

MERCOSUR TEN YEARS AFTER: LEARNING PROCESS OR DEJA-VU?²

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During the last decade the Common Market of the South (MERCOSUR) has been one of the integration experiences among developing countries that attracted most interest from analysts and practitioners alike. The economic dimension and the regional weight of member countries, the extraordinary rapid growth of intra-regional trade and investment flows and the fast progress made in tariff elimination had been quite unprecedented by developing countries' standards. However, after a promising start MERCOSUR confronted the challenges typical of "deepening", ie: the removal of non-border trade barriers, the harmonisation and oversight of competition-distorting domestic policies and the enforcement of common trade policies. In these areas achievements have been more modest.

This paper reviews the record of MERCOSUR during the last decade and provides a synthetic perspective of its current policy dilemmas. In the first section the paper presents an overview of the performance of MERCOSUR during its first ten years of existence. In the second section the paper attempts to account for MERCOSUR contrasting economic record, identifying a number of causal factors. In the third section the paper briefly discusses some of the policy issues and challenges currently faced by MERCOSUR. Finally, and based on the preceding analysis, a concluding section summarizes some of the major points raised.

The paper does not aim to present a comprehensive account of MERCOSUR. Instead, it purports to underline the major stylised forces that shape the potential for conflict and co-operation in the region. This explains our focus on Argentina and Brazil, the two major driving forces behind MERCOSUR.

1. The first decade of MERCOSUR: a stylised view

Although defining periods always involves an element of choice, the record of MERCOSUR during the nineties can be adequately summarised by three distinct phases (Table 1). Each phase is characterised by a particular combination of three indicators that jointly provide a dynamic account of performance. These three indicators are: 1) the evolution of interdependence; 2) the "relative enforcement gap"; and 3) the "politisation bias". Each one deserves a brief explanation.

"Inter-dependence" is an indicator of the intensity of spill-overs within a region. "Inter-dependence" can be adequately approximated by the intra-regional exports/total

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exports ratio (the “trade encapsulation index”) or the intra-regional exports/GDP ratio. Rising inter-dependence is neither a necessary consequence of trade preferences nor is it welfare improving. However, a preferential trade arrangement is expected to increase interdependence if it is to be meaningful to its members. Rising inter-dependence will create stronger incentives to co-operate and manage cross-border spill-overs.

In contrast to “interdependence”, the “relative enforcement gap” and the “politization bias” are qualitative indicators. The former makes reference to the existing gap between policy decisions (commitments) and implementation. Although effective implementation will always lag behind and imperfectly replicate decisions, a meaningful preferential trade arrangement cannot live hand by hand with an ever-widening “relative enforcement gap”. In the limit, a process of regional integration will become irrelevant when decision-making organs make rules that have no material effect on national regulations or economic agents.

Finally, the “politisation bias” tries to capture the prevailing mood through which members deal with differences and conflicting interests. “Negative politization” occurs when differences (including technical ones) are taken into the political arena and “captured” by the domestic political debate. However, “politisation” can also have a positive bias. This may be the case when over-riding political incentives provide a rationale for compromise.

These three variables do not capture the full range of factors that influence or characterise a regional integration process, but we believe that they provide a stylised view of MERCOSUR’s record and performance.

TABLE 1
THE FIRST DECADE OF MERCOSUR: A STYLISTED VIEW

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

1.a) The transition period (1991/1994)

In the Treaty of Asunción (March 1991) the period up to December 31, 1994 was named the “transition period”. During this phase intra-regional trade flows increased substantially and inter-dependence deepened, particularly between MERCOSUR two major partners. In a period of just four years the intra-regional exports/GDP ratio (as well as the “trade encapsulation index”) increased over sixty percent. By opening up the economies and enabling geographical proximity to operate, unilateral trade liberalisation decisively contributed to raise inter-dependence. But preferences also played a role (Frankel, 1997).

During this initial phase member countries adopted three major commitments, namely: 1) to implement a Trade Liberalisation Program (that consisted of automatic and across the board tariff cuts), ii) to adopt a common external tariff (CET); and iii) to co-ordinate macroeconomic and sector policies. Except for the co-ordination of macroeconomic and sector policies (for which no mechanisms were defined), by 1995 MERCOSUR had achieved significant liberalisation of tariff barriers and had agreed on a CET.

