also undergoing important changes associated with privatization programs. In view of this fact, Mercosul governments decided not to support any formal commitment to service liberalization until those reforms and their respective processes of privatization had been consolidated. Finally, a framework agreement (The Protocol of Montevideo on Trade in services) was reached in December 1997 with the compromise of full liberalization in ten years after ratification by each member country<sup>10</sup>.

Regarding the consolidation of the customs union, negotiations centered around the issues directly related to the definition of the common external tariff, including its structure, levels, exceptions, and enforcement procedures. Definitions pertaining to other issues that make up complementary disciplines of the customs unions (safeguards, anti-dumping, countervailing duties, policies that distort competition, etc) were postponed to the following period.

---

<sup>10</sup> Prior to that, in 1994, the North American Free Trade Agreement (NAFTA) had already provided for trade in services. NAFTA was the first international instrument to enter into force with such provisions. Only one year later, in 1995, the General Agreement on Trade in Services (GATS) would go into effect.

Considering that important sectors—sugar, automobiles, information and telecommunication products, and capital goods—had been granted exceptional treatment and that several issues related to complementary disciplines were not fully agreed upon, the customs union that came into force on January 1, 1995 was far from perfect. From then on, its consolidation became the most important issue in the internal agenda of Mercosul thus keeping trade issues at the top of the internal agenda. (VAZ, 2003)

From the perspective of the internal agenda of Mercosul and evolution, it was clear that integration was no longer a driving force or priority in the economic agenda of the four countries, most notably for Argentina and Brazil. Circumstances had complicated the possibility of advancements in the internal dimension, and therefore issues of the external agenda grew in importance for Mercosul.

This trend toward external relations was followed at the expense of internal consolidation. Mercosul countries' needed to renegotiate bilateral trade preferences granted in the framework of the LAIA, given that they were the natural counterparts of negotiations with the Andean Community members. Moreover, the effective start of the negotiation process of the Free Trade Area of the Americas in June 1995 posed the immediate need for Mercosul to strive for self preservation as a trading bloc and as a recognized partner to the United States. The negotiations with the European Union for the establishment of a free trade area between the two blocs also explain the broadening trend in detriment to the deepening agenda.

The international arena had become the dimension of activism for Mercosul. The strategy of the bloc was largely determined by the value its members placed on external negotiations as a means to reassert the bloc's credibility and cohesion, and in order to face their own vulnerability to financial external crisis and to meet the opportunities of acceding to the markets of their main trading partners in the developed world on a preferential basis.

Thus, the push towards external negotiations and the related strategy of Mercosul can be seen as a byproduct of a mix of operational, defensive, and assertive concerns with the clear prevalence of a particular aspect in each context. Negotiations with the Andean Community were launched as a response to the necessity of redefining and

adapting the trade preferences granted by each Mercosul member to other LAIA countries, and were justified by what can be termed an operative concern. As for the FTAA, despite the powerful incentive provided by the possibility of preferential access to the U.S. market, the huge economic asymmetries and the threat they posed to the very existence of Mercosul as a free trade arrangement, and the protectionist bias of the United States in relevant sectors for Mercosul exports made defensive concerns prevail. In the case of the trade talks with the European Union, Mercosul has adopted a more assertive stance towards market access for its agriculture exports.

The overall strategy with which Mercosul approached its external relations was not then, nor is it now, a carefully designed or homogeneous one. Rather, it is a complex and often ambiguous exercise of evaluating and balancing different perspectives on the incentives and risks of simultaneous trade negotiations in a context of rising financial instability and economic uncertainty. The heterogeneous, multifaceted profile of such strategy does not imply, however, that its main features cannot be identified. On the contrary, there are some common aspects of Mercosul motivations and behavior that help cast light on the rationale of its interests and on the way it has acted to promote and/or safeguard them in international negotiations.

In 1995 Mercosul started to face external negotiations independently of internal dynamics and agenda. In other words, Mercosul's external relations were to a certain extent dissociated from its internal dynamics in the sense that the latter should not formally constrain the former. On the contrary, having been given an international juridical profile by the Ouro Preto Protocol in 1994, Mercosul was willing and able to act as a negotiating partner to foster its own development. At the same time, internal issues and divergences should not pose restrictions for exploiting external opportunities. The intent was to have Mercosul's countries speak with a single voice internationally. The external agenda should then be dealt with as if it had no immediate, direct or necessary links to its internal agenda and to its domestic constraints. Having both agendas evolve in parallel fashion would represent the best option to maximize external opportunities and to project Mercosul internationally, while preserving higher levels of discretion to manage its internal affairs.

