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Christensen, Steen Fryba

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**Center for Comparative Integration Studies**  
at Department of History, International and Social Studies



**CCIS**

Center for Comparative  
Integration Studies  
Aalborg University  
Fibigerstraede 2-99  
DK-9220 Aalborg East

Phone: +45 9635 8310  
Fax: +45 9635 0044

E-mail: [ccis@lists.ihis.aau.dk](mailto:ccis@lists.ihis.aau.dk)

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Center for Comparative Integration Studies  
Fibigerstraede 2, room 99  
Aalborg University  
DK-9220 Aalborg East  
Denmark  
Tel. + 45 9635 8310  
Fax. + 45 9635 0044

E-mail: [ccis@lists.ihis.aau.dk](mailto:ccis@lists.ihis.aau.dk)  
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## **South American Regional Integration: Two Moments in Mercosur's Integration Trajectory**

Steen Fryba Christensen<sup>1</sup>

The focus of the analysis here is on two distinct periods in Mercosur's integration trajectory, namely 1991-2002 and 2003-2007. The reason for this is that Mercosur has changed its course between the first and the second of these phases. After a period of "open regionalism" and liberalizing reforms, a shift in Mercosur's integration model has occurred in recent years. The year 2003 is taken as the historical moment where this change took hold due to the convergence in thinking in Argentina and Brazil, the two countries that together form the central axis of Mercosur.

Mercosur was formed in 1991 with the four original members Argentina, Brazil, Paraguay and Uruguay. In 1995 the block created a customs union. Chile and Bolivia became associated members in 1996, and in 2006 Venezuela became the fifth full member of Mercosur. Thus, Mercosur has deepened and expanded through its historical trajectory. Today it forms the backbone of South American regional integration that has developed further with the introduction of South American presidential summits in 2000 (Lafer, 2004) and the creation of the Community of South American Nations in 2004 (Mercadante, 2006). Both of these developments happened on the initiative of Brazil.

Brazil has thus had a leading role in the construction of South American regional integration. With an economy that corresponds to more than 50 % of South American GDP (Guimarães, 2006: 273) Brazil is bound to maintain this leading role in the process of South American regional integration.

The analysis focuses on the integration trajectory of Mercosur in the light of *South American regional integration*. It is thus not the aim to analyze the Mercosur in the light of Latin American integration or integration at the level of the whole Western Hemisphere. The reason for this is that the Western Hemisphere seems to be splitting up into two parts with Central America and Mexico centred on North America and South America pursuing more diversified strategies. Along with the focus on South American regional integration, the relationship between USA and Mercosur is brought into the analysis as a central issue. In the early part of the 1990s it was generally believed that a free trade block of the Americas centred on the US economy would develop. The most likely scenario was a world economy divided into three major economic blocks centred on the US, the EU and Japan. However, the FTAA has never taken hold.

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<sup>1</sup> Assistant Professor at Aalborg University. [sfc@hum.aau.dk](mailto:sfc@hum.aau.dk).

## **Main objectives**

Latin America embarked on a route of liberalizing reforms in the 1980s and 1990s leaving behind a history of state-led development pursued through import-substitution and industrialization (ISI) strategies that had been pursued from the 1930s to the 1980s. However, the liberal reforms have had disappointing results and have led to a redirection in development strategies, particularly in South America, in recent years. The analysis aims at explaining the redirection in development strategies in South America, particularly with regard to how this is affecting the integration process in Mercosur and South America as well as with regard to how this affects the relationship between Mercosur and the United States.

## **Methodological and Theoretical Key Issues<sup>2</sup>**

The analysis combines a historical approach to integration with an emphasis on world historical situations seen in their totality. Country specific factors, with an emphasis on Argentina and Brazil, are considered at the same time, since integration between different countries cannot be understood without understanding domestic factors. With this approach I seek to explain the emergence and evolution of Mercosur.

The analysis sets out with a historical treatment of integration in order to achieve two goals, firstly to find significant patterns in historical processes of regional integration in Latin America that may shed light on the two phases in Mercosur's recent integration trajectory, and, secondly, in order to account for the historical and contextual factors that led to the emergence of Mercosur in the early 1990s and to account for the factors that led Mercosur on a different path in the second of the two phases of the analysis.

## **Outline of the Analysis**

The analysis developed below focuses on four periods. The first section focuses on the period from the "discovery" of the Americas to 1985 when Argentina and Brazil started to seek to develop a strategic partnership. The experience of "old regionalism" in LAFTA and ALADI are discussed. The second section focuses on the period from 1986 to 1990. The third section focuses on the period from 1991 when Mercosur was created and implemented a more open "new regionalism" than the more closed model pursued in earlier regionalist schemes. The typologies of old and new regionalism are useful in the discussion of the different phases of Mercosur's integration. The fourth section analyzes Mercosur's trajectory from 2003 to 2007 seeking to compare and contrast this

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<sup>2</sup> The scope of the present work does not allow a systematic in depth discussion of theory and method. Only the most central elements are discussed.

phase with the 1991-2002 phase and to discuss why such a change occurred and where Mercosur and South American integration may be going.

The analysis focuses particularly on Brazil and Argentina and to a lesser extent on Uruguay and Paraguay as well as other South American and Latin American countries. With regard to the fourth section, the issue of Mercosur's possible expansion and deepening is discussed as well as the relationship between Mercosur and the United States.

### **1. The Historical Background prior to 1986**

Latin American regional integration did not play much of a role until 1960. There was little mutual trade due to the similar specialization in raw materials of the economies, a typical characteristic of formerly colonized countries that some analysts refer to as the "colonial syndrome". Protectionist policies aimed at promoting national industrialization also worked against regional integration. However, some trade did take place within the region, particularly between Argentina, Brazil, Chile and Uruguay. Mutual trade between these countries increased in importance during the Second World War and in the first years after the war reaching a record high of 12.2% of their total trade in 1953 when a decline in mutual trade occurred, largely due to balance of payments difficulties experienced by the countries (Furtado, 1972: 197).

In response to this decline and inspired by ECLA's (Economic Commission for Latin America) ideas regarding the need for broader markets to sustain a more diversified industrialization process, Argentina, Brazil, Chile, Mexico, Paraguay, Peru and Uruguay established LAFTA (Latin American Free Trade Agreement) in 1960 (ibid). Later, Colombia and Ecuador and then Bolivia and Venezuela joined LAFTA (Rapoport and Musacchio, 1993: 60). With the diversity of the members LAFTA can be considered an asymmetric integration scheme. According to ECLA thinking the agreement sought to avoid unbalanced outcomes by giving special treatment to the less advanced economies. The ultimate aim was to establish a zone of free trade by 1973 (ibid). Along with free trade inside the region, the Montevideo Treaty included provisions for "*sectoral or 'complementarity' agreements, designed to promote co-ordination at the production level. The idea was to facilitate industrial integration by enabling producers to divide complementary activities among themselves and so to gain access to a larger market*" (Furtado, 1972: 200 [1970]). LAFTA represents the "classic" type of "old regionalism" characterized by high protectionist walls towards third countries outside the region and by a state-led approach to industrialization.

It proved difficult to turn the aims into reality. Trade levels recovered initially (ibid: 200-201) but fell back again from 1965 as countries experienced balance of payments difficulties. Negotiations aimed at establishing a free trade zone ran into difficulties in the industrial area where there was strong resistance at the national level (Mallmann, 1994: 22). Dissatisfaction with regional integration was particularly strong in the lesser developed Andes countries that decided to establish a sub-regional group in 1969 (Rapoport and Musacchio, 1993: 61-62). In other words, LAFTA was unsuccessful in dealing with the problems posed by initial economic asymmetries and balance of payments problems created difficulties in the negotiation process. This created nationalist and protectionist sentiments in the less developed countries.

During the period up to 1980, Latin American countries experienced quite diverse development outcomes. Brazil stands out as the most successful with the world's third highest average economic growth rate between 1900 and 1980 (Abreu, 2002: 15), whereas Argentina experienced a process of de-industrialization in the late 1970's as a consequence of its response to the oil crisis. This made Argentina fall behind Brazil in terms of industrialization, a trend that has continued during the 1990s (Ferrer, 2006).

As a response to the lack of success of LAFTA, a new and less formal integration scheme, the Latin American Integration Association (LAIA), was signed in 1980. Its goal was the establishment of a Latin American common market, but it was not established how this should be done nor a timeframe for reaching it (Rapoport and Musacchio, 1993: 62-63).