In just four years MERCOSUR made more progress towards intra-regional trade liberalisation than in the previous three decades. In effect, by January 1995 the bulk of intra-regional trade was subject to zero tariff rates. The exceptions were a handful of sensitive products with automatic calendars for tariff elimination by (at most) January 2000, and two “special sectors” (sugar and motor vehicles), transitorily excluded from free trade.¹ Although in the realm of non-tariff barriers (NTBs) progress was more modest, member states agreed to eliminate thirteen identified NTBs (mainly prohibitions and quantitative restrictions) by December 31, 1994.

By the end of 1994 member states had also agreed on a CET and a customs code. The conflicting interests that stemmed from divergent national protection structures were accommodated by a compromise that included the maintenance of national tariff rates subject to automatic convergence calendars for a limited number of sensitive products, plus capital goods, information and telecommunication products.

By January 1995 MERCOSUR was far from being a full customs union. Many NTBs were still in place, common trade policy instruments were only partially implemented, and policy asymmetries retained their full potential to distort competition in the region. However, relative to the typical LAC regional integration process MERCOSUR recorded significant achievements both in enforcement and implementation in a surprisingly brief period of time.

Although the “transition period” was not free from clashes among the participants (in particular, Argentina resented sizeable bilateral trade deficits with Brazil), these were generally managed using a co-operative and flexible approach. Examples of this were the Brazilian readiness to accept an increase in the Argentine statistical import tax surcharge from three to 10 percent at the end of 1992 (stimulated by the real appreciation of the peso and mounting trade imbalances) and Brazil’s

¹ Paraguay and Uruguay were given one additional year to complete tariff-cutting commitments. In Ouro Preto member states also agreed to include the sugar sector into the free-trade arrangements and enforce a common trade policy by December 2000. Motor vehicles’ trade should be run by a common regime as of January 2000.

decision to start to purchase oil and larger amounts of wheat from Argentina in order to reduce bilateral trade imbalances.²

1.b) The “age of the markets” (1995/1998)

As far as the performance of MERCOSUR was concerned the 1995/1998 period was one of contrasts. In effect, these were the years of rising interdependence and growing regulatory paralysis. During this period the prevailing view was that MERCOSUR was so successful that it could move forward pushed solely by private sector interests, while the policy agenda lagged well behind. As events proved later on, the situation was more complex and MERCOSUR began to accumulate ever-growing unfinished businesses.

During the 1995/1998 period the “trade encapsulation index” (and the intra-regional exports/GDP ratio) increased by nearly 50%. In terms of trade and investment flows this period was a “golden age”, led by market incentives strong enough to ensure a dynamic increase in interactions even in the context of a regulatory paralysis and a widening “relative enforcement gap”.

Although member states successfully implemented the agreed tariff cuts for sensitive products, sugar and motor vehicles remained subject to special rules and excluded from intra-regional free trade. More importantly, almost no progress was made in the realm of NTBs: border and non-border NTBs remained largely intact and no progress was made in terms of either identification or transparency. The implementation of common trade policies also lagged behind: the CET was only partially implemented, new temporary exceptions were authorised and the customs code proved inapplicable. As a result all goods traded remained subject to rules of origin, thus eliminating one of the major benefits of a customs union over a free-trade area. By the same token, after two free-trade agreements were successfully concluded with Chile and Bolivia, the negotiations with the Andean Community and Mexico broke down. The result was a temporary extension (or even expansion) of existing bilateral agreements that further eroded the CET.

The “deepening agenda” agreed on December 1995 in Montevideo (*Agenda Mercosur 2000*) also recorded almost no progress. The only major initiative was the signature of a Services Trade Protocol in 1997. However, even the Services Protocol was no proof of progress, as it went only modestly beyond the commitments already undertaken in the WTO. Common safeguards, antidumping and countervailing procedures were agreed, but not enforced.

From an institutional perspective, the major innovation in the period was the creation of a Trade Commission in charge of administering common trade policy instruments. However, the Trade Commission ended up burdened by the administration of internal trade disputes rather than by the enforcement of common trade policies. Despite mushrooming conflicts, the Dispute Settlement Mechanism (DSM) remained unused until 1999.³

² Brazil was a traditional market for Argentine wheat, but Argentine exports suffered the adverse effects of developed countries’ subsidised exports. In turn, following a “political decision” the Brazilian state oil monopoly (Petrobras) replaced part of its oil purchases in the Middle East by purchases in Argentina.