Starting in the mid-1990s, this separation of its internal and external agendas has been a central feature of Mercosul's strategy to face external negotiations. A second feature of the trade strategy of Mercosul was to treat each negotiation in its own terms, but to preserve some basic guidelines for all of them. This was, in part, a pragmatic recognition of a state of affairs, as each negotiation was subject to particular agendas, criteria, principles, procedures, instruments, and institutional frameworks. However, this should not necessarily preclude the possibility of either seeking a more integrated approach to some common issues or taking advantage of what was conceded, accepted or defined in one negotiation process to bargain and obtain desired outcomes in another.

Although attractive in principle, this has proved to be more a possibility rather than a frequently exercised component of Mercosul's strategy as the political framework, the agendas, the pace of negotiations, and the expected benefits vis-à-vis its potential costs did not allow much room for the exercising of this bargaining strategy. To some extent, this sort of linkage has been observed in cases of the negotiations of Mercosul in the context of the FTAA and those with the European Union. This has become possible because strengthening commercial and economic ties with Latin America is regarded as an important dimension of broader international strategies for the United States and the European Union, two of the major world economic powers and Mercosul's main economic partners.

Actually, the Mercosul-European Union 1995 Framework Agreement was widely interpreted as a reaction by the EU to the FTAA initiative aiming at countervailing the U.S. trade activism through a preferential arrangement in Latin America. Therefore, the linkage between both processes is not due to any Mercosul strategy, but to the strategy of the European Union. When pursued by Mercosul, the smaller partner in this economic triangle, this strategy tends to assume a predominantly defensive connotation in the sense that it represents a means of bridging asymmetries rather than an assertive way of promoting interests or reaching desired outcomes. (VAZ,2003)

Based on the success of the strategy internally pursued in the transition period, Mercosul strove for broad scope agreements, without permanent exceptions and with clear criteria and rules for the full incorporation of sectors and products temporarily granted exceptional treatment. At the same time, the bloc rejected special treatment for less

developed countries, thus sustaining the same principles of symmetry and reciprocity. These principles were actively discussed in negotiations with Chile and Bolivia, and subsequently in the Mercosul-Andean Community negotiations.

This leads to another distinctive trait and objective of Mercosul strategy since the mid-1990s: to approach external negotiations as a means of seeking the full enforcement of Uruguay Round agreements and strengthening multilateral norms, while refusing to negotiate beyond the World Trade Organization's disciplines. This element of Mercosul's trade strategy is of great relevance because it involves two areas to which Mercosul is extremely sensitive: the ability for partner countries to resort to anti-dumping and anti-subsidies measures to restrict exports, and the restrictions on agriculture trade. This same principle of adherence to WTO rules lies behind the position of Mercosul regarding environmental and social clauses in the FTAA advocated by the United States.

In contrast to the first four years, when the bloc benefited greatly from the trade strategy it pursued internally, the 1995-1998 period saw little internal progress. External relations also slowed considerably in that period. With the exception of the agreements with Chile and Bolivia, the other initiatives did not bring effective results either politically or economically.

The negotiations with the Andean Community did not advance. Those with the European Union evolved slowly, but without clear compromises on trade liberalization. The FTAA was still centered on the definition of methodology and time framework of the negotiations. However, the gap between expectations and external achievements must be attributed to factors beyond the nature of the agreements and to the dynamics of each negotiation. Among these are the constraints imposed by the adverse external economic environment, the priority granted to the management of domestic economic affairs and to the preservation of macroeconomic stability, the unwillingness of some of Mercosul partners to effectively engage in negotiations (as in the cases of the EU and the Andean Community), and the low profile of domestic agents in relation to external negotiations in the aftermath of unilateral, regional, and multilateral economic liberalization.

The results of these external negotiations differed. Negotiations with the Andean Community were suspended in 1998, due to the impossibility of harmonizing the

different views and the demands of both sides regarding rules of origins, special customs regimes, sensible sectors, and the more fundamental issue (for the smaller Andean countries) of special treatment for less developed countries.

