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**MERCOSUR – Another Failed Move  
Towards Regional Integration?**

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## 1. Introduction

On March 26<sup>th</sup>, 1991 the presidents of Argentina, Brazil, Paraguay and Uruguay signed the Treaty of Asunción (TOA) proclaiming the formation of the "Mercado Común del Sur" or "Mercado Común do Sul" (Mercosur). In 1994, the TOA was supplemented by the "Protocolo de Ouro Preto". The implementation period started with a schedule of progressive trade liberalization between 1991 and 1994 followed by the foundation of a Customs Union (CU). Presently, the completion of the Customs Union and the formation of a truly common market with free trade and free flows of factors of production (excluding labor migration explicitly) for the entire region and a system of harmonized macroeconomic and sectoral policies is under discussion.

Despite this seemingly progressive evolution of Mercosur there is evidence that the process of economic integration has slowed down in recent years.<sup>1</sup> The explanations of this development are ambiguous. Some Latin American analysts claim that international turmoil has caused this change of speed. They point to the Russian moratorium of August 1998 to date the end of an "entirely successful stage of an original project to create and consolidate a commercial block made up of economies that are not fully developed" (INTAL, 1999, p. 1)<sup>2</sup> and presume "a new phase in relations" between the member states of Mercosur. This new phase might bring even more turbulences but will most certainly end with the successful completion of the common market.

Others argue, instead, that the international turbulences are not the main cause of the difficult situation presently to be observed in Mercosur.<sup>3</sup> Rather, they suggest more deep rooted deficiencies of the concept of "open regionalism"<sup>4</sup> to be the main reason for stagnation. The future of the common market from this point of view is less promising.

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<sup>1</sup> See Inter American Development Bank (IADB), 1999 and INTAL, 1999.

<sup>2</sup> They admit that the Asian crisis and the Brazilian crash (both interrelated with the Russian moratorium) have had an important impact, too. Nevertheless, all three events are seen as exogenous factors.

<sup>3</sup> Panagariya for instance links the standstill of unilateral trade liberalization in Latin America to "the forces of regionalism". See Panagariya, 2000, p. 317.

<sup>4</sup> For a detailed discussion of this concept see for example Bergsten, 1997; Reynolds, 1997; Ethier, 1998.

In this paper, the present challenges of consolidation and deeper integration of Mercosur will be discussed, in order to shed some light on the nature of the problems, that might be responsible for the present slow down of the speed of integration.

In the second chapter I shall outline the concept of Mercosur. In the third chapter the formation of Mercosur since 1991 will be discussed and in the fourth chapter I shall evaluate the future prospects of Mercosur. Some concluding remarks follow.

## **2. The Concept of Mercosur**

Mercosur has repeatedly been characterized as a fundamentally new approach to regional integration in Latin America. While former (failed) experiences were based on the concept of import substitution and tried to apply the interventionist and inward looking national model to the regional level, the new approach emphasizes the concept of "open regionalism" (see Devlin/French-Davis, 1998; Peña, 1998).

"Open regionalism" means that the regionally integrating countries refuse to establish industrial policies aimed at the development of complementary industrial structures within the region and to protect these structures against outside competition. Instead, it is recognized that integration into the world market is imperative for the long run welfare even for a large integration area, and, therefore, specialization according to competitive advantage is seen to be essential both externally and internally. The large regional market, according to the concept of "open regionalism", may help to improve productivity and competitiveness by providing the preconditions for a better exploitation of economies of scale, a higher degree of diversification and an increasing scope of innovation and specialization. The bigger market is expected to intensify competition and it may help to improve the conditions for institutional reforms. Inherent to the concept of "open regionalism" is the belief, that all these positive effects of the large market can be realized only if market forces are allowed to work sufficiently well both internally and externally.

In short, the Mercosur concept of "open regionalism" aims at a non-discriminatory set of economic incentives (including zero barriers to trade) *within* the region, and a relatively low margin of preference against outsiders. In this interpretation of "open re-

gionalism" Mercosur indeed differs fundamentally from all former regional trade agreements in Latin America including the 1986 "Program of Integration and Economic Cooperation" between Argentina and Brazil (PICAB).<sup>5 6</sup>

The 1991 TOA proclaimed a three stages approach for the formation of Mercosur. During the first stage (1991 - 1994) the free trade area was to be created. This was followed by the formation of a Customs Union in 1995 which will eventually be transformed into a common market during the next years.

The political instruments introduced by the TOA in order to implement the integration schemes are the following:<sup>7</sup>

1. internal liberalization of trade on the basis of a pre-announced, automatic, linear and progressive reduction of tariffs,
2. the introduction of a common external tariff, starting with the Customs Union in 1995,
3. the coordination of macroeconomic and sectoral policies,
4. a set of 24 special provisions (protócolos) which also include some highly sensitive sectoral agreements (automobiles, capital goods).

There also exists a provisional institutional structure of Mercosur which basically consists of six "órganos". The highest political decision making body (ministerial level) is the "Consejo del Mercado Común" (CMC). Its decision making process is inter-governmental rather than supra-national.<sup>8</sup> Subsequent efforts to establish a

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<sup>5</sup> The PICAB still followed an essentially interventionist and sectoral approach that intended to integrate the two economies gradually and on a complementary basis. As such, it followed the tradition of the old Latin American regional concepts. See Schirm, 1999, p. 125 and Hirst, 1989.

