Title
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Publication Date
2004

Center for Latin American Studies
University of California, Berkeley

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January 2004
Paper No. 5

WORKING PAPER

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* The views expressed in this paper are solely those of the authors and do not necessarily reflect the views of the Inter-American Development Bank.

The authors are grateful to the participants of the seminar "Mercosul/Mercosur: The Market and Beyond" at the University of Texas for their comments and suggestions on a previous version of this paper.

CONTENTS

1. INTRODUCTION

In March 2003, the Southern Common Market (MERCOSUR) celebrated the twelfth anniversary of the signing of the Treaty of Asunción, which laid the foundations for economic integration between Argentina, Brazil, Paraguay and Uruguay.[1] During the past twelve years, the trading bloc has been tremendously successful in reducing tariff and non-tariff barriers and increasing intra-bloc trade, which jumped from 9 percent of total exports in 1990 to close to 21 percent of the group's total exports ten years later. Additionally, the group as a whole has reduced tariffs and non-tariff barriers to trade with countries outside MERCOSUR and has moved in the direction of a customs union thanks to the negotiation and implementation of a large percentage of common external tariffs.

Despite these advances, the integration process has experienced setbacks as the result of economic phenomena such as the Asian financial crisis, Brazil's currency devaluation and the prolonged economic crisis in Argentina. Setbacks to the integration process create credibility issues and could jeopardize the future of the process. In this paper we discuss some of these issues. The rest of the paper is organized as follows. Section 2 gives a brief description of MERCOSUR country members, while Section 3 discusses the current level of economic integration of MERCOSUR, focusing on how development strategy has shifted from import substitution to more open economies in the 1980s influenced the speed of the process and has resulted in mixed levels of economic integration. In Section 4 we discuss the main successes achieved during MERCOSUR's first decade, while Section 5 identifies the

[1] Chile and Bolivia are associated members of Mercosur. They belong to the free trade area, but they are neither members of the customs union nor of the common market.

failures. Section 6 deals with the unfinished businesses of MERCOSUR, focusing on the opportunities and challenges facing the bloc in the near future. In Section 7 some tentative conclusions are drawn.

2. MERCOSUR: PARTNERS OF ALL SIZES

The four full members and two associate members of MERCOSUR represent 67 percent of Latin America and the Caribbean region's land area, 46 percent of its population, and around 46 percent of its gross domestic product.[2] Although these are impressive numbers, they hide substantial differences among MERCOSUR members. For example, although the bloc represents two thirds of Latin America's total area, Brazil alone accounts for over 40 percent of the entire region, while Uruguay represents less than one percent. Similarly, Brazil contributed over 26 percent of the region's GDP in 2001, compared with less than one half of one percent by Paraguay. In other words, there are various and significant differences between member countries, as shown in Table 1.

[2] In 1997, the Mercosur countries represented 64 percent of the region's GDP measured in U.S. dollars. The economic slowdown and large devaluations of their currencies in the last years have reduced substantially their economic product measured in dollars.

Table 1: Land, Population, GDP by country

	Land		Population: 2000		GDP: 2001*	
	in million of km²	percent of Latin America and Caribbean	in millions	Percent of Latin America and Caribbean	in US$ billions	percent of Latin America and Caribbean
Argentina	2.8	13.7%	37.5	7.2%	268.8	14.1%
Brazil	8.5	41.5%	172.6	33.0%	502.5	26.4%
Paraguay	0.407	2.0%	5.6	1.1%	6.9	0.4%
Uruguay	0.176	0.9%	3.4	0.6%	18.4	1.0%
Bolivia	1.1	5.4%	8.5	1.6%	8	0.4%
Chile	0.757	3.7%	15.4	2.9%	63.5	3.3%
MERCOSUR	13.74	67.0%	243	46.4%	868.1	45.7%
Rest of Latin America and Caribbean	6.76	33.0%	280.7	53.6%	1031.9	54.3%
Latin America and Caribbean	20.5	100.0%	523.7	100.0%	1900	100.0%

Source: World Bank country's statistics

*The large devaluations of the Brazilian and Argentinean currencies vis-à-vis the US dollar had a very large impact on the size of MERCOSUS GDP measured in dollars. For example, the MERCOSUR share of the region's GDP was 64 percent in 1997 declining to less than 46 percent in 2001.