Under the FTAA negotiations, Mercosul was relatively successful at safeguarding its fundamental interests, namely gradualism and equilibrium of results, the broad scope of the agenda, the principle of “single undertaking,” compatibility with the WTO disciplines, and the preservation of sub-regional and regional integration initiatives. The reaffirmation of 2005 as the timeline to start the implementation of the FTAA, decided at the 1998 Santiago Summit, corresponded to a Mercosul proposition. However, it is entirely uncertain whether it will succeed at getting the U.S. to abide by strict norms concerning the application of antidumping, anti-subsidies measures, and countervailing duties in the context of the FTAA, or to give up environmental and social clauses.

In relation to the European Union, negotiations under the 1995 framework agreement initially focused on deeper economic cooperation and a tentative agenda for gradual progress toward trade liberalization between the two economic blocs. Mercosul has made it clear that a trade agreement of that sort is only feasible if agricultural protection is effectively resolved.

As previously mentioned, developments in this negotiation have also been very sensitive to the dynamics of the FTAA process. The prospects for an Mercosul-EU accord depend not only on the ability of Mercosul to promote its views and interests, but also on the results obtained in the FTAA negotiations as a source of incentives and/or constraints for the European Union to respond affirmatively to the demands of the Southern Cone.

***Add: July 24, 1998 Ushuaia Protocol on Democratic Commitment –  
democratic clause***

## **GETTING OVER OBSTACLES, FACING CHALLENGES**

### ***The Late 1990s: even harder times***

In the late nineties Mercosul faced probably the hardest times of its first 13 years. Increasing macro and microeconomic imbalances between Brazil and Argentina after the Asian and Russia's financial crises, Brazil's currency devaluation in January 1999, the progressive deterioration of Argentina's financial condition, the stagnant economic condition of Uruguay and Paraguay, and the decreasing rates of economic growth in the United States, Europe and Japan have exposed the internal fragility of Mercosul and the limits of its external strategy. The unprecedented crisis the bloc has experienced recently is expressed not only in the reduction of trade flows among the four member countries, but also in the unilateralism inside the bloc, as a result of the weakness of the mechanisms and institutions to counter it.

The crisis has made it imperative for policymakers to focus on some pending internal issues and on addressing macroeconomic coordination and problems in the external agenda as necessary steps for reinvigorating Mercosul. As a consequence, issues such as dispute settlement, decision-making procedures, and the transposition of norms have risen in the bloc's agenda, along with those directly related to trade disciplines and to the consolidation of the customs union. It has become necessary to reinvigorate Mercosul from inside to avoid its gradual self-dismantlement and to preserve it as a viable and effective channel for negotiating with other countries and economic blocs.

These needs led to the "relaunching" of Mercosul in 1999. That agenda included previously pending issues related to the implementation of Mercosul's trade disciplines, such as market access (especially non-tariff restrictions), the transposition of harmonized norms to national legislation, dispute settlement, the application of the common external tariff, commercial defense, protection of competition, and incentives for investment, production, and exports.

In addition to these trade issues, others related to macroeconomic coordination (e.g., the harmonization of economic indices and statistics, and the settlement of common goals for fiscal matters, debt and inflation) were introduced to move the

integration process beyond trade liberalization. Finally, the agenda included commitments to negotiate trade preferences as a bloc and to resume negotiations with the Andean Community.

The relaunching agenda was an effort to update and adjust Mercosul to respond to internal challenges and to those that external negotiations posed in the short and medium term. The operational approach of the relaunching agenda was the voluntary execution of specific tasks through negotiations at technical and executive levels, according to strict deadlines. This has not been successful in driving Mercosul out of the current crisis.

Recent efforts have been countervailed, to a large extent, by the political and economic problems brought about by Argentina's acute financial crisis as well as by economic imbalances in other member countries, including Brazil, and, finally, by important differences in policy areas and issues such as exchange regimes, dispute settlement mechanisms, the nature of Mercosul's institutions, and the FTAA.

In this context, it was almost inevitable that the debate should reopen over what is the most desirable and feasible form of integration among the four Mercosul members, although this contributed to widespread uncertainty regarding the possibility of preserving and attaining its original objective of a common market. At one extreme, many have argued that the bloc is doomed to failure and disappearance. Others suggest that even if it does not disappear, it will likely become increasingly irrelevant.