<sup>6</sup> It has to be recognized, however, that the PICAB had quite positive political effects on Argentine-Brazilian relations. Historically, both countries had cultivated a relation of distrust and (even military) confrontation, and were heavily engaged in a nuclear and arms race at that time. Starting with the PICAB in 1986 this unpleasant situation began to be removed as common infrastructural projects were launched and economic and political cooperation in the fields of nuclear energy and aeronautics were included in the treaty. The "political capital" that has been built up during this time has undoubtedly helped to proceed to the foundation of Mercosur.

<sup>7</sup> The political, economic and legal provisions of Mercosur will not be repeated here in any detail. See O'Keefe, 1997; Schirm, 1999; Gamelo, 1998.

<sup>8</sup> The remaining organs are "El Grupo Mercado Común", the "Comisión de Comercio", the "Comisión Parlamentaria Conjunta", the "Foro Consultativo Económico y Social" and the "Secretaría Administrativa del Mercosur". For a detailed discussion see Gamelo, 1998; Consejo Argentino para las Relaciones Internacionales (CARI), 1997.

more profound institutional setting for Mercosur have not been crowned by success until today.

After nearly 10 years of region building among the four member countries two out of the three stages on the way to a truly common market have been implemented. These are the formation of a free trade area between 1991 and 1994 and the introduction of the Customs Union in 1995. What remains to be done is to consolidate the Free Trade Agreement and the Customs Union, which both are still incomplete, and to form a common market (which means to implement a concept of deeper integration).

For analytical purposes a somewhat different classification might be appropriate: I shall differentiate between the period of progressive implementation of the provisions of the TOA (1991 - 1995) and the period of consolidation which began in 1995/96. While the consolidation (completion) of the Customs Union is still under way, there are also efforts to proceed towards the third stage, e. g. the creation of the Common Market. In the following I shall concentrate on phases one and two, because the present period of consolidation is critical and may decide the future of the whole project.

### **3. The formation of Mercosur**

#### **3.1. The period of progressive region building**

At the time when the TOA had been signed in 1991 most Latin American countries were heavily engaged in switching development strategies from import substitution to export orientation. In the field of trade policy this change meant an abrupt departure from long standing protectionism towards the re-integration into the world market (see Edwards, 1995). During this period of transformation the average level of tariffs in Latin America has been reduced unilaterally from about 45% in the late 80s to about 13% in 1995, and non-tariff barriers have been eliminated on a broad front (Devlin/French-Davis, 1998, 11).<sup>9</sup> At that time Latin American countries also began to engage in the multilateral trading system and actively participated in the Uruguay Round.

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<sup>9</sup> For a detailed analysis of Mercosur tariffs see: Isam, Miguel (1998).

The formation of Mercosur can be interpreted as the third pillar of this concept of trade liberalization and international economic integration of the early 90s. As such the Mercosur agreement explicitly formulated and implemented the above mentioned automatic and progressive sequence of internal and external trade liberalization. When the Customs Union was implemented in 1995, tariffs had been eliminated for about 90% of all tariff lines among member states and 85% of all tariff lines were included in the common external tariff (CET).<sup>10</sup>

Measured against the protectionist history of the Mercosur members, the tariff reductions between 1991 and 1994 are impressive and so have been their effects.<sup>11</sup>

*Table 1* provides an overview of the development of Mercosur trade between 1990 and 1995. Within the context of overall trade expansion at an average rate of 8.7% in exports and 20.4% in imports between 1991 and 1995, intra-Mercosur trade expanded 28.4% in exports and 26.6% in imports. Due to this change in favor of intra-Mercosur trade the percentage of intra-Mercosur exports (imports) relative to total exports (imports) rose from 8.9% (14.1%) in 1991 to 20.3% (18.1%) in 1995. Another important effect of integration is the increasing significance of regional production: more and more national and multinational enterprises are organizing production and sales activities within Mercosur (Peña, 1998, 9).

Apart from the intensive development of trade and investment there are some other important effects of the agreement. *First*, the credibility of the Mercosur concept was astonishingly high from the very beginning of the integration process. Apparently, governments (presidents) successfully convinced the public to trust in the new concept of "open regionalism" proclaimed as part of the new strategy of integration into the world markets. Thus, intra-regional economic activities began to spread rapidly.

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<sup>10</sup> This means that, within a short period of time internal free trade had been realized for the majority of tariff lines and protection declined for most of the rest. Externally, the CET level of about 11% also signifies a relatively low average level of tariff protection. Among the products excluded from the CET were capital goods, computers and information technology, textiles and automobiles. The external tariff protection of these "special" sectors ranged from 20 to 35%. Internally, the main groups of products which still have to be liberalized between the two biggest member countries are sugar and (again) automobiles.

<sup>11</sup> For an interesting evaluation of Mercosur in the broader context of Latin American reform policies beginning in the 80s see Estevadeordal et al. (2000).

*Second*, within the environment of a more reliable economic and political framework the old-fashioned Latin American nationalism began to erode and the door opened to still more international activities among the new partner countries (such as education, infrastructure, energy etc.).