³ For a detailed discussion of MERCOSUR’s institutional performance see Bouzas and Soltz (2000)

During the 1995/98 period differences were not dealt with as much accommodation as during the “transition phase”. However, during this period national governments made big efforts to prevent “negative politisation”. This endeavour became increasingly difficult as contrasting interests and perceptions turned more widespread and evident. As the political incentives to work together subdued, the scope for conflict and “negative politisation” widened considerably.

1.c) Times of turbulence (1998/?)

The devaluation of the Real in January 1999 is generally regarded as the prelude to falling inter-dependence and rising conflict among MERCOSUR partners. However, this view is an over-simplification of the multiple factors that have shaped the recent performance of MERCOSUR. In effect, the sources of MERCOSUR disappointing performance after 1998 must be searched in more fundamental reasons than the Brazilian devaluation.⁴ Some of these reasons were already pointed out in the previous sub-section and others will be more fully developed in section 2.

Since 1998 inter-dependence has contracted. During 1999 intra-regional trade flows fell in absolute terms by 27.6%, while the “trade encapsulation coefficient” returned to the levels recorded in 1995. During 2000 intra-regional trade flows recovered by 17.6%, but only to reach the levels of 1996. The “trade encapsulation index” remained stable at the levels recorded in 1995.

Lower inter-dependence in the region was to a large extent the result of adverse macroeconomic conditions, but also of policy decisions. In effect, the protracted economic recession in Argentina and the economic slowdown that followed the devaluation of the Real in Brazil severely curtailed intra-regional trade flows, confirming the evidence that intra-regional trade flows are more sensitive to aggregate demand levels than to real bilateral exchange rates.⁵ *Ad hoc* trade relief measures and (officially sponsored) private sector “orderly marketing arrangements” also repressed trade flows.

As far as enforcement was concerned, the post-1998 period saw a continuation of many of the trends that prevailed during 1995/1998. The phase-out of tariffs for sensitive products culminated as planned, but the “special sectors” (sugar and motor vehicles) remained excluded of intra-regional free-trade.⁶ Moreover, the refusal of the Brazilian government to accept the adoption of a safeguards mechanism led to a proliferation of *ad hoc* (formal and informal) protection measures that proved to be a hindrance to intra-regional trade. The treatment of NTBs also made no progress as member countries failed to increase transparency or move towards their identification and removal. Steps were taken towards mutual recognition of sanitary standards, but enforcement still depends of more detailed agreements.

⁴ To underline this point we adopt 1998 as the ending year of the second phase and the starting year of the last phase.

⁵ See Heymann (1999)

⁶ Sugar should have been included in the general rules by December 2000, but member states failed to reach an agreement. The issue is still pending. A common regime for motor vehicles was finally agreed in March 2000, but intra-regional free-trade will be enforced only in 2006.

Finally, common trade policies and the “deepening” agenda also remained in the doldrums. While the backlog in implementation remained untouched, a widening gap between commitments and implementation developed in areas such as customs procedures, standards and other regulations. Even the efficacy of the DSM was brought into question after an ineffectual “resolution” of the first case brought before it.

During this last phase “negative politisation” became predominant. Trade conflicts mushroomed and the devaluation of the Real amplified national authorities’ readiness to embrace private sector complaints and engage into a rhetoric of confrontation. The flame of dissent was further fuelled by frequent foreign policy clashes.

Although in June 2000 the four member states agreed on a “re-launching agenda”, it is still premature to bring this third stage to a close. The “re-launching agenda” is too complex and ambitious. However, at the turn of the century a number of factors may play in favour of a new dynamism on the part of MERCOSUR. We return to this point in the concluding section.

2. Accounting for MERCOSUR performance

Multiple factors account for MERCOSUR contrasting performance during its first decade of existence. However, in this section we concentrate on three that combined can give adequate account of the major reasons behind progress and stagnation (Table 2). The three factors in which we shall concentrate our attention are: 1) revealed national policy preferences; 2) the content of the agenda of negotiations; and 3) the external environment. To these we now turn.

TABLE 2
ACCOUNTING FOR MERCOSUR CONTRASTING PERFORMANCE

Phase	Variables	Revealed policy preferences	Nature of the negotiating agenda	External environment
1991/1994		Macro diverge/Micro converge	Border barriers (tariffs) and agreement on common trade policies	Conducive
1995/1998		Macro converge/Micro diverge	Non-border barriers, NTBs, implementation of common trade policies	Adverse

1998/?