However, in spite of its fragileness and inconsistency, Mercosul still represents an important political and economic asset that can play an effective role in providing economic opportunities and dynamism for its member countries, as well as in the definition of the prospects for regionalism and multilateralism. Mercosul as an institution is neither easily disposable, nor is it a self-sustaining strategic asset. Its importance and usefulness for member countries varies according to its effectiveness in addressing development needs and problems, political challenges and external risks and opportunities from the viewpoints of each individual member. In other words, the strategic relevance of Mercosul rests on the perceptions and evaluation of each member countries' policy makers

and prominent economic actors as to the bloc's functionality in providing viable alternatives to address international economic constraints and domestic problems.

It is important to note that despite the initial skepticism of most economic sectors about the prospects of integration, as time passed Mercosul came to receive wide political support and to play an important role in advancing liberal trade practices in its member countries. The acute economic crisis that seized Argentina, and spread to Uruguay, Paraguay, and Brazil, fuelled criticism of the economic policies to which Mercosul had been associated. Although only in relatively few instances has overt opposition to economic integration been expressed, in each member country an anti-free trade mood has risen, along with a perception that the bloc does not play a meaningful role in addressing most immediate economic concerns.

This ambivalence has not prevented member countries to reshape their strategies for Mercosul in an effort to adapt to new and more restrictive circumstances. Some features of its present strategy, although not yet fully developed, can be identified. They derive from the assessment of Mercosul's current course and from previous formulations, and reflect a predominantly principled, normative and voluntaristic view of the necessary conditions to reinvigorate the bloc.

The reassertion of the political commitment to the perfecting of the customs union and its disciplines and institutions plays, again, a key role. Rather than a mere rhetorical manifest, this commitment has practical consequences as it defines a clear agenda with specific issues to be addressed, thus stimulating the mobilization and convergence of efforts towards attainable goals. Nevertheless, this commitment has not found sound and equitable support among the member countries. Argentina repeatedly insisted on downgrading Mercosul to a free trade area, with the support of some economic and political sectors in Uruguay and Paraguay. Such propositions have not progressed due to Brazil's strong stance on preserving and consolidating the customs union as an essential element of the bloc's (and the country's own) regional strategy.

In such a context, policy coordination remains a desired objective rather than an actual accomplishment. Although important incentives for policy coordination exist, several obstacles remain. Domestic economic issues have systematically prevailed over those of the integration agenda. Restoring and preserving macroeconomic stability in face of domestic and external constraints continues to be an essential economic goal of Mercosul countries.

Besides that, measures adopted at the microeconomic level reveal important differences in policy preferences within national governments as to what Mercosul should be and the priority to be granted to it in face of other domestic demands. These differences make policy coordination even harder to achieve. As previously mentioned, although the four Mercosul countries have established some common macroeconomic goals, their achievement depends much more on domestic matters and corresponding economic policies rather than on incentives for cooperation associated with the regional project.

### ***Harmonization of Macroeconomic Policies***

The Treaty of Asunción also provided for the coordination of macroeconomic policies. The desired macroeconomic coordination, however, could not be carried out mainly because the State-Members governments feared they could become channels for managed trade practices. Economic authorities argued that the commercial objectives did not require at that time high levels of coordination, and therefore there was neither immediate incentive nor existent conditions for this type of management.

In addition, there were great disparities in terms of exchange, monetary and fiscal policies among the member countries, especially regarding the two major economies. Rising economic instability and inflation in Brazil from 1991 to early 1994, and inverted economic growth cycles between Brazil and Argentina created unfavorable social, political and economic environment for policy coordination.

Fortunately, the failure in coordinating macroeconomic policies did not prevent advancements in commercial integration. Still, the resistance put up by the national governments can be seen as lack of high commitment to a more comprehensive economic integration process aiming at a future common market.

To survive external shocks, economic integration among commercial partners requires a prior harmonization of their macroeconomic policies, mainly the exchange policy. Mercosul could not withstand exchange rate policies as diverse as those of Brazil and Argentina. The floating foreign exchange rate used by Brazil gave that country an enormous trade advantage over its partner. It also provided it with flexibility to absorb the shock without recession. In the case of Argentina, GNP fell by 15% and unemployment went to over 25% of the labor force. The crisis of Mercosul is explained largely by the financial opening of their economies to the global markets at a speed notably faster than trade liberalization. The quick financial opening made these countries particularly vulnerable to the volatility of capital flows. In addition, these economies have demonstrated a limited ability to adapt to capital flight scenarios, either because of external shocks, excessive public indebtedness or because of wrong exchange rate policies.