## **2. The Argentina-Brazil Integration Act (1986-1990)**

After a long history of rivalry between Argentina and Brazil (Guimarães, 2006: 273) and tensions until 1979 over the escalation of nuclear programs pursued by both countries (Ferrer, 2006; Escudé, 1995: 11), the two countries undertook an initiative of bilateral integration in the mid-80's. The settlement of the conflict over the Itaipú hydro-electrical project (Ferrer, 1998: 61)<sup>3</sup>, distension on the nuclear front (ibid) and the introduction of democracy in Argentina in 1983 and in Brazil in 1985 created a favourable context for closer cooperation.

At a presidential meeting in 1985, Brazil's new president José Sarney and Argentina's president Raúl Alfonsín made the political decision to pursue increased bilateral integration between their two countries. This decision was followed up by the signing of an integration act, within the LAIA framework, and the establishment of a programme for the integration and cooperation of Argentina and Brazil. The aim was to gradually establish a common market

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<sup>3</sup> Itaipú had negative impacts on the waterways downstream in Argentina.

(Ferrer, 1998: 56). The programme consisted of 24 protocols with sector specific projects, particularly in different industrial sub-sectors and in the energy sector. The idea was to promote common projects and intra-industrial integration (Lavagna, 1998: 171-179) and to assure balanced trade between the two countries, both in terms of the quantity and the quality of trade (Jardel and Barraza, 1998: 37-38). The integration process was thus characterized by a state-led approach to development. Protectionist policies towards third countries were maintained, no major effort at privatizations was made and integration was planned and managed by the states. Thus, this initial phase of integration between Argentina and Brazil is an example of “old integration”.

At the outset of this phase of integration, both Argentina and Brazil faced serious external economic constraints from their foreign debts, but pursued similar stabilization programs that helped reignite economic growth and led to a rise in mutual trade led by industrial exports (Lavagna, 1998: 255-256 and 281). However, the two countries ran into serious balance of payments problems due to a combination of external economic and political factors.

Regarding the economic side of the problems, the trade surplus fell in both countries in response to the stabilization programmes that strengthened the national currencies (Fanelli and Frenkel, 1993: 388; Dias Carneiro, 1988: 158) and increased the dependency on capital inflows to finance current account deficits provoked by the financing costs of the foreign debts that had virtually exploded between 1979 and 1982 in the context of international financial instability.

With regard to political causes of economic instability and stagnation, in the case of Argentina the Peronist opposition blocked the privatizations defended by the government and the IMF as a way to stabilize the economy (Torre, 1998: 46). In the case of Brazil, the government introduced a moratorium on interest payments to foreign private creditor banks in 1987 thereby defying the position taken to the foreign debt problem amongst the foreign creditors. According to Brazil’s finance minister at the time, the Brazilian view was that “*the sharing of the burdens between Brazil and its foreign creditors did not seem fair*” (Bresser Pereira, 1994: 345).

Thus, a rising dependency on foreign capital inflows to finance rising current account deficits combined with a perception amongst foreign creditors and the IMF that Argentina and Brazil were unwilling to honour their financial obligations led to a balance of payments crisis in both countries and provoked an economic downturn. The economic problems contributed to a rethinking of development strategies and a rethinking of the regional integration project in the following period.

### **Mercosur's first Moment: Regional Integration from 1991 to 2002**

The rethinking of development strategies in Argentina and Brazil can be characterized as an attempt to gain external confidence in order to create conditions for renewed economic growth. Therefore policies along the lines supported by powerful external actors such as the IMF, the World Bank, financial investors and multinational companies were adopted. Carlos Escudé has developed an influential theoretical position supporting such a strategy that describes the interpretation of the Argentine situation dominant in the Argentine government at the time well. According to his theory of weak peripheral states, the theory of “peripheral realism”, it is dangerous for weak states to pursue confrontational policies towards the leading states, particularly the United States, because this can hamper the access to foreign credit and thereby get in the way of economic growth (Escudé, 1995: 19).

The rethinking of development strategies had as one of its effects a redirection in the regional integration process. In the midst of the economic crisis experienced by both Argentina and Brazil, the two new presidents, Brazil's Fernando Collor de Mello and Argentina's Raúl Carlos Menem, met in July 1990 and signed the “Acta de Buenos Aires”. The new agreement sped up the integration process and changed the methodology of integration. The aim was to create a common market within a period of four years using generalized, linear and automatic tariff reductions that would end up with zero tariffs by the end of the transition period while allowing a longer transition period for sensitive industrial sectors (Rapoport and Musacchio, 1993: 65). The common active technological and sector policies were left behind as a more market-led approach was adopted (Ferrer, 1998: 121). In this way, “new regionalism” was introduced.

The regional integration scheme was extended with Uruguay and Paraguay with the Treaty of Asunción in March 1991 that created Mercosur. The two new member states were allowed one more year for the transition to a common market than Argentina and Brazil (Rapoport and Musacchio, 1993: 65-66).

Liberalization internally in Mercosur was coupled with unilateral liberalization extra-regionally. This combination of regional liberalization and a more generalized opening followed the liberalizing trend in all of Latin America in the early 1990s (Abreu, 2002: 7). The new “open regionalism” approach was part of a major shift in the strategy of development and international insertion. The tendency was to reduce import barriers, sell of state companies and leave behind active state policies aimed at picking the winners in the industrial sector.

The liberalization strategy followed the recommendations from the international financial institutions and the United States and finds its most highly profiled

expression in John Williamson's "Washington Consensus", a ten point list of recommendations to Latin America suggesting what the region should do to restart economic growth in the opinion of "Washington" (Williamson, 1990).

Why did Argentina and Brazil, much like most other Latin American countries, introduce this shift in development strategy and what was the aim?

The central aim was to promote economic development just as in the case of the former more state-led strategies. However, the traditional strategy used to assure economic development was no longer believed to be appropriate in the conditions of the early 1990's (Cervo, 2002: 7). According to a liberal analyst, the shift towards a more liberal strategy reflected "*the recognition that import substitution had failed to provide the incentives for high growth even in the economies where the strategy had been more successful in the past*" (Abreu, 2002: 17). The new liberal strategy was introduced by Argentina and Brazil in their search for a more competitive insertion in the global economy (Rapoport and Musacchio, 1993: 69), reflecting the notion that international competitiveness was essential to renewed economic growth and that competitiveness was best assured by a liberal market-led development strategy.

This notion built on a particular interpretation of the globalization process and its significance for Argentina and Brazil in the context around 1990. There are some differences in how Argentina and Brazil interpreted their situation at the time and how they believed they should go about improving their situation. However, the similarities are quite striking. Both in Argentina and Brazil, the context of globalization and external financial vulnerability with its negative impact on economic development induced them to introduce strategies of development and international insertion along the lines of the Washington Consensus. According to Amado Luiz Cervo (2002: 25) Argentina was particularly uncritical in its adoption of neo-liberal reforms whereas Brazil was somewhat more critical. In the case of both countries, however, the shift was built on the interpretation that national states in the periphery had lost the capacity to control their own national development due to the context of globalization that had transferred power to the centres of power made up by a combination of the leading states, financial markets and large corporations (see Ferrer, 2006: 5). There was no other option than seeking to adapt to this new context through a strategy of openness and integration in the global economy.

In the case of Argentina, the interpretation of Argentina's situation and of the international context in which it had to pursue its development led to the adoption of a position in external policy inspired by Carlos Escudé's doctrine of "peripheral realism". In the case of Brazil, the elites showed overall conformity with the neo-liberal agenda pursued by the United States (Herz, 2003), but a less

radical approach to the neo-liberal agenda was adopted reflecting some differences in thinking. Most significantly, there was a broadly shared scepticism of the US vision for the integration of the Western hemisphere in Brazil. It was believed that Pan-American integration along the lines promoted by the United States could harm Brazilian industrial interests and development possibilities due to the asymmetries in development between the two countries. Most other countries in Latin America reacted favourably to the US idea of a free trade area. According to José Augusto Guilhon Albuquerque (1998: 3) *“Brazil is the only country in Latin-America that resisted more or less openly to every U.S. initiative in Latin-America since the launching of the Nafta talks and the announcement of Bush’s proposal of a free trade area in the Americas.”* George Bush (1989-1992) launched this idea in 1990 when NAFTA talks took their start and the interest of Latin American countries in the idea may be explained by a relatively high dependence on the US market for their exports, as in the case of Mexico, Central America, Peru and Colombia or by the desire to have preferential access to US markets. The enormous size of the US consumer market is thus a source of attraction and of US negotiating power with its Latin American neighbours.