3. MERCOSUR: FREE TRADE AREA? CUSTOMS UNION? OR COMMON MARKET?

The economic integration process of MERCOSUR combined elements of different stages of trade liberalization in a short period of time. In twelve years the bloc went from a substantially restricted trade structure to nearly becoming a true free trade area, with additional efforts in establishing a customs union and progressing toward a common market. This aggressive process of economic integration was part of an economic development strategy based on three major pillars: a less interventionist state, a more open economy and democratic systems of government.

It is important to note that Latin America in general, and MERCOSUR members in particular, embarked on economic integration into the world economy (as well as more effective intraregional integration) only recently, specifically in the last two decades. Before this change in development approach, most Latin America countries adopted a more closed-economy development strategy, known as “industrialization via import substitution.” In the same way, MERCOSUR is the result of this larger change in development strategy embraced by the region as a whole. As discussed below, the economic crisis of the 1980s, after the collapse of the import substitution model, resulted in a shift from a more autarkic approach to growth toward open economies, starting with those closer geographically and economically. Additionally, the redemocratization process in the region changed the geopolitical goals of many countries in the region, reducing conflicts, and creating a more suitable environment for regional trade arrangements.

3.1. The Import-Substitution Model

Under the import substitution model, the state played a key role as the main investor in the economy and as the conductor of the whole development process. As such, sectors and products thought to be strategically important for the country’s economic development enjoyed generous subsidies and strong protection against foreign competition. This growth strategy resulted in inefficient and noncompetitive economies insulated from world markets. Prices of protected sectors and products reflected neither international market prices nor changes in domestic demand. The general population bore the costs of production inefficiencies as firms exercised their market power or through higher inflation. Also, the population bore the costs of subsidies through government spending, although the lack of transparency kept them from being explicitly shown in fiscal budgets.

Despite these problems, between 1950 and 1980, the import substitution strategy yielded economic growth rates for Latin America that were above international averages. Unfortunately, this strategy also resulted in a low level of participation in overall world trade and strong dependence on public (domestic) and foreign (private) investments.

The import substitution model was unsustainable and led ultimately to a widespread economic crisis in the 1980s, with growing budget and trade deficits, accelerating rates of inflation, and recession. Argentina and Brazil, for example, experienced the worst of two worlds, economic recession and high rates of inflation. At the same time the world economy was moving towards higher levels of economic integration, with increasing cross-border flows of capital, trade, and labor (migration).

3.2. Recent Changes in Economic Development Strategy

Latin America underwent a radical change in the last two decades as a response to the crisis triggered by the end of the import substitution strategy and also as a response to the changes in the international economic environment, namely economic globalization. Recent transformations have included substantial changes in the state's role in the economy, aimed at achieving fiscal equilibrium and increasing public-sector efficiency. A major component in reforming the state was a comprehensive program of privatization of state-owned enterprises that had accumulated over previous decades. The privatization program was designed to increase overall efficiency levels of the economy, where the state remains the primary supplier of public goods but exercises a smaller role in productive activities. Economic policy in Latin America adopted the main ideas of the so-called "Washington Consensus," seeking a market-oriented economy with less state intervention and pursuing fiscal austerity and realistic monetary and exchange rate policies consistent with a more competitive economy. The private sector became a major agent to capture private savings and invest them in the productive sector.

A second major component of the recent economic transformations in Latin America was the liberalization of trade and capital accounts. On one hand, the region sought to open new markets for its products and, on the other hand, it also experienced keener competition from foreign producers in local markets.

The taxonomy of economic integration suggests a hierarchy of liberalization of markets and coordination of policies, which would take countries from a position of an autarky to a monetary union. In general terms, this taxonomy could be summarized as follows:

Figure 1: A Taxonomy of Economic Integration by Selected Features

	Autarky	Some Trade	Free Trade Area	Customs Union	Common Market	Common Market with a Monetary Union
Economic isolation, no trade at all, consumption restricted to domestic production.	X					
Trade takes place, but with the presence of tariff and non-tariff barriers.		X				
Zero tariff structure for goods and services between members with reduced or eliminated non-tariff barriers to trade.			X	X	X	X
Common external tariff structure.				X	X	X
Free mobility of labor and capital across member countries.					X	X
Only one currency. Countries share a central bank, no individual monetary policy.						X

Although countries are not expected to follow the taxonomy described above in the exact order indicated, it is likely that economic integration might follow some sort of a “natural” path from lower to higher levels of integration. It is difficult to argue for a customs union when members have not yet created a true free trade area. The European Union is a good example of a long and gradual process of economic integration, although the group faced and continues to face many barriers to full implementation.