*Third*, with the formation of Mercosur a relatively large economic and political entity has been created in the Southern Cone. The new regional entity may enable the partner countries to act more powerfully in the international arena and at the same time attract more international capital and technology. The increasing interest of the USA and Europe in Latin America in recent years (documented by the new initiatives to create a "Free Trade Area of the Americas" (FTAA) as well as an intercontinental FTA between the European Union and Mercosur) have been taken as a first prove of this thesis (see Peña, 1998, 10). To sum up, at the time when the customs union had been introduced in 1995, Mercosur showed a strong performance in the fields of economic integration, institutional reform and political cooperation.

### **3.2. The period of consolidation**

The realization of the customs union in 1995 with an average external tariff of 11% and covering about 85% of all customs lines signified a successful implementation of the TOA so far - and officials have been optimistic at that time regarding the future of the customs union. Between 1995 and 2006 the remaining exceptions were planned to phase in and the still existing NTBs should be eliminated. Also macroeconomic and (external) trade policies should be harmonized.

However, things have developed less favorable since then both in terms of trade and economic growth and in terms of trade policy. *Table 2* shows the development of trade flows in the second half of the 90s. Exports kept on growing in 1996 and 1997, but shrank in 1998 and slumped in 1999. Imports reveal a similar pattern until 1998. It is obvious that this performance has been strongly determined by exogenous factors, e. g. the Asian crisis and its side effects. The fact that trade flows are estimated to grow again at a two digit level in 2000 seems to support this view.

However, some particular changes in the trade data during this period suggest that more fundamental forces are also at work. *First*, total exports grew faster during the

1995-1997 period (10%) than in the early 90s (1990-1995 = 8.7%) and this was due to a strong increase in extra-Mercosur trade. Thus, despite the still growing importance of intra-Mercosur trade (due to the absolutely higher rates of growth of intra relative to extra Mercosur trade) the average rates of growth of intra-regional exports in 1995-1997 decreased relative to 1990-1995. The respective rates of growth of extra regional trade increased. *Second*, the average rate of growth of imports in 1995-1997 dropped in each of the three categories, but it slowed down most heavily for intra-regional imports (from 26.6% to 20.1%). *Third*, the slump between 1997-1999 in intra-Mercosur exports has been far more severe than that of extra-Mercosur exports.

Clearly, the three year period between 1995-1997 is too short to interpret these data from the point of view of the future course of Mercosur and the exogenous shocks of 1998 - 1999, too, disqualify these years as relevant in a longer term context. Nevertheless, these figures may signal an early warning that the regional economic dynamic itself is losing strength. This view gains support, when it is combined with the changes in trade policies of Mercosur and its member countries which also took place since 1995.

Brazil was the *first* country to counteract the common Mercosur strategy of successive trade liberalization of the early 90s. In 1995 and 1996 it raised import tariffs from outside countries unilaterally up to 70% on a substantial number of consumer durables (automobiles, toys, electronics, footwear and others) (Baumann, 1998, 32ff.). *Second* was the (temporary) 3% increase of the common external tariff (CET), which has been approved by the XIII meeting of the council of the common market in December 1997. From that time on, frequent changes in trade policies took place in all member states. In some cases, tariffs or equivalent taxes have been changed repeatedly (e. g. the statistical tax in Argentina), and an increasing reliance on new NTBs and other hidden regulatory instruments has been observed.

It has been documented (see INTAL, 1999, a. a. O. and IDB, 1999, pp. 26), that most of the new trade policy measures came into effect on the sub-regional level and were implemented by Argentina and Brazil. Thus, for example, early in 1998 Brazil introduced a new scheme of prior licensing on agricultural (dairy), pharmaceutical, chemi-



cal and food products and somewhat later added new quality certificates for another 170 industrial goods and again extended the list of agricultural products subject to licensing. In October, a system of foreign exchange purchase has been established. Under this regime, "foreign currency ... must be bought ... at least 180 days in advance ... of the physical operation" for all imports of less than 40.000 \$ (INTAL, 1999, a. a. O.).

Argentina introduced new import control measures in March 1999, involving detailed specification and a priori declaration procedures of imports. This measure works similar to the Brazilian prior licensing system in delaying (and increasing the costs of) imports. Argentina also applied anti-dumping measures ever more frequently. The instrument has been used both internally (mainly against Brazil) and externally (against the EU and China) (see: WTO, 1998a, p. 31).

Trade policies concerning the most sensitive sectors are especially disappointing. These sectors had already been excepted from the general scheme of intra-regional trade liberalization in order to proceed more quickly towards the formation of the customs union. The sensitive sectors should then be reformed when Mercosur could be presented as an unambiguous success story. However, a solution to the alcohol-sugar problem still could not be found (the sector should have been liberalized on June 1, 2000), and new Argentine safety standards and conformity tests hinder Brazilian exports of electronic products.<sup>12</sup> Most critical to the future of the common market will be the treatment of the automotive sector which accounts for about 25% of intra-Mercosur trade and plays a key role in the envisaged intra-industrial specialization of the region. Presently this sector is still captured by a restrictive regime of managed trade which runs counter to the idea of "open regionalism".

The architects of Mercosur realized relatively early that this particular sector would have to be reformed substantially in order to establish an open regional market. Therefore, they proclaimed to re-integrate the automotive industry into the (world) market according to three basic principles:

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<sup>12</sup> In addition, in July 1999, Argentina introduced new import quotas on Brazilian textiles and the implementation of a voluntary export restraint on Brazilian shoes was discussed.