According to Raúl Bernal-Meza (1999: 163), Brazil was more compromised with Mercosur than Argentina, as Brazil saw Mercosur as an instrument in its dispute with the United States and as a way to gain leadership in the region. In this context, Mercosur was seen as a tool to balance the EU and the US in a strategy of international insertion focused on the US and the EU (Cervo, 2003). Brazil’s industrial leadership in the region can be seen as a structural element that helps explain Brazil’s larger emphasis on integration in Mercosur as regional integration could provide an extended home market for Brazilian industry and a platform from which to increase international competitiveness. Mercosur could function in the same way for Argentina. However, Argentina was less compromised with Mercosur and was very interested in the US proposal for a hemispheric integration scheme (Bernal-Meza, 1999).

Apart from Brazil’s criticisms of the US agenda for hemispheric integration three other differences in policy were discernible in Argentina and Brazil at the outset of Mercosur. Firstly, Argentina proceeded particularly fast with liberalizing imports. Average import tariffs were thus reduced from 26.5% in late 1989 to 9.7% in early 1991. Secondly, Argentina’s privatization process proceeded faster than Brazil’s. Argentina basically sold off all state companies between 1990 and the end of 1994 (Frenkel and González, 2002), while Brazil privatized little in this period (Lacerda, 2000). Lastly, Argentina’s fixed exchange rate policy differed from the stabilization strategies chosen in the other Mercosur countries. For instance, Brazil pursued a flexible exchange rate policy (Baumann and Mussi, 2006: 8). The combination of Argentina’s fixed exchange

rate and Brazil's flexible exchange rate policy led to Argentine deficits in bilateral trade until 1994 (Gerchunoff and Llach, 1998) and made it difficult to coordinate policies. However, Argentina's strategy was vastly more successful than Brazil's in terms of economic growth results. Argentina experienced yearly economic growth of between 6.0% and 8.9% between 1991 and 1994 (ibid), whereas Brazil's economic growth varied between -0.8% and 6.0% (BCB, 1997: 11).

The fact that Argentina had been vastly more successful in terms of economic growth with its more radical liberal strategy than Brazil had been with its more gradualist approach doubtlessly played an important role in Brazil's decision to implement the Real Plan that revolved around the strengthening of the Brazilian real in an effort to stabilize inflation. According to Amado Luiz Cervo (2002), Cardoso's<sup>4</sup> idea was to privatize, reduce foreign debt, create international competitiveness and stabilize inflation with the help of a strengthened currency. This was basically the same logic that had led Argentina to introduce its fixed exchange rate policy in 1991.

According to Bresser Pereira (1996) the combination of liberalizing reforms and socially oriented policies defended by the PSDB that both he and Cardoso belonged to corresponded to a modern social democratic policy in opposition to the old-fashioned and outdated approach that had emphasized state ownership and state intervention in the economy. Clearly, the idea was that liberalizing reforms were needed to assure renewed economic growth and social progress in the context of Brazil in the 1990s. A policy of adaptation to the neo-liberal agenda was therefore seen as progressive due to the assumed benefits it would provide in terms of economic growth and a broader tax-base from which to support socially oriented policies. The key to this development then was to implement a reform of the state and its involvement in the economy by selling off state companies and cutting back on the state subsidies that had characterized the ISI strategy.

Thus, national development strategies in Argentina and Brazil converged on a neo-liberal agenda with similar policies, particularly with the adoption of the Real Plan in Brazil in 1994. This had an impact on the character of the type of regional integration pursued. Old regionalism with its state-led and protectionist policies was left behind and new regionalism with its market-led and liberal policies along with privatizations took over.

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<sup>4</sup> Fernando Henrique Cardoso was Brazil's foreign minister until 1993 when he accepted the difficult position as finance minister. In this position he introduced the idea of the Real Plan that was popular with the electorate and brought him to electoral victory in presidential elections in 1994. After this, Cardoso was Brazil's president in two periods, namely 1995-1998 and 1999-2002.

It can be argued that it was believed that a strategy of passive adaptation to the policies preferred by the most powerful external actors provided the best possibilities of assuring development success for Argentina and Brazil that found themselves in a situation of weakness and lack of power resources. The logic of this view was that a cooperative strategy was likely to create external confidence. This would make it possible to get the foreign debt problem under control and to attract foreign investments which were an essential component in the development strategy. However, policy makers did not necessarily see the liberal strategy as a sign of passive adaptation and lack of national autonomy. Celso Lafer, for instance, has argued (2004) that the liberal approach aimed at assuring autonomy through integration in the world economy. Regional integration in combination with liberalism was thus seen as a conscious active strategy believed to be more suitable to the new context of globalization and national external vulnerability.

From this perspective, it can be argued that the creation of Mercosur itself represents an active policy that sought to attack the traditional “colonial syndrome” of low interdependence between Latin American countries by creating a more open preferential trade environment amongst the regional partners and thus promote intra-regional trade and at the same time avoid the trade-diversion that a more protectionist policy approach towards third countries would have provoked. It was hoped that open integration would ensure a more competitive insertion in the world economy and thus strengthen industrial exports from the region that had been extremely weak under the protectionist “old regionalist” policies. Apart from the traditional goal of providing broader markets for producers in the regional grouping, Mercosur’s regional integration was also a tool in the attraction of foreign direct investments and a way to combine forces to gain a stronger voice in the international arena.

In the first four years of its existence, Mercosur produced noteworthy results with regard to intra-regional trade. By 1994, intra-regional trade had increased from the 1990 level of 4,127 billion US\$ to US\$ 12,049 billion. This brought the weight of intra-regional exports up to 19.5% of total exports from 8.9% (ECLAC, 2005: 83). Particularly Argentina and Uruguay came to depend on intra-regional exports to a significant degree. In 1995, 32.1% of Argentina’s total exports and 46.2% of Uruguay’s total exports went to Mercosur (ECLAC, 2003: 76). The bilateral trade between Argentina and Brazil was characterized by a growing importance of advanced industrial exports, particularly from Brazil. Industrial exports from Argentina to Brazil also increased, but not to the same extent. Also, Argentina’s industrial exports tended to be less technologically advanced than Brazil’s (Lavagna, 1998: 255-256) reflecting Brazil’s leadership position in the industrial sector inside the region. As a result

of the growing intra-regional trade and the renewed economic dynamism, the open “new regionalism” approach was generally seen as a big success.

### **The Treaty of Ouro Preto and Mercosur as a Customs Union**

On the background of its success, Mercosur developed into a customs union in 1995 after the signing of the Treaty of Ouro Preto in December of 1994. With the introduction of the customs union, the countries introduced a common external tariff for 85% of all products with a medium tariff of 14% and a maximum tariff of 20%. With regard to the remaining 15 % of products, each country was entitled to fix its own external tariffs between a minimum of 0% and a maximum of 35%. However, external tariffs in this segment, which included some of the most advanced industrial sectors, were to converge lineally and automatically with a common tariff after a transition period of 5 to 10 years depending on the sector in question (Lavagna, 1998: 317-318). The treaty established differential treatment for the smaller economies, i.e. Paraguay and Uruguay, that were allowed a longer transition period and more exceptions at the level of the regional common market (CEPAL, 2002: 20).

The aim was to create a “perfect” customs union and a complete common market without exceptions. In other words, the approach was rules-oriented with an emphasis on fixed norms that corresponded to an ideal type of integration. The underlying assumption was that all of the countries should be able to thrive in such a scheme regardless of the asymmetries in existence at the outset of the transition period that would lead to a perfect customs union and a complete common market. This idea reflects the liberal conception underlying the choice of integration scheme. From a position emphasizing the danger that economic asymmetries could create asymmetrical outcomes and provoke disenchantment with integration, the strategy seems unsuitable to the circumstances of the smaller economies in the region. According to Lamas (2006) there always existed some criticisms of Mercosur inside Paraguay that the regional scheme would create competition problems but the worry of standing outside the region was even greater.

In Argentina there were different views of how Mercosur should develop. The economic minister, Domingo Cavallo, favoured Mercosur as a free trade zone in order to allow Argentina more freedom of action in international negotiations (Lavagna, 1998: 321). However, according to Lavagna, the fact that no trade agreement was reached with NAFTA and the United States paved the way for congressional approval of the introduction of the customs union.

