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MERCOSUR: IN SEARCH OF A NEW AGENDA

MERCOSUR´s Insertion into a Globalized World

Juan Ignacio García Pelufo

Special Initiative on Trade and Integration

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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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SUMMARY AND CONCLUSIONS

MERCOSUR emerged as a strategy of international insertion for the countries of the Southern Cone. That strategy responds to a set of shared and longstanding political motivations that surfaced in the new international and regional conditions spawned by globalization and the end of the Cold War. More than ten years after it was created with the signing of the Treaty of Asunción, MERCOSUR today is in complete disarray. With no argument other than the conventional wisdom that the calm follows the storm, it is to be hoped that the current situation will be overcome and that the Southern Cone economies will resume growth. If that happens, the question is: what will happen to MERCOSUR?

This study's thesis is that MERCOSUR will regain validity with the calm, for the simple reason that the motivations and conditions underlying its creation will persist. In the face of similar regional and global conditions, it is to be expected that the Southern Cone's political reflexes spur the same kind of response as they did to similar circumstances in the previous decade. The traumatic experience of the years of recession, however, will not be inconsequential. That experience will probably give rise to a reformulation of the integration model, wherein more comprehensive thought is given to the importance of coordinating MERCOSUR's international insertion. Such a reformulation, moreover, will take account of the significance of the member countries' size asymmetries, and of the fact that the biggest country's currency cannot serve as a reference for all the members.

This study is divided into six chapters. Chapter I briefly considers the international economic context in which MERCOSUR was created. At the end of the 1980s and the start of the 1990s, the governments of the Southern Cone countries faced the need to integrate themselves into a globalized world. This context imposed very particular policy constraints and lessened their autonomy. This chapter presents, first, the structural conditioning to which policies were subject. Such conditions are grouped into two categories: the globalization of trade and financial globalization. The globalization of trade offered greater certainty: countries had to participate in trade in order to grow, and to trade they had to comply with certain rules, as drawn up by the World Trade Organization (WTO).

Insertion into financial globalization did not offer the same certainty. This was not an area in which there were rules explicitly established by governments or international institutions with which agreements are reached. It was a world of markets and investors, which entailed submission to rules of conduct that sought to highlight investment opportunities and lessen risks as perceived by investors. The Southern Cone countries attempted various strategies to address these circumstances: Argentina's insertion into financial globalization in the 1990s was at one extreme of the possible alternatives. Chile, in the preceding decade, had taken another path that apparently proved more successful. The other MERCOSUR countries attempted some combination. The economic performance of the countries of the Southern Cone and MERCOSUR was influenced by the options chosen.

Chapter II examines the regional context in which MERCOSUR was created. In the mid-1980s the region's new civilian governments brought about a rapprochement between Argentina and Brazil. Choosing MERCOSUR as a means of insertion into the international trading system was not an option that flourished until the Argentine and Brazilian governments put in place their own programs of unilateral opening, and until the two countries' elites were willing partly to limit their autonomy in devising policies that favored their neighbors.

Chapter III analyzes the set of policies to be coordinated at a given stage of integration if the process is to work properly. It reaches the following conclusions:

- Trade integration, even in the free trade area phase, demands simultaneous resolution of the problems arising from the distortions to competition that are attendant on state aid; the impact of competitive devaluations among the member countries; and the economic and social effects of unemployment that stems from the change in the conditions of competition involved in reciprocal tariff reduction.

- A customs union is a very advanced stage of integration, one that calls for the harmonization of tariffs and a common trade policy. Trade diversion is an implicit part of a customs union, and has two main effects: first, opening up tariff policy reduces a country's policy options to counter macroeconomic instability in a neighboring country; and second, instability in the partner country raises the cost of trade diversion. A customs union is thus even more demanding than a free trade area in terms of the policies to be harmonized and the extent of the harmonization.

- The strategy tacitly adopted in the Treaty of Asunción - to establish a customs union before monetary integration and the free movement of productive factors (a strategy inspired by the European Union) - did not take full account of the structural characteristics of the countries of the region. In the European model the agreements follow an order of precedence from a free trade area to economic union, and monetary integration and the free movement of people are regarded as the final stages. This integration model works in the specific monetary context within which the European Union developed. Unlike Europe, in MERCOSUR there was no prior compatible monetary arrangement, and the currency of the biggest member could not serve as a reference for the others. Those circumstances demand that monetary and exchange rate issues be considered as priorities, and as concomitant with the customs union.

Chapter IV examines the opinion of the Argentine and Brazilian elites, their effect on how MERCOSUR has operated to date and how they determine the future agenda. This chapter is based on previous INTAL research on how Latin American elites view integration. The research confirms that there is a national way of looking at things, a viewpoint related to how the elites see themselves, how they construe their national destiny, and how they interpret their country's role in the world.

An integration scheme has to harmonize a broad range of policies. Such coordination entails the replacement of some policies by others in the countries of the region. Some of these policies might be part of a more general national project on which there is sufficient domestic consensus, and which might be hard to change through negotiations. For that reason, integration processes call for familiarity with and discussion of the projects that each country is pursuing, their underlying motivations, and the policies through which the policies find expression. With such knowledge, the boundaries of possible integration can be set.

The differences and similarities in the outlooks of the Argentine and Brazilian elites aid analysis of MERCOSUR's current situation and offer clues as to the group's future development. In particular, and with regard to insertion in the international trading system, there is substantial elite agreement on the value of integration among the Southern Cone countries and on commercial alliances in the region and the world.[1] In general, the Argentine and Brazilian elites are willing to accept the accession of other South American countries to the bloc, and favor autonomous insertion in the international trading system. In this they give primacy to multilateral insertion over that effected through the large existing trade blocs. In view of such concurrence and the clear stability of elite opinion, MERCOSUR's future trade strategy will probably have the same features as it has had to date, irrespective of changes in government in Argentina and Brazil.

Chapter V addresses exchange rate and monetary coordination in MERCOSUR. The impossibility of reaching agreement on exchange rate and monetary harmonization is explained by the different strategies of insertion into financial globalization pursued by MERCOSUR's two biggest countries. Brazil sought autonomous insertion in line with its elites' aspirations that the country should be a global player, while Argentina opted for complete integration in world capital markets. Both strategies were supported by a substantial degree of elite consensus in the two countries, and the negotiation of MERCOSUR was not strong enough to alter them.

Finally, Chapter VI look at MERCOSUR's future agenda. This chapter avers that when the MERCOSUR countries overcome current economic conditions they will probably persist with the trade strategy they have pursued thus far, one that it embedded in the opinions of their elites: that is, trade integration, the widening of MERCOSUR to other South American countries, a preference for negotiations in the WTO, and delaying tactics in negotiations for the FTAA and with the EU. It will then be time to consider deepening MERCOSUR. Some shifts in emphasis emerge here: rather than considering deepening as equivalent to tariff harmonization, the proposal is to postpone complete harmonization to a future date, and meantime to make headway in the institutional and monetary fields while moving forward on migration and the joint planning of infrastructure.

Institutional progress is not a matter of creating bureaucracies but of devising rules and institutions, chiefly in the area of unfair trade practices and state aid. These should apply throughout MERCOSUR and should be enforced as far as possible by national-level agencies. As to monetary matters, the study discusses the two main alternatives open to MERCOSUR: adoption of an external monetary standard or the introduction of a MERCOSUR fiduciary

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[1] This explains the success in swiftly reaching agreement on the trade aspects of integration, following the order of precedence set by the European model, according to which a customs union is one of the early stages of the process.

currency. The MERCOSUR elites' goal of autonomous insertion demands attention to the possibility of introducing a MERCOSUR currency. This is a long-term matter, however, and thus the agenda should focus for the moment on preparing the transition to that end.

Finally, the deepening agenda should cover issues that, in the European integration model, are deemed part of a more advanced stage of integration but that are not inconsistent with the current state of MERCOSUR's development. Particularly important here are the joint planning of infrastructure and the free movement of people and workers among the countries of the region. Agreements in these areas would help give a sense of progress towards and commitment to a more extensive form of integration in the future. At the same time they would obviate the danger that MERCOSUR might be subsumed in other agreements, such as the FTAA, that would make a simple commitment to a European-style customs union redundant.

I. THE CONTEXTUAL DETERMINANTS

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Globalization

The Two Facets of Globalization: Trade and Capital

The final two decades of the twentieth century witnessed new expressions of economic interdependence on an almost global scale, with an upsurge in trade, capital movements, technology, information in general and processes of cultural expansion. These phenomena were termed globalization. Its key trait is that it is imposed by the very technological development that drives the growth of trade and the movement of capital, while simultaneously rendering inoperable the traditional mechanisms to control such activities and close economies to them.

Two distinct facets of globalization are interesting from the viewpoint of this study. One of them concerns international trade; the other is related to the world capital market. Both are part of globalization but they are different aspects of that phenomenon, are not wholly connected, and have different effects. From the standpoint of the effects of globalization in the Southern Cone and the characteristics of the region's integration process, it is important to remember that both phenomena involve specific insertion strategies.

The Globalization of Trade

Trade grew at very high rates in the second half of the twentieth century. In recent years such growth has stemmed from growing economic openness and the establishment of international trade rules that cover more issues and are more forcefully applied. The World Trade Organization (WTO) now has more members, its disciplines apply to more issues, and its regulations are more strictly enforced (see Alemán [1998]).

The fact that trade is more open and structured does not make it more equitable. Temperate agricultural exporting countries can attest to the lack of equity in international trade rules. One of the asymmetries consists of the fact that trade in agricultural goods is not subject to the same discipline as trade in manufactures. The EU's agricultural policy, based on mechanisms such as guaranteed prices, export subsidies and import taxes, faced the United States in a reciprocal subsidy war. The Southern Cone countries were victims of this confrontation, since they had to suffer the consequences of a loss of purchasing power on the part of their main export items.[2]

In parallel, there is an increasingly pronounced tendency throughout almost the whole world towards the establishment or intensification of regional integration processes. The GATT developed on the basis of the most favored nation principle but its Article XXIV allows the creation of discriminatory trade areas. This apparent paradox recognizes the different strategies behind the political actions of the United States and the EU in creating international trade rules. While the United States

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[2] These countries sought to tackle this situation through the Cairns Group in the WTO, which sought to exert influence in the negotiating rounds with a view to including agriculture as one of the WTO's general disciplines. Moreover, the problem brought about a convergence of the Southern Cone countries around the idea of MERCOSUR as a form of defense against agricultural subsidies in international trade.

prefers multilateralism, Europe favors discrimination as a way of accommodating its colonial past. Hence Article XXIV is designed to recognize *de facto* circumstances such as the union of Europe, the Commonwealth and the Lomé Conventions.[3]

At the end of the century, however, there emerged a new and truly significant discriminatory trade accord in the shape of the North American Free Trade Agreement (NAFTA). For this study's purposes NAFTA has two significant features:

- First, the United States - which had championed commercial multilateralism - altered its policy, the precedents being the free trade agreements with Israel and then with Canada. This shift complicated the international trade outlook. For some, it signaled the creation of a new international trading system based on large trading blocs: future trade rules would be devised within those blocs rather than at the multilateral level of the WTO, wherein each country has a vote and the most favored nation principle is accorded primacy.

