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# The viability of Mercosur in the face of the Euro crisis

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The Future of Mercosur in the Face of the Euro-crisis

An honors thesis submitted in partial fulfillment of the requirements for the degree of  
Bachelor of Science in International Business

By

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## Abstract

This research examines the successes and challenges of the European Union, especially in the face of the crisis of 2008 and 2009. Based on the current structures of the European Union and Mercosur, this paper looks to assess the viability of further integration of Mercosur using the evolution of the European Union as a model of reference. Analysis of key economic measures provides the framework for assessment, with a special focus on the asymmetries between member countries within Mercosur. Differences in debt-to-GDP ratios, regional trade levels, and exchange rate fluctuations are the primary indicators used to provide policy recommendations for the future of Mercosur. Based on high levels of inequality on the key measures considered within the paper, greater integration within Mercosur is encouraged, given improvement upon and adherence to guidelines originally set forth by the European Union.

### Key Words:

Mercosur, European Union, Economic Integration, Economic Asymmetry, Latin America

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## **Introduction**

The European Union is widely regarded as a successful experiment in international economic and political integration. Indeed, it has largely succeeded in creating a unified front for fiscal, monetary, trade, and political policies. The EU's global power has drawn the attention of the rest of the world as a potential model for extensive integration on several fronts. However in recent years, the area has been deeply troubled by the effects of the 2008 financial crisis, with a strong impact on countries like Spain, Portugal, and Greece. The stability and longevity of the union are up for debate, as these weaker members must lean heavily on the rest of the EU for support. In response to these recent issues, this paper looks to examine the viability of the European Union as an example for the Latin American union of MercoSur, given the trials of the recent crisis in the European Union.

This research question has strong implications for MercoSur and other regional trade blocs, as there are lessons to be learned from the formation and structure of the European Union. If the EU can serve as a roadmap for integration in other areas of the world, is it necessary to follow this path exactly? More importantly, what are the pitfalls encountered by the EU, and how can others avoid them in the future?

In addition to the consideration of demographic structure, there are several important variables to consider in the analysis of this question. Most important among these are the rates of growth and inflation, in conjunction with the debt percentage and exchange rates for individual nations and in aggregate. These variables give a more-or-less complete picture of the disparities between countries, an important tool for analyzing the expected success of integration. Key statistical information comes from the databases of the Inter-American Development Bank and the International Monetary Fund, among other sources.

## **European Trade and Political Integration**

Integration in the European Union has been an ongoing process, rooted in the formation of the European Coal and Steel Community (ECSC) in 1951. A coalition of six countries (France, Germany, Italy, the Netherlands, Luxembourg, and Belgium) came together, forming a supranational organization that regulated the coal and steel industries among these countries. Its key initiative was to coordinate economic policy and create a more efficient market through tariff reduction (Groenendijk). This was principally done in an effort to aid World War II reconstruction across the region.

European reconstruction served as a primary driver for large-scale trade integration. The United States' Marshall Plan called for a free trade area, a customs union, and a reduction in social welfare spending (Carolan). The end-goal of the plan was to create an intra-governmental body that would eventually evolve into a common market in Europe (Carolan). In response to these demands, the Organization for European Economic Cooperation (OEEC) was created on April 16, 1948. The organization initially had 16 members from across Europe, and required unanimity among representatives for most decisions. As a result of the OEEC's efforts to encourage free trade, 89% of private intra-European trade in 1959 was subject to free trade regulation (OECD).

In September of 1950, the European Payments Union (EPU) was created within the OEEC to allow for easier currency exchange between European countries. Currency reserves were placed under the EPU to facilitate exchange until the currencies were established as tradable with the US Dollar in 1958 (Baldwin). In 1961, the OEEC was replaced by the newly created OECD, which has become a global cooperative with goals similar to that of its predecessor, the OEEC (OECD).

The European Union of today primarily regulates economic issues, although its powers have been extended to cover social and political concerns as well. The Union follows a common market policy, which provides for the free movement of goods between member nations. This policy has been expanded to cover intellectual property rights and foreign direct investment. External trade policy is dictated by the European Commission and the European Council, both of which are Union-level governmental institutions (Bakker). The two bodies work alongside each other to set the common customs tariff for goods imported from outside the EU, while also negotiating trade agreements with other countries.