1. Realization of intra-regional free trade,
2. abolishment of national (regional) incentives which were appropriate to influence the regional allocation of resources,
3. equal treatment for products from non-member countries.

Unfortunately, however, the implementation of a definite reform concept is still missing. After a sequence of negotiations during the last years the Mercosur automotive regime still follows a compensation philosophy (one country is entitled to export as much as it imports from the partner country)<sup>13</sup> for intra-regional trade and sets a CET against international competitors of 35% for cars and 14 - 18% for components. Also the compliance with the declaration to stop sectoral incentives as a means to attract new factories has a limited credibility, since Brazil subsidized a new Ford plant in Bahia right after the joint agreement had been settled in 1997. Last not least, the future local content provisions are still in dispute. Brazil advocates a 60% local content which would help to protect local producers but could hardly be met by the smaller partner countries, except by buying exclusively from (high cost) Brazilian sources.

A new deadline was set at 2004 for the implementation of a liberalized regime that would comply with the concept of "open regionalism". Early this year, another regional conference decided to reintegrate the automotive industry until 2006. Given the present situation in the automotive industries of Argentina and Brazil and the different positions of the respective interest groups in both countries it is an open question whether the new date will be matched.

Another field of concern for the future integration process is the apparent unwillingness of politicians to agree on (and comply with) a minimum degree of policy coordination in order to stabilize the incentive system for intra-regional investors. *First*, there is still a conceptual mismatch in macroeconomic policies between Argentina and the other members, that has become openly visible with the 1998 Brazilian crisis. While Argentina, with its currency board approach, fixes the nominal exchange rate, thus leaving the adjustment of the real exchange rate entirely to the market (and to internal factor mobility) Brazil emphasizes a stable real exchange rate and accepts

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<sup>13</sup> According to an Argentine proposal, Argentina should be allowed to export to Brazil about 3.5 to 4 times the amount of cars that Brazilian producers sell on the Argentine market.

occasional fluctuations of the nominal rate (Preusse, 1998). While both approaches may be compatible in equilibrium, the mechanisms involved in adjusting to both internal disequilibria and exogenous shocks are different and may introduce another element of instability for local investors. As a matter of fact, these kinds of instabilities are working in favor of the "location" Brazil and are adverse to the smaller partner countries.<sup>14</sup> In order to have a sufficient degree of compatibility between the two strategies it has been argued that "this requires one of the two countries to abandon its strategy" (INTAL, 1999, Appendix: Uruguay and Mercosur, p. 31). Presently, there is no solution to the problem in sight.

*Second*, customs unions, because of the common level and structure of external tariffs, are obliged to exhibit a common trade policy against non-members. This condition has frequently been hurt during the last years. For one thing, there are the uncoordinated decisions to change the rates of protection nationally which have already been reported. Second, after 1994, Brazil as well as Argentina have engaged in several negotiations about new free trade contracts with non-member states. Most important strategically is the Brazilian move towards the South American Free Trade Area, that has found a preliminary success with the proclamation of the formation of the free trade area between Mercosur and the Andean Community until 2002.

What is disturbing from the point of view of the Mercosur common trade policy is the fact that Brazil pushed for this solution without a mandate of its partners. In particular, when the Mercosur negotiations with the Andean Community did not proceed as quickly as it had been hoped, Brazil went on to negotiate alone and against its commitment to Mercosur. The envisaged new FTA may therefore come at the expense of the consolidation of the customs union in Mercosur, not to mention the formation of a common market.<sup>15</sup>

To sum up, in the year 2000 the customs union is still incomplete and, most probably, it is further away from completion than it had been when it was implemented. Most

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<sup>14</sup> In fact, since the Brazilian crisis of 1998 and the abrupt depreciation of the real exchange rate of the Real new investments in Argentina and Uruguay have been postponed or even reversed.

<sup>15</sup> For a comprehensive discussion of the "broading versus deepening" problem of Mercosur see Peña, 2000.

importantly, there are indications that the political will of the member states to act jointly in the field of external trade policy is eroding.

#### **4. How to evaluate the prospects of Mercosur?**

There are two basic hypotheses to explain the present situation of Mercosur. The first is that the observed divergence of the political and institutional development of Mercosur from the pre-established integration plan is a transitory phenomenon, but the integration process is still alive and on due course. The second hypothesis draws on a theory of collective action and suggests that the concept of open regionalism is intrinsically deficient (see for example Bhagwati/Panagariya, 1996). The proponents of this hypothesis claim that distinct polit-economic developments under a PTA tend to undermine the political will to form an open trade regime over time. From this perspective, the present set back in the consolidation and deepening of Mercosur may not be a transitory phenomenon but a first indication of the fundamental contradictions between multilateralism and regionalism.