- Second, the change thwarted the apparent Latin American homogeneity that had sought expression through the Latin American Integration Association (ALADI). The agreement's geometry of including countries into NAFTA "one at a time" prompted concern among the bigger Latin American countries, especially Brazil, which feared commercial isolation if Spanish America were to adopt a policy of accession to NAFTA.[4]

The international trading system was an aspect of globalization that required the Southern Cone countries to choose a concrete insertion strategy. It was a world of shared hegemony: NAFTA, Europe and Japan. In such a world there are new actors that project themselves forcefully, such as China and India. South America, although only a small part of this panorama, is a potentially significant region. In this rule-governed world of global interaction and shared hegemony, the joint insertion strategy of the Southern Cone countries (and perhaps of much of Latin America) is a wise approach. To prosper, this strategy demands compliance with rules: those rules allow discriminatory tariff agreements but no "fortress"-style integration. Open regionalism, by contrast, was an available option.[5]

Financial Globalization

The other feature of globalization concerns capital markets and is reflected in the global allocation of private capital, which has grown strikingly in recent years (see Avila [2000]). Previously, capital markets were segmented; now the move is towards global markets. As yet there is no global capital market, since only a small proportion of rich countries' national savings is in circulation. There is, however, greater market interpenetration. This has fostered the growth of international

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[3] All these agreements are two-way (that is, the smaller and developing countries enjoy preferences in the bigger markets and *vice versa*). They discriminate against Latin America's trade prospects and unquestionably help sustain the idea of Latin American integration, a notion with a long history in the region.

[4] In 1994 the countries of the Americas convened in Miami and launched the idea of the FTAA as the final synthesis of the partial and perhaps conflicting processes that were emerging between NAFTA and MERCOSUR.

[5] For an exhaustive analysis of the new strategies, see Devlin and Estevadeordal [2001].

capital flows and conferred unprecedented significance on those flows as an explanation of the economic activity of recipient countries on the periphery.

One characteristic of this new phenomenon is that, in contrast to the trade realm, the international rules have slackened. There is less discipline than previously because of non-compliance with the Bretton Woods agreements, the breakdown of the gold standard and the inability of international financial organizations (the World Bank and the International Monetary Fund) reasonably to "tame" this phenomenon and its effects.[6] Hence financial globalization features a higher degree of uncertainty than its commercial counterpart. The world of financial globalization does not have an order equivalent to that prevailing in the world of trade. In these circumstances the governments of emerging countries had to choose between autonomy and complete insertion in world capital markets. The latter involved opening up the capital account, foregoing an independent currency, and integration in the international financial system. The rules on discretionality dominated application of this strategy. The alternative strategy is one of defense against globalization: in general it consists of constraining the operation of the domestic financial system, exchange controls and the introduction of a fiduciary currency.

The Southern Cone countries pursued different strategies of insertion into financial globalization. A superficial reading suggests that the countries applied the same economic model based on the reforms of the Washington Consensus, baptized in Latin American political slang as the "neoliberal model", but in fact they deployed different strategies. Each strategy had a series of common characteristics related to the reappraisal of the market's role in resource allocation and the redefinition of the role of the state as a business agent or a supplier of infrastructure. As regards insertion into financial globalization, however, some countries opted for unlimited connection to world capital markets while others chose autonomy. The results were very mixed. A defensive strategy was not always successful, and an insertion strategy did not always fulfill its promises. Still pending are an assessment of the different strategies and the ways in which they were applied, and an explanation of their outcomes in Latin America. It is clear, however, that these differences of approach and policy were the main impediments to the smooth operation of the region's integration schemes, especially MERCOSUR.

The Regional Context

The Return of Civilian Authority in Latin America and Argentine-Brazilian Rapprochement

At the end of the 1980s the international economic context, characterized as globalization, posed fresh challenges to the new democracies of that period in the Southern Cone. As the previous section argued, in responding to these challenges the Southern Cone countries sought joint international insertion. This, however, was not inevitable. Despite the efforts made in this area almost since independence, historically the region had no relations with the world; rather, the countries had established international links on individual bases. Until MERCOSUR was created,

[6] A striking example of this situation was the aid package for Mexico to attenuate the financial crisis of 1995, wherein the IMF's share was just 15%.

South America had not managed to transfer its countries' individuality to another common organization that served as an intermediary in relations with the rest of the world. MERCOSUR was the first important and exclusively Latin American attempt in this regard.

Doubtless MERCOSUR was possible because political relations between the Southern Cone countries changed. The international context was the challenge, while the new regional political context was the catalyst that fostered the emergence of a strategy of joint international insertion. A politically important consideration is that civilian government returned to Argentina and Brazil in the 1980s. This allowed a radical shift in the region's geopolitical outlook, one of whose manifestations was the rapprochement between the governments of Raúl Alfonsín and José Sarney.

The First Stage: The Rapprochement between Presidents Alfonsín and Sarney[7]

The relationship between Argentina and Brazil had been one of permanent conflict because of border disputes and the arms race. This hostile climate was not solely between Argentina and Brazil. It also soured relations among many countries in South America, such as between Argentina and Chile. The rapprochement between Alfonsín and Sarney was a crucial turning point in relations between the Southern Cone countries. The dissipation of the notion of permanent conflict, and the shift in political attitudes from confrontation to cooperation, allowed political relations between the countries and their relationships with the rest of the world to be redefined.

At first, the rapprochement between Argentina and Brazil was essentially political. On the one hand it represented a kind of mutual support to strengthen civilian authority. On the other, it sought to relocate the region on the international stage and establish the Southern Cone as a peace zone unburdened by military security considerations. Both governments took concrete steps and pledged to end the arms race in South America that had conspired against security in the region, hampered democratic consolidation, and scared off investors.

In the initial phase of Argentine-Brazilian rapprochement, purely economic matters were secondary considerations. As the previous section explained, however, the nature and state of the international trading system almost naturally called for joint insertion into world trade. In that regard it is unsurprising that the rapprochement included a trade integration goal. Hence the Alfonsín and Sarney governments reached agreement on the basis of products and compensated trade among certain activities.[8] These accords, however, did not flourish. The shift to more liberal conceptions of trade, necessary for the process to prosper, was lacking. This shift finally occurred during the subsequent governments of Menem in Argentina and Fernando Collor de Melo, Itamar Franco and Fernando Henrique Cardoso in Brazil.

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[7] This section owes much to a conversation in 1999 with Celso Lafer, then Brazil's Minister of Development and Industry.

[8] In this stage President Julio María Sanguinetti of Uruguay joined the discussions, giving rise to the idea of MERCOSUR that later flourished with the inclusion of Paraguay.

The Second Stage: The Creation of MERCOSUR

The arrival of the new governments in the early 1990s brought a new dimension to the Argentine-Brazilian agreements and finalized the strategies of economic insertion. In particular, the new Argentine government completed the radical shift, begun by its predecessor, in the country's relations with the rest of the world.

The government founded Argentina's external relations on two bases. Rapprochement with Brazil included political matters, physical and commercial interconnections, and protection of MERCOSUR countries' industry. President Menem consolidated what Alfonsín had begun but he added a new dimension: automatic alignment with Washington. This was a radical shift in the Argentine foreign policy of permanent confrontation with the United States (see Tulchin [1990]). Argentina thus laid the ground for a new relationship with the world's biggest market, one that had clear global dominance in the technological and financial arenas. For the new Argentine government, the country's (and MERCOSUR's) insertion in the international financial and capital system was through the United States.[9]

In this stage, decisions were taken that shaped the development of MERCOSUR and its future performance.

First, there was a convergence of opinion between Argentina and Brazil on joint insertion into international trade, and further agreement on greater liberalism in the economic and trade fields; this facilitated the emergence of open regionalism.

Second, the Menem government established new relations with the United States. This endeavor found concrete expression in a strategy of insertion into financial globalization that explicitly acknowledged the United States' dominant role. The convertibility system, unlimited opening of the capital account and insertion into the world financial system were the most striking aspects of this strategy. Argentina thus opted for open regionalism as a means of inserting itself in international trade, and for political alignment with the United States as a means of dealing with financial globalization. Initially, this approach was not substantively different from that of Brazil: the 1994 Real Plan on stabilization differed little from this strategy. Future events, however, would show that this convergence was more apparent than real.

9 This interpretation owes much to a conversation with Joseph Tulchin in 1999.

II. THE TECHNICAL AND POLITICAL DETERMINANTS OF ECONOMIC POLICY COORDINATION

Policy Coordination in Integration

A country effects its international insertion through a combination of economic policies. Most particularly, a specific means of integration in world trade entails a particular tariff policy, tax policy, and external trade alliances. Similarly, insertion in world capital markets requires a certain policy on the exchange rate and on monetary and financial affairs. In other words, very many decisions covering a substantial range of economic policy areas stem from a country's more general strategies of international insertion.

Economic integration is part of these policies and the method of integration depends on them. Since two or more countries take part in an integration process, the kind of agreement that is feasible depends on the extent to which their strategies for external insertion coincide, and on the consistency of the policies adopted. If these strategies and policies are compatible, the agreement can be deep and wide; otherwise the accord will necessarily be partial and might fail. This is why policy harmonization is warranted in trade integration agreements. The usual approach has been to set out a certain model of trade integration and, on that basis, to coordinate policies in such a way as to make them compatible with the model. In other words, countries change their economic policy in order to adopt one that is similar to or compatible with their neighbors' policy. In this endeavor a country might have to alter its more general strategy of international insertion.

The preceding chapter examined the political rapprochement between Argentina and Brazil that gave rise to MERCOSUR. As mentioned, MERCOSUR flourished in a second stage of closer bilateral relations that began in the early 1990s. The reasons for the subsequent progress on integration are, first, the decision taken by the countries' governments to pool sovereignty on matters of economic policy; and second, the implementation of a policy of greater trade openness in both Argentina and Brazil. The process advanced because the elites of MERCOSUR's two biggest countries accepted less autonomy in economic policy-making and convergence towards more open trade patterns.

MERCOSUR's Integration Model

A second level of analysis of the Argentine-Brazilian rapprochement comprises the specific model chosen to bring about economic integration. That model was inspired by the European experience and was based on a detailed schedule of reciprocal trade liberalization and a timeframe for devising and adopting a common external tariff, these being the anchors of the commitment to integration. This model entailed trade liberalization, joint integration in the international trading system, and the parallel or subsequent coordination of a broad range of policies compatible with those agreements. As in the European model, the principle of a "single undertaking" did not apply, but rather an order of precedence among the agreements: free trade area, customs union, common market and so on. This was the path taken in the Treaty of Asunción: to ensure a substantial degree of integration at the outset, use it to induce a commitment to integration, and embark on a process of policy coordination so as to reconcile the strategies of all the MERCOSUR countries in line with the European model.