Additional institutions are in place to facilitate cooperation between members in other governmental areas. The Department for Justice and Home Affairs (JHA) focuses on internal Union issues, working to enforce EU law throughout the region (Bakker). For example, the cooperation of police, border control administration, and cross-border crimes all fall under the jurisdiction of the JHA.

The Lisbon Treaty of 2013 served to simplify and accelerate governing procedures and increase the Union's transparency on a global stage. Legislation on several issues that previously required a unanimous vote now only requires a majority vote, in an effort to facilitate greater responsiveness to key initiatives and to incentivize cooperation among member states (Archick). Ideally, if only a majority vote is required, countries will be more willing to compromise on legislation to reach a suitable agreement, instead of merely stalling the legislation indefinitely (a real possibility given a required unanimous vote). This policy change is partly in response to the planned expansion of the Union, since unanimity will become increasingly more difficult to achieve as more countries enter the Union. In order to increase the transparency and bargaining power of the EU on the global political stage, a new governmental title was created. The office

of High Representative of the Union for Foreign Affairs and Security Policy serves as the Union's head diplomat, providing a single, unified voice for the EU on foreign policy issues (Archick). Overall, the Lisbon Treaty seeks to elevate the political power of the Union as a whole and to streamline legislative procedures.

As the European Union continues to grow and mature as an economic and governmental institution, it has strived to present a unified image in regards to foreign affairs, while working to expand its regulatory power to cover a broad range of internal policy issues.

### **Monetary Implementation**

The foundation of the European Monetary Union is the Maastricht Treaty of 1992, in which the 15 member nations agreed to conform to a single currency, managed by a European central bank. According to Arestis, two prerequisites have historically been required for the sustainable success of a monetary union. The first, a preexisting political union, did not exist in its entirety before and during the implementation of the European Monetary Union, and indeed is still not a fully formed and functioning body today. Large strides have been made in the attempt to resolve this issue, mostly in the area of economic policy. The second historical condition for the success of a monetary union is convergence among members, measured most commonly by income per capita (Arestis). Years after the conversion to the Euro was complete, there were still large discrepancies among member states in income per capita. In fact, the largest country's income per capita was more than four times that of the smallest in 2004, and the Eurozone had yet to commence statistically-significant convergence by this date (Arestis).

The structure of the European Central Bank (ECB) outlines overarching goals for the region and also delineates certain powers to national governments. The primary goal of the ECB is to maintain price stability through interest-rate manipulation. The ECB targets price stability



by working to keep the inflation rate at or below 2%. In terms of fiscal policy, the ECB is left with few tools at its disposal to use the concept effectively. The ECB's budget is a mere 1% of the GDP of the Union as a whole (Arestis), preventing the possibility of meaningful fiscal intervention into the economy. Instead, fiscal policy is left entirely to member nations, with few guidelines as to the overall goals of fiscal policy. Along the same lines, there is no policy in place for income transfers or exchange rate devaluation in the case of external imbalances (Arestis). This makes persistent trade imbalances difficult to reverse, and is likely part of the issue with several countries that struggled in the recent economic crisis. Given the EMU's heavy focus on price stability and its limited budget, there are no overarching, supranational policies to pursue traditional economic goals of low unemployment and sustained economic growth. These goals are seemingly passed to member states to achieve.

The goal of convergence is addressed in the European Union through the Stability and Growth Pact, signed by every Eurozone member, which outlines policies to be undertaken by each individual country to limit budget deficits and overall debt. In order for a country to convert its currency to the Euro, national budget deficits were required to be less than 3% of annual GDP, with an overall debt less than 60% of GDP. Other requirements were set in place, limiting inflation to 3.2% per annum, and requiring government bond yields to be at least 7.7%. These very conservative guidelines have proved rather difficult for countries to meet consistently. Indeed, the EU's average debt to GDP ratio in the first quarter of 2013 was 92.8%, far exceeding the organization's original ceiling of 60% (Eurostat 2013). Although the events of 2008 called for drastic, corrective economic measures, the disparity between these two ratios is too high to accept as normal. It seems that the debt-to-GDP requirement has largely fallen by the wayside in recent years. Similarly, the requirement that budget deficits be no greater than 3% of

annual GDP makes national fiscal policy difficult to enact effectively, as funding for fiscal policy would therefore need to be taken from other departments. Economic policies are largely unattainable, given this restriction (Machinea).