##### **4.1. Stagnation of Mercosur - a transitory phenomenon?**

There are two principal arguments in favor of the "transitory obstacles to integration" hypothesis. First, national and international turbulences have hit the Mercosur economies most severely during the second half of the 90s. Nationally, the Brazilian economy had just begun to be reformed under the "Plano Real" when the Customs Union was started. During the course of macroeconomic stabilization trade policy was (necessarily) subordinate to the successful implementation of this program. Internationally, the Mexican crisis spread to Latin America in 1995 and international investors tested the validity of the new macroeconomic concept of Argentina and Brazil seriously. During that year, therefore, the governments in both countries were heavily engaged in stabilizing their economies within the context of extremely adverse conditions on the international financial markets. Both economies suffered severe declines in the respective growth rates of GDP, but they managed to recover quickly in 1996. Again, the integration process became subordinate. Just one year later, in July 1997, the Thai economy crashed, and the strong international interdependencies helped to spread the crisis quickly to other Asian countries, Russia and eventually to Latin America. In 1998, the Mercosur countries suffered a severe re-

cession. This time, the recovery took longer in Latin America despite the relatively quick revitalization in Asia. The main reason was that, other than the Tequila crisis, this time financial turbulences went hand in hand with the break down of important markets for Latin American exporters in East Asia and a dramatic downturn of the prices of primary commodities. As a result, the liberalization schedule of Mercosur again gave way to emergency measures which run counter to the long-run integration concept. From this analysis of international turbulences, therefore, an explanation of the discouraging results of the integration process since 1995 can easily be derived. The conclusion may be that the present stagnation of the process of region building is in fact temporary.

*Second*, and more difficult to evaluate, is the argument that the benefits of integration are diminishing as time goes by while the costs of adjustment are rising. As a consequence of such a change in the balance of perceived costs and benefits of trade reforms, the political will to push for further integration may diminish.

Apparently, this argument runs counter to mainstream trade theory which states that the gains from trade liberalization are always higher than the costs of adjustment. This argument holds not only in the static context but even more so in a dynamic analysis. The point is, that the costs of adjustment are temporary (and mainly short-run) while the gains from international specialization are available over time and may even become permanent.<sup>16</sup> The balance of benefits and costs should become more and more positive, therefore, when the adjustment process proceeds. In the light of these considerations, there are two additional arguments to be discussed in order to explain why the *perceived* balance of trade liberalization may differ from the one to be derived from the theoretical model.

#### 1) The "false" gains from trade case

As a matter of rule profound changes in economic strategy (such as a switch from an inward to an outward looking regime) use to take place only when the old paradigm has been severely discredited by poor economic results. In this situation, the economy usually suffers a severe depression with a low degree of capacity utilization and unemployment is abound. When the new regime is introduced, there is a consider-

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<sup>16</sup> For a comprehensive discussion of the point see: WTO, 1998b, chapter 4.

able chance to inspire a cyclical upswing that is mainly alimented out of existing capacity and does not put too much pressure on structural adjustment.<sup>17</sup> This is especially true in the case of exports because under a new and more open trade regime vent-for-surplus trade may instantaneously expand and help to improve capacity utilization. On the other hand, under a gradualist reform agenda, import competition may remain weak at the beginning of the reform process because tariff reductions may initially be restricted to the elimination of tariff redundancies.

In this scenario, the recovery of the economy may be falsely attributed to the trade reforms while the more painful adjustments of the production structure to the international market is still to come. In this situation, two critical points have to be overcome: *first*, investors must be convinced that the new regime is sufficiently reliable to justify this risky long-term commitments in the evolving export sectors, and *second*, factor markets must be sufficiently flexible to accomplish a smooth restructuring process from import competing to export production. In any case, this "true" process of structural adjustment to the new trade regime will be more difficult than the initial recovery from depression. As a result, the *perceived* balance of gains from trade and costs of adjustment may shift at the expense of the reform program.

## 2) The case of "selective problem solving"

Closely related to any strategy of gradual trade liberalization is the observation that politicians tend to proceed from easy reforms to the more complicated cases. Thus, as the reform program proceeds politicians are forced to pay more and more attention to the remaining reform deficits in these "sensitive" sectors. Often, these topics are put on the agenda only hesitantly, and when the first reform euphoria is fading out because restructuring is now under way (see above). Consequently, it will become both economically more difficult and politically less easy to sustain the reform process and the speed of change may diminish.

Mercosur is a case in point for this kind of political strategy. Starting from a high level of protection, the liberalization schedule was applied to those sectors where complications were expected to be of minor importance. In turn, sensitive sectors in each of the participating countries were excluded by means of a list of exceptions which each

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<sup>17</sup> For a more detailed analysis see Preusse, 1988.

country was allowed to constitute freely. In that way it became possible to free the initial integration process from any severe obstacle.

What remains to be done now is to resolve the remaining big problems, e. g. the automotive and the sugar sector and, following the concept of open regionalism, the implementation of an adequately low level of discrimination against outsiders. Still another fundamental problem which has not yet found a satisfactory solution is the coordination of national economic policies.

Considering this situation it is not surprising that the strategy of "selective problem solving" has run into trouble and the speed of the implementation of the common market has slowed down.

#### **4.2. Stagnation of Mercosur - the result of deficiencies in the concept of open regionalism?**

The hypothesis suggesting conceptual difficulties to be a major concern of open regionalism has been elaborated most clearly in the so-called "dynamic time path approach" (Bhagwati/Panagariya, 1996 a. a. O.). The authors question the notion that preferential trade agreements (PTAs) are superior to multilateral free trade. They claim, instead, that the construction of PTAs in general (and Mercosur in particular) according to a sound set of economic rules and institutions conducive to growth (as proposed by the advocates of open regionalism) will most probably run into trouble over time.