The questions that arise in this regard are as follows: first, whether the order of precedence of policies to be harmonized in line with the European model was appropriate in view of the nature of the MERCOSUR countries; second, whether it was politically possible to advance with all the necessary coordination - in other words, whether coordination would eventually conflict with more general strategies of international insertion that enjoyed broad domestic support in each country, and thus would fail to prosper.

The Technical Requirements of Policy Coordination

The role of policy coordination or harmonization is to create the conditions needed to ensure that the goals of economic integration are effectively met. To that end, policy coordination should facilitate proper resource allocation among the countries and regions in the agreement, in line with their comparative advantages. Moreover, it should allow economies of scale to be exploited and should equitably foster the dynamic effects on investment and growth among the member countries.

There is no single opinion on the set of policies that must be harmonized to ensure that an integration process works well. Some commentators maintain that practically all economic policies must be harmonized; others argue that efficient coordination calls for a distinction between three different situations: policies that can remain under the national control of each country, either because they do not substantially and negatively effect the goals of integration or because they form part of a legitimate sphere of competition between the members; policies that must be harmonized; and policies that must be eliminated because they amount to unacceptable distortions to competition. The MERCOSUR governments opted for the latter path so as to avoid excessive interference in the countries' decision-making autonomy.[10]

Experience of these three situations is extensive and the literature on them is abundant. The policies requiring harmonization obviously increase and become more complicated in line with the extent of the planned integration. Even the initial stage, however, the free trade area, calls for a complex coordination agenda. There is no common tariff in a free trade area but there is discriminatory access to the partner's market. That circumstance itself demands the harmonization of fiscal policy with a tariff-equivalent effect, as well as the elimination of public policies that distort competition - meaning state aid that confers excessive advantages on a group of producers or businesses depending on the country in which they are located. It also calls for resolution of the problem of competitive devaluations, which in turn raises the issue of exchange rate and monetary coordination.

At the same time, countries in a free trade area must address the problems attendant on the underuse of resources that necessarily arises from a change in the conditions of competition. The EU has addressed such problems by means of income transfers from the richer countries (or those that gained from the competition) to the countries that incur the highest adjustment costs. When such

[10] A decision in this regard was not always clear. In the calendar agreed at Las Leñas, for example, complete policy coordination was contemplated. The experience of the negotiations, however, shows that the alternative route of essential coordination was taken.

transfers are impossible, thought might have to be given to broader agreements on the movement of people and workers as a means of mitigating the economic and social impact of unemployment. Hence even a free trade area, apparently simple in terms of its demands on policy coordination, could involve extensive deepening in order to work properly.

A customs union - which in the European experience is the next higher stage of integration - also demands harmonization of the tariffs applied to third parties and a common trade policy; that is, it involves a coincidence of commercial alliances with third countries. A customs union boosts the importance of the policy coordination needed in a free trade area. In a free trade area there is agreement on discrimination, and hence too on trade diversion. The loss of independence in the implementation of tariff policy entails a loss of freedom to counteract any distortions that might arise from public policy-making or from abrupt shifts in competitiveness spurred by devaluations in partner countries, while such devaluations have a greater impact. Thus it is important to remember that a customs union is a much higher stage of integration than it appears at first glance. Before a customs union can be established the member countries must allow unlimited access to their markets, eliminate the effects of public policies that distort competition, harmonize their exchange rates and allow the free the movement of workers. Only when such coordination is complete can the tariff be successfully applied and the policy of common trade alliances be effected.

The MERCOSUR experience shows that the order of precedence among the policies to be harmonized is not a problem that can be solved in a general way, one applicable to any concrete exercise in integration. Each circumstance makes its own demands. The integrating countries evince structural features that might entail different priorities. MERCOSUR is marked by substantial asymmetry among its members and by the fact that the biggest market lacks a currency that can serve as a reference for the other members. In this context the European model is not necessarily the best one to follow. In the EU, the monetary and exchange rate agreements that pre-dated and paralleled the trade integration process facilitated the timing of the agreements that was enshrined in the text books. The EU was founded, first, on the basis of the Bretton Woods accords and then on the basis of the German mark as a reference currency (Mundell [2001]). This is why tariff matters could be addressed before agreement was reached on exchange rates and the currency.

Political Constraints on Coordination

Deciding on a path of consistent policy coordination, however, can be a somewhat theoretical exercise, since the advisability of or need to harmonize policies do not necessarily mean that coordination can be brought about. In this regard MERCOSUR's difficulty in policy coordination, and that of other regions, is clear. It should be kept in mind that policy coordination involves changing decision already made in the member countries. This is not always possible because there is a pre-existing domestic consensus on those decisions. MERCOSUR, for example, could not harmonize exchange rate policies at the same time as the schedule of tariff reduction and the application of the common tariff. This problem did not reflect ineffectiveness in the negotiations but rather that Argentina and Brazil, the two biggest partners, differed significantly and increasingly in their strategies of insertion into world capital markets. Those differing strategies were supported by a substantial degree of elite consensus within the two countries, and the negotiation of MERCOSUR was not strong enough to alter them.

When coordination is addressed in an integration initiative, therefore, thought must be given to the two different kinds of problems that arise. The first consists of determining the set of policies that must be coordinated; this depends on the degree of integration under consideration. The second consists of determining which set of policies can be harmonized. Coordination involves replacing some policies with others. Some of those policies might be part of a country's more general project, one on which there is enough agreement and which will be very hard to change. For that reason, integration processes call for familiarity with and discussion of the projects that each country is pursuing, their underlying motivations, and the policies through which the policies find expression. With such knowledge, the boundaries of possible integration can be set.

III. ON ELITES AND MERCOSUR

Contents

Elites in a Country's Policies of International Insertion

Research on national projects that are deeper, more stable and hard to change, and that explains why governments act as they do, comprises an important component of any analysis of an integration initiative. One way of conducting such research is to examine the opinions of national elites. Studying elite opinions as indicators of national public opinion has two basic advantages: first, it is simpler and faster to sound out elites in detail than to study public opinion; and second, putting in place a political project calls for decisive leadership, which can only come from national elites. Public opinion can block options, but it can scarcely posit and promote alternatives. Hence elite opinions on a country's strategic options can have a significant effect on whether they are adopted.

In the 1990s there were various studies of Latin American elites' opinions of their countries' international insertion. Such studies did not exhaust exploration of the matter, but some general conclusions can be drawn from them that are worth considering. First, it can be argued that national elites have an opinion: there is a country-specific way of looking at things. There is also a coincidence among national elites that transcends their divisions into occupational sectors, ideological or party inclinations, age groups and so on. In this regard there is greater similarity of opinion on strategies among two compatriots than among the members, for example, of an occupational subgroup in two different countries. This holds true for Latin America in general, but most particularly for Argentina and Brazil. Second, elite opinions on these issues are relatively stable and tend to persist beyond periods of government. Thus some policy approaches tend to continue, despite changes in national governments.

The discussion that follows essentially deals with MERCOSUR as a component of a more general strategy, as expressed by the members of the Argentine and Brazilian elites. The analysis uses the findings of a IDB-INTAL research project on the opinions of Latin American elites towards their countries' optimal insertion in the world economy (Achard, García Pelufo and González [2001]). That research involved a survey of over 700 members of the Argentine and Brazilian elites, and 165 in-depth interviews. The present analysis centers largely on the opinions of elites in Argentina and Brazil because of the role of those countries in shaping MERCOSUR.

There are two parts to the analysis. The first describes the Argentine and Brazilian elites' opinions of trade integration - that is, their assessment of regional integration; the value of concluding agreements that entail higher levels of integration (appraisal of the common tariff) or that are geographically more extensive than the present accords (attitudes towards the necessary trade-off between deepening MERCOSUR or expanding it to other countries); the direction of the agreement's enlargement (South America, NAFTA); and the preference for multilateral approaches rather than participation in blocs. Later, the analysis addresses the background to and aims of macroeconomic coordination in MERCOSUR, the problems for the incipient customs union that are attendant on the different exchange rate regimes in Argentina and Brazil, the harmonization strategies needed and the difficulties of applying them because of differences in government perceptions, which in turn are based on broad consensus among the national elites.

MERCOSUR as Part of a Country-Project as Expressed by the Elites

Argentina and Brazil have diversified trade structures and trade equally with the United States, the EU and Asia. Regional trade has intensified because of the reciprocal preference granted within MERCOSUR, and its pattern is different from commerce with the rest of the world inasmuch as it comprises a greater share of manufactures. Naturally, therefore, both countries deem it important that they have preferential access to their neighbor as a strategy of industrial development, and they favor the multilateral approach to trade issues and market access over the alternative of accession to a hemisphere-wide bloc.

There are, however, various opinions on different strategic issues. Brazil is a country on a continental scale and is therefore seen as big by its elites, which unambiguously evince their vocation for a Brazilian presence on the world stage. Hence Brazil has sought for decades to develop its industrial capacity as a condition of a more independent participation in the international system (Soares de Lima and Hirst [1994]). This strategy found expression in the Vargas model in the 1950s. Application of the model gave rise to a coalition of entrepreneurs, politicians and diplomats, an alliance that sought industrialization on the basis of the protection of the domestic market.

The transformation of the world economy at the start of the 1990s affected elite opinions. In Brazil there persisted a substantial consensus on industrialization as a strategy of development and international insertion. There was agreement that the Vargas model had been successful, since the country had a more diversified productive structure. Few believed that this would have been possible without state intervention. Nonetheless, most admit that the import substitution model had run its course from the 1980s onwards, and that economic opening was inevitable. There is further agreement that industry must mature in order to grow outwards, and that the process calls for domestic policies that are more compatible with internationally accepted trade rules.

The Argentine elites lack a single view of their country's role in the world, one as structured as that evident in Brazil. While the perception in Brazil is that interventionism was positive for industrial development, in Argentina the application of autonomous macroeconomic policies is more associated with the notion of a relative loss of the country's international wealth ranking and with hyperinflation. For Argentina, the relationship with Brazil is mainly with the latter's market. Fear of commercial isolation is not evident, and there is no perception of political goals beyond the possible importance of uniting to negotiate international market access conditions in multilateral organizations.

The Customs Union

The Argentine and Brazilian elites agree on the goal of trade integration between the two countries. The prospect of a preferential market is deemed important for both countries' industrial development, but there is no unanimity on the advantages of making the trade agreement a customs union. Brazilian opinion is divided on the common tariff. Those in favor are grouped into two schools of thought: one is more liberal, according to which the common tariff is a means of locking in Brazil's opening. Generally, proponents of this view admit that the level and structure of the common tariff are correct. The second view is that the common tariff, and the common trade policy that it implies, serve Brazil's interest in averting the commercial isolation that could have arisen should a competitive model such as NAFTA have proven attractive for its immediate neighbors, especially Argentina and Chile.