In response to the economic crisis of 2008, the European Union has responded to the lack of an institution to aide in the event of balance of payments crises and other flawed economic structures with the creation of the European Stability Mechanism. This fund, with a budget of 500 billion euros, is an attempt to account for the differences between member nations and assist in the event of a crisis (Andor). Theoretically, this fund could have lessened the recent crisis by mitigating the effects of debt crises in Greece, Spain, and Ireland, among others.

#### Financial Effects of Euro Implementation

Large costs were obviously associated with the transition to a uniform Eurozone currency, hopefully outweighed by the benefits that such uniformity would give to the European community at large. Switching costs were incurred globally, as financial institutions worked to update and create new software capable of calculating accurate exchange rates between the Euro and the US dollar (then frequently used as a vehicle currency between European countries) and between the Euro and its pre-Euro counterparts (Claes). An estimated 100 billion US\$ were spent to prepare for the Euro switch (Wheelen). The required reduction of national spending on social welfare also has an indirect cost in the form of magnified effects of unemployment. Budget limitations restrict the level of spending on social welfare programs (Wheelen), which greatly diminishes the potential impact of government intervention to counteract the effects of unemployment and other socioeconomic problems.

The benefits of a single European currency are compelling, even in the face of such costs. In a 2000 report, Rose states that the “adoption of a common currency has a positive impact on

trade,” which occurs for several reasons. The ability to conduct business between member countries in a single currency significantly reduces transaction costs, given the fact that currency exchange never enters the situation. According to Claes, “two-thirds of the commercial relations of EU member states take place between members,” representing a large majority of member transactions and as such a large reduction in incurred transaction costs. Cross-country transactions between member states have become much simpler as a result, eliminating the need for currency exchanges. Additionally, a reduction in transaction costs would be realized in international trade—that is, trade between a Eurozone member and a non-member (Claes). The rise of the Euro as a key financial currency, similar in importance to the US dollar, allows for easy currency exchange, without the need for a vehicle currency to fairly convert prices from one currency to another.

An added benefit to the implementation of a common currency is the effect on trade barriers. Indeed, it has been shown that the likelihood of non-tariff trade barriers is much lower in a region with a common currency (Machinea). A reduction in trade barriers generally leads to higher levels of trade, and subsequently higher GDP.

### **Labor Mobility**

In the absence of the possibility of exchange rate manipulation and regulated income transfers, convergence between countries within a monetary union depends largely on labor mobility as an equalizing factor to maintain stability within the union. The Eurozone finds itself in exactly this position, as no supranational guidelines are in place to correct income disparities and persistent trade imbalances among countries.

Before delving into the statistics of Eurozone labor mobility, it is important to note that several countries have in the past imposed restrictions on labor mobility as the Eurozone

expanded (Dijkstra). Many countries (e.g., Italy, Greece, Spain, Portugal) have lessened these restrictions over time; however, this does skew comparisons with large countries such as the United States.

Statistically, cross-border labor mobility between Eurozone member states has remained low, as seen in Table 1. This figure is less than half of the comparison statistic (1.98%) for the USA, a large country with low inter-state migration barriers. As of 2013, cross-border migration within the EU has improved drastically, with 3% of EU citizens living and working in a country other than their home country.

*Table 1: Labor Mobility of USA vs EU-27, 2006*

	US	EU-27
Share of working age residents who moved from a different region/state	1.98%	0.96%
Net migration	0.40%	0.32%

*Source: Dijkstra*

### **Demonstrated need for migration and mobility**

The overarching structure of the EU creates a dependency on labor mobility as an adjustment mechanism to correct economic divergence between Member States. The absence of the possibility of exchange rate manipulation and the lack of supranational or national fiscal policy (due to budget deficit restrictions) prevent the use of other commonplace adjustment mechanisms. However, it is unclear if mobility rates are high enough to truly serve as a correction mechanism. In 2013, just 3% of EU citizens lived and worked in a member nation other than their home country (Hayden). Low levels of mobility prompted the EU Employment Commission, Lazlo Andor, to remark, “With much higher levels of unemployment in some member states than others at the moment, it is all the more important to make it easier for those that want to work in another EU country to be able to do so” (Andor, qtd in Hayden). Thus, labor

mobility is seen as a tool to lessen the disparities between member countries, especially under the modern circumstances of high unemployment across the region. Greater labor mobility must be encouraged to accelerate convergence between EU Member States for the long-run success of the Union.

