

**LESSONS FROM REGIONAL COOPERATION:
THE EXPERIENCE OF THE
COMMON MARKET OF THE SOUTH
(MERCOSUR)**

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In the last fifteen years Southern Cone trade regimes underwent far-reaching reforms. Following a timid start in the late 1980s, unilateral trade liberalization accelerated markedly after the turn of the decade in Argentina as well as in Brazil. Trade policy reform was reinforced by multilateral negotiations. In effect, the conclusion of the Uruguay Round had significant implications for trade in goods as well as for a broader range of disciplines previously not subject to effective international scrutiny (such as trade in services, protection of intellectual property rights and trade-related investment measures).

This outward-oriented trade policy environment provided a more favourable background for substantive regional integration. Although the history of preferential liberalization in the Southern Cone is old, during the last decade regional integration made more substantive progress than at any time in the past. In a relatively short period the Common Market of the South (MERCOSUR) formed by Argentina, Brazil, Paraguay and Uruguay eliminated tariffs on all goods' trade (except automobiles and sugar) and agreed and partially implemented a common external tariff (CET). During this period regional trade interdependence doubled in a context of limited trade diversion. These were remarkable achievements by Latin American standards.

However, after an initial encouraging start MERCOSUR faltered. Non-tariff measures (NTMs) remained largely untouched and enforcement of the CET was at best partial. Governments made scant progress in the so-called "deepening" agenda, involving issues such as trade in services and government procurement. After a decade of rapid increase in trade interdependence and fast intraregional liberalization, in the late 1990s MERCOSUR reached a plateau. In some regulatory areas, such as NTMs and enforcement of the CET, it moved even backwards. These negative trends were aggravated by the macroeconomic turmoil that shocked the region after the East Asian financial meltdown. But their determinants are more fundamental.

This paper provides a stylized account of the record of MERCOSUR during the 1990s and explores its main determinants. It necessarily offers a simplified account of events, but one that hopefully helps to understand the underlying incentives and obstacles for deeper and more effective regional economic integration in the Southern Cone. The first section provides a summary account of the performance of

MERCOSUR since the signature of the Treaty of Asunción on March 1991. The second section offers a stylized view of the factors that help to account for performance. A third and final section draws some conclusions based on the preceding discussion.

1. A stylized review of MERCOSUR

The performance of MERCOSUR in the 1990s can be summarized by examining three indicators, namely: 1) the evolution of trade interdependence; 2) the effectiveness of the policy and regulatory process (the “relative enforcement gap”); and 3) the way in which differences of interests and perceptions were digested by the domestic political process (the “politization bias”).

Trade interdependence can be measured by indicators such as the ratio of intraregional to total foreign trade or the ratio of intraregional trade to gross domestic product (GDP). Trade interdependence can be taken as a proxy indicator of the intensity of regional spill-overs. Although closer interdependence caused by trade discrimination may not be welfare-enhancing, a preferential trade arrangement that does not lead to enhanced regional interdependence is unlikely to be meaningful to its members. Heightened interdependence, in turn, creates stronger incentives to cooperate and manage growing cross-border spill-overs.

The “relative enforcement gap” and the “politization bias” are qualitative indicators. The former makes reference to the gap that exists between policy decisions (commitments) and implementation. Although implementation will always lag behind decision-making, a meaningful preferential trade arrangement is incompatible with a continuously widening “relative enforcement gap”. In the limit, regional integration policies will become irrelevant when decision-making organs generate rules that have no material effect on the behaviour of economic agents.

The “politization bias”, at last, attempts to capture the way in which the polity of member states deal with their different and conflicting preferences and interests. Negative politization will prevail when differences (including technical ones) are “captured” and exacerbated by the domestic political process, thus leading to

polarization and raising the price of compromise. But the politization process can also have a positive bias, as it would be the case when over-riding political incentives provide the backbone of constructive compromise.