The contrary opinions are generally held by part of the business sector and some political groups that oppose the common tariff because it hampers policies to protect domestic industry. Proponents of this view maintain that Brazil, by virtue of the size of its market, should not be subject to the smaller markets' considerations of competitiveness. Much Brazilian elite opinion argues that the country should be more autonomous. In general, these sectors believe that the tariff is very low, and thus that it provides inadequate protection for national industry in the face of competition from industrialized countries. They see the common tariff as a constraint and a threat to Brazil's industrialization efforts.

The smaller MERCOSUR countries, like Uruguay, share the view that the tariff should be the anchor of economic opening but argue that it should be lower. In Uruguay particularly, questions arise about some aspects of the tariff structure, such as the level of tariffs on capital goods, information technology products and some general inputs such as chemicals and metals. This view is consistent with the productive structure of specialized industry dependent on access for inputs at international prices.

The Trade-off between Deepening and Widening

There is a trade-off between the depth of an integration agreement and the prospect of extending it to other countries. The more sophisticated the agreement, and the more numerous and complex the policy instruments involved, the harder it is to include new members. In MERCOSUR the point in question arises because of the customs union, which involves a common tariff and a commitment to a common trade policy among the members. This became the main obstacle to the inclusion of Bolivia and Chile in MERCOSUR. Chile's tariff, for example, is different from and lower than that of MERCOSUR, and the country gives priority to a trade policy that is both independent and balanced in its relations with the different regions of the world. Thus it cannot adhere to MERCOSUR's tariff accord.

This circumstance necessitated agreements of a different kind between MERCOSUR and the potential new members, which entailed asymmetries that often run counter to the immediate interests of the founding members. Moreover, it gives rise to different kinds of membership, which is unhelpful from a political standpoint and contrary to the goal of uniting all of South America. Hence, if the priority is to incorporate new members, it is important that the agreement be simple and that it involve few instruments, as is the case of a free trade area. If the priority is to build an economic union, the accession of new members must be foregone.

Argentine opinion favors deepening the MERCOSUR agreement over enlarging the bloc immediately. There is general agreement on extending membership to Bolivia and Chile because of their geographic proximity, but as a final step before further deepening. The agenda of deepening must include, as a priority, completion of the customs union and macroeconomic policy coordination. Argentine opinion is rooted in two main aims. The first is favored access to the Brazilian market for a prudent length of time, without the competition of the rest of the world (preferential access).

should be seen as the optimal approach in a strategy of insertion into world trade. Many, however, recognize that a bias for hemispheric integration could be helpful, since the priority relationship with the United States could help resolve problems in trade rules (in the area of agricultural trade, for example) that are hard to tackle in multilateral fora.

The Elites' Agreement on the Trade Project

Analysis of the opinions of Argentine and Brazilian elites reveals substantial agreement on the goals of regional integration and the preference for multilateralism. These agreements explain the swift implementation of MERCOSUR's tariff reduction schedule between 1990 and 1994, as well as success in devising the common tariff and its adoption (with some exceptions) in Ouro Preto in 1994. The agreement also explains, and for the same reasons, the success of applying the European model to the negotiation of MERCOSUR. According to the European model, agreements on reciprocal tariff reduction and the establishment of a common tariff (the areas of consensus between the MERCOSUR elites) are the first steps in an integration initiative. MERCOSUR, however, could not prosper as a customs union with distinct national monetary regimes and a very modest degree of institutionalization.

During the negotiation of the Ouro Preto Protocols the various delegations were aware of the possible problems that might stem from a lack of agreement in the area of exchange rate and monetary policies. Hence they set up working groups to determine courses of action in these areas. Below, the study examines this background to monetary coordination in MERCOSUR and the reasons for the scant progress made in this field in the bloc's first ten years. In this case, the motivations of the different countries' elites diverged, a circumstance that entailed the establishment of financial, monetary and exchange rate policies that were incompatible with the commercial commitments assumed in the Treaty of Asunción.

The second is to limit the discretionality of Brazilian policy by "tying" Brazil to an agreement that truly acts as an anchor of national stabilization policies (macroeconomic coordination).

Brazilian opinion is not unanimous in this regard. One school of thought - linked to more liberal sectors - regards deepening as a priority. Normally, these sectors view MERCOSUR as an anchor of policies of economic opening and of the stabilization strategy. The other school of thought, generally associated with Brazil’s traditional industry, gives priority to the expansion of free trade accords to the rest of South America. According to this view, Brazil should prioritize access to those markets that have trade growth potential similar to that displayed by MERCOSUR when it was established. Proponents of this view prefer to weaken commitments on the common tariff and common trade policy if such a course helps facilitate agreements with the rest of South America. These opinions are normally held by the same people who believe that the common tariff offers inadequate protection and that it unhelpfully lessens Brazil’s flexibility to adapt its protection to different contexts and to its own industrial circumstances.

Widening to Where?

As regards widening MERCOSUR, there is almost unanimous agreement in Brazil that accession to NAFTA would not be beneficial, and that it would be better to extend the agreement to the rest of South America. There are various nuances and lines of argument in this view. First, those linked to the business, political and diplomatic sectors believe that accession to NAFTA is not conducive to Brazil’s industrial development. They maintain that Brazilian industry is currently unprepared to face competition from US industry, and thus integration with the US economy would have an deindustrializing effect. Hence closer relations with the United States are seen as a threat from the standpoint of those industrialists who benefit from protection, and from the perspective of a policy to develop industrial capacity as a means of fostering greater independence for Brazil on the international stage.

The other line of argument is advanced by more liberal academics and politicians. These believe that opening the Brazilian economy to the United States would amount to an unsuitable combination of high adjustment costs and trade diversion, since they see integration with the United States as a suboptimal alternative to multilateral opening. They argue that henceforth the opening should be negotiated in the WTO (see Fritsch [1989]).

By contrast, the inclusion of new members in South America is workable from both perspectives in Brazil, since integration with smaller economies is not viewed as deep integration and does not threaten Brazilian industry. Rather, it would extend the country’s influence and give it preferential access to new markets. From a strategic viewpoint, the integration of South America would obviate the danger of Brazil’s commercial isolation as a result of an agreement between the United States and Spanish America, and would strengthen Brazil’s political position in negotiations on international trade rules in specialized fora.

The emphases are different in Argentina, where it is argued, first, that the extension of the agreement, even to South American countries, could be unhelpful since it could lead to the "aladification" of MERCOSUR. Second, there are fewer objections than in Brazil to deeper hemispheric integration in future. The opinions are quite convergent that MERCOSUR could use its political strength to exert influence in multilateral organizations, and that multilateralism

IV. MACROECONOMIC POLICY COORDINATION IN MERCOSUR

Background to Macroeconomic Policy Coordination

According to the Treaty of Asunción, macroeconomic coordination is one of the commitments of integration. The treaty, however, neither sets dates for its implementation nor defines the substance of this commitment, which can be interpreted in different ways. In the early years of the integration process there was no evident need to address the problem of macroeconomic coordination. The basis of coordination is interdependence (see Branson *et al*. [1990]), and initially this was relatively low among the MERCOSUR countries, especially between the biggest members. With the passing of time, however, the trade agreement increased such interdependence and the danger of competitive devaluations among the partners became more evident. Hence the need for some kind of limit on such policies or, alternatively, compensatory instruments to deal with their effects.

To that end the High-Level Group was set up in 1993 to advance work on this issue. The group discussed two approaches: one, proposed by Argentina, implied harmonizing exchange rate regimes on the basis of fixed rates relative to the dollar, and devising a program for macroeconomic coordination. This strategy entailed MERCOSUR's monetary integration through the adoption of an external monetary standard, Argentina's strategy for insertion in world capital markets since the start of the 1990s. This approach, however, was incompatible with the Brazilian strategy of autonomous insertion based on the development of a fiduciary currency unsubject to the rules imposed by convertibility. Such differences in macroeconomic policy were not minor; they sprang from circumstantial options that could change once it became apparent that it would be useful to choose the other's policy. What seemed to be a divergence in short-term adjustment policies, however, wherein Argentina gave priority to rules and Brazil favored discretionality, was part of more basic policy options that were very hard to change.

Aware of the difficulties of reaching agreement on monetary integration at this stage of the negotiations, the Brazilian delegation suggested another approach related to the MERCOSUR countries' policy responses to a competitive devaluation by one of them. This approach contemplated monitoring real exchange rate movements and setting a maximum band for fluctuations. If the real exchange rate surpassed these limits, a partner could apply countervailing measures. There was no consensus on this matter, however, and hence the discussions did not lead to a specific protocol at Ouro Preto.

In 1999, in the face of problems caused by the devaluation in Brazil, a similar group with a comparable mission was set up. This time, in contrast to its posture in the High-Level Group in 1993, Brazil opposed the application of countervailing measures as a result of its devaluation. With the four MERCOSUR countries at loggerheads over the proper response to the devaluation, the new group focused on preparations for the choice of macroeconomic convergence variables. With some interruptions, the group's work has continued to date but little progress has been made except in enhancing the measurement of aggregate variables.

The Advisability of Macroeconomic Coordination

The literature offers conflicting opinions on the need for or advisability of macroeconomic coordination in trade integration schemes. Strictly speaking, trade needs neither macroeconomic coordination nor macroeconomic stability in the countries doing the trading. The free trade option makes provision for automatic adjustment mechanisms for balance of payments disequilibria. In this regard it can be said that trade integration can flourish without other accords on the exchange rate, inflation or the fiscal deficit. There are reasons to advocate such policy coordination, however, and it is particularly significant for MERCOSUR. First, one of the aims of integration is to exploit the development of activities on the basis of economies of scale and the growth of intra-industrial trade. These goals are very hard to meet if exchange rates are not stable. Efforts to avert exchange rate volatility, therefore, are conducive to the comprehensive exploitation of the potential advantages of integration.

Second, the trade diversion costs associated with tariff preferences rise in line with the instability of real exchange rates and the variability of competition conditions arising from that instability. A clear example of this circumstance is provided by the effects of the devaluation of the Brazilian real on Argentina. Brazil’s devaluation contributed to a 7% fall in output in Argentina during the third quarter of 1999. That average, however, comprised a 22% decline in activities geared mainly to the Brazilian market and a 2% fall in the rest. The most significant effects were on Brazil-dependent activities - those whose trade is effected exclusively through discriminatory agreements and which cannot compete in other markets. Output in the automotive sector, for example, fell by almost 50% that year. In a free trade area the member countries retain discretional control of tariff policy, thus preserving their autonomy to influence such discrimination and to lower the costs attendant on a partner’s diversion and instability. In a customs union, by contrast, discrimination is agreed; hence the partners lack such freedom. In a customs union, therefore, agreements on macroeconomic coordination designed to attenuate the effects of instability in a partner country are more important.