Additionally, there are significant benefits to the encouragement of labor mobility within the region. With an unemployment rate of 10.9% across the EU in 2013 (Andor), it is increasingly more important that job seekers have the ability to take advantage of the opportunities provided to them through the sophisticated integration of EU member states. Labor mobility creates a natural mechanism for the removal of unnecessary labor from a country, while also freeing that government from the high cost of supporting that unemployed labor force (Kahanec). Receiving countries benefit from the added human capital, and migrant workers benefit financially from gained employment. These represent significant structural and financial benefits to the region as a whole. As an additional incentive, labor mobility tends to cause more freely moving wage rates. As the supply and demand of labor vary, wage rates should begin to normalize across the region. Although wage rates typically do not fall, it is likely that some wages will rise in an effort to attract more labor, thus minimizing the difference between wages on a country-by-country basis.

### **An Overview of Mercosur's Member Countries**

The Common Market of the South, or Mercosur, is currently comprised of five member nations: Argentina, Brazil, Paraguay, Uruguay, and Venezuela, with several other South American countries that have achieved associate membership. The five full members of Mercosur have functioning democracies.

Economically speaking, the countries that comprise Mercosur are very diverse, with different levels of development and global influence. Brazil's economy, the largest in South America, is diversified into several different sectors, rather than depending heavily on one key industry (CIA). A strong recovery after the devaluation of its currency in 1999 has made Brazil the largest South American economy (Rios). Due to its large population, Brazil's domestic market serves as an insulator against shocks in the external market (World Bank). Significant efforts have been made to reduce the income inequality that has plagued Brazil for many years; income inequality has been falling steadily for the past decade (IMF). These positive measures have led to the appreciation of the Brazilian real ("Brazil..."), representing a major concern for the competitiveness of Brazil's large export sector.

The second-largest player in Mercosur has greater problems to face. Argentina in recent years has faced double-digit inflation, due to a dependence on expansionary governmental policy to sustain growth (CIA). In response to such high inflation, the Argentinian government has stepped in to try to counteract the problem. Import restrictions have been levied, and currency controls have been expanded in an effort to stabilize the economy (IMF). On a more positive note, sustained economic growth has led to a reduction in unemployment to levels not seen since before the country's economic crisis in 2002 (World Bank).

Similarly, Paraguay is facing large economic issues of its own. With no large industries to build the economy, Paraguay relies on agriculture as a key factor in its economy (BBC). The government has depended upon stimulus spending to encourage and maintain growth in the face of several agricultural shocks to the economy (IMF, 2013). Additionally, high levels of corruption and smuggling across Paraguayan borders have proved difficult to curtail (BBC).

Recent political uncertainty and a lack of infrastructure compared to its MercoSur counterparts (CIA) pose challenges to the long-term sustained growth of Paraguay.

Uruguay seems to have benefitted the most from its membership to MercoSur. Its economy is largely dependent upon agricultural exports (BBC), which have been leveraged to expand trade globally. Despite large government expenditure following the 2002 crisis, Uruguay has managed to expand total trade within MercoSur by 70% and nearly double its total trade with the rest of the world (IMF). It has seen positive economic progress in recent years, as the country has continued to decrease its public debt to GDP ratio year over year (World Bank).

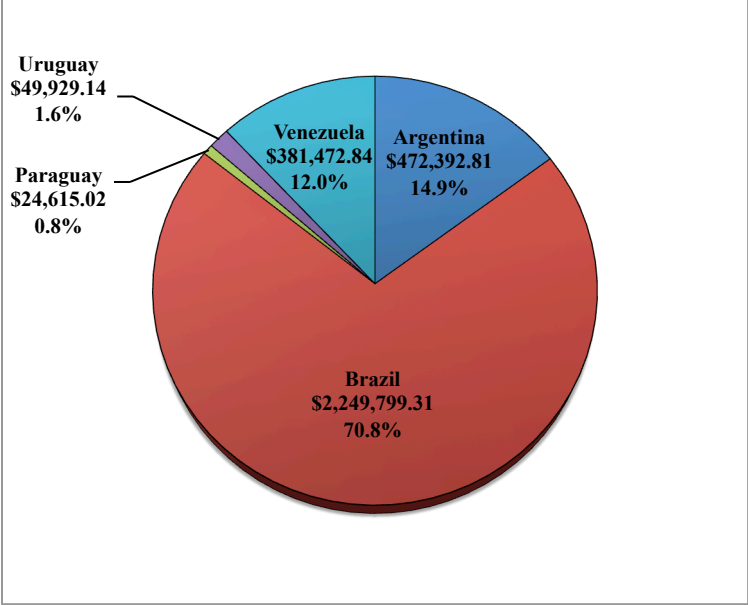
Venezuela, the newest full member of MercoSur, has many serious economic problems that pose a threat to the long-term growth of the nation. The country's dependence on oil as its key industry allows for large swings in overall economic performance. Accounting for 95% of the country's exports (CIA), a sharp drop in oil prices in 2011 sent the country into a recession. A fixed exchange rate with the US dollar has led to record inflation levels, reaching near 50% in 2014 (BBC). Public debt as a percentage of GDP has risen to 49% (IMF), raising concerns about the overall health of the country.

