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# MERCOSUR: IN SEARCH OF A NEW AGENDA

## Rapporteur's Report

Andrew Crawley

*Special Initiative on Trade and Integration*

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This Working Paper was prepared as part of the Inter-American Development Bank's Special Initiative on Trade and Integration, approved by the IDB's Board of Executive Directors and managed by the Integration and Regional Programs Department. The goal of the Special Initiative, which began in 2002, is to enhance the Bank's capacity to: (i) contribute to the policy debate on integration and trade; (ii) provide technical support to governments; and (iii) support public outreach on trade and integration initiatives.

This document is part of the Initiative's first component.

This study was presented in the conference "MERCOSUR: In Search of a New Agenda", which was held in the Getulio Vargas Foundation in Rio de Janeiro in June 2003. In view of the trends in emerging policies, which point to a renewed interest in furthering the initiative after the turbulence of the 1999-2002 period, the aim of the meeting was to discuss activities in the various areas geared to deepening the integration process. The preparation of the documents and the conference were supported by Inter-American Development Bank's Integration and Regional Programs Department through the Special Initiative on Trade and Integration.

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# MERCOSUR: IN SEARCH OF A NEW AGENDA

## - RAPPORTEUR'S REPORT -

Andrew Crawley\*

### I. INTRODUCTION

MERCOSUR made substantial achievements in a short period. There was a great deal of liberalization; intra-regional trade increased significantly; a certain sense of regional belonging was inculcated among national publics; and the regional project served as a pretext for national adjustments. Inconsistencies nonetheless persisted between the project's goals, on the one hand, and its institutions and mechanisms on the other; there have been persistent gaps between rhetorical aims and concrete practices; and by the turn of the present decade various subregional crises seemed to call MERCOSUR's relevance into question. Against that background the Inter-American Bank and the Getulio Vargas Foundation organized a seminar in Rio de Janeiro on June 5 and 6, 2003. The meeting brought together a small group of trade and integration specialists to examine the bloc's achievements and problems thus far, and to debate possible elements of a new subregional agenda.

Full versions of the papers presented at the seminar are available separately in this Working Paper Series, namely: WP-SITI-06b "Mercosur's Insertion into a Globalized World", by Juan Ignacio García Pelufo; WP-SITI-06c "Mercosur: Dilemmas and Alternatives for the Trade Agenda", by Sandra Polónia Rios; WP-SITI-06d "Exchange Rate Instability in Mercosur: Causes, Problems and Possible Solutions", by José Luis Machinea; and WP-SITI-06e "Mercosur's Institutionalization Agenda: the Challenges of a Project in Crisis", by Pedro da Motta Veiga.

Throughout the various sessions of the event, moreover, a number of issues recurred in different contexts and were debated from different angles. For those reasons, in general terms this report on the seminar attempts neither a comprehensive summary of each paper nor a session-by-session synthesis of the proceedings. Rather, it takes a thematic approach in an effort to demonstrate which issues emerged as particularly significant in the flow of debate, which arguments were accorded the greatest validity, in which area divergences were apparent, and where the grounds for consensus lay. In outlining the debate in this way, every effort has been made to avoid taking individual viewpoints out of context, while including those opinions in the overall thematic structure.

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## II. DEVISING A NEW AGENDA

MERCOSUR, as all speakers at this seminar acknowledged, is not in good health. Brazil has preserved stability but remains vulnerable to the fortunes of world financial markets. The other members are in recession. Indeed, according to one speaker, since 1999 the bloc has been moving in a direction opposite to integration. Broadly speaking, the member countries' responses to the economic challenges of the late twentieth century remain valid, but it seems clear that MERCOSUR needs a new agenda if it is to remain viable in the future: the danger that it might become irrelevant was a concern voiced by several speakers. To remain relevant the bloc must deepen by avoiding its earlier mistakes, by revising the former methodology of integration and, above all, by overcoming its own inconsistencies.