In general these considerations are valid for any integration agreement, but they are even more so in the case of MERCOSUR because of the size asymmetries among the members and the absence of a dominant currency. As mentioned earlier, the country with the region’s biggest market lacks a currency that can serve as a reference for the others. This was not the case in other integration experiences. In Europe, particularly, the presence of the dollar standard until the 1970s and the mark-based system thereafter explains why monetary integration issues were tackled after much trade had been liberalized and much of the customs union had been built. In other words, a model of integration that progressed from a free trade area to a customs union, then to a common market and finally to economic union, one with explicit provisions for monetary issues, responded to a very specific monetary context. Hence MERCOSUR should follow a sequence different from that of Europe if the scheme is to work properly.

Exchange Rate Incompatibility

Brazil devalued the real in January 1999 and for that year as a whole - given the modest transmission of prices from the original devaluation - its currency depreciated by about 40% in real terms. This made Brazil dramatically more competitive than its smaller neighbors. That was the first of three years in which Brazil's exchange rate floated while Argentina clung to the convertibility regime. This disparity in exchange rate systems was obviously inconsistent with MERCOSUR's aims. The dynamics of balance of payments adjustment differ in the two countries and militate against the short-term maintenance of output levels in a country that does not devalue in order to adjust. In a fixed exchange rate regime (such as the Argentine convertibility system), if the real exchange rate is disrupted it finds its new level through price deflation. In a floating rate system, the shock is absorbed directly by a nominal depreciation of the domestic currency. This helps cushion the effect on employment by "exporting" part of the recession to the rest of the world. A customs union agreement - which entails "opening up" tariff policy - imposes a further constraint on the balance of payments adjustment policies of a country with a fixed exchange rate, limiting its options to price deflation as a means of re-establishing balance.[11] In this regard it is plain that a customs union further complicates an adjustment policy when there is disparity between exchange rates.

In 1999 MERCOSUR's senior bodies held several meetings to assess this situation. The Brazilian government opposed the adoption of general defensive measures - such as fiscal devaluation - as a means of attenuating the effect on economies with fixed exchange rates. Brazil's position left its partners with few options other than to devalue their own currencies.

These circumstances did not make provision for the fact that the convertibility regime was a central part of Argentina's stabilization and growth policy, and that it amounted to a strategy of insertion into world capital markets that the country had chosen ten years earlier. This explains the co-existence, for almost three years, of different exchange rate regimes incompatible with the proper functioning of the trade agreements. In mid-2001, Argentina unilaterally embarked on a fiscal devaluation[12] that even applied to trade with the other MERCOSUR countries. In early 2002, amid a significant run on the banks, Argentina abandoned convertibility after almost four years of recession. This dragged down the smaller countries of the region. The MERCOSUR countries' currencies now float against each other - a situation of complete monetary disintegration. Their exchange rate regimes coincide, but the disintegration is absolute. To regain the path of integration entails replacing the current arrangement with an exchange rate and monetary agreement that is compatible with the trade and tariff accords.

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11 This hampers, for example, use of a fiscal devaluation to cushion the effects of a negative external shock.

12 In Argentine political slang this is known as the "splicing" of parity.

V. ISSUES FOR A FUTURE AGENDA

Contents

The region is not in good shape. Brazil has preserved stability but remains vulnerable to the fortunes of world financial markets. The other members are in recession. No further analysis is needed to assert that since 1999 MERCOSUR has been moving in a direction opposite to integration. The MERCOSUR countries have had to bear the ravages of the world economy, and since 1999 they have had to absorb much of the recession exported by Brazil.

How does the region's current situation affect MERCOSUR? If the recovery of the Southern Cone economies is a likely future scenario, what will remain of MERCOSUR in that scenario? How is it likely to develop? Elucidation of these matters requires attention to the main determinants of MERCOSUR and its future development. First are the conditions imposed by the international and regional contexts. Such conditioning has changed little in the last ten years and is unlikely to change in the near future. Second, elite opinions on the strategies that the countries should adopt in pursuit of international insertion should be kept in mind.

The opinions of the elites, as mentioned earlier, are relatively stable. In the area of insertion into the international trading system, the external stimuli and conditioning are similar and the strategy to tackle them will probably be the same. In the case of insertion into financial globalization, however, the outlook is less simple. The problem consists of the decisions taken by Argentina. Unlike Brazil, Argentina lacks a wholly structured project of international insertion. Historically, Argentina elites have been radically divided between economic liberals advocating complete insertion and, on the other hand, a more populist and autarchic approach.[13] Argentina is now reconsidering its policy options, and it is hard to predict what strategy will emerge from that process. The argument herein is that the region will preserve a willingness to integrate commercially but that there is unlikely to be the same form of insertion into financial globalization as in the past. Unfortunately, it is impossible to guess which alternative strategy will be adopted.

Third, one of the factors that will affect MERCOSUR's future agenda consists of the ten years of experience to date. In that regard the influence of some recurrent trade disputes, and the inadequate development of rules and institutions (a failing that reveals MERCOSUR's marked difficulties in resolving such disputes), should not be underestimated. At the same time there persists a vivid memory of the devastating impact of exchange rate volatility and the incompatibility of exchange rate regimes. Finally, certain structural characteristics of the MERCOSUR member states, such as size asymmetries and the absence of a common reference currency, will doubtless shape the future agenda.

On the basis of these factors there follows a proposal to shift the emphasis from the common tariff commitment that has prevailed thus far to an agenda that covers the three most important issues for deepening MERCOSUR: institutional matters, the problem of exchange rates, and migration. This approach is valid for three main reasons: it is an appropriate response to MERCOSUR's external challenges; it is an approach that the region's elites can share; and it confers greater legitimacy on the agreement than it has enjoyed to date, thus facilitating a more equitable distribution of benefits.

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[13] For an historical analysis of this dichotomy see Shumway [1993].

Reconsidering the Common External Tariff

From Ouro Preto to the present, tariff harmonization has been the main item (often the only item) on the agenda for deepening MERCOSUR. This is explained in the context of the European integration model, according to which a customs union is the second stage of the process and must be completed before countries advance to a new stage (a common market).

Between the signing of the Treaty of Asunción and Ouro Preto, MERCOSUR made great efforts to agree on and put in place a common tariff. Certain policy decisions were taken, such as defining a rising tariff structure with 2% increments, a ceiling of 20%, and a zero rate for non-produced goods. The aim was to make the effective protection vertically uniform throughout the chain, and horizontally so for the various links in the process. Using these criteria the governments devised a tariff that nonetheless harbored some inconsistencies. These stemmed from the industrial circumstances of the biggest countries or their policy needs. In particular, widespread intermediate phases in the chemicals chain and the metals chain were left with greater effective protection than the rest. Paraguay and Uruguay secured temporary exceptions so as to avert the deindustrializing effect of these tariff inconsistencies, and they temporarily retained tariff autonomy in capital goods, telecommunications products and key inputs for agriculture. Such exceptions were an important part of the two countries' industrial policies and the temporariness became permanence over time.

Work on the common tariff advanced swiftly, although it was impossible to complete it for political economy reasons. The tariff and its exception regimes amounted to a political agreement and balanced out positions that were very hard to change without causing a severe bias against the interests of some parties to the accord, especially the smaller countries. The common tariff entailed a cost for those countries, one that would be fully apparent if the tariff were to be harmonized in line with the current Brazilian tariff. The argument is related to Jacob Viner's traditional argument on trade diversion, and to the significant size asymmetry among the member countries. For countries like Paraguay and Uruguay, the adjustment costs of regional opening in MERCOSUR are the same as opening to the world. The effects of such an opening, however, are nor the same as a global opening in terms of efficiency, since the partners are not the most efficient suppliers of all the inputs that a country imports. Thus for small countries, once their economies are open to the region, a relatively high tariff comprises a cost that is hard to justify in economic or simply political terms.

The problem is even worse when the tariff is applied in the absence of stability in the smaller countries' access to the larger economies. Because of the region's exchange rate volatility or the use of policies that distort competition, the smaller countries have not fully received the benefits of access to neighboring markets. This is a paradigmatic case of the inadvisability of taking the path dictated by Europe's order of precedence without prior resolution of monetary coordination issues, and without having made real progress on developing institutions to battle against state aid.

Another aspect of this problem is the demand imposed by a common trade policy when there are limits on access to the regional market. When there is a economic contraction, competitive devaluation or policies to protect the domestic market, the smaller countries must find alternative markets for their products and secure inputs at international prices so as to nourish domestic output. In these cases the constraints of a misunderstood common trade policy can compromise a small country's economy. Tariff harmonization, therefore, should be part of a single undertaking that includes exchange rate and monetary agreements, as well as institutional mechanisms that avert or counteract the consequences of state aid. The time that these agreements take to reach will determine how long it takes to secure complete tariff harmonization.

In this light, it might be said that the tariff is solely part of a conflict of interests between MERCOSUR's big and small countries. This is only partly true. The common tariff policy faces strong opposition among large sectors in the bigger countries. As mentioned in Chapter III, in Brazil there is strong resistance to delegating the protection of Brazil's domestic market and its policy of internal alliances to the other MERCOSUR countries. This was shown by Brazil's proposal to create a South American Free Trade Area (SAFTA) in 1993, the tariff lists (the Dalliari list and others) with which Brazil acted with increasing independence from 1995 onwards, and Brazil's negotiations with the Andean Community (independently of MERCOSUR) in 1999. Hence the current tariff disparity - which in any case centers on a relatively narrow range of items - reflects a balance of interests among the MERCOSUR members and within the bigger countries. It is not only inadvisable to harmonize completely before the other agreements mentioned earlier; indeed, it will be politically difficult in the short term because of the role of tariff disparity in the smaller countries' policy and the opinions prevailing among substantial sectors in the larger countries.

The Institutional Agenda

Size asymmetries in MERCOSUR are the main reason for its relative institutional underdevelopment. In general it can be argued that Brazilian elites have been reluctant permanently to cede significant autonomy to a group of smaller partners. The country has been willing to renounce some independence for the purposes of joint policies in the area of international trade, as evidenced by the customs union project and the concrete progress made on it. Nonetheless, it has resisted being subject to rules that might irretrievably compromise that portion of shared autonomy, and has always sought to make such rules a target of continuous modification in a negotiating process wherein it is the dominant player.

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. Notably, the application of national rules on unfair trade practices to intra-MERCOSUR trade amounts to protection, used recurrently by Argentina in particular, to cushion the effects of the devaluation of the real. State aid, be it offered by a central, state or provincial government, provides a spurious stimulus to competition for the location of investment and affects trade in other ways. Examples of the latter are the "fiscal wars" between Brazilian states to attract investment, especially in the automotive sector.