The basic reason for this claim is, that there are strong incentives for local interest groups to form a region wide opposition against new members and in favor of a high preferential margin against outsiders. These groups may also lobby effectively against too much competition on the regional level. These lobbying activities may be less influential in the short run because national interest groups are initially weakened when the PTA is implemented. Thus, there may well be a relieve from the pressure of vested interests during the first years of integration (Berthold, 1996). However, these pressure groups are expected to return even more powerfully later on, because both the incentives and the ability to organize and to lobby on the regional level are increasing over time. In turn, the forces driving the reform process (and op-

posing these groups) tend to weaken, foremost because consumers are even less capable to organize on the regional level than on the national level. Even exporters which should have viable interest in open markets are expected to oppose protectionist pressures only weakly because they feel compensated by the bigger regional market<sup>18</sup>.

Also, governments themselves may play an ambiguous role in the process of region building, if government officials and bureaucrats are following their own specific interest rather than a social welfare function. In recent models, specific interests and social welfare are both considered as parameters of the politician's reaction function. Politicians in this context will weigh up the benefits to be derived from concentrating on one of these conflicting goals against its costs (losing voters). Under this condition, the political will to proceed in the reform process may diminish, if the relative attractiveness of more openness is declining. This may in fact be the case, when the so-called "our market is large enough" syndrome (Bhagwati, 1993, p. 20) applies or when the attractiveness of the Customs Union (Common Market) is fading out (see above). Last not least, pushing for regional solutions may also be politically more attractive and technically less demanding (Bhagwati/Panagariya, 1996 a. a. O.) than the multilateral approach, because politicians and bureaucrats can negotiate and distribute the perceived revenue of regionalization more comfortably among "like-minded" people.

From an other point of view, the new regionalism is not at all meant to end up in multilateralism but is the outcome of a conscious political strategy to defend political power against the effects of globalization (Schirm, 1999). The hypothesis claims that globalization both increases the gains from trade and international specialization and decreases national political sovereignty. Politicians try to find an intermediate position

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<sup>18</sup> In the discussion of the concept of Mercosur the problem of structural adjustment caused by opening up to foreign competition has been central from the beginning. In particular, the formation of an open PTA had to face strong opposition from a large part of the national industry that had been established under the protectionist hide of the import substitution regime. Faced with international competitors many of these industries (enterprises) would have to undergo a costly process of restructuring or even leave the market. In this context the promotion of a dominantly intra-regional and intra-industrial division of labor has been recommended in order to minimize the cost of adjustment. The assumption is that with intra-industry specialization the adjustment costs are lower than with inter-industry specialization. Implicit to the concept is the concentration on regional trade expansion (which is supposed to be of an intra-industrial nature) at the expense of inter-industrial specialization which is prevailing in trade with the advanced industrialized countries. I will elaborate on this particularly dangerous argument in a future paper.



between both. Schirm argues, that the driving forces of globalization are private agents and, in particular, multinational enterprises (MNEs). These MNEs are using (increasingly) mobile factors of production to optimize the allocation of resources internationally and beyond the reach of national governments. In this scenario, the relative attractiveness of an economy becomes a critical factor in international locational decisions. This in turn makes national governments less free in their choice of economic (and social) policies because they are obliged to improve the relative attractiveness of their local economy. In particular, the scope for demand management and social policy decreases, while supply side policies are gaining importance during the globalization process.

In this scenario, governments use regionalism as an instrument to exploit the gains from trade (globalization) in the regional market (but refuse to exploit the even bigger gains on the world market) while trying to stabilize its political impact through shared sovereignty on the regional level. If this is the driving force behind modern regionalism, as Schirm argues, the optimal region will always be smaller than the world economy and multilateralism will cease to be a final political target.

Finally, the obligation to share political sovereignty itself may become a major obstacle to the formation of a PTA. *First*, for a customs union or a common market to function sufficiently well, it is important to define the common goals sufficiently clearly and to split responsibilities between the participating countries and (in the case of deeper integration) between these countries and supra national institutions. *Second*, even when there exists a common goal that has found complete acceptance by all member countries (e. g. a common market) there may still be a lot of differences regarding the split of responsibilities and the individual interpretations of the joint project.<sup>19</sup> This may be the case for example when the potential trade off between globalization and

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<sup>19</sup> The experience of the European Community shows that this process of regional institution building and power sharing is among the most difficult tasks in the formation of a common market. In the case of Mercosur today neither the process of institution building nor a sound concept of power sharing are seriously discussed. On the contrary, the still unresolved discrepancies in the concepts of macroeconomic policies and the frequent national political activities against the principle of a common Mercosur trade policy show these deficits. This is not to say that Mercosur necessarily needs an institutional structure comparable to that of the European Union. However, relying on ad hoc decisions resulting from occasional presidential meetings cannot substitute for a minimum institutional setting when the common market is really aimed at.

political sovereignty is evaluated differently in the partner countries. A politically sensitive nationalist government may value political sovereignty higher than its partners. Likewise, a country with a complex and less competitive industrial sector may have a greater interest in defining "open regionalism" restrictively. Apparently, when the more nationalist country is the biggest player in the region (bigger countries use to be more nationalist as a matter of rule), the PTA may have a bias against openness.<sup>20</sup> And this bias will be even more pronounced when the more restrictive country has also a weak industrial sector (and strong vested interests in favor of protection).