The development policies of Argentina and Brazil tended to converge more from 1994/95 with Brazil’s introduction of the Real Plan and intra-regional trade

continued its expansion in relative and absolute terms. In spite of these factors, that ought to have been conducive to ever deeper integration, the development strategies of the two countries came to produce serious development problems and these problems led to a crisis of the regional integration project around the turn of the century.

The key problem was that growing trade and current account deficits increased the dependence on capital inflows. In Brazil, the combination of liberal imports and a strong currency led to a virtual import boom in 1995. Imports rose from around US\$ 33 billion in 1994 to around US\$ 50 billion in 1995 (IMF, 1998). While intra-regional exports rose significantly in Mercosur, extra-regional export results were less positive. Therefore, the import boom provoked trade deficits and substantial current account deficits. In Brazil's case, the country ran trade deficits with all world regions in the period between 1995 and 1998 after the introduction of the Real Plan. This development led to a boom in current account deficits that reached more than US\$ 34 billion in 1998 (BCB, 1999: 120) compared to a situation in 1993 where there was practically current account balance (IMF, 1998: 7). Argentina faced a similar situation, and the foreign debts of the two countries escalated fast. In order to deal with the deficit, Brazil pursued a policy of massive privatizations (Lacerda, 2000).

The "competitive insertion" pursued by the two governments thus surely created a much more competitive environment for their import-competing businesses but it was not particularly successful in helping to assure the competitiveness of the industrial sector. As a consequence the relative weight of the industrial sector in national GDP fell. In Brazil's case this happened particularly in the 1995-1998 period (Vieira, 2006: 19). However, the fall in the relative weight of manufacturing industry was more pronounced in the other Mercosur countries in the period between 1990 and 2005 than in the case of Brazil. Particularly Argentina was hard hit (Baumann and Mussi, 2006: 12) and in 2003 Brazil's industrial output was almost four times as big as Argentina's (ECLAC, 2004: 200).

The rise in current account deficits provoked a new fast rise in foreign indebtedness both in Argentina and Brazil in spite of the income from privatizations. The growing foreign debt and sluggish export growth led to a growing dependency on financial inflows and thus a higher level of external vulnerability. This growth pattern provoked a new financial crisis in Brazil as well as development difficulties in all of the Mercosur member countries in the period between 1998 and 2002 and led to tensions in the regional group.

### **Brazil's Devaluation, Mercosur's Crisis and Argentina's default**

The period from 1999 when Brazil devalued its currency in January to 2002 can be seen as a transition period for Mercosur's trajectory. In this period the regional integration project is faced with the challenge posed by economic crisis.

Intra-regional exports were hurt by the crisis off-set by Brazil's devaluation. In 1999, Argentina's exports to Brazil fell from US\$ 8.034 billion to US\$ 5.812 billion (Bernal-Meza, 2002: 87), something that was quite serious for Argentina that had developed an important degree of dependence on the Brazilian market. Total intra-regional exports fell from US\$ 20.322 billion in 1998 to US\$ 15.162 billion in 1999 (ECLAC, 2005: 83).

This led to tensions in Mercosur, but also to an attempt to revitalize Mercosur. Argentina's new Alianza government that gained power in 1999 proposed a new emphasis on Mercosur and on more socially oriented policies in its election platform (Bernal-Meza and López, 2000: 6), and in December 2000 the goal of revitalizing Mercosur was announced in a Presidential Declaration of the Mercosur. In practice, the agreement reached between the presidents called for convergence measures including inflation targets and fiscal targets for the public sector (ECLAC, 2001: 99) in what we may call a "mini-Maastricht" agreement.

At the same time, positive trends in terms of regional integration happened at the South American level. In August 2000, the first South American presidential summit was held on the initiative of Brazil. At the summit, the main point of discussion was the IIRSA initiative, an initiative that aimed at developing a series of energy and infra-structural cooperation projects. The idea was that such a practical approach to regional integration would be very useful because it could help create a more competitive insertion in the global economy (Lafer, 2004). What one should note here is that IIRSA was conceived around planned development with cooperation between the different South American governments and the private sector. It was therefore one of the initial steps in the direction of a post-liberal agenda in the region, it could be argued. Pedro Da Motta Veiga and Sandra Polônia Rios (2006: 3) thus argue that the liberal paradigm was giving way to a doctrine emphasizing managed globalization. As we shall see in the analysis of Mercosur's 2003-2007 phase, this tendency has now come to characterize Mercosur, although this has not led to the re-introduction of the classical "old regionalism" of LAFTA.

In spite of these attempts at a renewed emphasis on regional integration, Brazil's devaluation as well as other factors provoked an economic downturn in Argentina and Uruguay, and in response to this development Argentina introduced a number of policies that broke with intra-regional trade rules. In August 2000, the Argentine government broke the rules in the automotive

programme with a rule that required 30% of local components. In the same month, Argentina introduced minimum prices for poultry imports from Brazil as an anti-dumping measure (ECLAC, 2001: 97-98). The aim was to protect national production in Argentina that was caught in a period of economic recession.

These policies can be seen as a clear break with “new regionalism” and they produced tensions within Mercosur. Demands for protection from domestic producers may have influenced the Argentine government to introduce these policies, but surely the difficulty of financing the current account deficit was also a potent motivator in a situation where Argentina found it very difficult to maintain the confidence of international financial market actors that was needed to balance the external accounts of the country. In this way the passing from the phase of “new regionalism” to a new phase of Mercosur responds to a combination of balance of payments related problems and development problems just as the passing from “old regionalism” to “new regionalism” around 1990 had responded to this combination of problems.

A small improvement occurred in intra-regional trade in 2000, but after this the downward tendency continued in response to Argentina’s and Uruguay’s economic crises. Argentina’s GDP per capita fell by 5.6% in 2001 and a staggering 11.9% in 2002. Uruguay followed Argentina’s trend with a fall of 4.2% in 2001 and 11.4% in 2002 (ECLAC, 2003: 31). As a consequence intra-regional exports fell to their lowest point since 1993 reaching just US\$ 10.197 billion in 2002 which corresponded to 11.4% of total exports compared to the 24.9% in 1997 (ECLAC, 2005: 83). This pattern is typical in Latin America. In periods with severe balance of payments problems intra-regional trade tends to fall more than extra-regional trade as a consequence of the structural characteristics of the economies. In Brazil’s case intra-regional exports fell to just 5.5% of total exports as a response to a staggering reduction in intra-regional exports of 48% in 2002 (BCB, 2003: 136). Would this development mean that Mercosur would be perceived as being irrelevant and perhaps provoke the regional integration project’s demise?

The crisis of national development and reduced intra-regional export possibilities led to tension and conflicts within Mercosur. From the late 1990’s the principles of a common market with a zero tariff internally and common external tariffs were broken repeatedly (ECLAC, 2005: 101). This lack of compliance with the principles and rules formerly agreed to is looked at in different ways. Some analysts see it as highly problematic and as a sign of crisis in the regional group (Polônia Rios 2006). Others find that emphasizing how these tariff rules were broken misses the point. Bernal-Meza (2002b) argues that Argentina’s crisis in 2001 and 2002 made it clear that there was a need to revise

the nature of Mercosur. According to Bernal-Meza, what was important was to leave behind the neo-liberal agenda and turn Mercosur into a group based on solidarity between member states and a group with a common external policy based on a solid internal cohesion. Paulo Nogueira Batista Jr. (2006) argues that what we have been experiencing is not the crisis of Mercosur but rather of the liberal conception characterizing Mercosur and the development strategies pursued before the crisis. Faced with its development crisis, the Argentine government introduced a more autonomy seeking policy that was policy-driven contrary to the rule-driven approach that had characterized the experiment with “open integration” so far. Pressures from society and national development considerations came to override the concern for confidence from powerful external actors as Argentina defaulted on its foreign debt and challenged the interests of foreign companies that had bought up Argentine state companies in the 1990s (Mortimore and Stanley, 2006). Similarly, these pressures and considerations were behind Argentina’s tendency to break the trade rules of Mercosur.