The prospect of subjecting state aid to MERCOSUR control is the main point but, at the same time, the hardest to achieve because of the motivations of the member countries. An integration process cannot be deepened, however, without finding a satisfactory solution to this matter. In this regard, size asymmetries play a fundamental and pernicious role: the biggest country, as mentioned, has a significant incentive to retain autonomy in the area of state aid, while its application of such policies has a devastating effect on the smaller countries.

The argument normally made against institutional development centers on the need to avoid the creation and proliferation of costly and ineffective multinational bureaucracies. This concern is wholly understandable: creating institutions does not solve the underlying problem, which is the governments' resistance to relinquishing a degree of autonomy, and thus the proliferation of institutions can subsequently lead to a waste of resources. Completion of the institutional apparatus, by contrast, should center on creating norms and procedures that facilitate trade and avert anti-competitive distortions. One way of doing this is to devise a common set of regulations on the protection of competition, one applied to MERCOSUR as a whole and that, duly transposed into domestic law, can be enforced by the national agencies working in this field. Thus the national-level institutions, using a common MERCOSUR rule, would be responsible for rectifying a public policy or applying a countervailing measure so as to correct that policy's effect when the legitimate interests of the citizens or businesses in a partner country are affected.

Unfair Trade Practices and State Aid

Three problems related to unfair trade practices conspire against deeper trade integration: dumping, monopolistic practices, and state aid. A good is the object of dumping when the export price is below the sale price in the country of origin. This is a business practice that does not arise from the application of policy. Dumping can only happen if the markets are segmented.[14] It gives rise to the application of specific rules and procedures provided for by law and is corrected using border measures - antidumping duties - against the foreign exporting company.

Monopolistic practices also stem from business conduct and are evident, among other things, as price discrimination or the fixing of prices above the competition price. A monopoly allows certain firms to exploit the MERCOSUR market in the shelter of the protection afforded by the tariff. In some countries this kind of behavior is tackled through specific legislation - antitrust law - and is dealt with in the courts and through special procedures. In this case the offender is a domestic market-based company and the regulations are designed to discipline uncompetitive behavior. The corrective measures provide for protecting the consumer from the goods and services provided by the monopolistic supplier.

State aid is a matter of public policies, not business practices. These are transfers that confer competitive advantages on a company or group of companies according to the country in which they are located. As regards this kind of distortion, WTO rules make provision for the application of border measures - countervailing duties - on imports of products from the country that provides state aid.

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[14] In a customs union, dumping in intraregional trade can only happen when the union's market is not well integrated - that is, when complete tariff uniformity is lacking and there are still barriers to reciprocal trade. This is the case in MERCOSUR, and thus dumping among firms in the bloc is technically possible.

Protection against Unfair Trade Practices

To work well, a free trade area needs a different approach to deal with unfair trade practices, so as to ensure that resource-allocation in the enlarged market is effected on the basis of the comparative advantages of each region and, additionally, that investment is allocated efficiently among all the countries of the agreement. First, antidumping and countervailing duties should be applied to extra-regional imports on the basis of a harmonized set of regulations, but it is inadvisable to apply them to intra-regional trade. In the latter case, given the characteristics of traditional antidumping rules, use of them can conspire against the integration of the economies and raise a further non-tariff barrier (NTB). Second, a framework must be established for impartially dealing with public policies that distort competition. Such practices originate with the governments themselves; hence the need for independent regulations and institutions to address the matter.

This can be done better by replacing traditional the antidumping regulations for intraregional trade with other rules on safeguarding competition that simultaneously deal with dumping, monopolistic practices and state aid. The advantages of such an approach are as follows:

- The aim of rules on protecting competition is efficiency, and the corrective measures are geared to remedying the social harm arising from anti-competitive practices. Antidumping regulations, by contrast, protect the interests of those firms, based in a particular country, that are affected by the dumping. Hence antidumping legislation and its application to intraregional trade has a potentially protectionist effect, and thus can be a means of imposing new NTBs.
- The discipline of antitrust legislation is much more stringent and restrictive for the application of measures that constrain trade, and therefore it has much less protectionist potential.
- This kind of regulation can offer an appropriate framework for addressing, in an orderly manner, the harmonization and/or dismantling of public policies that distort competition in MERCOSUR, including the removal of NTBs and the use of corrective measures against such policies.

This approach was accepted by the different delegations of the MERCOSUR member countries. In 1994, however, in Ouro Preto, the governments opted to address the protection of competition as a strictly antitrust matter at the level of the national delegations, and the problems caused by dumping and subsidies (state aid) were referred to the Trade Commission, which thenceforth would act as an inter-governmental body. This meant, first, that trade dispute settlement remained in the realm of negotiations rather than being subject to jurisdictional rules and institutions. Second, the governments thus avoided having to subject their state aid-granting authority to a general regulation enjoying region-wide acceptance.

Macroeconomic Coordination and Monetary Integration

Deepening MERCOSUR requires eliminating exchange rate volatility among the member countries. Exchange rate volatility keeps the market segmented along national lines, which minimizes the positive effects of integration on resource-allocation, the exploitation of economies of scale and investment. Trade integration, especially in the form of a customs union, exacerbates the negative effects of exchange rate volatility since it raises the cost of the trade diversion attendant on tariff discrimination. This latter problem is more serious when there are size asymmetries among the countries and the negative shock comes from the biggest country. An example of this situation, as mentioned elsewhere in this article, is the effect of the devaluation of the Brazilian real in 1999 on output in the other members.

The lowering or elimination of exchange rate volatility demands the joint, negotiated (even as regards their quantitative aspects) implementation of monetary and fiscal policies. In this regard the High-Level Group on Macroeconomic Coordination (which was created by decision 6/99 of the Common Market Group) produced studies on the choice of variables to be harmonized and how to measure them correctly on comparable bases; these amount to a crucial prerequisite of future stages of deepening MERCOSUR.

Macroeconomic coordination is necessary to avoid exchange rate volatility, but the experience of flexible rates since the 1970s reveals that such coordination is not enough. This is evidenced by the exchange rates between the dollar, the euro and the yen. The three currencies correspond to three large areas of monetary stability and display a substantial degree of convergence (their rates of inflation are under 2.5%). Nonetheless, these three currencies fluctuate significantly against each other. Hence the monetary arrangement to limit exchange rate volatility in MERCOSUR must make provision for establishing stable movements among the member countries' currencies. This, however, demands a more developed institutional apparatus than mere macroeconomic coordination.

The Future of Macroeconomic Coordination

The present state of the MERCOSUR economies does not spur hopes of swift action on macroeconomic coordination. Now is the time, however, to consider the options that will be available once the economic situation is more settled. Once the Southern Cone countries are in "less turbulent waters", this aspect of political and economic relations among them should be revisited as a priority.

In choosing an exchange rate arrangement for MERCOSUR, two things must be considered: one is the relationship between the MERCOSUR currencies; the other is their relationship to the leading currencies. As to the first of these, this study has sought throughout to demonstrate that the retention of national currencies and uncoordinated exchange rate regimes is not conducive to effective trade integration. This is the case of the 1999-2001 period, when flexible and fixed regimes were combined. It is also true for the situation that emerged in 2002, when all the member countries agreed on floating exchange rates. The coincidence of exchange rate regimes did not necessarily mean that the arrangement was compatible. Generalized floatation amounted to a complete absence of rules and a minimum level of monetary integration. Were this situation allowed to continue, it would mean a more general decision had been taken to keep the level of trade integration to a minimum. The alternative is to establish some stable and familiar rule among the parities of the MERCOSUR currencies. This option, in turn, opens up two alternatives as regards the relationship between the MERCOSUR currencies and the other currencies. The great dilemma to be resolved is the following: whether MERCOSUR will have a fiduciary currency of its own, one that floats against others, or whether it will adopt an international currency as a monetary standard.

The advantage that economic theory assigns to a currency of one's own is the chance of using monetary policy to tame the cycle. This prospect, however, rests on the implicit assumption that the demand for money is stable and that the currency in question meets the requirements that such a demand imposes on money. The problem is that most of the currencies do not meet these requirements. That circumstance raises the more general problem of fiduciary currencies and the costs and benefits of adopting them.

Fiduciary currencies are a recent phenomenon, dating from the breakdown of the Bretton Woods agreements in the 1970s. Before that, currencies always had a reference to another currency or to a commodity. In the final analysis, a currency's value depended on the commodity to which it was linked, usually gold or silver. The circulation of fiduciary currencies, which have proliferated throughout the world in the past 30 years, is normally imposed by laws on forced tender within the sovereign territory of a nation state. The law on tender, however, is not enough to ensure that a currency serves as money. For that to happen, the currency must also inspire confidence.[15] Confidence in a currency depends on the credibility of the monetary and fiscal institutions of the country that issues it. It has not been easy to develop the institutions that support fiduciary money, to the extent that these days there are very few currencies that wholly fulfill the functions of money.

The prospect of having an independent monetary policy is contingent on a quality fiduciary currency having been developed - that is, a currency that fully meets the requirements of money: a unit of account, medium of payment, and security (Pou [1999]). Low-quality currencies normally fail to fulfill the latter function: they act as a medium of payment but contracts involving the passing of time, such as credit, installment sales or leasing are denominated in another currency or based on another reference standard. In these circumstances it is plain that monetary policy is of little use in affecting economic activity. If the interest rate is chosen, changes in the rate will only affect the fiscal deficit, since in these cases only the state has debts and credits in local currency. Whatever the instrument chosen to implement it, countries that issue low-quality currency cannot have an independent monetary policy. Hence the goal of a MERCOSUR currency should not be founded on the traditional argument of demanding an independent monetary policy, but on how to develop the institutions that allow the region to issue a high-quality currency.

The Monetary Option and Generating Savings to Finance Investment

In the end, the choice between a MERCOSUR currency and the adoption of an international currency depends on decisions related to the means of financing economic growth, to the opening of the capital account, and to the structure of the financial system. These decisions, in turn, are part of the more general motivations for a country's international insertion. The problem resides in financing the necessary investment to sustain a growth rate that is compatible with the potential growth of the economy. Adoption of an international currency as a monetary standard, opening the capital account and structuring the financial system with complete insertion into international capital markets are different aspects of a strategy whose ultimate aim is to secure external resources to finance growth. This financing choice was the one made by Argentina at the start of

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[15] *Fiducia* is Latin: trust.

the 1990s. The financial structure consistent with this option acted as the transmission belt for external shocks that compromised liquidity and affected the very foundations of the economy.

Brazil opted for its own currency, forced tender and exchange controls. Nonetheless, it failed to develop the policies and institutions that allowed it to generate enough domestic savings to finance growth. Brazil's economy did not fall into as deep a crisis as Argentina's, but the country did not manage to make itself independent of external financing. Economic activity was thus spasmodic: a recurrent pattern of growth, an external financing shock, and a drop in output.