The twelve years of experience since the conclusion of the Treaty of Asunción have helped nourish a debate on what the new agenda should be, and it was maintained at this seminar that the determinants of that new agenda will essentially be three-fold:

- *The regional and extra-regional environment.* In this regard the conditioning factors have altered little in the past decade, and it seems unlikely that they will change significantly in the near future. These determinants of the new agenda, in short, will be the same as in the past.
- *The attitudes of subregional elites* towards the strategies adopted to ensure their countries' international insertion. Such attitudes were said to be fairly stable in the area of trade: the external circumstances are unchanged and the strategies deployed to adapt to them will be similar. International financial insertion, however, could pose problems inasmuch as the outlooks of the two larger partners differ from each other in this respect.
- *The experience to date.* There are three considerations to be noted here. First, the member countries have vivid memories of recurrent trade conflicts, and of the inadequacy of prevailing institutions and regulations to mediate them effectively. Second, they recall with equal sharpness the devastating impact of exchange rate volatility and the incompatibility of exchange rate regimes. Third, certain structural characteristics of the member states, such as size asymmetries and the absence of a common reference currency, will also shape the future agenda.

Against that background, the message that emerged from the various presentations and discussions at this seminar was that the future agenda for deepening the Southern Cone integration process will center on certain core elements: elimination of major non-tariff barriers, institutional arrangements and the system for making rules; the forging of a common vision of what MERCOSUR is and where it is going; exchange rate questions and macroeconomic coordination; and the formulation of a common trade program.

Such an agenda entails a reconsideration of the primacy thus far accorded to the completion of the customs union. From the Protocol of Ouro Preto in December 1994 to the present day, tariff harmonization was said to have been the main item (often the only item) on MERCOSUR's agenda. This is perhaps explained by the constant tendency to refer to the European model as a guide to the process in the Southern Cone. The European Union (EU) is often cited as a reference point for MERCOSUR, but to many participants it seemed time for the bloc to find its own path. According to the European model, a customs union is a second stage of integration and it must be completed before the process can advance to the next stage - a common market.

Complete tariff uniformity in MERCOSUR, however, will be politically difficult to attain in the short term, largely because of the role played by tariff disparity in the smaller countries and the opposition of significant sectors in the bigger members. In the meantime, attention could usefully focus on other key elements of a new agenda. One of the most important issues to be addressed in that regard relates to the divergent attitudes to integration that are attendant on size asymmetries.

### III. SIZE ASYMMETRIES AND DIFFERING OUTLOOKS

A constant theme of the seminar discussions, repeatedly adduced to explain subregional difficulties in the institutional, macroeconomic and external negotiating arenas, was the different national attitudes to Southern Cone integration that arise from size asymmetries among the member states. The reiterated argument was that the effects of size asymmetries are reinforced by certain subregional elite attitudes that are inconducive to deeper integration. Brazilian elites in particular, it was argued, have been reluctant to cede significant autonomy to smaller partners. The country has been willing to renounce some independence in the area of international trade; but it has resisted being subject to rules that might entail an irretrievable loss of that independence, and has always sought to make such rules a target of continuous modification in a negotiating process wherein it is the dominant player.

Differences in size and economic structures among the members give rise to asymmetric interdependence. The smaller partners have a greater reliance on neighboring markets than the larger members, and are affected much more by the latter's economic policy decisions. A devaluation in a large country can cause havoc in a small one; the provision of state aid to certain sectors in a bigger partner can undermine an entire sector in a small country. Thus each country's incentives to put an issue on the regional agenda differ markedly. The smaller countries, for example, have stronger reasons to include issues that reduce national autonomy in policymaking. This circumstance is complicated by a Brazilian tendency to regard MERCOSUR as a contingency, as one option among others, a view that constrains a truly regional approach.

Simply put, the member states have divergent perspectives of how they are to project themselves on the world stage, and their inhabitants have different views of themselves and their countries' international role. As argued at this seminar, it is not essential that the members all share the same national strategies, but it is crucial that the strategies be consistent, and that they conform to a matrix of complementary interests. This is a difficult undertaking, since the determinants of the strategies change according to national, regional and international circumstances. In this view, unchangeable and *de facto* asymmetries are less important than asymmetries in *policy*. MERCOSUR's problem in this regard is not geographic but political: countries have not done what they pledged to do, because domestic agendas took primacy over the regional project. This has constrained the institutional development necessary for tackling new issues as the process evolved.



#### IV. INSTITUTIONS AND RULE-MAKING

The institutional issue prompted perhaps the most extensive debate throughout the various sessions of this seminar. Viewed by a majority of speakers as institutionally underdeveloped, MERCOSUR has preserved a low institutional profile from the outset - an approach previously supported by all member governments and most independent analysts. Among subregional policymakers, the dominant perspective tended to associate institutional development with the creation and proliferation of costly and ineffective bureaucracies. There was general agreement in the seminar discussions that, at least initially, this was a correct and understandable viewpoint.