High volatility of the financial flows has distorted everything else, deteriorating the Balance of Payments, the fiscal balance and the previously agreed trade rules. In fact, capital flight forced the Mercosul countries to substantially increase interest rates, which subsequently had an adverse impact on servicing public debt. This increase forced a recessive fiscal adjustment. Together with the reduction in private economic activity associated with the increase in interest rates, this strongly reduced tax yields, generating a vicious circle of recessive budgetary adjustments that, in the Argentine case, ended by destroying the convertibility of its currency and triggered the extremely serious financial crisis in that country.

Mercosul's crisis was aggravated because the foreign exchange policies of Brazil and Argentina were at polar ends after the Brazilian devaluation of 1999. The fixed foreign exchange rate linked to the dollar in Argentina put the economy in a straightjacket. The economy had to simultaneously confront a reduction in the external capital flows, an appreciation of the dollar against the euro, and the Brazilian devaluation. Argentina adjusted by drastically reducing its levels of activity, and generating even deeper fiscal deficits. The loss of competitiveness could not be compensated with a devaluation of the Peso due to the convertibility rule. Argentina appealed to the only instrument available to reduce its increasing commercial deficit: to break the Mercosul common tariff rules and to impose a series of administrative restrictions to imports from its commercial partners.

On the other hand, Brazil –with its flexible exchange rates– could respond to the Argentine shock through a series of currency devaluations and the aggressive use of export subsidies, going beyond what was agreed previously by the Mercosul countries.

## **OUTLOOK AND TRENDS**

### ***Buenos Aires Consensus***

October 2003 brought to scene the Buenos Aires Consensus, a Joint Statement by President Luiz Inacio Lula da Silva of Brazil and Nestor Kirchner of Argentina. It is a 22-topic document referring to bilateral, regional and multilateral issues, by which both Head of States reaffirmed the desire to increase cooperation, highlighting the *‘profound conviction that Mercosul is not only a trading bloc but a catalyst for the realization of shared values and traditions’*, as well as the awareness that South American integration constitutes a *“strategic option for strengthening the position of our countries in the world.* The statement kept the commitment to the negotiations aiming at achieving a balanced agreement for the Free Trade Area of the Americas (FTAA), to be reached in January 2005. Regarding unilateral policies and international law, the document stressed the central role of the United Nations Security Council.

### ***The Declaration of Copacabana***

In February 2004, Brazilian President Lula and Argentine President Kirchner agreed in Rio de Janeiro to hold a common policy and bilateral consults during their respective negotiations with multilateral lenders. Presidents Lula and Kirchner sealed the strategy by signing a joint statement known as the "Declaration of Copacabana", calling for cooperation for economic growth with equity.

Brazil and Argentina<sup>11</sup>, Mercosul’s biggest economies decided to campaign to change International Monetary Fund (IMF) accounting rules to allow developing nations to invest more in infrastructure projects such as roads, dams and sewers. They proposed that investments in infrastructure are not counted against their budget deficits. Such

---

<sup>11</sup> Argentina owes international institutions about \$84.2 billion (R561 billion). Brazil's total foreign debt is about \$230 billion.

projects can provide thousands of jobs, from construction to engineering, activating almost all areas of the economy.

The IMF has traditionally rejected that idea as incompatible with fiscal austerity. Up to now, IMF authorities find it premature to change the rules, but they appear to agree on developing a statistical framework so that investments made by commercially oriented enterprises could be excluded from the public sector balance. IMF has also shown willingness to find guidelines for making better use of public-private partnership models for the financing of public infrastructure.

### ***Physical Integration***

In order to have sustained growth and competitiveness, the region need also more infrastructure investments. Infrastructure is a basic vehicle for a competitive economy. Within the new geographical configuration of South America, Mercosul plays the most dynamic role for the regional integration. The free trade agreements (4+1 format) with Chile, Bolivia and recently Peru, and the ongoing negotiations with the Andean Community, are the precursors in that direction. Chile gives a two-ocean dimension to the customs union: the territory of the expanded market extends from the Atlantic to the Pacific, opening the Chilean ports to enable Mercosul's products to reach Asia. In the center of the continent, Bolivia acts as a bridge with the Andean Community and as an infrastructure link for energy (natural gas) and transport (waterways).