In March 2001 Argentina took unilateral measures as it reduced its external tariffs on capital goods and raised tariffs on consumption goods. Brazil first complained over this unilateral action by Argentina but after negotiations an agreement was reached (ECLAC, 2001: 97). In April Argentina introduced an incentives regime in order to promote the national production of capital goods, telecommunications and IT, and in May Argentina fixed a minimum price for imports of shoes and textiles from all origins (CEPAL, 2002: 23). In July, Argentina broke the agreement on the common external tariff reached in March by reducing the differentiated tariff from outside Mercosur to 8% with the inclusion of the, for Brazil, strategically important sectors of capital goods, telecommunications, IT and automobiles. Few days later Brazil suspended all trade negotiations with Argentina. In the same month Uruguay decided to increase tariffs on all imports including those from Mercosur (ibid: 22-23). Clearly, Mercosur at this juncture found itself in a deep crisis. It is important to note, however, that this crisis is clearly connected to the development crises experienced by Argentina and Uruguay as a consequence of high foreign debt exposure and volatile capital flows.

As Marcelo De Paiva Abreu argues (2002), support for mercantilist ideas of interventionism was becoming widespread in Argentina and Brazil and the interpretation that liberalism had failed was gaining in strength. With regard to FTAA negotiations problems mounted in response to the strengthening of protectionist views and policies both in Mercosur and in the US. In the United States president Bush introduced protectionist policies in the steel sector, a sector where Brazil is competitive, and a new Farm Bill in 2002 meant rising

agricultural subsidies within the United States, a policy that Mercosur members are against (Abreu, 2002).

The issue of fairness in distribution at the national and international level and the issue of the “correct” role of the state in the economy and in society at large came to play an important role in Mercosur as a consequence of the development crises experienced. The perceived failure of the liberalization paradigm is at the root of this change.

### **Mercosur’s second Moment: Regional Integration from 2003 to 2007**

In order to account for Mercosur’s new direction after Argentina’s deep crisis and the ensuing crisis of the regional integration process, it is useful to briefly examine the domestic reaction to the crisis context in Argentina. Argentina’s development policy underwent a major shift after the crisis broke out. At the end of 2001, Argentina announced a default on the state’s foreign debt of more than US\$ 100 billion. In the case of the privatized public service sector companies, prices were ‘pesified’. This meant that the conditions of a large number of privatization contracts were broken and that the dollar value of public services nosedived (Mortimore and Stanley, 2006). These two policies contradicted the emphasis of the neo-liberal period between 1990 and 2001 which was exactly to maintain policies that created confidence amongst foreign investors, both financial investors and direct investors. The government defended its policy on the argument that the crisis conditions legitimized its policies. According to the legitimacy argument, the privatized companies had enjoyed overly large profits while the production system had entered a deep crisis and while poverty and social problems had expanded. Therefore, there was a lack of balance in the distribution of gains and losses between the privatized companies and society at large (Schoor and Azpiazu, 2003). In other words, the crisis provoked a policy of defending society at the expense of foreign economic interests on arguments of distributional fairness.

Brazil’s trajectory and policy choices have been different. Brazil did not default on its foreign debt nor has it pursued a policy of nationalization or breaches of contracts. This has led some analysts to argue that the Lula government can be seen as a government of continuity in the area of economic policy (Lafer, 2004). This view is debatable and I do not agree with it although it is true that there are important elements of continuity in Brazil’s overall economic policy. The Lula government has pursued a policy emphasizing the need for primary fiscal surpluses as a way to assure creditor confidence and it has not broken privatization contracts. In this way, Brazil has not followed Argentina’s example. However, important elements of discontinuity are observable in the Lula government’s economic policy. There has been a tendency to emphasize

strategically oriented state policies directed at particular economic sectors (Cervo, 2003)<sup>5</sup>. The strategic and active state involvement approach is also clear in the government's determined pro-export policy that aims at diversifying exports through concrete diplomatic initiatives (Mercadante, 2006). This policy has had an important impact on Brazil's export performance and on the stabilization of the economy. During Lula's first presidency (2003-2006) exports have risen from US\$ 60.362 billion in 2002 to US\$ 137.471 billion in 2006 (MDIC/SECEX, 2007: 11). This development is impressive although part of the export growth can be attributed to higher prices for Brazilian commodity exports. However, Brazilian exports are overwhelmingly industrial with manufactured and semi-manufactured exports accounting for approximately 70% of total exports in 2006 (ibid: 17). Another difference in emphasis has been the strong emphasis given to South-South cooperation and South American integration by the Lula government. South-South cooperation has been important in the area of international trade negotiations where the G20 has become an important player and has given a more prominent role to developing country concerns in the negotiations. The main issue promoted by G20 in negotiations is that developed countries should liberalize their agricultural sectors giving better market access to producers from developing countries and eliminating export subsidies that depress international agricultural commodity prices and makes it difficult for developing country producers to compete. This position has been defended with a discourse that has stressed the lack of fairness in current trade rules and that the existing rules and practices contribute to worsening problems of poverty and inequality hurting poor people in the developing countries.

All these examples show an attitude of a state that actively defends its interests in the international realm while pursuing domestic policies aimed at reducing external vulnerability while respecting contracts. It is certainly a quite different approach than the more passive integration in the global economy promoted during much of the Cardoso period. An important difference between the two periods is the view of the role of the state in the economy. Lula's government emphasizes the important role of the state in the strategic planning of Brazil's insertion in the global economy. In this way, the neo-liberal policy of the state's withdrawal from the economy has been left behind without an outright return to the situation prior to 1990.

Critics of the Lula government find that the emphasis on Third World cooperation has overshadowed the relations with the developed countries and has gotten in the way of trade agreements with the United States and the EU

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<sup>5</sup> Marcelo de Paiva Abreu (2002) who is critical of such policies points out that all presidential candidates in the 2002 election campaign favored more state interventionism and that there was a strong demand in society, including amongst economic elites, for more state interventionism.

(Abreu, 2006). This argument of a lack of emphasis on cooperation with the developed nations is often defended with the use of trade statistics. These show that Brazilian exports to EU and USA have fallen from 50.7% of total Brazilian exports in 2002 (BCB, 2003) to around 40.1% in 2006 (MDIC/SECEX, 2007). However, exports to the EU and the USA have risen strongly between 2002 and 2006. What has happened is that exports to other regions have increased even more. In this way, the emphasis on export diversification and the valuation of export markets in the global South has been successful.

Summing up, a defining element in the change that has taken place in Mercosur in this second period of the Mercosur is the importance given to strategic state action in defence of national development interests. This has been coupled with a policy that has put more emphasis on the diversification of exports, particularly to non-traditional markets in the South with emphasis on the large emerging markets such as China and India (Regueiro Bello, 2005: 76). More autonomous policies based on an alternative vision of the international system and of how national interests are best promoted in the international sphere characterize the period. The question this raises with regard to regional integration efforts in Mercosur and in South America is then what kind of impact this change in vision, with its nationalist aspects, has had on integration in Mercosur and at the level of South America.

### **Economic Nationalism and the Issue of Cohesion and Crisis in Mercosur**

Argentina's crisis led, as we have seen, the Argentine government to break contracts with foreign investors and to break the trade rules of Mercosur both with regard to the common external tariff and the rules for intra-Mercosur trade. This tendency continued during Mercosur's second period with the argument that Argentina needed to protect its industrial capacity (Batista Jr., 2006).

According to Pedro da Motta Veiga (2005), trade negotiations have become part of the domestic agenda in Mercosur and there have been a number of tensions between Argentina and Brazil with regard to intra-Mercosur trade policy. The key issue has been Argentina's petition to establish new safeguard mechanisms within the functioning of the block. The aim with this policy is to reduce asymmetries between Argentina and Brazil and to avoid an "invasion" of Brazilian products. Initially Brazil was unwilling to accept the idea that was very unpopular in the Brazilian business sector (Regueira Bello, 2005: 84), but after bilateral trade became increasingly unbalanced with growing Brazilian surpluses during the period from 2004 to 2006 Brazil accepted such safeguard mechanisms in 2006 to the irritation of the political opposition in Brazil. Along with this a diplomatic crisis between Argentina and Uruguay over the construction of paper companies in Uruguay close to its border with Argentina

has developed, and Uruguay and Paraguay have openly complained about the lack of emphasis on asymmetries inside Mercosur. This has led some commentators to speak of a crisis of identity of the Mercosur project (Costa, 2006: 30-33). A critic (Abreu, 2006) argues that the up-beat rhetoric of the Brazilian government regarding Mercosur and South American cooperation does not correspond to reality and José Guilhon de Albuquerque criticizes Brazil's willingness to accommodate Argentina, since such a flexible posture involves costs for Brazilian business (Campos and Filho, 2005).