The institutional requirements of the bloc's early phase (the transition to a customs union, 1991-1994) were minimal: the process was based on a comprehensive, across-the-board tariff reduction program that operated automatically once the governments of the member states had agreed on it. Hence the strategy of a low institutional profile worked reasonably well when MERCOSUR was dealing mostly with border and trade matters. It was deficient for tackling other issues, however, and it hampered a necessary debate on institutionalization when the crises in the subregion deepened in the late-1990s. Additionally, attitudes to MERCOSUR's institutional dimension have been conditioned by a desire to avoid the perceived risks inherent in introducing the issue of supranationality to an agreement whose largest member clearly seems to favor strictly inter-governmental mechanisms.

MERCOSUR's internal program had already shifted focus with the adoption of Agenda 2000 in Montevideo in December 1995. The issues of the non-trade agenda that emerged in 1995 necessarily made greater institutional demands, but there was a reluctance in some quarters to address those requirements effectively. As the demand for institutional responses to new issues and changing circumstances outstripped the capacity of the existing institutions to act, the sense of a *regional* project began to lose relevance. Significantly, the stagnation of the regional endeavor began to become apparent at precisely the moment when efforts were required to tackle non-trade issues involving policies that the members persisted in regarding as matters of domestic concern. Thus some significant integration-related issues were dealt with by means of superficial (and in some cases cosmetic) commitments to norms that were not enforced, and that added little to obligations already assumed in multilateral negotiations.

As the regional process lost focus, MERCOSUR's agenda expanded somewhat chaotically. Moreover, it became increasingly evident that the institutional deficit was giving rise to another deficit in the area of implementing measures already agreed. Subregional norms and protocols were inadequately transposed into the domestic legislation of the member countries, and MERCOSUR consequently began to lose credibility and relevance for public and private actors throughout the subregion. Participants at this meeting evinced broad agreement that, in the realm of institutions, a crucial stumbling block to the retention of relevance was MERCOSUR's system for making and implementing rules.

## Making Rules

The methodology adopted to make and apply rules has complicated efforts to meet the institutional challenges of deepening the process. There was broad consensus that the absence of common rules allowing the impartial mediation of disputes has had a significant impact on trade flows and has undermined the prospect of exploiting the full potential of integration to the equitable benefit of all member countries. According to one speaker, the bloc's problem is not that there are too few rules. On the contrary, MERCOSUR has too many rules, but they are of poor quality, are inadequately focused, and in some cases do not in fact regulate anything.

The latter assertion was graphically illustrated by a presentation that catalogued failings in subregional rule-making: the literature on MERCOSUR, it was argued, often talks of what the bloc has done in this area without explaining what has really been achieved. For example, MERCOSUR has 37 norms on the harmonization of sanitary and phytosanitary standards but they do not really harmonize anything; they amount to little more than a list of measures; the Protocols of Colonia and Montevideo are mutually incompatible; nothing has been achieved in the area of rules on service trade, apart from telecommunications; and (a striking example of institutional inertia) the 1995 inter-regional framework cooperation agreement between MERCOSUR and the EU has never been formally approved by MERCOSUR.

The system's rule-making credibility is thus a basic difficulty. MERCOSUR was conceived as a deep integration scheme that would *evolve*. It was not intended to end with an accord like the North American Free Trade Agreement (NAFTA), but to be more like the EU. Despite its aspirations, however, MERCOSUR has not devised rules governing how rules should be produced. This is a critical aspect of integration schemes that are meant to evolve, because otherwise the momentum of the process can become subject to political considerations born of an unfavorable environment or particular national circumstances. The *production* of protocols and regulations has become detached from such instruments' *implementation* in terms of deadlines, timing, compliance and enforcement. The integration process thus becomes a model based on power rather than on rules.

Virtually all speakers were in agreement on this matter. A bloc that was insufficiently rules-oriented, MERCOSUR became infected by what one participant termed "*aladificación*" and was marked by a culture in which it was thought that agreed regulations could be disregarded. There was no stimulus for the member countries to be rules-oriented despite the fact, as one speaker pointed out, that a rules-based process has a clear economic rationale: it has a disciplinary effect, since implementation of and compliance with agreed subregional rules provide arguments that can be used to deal with domestic lobbies; an investment effect, inasmuch as a rules-based integration process is conducive to capital inflows; and a credibility effect.