Overall, the economies of MercoSur fall into two distinct groups: those that continue to realize growth, and those that are struggling to maintain current economic levels. The majority of member nations have seen large increases in public expenditure and public debt in an effort to combat the effects of the economic crisis of 2010. Additionally, high inflation is a major concern for several countries and has not yet begun to subside. These factors have a large impact on the overall health and sustainability of MercoSur as an institution.

The relative size of each country's economy represents an obstacle to higher-order integration. The trade bloc is dominated by two members, Brazil and Argentina, who comprise

85% of the overall GDP of MercoSur. While this is positive in that the two countries can provide clear leadership, their dominance also reinforces the structural differences between countries, a potential problem for the continued integration of the region.

Figure 1: GDP Levels as a Percent of MercoSur, 2012



Source: IMF

Disparities between the member nations of MercoSur also pose a threat to the longevity of the organization. Varying levels of dependency on the organization can be seen through the trade intensity levels presented in Table 2. Exports to other Mercosur countries range from 13% to 85%. While import levels are more or less consistent, this data demonstrates the impact that trade within MercoSur has for each country. Such a wide range brings to mind questions of the possibility for unified goals for the future of MercoSur. It stands to reason that there could be a conflict of interest for overall goals among members: more dependent members focusing more on regional trade, while other members concentrate on the expansion of external trade agreements.



*Table 2: Trade Intensity, 1999-2001*

	<i>% Exports to Mercosur</i>	<i>% Imports from Mercosur</i>
<i>Argentina</i>	<i>30.0</i>	<i>0.9</i>
<i>Brazil</i>	<i>13.3</i>	<i>0.5</i>
<i>Paraguay</i>	<i>85.6</i>	<i>1.3</i>
<i>Uruguay</i>	<i>43.5</i>	<i>1.0</i>

*Source: Rios*

If countries cannot thrive on their own, is it possible for them to meaningful growth within the confines of a larger customs union? Furthermore, does it become the responsibility of more economically stable members to support those countries that falter?

### **Structure of MercoSur**

While MercoSur's governing institutions are not as complete as their European counterpart, the trade bloc has established several bodies to regulate policies and further encourage integration. The Treaty of Asunción in 1991 formed the basis of modern-day MercoSur, extending a previous agreement between Brazil and Argentina to also include Paraguay and Uruguay (Bakker). These four countries comprised the main member states of MercoSur until the admission of Venezuela as a full member in July 2012. Three primary institutions serve as the primary foundation of the intergovernmental organization: the Common Market Council (CMC), the Common Market Group (GMC), and the MercoSur Trade Commission (CCM).

Firstly, the Common Market Council serves as the primary political body for MercoSur. Comprised of Ministers of Foreign Relations and Economy from each member country, the CMC is considered the most powerful governmental body within MercoSur (Bakker). Its primary focus is to establish the political direction of the bloc and to serve as the primary decision-making body on general policy issues. In contrast, the Common Market Group serves as the executive branch of MercoSur, charged with implementing the policies set forth by the CMC.

The GMC is made up in large part by representatives from each member country's central bank (Doctor). Finally, the MercoSur Trade Commission establishes trade policy for the union, both internally and externally. It manages trade relationships internally between member states and also oversees external agreements between MercoSur and other countries.

