Mercosur: past, present, and future

Paulo Paiva
Vice President for Planning and Administration
Inter-American Development Bank

Ricardo Gazel
Economic Advisor
Inter-American Development Bank

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Abstract

In March 2003, the Southern Common Market (Mercosur) celebrated its twelfth anniversary. In twelve years, the bloc went from a substantially restricted trade structure to a practically free-trade area, with additional efforts in establishing a customs union and progressing toward a common market. Despite these advances, the integration process has experienced setbacks as the result of such different economic phenomena as the Asian financial crisis, Brazil's currency devaluation and, later, economic uncertainty in Argentina. Setbacks to the integration process create credibility issues and could jeopardize the future of the process. This paper discusses the current level of economic integration of Mercosur, the speed of the process, and the resulting mixed level of different stages of economic integration. It also discusses the main achievements in the last twelve years, identifies the shortcomings as well as the opportunities and challenges facing the bloc in the near future.

Resumo

Em março de 2003, o Mercado Comum do Sul (Mercosul) celebrou seu décimo segundo aniversário. Em doze anos, o bloco passou de um arranjo comercial bastante restrito para, praticamente, uma área de livre comércio, com esforços adicionais no sentido do estabelecimento de uma união alfandegária e da progressão em direção a um mercado comum. Apesar destes avanços, o processo de integração sofreu retrocessos em função de diferentes fenômenos econômicos, como a crise financeira asiática, a desvalorização da moeda brasileira e, posteriormente, a incerteza econômica na Argentina. Os retrocessos para o processo de integração criam problemas de credibilidade e poderiam ameaçar o seu futuro. Este artigo discute o nível atual de integração econômica do Mercosul, a velocidade com que este processo ocorreu, assim como os diferentes estágios de integração econômica que coexistem atualmente como resultado da rapidez deste processo. Discute também as principais realizações nos últimos doze anos, identificando os problemas bem como as oportunidades e desafios que o bloco tem diante de si no futuro próximo.

Palavras-chave
Mercosul, integração econômica, política comercial, globalização.

Classificação JEL *F02, F13, F15.*

1_ Introduction

In March 2003, the Southern Common Market (Mercosur) celebrated the twelfth anniversary of the signature of the Treaty of Asunción, which laid the foundations for the economic integration between Argentina, Brazil, Paraguay, and Uruguay.[1] In these twelve years, the trading bloc was tremendously successful in reducing tariff and nontariff barriers and increasing intrabloc trade up to 1998.[2] Additionally, the group as a whole has reduced tariffs and nontariff barriers to trade with countries outside Mercosur and has moved in the direction of a customs union thanks to the negotiation and implementation of a large percentage of common external tariffs.

Despite these advances, the integration process has experienced setbacks as many integration processes before it. At a more global level, reviewing the historical lessons of previous global economic integration waves, James (2001) outlines three interpretations – self-destruction, backlash, and weaknesses in institutional regulations – related to the end of those globalization processes.[3] He defends the idea that resentments against the three major components of globalization (capital flows, trade, and international migration) were among the major reasons (protectionism, nationalism *etc.*, largely rejecting the principles of globalism) that resulted in the Great Depression. He raises the question whether the failure (and riots as well) of the World Trade Organization ministerial meetings in Seattle in November 1999 set the tune for the new century and concludes that

> *at present there is the beginning of an antiglobalist coalition, based on hostility to immigration (because of concerns about the labor market), a belief in capital controls (in order to prevent shocks emanating from the financial sectors), and skepticism about global trade.* (James, 2001, p. 223).

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

2 The intrabloc trade jumped from 9 percent of total exports in 1990 to a quarter of the group's total exports eight years later but declined substantially after the Asian crises, the Brazilian currency devaluation and, more recently, the Argentinean crisis. Preliminary data for 2002 and 2003 show some improvement in the intrabloc trade.

3 As the title of his paper indicates, "The End of Globalization, Lessons from the Great Depression", he gives special emphasis on the great globalization wave of the end of the nineteenth century that culminated with the Great Depression, heavy protectionism, and nationalism of the interwar period.