Macro/Micro
divergeNon-border
barriers, NTBs,
implementation of
common trade
policies

Adverse

2.a) *The transition period (1991/1994)*

During the “transition period” the performance of MERCOSUR was facilitated by a positive set of circumstances that included congruent national (microeconomic) policies, a negotiating agenda focused in “hollow integration” and a favourable external environment. This set of factors proved beneficial for the progress of regional integration, particularly in its early stages.

During the 1991/1994 period member countries revealed a mix of congruent (microeconomic) policy preferences, combined with divergent macroeconomic approaches. After two hyperinflationary episodes Argentina stabilised its economy with the Convertibility Plan in April 1991, adopting a nominal peg and a currency board. This regime not only wiped out monetary discretion, but also severely constrained fiscal laxitude. Limited in its ability to borrow from the Central Bank, the federal government was forced into a program of fiscal consistency only partially relaxed by revenues from privatisation and foreign borrowing. As a result inflation fell sharply, growth resumed at a brisk pace and the real exchange rate appreciated. Brazil, in contrast, was at a very early stage of the process of stabilising its macroeconomy: inflation was still high, fiscal accounts fragile and the exchange rate regime was a crawling-peg. Despite these divergent macroeconomic trajectories, at the micro-economic level policy preferences converged notably: structural reform, deregulation and privatisation became the words of the day. Although this convergence was more intense in rhetoric than in substance, both countries engaged in pro-market reforms and unilateral trade liberalisation. In particular, the latter reinforced (and was in turn strengthened) by preferential trade liberalisation in the context of MERCOSUR.

At this stage the policy and regulatory agenda of MERCOSUR was dominated by tariff cuts and the removal of border barriers to trade (“hollow” integration). With this objective in mind (and congruent with the shift towards unilateral trade liberalisation) in 1990 the Argentine and Brazilian governments signed the *Acta de Buenos Aires* adopting a linear, automatic and across the board tariff-cutting program that was unprecedented by Latin American and Caribbean standards. This program, adopted by the four member states when the Treaty of Asunción was signed in March 1991, involved a major change in focus and procedures. Once enacted by national legislatures the Trade Liberalisation Program became domestic law and was automatically enforced. The result was that the logic of intra-regional trade negotiations changed radically, as officials focused on “negative” rather than “positive” lists of concessions. The result of this approach, made possible by the broader trade policy environment, was a remarkably rapid process of intra-regional trade liberalisation.

The agreement on common trade policy instruments (particularly a CET) was also made easier by the convergence of national trade policy regimes (particularly trade liberalisation in Brazil) and a flexible approach materialised in long transition periods for sensitive products and sectors. While the CET largely replicated the structure of protection in Brazil, long transition periods served to smooth the conflictive interests that stemmed from heterogeneous national protection (and productive) structures.

At last, the external environment proved conducive to the rapid progress of trade liberalisation. On the one hand, liquid international financial markets relaxed the major constraint on economic growth that had operated during the eighties and reduced the conflicts associated with rising bilateral trade imbalances. Moreover, the launching of negotiations for a North American Free Trade Agreement (NAFTA) and the Enterprise for the Americas Initiative in 1990, and the Miami presidential summit of December 1994, all contributed to stimulate “defensive” incentives in the region (and particularly in Brazil) thus raising the stakes of the regional exercise⁷

2.b) *The “age of the markets” (1995/1998)*

During the 1995/1998 period the major factors playing in favour of MERCOSUR were the rapid rise of intra-regional trade and investment flows (that increased the stakes of those involved in the process and broadened its impact) and the favourable conditions created by *de facto* convergent macro-economic policies. However, the adoption of the Plano Real in Brazil in mid-1994 was soon followed by a shift at the microeconomic policy level. In effect, Brazilian (central and local) governments moved towards a pattern of sector and horizontal intervention (such as the automotive regime for the Northern and Northeastern regions, the provision of development and export finance, etc) (da Motta Veiga, 1999). The Argentine government, in turn, continued its trajectory of very limited intervention moved by ideological preferences as much as by institutional deficiencies. The divergent path of micro-economic policies broadened the room for conflict, as the more interventionist stance of Brazil distorted incentives for trade and investment location.