In recent years, MercoSur has expanded the breadth of its governmental institutions to cover a wider range of issues. The early 2000s were marked by a period of restructuring, in which MercoSur shifted beyond trade and economy into more sociopolitical issues (Santos). In 2006, ParlaSur was created from the former Joint Parliamentary Commission, in order to address problems outside of trade, business, and the economy. More specifically, ParlaSur focuses on social issues such as education and environmental issues (Bakker). However, it has struggled to make an impactful difference, as its resolutions are nonbinding and funding for such endeavors is limited (Botto). Additionally, the parliamentary body has struggled to come to a conclusion regarding fair representation among members. The debate centers around equal representation by country, or representation based on population. The likely conclusion of this issue is that Brazil and Argentina will comprise 48% and 27%, respectively, of ParlaSur by 2015 (Bakker). Similarly, the judicial system within MercoSur has struggled to find a way to enforce its laws. Because each member state retains a high degree of autonomy, MercoSur legislation does not supersede that of an individual country, so binding resolutions must be incorporated into each country's body of laws (Doctor). As of 2004, only 48% of MercoSur legislation had actually been enforced (Bakker), calling into question the efficacy of the organization as a long-term driver for integration.

A marked difference between the institutions of MercoSur and the EU is their respective treatment of the necessity for structural adjustment. While the EU recognizes this issue, its

monetary fund for structural adjustment is largely unfunded, comprising just 1% of the European Monetary Union's overall budget (Wheelen). In contrast, its Latin American counterpart, MercoSur's Fund for Structural Convergence (FOCEM) has received significant contributions from MercoSur's member nations in an attempt to lessen the disparities between countries on several fronts, including education, healthcare, and infrastructure. Over the next ten years, MercoSur's member nations will annually contribute 100 million US dollars to the fund, with the majority of financing being provided by Argentina and Brazil (Ramon-Berjano). Disbursements will be received primarily by the remaining members for improvements to infrastructure, although the potential impact of such projects is debatable (Ramon-Berjano).

### **Challenges to MercoSur's Success**

While MercoSur has certainly come a long way since its inception in 1991, the trade organization still has challenges that it must face head-on. There are lessons to be learned by looking at the highly integrated European Monetary Union, which in recent years has struggled to deal with a deep-rooted financial crisis, stemming from structural imbalances between its member nations. MercoSur must therefore chart its own path for continued integration and hopefully avoid the problems faced by its predecessors.

The first major issue that the member countries of MercoSur must address is their continued insistence on preserved autonomy, instead refocusing their efforts on a small amount of reduced autonomy with the ultimate goal of further regional integration. Currently, MercoSur has no supranational institutions to collectively govern the member nations. In some respects, this is advantageous, as it allows a wider range of responses to economic issues. For example, a member of MercoSur that finds itself in economic distress can use both monetary and fiscal policy in an attempt to recover from the troubles at hand. This is not the case for countries within

the EMU, as monetary policy is controlled and allocated by the Stability and Growth Pact (Wheelen). However, fiscal and monetary policies are not the historical course of action for MercoSur. The economic crises of 1999 and 2002 in Brazil and Argentina, respectively, were not seen as opportunities to lean on the other members of MercoSur for support. Instead, both countries chose to return to more protectionist policies, due in large part to the extreme pressures applied by each country's population (Doctor). The devaluation of the Brazilian real saw in response greater protectionist measures by the rest of the region, as the area's most dominant player suddenly became much more competitive, due to exchange rate manipulation (Machinea). As the economies of MercoSur become increasingly more integrated, protectionism will become more and more difficult to implement effectively, instead forcing countries to rely more heavily on open trade.

Another obstacle facing MercoSur is the varying degree of dependency that each member country has on the trade bloc as a whole. As stated by Botto, "irregularities between national markets hamper growth" in the long run. This is certainly the case for MercoSur, especially when one considers the prevalence (or lack thereof) of inter-regional trade. As can be seen in Table 2, Paraguay and Uruguay are exceptionally dependent upon trade with other MercoSur members, as more than 40% of each country's exports are with other members. Argentina is similarly dependent upon the organization, with approximately 30% of trade occurring with other members. Brazil, however, is in a much different situation. Largely seen as the primary leader of MercoSur, trade with member countries represents just 10% of its total GDP (Ramon-Berjano). I would argue that this disparity is not, in reality, a purely negative characteristic of the organization. According to Grigoli, GDP growth rates between the members of MercoSur have converged over time, as the level of economic integration has increased. The author also

concludes that regional trade decreases as openness to trade increases, due to each country's increased focus on exports outside the trade union (Grigoli). These findings seem to support MercoSur's current trajectory. As can be seen in Table 2, the more globalized economies of Argentina and Brazil do indeed have a much less regional focus than their counterparts. Although there are disparities between nations, growth rates and regional dependencies should continue to converge while member nations shift their focus to newer trade partners.