Physical integration (roads, bridges, ports and waterways improvements) and energy integration (natural gas, oil, water, electricity) are a pole of attraction for investment with the prospect of greater benefits for the countries and consumers of the region. Infrastructure is not an ancillary issue to trade negotiations. It is a fundamental issue, and the European experience proves it<sup>12</sup>.

---

<sup>12</sup>The relation between trade, development and infrastructure (specially transportation) has been a major concern of public policy also in the United States. The creation of the US Interstate Commerce Commission in 1887 as a regulatory body to deal with railroads, is an example of such concern.

The South American Regional Infrastructure Integration Initiative (IIRSA)<sup>13</sup>, was launched in 2000 by Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, Surinam, Uruguay and Venezuela to improve coordination of their infrastructure development plans, modernize their regulatory frameworks and harmonize their policies for three key sectors: transportation, energy and telecommunications. The initiative seeks to bring to a regional level the intense process of physical and economic integration that took place at binational and sub-regional levels in South America over the past decade as a means to raise productivity and competitiveness.

IIRSA aims at upgrading the highways, ports and airports that connect this region with the rest of the world, improving the regulations for the energy and telecommunications sectors and the markets for services such as shipping, insurance, warehousing and licensing. It also supports the formation of regional electricity markets as a step towards regional power integration. Its projects will seek to improve living standards and create economic opportunities in the communities along the integration axes, taking into account the environmental and social impact of public works and including consultation and participation mechanisms.

The existence of adequate physical infrastructure that favors and facilitates fluid cross-border movement of goods, services and people is one of the crucial factors in creating an effective and ordered regional space that strengthens trade integration and communication, and the region's international competitiveness. The development of the physical infrastructure is needed to back the integration process and the international competitiveness of the region, especially in the areas of roads, energy, telecommunications and **river** integration in Latin America.

The objective of the **Initiative** is to improve the competitiveness of the regional economy and its integration into the global economy, and promote sustainable socioeconomic development in these countries, especially through the modernization and integration of their infrastructure and logistics in the transport, energy and telecommunications sectors.

---

<sup>13</sup> The Andean Development Corporation (CAF), the Financial Fund for the Development of the Plate Basin (Fonplata) and Inter-American Development Bank<sup>13</sup> (IDB) provide technical and financial support to IIRSA. The IDB is the leading public financier in Latin America. Brazil and Argentina are the two main borrowers.

### ***Public Private Partnership***

In November 2003, Brazilian government under President Lula's administration submitted a bill to the Congress<sup>14</sup> aimed at promoting public-private partnerships to carry out needed infrastructure investments. The partnerships are supposed to stimulate private companies to invest about US\$ 3,4 billion a year in roads, railways, port projects and other public works<sup>15</sup>, thus reviving economy, improving competitiveness and boosting exports.

According to the public-private partnership proposal, a fund will be created to guarantee private company payments by future governments during the term of project contracts that in some cases will be as long as 35 years. The bill also includes a social responsibility clause, which states that in case of ties for government contracts the company with greater capacity to generate employment would win. The PPP project is a response for the potential private partners who call for greater transparency and a strong regulatory framework in order to have a reliable and stable investment environment..

---

<sup>14</sup> The Chamber of Deputies (the lower House of Brazilian Congress) passed the bill on March 17, 2004, and immediately submitted it to the Senate.

<sup>15</sup> Infrastructure public works include sanitation projects.

## **RECOMMENDATIONS AND FINAL REMARKS**

The latest conflict within Mercosul involving Brazilian and Argentine textiles sectors (fabric industry) should not be regarded as an ordinary episode. It is a setback to use quotas, such as the voluntary export restraints (VER) to be undertaken by the Brazilian exporters at the request of Argentine textile industry request. Such a conflict is not common in the routine of well-succeeded regional integration experiences. Protectionism and individualism have no place in integration.