In this regard several participants made the point that the transposition of MERCOSUR norms into domestic law is particularly complicated in Brazil, because constitutional precepts dictate that domestic law has to take primacy over MERCOSUR regulations. This view was challenged by another speaker, who pointed out that Brazil is a member of the World Trade Organization (WTO). The international law that emanates from WTO decisions imposes obligations on the Organization's members that have to be effected immediately, without recourse to domestic ratification or transposition. If there is no constitutional obstacle to the full assumption of WTO

obligations, then there should be no such obstacle to the acceptance of MERCOSUR norms. In this view, the reason for non-acceptance of obligations in the MERCOSUR framework is not constitutional but political: they are simply not wanted.

### **A New Institutionalization**

Given the shift in focus of the bloc's agenda, as well as the need to deepen in order to remain relevant, the institutional arrangements prevailing to date no longer serve. The low-profile approach has caused some initiatives to be blocked, and it is clear that MERCOSUR suffers from an institutional deficit. Since the new MERCOSUR agenda should spur greater convergence, it calls for a higher level of institutionalization. The new phase of integration demands more *political* commitment on the part of the member governments, and the low profile of the institutional structure is insufficient to embody such commitment or to implement a new agenda.

In this light, "institutionalization" is not a question of creating institutions but of conferring credibility on a system for producing and implementing subregional rules. This, according to one speaker, should be the main goal of the institutional agenda. Indeed, it is the institutional dimension that demands the most attention during MERCOSUR's current difficulties, because all areas of the integration process are permeated by it. Enhanced institutional arrangements could decisively reverse the present stagnation. In this regard the priority areas for attention are: the system for producing the rules; the mechanisms for implementing those rules; and the substance or focus of the rules themselves. Several recommendations were made for overcoming the obstacles in these areas:

- *The negotiation and conclusion of a new constitutive treaty.* This would upgrade and consolidate not only MERCOSUR's primary juridical regulations but also its secondary legislation, such as protocols on investment, trade in services and competition policy. In another context it was said that this would be good for business: the MERCOSUR private sector, according to this view, is uncertain how to operate at the subregional level because the rules can only be understood by someone with specialist knowledge; a new and clearer treaty would rectify that circumstance.
- *Strengthening the Common Market Council (Consejo del Mercado Común, CMC).* One suggestion was that the Council should meet at least once a month to provide intra- and extra-MERCOSUR negotiations with political guidance, although other participants felt that meetings of such frequency are not a realistic prospect. Regular meetings of senior officials and experts were recommended as an alternative. Such a course of action will require a dedicated budget.
- *The national parliaments must be more involved in the process.* This is not a risk-free undertaking, but it can be deferred no longer if the project is to have greater credibility. There was widespread consensus on this matter in the discussions. It was felt that MERCOSUR activities should be submitted periodically to parliamentary ratification so as to increase the legitimacy of the executives' negotiators and to stimulate public debate on MERCOSUR issues.
- *The Secretariat should be reinforced.* The Secretariat, which to some extent has a supranational dimension, needs human, technical and financial resources to enable it to become a body that devotes itself to the *regional* project.



- *The private sector should be given a greater role in shaping the process.* There were repeated calls for stronger business engagement with internal and external negotiations. This applies not only to the upper circle of the business community; the entire sector should be mobilized. In fact, it was argued, meetings of the Common Market Group should be preceded by a business forum.

In general, rules-making should be more transparent. One means to that end is to make better use of the Internet and to make all relevant documentation on MERCOSUR norms available on-line. An unfavorable contrast was drawn between the websites of the MERCOSUR Secretariat and that of the Andean Community's General Secretariat, which features an abundance of information on all areas of the Andean integration process. Moreover, such transparency is needed to ensure the stronger involvement of civil society in MERCOSUR integration.

As to the focus of the system of rules, this should center on the customs union. In their intra-bloc negotiations the members have lost focus: unable to add real value (relative to the members' WTO obligations) to the commitments assumed and decisions made in areas crucial to the completion of the customs union, MERCOSUR gradually lost relevance and credibility for the member states and private actors. Hence future efforts to institutionalize the process might be fruitless if they are not matched by an attempt to focus the negotiating agenda on those issues that are priority matters for consolidating the customs union.