These three indicators do not exhaust all the facets of the performance of MERCOSUR since inception. Yet they offer a stylised account of the record focusing on trade flows, institutional efficiency and the role of domestic politics. By organizing time according to alternative combinations of this set of indicators the recent history of MERCOSUR can be summarized in three distinct phases: a) the 1991-94 “transition period” to the customs union; b) the 1995-98 period of rising interdependence and low regulatory efficiency, and c) the post-1998 crisis (or collapse?) (see chart 1).

Chart 1
The first decade of MERCOSUR: a stylised account

Phase \ Variables			
	Interdependence	“Relative enforcement gap”	“Politization bias”
1991/1994	Rising	Low	“Positive”
1995/1998	Rising	High and rising	“Neutral”
1998/?	Falling/Stagnant	High and rising	“Negative”

1.a The “transition period” towards the customs union (1991/1994)

The Treaty of Asunción christened the period scheduled to conclude on December 31, 1994 as the “transition period” towards the customs union. During this period intraregional trade flows increased rapidly, deepening inter-dependence (particularly between MERCOSUR two largest partners, Argentina and Brazil). In a period of just four years the intraregional exports to GDP ratio (and the intraregional to total foreign trade ratio) increased by over sixty percent. By opening up the economies and enabling

geographical proximity to work, unilateral trade liberalisation was a decisive –but by no means the sole- factor behind higher regional interdependence.¹

In the Treaty of Asunción member countries undertook three major commitments, namely: 1) to implement a Trade Liberalisation Program (TLP, consisting of an automatic, linear and across the board tariff cutting programme), ii) to adopt a common external tariff (CET); and iii) to co-ordinate macroeconomic and sector policies. The mechanisms set in motion to make these commitments effective were quite different: while the TLP triggered a mandatory and automatic process of tariff elimination, the adoption of a CET and the co-ordination of macroeconomic and sector policies were statements of intent. By the end of the “transition period” MERCOSUR member countries had significantly lowered most tariff barriers (enforcing 100% preferences over MFNs tariff rates for nearly 85% of the tariff schedule) and reached an agreement on a CET. No effective progress had been made, however, towards the coordination of macroeconomic and sector policies.

In any case, in just four years the Treaty of Asunción made more progress towards intraregional trade liberalisation than any other agreement in the previous three decades. By January 1995 only a handful of sensitive products still paid import duties, scheduled to be eliminated according to an automatic phase-out calendar by January 2000 at the latest. Two “special sectors” (sugar and motor vehicles) were transitorily excluded from intraregional free-trade, but should be placed under the general disciplines by the end of the decade.

By the end of 1994 MERCOSUR member states also had agreed on a CET and drafted a customs code. The conflicting interests stemming from divergent national production and protection structures were accommodated through a compromise. The compromise consisted in the adoption of a CET that largely replicated the structure of protection of the largest partner (Brazil), combined with the maintenance of national tariff rates subject to automatic convergence schedules for a limited number of sensitive items (national exception lists, capital goods, and information and telecommunication products) (Olarreaga y Soloaga, 1998). By January 1995 MERCOSUR was still far from being a full-fledged free/trade area and even less an effective customs union.

¹ Frankel (1997), for example, argues that trade preferences also played a significant role.

However, relative to the typical Latin American regional integration process it had made significant progress.

The “transition period” was not free from interest clashes between member states, the most visible of which were those caused by Argentina’s growing bilateral trade deficits with Brazil.² However, these conflicts were typically addressed with a pragmatic approach that emphasized cooperation and compromise. Examples of this were the acceptance of Argentina’s increase in the statistical import tax surcharge from three to ten percent at the end of 1992 and the Brazilian official decision to purchase oil and wheat from Argentina to partly reduce the bilateral trade deficit.³

On balance then, the “transition period” was quite successful at least when compared to past experience. This positive record laid the ground for an optimistic view about the prospects of regional integration in the Southern Cone. Such optimistic view derailed as the decade progressed.