He argues that these manifestations have produced neither a coherent "intellectual cement" against globalization nor a specific model of national success, and the absence of these two features

> *explains why the pendulum is so slow in swinging back from globality. But it does not and cannot explain why it will not swing.*

Not differently from the more global trends discussed by Harold James, the integration process of Mercosur has experienced setbacks as the result of such different economic phenomena as the Asian financial crisis, Brazil's devaluation of its currency and, later, economic uncertainty in Argentina. Setbacks to the integration process create credibility issues and could jeopardize the future of the process. Additionally, it is not clear what consequences the global trends discussed by James (recent breaking down of the World Trade Organization talks in Cancun and the difficulties associated with the negotiation of the Free Trade Area of the Americas – FTAA) will have on Mercosur as member countries may be tempted to negotiate bilateral agreements with other countries or move further into negotiations as a cohesive bloc. In this paper, we discuss some of these issues.

The rest of the paper is organized as follows. Section 2 discusses the current level of economic integration of Mercosur, focusing on how the development strategy shifts from import substitution to more open economies in the 1980s, influenced the speed of the process and resulted in a mixed level of different stages of economic integration. In Section 3, we discuss the main successful achievements in the last twelve years, while Section 4 identifies the shortcomings. Section 5, deals with the opportunities and challenges facing the bloc in the near future and, in Section 6, some tentative conclusions are drawn.

2_ Mercosur: partners of all sizes

The four full members and two associate members of Mercosur represent 67% of Latin America's land area, 47% of its population, and more than half of its gross domestic product. Although these are impressive numbers, they hide substantial differences among Mercosur members. For example, although the bloc represents two thirds of Latin America's total area, Brazil alone accounts for over 40 percent of the entire region, while Uruguay represents less than one percent.

Similarly, Brazil contributed close to 37 percent and 38 percent of the region's GDP in 1998 and 2001, respectively, compared with less than one half of one percent by Paraguay in both years. In other words, there are various and significant differences between member countries, as shown in Table 1.

3_ Mercosur: free trade area? Customs union? Common market?

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

It is important to note that Latin America in general, and Mercosur members in particular, embarked on economic integration into the world economy (as well as more effective intraregional integration) only recently, specifically in the last two decades. Before this change in development approach, most Latin America countries adopted a more closed-economy development strategy, known as "industrialization via import substitution."

3.1_ The import-substitution model

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

Table 1_ Land, population, and GDP by Country

	Land		Population – 2000		GDP – 1998[1]		GDP 2001[1]	
	in km^2	% of LatAm	in '000s	% of LatAm	Constant 1995 US$ millions	% of LatAm	Constant 1995 US$ millions	% of LatAm
Argentina	2.780.400	13,50	37.032	7,30	281.450,20	14,78	257.723,50	12,94
Brazil	8.511.965	41,40	170.693	33,60	703.647,60	36,96	749.505,70	37,64
Paraguay	406.752	2,00	5.496	1,10	8.594,00	0,45	8.737,00	0,44
Uruguay	177.414	0,90	3.337	0,70	20.517,70	1,08	18.780,20	0,94
Bolivia	1.098.581	5,30	8.329	1,60	7.727,00	0,41	8.036,00	0,40
Chile	756.626	3,70	15.211	3,00	84.953,20	4,46	90.622,20	4,55
Mercosur	13.731.738	66,80	240.098	47,30	1.106.890,00	58,14	1.133.405,00	56,91
Rest of Latin America	6.814.350	33,20	267.832	52,70	796.849,20	41,86	858.090,70	43,09
Latin America	20.546.088	100,00	507.930	100,00	1.903.740,00	100,00	1.991.496,00	100,00

Note: (1) Data from the Anuario Estadístico de América Latina y el Caribe 2002, CEPAL.

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

The import substitution model was unsustainable and ultimately led to a widespread economic crisis in the 1980s, with growing budget and trade deficits, accelerating rates of inflation, and recession. Many Latin American countries experienced the worst of two worlds, economic recession and high rates of inflation. At the same time, the world economy was moving towards higher levels of economic integration, with increasing cross-countries flows of capital, trade, and labor (migration). This process has become known as globalization.