A major advantage of the structure of MercoSur is its adherence to the Most-Favored Nation concept. In theory, each country's competitive advantages in trade are shared with the organization as a whole, in order to make the entire organization more competitive. Under this theory, each country follows a similar structure for tariffs and customs fees. This concept was initially enforced by the Common External Tariff of 2001 (CET), which by 2006 covered 85% of the region's traded goods, while 95% of trade between member nations fell under a free trade area (Doctor). Despite the success of the CET, it was replaced with a more complete customs code that was signed in 2010. The new customs code ensures a 1-time-only customs duty within MercoSur, eliminating dual customs charges for transporting between member nations (Ramon-Berjano). This simple alteration to MercoSur's import policy makes the region much more attractive to external trade partners because of an immediately lower cost of importation. The European Union, previously reluctant to sign a bilateral trade agreement with MercoSur, has showed renewed interest in the trade bloc as the area becomes a more attractive trade partner (Ramon-Berjano). The continued institutional development of MercoSur makes it more competitive on a global scale, deepening the prospects for further external trade.

With that said, it is important to note the difficulties of actualizing bilateral trade agreements. The current structure of MercoSur requires a unanimous vote on new trade

agreements (“Brazil Seeks...”). Indeed, this requirement extends to several areas of the organization, raising questions of MercoSur’s ability to reach meaningful decisions in the future. As MercoSur continues to expand (with Venezuela becoming a full member as of July 2013), a unanimous vote becomes increasingly more difficult, especially given the high degree of autonomy retained by each member country. If any current member felt that a trade deal would violate its own interests for the betterment of the organization as a whole, it is entirely plausible that the measure would be vetoed. The unanimous vote also stands in the way of continued integration. Moving forward, it stands to reason that at least some degree of independence should be relinquished in order to reduce barriers to trade and simultaneously make the region a more attractive trading partner.

### **Recommendations and Conclusion**

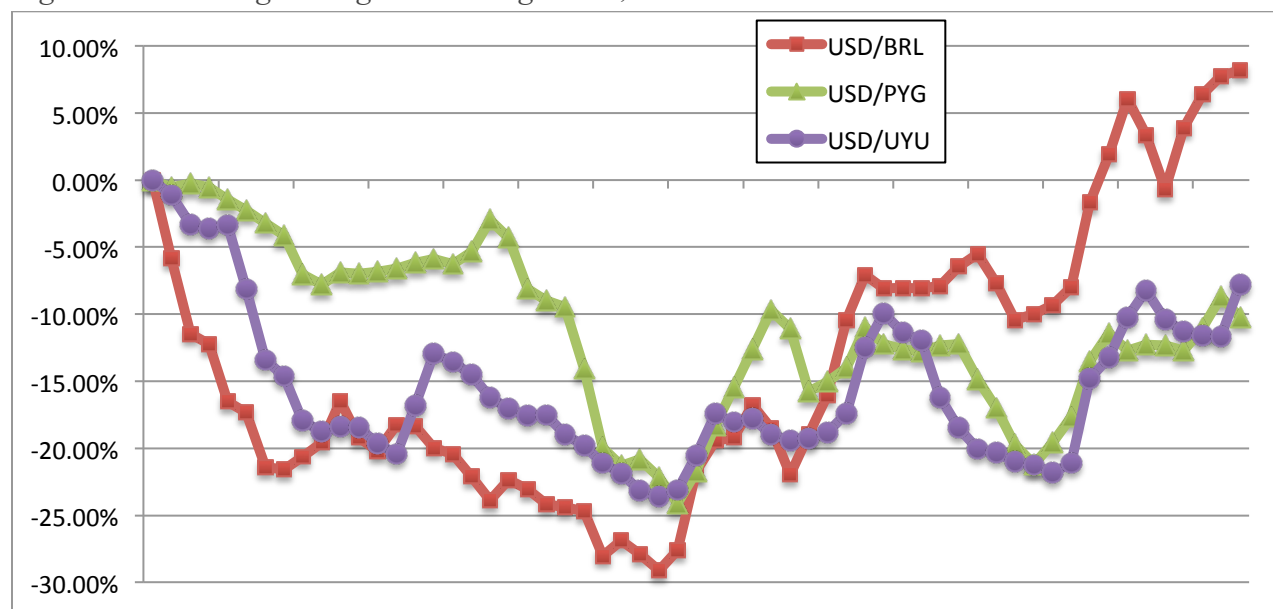
As MercoSur looks to the future, there are several key takeaways from the information presented in this paper. First, the organization must look to strengthen its weakest structure: ParlaSur. In order to move toward a more integrated future, it is necessary that the citizens of MercoSur be placed on equal footing. Educational standards are already in place to reduce the disparity between nations, but more social policies must be enacted to further lessen social differences. The introduction of unified policies that deal with labor relations, wage rates, and other issues would do much to create a more standardized base for human capital across the region.