2.a The paradox of MERCOSUR’s “golden age” (1995/1998)

The 1995/1998 period was one of contrasts. Regional trade interdependence continued to rise, pushed by the fast recovery of the Brazilian economy triggered by the *Plan Real*. However, the regional regulatory and policy-making process grew increasingly ineffective. The continued expansion of intraregional trade and investment flows in the context of growing regulatory ineffectiveness was interpreted as an indication of the strength of market based incentives for closer regional economic integration. According to this view, closer regional interdependence was a consequence of the ability to exploit “natural partnerships” made possible by unilateral trade liberalization, independently of the effectiveness of regional integration policies.

² The currency board enforced by Argentina on April 1991 led to a significant real appreciation of the domestic currency and a fast recovery of domestic demand. Both factors accounted for a sizable increase in bilateral trade deficits with Brazil.

³ Brazil was a natural market for Argentine wheat, but Argentine exporters suffered the competition of developed countries’ subsidized exports. Similarly, Brazil had traditionally purchased oil in the Middle East, but shifted its supply sources towards Argentina following an official decision by Petrobras (the Brazilian state oil company) and the deregulation of the energy sector in Argentina.

During the 1995/1998 period the ratio of intraregional to total foreign trade (and the ratio of intraregional exports to GDP) increased by nearly 50%. This occurred in parallel to a continuously widening “relative enforcement gap”. Although member states successfully implemented the agreed tariff cuts on sensitive products, sugar and motor vehicles remained subject to special rules and excluded from intraregional free trade. More importantly, very little progress was made in the area of NTMs: border and non-border NTMs remained mostly untouched. National discretion concerning the implementation of NTMs remained largely intact as well, endangering the stability of market access conditions. This was an especially important consideration for the smaller countries, for which closer regional interdependence increased the demand for co-ordination.

Implementation of common trade policies was also partial because of three major reasons: a) the CET became plagued by a growing number of exceptions; b) except for the free-trade agreements signed with Chile and Bolivia, MERCOSUR collective negotiations with the Andean Community and Mexico broke down and led to additional CET perforations (Bouzas, 1999); and c) there was no unification of the four customs territories into a single one (the customs code approved in 1994 was not enforced and the issue of revenue distribution was not even discussed). This made inevitable that all traded goods remained subject to the application of rules of origin, in practice inhibiting the free circulation of goods (allegedly one of the major benefits of a customs union over a free-trade area).⁴

The even more demanding “deepening agenda” agreed on December 1995 in Montevideo (*Agenda Mercosur 2000*) recorded very limited progress as well. A Services Trade Protocol signed in 1997 established that service trade liberalization would be reached at the latest ten years after the ratification of the protocol. The services protocol also established a GATS-like mechanism of periodical rounds of negotiation.⁵ In the area of government procurement, negotiations towards a protocol started only in 1998, while in the realm of tax harmonization the 1994 decision on export incentives gave rise to frequent conflicts as a result of divergent national

⁴ The maintenance of national special import regimes (such as import duty draw backs) also made imperative the enforcement of rules of origin.

⁵ Although there have been three rounds of negotiation, the Services Protocol has not entered in force yet because it has not been ratified by the Legislatures.

structures of indirect taxation.⁶ MERCOSUR member countries also agreed on safeguards, antidumping and countervailing duties common procedures, but they failed to be enforced and remained largely paper commitments.

From an institutional perspective, the major innovation of this second period was the Ouro Preto Protocol, that created new organs (remarkably the Trade Commission in charge of administering common trade policy instruments), defined more precisely decision-making responsibilities, gave MERCOSUR existence under international law and set a mechanism to make and enforce decisions. The institutional structure and rule-making procedures established by the Ouro Preto Protocol proved quite ineffective. The Trade Commission was rapidly overloaded by the management of intraregional trade disputes rather than by the enforcement of common trade policies and, in spite of mushrooming trade conflicts, the Dispute Settlement Mechanism (DSM) remained inactive until 1999.⁷ During this period the problems posed by “internalization” (incorporation of MERCOSUR organs decisions into domestic law) became more and more evident, as a growing number of decisions failed to be fully implemented, adding to the backlog of “unfinished business”.