As latecomers to the game, MERCOSUR members speeded up their economic integration process in an attempt to catch up with the rest of the world. Accordingly, the bloc currently has characteristics of a free trade area, a customs union, and some advances toward a common market, but none of these stages are completely consolidated.[3] Some of these characteristics are as follows:

Free Trade Area:

- Most tariffs on goods were eliminated by 1995, although exceptions for some sensitive goods are still present.

Customs Union:

- A common external tariff structure was introduced in 1995. Capital goods and many electronic goods were not included in the common external tariff schedule, although tariffs are expected to converge by 2006 for some goods and some countries.
- Uniform anti-dumping regulations have been developed and are being evaluated.

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[3] On April 2001, Domingos Cavallo, the Argentinean Finance Minister at that time, increased tariffs on imported consumer goods to an average of 35 percent and unilaterally decreased tariffs on imported capital goods to zero, departing from the bloc's common external tariffs. These actions were ratified by the Common Market Council of MERCOSUR, authorizing the changes, on a temporary basis, until December 31, 2002. In December 2002, the same Council authorized Argentina to apply different tariff levels to imports of specific capital goods from countries outside MERCOSUR.

Common Market:

- Labor mobility is quite restricted.
- In 1997 the Protocol of Montevideo was approved which included a plan to phase out restrictions on trade in services over a 10 year period and to decrease restrictions on financial services, air transportation, satellite communications, insurance and professional services at a more rapid pace (all under negotiation).
- The 1998 Memorandum of Understanding called for mutual recognition of university diplomas. Full implementation would allow university graduates to work in any MERCOSUR country including Bolivia and Chile. A common standard to evaluate the quality of universities will be needed to implement this plan.
- In 1999 Brazil and Argentina established groups to study coordination of macroeconomic policies in order to harmonize statistical data and methodology of economic indicators.
- A "Small Maastricht Treaty" has been proposed in order to establish fiscal balance among members. Fiscal responsibility laws were passed in Brazil and Argentina.
- In 2002, the core and associate members signed agreements on immigration and residence status, a big step towards labor mobility in the region. The agreements allow citizens of member countries to apply for temporary residence status for a period of up to two years and subsequently to seek

permanent residence in any other member country. A person with resident status can freely enter, exit, circulate and remain in the receiving country with the right to work and conduct all types of licit activities under the law.

- In 2002, the Council postponed the achievement of the inflation target to 2006.

4. SUCCESSES

The process of trade liberalization among MERCOSUR members has been successful on many fronts, from increased trade flows and cross-country investments to consolidation of democratic regimes. Some of these achievements are highlighted in this section.

4.1. Increased Intraregional Trade and Investment Flows

Economic integration brought an impressive surge in intra-bloc trade flows, a nearly fivefold increase between 1990 and 2001. As shown in Table 2, intra-group exports jumped from less than 9 percent of the bloc's total exports in 1990 to 25 percent in 1998. Subsequently, due first to the contagion effect of the Asian crisis in 1998 and later to the global and regional economic slowdown and more recently the deepening of the economic downturn in Argentina, the intra-bloc share of total exports declined to 17.3 percent in 2001. This jump in the share of total exports was the result of a much higher growth rate in intra-bloc exports compared with exports outside the bloc up to 1998. From 1990 to 1998, total exports increased by 75 percent, representing growth of 44 percent for exports to countries outside MERCOSUR and an astonishing rate of almost 400 percent growth for intra-bloc exports.