By the same token, the creation of a single customs territory (a pre-requisite of a true customs union) and the adoption of a common trade policy are priority issues for a pro-institutionalization agenda. Equally important to the consolidation of the customs union is the establishment of a system governing state aid, one that goes beyond the WTO's Agreement on Subsidies and that is designed to discipline national policies on support to particular businesses and sectors. Finally, this agenda also requires shared financing mechanisms for infrastructure projects at the subregional level or for less developed regions within the member countries.

Political will, it was generally agreed, does not suffice to resolve the institutional issues. Indeed, there has always been substantial political will (at least rhetorically) for the process to endure. The problem, as one participant put it, is that MERCOSUR "cannot live by politics alone", and the forging of some common vision of where the process is leading is crucial to further progress. Focus is all: a fundamental precondition for deeper integration is a shared political view among all members of what MERCOSUR is and where it is going. The need for a stronger "common vision", a more pronounced sense of a community of interest, was one of the most reiterated assertions throughout the meeting, most particularly in discussions of the bloc's trade agenda.

## V. TRADE ISSUES

There is no doubt that MERCOSUR has been beset by credibility problems both internal and external, and the member countries do not seem to share a common vision of integration. Further progress on the trade front, as with the institutional agenda, requires that the members undergo a change in attitude to MERCOSUR itself and to integration in general.

Notwithstanding the progress made in some areas, the persistence of divergent views of the process has been an obstacle to deeper integration in the commercial sphere. No progress has been made on the harmonization of legislation. The group's trade has been regionalized since 1991 but the degree of regionalization varies among the countries. National bureaucracies have not displayed great commitment to real trade integration, and thus have been vulnerable to special interest lobbying at the national level. As a result, barriers have been raised to goods trade. Such barriers, which have grown since the devaluation of the Brazilian real in 1999, have spurred a variety of trade disputes.

A review of the claims presented to the Trade Commission, the Common Market Group and the dispute settlement mechanism in the period 1995-2000 reveals that trade disputes were at a high level at the start of the period, fell around 1998, and then rose again from 1999 onwards. Argentina has presented the most claims, and Brazil has been the most subject to them. Agro-industrial goods accounted for the bulk of the cases (39%), and the main issues raised in the claims have been technical barriers, fiscal discrimination, tariff preferences, import licenses, export and import bans, antidumping and rules of origin.

Moreover, structural differences between the countries and a series of economic crises have led to unilateral breaches of the common external tariff (CET). Problems with a common tariff are inherent to the creation of a customs union, and from the outset exceptions were allowed for capital goods and for information and communications technology products. Additionally, national exception lists were drawn up for those products that governments believed would be damaged by an abrupt decline in protection. The preservation of national vehicle regimes also entailed breaches of the CET, as did the retention and renegotiation of various tariff preference agreements by some members (Brazil-Andean Community, Uruguay-Mexico, Argentina-Mexico and so on).

In June 2001 the Common Market Group decided to establish a High Level Group to review the structure of the CET, and to analyze the consistency and dispersion of the tariff structure. Not a great deal of progress seems to have been made by the latter group, despite the urgency of the matter. Apart from internal pressure for such a revision, the exercise is important in terms of the bloc's future agenda, especially the negotiations for the FTAA and for an agreement with the EU. Negotiations in those fora entail a need to define the CET as a basis for the schedule of tariff-reduction agreed with extra-subregional partners.

Breaches of the CET are accompanied by other aspects of trade policy that contravene the spirit of a customs union, in which goods should be able to move freely: certificate of origin requirements; the persistence of customs control of intra-bloc trade; the maintenance of drawback and other special import regimes; the imposition of anti-dumping measures and the lack of a single regime for imports from third countries.

## The External Agenda

The negotiations for the FTAA and with the EU will demand greater cohesion and coordination among the MERCOSUR member states. At present, however, significant divergence is evident in a number of areas:

- *Services.* According to the Montevideo Protocol, signed in December 1997, the member countries are to liberalize trade in services over a ten-year period, starting from the protocol's entry into force. It will enter into force when it has been transposed into national law by three of the four members. Thus far, only Argentina has done so. The absence of internal agreement on the matter, as well as differences between the countries as regards their GATS commitments, make it difficult for MERCOSUR to devise a common negotiating position in its external negotiations.
- *Agriculture.* All members have an interest in the liberalization of agricultural trade, the elimination of trade-distorting subsidies, and negotiations on sanitary and phytosanitary barriers. Nonetheless, it is important to note that the scale of the concessions that the members would have to make in order to secure significant outcomes in the negotiations is different for each of them, because of the differences in the size of their economies.
- *Antidumping.* Applying discipline to antidumping measures, so as to avert the abusive use of such instruments, is one of the most important issues for Brazil in negotiations involving the United States (FTAA and WTO). For Uruguay and Paraguay this matter is not particularly significant. Until recently Argentina was reluctant to take the same position as Brazil, but in a May 2003 document submitted to the WTO the Argentine government took broadly the same approach as Brazil.
- *Investment.* This too is a problematic negotiating area for MERCOSUR, since the bloc has no common framework for either intra-bloc investment or extra-MERCOSUR flows. The two protocols governing the issue were signed in 1994 but have not been transposed into domestic law.
- *Government procurement.* This issue has been under negotiation in MERCOSUR since 1997. There has been no agreement to date because of differences on issues such as coverage (national or state/province/municipal level), whether to establish preferences for MERCOSUR countries relative to extra-regional purchases, and whether to include services in the government procurement regime. Such divergences hamper the formulation of common external positions.

In addition to these kind of differences, permanent tensions are triggered by divergent visions of bilateral relations with the United States.

## Current Dilemmas in the Trade Realm

In the commercial arena, MERCOSUR was said to face two main dilemmas: free trade area *versus* customs union; and focus *versus* scope. As an intermediate stage in a transition to a deeper form of integration, a customs union has the advantage of being more transparent and involving lower transaction costs than a free trade area. To realize those benefits, however, the bloc must

define a common protection structure, remove internal controls on trade, and devise mechanisms to distribute customs revenue.

These are doubtless difficult undertakings, but there was general agreement that, despite the costs involved, it is inadvisable to abandon the customs union. There are several reasons for this. The subregional unity conferred by the customs union project is an asset that should be neither underestimated nor squandered. It is important, for example, in the bloc's external negotiations. Indeed, the group's trade partners tend to place greater value on that asset than the members themselves. Notwithstanding the problems that MERCOSUR has faced in establishing common positions and speaking with a single voice, it has been able to make itself heard at the negotiating table.

In any case, completion of the customs union is important in the context of the FTAA negotiations. The fact that it is incomplete forecloses what should be its main advantages over a free trade area: an absence of rules of origin and other administrative burdens, as well as the capacity to negotiate effectively as a bloc. Time is running out in this regard. Unless efforts are made immediately to complete the customs union, MERCOSUR is in danger of losing relevance when the FTAA comes into being. The customs union is also important for the foreign investment in the member countries, whose CET is an important element of their business strategies. The abandonment of the customs union could have a substantial effect on the members' credibility in terms of respect for rules and contracts.

As to the question of focus and scope, the member countries must make the integration process more credible and sustainable, an effort that demands an agenda that is both ambitious and realistic. The experience of the 1998-2001 period showed that MERCOSUR can produce a large number of rules that were not transposed into domestic law, and that thus give a false impression of progress. Hence the agenda should be sufficiently broad to reflect the countries' strategic vision of integration, but must also involve a realistic calendar for the implementation of priority issues.

What the priority issues really are was a matter that prompted some debate. The main issue, according to some participants, is the external agenda. Since intra-bloc trade cannot grow much further, what is important is access to the US and EU markets. Effective negotiation, in turn, demands that MERCOSUR decide on the CET. The external negotiations therefore determine the decisions about what is to be done *internally*. In fact, they could determine whether *anything* happens internally: according to one proponent of this view, if Brazil is not interested in real external negotiations, the smaller countries can be expected to ask what purpose MERCOSUR really serves.

Other speakers disagreed, arguing that MERCOSUR certainly needs a stronger presence in external negotiations but that this is not an issue that has to be prioritized. In the view of other participants, the focus of the methodological debate should not be the external negotiations themselves but what will happen when they are completed. It is economically important to preserve a long-range perspective: the short-termism of what was termed the "existentialist" debate as to whether MERCOSUR should exist has wrought substantial damage by causing potential investors to withhold their funds. Finally, a substantially more pessimistic (and minority) position was that, in any case, the MERCOSUR countries will not secure very much in the negotiations whether they act *en bloc* or separately.