In summary, the second phase of MERCOSUR is in a way one of paradoxes. While regional interdependence continued to deepen at a rapid pace boosted by the stabilization of the Brazilian economy, the regulatory process gradually lost effectiveness and credibility. Even the cooperative approach that characterised the administration of conflict and differences of interest during the initial years of MERCOSUR (when political commitment was at a peak) gradually left place to growing polarization and rift.

3.c Crisis or collapse? (1998/?)

The January 1999 maxi-devaluation of the Real is conventionally singled out as a turning point in the recent history of MERCOSUR. This is an overstatement: the factors that account for the recent disappointing performance of MERCOSUR are more

⁶ Brazil's federal indirect taxes were the source of many conflicts.

⁷ For a detailed discussion of MERCOSUR's institutional performance see Bouzas and Soltz (2001)

fundamental than the Brazilian devaluation. Some of them have been already referred in the earlier sections and will be more fully developed in the next.

One of the facets of the disappointing performance of MERCOSUR since 1998 is the significant contraction experienced by regional trade interdependence. During 1999 intraregional trade flows fell in absolute terms by over a quarter, while the intraregional/total foreign trade ratio returned to the levels recorded in 1995. Intraregional trade flows recovered by 17.6% in 2000, but to reach only the levels recorded four years earlier. The ratio of intraregional to total foreign trade, in turn, remained constant at the same level of 1995.

Falling regional trade interdependence was to a large extent the result of adverse macroeconomic trends (stagnant or falling aggregate demand), but also a consequence of explicit policy decisions. In effect, Argentina's protracted economic recession (that extended for over three years before exploding into a full-fledged foreign exchange and financial crisis) and the economic downturn in Brazil after the devaluation of the Real lowered intraregional trade flows significantly (Heymann, 1999). But intraregional trade was also hit by *ad hoc* relief measures in response to domestic pressures, such as new NTMs and (officially sponsored or tolerated) private sector "orderly marketing arrangements". The lack of safeguard procedures to deal with special circumstances led member states to use non-transparent and discretionary NTMs, placing market integration in reverse.

In the context of more fragmented markets, the issues of common trade policies and "deepening" lost content and credibility. In practice, member countries grew increasingly apart over the CET and, at least in the case of Argentina and Uruguay, a strong criticism about the customs union approach gained influence. In Argentina the implementation of the CET experienced a significant reversal on March 2001, when the government unilaterally decided to increase the tariff rate on consumer goods to 35% and to cut down to zero import levies on capital goods.⁸

⁸ Shortly after the Common Market Council temporarily waived Argentina of its CET obligations. In 2002 Argentina reestablished the pre-existing tariff rates, except for a number of capital goods.

Scant progress was recorded in the “deepening” agenda as well. After three rounds of negotiations the regional commitments on services liberalization included modest GATS-plus liberalization (the coverage ratio and the share of unrestricted offers on negotiated sectors was higher in MERCOSUR than in GATS). But these benefits were still pending on Congressional ratification of the protocol.⁹ In the area of government procurement, despite the launching of negotiations in 1998, by 2002 member states had failed to agree on the technical details required to draft a protocol. In the critical area of macroeconomic cooperation the only remarkable decision was an agreement setting indicative targets for a number of nominal variables in mid-2000. However, the agreement was purely indicative, it failed to include procedures to stimulate compliance and made no provisions on what should be done in case of non-compliance. The collapse of the currency board in Argentina on January 2002 and the sharp devaluation of the Uruguayan peso shortly after played havoc with the nominal targets agreed.

During this later phase the growing number and intensity of MERCOSUR inter-state conflicts stimulated “negative politization”. The conflicts that followed the sharp devaluation of the Real were probably the most visible, but they were by no means unique. Apart from a lack of focus, member states showed growing disagreements over the desired content of regional integration, international trade strategies and even the choice of monetary regimes. These differences were frequently captured by the domestic policy debate, leading to polarization and negative politization.

As a result, since 1998 MERCOSUR has been in a state of near collapse. Trade interdependence fell, market fragmentation increased through new NTMs and other restrictive trade measures, and no progress was made towards harmonization or more effective enforcement of decisions. This happened in the context of a sour political climate that conspired against bridging the existing differences of interests and perceptions. The much publicized “re-launching” of MERCOSUR in mid-2000 produced no practical results.