Paulo Nogueira Batista Jr. (2006) disagrees. He argues that Mercosur is not experiencing a real crisis. It is reasonable when Argentina argues for the need for flexibility in order to protect its industrial capacity and deal with asymmetries. Aldo Ferrer (2006) argues along these same lines that Brazil's flexible attitude is correct, since Argentina needs to re-industrialize after a period of de-industrialization provoked by erroneous policies that did not give sufficient emphasis to the promotion of Argentine industrial development.

Recently, the Brazilian government accommodated Argentina's claim for the institutionalization of safeguard mechanisms in intra-Mercosur trade (Mercadante, 2006). Similarly, Mercosur introduced a structural fund aimed at supporting the small economies in Mercosur that same year (*ibid*). In this way, Mercosur seems to be moving in a direction of attacking asymmetries between member countries in order to assure more balanced outcomes. This is a deliberate policy on the part of the Brazilian government and reflects its emphasis on regional integration in South America (Guimarães, 2006).

There are different reasons why Brazil places such a large emphasis on regional integration in South America. One is certainly that the Lula government sees Brazil as a regional leader in South America and believes that a cohesive South American block will strengthen Brazil's international political prominence (Lima and Hirst, 2006). Samuel Pinheiro Guimarães who is considered one of the main ideological forces in the Lula government has exactly argued this point suggesting that Mercosur should gain a more prominent role in the reorganization of the international economic and political order (2006: 128-129). This position is vastly different from Escudé's position of "peripheral realism" in the early 1990s that called for a passive adaptation to the designs promoted by the United States. The present Brazilian government is actively seeking to influence and change aspects of the international order and has gained prestige on the international scene from its initiatives (Seitenfuss, 2007), although some observers believe that Brazil's attempt at influencing the world order is unrealistic and has not produced any results.

Another important reason for Brazil's interest in maintaining a cohesive block at the level of Mercosur and at expanding South American cooperation is economic. South America takes a prominent role in Brazil's export profile. In spite of Mercosur's crisis in the early part of the present decade, intra-Mercosur trade has more than doubled between 2002 and 2005 and its relative importance in total exports is rising again (CEPAL, 2006: 81). Brazilian exports to LAIA members, including Mercosur, corresponded to 22.8 % of total exports in 2006, with 10.1% going to Mercosur members and the last 12.7% going to other LAIA members. This makes LAIA Brazil's largest export market surpassing both the EU, which has traditionally been Brazil's largest export market, and the United States (MDIC/SECEX, 2007: 20-21), and exports directed at LAIA are overwhelmingly industrial at around 90 % of the total (BCB, 2005: 121). Venezuela, which became the fifth Mercosur member in 2006, turned into Brazil's tenth largest export market in 2006 where Venezuela was Brazil's fastest growing export market amongst Brazil's 12 largest export markets (MDIC/SECEX, 2007: 21). At the same time, Brazilian businesses are investing heavily in the region. There are thus strong commercial and economic motives behind Brazil's interest in regional integration apart from such motives as the desire for a leadership role at the regional and global level. Some analysts argue that Brazil also aims at challenging US leadership in the region. I will turn to these debates in the following.

### **International Aspects of Current Regional Integration in South America**

In this section I analyze international political, economic and ideological aspects of Mercosur's integration trajectory in recent years. I emphasize three interconnected issues. First, I focus on the construction of a common vision for the insertion of Argentina and Mercosur in the international system. Then, I analyze the relationship between Mercosur and the United States with an emphasis on the FTAA negotiations and US-Brazilian relations. Finally, I analyze Mercosur's expansion and cooperation in South America.

#### **A Common Vision: the "Buenos Aires Consensus"**

In October 2003, Brazil's new president Luiz Inácio 'Lula' da Silva and Argentina's new president Néstor Kirchner met in the capital of Argentina, Buenos Aires. One of the outcomes of the meeting was the formulation of a common vision of the two governments. This vision was given the name of the "Buenos Aires Consensus" and it can be seen as a response to the "Washington Consensus".

The Buenos Aires Consensus was formulated in a context where Argentina was struggling to emerge from its crisis and the new government of Brazil was

seeking to gain confidence from international financial markets in order to avoid a default on its foreign debt. It was formulated shortly after the Cancún meeting of the WTO. At the Cancún meeting an obstacle to agreement on international trade issues had been disagreement between the newly formed G20 coalition of developing countries and the leading industrial countries. All the member states in Mercosur are amongst the members of G20 as are regional leaders in the developing world India, China and South Africa. The G20's aim is to reform agricultural trade rules with a view of opening the markets of the developed countries for imports from the South and of convincing the developed countries to give up export subsidies in the agricultural sector and cut down on domestic subsidies to agriculture. This same issue was also on the agenda in the FTAA negotiations with the United States and the rest of the Western Hemisphere in November, i.e. a month after the formulation of the Buenos Aires Consensus. Thus, October 2003 can be seen as a moment central to the definition of the insertion of Mercosur in the global economy.

In this context, the two presidents signed the Buenos Aires Consensus<sup>6</sup> in which they called for a more balanced globalization that would be more conducive to development in developing countries. The presidents promised to honour the foreign obligations of their countries on the condition that this could be coupled with sustainable economic growth characterized by job creation and room for social policies that would allow a more socially balanced development.

The Buenos Aires Consensus can therefore be seen as a progressive agenda that calls for a more equilibrated world order that reduces asymmetries at the global level. It can thus be seen as a political intervention in the diplomatic agenda between Mercosur and the leading industrial countries. The common vision of Argentina and Brazil thus represents an attempt to create a more legitimate world order seen from their perspectives. As we have seen, the issue of asymmetries has also received attention within Mercosur recently, and particularly Brazil is taking leadership within the group in an attempt to reduce asymmetries inside Mercosur. The fight against social exclusion and asymmetric development at the national level is also emphasized in the domestic policies of individual Mercosur member countries. In other words, Mercosur's agenda is characterized by this emphasis on dealing politically with reducing development asymmetries and poverty. During the neo-liberal period, it was also hoped that liberal policies would promote economic growth and reduce poverty, but free market rules were the core component believed to produce such outcomes whereas state involvement has a more central role in the present approach.

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<sup>6</sup> *Consenso de Buenos Aires*. From Instituto del Tercer Mundo. Downloaded on October 20<sup>th</sup> from [http://www.item.org.uy/Documentos/consenso\\_portugues.htm](http://www.item.org.uy/Documentos/consenso_portugues.htm).

It is significant for Mercosur's trajectory from 2003 that Argentina and Brazil had come to some degree of a shared vision on these points given the centrality of bilateral relations between these two countries in the regional integration of Mercosur and of South America (Cervo, 2003; Guimarães, 2006). On the basis of this shared vision Mercosur developed an assertive position in its negotiations with the developed centre countries and an active policy aimed at expanding South American integration while taking into consideration existing asymmetries. These issues are taken up in the following sections.

### **The FTAA and Relations between Mercosur and the United States**

During the presidential campaign, Lula described the FTAA as not being a project of integration but a project of annexation of Latin America by the United States (Bandeira, 2005: 4). Briefly after the election of Lula, Samuel Pinheiro Guimarães, who is a leading figure in the foreign policy making elite in the Lula government and who is seen as a leading ideologue behind the diplomatic vision of the government, argued that it would not be dangerous for Brazil to stand outside the FTAA if such an agreement was reached. He further argued that FTAA, as it was envisioned at the time, would prevent Brazil from pursuing active policies in a number of areas such as in the area of industrial policy, technological policy and foreign investment policy. This was unacceptable for Brazil, because Brazil needed to be able to pursue active and strategic policies in these areas if it was to successfully face its three main development challenges which were to reduce social and regional disparities, eliminate the chronic external vulnerabilities and achieve Brazil's true potential (Guimarães, 2002).

A few days after the government took over power, Guimarães elaborated on how Brazil should face its main challenges. Brazil should work towards creating a multipolar world order and Mercosur was a key instrument in achieving this. Brazil should also avoid making agreements that would reduce its ability to pursue autonomous policies (Guimarães, 2003). It would be a mistake to agree to the type of rules that the US wanted and it could lead to a deepening of the economic and social crisis in Brazil and provoke de-industrialization and thereby further accentuate asymmetries between the United States and Brazil and increase external vulnerabilities (Guimarães, 2006).