3.2_ Recent changes in economic development strategy

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

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

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

Figure 1_ A taxonomy of economic integration by selected features

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

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

As latecomers to the game, Mercosur members speeded up their economic integration process in an attempt to catch up with the rest of the world. Accordingly, the bloc currently has characteristics of a free trade area, a customs union, and some advances toward a common market, but none of these stages are completely consolidated.[4] Some of these characteristics are as follows:

4 For example, in April 2001, Domingos Cavallo, then the Argentinean Finance Minister, increased tariffs on imported consumer goods to an average of 35% and unilaterally decreased tariffs on imported capital goods to zero, departing from the bloc's common external tariffs. These actions are supposed to be temporary.

Free trade area

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

Customs union

_ common external tariff structure introduced in 1995. Capital goods and many electronic goods were not included in the common external tariff schedule (for some goods and some countries, it is expected to converge by 2006);

_ a common antidumping legislation has been developed and is being evaluated.

Common market

_ labor mobility is quite restricted;

_ the Protocol of Montevideo – phased out restrictions on trade in services (10 years) and faster for financial services, air transportation, satellite communications, insurance, and professional services (all under negotiation);

_ 1998 – a memorandum of understanding called for mutual recognition of university diplomas – full implementation would allow university graduates to work in any member country (including Bolivia and Chile) . It will require a common standard to evaluate the quality of universities;

_ in 1999, Brazil and Argentina established groups to study the coordination of macro policies – harmonize statistical data and methodology of economic indicators;

_ a "small Maastricht Treaty" has been thought in order to establish fiscal balance among members. Fiscal responsibility laws in Brazil and Argentina.[5]

4_ Successful outcomes

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

4.1_ Increased intraregional trade and investment flows

Economic integration brought an impressive surge in intrabloc trade flows, an increase of close to fivefold between 1990 and 1998. As shown in Table 2, intragroup exports (only the four full members) jumped from less

[5] Fiscal responsibility laws are in the agenda of the new government in Paraguay.

than 9 percent of the bloc's total exports in 1990 to 25 percent in 1998. From 1999 to 2002, due to the contagion effect of the Asian crisis in 1998 and subsequent Brazilian devaluation of the real and, more recently, the crises in Argentina, the intrabloc share of total exports declined substantially to a low 11.3% in 2001. The jump in the share of total exports for the 1990-1998 period was the result of a much higher growth rate in intrabloc exports compared with exports outside the bloc. From 1990 to 1998, total exports increased by 75% representing a growth of 44% for exports to countries outside Mercosur and an astonishing rate of almost 400% growth for intrabloc exports. However, this trend slowed dramatically and, for the 1990-2001 period, total exports increased by 82% with a 77% increase in exports to countries outside Mercosur and a 131% increase in exports within Mercosur. The years 2001 and 2002 are likely to represent the bottom of this trend and preliminary data show that conditions were improving in the first half of 2003. For example, intrabloc exports increased by more than 15% in the first half of 2003 compared to the same period in 2002.