⁹ Many of the protocols approved as annexes to the Treaty of Asunción (such as the investment protection protocol or the services protocol) need to undergo the Congressional ratification procedure typical of any international treaty. The investment protection protocol, negotiated over a decade ago, has not been ratified by all Parliaments yet.

2. Accounting for performance

Many factors have influenced the performance of MERCOSUR during its first decade of existence. Some of them are structural (such as the level of economic and institutional development or the nature of regional interdependence), while others have changed along time. Structural factors are subject to slow change and thus cannot account for the contrasting performance of MERCOSUR throughout the 1990s. This is why this section focuses on three contextual factors that can help to understand the cycle of progress, stagnation and reverse that MERCOSUR experienced since 1991 (see figure 2). These three factors are: 1) revealed national policy preferences; 2) the nature and content of the negotiating agenda; and 3) the external environment.

Figure 2
Accounting for MERCOSUR contrasting performance

<i>Variables</i>	<i>Revealed National policy preferences</i>	<i>Content of the policy agenda</i>	<i>External environment</i>
<i>Phase</i>			
<i>1991/1994</i>	<i>Macro diverge/Micro converge</i>	<i>Border barriers (tariffs) and agreement on common trade policies</i>	<i>Positive</i>
<i>1995/1998</i>	<i>Macro converge/Micro diverge</i>	<i>Non-border barriers, NTBs, implementation of common trade policies</i>	<i>Worsening</i>
<i>1998/?</i>	<i>Macro/Micro diverge</i>	<i>Non-border barriers, NTBs, implementation of common trade policies</i>	<i>Negative</i>

2.a *Revealed national policy preferences*

Engagement in a process of regional economic integration assumes the existence of a potential for mutual gains. Apart from structural conditions, the realization of these mutual gains is helped by shared interests, similar perceptions (visions of the world) and convergent revealed policy preferences. Governments that pursue economic integration may not share exactly the same motivations, but these cannot be mutually inconsistent. Reaching a satisfactory compromise between not fully identical interests, perceptions and revealed policy preferences is the subject matter of politics. So it is the maintenance of a dynamic compromise over time.

During the last decade the revealed economic policy preferences of MERCOSUR member states showed at best times of only partial convergence.¹⁰ During the initial 1991-94 period microeconomic policy preferences were largely similar, but in the context of widely divergent macroeconomic frameworks. In effect, after two hyperinflationary episodes Argentina stabilised its economy through the enforcement of a nominal peg and a currency board. This rigid regime severely limited the discretion of monetary authorities. Constrained in its ability to borrow from the Central Bank, the federal government was left with no option but raising public sector revenues through taxation, privatization or borrowing abroad.¹¹ This policy mix led to a drastically lower inflation rate (that laid the basis for an aggregate demand boom) and a real appreciation of the domestic currency. In contrast, by the same period the Brazilian government was implementing a crawling-peg in an environment characterized by high inflation and a much more fragile fiscal stance.

Despite these widely divergent monetary, exchange rate and fiscal policies (and macroeconomic performance), microeconomic policy choices showed remarkable convergence. In the early 1990s trade liberalization, deregulation and privatisation

¹⁰ The discussion focuses on Argentina and Brazil because their governments' policy choices have been decisive in shaping MERCOSUR.

¹¹ Domestic financial markets were almost non-existent after the hyperinflation. However, they gradually developed again during the 1990s. By the end of the decade a large share of the assets of commercial banks and pension funds were again public sector bonds.

became keywords in Argentina as well as in Brazil. Although the Argentine and Brazilian governments differed in the details of their policy approaches towards micro market reform, the general thrust was towards more market-friendly types of intervention. This was most visible (and important for our discussion) in the realm of trade policy, where unilateral trade liberalisation provided a background conducive to the preferential reduction of barriers to intraregional trade.