It is clear that the position taken by the Brazilian government therefore stood in the way of the creation of an FTAA along the lines proposed by the United States that apart from assuring better market access for industrial products and services also wanted to introduce WTO-plus provisions, the so-called new issues or Singapore issues in the area of foreign investment, intellectual property, public procurement, services and competition (Abreu, 2005: 10). The US interest in juridical security to investors was a delicate issue because it could get

in the way of autonomous industrial policies (Oliveira, 2003: 317) and create the kind of protection, security and freedom to investors that would allow investors to sue governments if they believed that national policies somehow jeopardized their profits, not only in the case of outright expropriation and nationalization but also in cases where rules and regulations were changed to their detriment. One example of such changes in rules and regulations was exactly Argentina's pesification policy mentioned earlier.

Brazil's position towards the FTAA, led some analysts to argue that the Lula government was anti-American. Samuel Pinheiro Guimarães disagreed with this and argued that Brazil wanted to increase cooperation with the United States as long as the cooperation was based on the common ideas of democracy, fairness and sovereignty (Guimarães, 2003). The implication of this view is that the WTO-plus provisions should be avoided both in WTO and FTAA negotiations, and for that matter also in the negotiations between Mercosur and the EU, in order to assure fairness and the maintenance of the ability and right to pursue autonomous development policies on the part of Mercosur countries.

On the basis of these views, Brazil and Argentina did not present offers in the areas of public procurement, services and investments, and intellectual property rules in FTAA negotiations (Oliveira, 2003: 320), while the United States gave differentiated offers to different groups of countries without offers in agricultural subsidies and anti-dumping policies (Bouzas, 2005: 15) where Mercosur were *demandeurs*. As a consequence an 'FTAA Lite' was adopted establishing different levels of agreement between different countries (ibid) and today the FTAA is largely considered to be dead after it was rejected by Argentina, Brazil and Venezuela. The United States has instead embarked on bilateral trade negotiations with Latin American countries and it goes on defending the type of policies it has promoted in NAFTA and in FTAA negotiations earlier on. Agreements have been reached with Chile, Peru, Colombia and Central America along these lines (Batista Jr., 2006).

The potential for strengthening a South American block that is one of Brazil's main foreign policy goals (Lima and Hirst, 2006; Guimarães, 2006: 263) in its quest for a more balanced multipolar world order from a position of autonomy in relation to the United States (Cervo, 2003) therefore seems to have become greater in this second moment of Mercosur although a number of challenges such as the bilateral trade deals between the US and different Latin American governments persist. I turn to this issue in the last section below.

## **Mercosur's Expansion and South American Integration**

In an article on the Lula government's diplomatic concepts and strategies Celso Amorim, Brazil's foreign minister, argues that Brazil's priority is South American relations. He describes integration as an imperative and argues that the destiny of Brazil and its South American neighbourhood rests on their mutual dependence (Amorim, 2004). Samuel Pinheiro Guimarães stresses this same point (2006) and argues that a stable, democratic and prosperous South American region is in Brazil's interest. Improved economic and social development would not only help stabilize the countries politically but it would also improve business and export opportunities. Countries such as Peru, Ecuador and Bolivia had almost developed into "failed states" (Almeida, 2006) after the liberal experiments of the 1990s and Venezuela has recently gone through a period of political polarization and economic instability as it has opted for a nationalist and anti-American leadership.

In one way this context makes South American regional integration a challenging endeavour due to nationalist policies and different national strategies. On the other hand, however, the broadly shared criticism of market-led development with a passive state and a shared scepticism in many South American countries of US-led initiatives such as the FTAA creates a fertile ground for regional integration.

In the following I first analyze the issue of Mercosur's internal cohesion in the second moment of Mercosur's historical trajectory and then I go on to analyzing the expansion of Mercosur and other initiatives that point towards an enhancement of South American integration.

With the crisis in intra-regional trade and faced with an agenda dominated by Argentina and Brazil, Paraguay and Uruguay felt that Mercosur was not responding sufficiently to their needs and interests. Uruguay was dissatisfied with its market access to the other members and with the lack of participation in productive industrial networks (Pereira, 2006: 40-41). Paraguay had similar criticisms and both countries wanted to be able to make bilateral agreements with the United States (Costa, 2006: 30-33). In short, the perception in the small member countries was that Mercosur was too asymmetrical and did not assure a fair distribution of gains. The danger was therefore that they would want to leave the regional integration scheme. Uruguay's announcement that they were considering a free-trade agreement with the United States (Pereira, 2006: 41) created speculation that the US might be able to contribute to splitting up the group. According to Brazil's foreign minister Celso Amorim, the dissatisfaction of the two small member countries was reasonable. He proposed that a New Deal should be developed to reach a new understanding with Paraguay and Uruguay. Such a New Deal should include financing mechanisms and

investment projects amongst other things (Costa, 2006: 33). An initial step taken in this direction was the introduction of structural funds in 2006 with the aim of reducing asymmetries in the block. This new institutional development is known as FOCEM. The funds are to particularly benefit the small members and to be mainly financed by Brazil (ibid; Pereira, 2006: 41). Lula has visited Uruguay in February 2007, briefly before the visit of US president George Bush in Uruguay, and he has visited Paraguay in May 2007. During his visits, Lula offered Uruguay a “package” consisting of investments, financing mechanisms and facilitation of Uruguayan exports to the Brazilian market<sup>7</sup> and he offered a similar “package” to Paraguay with a particular emphasis on cooperation in the bio-energy sector.<sup>8</sup> The fear that Uruguay might leave Mercosur, coupled with the favourable inclination of the Lula government to manage globalization and regional integration actively with a view of enhancing strategic goals and reducing structural asymmetries seem to have been the two key motivational factors behind this initiative. On top of these initiatives, Brazil has introduced an innovative policy aimed at increasing imports from its South American neighbours in general in order to reduce its huge export surplus in the region and promote development.

Mercosur has been enlarged with the entrance of Venezuela as a full member in 2006 and Bolivia has shown interest in joining the block and negotiations are underway. These two countries have pursued strongly nationalist policies with nationalization and increased taxation in the energy sector which dominates the export profile in both countries. In the case of Bolivia the nationalization policy affected Brazilian interests as Petrobras has a strong presence in Bolivia. Views are split on the merit or lack thereof of the inclusion of Venezuela and Bolivia in Mercosur. Critics find that Venezuela in principle could strengthen Mercosur but that it is likely that Venezuela’s president’s strong rhetoric against the United States and neo-liberalism could lead to conflicts in the block and in the block’s extra-regional relations. Marcelo de Paiva Abreu (2006) believes that the pro-Venezuelan policy of the government is a mistake, while Batista Jr. (2006: 5-6) finds that Venezuela’s entry in Mercosur shows that Mercosur is not in a deep crisis. Luiz Alberto Moniz Bandeira (2006) goes even farther arguing that the entry of Venezuela strengthens and consolidates the economic and political unity of South America and that Venezuela’s huge energy reserves are of strategic importance to the region. In mid-2007, however, a diplomatic crisis developed between Venezuela and Brazil as Venezuela’s president Chávez criticized the Brazilian congress for representing the interests of Brazilian business elites and for being too closely allied with the United States. From the

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<sup>7</sup> *Folha de São Paulo*, 24/02/2007, “Contra EUA, Lula oferece ”pacote” ao Uruguay”. Downloaded on February 26, 2007 at <http://tools.folha.com.br/print?site=emcimadahora&url=http%3A%2F%2Fwww1.fol...>

<sup>8</sup> *Folha de São Paulo*, 20/05/2007. Denize Bacoccina, “Quatro anos depois, Lula visita Paraguai com pacote de ajuda”.

perspective of the Venezuelan president, this had the negative effect on the Mercosur that its rules and approach to regional integration continued to be overly neo-liberal favouring big business rather than a more people-oriented approach to regional integration<sup>9</sup>. In this way, Venezuela remains difficult to integrate in Mercosur as Chávez wishes to have a large imprint on the nature of Mercosur and finds it hard to accept difficulties in the ability to shape Mercosur.

The Brazilian government is taking a pragmatic attitude in its relations with its neighbours in order to promote this widened integration at the South American level. This is particularly evident in the case of Bolivia. In spite of the nationalization of energy sources that affected Petrobrás negatively, the Brazilian government has been quite accommodating towards Bolivia. For instance Amorim has argued that it was Bolivia's right to nationalize (Silva, 2006: 16) and Lula has argued that it was obvious that Bolivia was going to nationalize at some point because the population had voted overwhelmingly for this option making it a legitimate policy. For Brazil the question was to that a reasonable agreement was reached between Bolivia and Petrobrás<sup>10</sup>, and in this regard the main issue was to assure stable access to Bolivian gas.