Table 2_ Exports within and outside Mercosur – 1990-2000 US$ millions

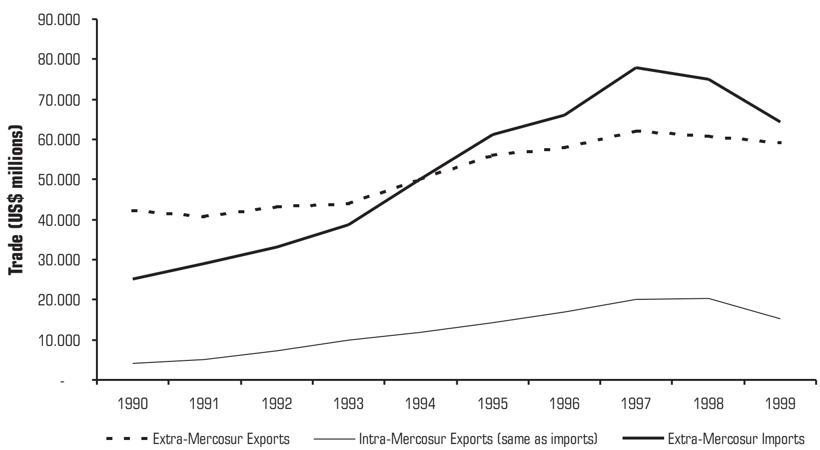
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total	46,402	45,891	50,463	54,122	62,113	70,402	74,998	82,342	81,323	74,320	84,659	84,279
% growth	-0.3	-1.1	10.0	7.3	14.8	13.3	6.5	9.8	-1.2	-8.6	13.9	-0.4
Outside Mercosur	42,275	40,788	43,246	44,095	50,157	56,019	57,960	62,289	60,972	59,158	66,961	74,742
% growth	-1.0	-3.5	6.0	2.0	13.7	11.7	3.5	7.5	-2.1	-3.0	13.2	11.6
Within Mercosur	4,127	5,103	7,216	10,026	11,957	14,384	17,038	20,053	20,351	15,163	17,698	9,537
% growth	7.6	23.6	41.4	38.9	19.3	20.3	18.5	17.7	1.5	-25.5	16.7	-46.1
Intra/Total	8,9	11,1	14,3	18,5	19,3	20,4	22,7	24,4	25,0	20,4	20,9	11,3

Source: IDB Periodic Note on Integration and Trade in the Americas, December 2002.

A very important point to make here is that, although intrabloc trade flows increased substantially since Mercosur came into existence, the evidence suggests that the preferential regional agreement did not result in a large trade diversion as one might have expected. As shown in Chart 1, total imports by Mercosur members increased proportionally more than total exports and, more importantly, imports from countries outside the bloc grew strongly as well. The process of regional trade liberalization took place in a context of overall trade liberalization (open regionalism), which reduced the likelihood of trade diversion. The unilateral trade liberalization registered in the past decades was part of the overall opening of the region's economies and the new economic development strategy. For example, as Devlin and Ffrench-Davis (1998) observe

> *the average tariff for Latin America and Caribbean has declined from 45 percent in the second half of the 1980s to 13 percent in 1995, accompanied by a sharp reduction of tariff dispersion as well. Furthermore, over the same period the share of the region's imports subject to non-tariff barriers declined from 31 percent to 11 percent.*

Chart 1_ Extra and intra Mercosur trade flows



Source: CEPAL – Anuario estadístico de América Latina y el Caribe, various issues.

Additionally, there was an increase in intraregional investment flows. Bonelli (2001) argues that

> *one of the most important consequences of Mercosur integration was the increase in the levels of direct foreign investment (DFI) in the region, particularly between Argentinean and Brazilian firms.*

He adds that recent studies (before the change in the Brazilian exchange rate regime) show that

> *the DFI flows between the two countries increased by the end of the decade compared to the rest of the 1990s,*

and that

> *the increases in DFI are substantially higher than the increase in trade flows between the two countries.*

4.2_ A common external tariff structure

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

4.3_ Harmonization of macroeconomic policy

The process of harmonizing macroeconomic policy is a necessary condition, although not sufficient, to establish a common market and to consolidate the integration process. In addition to the steps towards harmonizing economic statistics, the December 2000 meeting of ministers of economic affairs and presidents of central banks of the full and associate member countries of Mercosur established concrete common macroeconomic targets for the near future. For instance, they agreed on a maximum inflation target of 5% for the period 2002-2005, and starting, in 2002, a budget deficit of no more than 3% of GDP and a suggested ratio of public debt to GDP of no more than 40%. Moreover, both Brazil and Argentina have passed fiscal responsibility legislation in an attempt to restrain fiscal deficits.

4.4_ Consolidation of the democratic process

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

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

4.5_ Negotiating bloc

One other important gain has been the increased bargaining power that the Mercosur countries acquired as a bloc to negotiate trade agreements with other countries. Good examples of such gains are the "Four plus One" talks with the United States, the talks with the EU and the discussions on the Free Trade Area of the Americas (FTAA). In other words, the Mercosur has a political dimension which transcends the commercial dimension. Currently, the Mercosur can be a very important tool for Argentina, Brazil, Paraguay, and Uruguay to negotiate their insertion as well as to create a path for the insertion of Latin America within the realm of the FTAA, EU, and WTO. In one of the last Mercosur summits, the presidents of the member countries have decided to negotiate with the EU and FTAA as a single bloc. This shows that, despite the transitory difficulties, which can harm trade relations within the bloc, political relations are deeper and more stable.