The 1995-98 period was one of partial policy convergence as well. In effect, after the implementation of the *Plan Real* Argentina and Brazil experienced *de facto* convergence on macroeconomic (particularly exchange rate) policy. This shift, however, coincided with a growing split on the predominant microeconomic approach. While the Argentine government continued its policy of government restraint based on ideological preferences as well as institutional constraints, Brazilian (central and local) authorities gradually moved towards more activist sector and horizontal policies (such as the automotive regime for the Northern and Northeastern regions or more aggressive development and export finance policies) (da Motta Veiga, 1999). In a context in which member states failed to reach agreement on how to deal with distortions caused by public sector aids, these divergent patterns of microeconomic intervention proved particularly conflictive.¹²

During the third and most critical period, Argentina and Brazil displayed divergent policy preferences both in the macro and microeconomic realms. On the macroeconomic side, the devaluation of the Real on January 1999 brought *de facto* convergence to an abrupt end. The adoption of a floating exchange rate while Argentina stuck to the currency board confirmed a widening gap in policy preferences that became a major source of conflict and dissent. Preliminary exchanges on a common currency and other initiatives aimed at macroeconomic coordination were largely formal and lacked substantive content. Paradoxically, although the collapse of the currency board and the devaluation of the Argentine peso on January 2002 removed one major obstacle to macroeconomic cooperation, the financial crisis and the economic instability that followed led to a context adamant to economic cooperation. As far as microeconomic

¹² The issue of distortions to investment location was particularly conflictive in the case of the automobile industry. Argentine negotiators pushed for an agreement on public sector aids or for the inclusion of public sector aids within the reach of the protocol on competition defense. The reluctance of Brazilian authorities led to the maintenance of national antidumping and countervailing duty regimes.

policies were concerned, Argentina and Brazil maintained their divergent views and practices. They also made no progress in dealing more effectively with the effects of divergent microeconomic approaches (including subsidy competition).

2.b The content of the policy agenda

During the initial years of MERCOSUR the policy and regulatory agenda was mainly focused on the removal of tariffs and other border barriers to trade (“hollow integration”). The *Acta de Buenos Aires* signed by the Argentine and Brazilian governments in 1990 adopted a very effective method to eliminate tariff protection (later on incorporated into the Treaty of Asunción as the Trade Liberalization Program, TLP). The TLP (a linear, automatic and across the board tariff-cut program) constituted a major change in the focus and procedures for preferential trade liberalization as compared to the past. The shift in emphasis from a “positive” to a “negative” list approach, and the launching of an automatic liberalization schedule, meant that intraregional tariff cuts moved forward swiftly. In turn, the agreement on a common trade policy (a CET and a customs code) at the end of 1994 was facilitated by convergent national trade policies, complemented with a flexible approach materialised in long transition periods for sensitive products and sectors.

However, by the mid-1990s the success of MERCOSUR’s tariff cutting exercise had brought new issues to the negotiating table. With most tariff barriers removed or subject to automatic schedules for elimination, the negotiating agenda shifted towards the more complex issues of identifying and removing non-tariff restrictions and non-border barriers to trade and effectively enforcing common trade policies. NTMs and non-border measures are problematic because they are intrinsically non-transparent, their obstructiveness is to a large extent dependent on enforcement, the distinction between “legitimate” and “illegitimate” regulations is blurred and there is limited consensus over the optimal degree of harmonisation. The consequence is a more complex and conflict-prone negotiating agenda in which the automatic procedures adopted by the TLP could make very limited contribution.

The adverse macroeconomic environment that prevailed after the East Asian crisis made MERCOSUR non-border negotiating agenda even more relevant. In the absence of pre-established mechanisms to deal with contingencies, poor macroeconomic performance led to a battery of new *ad hoc* trade restrictions. As a result, MERCOSUR not only failed to tackle the inherited stock of “unfinished businesses”, but it faced to a continuously growing inventory of questionable practices. In a context of reduced credibility, the more demanding issues of common trade policies and “deepening” became the object of cosmetic exchanges rather than substantive negotiation.