By leaving to the national industry the task of negotiating with their Argentine counterparts, Brasilia tried to avoid, or diminish the cost of a direct disagreement with Buenos Aires. Once again it emphasized political relations to the detriment of commercial interests, when politics and economics should be cooperating for integration as a higher end.

Relying solely on this kind of choice (politics or economics as if the two realms were totally separated) is risky, and involves an illusion. Without broader and deeper economic fundamentals, the coincidence of external interests may be easily broken. It is necessary to create conditions for a rather complete convergence of economic interests. But that will depend upon a policy to strengthen Argentine industrial sector. Brazil and Argentina – or Mercosul, as a whole – should consider strategies so far not implemented, such as complementing and articulating their chains of production. That would be acknowledging integration as an opportunity for all agents involved.

Economic integration within the context of Mercosul – and aiming at a broader integration comprising South America - should bring about new specializations or accentuate the regional division of pre-existing labor, in a scheme in which economic complementarity becomes increasingly important and, in some cases, irreversible. Finding niches in the Brazilian and Argentine markets for the production and export of manufactured products from Uruguay and Paraguay is still one of the major challenges in coming years within the field of the consolidation and deepening of Mercosul. It is

extremely necessary to establish a strategy framed around internal complementation and integration of productive sectors across the borders.

There is no place in integration for protectionism and individualism.

## **CONCLUSION**

The Southern Common Market (Mercosul) is an ambitious project undertaken by Argentina, Brazil, Uruguay, and Paraguay, four very asymmetrical developing countries. It marked the resurgence of a historical vocation translated into a constant trend in the political economy of South America: regional integration.

Mercosul may be seen as the heir of the initiatives involving Argentina and Brazil in the late eighties. The Argentinean-Brazilian joint initiative of the eighties, however, had been more effective in political terms. Mercosul, in its turn, managed to combine the political approach with the long-awaited economic objectives inherited from the frustrated LAFTA and LAIA experiences.

Since the Treaty of Asunción entered into force in 1991, Mercosul has defined its trade strategies based on the interaction of strategic political and economic objectives and international and domestic constraints. The trade strategies are adaptive responses to changing contexts, possibilities and constraints, thus reflecting the lack of an encompassing, long-term operational approach.

During its first four years of existence, Mercosul played a key role in supporting the economic reforms Argentina and Brazil governments implemented in the nineties. Therefore, the bloc helped restoring the credibility in economic functionality of regionalism in Latin America. Besides, it also managed to increase trade flows (trade creation) among the four countries and with other countries. Mercosul benefited from a favorable external economic environment to implement its internal commercial agenda. In the following phase, the focus shifted to the external agenda as a means of exploiting political and economic opportunities to consolidate a political profile within a context of more restrictive economic conditions.

From the mid-nineties on, successive trade conflicts rose among Mercosul State-Members (the automobile sector) and external financial constraints (Mexico, 1994; Asia; 1997, Russia; 1998) dramatically changed the political and economic environment. The Southern Cone sub-region was forced to adapt its policies to a more restrictive and unstable external context while preserving macroeconomic stability domestically.

From 1995 to the end of 1998, the trade strategy of Mercosul shifted its focus from the internal agenda to its external relations as the main arena for activism in terms of seeking opportunities for greater market access. This shift did not represent a rupture with the achievements of the transition period, rather Mercosul built upon those achievements to define principles and guidelines for the negotiations it engaged in with several trading partners. With the unprecedented macroeconomic convergence between Brazil and Argentina in the second half of the 1990s, it was the instability of international financial markets that acted as the main constraint on the revision of Mercosul's strategy.

This instability did not prevent the bloc from pursuing a coherent trade strategy, but it curtailed the development of a strategy in which internal accomplishments could be fully incorporated. Policy makers were forced to concentrate on the immediate impacts of international instability on national economies, and on preserving macroeconomic stability. This severely reduced their ability to enhance the integration process with improved coordination of internal and external policies, a necessary step for the creation of an encompassing trade strategy. Moreover, the dispersion of effort caused by simultaneous negotiations made it difficult for Mercosul to develop a single and homogeneous trade strategy in that period.

In more recent times, the bloc has worked hard to harmonize and balance increasing different national interests, to create opportunities to reinvigorate itself and to overcome the severe crises it faces. However, it has become more vulnerable than in previous phases to domestic and external injunctions, and is confronted with the prospect of stagnation or even retrocession.