Table 2: Exports within and outside MERCOSUR — 1990-2000 US$ millions

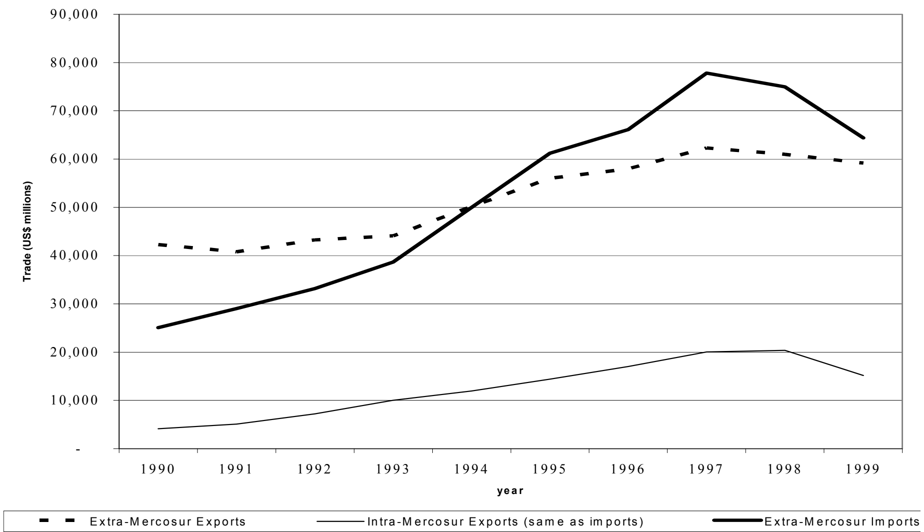
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total	46,402	45,891	50,463	54,122	62,113	70,402	74,998	82,342	81,323	74,320	84,659	87,927
% Growth	-0.3	-1.1	10.0	7.3	14.8	13.3	6.5	9.8	-1.2	-8.6	13.9	3.9
Outside MERCOSUR	42,275	40,788	43,246	44,095	50,157	56,019	57,960	62,289	60,972	59,158	66918	72796
% Growth	-1.0	-3.5	6.0	2.0	13.7	11.7	3.5	7.5	-2.1	-3.0	13.1	8.7
Within MERCOSUR	4,127	5,103	7,216	10,026	11,957	14,384	17,038	20,053	20,351	15,163	17741	15171
% Growth	7.6	23.6	41.4	38.9	19.3	20.3	18.5	17.7	1.5	-25.5	17.0	-14.5
Intra/Total	8.9	11.1	14.3	18.5	19.3	20.4	22.7	24.4	25.0	20.4	21.0	17.2

Source: IDB database and CEPAL.

A very important point to make here is that, although intra-bloc trade flows increased substantially since MERCOSUR came into existence, the evidence suggests that the preferential regional agreement did not result in large trade diversion as one might have expected. As shown in Chart 1, total imports by MERCOSUR members increased proportionally more than total exports, and, more importantly, imports from countries outside the bloc grew strongly as well. The process of regional trade liberalization took place in a context of overall trade liberalization (open regionalism), which reduced the likelihood of trade diversion.

The unilateral trade liberalization registered in the past decades was part of the overall opening of the region's economies and the new economic development strategy. For example, as Devlin and Ffrench-Davis (1998) observe "the average tariff for Latin America and the Caribbean has declined from 45 percent in the second half of the 1980s to 13 percent in 1995, accompanied by a sharp reduction of tariff dispersion as well. Furthermore, over the same period the share of the region's imports subject to non-tariff barriers declined from 31

Chart 1: Extra and Intra MERCOSUR Trade Flows



percent to 11 percent."

Additionally, there was an increase in intraregional investment flows. Bonelli (2001) argues that "one of the most important consequences of MERCOSUR integration was the increase in the levels of foreign direct investment (FDI) in the region, particularly between Argentinean and Brazilian firms." He adds that recent studies (before the change in the Brazilian exchange rate regime) show that "the FDI flows between the two countries increased by the end of the decade compared to the rest of the 1990s," and that "the increases in FDI are substantially higher than the increase in trade flows between the two countries."

4.2. A Common External Tariff Structure

Since 1995, MERCOSUR members have established a quasi-customs union with a common external tariff (CET) covering around 85 percent of imports. The CET includes twelve tariff levels, ranging from 0 to 23 percent, and represents a real decrease in overall tariffs with the rest of the world. It was also established that, for most exceptions, the countries would continue to use their own tariffs but would converge to a common external tariff by 2001; for a few other exceptions, convergence would come later. For example the CET for capital goods would be 14 percent starting in 2001, and for computer-related goods it would be 16 percent starting in 2006.