In addition, MercoSur should look to continue expanding its external trade agreements over time. As discussed by Grigoli, business cycle integration improves with the expansion of external trade. This in turn reduces the trade differences between member nations, allowing for smoother and more effective integration. Given MercoSur’s history of increased protectionism in

times of economic hardship (see Argentina in 1999 and Brazil in 2001), this issue should also be addressed. Rather than relying on individual protectionist policies, inter-regional barriers to trade should be virtually eliminated, instead focusing on the use of the Customs Code of 2010 to protect industry across the region when necessary. To aid in the transition to greater utilization of Customs Code, the FOCEM can be utilized to make structural adjustments between countries. Its large budget makes the FOCEM a great tool to continue the convergence of economies throughout MercoSur.

Finally, monetary integration in MercoSur is a distant possibility, contingent upon several conditions that serve to lessen the structural differences between member countries. Exchange rates should begin to converge within the region, and should ideally follow the same trends over time. This can be achieved with greater external trade integration as the region becomes more dependent on external trading partners. Greater dependency on foreign trade partners creates greater dependency on global economic outlook. This dependency is translated into the expectations and valuations of each country's exchange rate, which should create greater alignment for exchange rate fluctuations within MercoSur. Indeed, this seems to be the case for several of the currencies within Mercosur, as can be seen in Figure 2. It seems that the currencies of Brazil, Paraguay, and Uruguay have roughly followed similar trends over the past five years. In spite of following similar trends with the rest of the region, Brazil has encountered inflation beyond that of Paraguay and Uruguay. Argentina has seen consistent inflation that has outstripped all of the other freely-floating exchange rates within the organization, ending 113% above its value in March of 2009. For this reason it has been omitted from the table, in order to better show the similar trends within the region.

Figure 2: Percentage change in exchange rates, March 2009 - March 2014.



Source: [www.oanda.com](http://www.oanda.com)

If large fluctuations in exchange rate valuations cannot be mitigated by increasing external trade, there is the possibility of a banded exchange rate regime. Machinea asserts that this policy is the most suitable alternative if currency integration is not possible. However this approach should be considered with caution, as Venezuela has adopted a fixed exchange rate with the US dollar and has since seen high levels of inflation, in spite of multiple currency devaluations over the past several years. In theory, adopting similar exchange rate regimes across the organization controls for large exchange rate fluctuations, leading to greater stability in relative prices across the region.

Monetary integration is also dependent upon the consistency of interest rates and inflation rates across the organization. These measures are extremely important if MercoSur is ever to transition to a supranational central bank, so that financial disparities between countries are minimized. MercoSur set an inflation ceiling of 4% for the region (Machinea), which seems plausible for an organization comprised of developing countries. Although it is above that of the European Union, one must consider that developing countries would normally experience greater



inflation as GDP increases. Most importantly, a cap should be placed on the debt to GDP ratio for each country. The wide range of debt to GDP percentages can be seen in Table 3, yet another structural difference between member countries. The European Union placed a cap at 60% of GDP, however this was not strictly enforced. It is *imperative* that debt ratios be managed in order to minimize the likelihood of default and the ensuing reliance on other countries for financial support. The disregard of this condition within the European Union was a large contributing factor in the extensive debt crisis of the late 2000s.

*Table 3: Public Debt to GDP ratio*

Argentina	Brazil	Paraguay	Uruguay	Venezuela
44.2%	66.2%	13.5%	54.1%	45.5%

*Source: IMF*

Admittedly, integration is a slow process that requires compromise from all sides in order to progress effectively. However, integration can be achieved if the best interests of the whole are kept at the center of debate. The European Union is an effective model to use when looking to structure a highly integrated region, but its power comes not only in the example it has set, but also in the pitfalls it has encountered along the way. The continued integration of MercoSur is challenging, but incredibly possible thanks to the lessons learned by the European Union.

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