Avoiding these prospects requires the reassertion of its cohesion, of its identity as a negotiating entity, the strengthening of its trade disciplines and a more assertive profile in its relations with its main economic partners. So far, progress in each of these tasks has been uneven, while domestic and external economic circumstances remain unfavorable for the advancement of integration.

As to trade policy, Lula administration has announced clear determination to fight any form of protectionism that affects Brazilian exports, open markets, and seize trade opportunities in emerging markets for Brazil and Mercosul. Brazilian new

government is also making efforts (domestic and international) to stimulate investments in infrastructure as a means of improving efficiency and competitiveness.

The paths chosen by Argentina to overcome economic crisis and the role played by Brazil in this regard are also key elements for the definition of the political and economic profile of Mercosul in the short and mid terms. The Argentine crisis (2001 default) has affected Mercosul directly. Most immediately, it led to a significant decrease of trade and investment flows.

Politically, the crisis has raised uncertainties as to the form and the degree of integration Mercosul might eventually assume. In its early stages, the crisis contributed to the gradual rise of managed trade practices that eroded the free trade regime. It forced Brazil and Argentina to give up efforts aimed at restoring and consolidating the common external tariff and the customs union, one of the main objectives of the Mercosur relaunchment agenda agreed upon at the beginning of De La Rúa presidency. Negotiations on this crucial issue were resumed in early 2003 as part of the initiative launched by the Brazilian new government aiming at reinvigorating Mercosur.

The prospects for Mercosur's trade policies and strategies will become more clear only as the member states' governments get to move away from the immediate and short term approaches. Moreover, improved institutions and enhanced political willingness are undoubtedly necessary if Mercosur countries seek better collective results. Mercosur must pursue such purposes, and simultaneously develop its joint ability to adapt and shift strategies in response to dynamic internal and external challenges in an ever-changing world.

After complete customs union has been achieved with the unification of the Common External Tariff, the political will of the members countries will be put to the test with the deepening of integration and the ability to retain its own identity in the future hemispheric free trade area. From 2005 on, having confirmed the political will of the four member countries to follow this direction, Mercosul must face this new challenge, focusing on delicate and sensitive areas such as the creation of supranational institutions and the establishment of a single currency.

Mercosur is likely to remain an important actor in hemispheric negotiations. However, in order to fully take advantage of this potential, the trading partners will have to improve considerably the enforcement of common trade policies. In effect, since the end of the "transition period" in December 1994, Mercosur member countries have failed to effectively enforce the common external tariff (CET) and other trade policy instruments (such as a customs code and a regional antidumping and countervailing regime) required to shape a common negotiating stance. Moreover, the "deepening" agenda has been slow to advance.

## **BIBLIOGRAPHY**

DUNN, Robert M. & MUTTI, John H. *International Economics*. Routledge, NY, 2004.

KINGSTONE, Peter R. & POWER, Timothy J. *Democratic Brazil – Actors, Institutions, and Processes*. University of Pittsburgh Press, Pa, 2000.

MANZETTI, Luigi. “Argentine-Brazilian Economic Integration: An Early Appraisal”. *Latin American Research Review* 25: 109-40.

\_\_\_\_\_. 1994. “The Political Economy of Mercosur.” *Journal of Interamerican Studies and World Affairs* 35: 101-41

O’KEEFE, Thomas Andrew. *Latin American Trade Agreements*. New York, 1997.

PEÑA, Félix. *As Perspectivas do Mercosul: Desafios, Cenários e Alternativas Para a Próxima Década*. In: *Mercosul: Análisis de Una Década y Tendencias Hacia el Futuro*.

ROETT, Riordan. *Mercosur – Regional Integration, World Markets*. Boulder, CO, 1999.

SMITH, Stephen C. & TODARO, Michael P. *Economic Development* 8<sup>th</sup> ed. The Addison-Wesley, 2003.

Vaz, Alcides C. *Mercosul aos Dez Anos: Crise de Identidade ou de Crescimento?* In: *Revista Brasileira de Política Internacional*, n. 2001, p. 43-54.

VAZ, Alcides C. *Trade Strategies in the Context of Economic Regionalism – the Case of Mercosur*. University of Brasilia, 2003.

WEBER, Max. *Politics as a Vocation*. In: *Essays in Sociology*. Oxford University Press, 1946.