As discussed before, the crisis in Argentina led to changes in the external tariffs. Among other measures, Argentina increased tariffs on imports of consumer goods and eliminated tariffs on imports of capital and intermediate goods. These measures, although temporary, represent a departure from the agreed CET. With these recent changes, it has been estimated that the CET covers now only around 50 percent of imports.

4.3. Harmonization of Macroeconomic Policy

The process of harmonizing macroeconomic policy is a necessary, although insufficient, condition to establish a common market and to consolidate the integration process. In addition to the steps towards harmonizing economic statistics, the December 2000 meeting of ministers of finance and presidents of central banks of the full and associate member countries of MERCOSUR established concrete common macroeconomic targets for the near future. For instance, they agreed on a maximum inflation target of 5 percent for the period 2002-05 and, starting in 2002, a budget deficit of no more than 3 percent of GDP and a suggested ratio of public debt to GDP of no more than 40 percent. The inflation target goal was postponed to 2006 during the Brasilia meeting in December 2002. As mention earlier, both Brazil and Argentina have passed fiscal responsibility legislation in an attempt to restrain fiscal deficits.

4.4. Consolidation of the Democratic Process

The consolidation of democracy among MERCOSUR's members is one of the most important achievements of the economic integration process. In the 1998 Ushuaia Protocol, member countries agreed that democracy was an essential condition of the integration process among them, and they established procedures to follow in case of a rupture of the democratic order in any member country. At the same meeting, they declared MERCOSUR, Bolivia and Chile as a "peace zone," free of arms of mass destruction.

The commitment to a democratic regime was confirmed with the declaration of June 1999, when the presidents of the member countries repudiated violence as a resource of political action as occurred in Paraguay in March 1999. They also confirmed their support for the democratic system in Paraguay and for the process of normalizing and strengthening that country's institutions.

4.5. Negotiating Bloc

Another important gain has been the increased bargaining power the MERCOSUR countries acquired as a bloc to negotiate trade agreements with other countries. Good examples of such gains are the recent "Four plus One" talks with the United States, the ongoing talks with the European Union (EU), and the discussions on the Free Trade Area of the Americas (FTAA). In other words, MERCOSUR has a political dimension than transcends the commercial dimension. Currently, MERCOSUR is a very important tool for Argentina, Brazil, Paraguay and Uruguay to negotiate their insertion, as well as to create a path for the insertion of Latin

America, within the realm of the FTAA and the EU. In a MERCOSUR summit, the presidents of member countries decided to negotiate with the EU and the FTAA as a single bloc. In December 2002, the member countries reaffirmed their commitment to deepen and strengthen the mechanisms of coordination in the external negotiations. They also signed, as a bloc, an agreement of economic complementation with the Andean Community. This shows that, despite the transitory difficulties, which can harm the trade relations within the bloc, the political relations are deeper and more stable.

5. FAILURES

The failures of the integration process are, to a certain degree, related to the general background within which the scheme took place. For example, MERCOSUR came into existence within a broader liberalization project, when the economies of member countries were being opened unilaterally to the rest of the world. Against this backdrop the four member countries engaged in a deep, fast and ambitious integration process among themselves. This process evolved rapidly and steps to higher levels of integration were taken without strong consolidation of previously negotiated lower levels of integration.

Another important fact to note is that the integration process was launched and developed while these countries were conducting macroeconomic stabilization plans. However, the timing of these plans was not synchronized and, as such, created additional difficulties for the liberalization process. At the same time, changes in international financial markets and the exposure of the region's economy to those markets increased the vulnerability of MERCOSUR economies to external shocks. Moreover, this period was characterized by current account deficits resulting in a dependence on foreign financing of the balance of payments. These increasing difficulties have resulted in setbacks in the liberalization process due to internal or external economic problems, harming the credibility of the integration scheme. Country members have unilaterally changed tariff levels and non-tariff barriers too many times, creating a poor environment to consolidate gains and move toward higher levels of integration.

The lack of a more formal mechanism for settling disputes and dealing with trade flow imbalances contributes to these occasional setbacks as decisions continue to depend on "diplomatic/political" actions, and costs of setbacks are not known *ex ante*. The question of how to avoid these occasional setbacks is discussed below.