### **Mercosur-Andes Community Relations and Unasul**

Apart from the strengthening of Mercosur through a recent tendency towards more cohesiveness in the group and the enlargement of Mercosur with Venezuela, Mercosur has also moved closer to the rest of the Andes countries. In 2003 Mercosur and the Andes Community reached a trade agreement. This development helped create the conditions for the foundation of the South American Community of Nations, or CASA, in December 2004. The Mercosur countries, the Andes Group countries, Chile, Guiana and Suriname partake in this new block that aims at increasing cooperation in a number of areas such as the integration of the region's transport and energy infrastructure (Mercadante, 2006: 38-39). Recently, at the first South American energy summit on Isla Margarita (Venezuela) in April 2007, CASA was renamed Unasul and it was agreed that Unasul cooperation should be institutionalized with a secretariat in Ecuador. The energy summit was yet another initiative towards greater South American integration. More cooperation in the energy and transport sectors can be seen as a way to seek to increase South America's systemic competitiveness. It fits the new regional integration conception that has left an almost exclusive emphasis on commercial issues and now focuses more on strategic long-term planning and physical integration. The rules-oriented approach from the 1990s

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<sup>9</sup> "Mercosur: Hugo Chávez choca con Brasil y amenaza con abandonarlo". *Infolatam*, June 2<sup>nd</sup> 2007. <http://www.infolatam.com/entrada.jsp?id=4369>

<sup>10</sup> *O Globo*, October 10<sup>th</sup> 2006, "Lula ataca Alckmin e diz que PSDB é empresa de vender estatais".

has been supplanted by a policy-oriented approach that emphasizes systemic improvements in productivity at a South American scale and a solidarity oriented approach to tackling asymmetries. The systemic view of national competitiveness thus seems to have taken over from the view emphasizing liberal markets. A systemic view implies that national economies, or regional economies, should be thought of in systemic terms and development strategies should emphasize how national economies can become competitive. Along these lines, Lima and Coutinho (2006) have argued that what we are seeing is a return to the *national developmental* approach but now on a regional South American scale. It remains to be seen if this recent development will be successful, but it seems clear that the dominant policy-driven conception of South American regional integration with its aim on solidarity, reduction of asymmetries and emphasis on physical infrastructure integration aims at a *flying geese* model of regional integration.

The developments discussed above can be seen as positive steps towards more cooperation in South America.

However, there is still some way towards assuring a cohesive block that could pursue a common external policy. The bilateral free trade agreements between the United States and different South American countries are not compatible with the integration of countries like Peru, Colombia and Chile in Mercosur or a South American customs union (Batista Jr., 2006: 8), since Mercosur does not allow countries individual free trade agreements with extra-regional partners. Thus, it seems that the United States has been successful in promoting policies that make it difficult to promote a cohesive and unified South American block. In other words, the United States seems to have given up on the FTAA project of hemispheric integration and embarked on a plan B that focuses on tying Latin American countries to the United States through bilateral agreements along the lines of NAFTA and in this way obstruct the construction of a solid unified South American block. At the same time, the United States seeks cooperation and more modest trade agreements, in terms of their range, individually with Mercosur countries.

Although it thus does not seem likely that a unified and cohesive South American block is about to emerge, South American integration seems to be moving forward fast with an expanded Mercosur that is becoming more cohesive. Furthermore, Mercosur has been successful in fostering closer cooperation with other South American countries with regard to trade and investment relations as well as infrastructure integration and energy cooperation. This can be seen as a step in the direction of an enhanced level of cooperation at the level of South America and thus a step in the right direction from the perspective of South American integration and development.

## **Conclusion**

Latin American countries have historically been characterized by an international insertion characterized by heavy economic links to Europe and United States and a limited level of intra-regional trade, largely on account of an economic specialization in the area of primary products. This characteristic, also known as the “Colonial Syndrome” has made it either uninteresting or difficult to integrate “horizontally” with neighbouring countries because of uncomplimentary economic structures and strategies aimed at national development behind protectionist barriers.

Mercosur represents the most successful attempt at modifying this heritage. Mercosur emerged as an expansion of the initial initiative of Argentina and Brazil to integrate their economies through strategic sector agreements in the 1980s. With the expansion Paraguay and Uruguay were added at the same time that the integration scheme moved towards a more liberal insertion in the international economy through a strategy of “open regionalism” characterized by rapid liberalization of intra-regional trade along with liberalization towards the rest of the world. The goal was to tackle the financial and development crises affecting member countries in the early part of the 1990s through a strategy that depended heavily on foreign investments and the confidence of foreign creditors. The integration project focused on commercial issues and was conceived in a rules-oriented way with a strong inspiration from liberal thinking. The strategy was successful in terms of increasing intra-regional trade both in absolute and relative terms, thus reducing the traditional “Colonial Syndrome”. However, the way stabilization strategies were conceived created increasing problems due to external imbalances and a growing dependency on foreign capital inflows. As a consequence of this development all member countries came to face international financial volatility in the late 1990s and first years of the present decade. This provoked stagnation and a major development crisis in Argentina and Uruguay in 2001 and 2002. At the same time, these development problems led to tensions within the regional grouping and to a large number of policies that broke Mercosur’s internal trade rules. Argentina was the main offender. The motivation for breaking Mercosur rules as well as for defaulting on Argentina’s foreign debt and for changing privatization contracts with the companies that had taken over state companies in the service sector was to protect society from the economic crisis and find new ways to reignite economic growth and job creation. This meant that the neo-liberal ideas that characterized the 1990s came under attack and that Mercosur changed its nature and became more policy-driven and more focused on the need to fight economic asymmetries and to emphasize solidarity at the regional level. This implied costs for Brazil, as the most advanced economy in the region, and there was some resistance to this development from the business sector and the political opposition.

The experience of national development crises created tensions inside the block and more generally between South American countries, but at the same time it led most South American countries to distance themselves from the FTAA as proposed by the United States due to its neo-liberal conception and due to the growing scepticism towards US policies towards the region. This helped strengthen regional cooperation and integration now guided by a conception that was more policy-driven and emphasized physical integration and state involvement. Mercosur and the Andes Group reached a trade agreement that opened up for the Community of South American Nations (CASA) that recently changed its name to Unasul, and Venezuela joined Mercosur in response to other Andes Group members' celebration of preferential trade agreements with the United States inspired by NAFTA and neo-liberal ideas. At the same time Bolivia has shown interests in entering Mercosur.

South American integration is thus developing in two speeds. Mercosur represents the core and its integration is developing the fastest, now with an integration conception focusing on strategic state action and coordination between the states. The commercial emphasis has been downplayed. Instead physical integration and a systemic conception of the economic competitiveness of the region is emphasized along with ideas of solidarity and the reduction of asymmetries. Intra-regional trade is growing again and Mercosur countries are engaged in strategies that aim at a geographically more diversified export structure. In practice exports to other Southern markets is the way in which Mercosur countries seek to assure export diversification. This is yet another step towards leaving behind the old "Colonial Syndrome" by reducing the relative weight of the traditional export markets, Europe and United States. This step aims at reducing the dependency on these countries and thus at increasing national autonomy. Regional integration is an element in assuring this autonomy and a stronger voice in international economic negotiations. Outside the Mercosur core, cooperation with countries such as Chile, Colombia and Peru, that have free trade agreements with the United States, has increased with the construction of CASA/Unasul and the recent celebration of the first South American energy summit. With the emphasis on energy cooperation and infrastructural integration as well as on trade cooperation between Mercosur and its South American neighbours thus follows the general trend of Mercosur. Mercosur is that at the heart of a tendency towards ever closer integration in South America that may lead to an important break with the "Colonial Syndrome", although asymmetries in the region means that some countries have a long way to go in terms of industrializing their economic structures. However, the tendency towards more autonomous national policies along with a conception of integration that emphasizes the desirability of reducing economic asymmetries and strengthening the South American region's economy in systemic terms may prove to help the less developed countries in the direction of

more diversified economic structures and industrialization. If this happens, would be stepping down the path of East Asia's development experience with its *flying geese* model of development. Japan's role in the East Asian development trajectory would be left primarily to Brazil, and secondarily to Argentina and oil-rich Venezuela. However, it remains to be seen if Mercosur will be able to integrate Venezuela with its highly ideological and un-diplomatic leader.

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