Against that background, a number of recommendations were made for a new MERCOSUR commercial agenda.

- *Eliminate non-tariff barriers and adopt the measures included in the MERCOSUR Business Facilitation Program.* This effort should include harmonizing technical regulations and promoting mutual recognition of conformity with technical standards. Antidumping measures should not be applied to intra-MERCOSUR trade.
- *Transpose the instruments already agreed at the MERCOSUR level into domestic law.* The priorities in this area include the parliamentary ratification of the Montevideo Protocol on Trade in Services.
- *Discipline and harmonize the use of production, export and investment incentives.* The clear difficulties involved in making progress in this area should not curb efforts to tackle the problem. MERCOSUR should devise a common incentives policy.
- *Develop instruments that foster the integration of productive chains and stimulate exports.* Such instruments should respond to the problems attendant on information asymmetry and deficient infrastructure.
- *Develop financing instruments to facilitate integration.* It is crucial to devise means of financing infrastructure projects for physical integration and to induce industrial reconversion. Efforts to include FONPLATA in the *Corporación Andina de Fomento* (CAF) are important in this regard. Another priority is to make financing available for intra-bloc trade.
- *Avoid the establishment of new barriers or distortions caused by the creation or modification of domestic regulations.* One of MERCOSUR's main problems has been the member governments' limited awareness of the impact of domestic legislation on other members. The countries should be willing to discuss reforms or new regulations with their partners before they are implemented.
- *Regulate special import regime incentives.* The agenda must include a definition of the way that special import regimes are dealt with, as well as of the intra-bloc sale of goods produced in special customs areas.
- *Maintain cohesion in external negotiations.* It is crucial that MERCOSUR retain its cohesion in negotiations for the FTAA and with the EU. Simultaneously, intra-MERCOSUR positions in the WTO must be further coordinated.
- *Rationalize the CET structure.* It is advisable to analyze the present inconsistencies, to examine how an ideal structure might be designed, and to correct the most evident distortions as soon in the near future.
- *Adopt measures that complement the customs union.* To consolidate the customs union and deepen the integration process it is crucial to adopt a common customs code, eliminate the CET's double taxation, and devise a means of distributing customs revenue.

Finally, MERCOSUR should *create mechanisms that attenuate the effects of severe exchange rate fluctuations* on intra-bloc trade. This issue, which received a great deal of attention in the seminar presentations and discussions, is discussed in greater detail in the following section.

## **VI. EXCHANGE RATE VOLATILITY, MACROECONOMIC COORDINATION AND MONETARY INTEGRATION**

If the MERCOSUR integration process is to deepen, exchange rate volatility must be eliminated. Such volatility keeps the market segmented along national lines and undercuts what should be the positive impact of integration on resource-allocation, investment, and the exploitation of economies of scale. Trade integration, especially in the form of a customs union, aggravates the negative consequences of exchange rate volatility by raising the cost of the trade diversion arising from tariff discrimination. The latter problem, in turn, is exacerbated by size asymmetries between countries and negative shocks originating in the larger partners.

Volatility, moreover, has spawned political resistance that undermines the member governments' capacities to adopt more collaborative policies. Thus deeper integration is virtually unthinkable without lessening the exchange rate variability among the MERCOSUR members. The level of macroeconomic coordination associated with that goal would involve net benefits to the extent that the member governments truly have the political will to move on to deeper integration. If they lack the will, there is little purpose in incurring the costs entailed by such coordination in terms of the loss of autonomy in economic policymaking.

Macroeconomic coordination is a necessary but insufficient pre-condition of avoiding exchange rate volatility. Rate movements among the members' currencies must be kept relatively stable, which itself demands a stronger institutional framework than just macroeconomic coordination. Such coordination has been debated since MERCOSUR was founded. Indeed, the first article of the Treaty of Asunción stipulates the need for "the coordination of macroeconomic and sectoral policies among the members states ...". At the time, the demand for such coordination was constrained by the weakness of macroeconomic linkages among the members, especially Argentina and Brazil. Since then, intra-subregional trade has grown substantially but it remains relatively modest in terms of its effect on GDP. The impact is significantly greater on the trade balance and the capital account.