Summing up the pessimistic view of open regionalism leads to the following conclusions:

1. There are vested interests influencing the process of region building. These interests work against the concept of open regionalism in the long run.
2. Politicians instrumentalize regionalism as a means to reduce the loss of sovereignty to be expected from globalization rather than a means to find a quicker path to multilateralism.
3. The need to share sovereignty within the PTA is itself a major obstacle to deep integration when nationalist sentiments are abundant.

These three aspects of regionalism are focused in the political arena where politicians and bureaucrats are trading vested interests against social welfare to survive. Open regionalism is challenged under these conditions both because of the growing importance of protectionist interests and the reluctance of politicians to share sovereignty with the regional partners. The result is that the process of region building runs into mounting difficulties over time and may not end in a sustained open regime.

#### **4.3. Is Mercosur in a transitory stage of stagnation?**

Looking at the international economic environment of the second half of the 90s and the particularly strong impact of the Asian crisis on Latin America suggests that the completion of Mercosur has indeed been negatively influenced by transitory factors. As far as these factors are concerned, the hypothesis cannot be ruled out that Mer-

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<sup>20</sup>A particularly negative role in shaping the time-path of the PTA is expected to be played by a hegemonial power. This case is discussed extensively in Bhagwati/Panagariya (1996) with emphasis to the role of the USA within NAFTA. They claim that a PTA with a hegemon as a partner is the worst case scenario because the hegemon is likely to dominate not only its partners but will instrumentalize the PTA in order to change the multilateral system to its own favor.

cosur will soon become revitalized and proceed in constructing a customs union (common market) based on the principles of "open regionalism".

The problem with this statement is that the acceptance of the transitory stagnation hypothesis does not rule out the possibility that more deep rooted obstacles to further regional integration are also at work. A clear proof of this proposition is difficult to establish at this time, but some arguments in favor of the "fundamental deficiency" hypothesis can easily be raised:

1. Within the context of a dynamically evolving global system change is a crucial aspect of economic and political life and international turbulences are not unusual. Unless it can be shown that the exogenous shocks of the 90s had an exceptionally severe impact on Latin America, they should not be taken as an argument to rationalize the dramatic increase of protectionism that has taken place. In fact, both Argentina and Brazil would have been able to avoid the most serious effects of the international crisis of the 90s even without reversing the integration (liberalization) strategy<sup>21</sup>, if they were prepared to keep the reform process of the early 90s firmly running.
2. The Asian crisis and its rapid spread to other emerging markets may be accepted as an extraordinary burden for Mercosur in 1998 and 1999. Again, however, protectionist instruments which run counter to the formation of a customs union (common market) have been identified almost before this crisis erupted.
3. A satisfactory solution for the deregulation of the automotive sector and the liberalization of the sugar sector is still not in sight. The point is that both sectors are heavily depending on state subsidies and stiff regulations in order to survive. Vested interests appear to be particularly strong in these industries, but things appear to be not much different in the textile and footwear industries.

In essence, this means for a large part of the industrial sector in Argentina and Brazil that the old structures inherited from the import substitution era are still

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<sup>21</sup> In fact, the progressive approach of multilateral trade liberalization of the early 90s seems to have been abandoned with the implementation of the CU. See da Motta Vega, 2000, pp.28, and Valls Pereira, 2000, pp. 14.

alive and defended by strong lobbying groups. It is unclear, how these industries can be reintegrated into the world market as long as a profound restructuring process is ruled out.<sup>22</sup>

4. Closely linked to the problem of restructuring and upgrading of the old fashioned industries is the believe that the promotion of intra-industrial specialization and trade within Mercosur might be the structurally easier and equally successful path to international competitiveness as compared to a courageous expansion of North-South relations. It is not possible to evaluate this argument here in any detail, but some crucial aspects have to be mentioned:<sup>23</sup>

1) intra-industrial specialization may be a sound compliment to inter-industry specialization, but not a substitute. This is especially true for developing countries which will most strongly profit from conventional comparative advantage but are only poorly equipped to exploit the potential gains from intra-industry specialization.<sup>24</sup>

2) One of the most important ingredients for a successful upgrading process of less developed countries is close contact with those who dispose of advanced technologies and specialized human capital. It is these linkages which are crucial for a quick absorption of technological competence and an indispensable precondition for the development of comparative advantages in more sophisticated industries. MNEs and intimate trade relations with economically advanced countries are the key to appropriate this knowledge. The benefit to be harvested from both the exploitation of comparative advantage and the adaptation of advanced technologies are maximized in North-South but not in South-South trade (see for example Conolly/Gunther, 1999). This argument becomes the more important when the wrong guided reliance on

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<sup>22</sup> It has been demonstrated, that, despite an enormous increase in trade volume, trade structures did hardly change during the 90s both within Mercosur and in external trade. See Markwald/Bosco Machado, 2000.

<sup>23</sup> See Preusse, H. G. (1992), Modern Trade Pessimism - Justified Fears for the Development of a Free International Division of Labour? in: *Economics*, 46, pp. 102 - 119.