5_ Shortcomings

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

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

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

6_ Unfinished business: opportunities and challenges for the future

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

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

Temporary setbacks in the process of economic integration create tension between members and can damage the long-term credibility of the integration scheme and, if they persist, can threaten its very survival. Thus, the lost of credibility is maybe the worst problem member countries can encounter in their economic integration process. Iglesias (2000) suggests that "*launching an integration initiative is easier than sustaining it*." Talking about integration initiatives prior to the 1990s, he recalls that

> *while not without their achievements, none of the early initiatives fully realized their ambitious objectives,*

and adds that

> *indeed, all these early post-war agreements lost momentum during the late 1970s and fell into open crisis in the 1980s.*

As discussed above, when governments face external (or internal) economic problems resulting in relatively large trade deficits, they generally also face pressures to raise tariff and nontariff barriers to reduce imports and/or increase exports. They must decide whether short-run political gains of raising tariff and nontariff barriers are larger than long-run economic losses.[6]

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

7_ Escape clauses: flexibility within the agreement

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

Some scholars argue that the flexibility of the Mercosur agreement, the lack of a large bureaucracy, formal safeguards, and escape clauses helped the free-trade zone to flourish in its first years of existence (Baumann, 2001). There is merit in this argument as the success of Mercosur in the last ten years suggests that, at least in that case, the lack of a formal and more rigid structure seemed to serve the integration process well. However, this more flexible approach has also a cost for the integration process. Some issues related to it are worth mentioning.

First, a flexible approach lacking more formal structures to settle disputes and especially escape clauses to deal with temporary imbalances in trade flows seems to work better in the first years of trade liberalization, when the core of integration is focused on tariff reductions. At higher levels of integration, when more complex negotiations take place and more is at stake, a more formal structure with clear rules seems to be more efficient to

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

avoid conflicts and maintain the credibility of the integration process.[7] Furthermore, flexible approaches have not passed the test of crisis and prolonged recession. For example, as long as Mercosur economies were experiencing economic growth and the exchange rate regimes in Brazil and Argentina were following similar patterns, the flexible approach worked well. As a matter of fact, it was with the Asian financial crisis and its contagion effect that resulted in recessions and the Brazilian devaluation of the real that problems have intensified. In the absence of a formal structure to deal with imbalances in trade flows, unilateral moves have created tensions and put into question the credibility of the integration process and, consequently, the future of the customs union and common market.

8_ Harmonization of macroeconomic policy

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

9_ Setbacks: increasing economic costs and decreasing political gains

It has been noted before that frequent setbacks in the liberalization scheme bring a loss of credibility to the entire integration process. It has also been argued that governments have an incentive are inclined to used use tariff and nontariff mechanisms when faced with trade flow imbalances if the political gains in the short run are perceived to be higher than the costs

7 The most successful integration processes such as that of the European Union and, up to certain degree that of NAFTA, have more formal structures and mechanisms to deal with trade disequilibrium problems.

associated with those actions. Thus, a natural way to avoid potential setbacks is to reduce potential gains and/or increase the costs of such measures. As for perceived political gains, unless there is a major change in the economic perception of the population and people become free-traders, not much can be done in that area. However, there are many routes to increase the associated costs and thus reduce the likelihood of frequent setbacks and their negative impacts on the integration process credibility.

10_ Going beyond a free trade area

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

11_ Increasing the depth of micro integration

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

Although there was an increase in cross-country investments, they do not seem to be high enough to exercise a strong deterrence effect on trade policy setbacks. However, as they become more prominent, this new business ownership structure can play an important role not only in the short-run increased costs of setbacks, but also in the long-run integration scheme, as they would provide more support for deeper levels of integration.

12_ Increasing the group size: SAFTA – South American Free Trade Area, FTAA – Free Trade Area of Americas, EU – European Union, WTO – World Trade Organization?