Similar difficulties were faced to effectively enforce the agreed common trade policies. Implementing common trade policies involves a degree of “positive” integration that pre-supposes not only the existence of shared interests and preferences, but also comparable institutional capabilities. It was mentioned before that the adoption of the CET was the result of a transaction between divergent national production and protection structures in an asymmetric environment. Consequently, the stability of the transaction will partly depend on contingent trade-offs that may or may not materialise as the integration process moves forward.

The issue of macroeconomic co-ordination deserves special mentioning. Article I of the Treaty of Asunción established as an objective the coordination of macroeconomic and sector policies, but it failed to establish a mechanism to ensure it. Lack of co-ordination was compatible with a rapid dismantlement of tariffs and rising intra-regional trade flows during 1991-98, either because of *de facto* convergence (such as between 1994 and 1998) or because of extremely favorable international conditions (as between 1991 and 1994) (see below). The macroeconomic disruptions that followed the East Asian crisis confirmed that regional integration cannot make progress –or even maintain the levels attained- in a context in which significant macroeconomic divergency and instability prevail.

In summary, as the “easy” phase of tariff elimination was completed in the mid-1990s, MERCOSUR’s negotiating agenda shifted towards more complex matters that demand deeper coordination and more effective restraints on national policy discretion. The emerging non-border agenda is intrinsically more complex than the removal of

border barriers to trade, as it demands more convergence in preferences and similar institutional capabilities. Moreover, appropriate mechanisms have to be designed in order to make progress sustainable. The fragilities of MERCOSUR to create and implement rules have severely limited effectiveness.

The external environment

At last, the record of MERCOSUR during the 1990s cannot be properly understood without taking into account the influence of external factors, of which two shall be underlined. One is the state of international financial markets and the availability of credit. The other is the pace and credibility of other preferential negotiations, particularly those of the Free Trade Area of the Americas (FTAA).

The state of international financial markets has no obvious bearing on the performance of regional economic integration. However, international financial markets have been a key factor in the record of MERCOSUR. During the 1991-1994 period, liquid international financial markets served as a lubricant for regional economic integration. In effect, the end of rationing in world capital markets and the reestablishment of easy borrowing conditions relaxed a major constraint on economic growth, thus helping to reduce the conflicts associated with growing bilateral trade imbalances and economic adjustment in a slow-growth context. In a context of economic expansion, trade liberalization and the financing of current account deficits were both made easier. However, these favourable conditions temporarily changed after the “tequila” crisis” and severely worsened after the 1997 East Asian crisis and the 1998 Russian default. In a context of limited international credit availability regional economic growth suffered, the advancement or maintenance of trade liberalization became more conflict-prone and the reduction of the current account deficit (mainly through lower trade deficits -taking into account the inelasticity of the services balance) turned into a major policy objectives. Successive foreign exchange crisis led to a significant devaluation of the Real in January 1999 and to the collapse of the currency board in Argentina three years later. This context was certainly not conducive to economic integration and trade liberalization, whether it is preferential or unilateral.

The second external factor to be taken into consideration is the pace and credibility of other preferential negotiations, particularly the FTAA. When the Argentine and Brazilian governments signed the *Acta de Buenos Aires* in mid-1990 (adopting an automatic mechanism for trade liberalization), a major incentive was the perception that the proliferation of regional arrangements (especially the announcement of FTA negotiations between Mexico and the US), urged a regional response. It was not by chance either that the pace and commitment to reach a settlement on the CET peaked just prior to the Miami hemispheric presidential summit of December 1994, that launched hemispheric-wide negotiations towards a free-trade area. Particularly for Brazilian negotiators, the incentives to strengthen MERCOSUR increased *pari passu* with perceived defensive interests. One of the major consequences of regionalism is, precisely, that it gives rise to “defensive interests” and “domino effects”. The impact of these considerations in shaping Brazil’s trade strategies was very significant.

But the perceived external pressures to consolidate MERCOSUR relaxed significantly after the mid-1990s, following the US administration failure to secure fast track negotiating authority from Congress. This severely damaged the credibility of the negotiations, reducing the Brazilian incentives to consolidate an effective regional coalition in the Southern Cone. If MERCOSUR was regarded as a mechanism to improve the international bargaining position of its member states, the loss of credibility of FTAA negotiations probably lowered the incentives to compromise.