Current conditions in MERCOSUR do not raise hopes of short-term improvements in coordination. Nevertheless, it is worth considering the possibilities in the expectation that one of them might be applied in a more distant future. The possible options for exchange rate coordination must meet certain conditions: they must respect the determinants of financial globalization; they must take account of the macroeconomic features of the MERCOSUR countries; they must help deepen trade integration; and they must be compatible with the thinking and motivations of MERCOSUR elites. These are not easy conditions to meet. There are essentially three options:

- fixed parities with the dollar, and thus among the MERCOSUR currencies;
- dollarization;
- adoption of a single, common currency.

The advantages of the fixed parities option are that it does not entail a loss of seigniorage revenue, it resolves the problem of deeper trade integration, and it is the simplest way of securing macroeconomic convergence. This strategy, however, involves the free movement of capital and the dollarization of bank liabilities, which in turn calls for a lender of last resort so as to obviate

the recurrent liquidity problems triggered by negative external shocks. The necessary agreements with US monetary authorities required for these purposes amounts to something close to formal dollarization. In practice, therefore, the establishment of stable parities among MERCOSUR currencies becomes a choice adoption of a MERCOSUR fiduciary currency that floats against others, or use of an international currency, presumably the US dollar.

The latter route would imply changes in institutional arrangements in terms of the use of seniorage, the function of the lender of last resort, and the structure and oversight of the financial system. This could be a permanent arrangement, or it could be a transition phase lasting until the necessary macroeconomic coordination and credible institutions were in place to issue a single MERCOSUR currency. This option faces two obstacles. First, the collapse of Argentina's convertibility program suggests that a similar strategy will not be considered by the subregion's governments for some considerable time. Second, it involves a high cost in symbolic terms and contravenes the search for independent development favored by many among the MERCOSUR elites.

A monetary union would resolve the problems of exchange rate volatility. The emergence of similar external shocks and the growth of trade integration in the 1990s have given rise to a closer correlation in the members' economic cycles. Nonetheless, the conditions for monetary union do not obtain in MERCOSUR. There are three main reasons for this: first, the required political will for deeper integration is presently lacking; second, the subregion has no independent central bank of sufficient reputation to underpin such a project; and third, despite the increased intra-bloc trade, the member countries (especially Brazil) reveal a relatively low level of commercial inter-dependence.

The absence of political will to deepen integration in the last decade was evident in the lack of coordination mechanisms. Against that background, exchange rate variability triggered trade disputes and political tensions that conspired against integration. It is clear that without stability there can be no coordination, and that such stability demands the attainment of certain targets in the areas of inflation, public debt, fiscal deficits, short-term indebtedness and the solvency of financial systems. To meet these goals, the member countries would have to institute structural reforms.

Additionally, greater stability calls for the establishment of funds to compensate for the losses arising from external (especially financial) shocks. Important in this regard would be automatic disbursements from international organizations in the case of severe shocks, the creation of regional funds, and perhaps even national stabilization funds. Without mechanisms to compensate for significant intra-subregional variations in exchange rates, integration will be hard to deepen.

## VII. CONCLUSION

This seminar covered a very broad array of issues that are critical if MERCOSUR's present stagnation is to be reversed, if the project is to remain relevant against the background of current trade negotiations (especially the advent of the FTAA), and if the bloc is to advance to stages of deeper integration. Consensus was elusive in some areas. Notable in this regard was the evident divergence as to whether efforts should focus on completing the customs union, on external negotiations, or on what happens after the negotiations. In most areas, however, there was broad concurrence on the diagnosis of current problems and the steps required to rectify them. In summary, a number of recurrent issues reflect the event's prime messages as to how a future agenda might be defined.

- *Political leadership.* The scheme's senior partner, like the leading country in integration schemes such as the EU, should display generosity and political leadership in the regional project. Short-term mercantilism is to be avoided. For Brazil, more than for the other member states, MERCOSUR is a geopolitical option.
- *Political will.* There is plenty of this in MERCOSUR, at least in rhetorical terms. Political will alone is not enough. It must be embodied in a series of effective institutions and mechanisms if the process is to bear fruit. In particular, an enforcement-authorized dispute settlement system and a secretariat with solid technical capacity are important.
- *The CET.* Temporary exceptions to the common tariff remain important as a safety valve in the interests of internal cohesion, but over the longer term it is essential to complete the CET as a means of deepening integration and negotiating externally as a bloc.
- *The external agenda.* It is important for MERCOSUR's credibility that the group has an ambitious external agenda, especially in its North-South negotiations (for the FTAA and with the EU) and in the WTO.





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