The costs associated with adopting trade-restricting policies for a member of a trade preferential area are relatively proportional to the economic size of the area. For example, a member country of the WTO would face a much higher cost in raising protection barriers unilaterally and outside the organization's parameters. The probability of retaliation or exclusion from such a large club has a deterrence effect.[8] Similarly, one did not observe setbacks in NAFTA (North American Free Trade Agreement) as Mexico slid into crisis in the 1990s.

Undoubtedly, if it is successfully negotiated and implemented, a larger free-trade area will work as a deterrent to setbacks in the trade liberalization process. These results should be expected of a free-trade agreement negotiated with the rest of South America, FTAA or EU. But, in such cases, what would happen to Mercosur? Would it disappear as a separate entity? It certainly would if the bloc did not consolidate to a level of economic integration above the free-trade area. As a free-trade area, Mercosur would make no sense within a larger free-trade area. However, if the bloc established a full customs union and advances into a common market, it would not be incompatible with a larger free-trade area. To be sure, currently, the core Mercosur nations (Argentina, Brazil, Paraguay, and Uruguay) have moved beyond a free-trade area (as they has partially adopted a common external tariff and other features which go beyond a simple free-trade area agreement), although they are still within a larger free-trade area (*i. e.*, the core Mercosur plus the associated members – Bolivia and Chile).

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

A South American free-trade area, FTAA or a Mercosur-EU free-trade area are likely to improve credibility of the integration process in the Southern Hemisphere if Mercosur can go beyond the free-trade area status before implementing those larger agreements. As a matter of fact, if Mercosur remains cohesive and negotiates those agreements as a bloc, the negotiation process *per se* would improve the bloc's credibility as an important economic integrated area.

The current uncertainty is related to what path the member countries will take as WTO and FTAA negotiations become more difficult. Are they going to remain together to negotiate as a bloc and, at the same time, deepen their trade levels and strengthen their integration at all levels including infrastructure, *etc*.? Or will member countries negotiate bilateral agreements with other countries and somehow weaken the bloc as a negotiation tool? Will Mercosur strengthen its links with the rest of South America, especially via infrastructure (transportation, energy, telecommunications) creating, in this way, better conditions for further economic integration?[9] There are many uncertainties, many questions to be answered, many challenges to be faced within a historical context of appealing protectionism due to recent crisis and setbacks.

13_ Conclusions

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

It was argued that, in general, setbacks to integration processes are the result of a cost-benefit analysis by governments facing balance of payment problems. On the benefit side, in the absence of a complete change in the economic culture with voters becoming free-traders, it is difficult to avoid setbacks as it is difficult to decrease perceived political gains of raising tariff and nontariff barriers to trade. On the cost side, however, there are different alternatives that can increase the relative costs of setbacks if they are

[9] For example, between August 30 and September 1st, 2000 the presidents of all South American countries met in Brasilia for the first time in the region's history. Additionally, under the leadership of President Lula, the region has continued the dialogue of further integration in different fronts.

implemented and thus contribute to build credibility and improve the chances of consolidating and expanding an economic integration process. Among others, the negotiation and implementation of escape clauses to deal with temporary trade imbalances, harmonization of macroeconomic policy so as to converge policy responses to crisis, achieving higher levels of economic integration, increasing the depth of microeconomic integration, and expanding the size of the trading bloc are some initiatives that could improve the chances of success of an integration process. These types of initiative may help to consolidate Mercosur, especially since the current strong economic uncertainties will certainly test the political commitment of Mercosur members to their integration efforts.

Mercosur members – as other countries in the world – face the challenges outlined by Harold James, the dichotomy between integration (action) and protectionism (reaction). Within the global scenario, it is not clear whether the difficulties of larger trade negotiations (FTAA, WTO) would strengthen or weaken the smaller, regional trade agreements. It is not clear whether a wave of protectionism would occur and, if it does, whether it would be circumscribed to large, multilateral trade agreements or include all types of economic integration. In any case, the levels of credibility achieved by Mercosur could make a difference. If members believe in the long-term benefits of Mercosur, an orchestrated effort to increase the credibility of the agreement must be a priority if it is to survive.

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Author's e-mail:
ppaiva@iadb.org
ricardog@iadb.org