Withering Mercosur?

The current *impasse* of MERCOSUR and the open debate over its prospects are the result of a set of factors that includes divergent interests and perceptions, an increasingly complex negotiating agenda and an adverse external environment. Their implications for regional economic integration, however, could have been dealt with through adequate political bargaining. The fact that this bargaining has failed to materialize is partly a consequence of a deficit in regional leadership.

Regional integration cannot proceed without the provision of certain collective goods, a task that involves a cost. That some of the participants may be ready to bear

this burden requires a long-term (strategic) view about costs and benefits that will necessarily involve trade-offs with other short-term priorities. When seen in this perspective, MERCOSUR has displayed a significant “leadership gap”. This “leadership gap” can be accounted for by two facts. One is the absence of a member that perceives sufficient rewards from economic integration to have the incentive to play the role of a “benign hegemon” and thus bear the burden of “leadership”. The other is the lack of resources to make that leadership effective, even if the perception of a rewarding pay-off matrix exists. The structural features of MERCOSUR –mediated by politics- provide the foundations of the “willingness” and “ability” to lead. There are two major structural features of MERCOSUR member states relevant to the present discussion. The first one is the intensity of regional interdependence. The second concerns economic and institutional development.

One major structural feature of MERCOSUR is the low and asymmetric level of interdependence that prevails in the region. The ratio of intra-regional exports to GDP is only 2% (well below the levels recorded by the European Union in the early 1970s). This is the result of a relatively low ratio of intra-regional to total foreign trade (20% in 2000) and low foreign trade openness on the part of the larger economies (the export/GDP ratio in Brazil is below 10%). This means that while Paraguay and Uruguay are two small and open economies highly vulnerable to regional events, Brazil is a continental and relatively closed country with very limited interdependence linkages with the rest of the region.

This structural feature decisively shaped national economic incentives to coordinate, and accounts for the fact that the original transaction that brought MERCOSUR member states together included different blends of trade and non-trade considerations. For the Brazilian negotiators MERCOSUR was a means to increase the country’s bargaining resources *vis-à-vis* the rest of the world rather than a vehicle to increase welfare through regional specialization. This led them to weight the benefits of MERCOSUR in terms of its contribution to raise Brazilian international bargaining stance.¹³ Instead, for the smaller parties (including Argentina) the attraction of gaining better and more stable access to a large (and relatively protected) market was far more

¹³ This accounts for the fact that the Brazilian authorities always emphasized the customs union approach as the only one acceptable.

important. Since both expectations were frustrated as the 1990s progressed, the incentives to provide leadership (as well as to abide) shrank proportionally.

However, even if a sustainable bargaining were possible and consequently there were enough incentives to provide (and pay for) the required leadership, that may not be enough. In effect, a “benign hegemon” also needs resources to make leadership effective. But resources are scarce and must be allocated between alternative uses. Moreover, resources to exert effective leadership may not even be there. This has been the case with the absence of a regional partner able to provide an anchor for regional macroeconomic stability and a focal point for convergence. The obvious candidate to play such role (Brazil) has a poor track record, and the country with the most stable macroeconomic performance in the region (Paraguay) is a candidate unlikely to have the other attributes required to play that role.

The issue of the “ability” to lead relates to the broader issue of economic and institutional development. The strength of regional agreements is not independent from the broader governance and economic policy environment. When governance institutions are fragile, ineffective and lack adequate mechanisms for accountability, commitments rarely translate into implementation. This underlines the key issue of the design of appropriate and feasible procedures for rule-making and implementation, taking into account the kind of prevalent domestic institutions. By the same token, in an unstable macroeconomic environment, the sustainability of trade liberalization (either unilateral or preferential) will remain fragile. Under such circumstances, a more focused definition of objectives and an emphasis on institutional design that effectively contributes to reach that target will contribute to effectively reap the gains of deeper market integration and closer political cooperation, eventually leading to a learning process that may develop into deeper forms of cooperation.

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