The MERCOSUR countries have not effectively resolved their insertion into financial globalization. Their strategies have been isolated from each other and have failed to meet their aims. This issue remains to be addressed, and demands priority attention. It is a question of defining a single strategy and effective instruments for exchange rate arrangements and the currency to be introduced. The choice made should meet the twin goals of improving MERCOSUR's insertion into financial globalization and facilitating a deepening of the bloc's trade project.

Thereafter there will be a review of some alternatives that are technically open to future negotiation in the area of exchange rate and monetary coordination. All of those, in order to become a valid alternative, must meet certain requirements: 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. None of the available strategies will find it easy to meet these conditions. The future of MERCOSUR, however, depends on finding a policy that passes the test. Essentially, three alternatives are technically open to negotiation: fixed parities, dollarization, or adoption of a MERCOSUR currency. There could be other arrangements, but all of them come together in one of these options. As we shall see below, moreover, these are really two choices: dollarization or a MERCOSUR currency.

Adoption of an International Currency Standard

One of the options available in the monetary and exchange rate area is to retain national currencies, establishing fixed parity with the dollar (or a basket of relevant currencies), which means establishing fixed parities between each other. The advantages of this option are as follows: first, unlike complete dollarization, this option does not entail a loss of seniorage revenue; second, it solves the problem of intensifying trade within MERCOSUR; and third, fixing all currencies to an external standard is the simplest system to secure macroeconomic convergence.

Adoption of a system of a fixed exchange rates against an international currency, such as the conversion fund, entails acknowledging that there is only a slim prospect that a MERCOSUR country will be able to issue a quality currency. This arrangement can be regarded as a means of adjusting the convergence of the macroeconomic variables, while at the same time developing financial and fiscal institutions that lay the ground for a future MERCOSUR currency. In this regard, this system can be viewed as a transitional stage towards the other two available options (Pou [1999]).

It should be kept in mind, however, that fixing the currencies to an international standard accompanies the free movement of capital from abroad and the dollarization of bank liabilities. This demands solving the problem of the financial system's lender of last resort, so as to avoid the recurrent liquidity problems caused by negative external shocks and the possible insolvency of the system, as happened in Argentina in the second half of 2001 amid a severe run on the banks.

The formula of lender of last resort in a dollarized financial system makes necessary a monetary agreement with the US authorities. The consistency of the establishment of fixed rates therefore requires a monetary agreement with the United States, which in practice would mean making this system something very close to complete dollarization. A key characteristic of this arrangement would be a US commitment that the Federal Reserve or some intermediary organization (such as the IMF) would act as lender of last resort and banking overseer. Clearly, such an arrangement could be permanent; but it could also be temporary, giving way to the development of MERCOSUR's own currency in the time needed for that purpose.

In short, one of the paths towards an exchange rate arrangement that is consistent with the region's macroeconomic conditions and compatible with the goals of trade integration is to adopt an external currency (presumably the dollar), which implies institutional changes connected to the use of seniorage, the function of lender of last resort, and the structure and supervision 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. There are, moreover, variations of this alternative. Its two extremes are fixing exchange rates with the dollar, and the plain and simple adoption of the dollar as a medium of payment in the economy.

The difficulties with either of these alternatives, even in their less bold versions, arise from the recent history of the Southern Cone and their inconsistency with the autonomous development initiative so dear to MERCOSUR's elites. The collapse of convertibility in Argentina suggests that a similar strategy will not be considered by the subregion's governments for some considerable time. Complete dollarization will probably be more acceptable than a conversion fund. Any option related to the adoption of an external monetary standard has a high symbolic cost in terms of the MERCOSUR economies' role in the world, and it contravenes the notion of an independent role favored by the Brazilian elites and by many among Argentina's elites.

The MERCOSUR Currency

A MERCOSUR fiduciary currency cannot be devised in the short or medium term. To serve as money, the currency must be founded on confidence. The MERCOSUR countries have not been particularly successful in developing the institutions to underpin such confidence, and the present moment does not seem to be the best time to introduce a MERCOSUR currency. It is, therefore, a long-term goal.

The benefits of such a currency stem from the prospect of deploying strategies of insertion in world capital markets that differ from opening the capital account and dollarizing bank liabilities. The costs are related to the time needed to build credibility in the institutions backing the currency, and the constraints on access to world capital markets to finance domestic investment. Both problems could be manifest in the payment of an interest rate premium that would not apply if there were a more complete insertion in capital markets, and thus in lower economic growth rates than would be possible in such a case.[16]

Since the adoption of a MERCOSUR currency is both technically and politically remote, it is more interesting to ask how to cover the ground towards that goal from where we are today - in other words, to design the transition to that end. This transition should take account of certain constraints and be mindful of the following considerations:

- In all cases there is a need for convergence on certain monetary targets, interest rates, the fiscal deficit and inflation. In that regard MERCOSUR has not been particularly effective to date. The exchange of information and the harmonization of statistical measurement of the variables subject to convergence are preconditions of coordination. Nonetheless, MERCOSUR's size asymmetries hamper its acting as the proper anchor for the member countries' policies. In general, all the MERCOSUR countries have programs with the IMF or are negotiating with the Fund. The IMF has been shown to exert greater discipline than MERCOSUR. This will continue.

- The convergence of these macroeconomic variables does not itself ensure exchange rate stability. This is something to which due consideration must be given when the MERCOSUR countries choose their exchange rate regimes if the deepening of the agreement is to be a priority.

- The recurrent financing crises that have marked the development of the MERCOSUR countries' activity in the past decade point to the advisability, in the transition phase, of creating institutions that foster internal saving and its use for domestic investment, with a view to minimizing the economies' dependence on the "mood" of the financial markets. One tested institutional formula in Latin America is Chile's social security reform, which was an effective alternative to the obsolete recourse to exchange controls as a means of ensuring the availability of resources for domestic investment.

Migration and the Free Movement of Workers

There is much discussion as to whether the phenomenon that we call globalization is new. A phenomenon akin to the current momentum of globalization was the huge growth of trade and financial interpenetration in the late nineteenth and early twentieth centuries. That wave of globalization was accompanied by enormous flows of migrants seeking work in the world's most dynamic areas. Those flows shaped today's West. Modern globalization lacks a similar feature, not because the conditions for its recurrence are not present but because prevailing legislation imposes constraints on such a process.

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[16] This latter argument, however, takes no account of the need to offset the sporadic but devastating effects of the liquidity crises attendant on striving to live with the "mood" of the financial market, as happens with the inconsistent adoption of the other alternative.

Integration agreements have been an imperfect means of bringing about the movement of people and workers. In the European model this stage was defined as a common market, which followed the creation of the customs union. In MERCOSUR, however, it should be concomitant with trade integration. As mentioned earlier, MERCOSUR is marked by the size asymmetries of its member countries and its regions' different levels of industrial, technical and economic development, even within the same country. Unfettered opening to reciprocal trade among the member countries necessarily involves adjustment costs that are evident as the unemployment of productive resources, including the unemployment of labor.

MERCOSUR is not an agreement between rich countries. On the contrary, all of the members, including the bigger countries, face an endemic lack of public resources. MERCOSUR was negotiated and implemented without having the resources to cushion the effects of the adjustment costs that the countries and their regions incurred when competition conditions changed. In the negotiations before Ouro Preto, an effort was made to address this problem by means of the Adaptation Regime, whereby the two smaller countries enjoyed longer deadlines in the tariff-reduction schedule. That differential, however, came to an end in 2001.

When the problem is confined to a region, the effects of unemployment can be attenuated through the internal migration of workers. When the problem affects a whole country, especially one of the bigger countries, there is no such escape mechanism in MERCOSUR. For that reason the agenda for deepening the trade agreements must include a chapter devoted to migration. A realistic consideration of these problems should take account of the following:

- Development of a system of compatible pensions and inter-system agreements that allow the transfer of contributions that a worker has amassed throughout a working life, irrespective of the countries in which the contributions were made, and the payment of benefits in the country where the worker decides to live at the end of his or her working life. Pension systems based on the Chilean model would meet these kinds of demands on such systems in an integration agreement. Hence the personal accounts system not only facilitates a transition from the current situation to a single MERCOSUR currency, but is also an instrument for integrating the bloc's human resources.

- If it is impossible to make progress jointly, an effort should be made to reach agreements on migration among pairs of countries that display greater political will in this regard, between which there is greater prior integration, and which have advanced further in integrating their pension systems. This partial progress should be towards a model to which all MERCOSUR countries and their commercial associates can adhere in the future.

VI. FINAL CONSIDERATIONS

Contents

The General Ideas

The preceding pages are an attempt to assess MERCOSUR's current status and possible future development, and also to propose a possible way of deepening the integration scheme. This endeavor rests on some general ideas that inform the study and that can be summarized as follows:

1. Reappraisal of the last ten years' experience in defining the issues on the agenda

Ten years have passed since the Treaty of Asunción was signed, and the experience of that period has been rich. Hence an effort to find issues for an agenda to deepen MERCOSUR should not start with text books written in other countries for other circumstances, but should focus on the region's own experience. In that light, the problem is to choose among the essential experiences. There have been many of these, and thus the choice of the main events entails value judgments that might color the analysis. There are, however, at least two events that bear underlining. One was the devaluation of the real in 1999 and its effects on the MERCOSUR economies, an event that spurred reflection on the reasons for the devaluation of the real relative to the currencies of Brazil's smaller neighbors. The other was the inadequate attention to distortions to trade and competition caused by what might be termed state aid. The experience reveals deficient regulations and insufficient institutional development to tackle these problems, which gave rise to conflicts that are hard to resolve. This is what we term MERCOSUR's scant institutional development.

The negative effects of exchange rate volatility among the MERCOSUR countries, the lack of institutions and the decline in procedures are important developments of the past decade's experience.[17] Overcoming these circumstances, then, should be a priority on the agenda to deepen MERCOSUR.

2. The motivations

When it chooses to join an integration scheme, a country does so in light of its more general and not always explicit policies, which shape its positions on integration issues. These strategies might be part of a specific political project or they might simply amount to the citizens' way of looking at things. When two or more countries integrate there is an interaction of different self-images, and of interpretations of a country's role in the world.[18] Such projects help explain integration strategies and the different political attitudes that countries have towards them. MERCOSUR offers a good example: agreement on a project gave rise to the bloc and determines its current status. MERCOSUR helped satisfy the aspirations for autonomous international insertion that its elites hold dear. The political rapprochement among the Southern Cone countries and the goal of autonomous international insertion were crucial reasons for their integration. MERCOSUR is an

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[17] These issues refer to negative situations, to things that have not worked well in MERCOSUR, although other things did so. The agenda for deepening, however, should take account of what did not work well in order to rectify it.