6. UNFINISHED BUSINESS: OPPORTUNITIES AND CHALLENGES FOR THE FUTURE

There are many factors that increase the probability of member countries reaching a situation where setbacks to an economic integration process are likely to occur. For example, countries with more open economies are less likely to give in to short-term pressures, since the cost of setbacks is higher due both to large distortions on the import side and, if retaliation occurs, to larger losses on the export side. Another factor is the level of synchronization of the member countries' economies. If their economies are in sync, major economic and/or financial crises are likely to require similar policy responses that could be negotiated among member countries without the need for unilateral changes in tariff and non-tariff instruments. However, in the absence of strong harmonization of macroeconomic policies, it is very difficult to coordinate policy responses to external shocks.

There are many occasions—such as the recent Asian crisis, the Brazilian devaluation and the Argentinean economic downturn—when countries, which are part of a small preferential trade agreement, feel tempted to restrict trade temporarily, creating an environment where trade sanctions flourish and further economic integration is strongly jeopardized. The main reason for such behavior is that there is some type of a trade-off between short-term and long-term policy options. In the short run, governments have a tendency to raise tariff and non-tariff barriers to trade when faced with a balance-of-payments problem. For example, in 1997, Brazil and Argentina increased common external tariffs by 3 percent, while Paraguay and Uruguay applied them more selectively. Brazil increased import duties on several products in 1998 and also raised non-tariff barriers such as licenses. In 2001, Argentina unilaterally increased tariffs on imports of consumer goods and, at the same time, abolished tariffs on imports of capital and intermediate goods.

Temporary setbacks in the process of economic integration create tension between members and can damage the long-term credibility of the integration scheme, and, if they persist, can threaten its very survival. Thus, the loss of credibility may be the worst problem member countries can encounter in their economic integration process. Iglesias (2000) suggests that "launching an integration initiative is easier than sustaining it." Talking about integration initiatives prior to the 1990s, he recalls that "while not without their achievements, none of the early initiatives fully realized their ambitious objectives," and adds that "indeed, all these early post-war agreements lost momentum during the late 1970s and fell into open crisis in the 1980s."

As discussed above, when governments face external (or internal) economic problems resulting in relatively large trade deficits, they generally also face pressures to raise tariff and non-tariff barriers to reduce imports and/or increase exports. They must decide whether the short-run political gains of raising tariff and non-tariffs barriers are larger than long-run economic losses.[4]

Under the circumstances and frequent pressures discussed above, the question is how to preserve credibility during a crisis and how to reduce the likelihood of setbacks, which hurt the credibility of the integration process. Among others, there are four important actions which could help to achieve these goals.

6.1. Escape Clauses: Flexibility Within the Agreement

Most free trade areas have detailed escape clauses that allow member countries to deal with surges in imports or other temporary economic problems without violating the agreement. Although MERCOSUR has a common escape-clause structure to deal with extra-bloc trade, there are no such clauses to address intra-bloc trade imbalances.

Some scholars argue that the flexibility of the MERCOSUR agreement, the lack of a large bureaucracy, formal safeguards and escape clauses helped the free trade zone to flourish in its first years of existence.[5] There is merit in this argument as the success of MERCOSUR during its first eight years suggests that, at least in that case, the lack of a more formal and rigid structure seemed to serve the integration process well. However, this flexible approach also has a cost for the integration process. Some issues related to it are

[4] The real gains and losses in terms of welfare impacts (measured for example by equivalent variation) are less important for a government's decision than the perceptions of gains and losses. Governments, in general, act upon their perceptions of short-term political gains, which are focused more on the political cycle than on long-term economic impacts. To be sure, Baldwin (1989) discusses at length the questions of the political economy of trade and gives many examples of second and third-best policies that introduce distortions but are frequently used by governments.

worth mentioning.