By about the same time, the very success of MERCOSUR’s tariff cutting exercise placed a more demanding agenda of negotiations. Once most tariffs had been removed or made subject to calendars for automatic elimination, the agenda shifted towards the more complex issues of identifying and removing non-tariff restrictions and non-border barriers, as well as to effectively enforce common trade policies. It is well known that NTBs and non-border restrictions pose the toughest challenges to trade liberalisation. NTBs and non-border restrictions lack transparency, they can be enforced in an obstructive manner, the border between legitimate restrictions (such as those to protect health or sanitary conditions) and obstructive regulations is blurred, and there is little consensus about the optimum degree of policy harmonisation. The result is a more complex and conflict-prone agenda.⁸

⁷ For a discussion of the role of “defensive incentives” see Bouzas and Ros (1993)

⁸ The European experience shows that after years of harmonisation the adoption of the principle of “mutual recognition” proved the way out from the *embroglio*. However, mutual recognition is only conceivable where standards and enforcement display relatively limited variety.

Something similar happened with the enforcement of common trade policies. Implementing common trade policy instruments involves such a degree of “positive” integration that makes necessary not only shared interests and preferences, but also comparable institutional capabilities. Moreover, when common policies are the result of a compromise between different interests and perceptions in an asymmetric context (as it was the case with the adoption of the CET in MERCOSUR), the acceptance of the agreed bargain involves dynamic trade-offs that may or may not materialise as the process evolves.

At last, during the 1995/1998 period the external environment became more adverse. The conditions prevailing in international capital markets changed after the Mexican crisis of December 1994, and worsened markedly after the East Asian crisis of 1997 and the Russian default one year later. Failure of the Clinton Administration to obtain a fast-track negotiating authority also relaxed the perceived pressure to “deepen” MERCOSUR. This was a particularly relevant consideration in the case of Brazil, that has viewed the hemispheric process largely through a strategic lens.

2.c.) Times of turbulence (1998/?)

The most recent phase of MERCOSUR combined negative developments in the three areas under examination. In effect, after the devaluation of the Brazilian currency in January 1999 the *de facto* convergence of macro-economic policies brought about by the Plano Real ceased to exist. The shock produced by the devaluation the Brazilian currency threatened to severely disrupt intra-regional trade flows but, more importantly, confirmed that policy preferences (particularly as regards the preferred exchange-rate regime) widely diverged among member states. Constrained by the currency board and a high level of “dollarisation” of financial assets, the Argentine government regarded the Brazilian move as inconsistent with its emphasis on macroeconomic stability. Moreover, divergent preferences also became explicit in the trade policy realm, where the expected trade-offs in exchange for the adoption of the CET failed to materialise (particularly as regards more stable and secure access into the largest market).

This context magnified the existing discrepancies, posing new obstacles to the effective treatment of the pending intra-regional agenda. The worsening macroeconomic environment led to an increase in *ad hoc* trade measures and soured the political climate. As a result, the unfinished agenda on market access issues remained untouched (indeed it was aggravated by new trade restrictions), while the more demanding issues of common trade policies and “deepening” lost substance, when faced to the succession of daily disputes.

The external environment did not improve either, except for the renewed impetus of the FTAA process that followed the decision to effectively start negotiations adopted in the Santiago de Chile in 1998.

3. The future of MERCOSUR: issues and challenges

Presently MERCOSUR faces significant challenges. As we argued in section 2, the reasons that explain the current stalemate go far beyond the adverse effects produced by

the devaluation of the Real in January 1999. In effect, MERCOSUR was displaying clear signs of a regulatory paralysis well before the Brazilian foreign exchange crisis. Focusing on this episode would provide a distorted image of MERCOSUR's current issues and policy challenges. The Brazilian devaluation aggravated trade conflicts and undressed the regulatory lagoons of MERCOSUR. But it cannot be singled out as the event responsible by the current state of affairs.

As explained in section 2, the factors that account for MERCOSUR performance are complex and multiple. Leaving the present stalemate behind cannot be the result of isolated initiatives. In this section we focus on three broad issues that must be addressed more effectively if MERCOSUR is going to recover its original dynamism. These issues are: 1) the challenge posed by divergent interests, perceptions and policy preferences; 2) the "problem of leadership"; and 3) the need to identify and implement a co-operative agenda. In the remainder of the section each one is briefly discussed.