[18] In his *La Invención de la Argentina,* Nicolás Shumway refers to this concept as "guiding fictions". The guiding fictions, according to Shunway, "cannot be proven, and in fact are usually as artificial as literary creations. But they are necessary to give individuals a sense of nationhood, of community, of collective identity and of a common national destiny".

instrument of such motivations, and the latter are its main goal. The logical conclusion is that there should be a common project; at the least, there should be a substantial degree of consistency between national projects because otherwise integration will not flourish. Integration prospers when motivations overlap, or at least are compatible. Hence the need for greater familiarity with and discussion of such motivations so as to craft integration.

3. The two facets of globalization

This study has divided globalization into two dimension, commercial and financial. This is not a theory that explains globalization but a characterization that facilitates analysis of MERCOSUR. The trade sphere is the world of rules and institutions, one known by the public officials and diplomats who undertook to build MERCOSUR. The four member countries agreed on trade integration as a means of establishing links to the international trading system; this was the old South American model of strength through unity.

The financial sphere, by contrast, is an unknown world, one full of uncertainty. There is no pre-conceived paradigm for establishing links with this world, and the countries differ on how to do so. At the same time, policies on insertion into international capital markets are connected to exchange rates and the structure of the financial system, issues normally viewed as the preserve of countries' domestic policy and unsubject to external negotiations. The actors in those policies, moreover (the economy ministries and central banks), are not the leading players in integration.

Characterizing globalization in this way helps explain why MERCOSUR was built around a trade initiative, one geared to insertion into the international trading system, and its scant development in other areas related to the financial sphere. This approach was underpinned by the absence of a reference currency for all members and the availability of the European integration model as a path for the negotiations in MERCOSUR.

4. The lack of a reference currency

The two most important economic blocs - the EU and NAFTA - together account for the bulk of the questions that arise in these kind of projects. They differ in motivations and methodology. The EU contemplated the economic union of the whole continent, while NAFTA sought to set up a free trade area among the countries of North America. NAFTA's methodology is based on the principle of a single undertaking, while the EU established an order of precedence among agreements, from a free trade area to economic union, which became the paradigm of an integration process enshrined in the text books.

They are similar in that both agreements' center of gravity consisted of a market and a currency. In this regard the United States' role in NAFTA is plain. There was no question about the country's function in that respect because of the significance of the US market within NAFTA and the dollar's universal role. The European case is less clear, although in the EU too the system is based on a market and a reference currency. In its early stages, the group adopted the dollar as its monetary standard. With the breakdown of Bretton Woods, that role was played by the German mark until the latter was recently replaced by the euro.[19]

MERCOSUR, for its part, was born without such a center of gravity. The country with the biggest market lacked a currency that could serve as a reference for the others, and was unwilling to adopt an external monetary standard to play that role. The absence of a dominant currency explains why it was possible for Argentina and Brazil to choose different policies on international financial insertion, policies that later proved incompatible.

5. The model

MERCOSUR adopted the European model of integration: there was a substantial initial commitment to integration and later an impetus to coordinate other policies in the order of precedence established by the European model. To some extent this served the countries' goals and state of mind at the start of the integration process. As mentioned earlier, the initiative that responded to the old paradigm of Latin American integration was a trade project. The European model was consistent with that initiative inasmuch as it prioritized trade integration and a customs union as the first stages of integration. In this regard, however, the European model gave rise to confusion and underpinned a state of affairs in which the countries tended to leave aside some crucial aspects of integration. The European model was effective in the context of a reference currency and a prior monetary agreement. There was nothing comparable in MERCOSUR, and the European order of precedence caused a loss of perspective on the series of agreements to be concluded simultaneously in the manner of a single undertaking.

6. Size asymmetries among the MERCOSUR countries

A distinctive feature of MERCOSUR, relative to other integration schemes, is the significant size asymmetries among the member countries. The upshot is a broadening of the negative effects of the inconsistencies. In MERCOSUR, for example, the Brazilian devaluation severely affected the economies of the smaller countries. Similarly, competition-distorting state aid can undermine entire economic sectors in some countries. Hence the elimination of such distortions is more important than in other integration schemes.

From a political perspective, the size asymmetry poses the danger that MERCOSUR will become an exclusively Brazilian project. That asymmetry imposes further demands on the project in terms of the discussion of the agreement's costs and benefits for all members. For the smaller countries, this assessment demands a clear elucidation of the anticipated benefits of integration and the costs incurred. For the bigger countries, it entails a fair assumption of the costs of leadership. The widening of the agreement to other countries might help dilute the political effects of the asymmetry and make the accord an effective disciplining mechanism for all members with a view to averting distortions.

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[19] Given the relative sizes of the various European countries, and the region's history, no country was willing to grant another the role as the group's center of the gravity. The creation of a complex and elaborate institutional framework managed to move the center of gravity from Germany to a set of intermediary institutions that represent all the member countries. This latter step is a significant cession of independence on the part of the large country.

The Diagnosis

Concurrence on the trade project. The MERCOSUR initiative largely centered on the trade sphere. The Argentine and Brazilian elites' agreement on insertion into the international trading system explains MERCOSUR's success in setting up a customs union: the creation of a preferential trading area, the coordination of positions in multilateral fora, and the choice of multilateralism. This strategy was compatible with the aim of strengthening industry, autonomous international insertion, and the consolidation of a role as a global player in world trade. For the initiative to work, however, the economies must grow and the exchange rates must be stable. The governments were aware of these demands but the choice of the monetary standard, the regulations on capital movements and the structure of the financial system were not coordinated. Moreover, strategies were adopted that were inconsistent with their aims.

Autonomy. Opting for autonomy through integration is a contradiction, inasmuch as securing autonomy on the international scene entails foregoing autonomy in favor of a neighbor. If the projects coincide, this poses no problem; what would have been done independently is coordinated with the neighbor. A problem arises, however, from the difficulties associated with effecting the project: trade liberalization among the member countries necessarily brings with it a conflict of interest among the governments and private citizens of the different member countries. Resolving that conflict demands a further cession of autonomy, normally expressed as the creation of an independent institutional apparatus. In MERCOSUR the lack of will to make this further cession of sovereignty hampered the deepening of the process. Thus MERCOSUR became an arena of distortions to competition that were unilaterally imposed by the governments, with no remedy other than diplomatic discussion and negotiation.

Insertion into financial globalization. There was not only an absence of coincidence, however, but also divergences. As regards financial insertion, the choice of a monetary standard or exchange rate regime, the use of exchange controls and the structure of the financial system, the options were diverse and that disparity triggered many of the subsequent problems.

The Proposal

Economic growth and stable exchange rates. MERCOSUR cannot be deepened without solving the problems of stability and growth. The strategy for macroeconomic policy, therefore, is a priority on the MERCOSUR agenda. Exchange rates among the countries must be stable, moreover, and thus the choice of the monetary standard and the structure of the financial system must be coordinated.

Monetary and exchange rate agreements in MERCOSUR. The choice of a single monetary standard for the four countries lies at the heart of this problem. That choice should be conducive to stable relations among the currencies of the MERCOSUR members. There are two alternatives: an external standard or a MERCOSUR currency. MERCOSUR's basic motivation of autonomy prompts the conclusion that the choice will be the latter. Nonetheless, autonomy is not secured through the political will to introduce a regional currency. The problem is one of growth that is independent of the "mood" of the markets. The experiences of Argentina and Brazil in the 1990s reveal economies that move in sudden fits and starts because of fluctuations associated with international financing conditions. This raises the issue of internal savings and how to finance growth.

A society's choice between consumption and savings is the sum of individual decisions that cannot be dealt with in economic terms. Using such savings to finance the economy, however, and securing external savings for the same purposes, is a matter of policy. Due consideration should be given to the Chilean strategy of insertion into world capital markets, but this is not the core of the argument. It is important to stress that according priority to the currency and exchange rates means introducing these kinds of strategies into the debate in MERCOSUR. It should also be noted that these issues, discussion of which is often confined to the domestic arena in the member countries, are on the agenda for deepening MERCOSUR. It might sound strange, but the reform of the Brazilian pension system is a matter of key concern on the agenda for deepening the bloc.

The MERCOSUR path. It is plain that MERCOSUR should find its own model of integration. The European model served the characteristics and circumstances of the countries involved; it cannot be adopted unchanged by other countries in different circumstances. The issues are the same; the problem is how to order them and how to devise a means of moving towards the goals.

The MERCOSUR "plus". Addressing integration in such terms as expounded above takes time. There are forces at work, however, that do not seem to allow for that time. The fast track authority secured by the US president adds urgency to US relations with South America. The FTAA poses a challenge, and a decision must be made as to whether MERCOSUR is to be subsumed in the hemisphere-wide trade area of if there is some capacity to define a MERCOSUR "plus", such that the group retains its relevance. In this regard, work can be undertaken in several areas. It is unnecessary stubbornly to respect the order of precedence ordained by the European model. The path towards a deeper MERCOSUR should be determined by the bloc's initial motivations: the peace zone, the interconnection of infrastructure, and autonomous international insertion. There are ways of moving forward even though progress might have been insufficient on the issues mentioned above. In particular, everything connected to the free movement of people and workers in the region would amount to concrete economic progress, and would give a sense of forward momentum to the agenda in an area that would help inculcate people's feeling of belonging to some bigger entity, thus sustaining the notion of a more complete and inclusive project in future. Second, the joint planning of infrastructure development and interconnections is a promising means of economic integration and of increasing trade, areas in which international organizations can play a key supporting role.

The road map. In short, this study suggests that MERCOSUR's more than ten years of experience highlights certain areas as priorities for the agenda to deepen the bloc, and it proposes a different kind of timing on agreements, one that is adapted to the characteristics of the MERCOSUR countries. The stability of exchange rates among the member countries can only be attained if MERCOSUR adopts a common monetary standard. Given the political constraints on the agreement, which stem from its own motivations and are reflected in the opinions of the Argentine and Brazilian elites, that common monetary standard can only be a MERCOSUR currency. This strategy places domestic savings and their use to finance domestic investment at the heart of the debate.

One consequence of this conclusion is that exchange rate stability is a long-term goal. Hence, logically, tariff harmonization is also a long-term matter, one to be resolved at the same time as exchange rate stability. This involves a shift in the priorities maintained to date: in the current discussion, tariff uniformity is the next immediate step and a pre-condition to any further progress. This study, by contrast, argues that the priority is to define the goals in the area of the tariff, currency and exchange rate regime, and on those bases to devise and effect a transition towards such goals.

This shift in approach does not means taking the agreement back to a free trade area and minimizing the original aspirations enshrined in the Treaty of Asunción. On the contrary, it means embarking on a MERCOSUR-specific path to integration, one adapted to the characteristics and circumstances of the MERCOSUR member countries, rather than insisting on treading the path cut by the European model, which served the interests of other countries in different circumstances. This new road map should include progress in the institutional realm, liberalization of the movement of people and workers, and the joint planning of infrastructure development. All these issues do not demand simultaneous progress on other pending matters, and they would help give a sense of forward momentum and government commitment, while imbuing people with a sense of belonging to a larger group.

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