First, a flexible approach with a lack of more formal structures to settle disputes and especially escape clauses to deal with temporary imbalances in trade flows seems to work better in the first years of trade liberalization, when the core of integration is focused on tariff reductions. At higher levels of integration, when more complex negotiations take place and more is at stake, a more formal structure with clear rules seems to be more efficient to avoid conflicts and to maintain the credibility of the integration process.[6] Furthermore, flexible approaches have not passed the tests of crisis and prolonged recessions. For example, as long as the MERCOSUR economies were experiencing economic growth and the exchange rate regimes of Brazil and Argentina were following similar patterns, the flexible approach worked well. However, problems intensified when the Asian financial crisis and its contagion effect resulted in recessions and Brazil devaluated the real. In the absence of a formal structure to deal with imbalances in trade flows, unilateral moves have created tensions and called into question the credibility of the integration process and, consequently, the future of the customs union and the common market.

The recognition of the need for a stronger institutional structure of MERCOSUR resulted in some steps in that direction during the Presidential Summit of December 2002. The presidents supported the transformation of the Administrative Secretariat into a Technical Secretariat. Additionally, the presidents agreed on the need to incorporate MERCOSUR standards into the legislation of the member countries.

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[5] See, for example, Baumann (2001).

6.2. Setbacks: Increasing Economic Costs and Decreasing Political Gains

It has been noted before that frequent setbacks in the liberalization scheme bring a loss of credibility to the entire integration process. It has also been argued that governments have an incentive to used tariff and non-tariff mechanisms when faced with trade flow imbalances if the political gains in the short-run are perceived to be higher than the costs associated with those actions. Thus, a natural way to avoid potential setbacks is to reduce the potential gains and/or increase the costs of such measures. As for perceived political gains, unless there is a major change in the economic perception of the population and people become free-traders, not much can be done in that area. On the other hand, there are many routes to increase the associated costs and, thus, reduce the likelihood of frequent setbacks and their negative impacts on the credibility of the integration process.

6.3. Harmonization of Macroeconomic Policy

The harmonization of macroeconomic policy is a necessary step in the direction of a common market. However, even before the consolidation of further economic integration, the process of harmonizing macroeconomic policies could bring economic gains and, most important, add credibility to the integration scheme. As member countries implement parameters of macroeconomic performance—such as inflation targets and ceilings for budget deficits, among others—they reduce the need for strong changes in trade policies among themselves. Given the convergence of their economies, even in the case of an external shock, their policy responses are likely to be similar, avoiding extreme, conflicting responses, which would have

[6] The most successful integration processes such as European Union and, up to certain degree, NAFTA have more formal structures and mechanisms to deal with trade disequilibrium problems.

the potential of hurting the credibility of the integration process.

Exchange rate policies by MERCOSUR member countries, especially Brazil and Argentina, have been a constant source of trade imbalances and political tensions between members. It is likely that, given their vulnerability to external shock, the absence of a common currency will remain a major source of setbacks to the economic integration in the area and put the harmonization of economic policy among the member countries in constant jeopardy.

6.4. Increasing the Depth of Micro Integration

Cross-country investments are, at some level, a consequence of the economic integration process. As more companies from one country engage in acquisitions, joint ventures, and take-overs of companies in another member country, these countries' economies will become more integrated at the micro level. The increased integration of businesses among member countries solidifies the linkages between them and increases the costs of setbacks.

Although there has been an increase in cross-country investment, it does not seem to be high enough to exercise a strong deterrence effect on trade policy setbacks. However, as it becomes more prominent, this new business ownership structure can play an important role, not only by increasing the cost of setbacks in the short-run, but also by providing support for deeper levels of integration in the long-run integration scheme.

6.5. Going Beyond a Free Trade Area

The argument here is quite simple. The cost associated with setbacks at a lower level of integration (restricted trade, free trade area) is lower than the cost of setbacks at a higher level of integration, such as a customs union, common market or monetary union. The higher costs would come from stronger chances of retaliation and more and deeper disturbances at higher levels of integration. Consider this extreme example: a unilateral policy decision to raise tariffs within a common market structure could trigger a series of retaliatory actions that could result in restricting labor mobility, for instance, or even forcing workers to return to their home countries. Again, this is an extreme example, but it shows that very high potential costs could act as a deterrent to the initial policy response to an economic problem. Even if a particular government feels it unlikely that other members countries would react strongly, the high potential cost could result in an avoidance of such policy and the investigation of alternative, negotiated solutions.