3.a) Divergent interests, perceptions and policy preferences

The member states of MERCOSUR did not engage in the process of regional integration moved by the same interests. As a matter of fact, Argentine and Brazilian motivations differed from the start-out: while the Brazilian government regarded MERCOSUR as a means to enhance its role in the international arena (particularly in the foreign policy realm), the Argentine government was mobilised by the prospect of commercial gains and domestic political considerations. This example serves to reject the notion that participating countries originally shared the same interests. Indeed, perceived national interests usually differ. But if these differences do not involve incongruent preferences, a mutually beneficial arbitrage may be possible. Ultimately, what is required is that legitimate differences of interests can be successfully bridged by a compromise that leads to balanced mutual gains.

The matrix of different (but congruent) interests that provided the original glue for MERCOSUR was placed increasingly into question by divergent policy preferences. During the nineties the Brazilian government frequently considered its foreign policy priorities challenged by Argentine attitudes that made of its close alignment with the US a foreign policy cornerstone. Conversely, the benefits that the smaller partners of MERCOSUR (including Argentina) expected as a result of better and more stable access to the Brazilian market failed to materialise as policy asymmetries remained in place and MERCOSUR did not make progress towards a rules-oriented system. The gradual dissolution of this matrix and the failure to replace it by a new one lays at the basis of MERCOSUR's stalemate.

The (real or perceived) discrepancies between member states extend over several critical areas. A major one is the debate about the level and structure of protection. The agreement over a CET was made possible in 1994 by a compromise that closely replicated the Brazilian structure of protection and allowed long convergence periods for the other partners' sensitive products and sectors. However, the prevalence of uncertain rules, a high level of discretion and public policy asymmetries reduced the expected gains of the smaller partners (including Argentina). When convergence calendars began to bite, the perception that the costs associated with the agreed level

and structure of protection were not being adequately compensated by other gains placed the basic deal into question.

Member countries also showed significant discrepancies over their revealed preferences as regards the desirable extent of activist public policies. In effect, after the ‘neo-liberal’ *intermezzo* of Collor de Mello, Brazil returned to (more market-friendly) activist public policies that contrasted markedly with the ideological inclinations and the institutional and economic capabilities of the other partners of MERCOSUR. As MERCOSUR (largely due to the opposition of Brazil) failed to tackle the issue of competition-distorting public policies, their perceived effects on trade flows and investment location proved a source of conflict. As the experience of the European Union shows, fully convergent public policies are not a necessary condition for a process of regional integration to progress. However, some basic disciplines to deal with distorting interventions must be agreed and enforced.

The exchange rate regime is a policy arena where this divergence has been more clear. In effect, while Argentina has run a currency board and a fixed nominal peg since 1991, Brazil has adopted different regimes and has undergone major devaluations such as that of 1999. Since convergent exchange rate policies are unlikely to prevail in MERCOSUR in the foreseeable future (Brazil has few incentives to move towards a more rigid exchange rate system and Argentina faces great obstacles to abandon its current rigid regime –not least because of the extensive “dollarisation” of financial assets and liabilities), agreed procedures to deal with shocks and their effects should be in place. Since MERCOSUR lacks any mechanism to deal with the effects of exchange rate shocks, it can only rest either on *de facto* convergence or in *ad hoc* interventions during times of stress.⁹

Governments have also diverged over their perception of the effects that stem from the external environment. For example, and taking the case of the FTAA process, while the Argentine government generally regarded it as a positive development by itself and a potential catalyser for MERCOSUR, the predominant Brazilian perspective has been that of a “threat”. This has placed obstacles to working in common and the creation of trust, necessary condition for enhanced co-operation. Whether these divergent national positions are grounded in well-defined interests or are ideologically biased is to a large extent irrelevant to the issue at stake.

3.b) The “problem of leadership”

In order to be sustainable any process of regional integration needs a leader. Moreover, if that process is to survive as a voluntary agreement leadership and hegemony must be exercised in a benign way. Since regional integration is unthinkable without the provision of collective goods, it is necessary that one (or more of the) participants incurs in the cost of supplying them. In addition, making sure that the glue that holds the partners together is solid frequently requires a long-term (strategic) view that involves a trade-off with short-term priorities. MERCOSUR has not been free from this demand,

⁹ The announcement of common fiscal and inflation targets in 2000 was made on the assumption that fiscal and nominal convergence will stabilise real bilateral exchange rates. Although the targets are solely indicative, and thus involve no element of cohesion, they transpire awareness about the issue.

but a large gap has developed between this need and the effective supply of leadership within the region.