<sup>24</sup> The exploitation of economies of scale for example depends crucially on the existence of high income markets with a widely differentiated demand for innovative products.

intra-industrial specialization goes hand in hand with an intra-regional specialization against comparative advantage as has been demonstrated for Mercosur (Yeats, 1998).

Drawing on these arguments the Mercosur strategy to put particular emphasis on the development of intra-industry specialization and trade in order to avoid the more complicated adjustment process to be expected from North-South trade is misleading. This strategy, though tempting in the short run, does not have the potential to initiate a lasting upgrading process because the scope for intra-industry specialization within the region is limited. Also, with a timid trade policy towards the industrialized countries the flow of advanced technology from the North which is urgently needed in order to upgrade economically, will remain low. If this pessimistic scenario applies re-integration of Mercosur into the world market will probably remain wishful thinking. In turn, protectionism will threaten to rise once again and the idea of "open regionalism" will eventually be discarded.

## 5. Concluding remarks

In this paper the present state of the Mercosur integration process has been analyzed. I have identified two stages of the integration process: the period of progressive region building (1991 - 1995) and the consolidation period (1996 - ...) during which the integration process has virtually come to a standstill. Thus, Mercosur is at a crossroads. For the integration process to proceed after economic recovery from the Asian crisis some important obstacles have to be removed: *first*, there are strong vested interests in the leading economies of the region which try heavily to avoid rigorous structural adjustment to the world market. This adjustment, however, is indispensable if Mercosur is to become an open region after a long period of import substitution.

*Second*, there appears to be a discrepancy between the proposed concept of a "common market of the South" and the political readiness to share sovereignty and act jointly. Presently, neither a consistent macro economic concept exists within the region nor is there a reliable framework for the establishment of a more intense (market oriented) intra-regional specialization. Last not least, governments are hesitant to

act as one political unity as far as external trade relations are concerned. If these conceptual deficits cannot be solved, inter-regional integration will most probably be further delayed.

Under these conditions, the political initiative to enlarge Mercosur to a South American free trade area until 2002 (merging of Mercosur and the Andean Community) appears to be more of an escape strategy that (again) concentrates on easy results (excluding sensitive sectors) rather than treating the fundamental problems which have to be solved *within* Mercosur. All together, this situation does not credit the hypothesis that Mercosur is on a promising road to the formation of a consolidated Customs Union (or even a Common Market) based on the concept of "open regionalism".

Table 1  
**Mercosur Exports and Imports 1990-1995**

(Billions of US\$)

	1990	1991	1992	1993	1994	1995
X Total	46.5	46.0	51.6	54.3	62.9	70.2
X Intra	4.1	5.1	7.2	10.0	12.0	14.2
X Extra	42.4	40.9	44.4	44.3	50.9	55.8
M Total	31.6	36.7	40.8	51.6	63.7	79.4
M Intra	4.5	5.5	7.5	9.8	12.5	14.4
M Extra	27.1	31.2	33.3	41.8	51.2	65.0
<u>X Intra</u> X Total	8.9	11.1	14.0	18.5	19.2	20.3
<u>M Intra</u> M Total	14.1	14.9	18.5	19.0	19.5	18.1

**Percentage Change**

	1991-95	1990	1991	1992	1993	1994	1995
X Total	8.7	3.6	-1.3	12.3	5.3	15.7	11.4
X Intra	28.4	11.3	23.7	41.4	39.5	19.7	17.8
X Extra	5.8	2.9	-3.7	8.6	-0.3	14.8	9.8
M Total	20.4	13.9	16.1	11.1	26.6	23.4	24.7
M Intra	26.6	8.4	21.9	38.3	29.9	27.2	15.5
M Extra	21.5	14.8	15.1	16.4	25.9	22.5	27.5

X = Export, Intra = Mercosur intraregional trade  
M = Import, Extra = Mercosur extraregional trade

Source: Inter American Development Bank

Table 2  
**Mercosur Exports and Imports 1990-1999**

(Billions of US\$)

	1990	1995	1996	1997	1998	1999
X Total	46.5	70.2	75.2	83.6	81.4	69.9
X Intra	4.1	14.2	17.1	20.8	20.4	13.9
X Extra	42.4	55.8	58.1	62.9	61.0	56.0
M Total	31.6	79.4	88.9	105.7	103.4	
M Intra	4.5	14.4	17.9	21.6	22.2	
M Extra	27.1	65.0	71.0	84.1	81.2	
<u>X Intra</u> X Total	8.9	20.3	22.7	24.8	25.1	19.9
<u>M Intra</u> M Total	14.1	18.1	20.1	20.4	21.4	

**Percentage Change**

	1991-95	1995-97	1995	1996	1997	1998	1999
X Total	8.7	10.0	11.4	7.4	11.2	-2.6	-13.7
X Intra	28.4	19.9	17.8	20.3	21.7	-1.7	-31.6
X Extra	5.8	7.3	9.8	4.1	8.1	-2.9	
M Total	20.4	18.5	24.7	12.0	18.9	-2.2	
M Intra	26.6	20.1	15.5	24.5	20.4	2.8	
M Extra	21.5	18.2	27.0	9.2	18.5	-3.4	

X = Export, Intra = Mercosur intraregional trade  
M = Import, Extra = Mercosur extraregional trade

Source: Inter American Development Bank



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