6.6. Increasing the Size of the Group: Is the FTAA a Solution?

The costs associated with adopting trade-restricting policies for a member of a trade preferential area are relatively proportional to the economic size of the area. For example, a member country of the World Trade Organization would face a much higher cost in raising protection barriers unilaterally and outside the organization's parameters. The probability of retaliation or exclusion from such a large club has a deterrence effect.[7] Similarly, one did not observe setbacks in NAFTA as Mexico slid into crisis in the 1990s.

There is no doubt that, if the Free Trade Area of the Americas (FTAA) is successfully negotiated and implemented, it will work as a deterrent to setbacks in the trade liberalization

[7] This does not mean that WTO member countries do not raise tariff and non-tariff barriers from time to time. There are many examples of that, and the WTO has mechanisms to deal with such actions. Additionally, any member country can bring a case against another member country as it sees fit. The argument here is that countries do not, unilaterally and frequently, raise and reduce barriers to trade that go against WTO rules as they would do if they were part of a small trade area.

process. Similar results should be expected of a free trade agreement negotiated with the European Union. But, in those cases, what would happen to MERCOSUR? Would it disappear as a separate entity? It certainly would if the bloc does not consolidate to a level of economic integration above the free trade area. As a free trade area, MERCOSUR will make no sense within a larger free trade area. However, if the bloc establishes a full customs union and advances into a common market, it would not be incompatible with a larger free trade area. To be sure, the core MERCOSUR nations—Argentina, Brazil, Paraguay and Uruguay—have moved beyond a free trade area. They have partially adopted a common external tariff and other features beyond a simple free trade area, but they are still within a larger free trade area (core MERCOSUR plus associated members Bolivia and Chile).

The FTAA or a MERCOSUR–EU free trade area are likely to improve the credibility of the integration process in the southern hemisphere if MERCOSUR can go beyond free trade area status before the implementation of these larger agreements. As a matter of fact, if MERCOSUR remains cohesive and negotiates those agreements as a bloc, the negotiation process *per se* would improve the bloc's credibility as an important integrated economic area.

7. CONCLUSIONS

Twelve years after it started, MERCOSUR has accumulated more successes than failures. However, frequent setbacks resulting from domestic and external shocks have hurt the credibility of the integration process. Decreasing credibility can jeopardize the consolidation of the gains achieved in the past and seriously block higher levels of economic integration among MERCOSUR members.

In general, setbacks to integration processes are the result of a cost benefit analysis by governments facing balance of payment problems. On the benefit side, in the absence of a complete change in the economic culture with voters becoming free-traders, it is difficult to avoid setbacks as it is difficult to decrease perceived political gains of raising tariff and non-tariff barriers to trade. On the cost side, however, there are different alternatives that, if implemented, can increase the relative costs of setbacks and, thus, contribute to building credibility and improving the chances for consolidating and expanding an economic integration process. Among other options, negotiating and implementing escape clauses to deal with temporary trade imbalances; harmonizing macroeconomic policy to converge policy responses to crisis; achieving higher levels of economic integration; increasing the depth of microeconomic integration; and expanding the size of the trading bloc are some initiatives that could improve the chances of success of an integration process. These types of initiative may help to consolidate MERCOSUR, especially since the current strong economic uncertainties will certainly test the political commitment of MERCOSUR members to their integration efforts. If members believe in the long-term benefits of MERCOSUR, an orchestrated effort to increase the credibility of the agreement must be a priority if it is to survive.

There are other issues not discussed here that member countries are likely to face in the near future. Within the realm of game theory, for example, member countries may face the choice between the geopolitical and economic gains of negotiating as a bloc and opting for bilateral negotiations with another country or group of countries. Since trade negotiations are not necessarily a cooperative game and given the uncertainties of payoffs, a country could perceive higher gains in a bilateral agreement with a third country or group of countries than what it expects to achieve by following the path of bloc negotiations. How each member country reacts to these potential options will impact the levels of credibility and, as a result, the future of MERCOSUR.

There are many challenges in the future, but there are opportunities as well. The end result will be highly dependent on building credibility and maintaining the political will to sustain it. Given the global environment and constant and increasing pressures to respond to external and internal shocks associated with the historical trend to raise barriers to trade, the task ahead is not an easy one, but MERCOSUR has shown substantial strength in surviving the setbacks so far. There is no doubt that the path walked by MERCOSUR in the future will strongly influence the trade environment in the region as a whole, and this will remain an interesting process to observe.

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