The “problem of leadership” in MERCOSUR is not that of willingness (or lack of it) on the part of one or more member countries. The problem is more complex. MERCOSUR has a “leadership problem” shaped by structural factors, the effects of which can only be countervailed by hard political decisions. Moreover, it is the result of a combination of “problems” (“three problems”), rather than just one.

The first one we call the “Argentine problem”. Briefly, it can be described as Argentina’s difficulties to accept a key role in the provision of leadership. Given the significant size asymmetries that prevail in MERCOSUR, it is hard to imagine a sustainable scenario in which Brazil would not play a leading role in policy formulation and in the shaping of MERCOSUR (as it did, for example, in the case of the CET). The “Argentine problem” is rooted in a history of rivalry and competition with Brazil and in wide discrepancies in the national political economies. Presently, the “Argentine problem” is not so much a result of a clash of ambitions over regional leadership and international prominence (as at one stage it used to be), but of divergent preferences over the desired pattern of development and insertion into the world economy. The “Argentine problem” weakens the foundations for strong bilateral ties, stimulating dissent in those areas in which the Brazilian government is most sensitive about Argentine support, such as international affairs and foreign policy. It is clear that this “problem” has no easy answers.

The remaining two “leadership problems” touch more directly onto the large partner. Although both can be seen as part of a same whole, for analytical purposes they can be fruitfully separated into two distinct issues. The first one (the “Brazilian problem #1”) embodies what may be called the “willingness to lead” and it refers to an issue of commitment. A benign hegemon needs to be committed to the provision of the collective goods required. As the provision of these collective goods (such as stable and enforceable rules) usually involves costs (such as a loss of discretion), “willingness” requires a pay-off matrix in which the perceived benefits for bureaucrats, politicians and other interested parties can be clearly identified. In the case of MERCOSUR Brazil’s “willingness to lead” is negatively influenced by two factors, one structural and the other policy-induced. The structural factor is size asymmetries. The policy-induced factor is the perception that the originally expected trade-offs have failed to materialise.

But even if there was “willingness to lead”, that would not suffice. In effect, a benign hegemon also needs resources to make leadership effective. This side of the coin is what we call the “Brazilian problem #2”. Resources tend to be scarce and they have to be allocated between alternative ends. Moreover, the resources to exert effective leadership may not even be there. That has been the case, for example, with macroeconomic discipline and stability. Since the sub-region has a problem with credible macroeconomic stability, a major potential contribution from a leader could be the provision of a focal point and an anchor for convergence. However, Brazil has lacked the attributes to play this role in MERCOSUR, as Germany did in Western Europe and, by alternative means, the United States in North America. This handicap in terms of “ability to lead” reduced the incentives of the other partners to follow.

In summary, the gap between the demand and the supply of leadership in MERCOSUR is significant. Closing that gap will demand a strong political will and an appropriate understanding of the current shortcomings and its implications. Rather than making long lists of unfinished business, what MERCOSUR needs most at this time is the re-creation of a sense of political understanding and shared interests that may raise the incentives to co-operate.

3.c) Setting and implementing a co-operative agenda

During the last few years the internal agenda of MERCOSUR focused in the administration of conflict rather than in the fostering of a co-operative agenda. Moreover, as discussed in section 1, divergencies were occasionally politized making more difficult to reach an acceptable settlement. Negotiations have been undertaken on the basis of “shopping lists”, in which member states bring together their reciprocal demands. This is an inadequate base to further the process of regional integration, as it de-emphasizes the co-operative elements that are the foundations of regional integration. Therefore, if the current phase is going to be left behind member states will have to replace the conflict-prone agenda that has been prevalent in recent years, focusing instead on co-operative arrangements capable of fostering common interests. This shift in focus can take place in at least three different areas, ie: 1) the management of productive restructuring; 2) the promotion of growth and productivity; and 3) the implementation of external trade negotiations.

The issue of administering the effects of productive dislocation has received little systematic attention. After safeguards were eliminated at the end of the transition period, no instrument was put in place to deal with the pressures emerging from shocks and unforeseen changes in competitive conditions. This issue became particularly critical after the devaluation of the Real in January 1999. Instead of finding common instruments to deal with the effects of that shock, member states adopted unilateral *ad hoc* measures (such as a more aggressive implementarion of trade remedy laws) and favoured private sector “orderly marketing agreements” (such as in the diary industry, paper, steel and others). Apart from these sectors MERCOSUR has been also postponing addressing comprehensively the issue of productive restructuring in the “special sectors” (sugar-cane and motor vehicles).

Private sector agreements and special trade regimes (such as those prevailing in motor vehicles and sugarcane) can be useful as transitory mechanisms in the context of sustainable long-term adjustment. However, most of these programs have included no restructuring targets. Therefore, they risk to become mechanisms to foster cartelisation and protect particular interests at the expense of the consumers and aggregate efficiency. The alternative to this approach is not market-led adjustment. Adjusting to transitory shocks may not be optimal. Moreover, as experience has shown, political economy considerations makes such a drastic approach difficult to implement. Instead, what may be required is a better understanding of permanent changes in competitive conditions and more transparent instruments to deal with transition costs and the effect of shocks. This not necessarily involves more interventionis public policies, but a more active role of the public sector as a co-ordinating agent and a supplier/disseminator of information.

A stronger co-operative approach is required not only to restructure, but also to promote pro-growth policies. One of the major benefits of economic integration is the possibility to share the costs of activities with large indivisibilities (such as research and development) or with strong complementarities or cross-broder externalities (such as infrastructure investment). In these areas with a high potential for “positive” integration the record of MERCOSUR has been modest. Focusing on long-term growth-promoting policy instruments may help to shift the focus from a conflict-prone agenda towards a more co-operative one.

At last, although MERCOSUR has been able to maintain a unified stance in preliminary negotiations in the FTAA or with the European Union, the basis for such co-operation seems a weak one. In effect, there is no systematic mechanism to identify common interests and areas of divergencies, as well as the trade-offs that may contribute to build a sustainable common negotiating stance. MERCOSUR lacks a forum where public officials can examine in detail their national agendas and arbitrage existing or emerging differences. Despite the unified stance of MERCOSUR in its dealings with the FTAA and the European Union, failed negotiations with the Andean Community and Mexico suggests that a common stance is not so easy to maintain when negotiations enter into the critical phase of exchanging concessions.

A more structured mechanism to identify and implement a common strategy for external trade negotiations seems badly needed. At this stage this may not involve the transfer of exclusive competences to a “supra-national” organisation (such as the European Community), but the start of an incremental process that may eventually lead there. More structured technical assistance and information gathering/exchange can at this stage render fruitful results and help to identify common interests.

4. Conclusions

We have argued in this paper that MERCOSUR faces significant challenges. However, the political, economic and technical capital accumulated in the last decade provides the foundations upon which to build. The “re-launching” agenda agreed in June 2000 is an ambitious one and may not be fully at reach. However, a change of direction cannot be ruled out. In order to change course MERCOSUR member states need to phase three set of strategic issues, namely: 1) the existence of divergent national perceptions and policy preferences; 2) the supply of adequate leadership; and 3) the identification and implementation of a co-operative agenda.

Three reasons may help in this endeavour. The first one is the significant increase in interdependence that has taken place in the last decade. The economies of the region (and particularly Argentina and Brazil) are currently linked not only by trade flows but also by “contagion” effects that create common dilemmas and interests. Moreover, the fact that MERCOSUR was for long associated with a successful experience of South-South regional integration means that a significant amount of common political capital has been accumulated. National governments may be reasonably adamant to dilapidate it.

The second reason is that national administrations have perceived that macroeconomic convergence is a strong requirement for successful economic integration. During the year 2000 member states have emphasised the promotion of macroeconomic co-operation, starting with indicative targets for a number of variables (inflation rate, fiscal deficit/GDP ratio and public sector debt/GDP ratio). Although this exercise has no element of compulsion, it may turn out to be a first step towards increasing the exchange of information and the amount of interaction between national economic agencies and central banks. The admission that member countries are likely to maintain divergent exchange rate regimes in the foreseeable future have shifted emphasis towards other areas of macroeconomic policy.

Finally, FTAA negotiations will enter a key stage as the year 2005 deadline approaches. This suggests that the “defensive” incentives to co-operate may increase, particularly if US negotiators gain credibility through the granting of fast-track authority. In the past, Brazil’s readiness to make concessions to its partners has been partly proportional to the credible threat of the FTAA as a centrifugal force. As the hemispheric process enters the stage of substantive negotiations, the viability of MERCOSUR will be put at trial. The ability to identify common interests and to successfully arbitrate divergent agendas will be its acid test.

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