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Economic Integration in Latin America: A Review of the MERCOSUR Organization

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Abstract
The intention of this capstone project is to provide an assessment of the level of economic integration in the MERCOSUR organization of the Latin American Region, and to offer suggestions for future considerations for the continued success of the organization. The paper will review the different levels of economic integration that countries can engage in and further explore the ways in which MERCOSUR has engaged in the economic integration process. There will be special emphasis placed on the role of MERCOSUR's two main players: Brazil and Argentina. Despite the numerous challenges and setbacks faced by the MERCOSUR organization, it has gained a degree of success and will continue to do so in the future with a realignment of macroeconomic and domestic policies between member states.

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Economic Integration in Latin America: A Review of the MERCOSUR Organization

A Master's Thesis submitted to

The Faculty of the Master of Science in International Studies Program

In Candidacy for the Degree of

Master of Science in International Studies

By

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Abstract

The intention of this capstone project is to provide an assessment of the level of economic integration in the MERCOSUR organization of the Latin American Region, and to offer suggestions for future considerations for the continued success of the organization. The paper will review the different levels of economic integration that countries can engage in and further explore the ways in which MERCOSUR has engaged in the economic integration process. There will be special emphasis placed on the role of MERCOSUR’s two main players: Brazil and Argentina. Despite the numerous challenges and setbacks faced by the MERCOSUR organization, it has gained a degree of success and will continue to do so in the future with a realignment of macroeconomic and domestic policies between member states.
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Since the end of World War II, the international economy has seen several changes. Many countries formerly in the background on the international economic stage are now expanding and moving to the forefront. One of the most popular trends at this time in the economic world is the move towards regional trading blocs and economic integration. What is economic integration and what benefits does economic integration offer? What are the drawbacks to such agreements? What are the motivating factors for economic integration? Why are economic integration and regional trade agreements increasing in popularity? Who on the international economic stage is participating in economic integration? How do countries and regions go about beginning the process of economic integration? How do regions engaged in economic integration agreements gain creditability and legitimacy?

What follows will be a discussion surrounding economic integration on the international stage, with a specific focus on Latin American integration and the MERCOSUR organization. The writing will begin with a discussion of economic integration itself, and will address the previously listed questions. Moving forward, the piece will continue with a discussion surrounding the formation of MERCOSUR and what has been accomplished through the integration agreement. The final area of the piece will discuss the future of MERCOSUR and economic integration in Latin America, with recommendations for future paths to follow.

The information provided in this work will come from a variety of sources that are considered experts in the fields of economic and Latin American economics. In addition, I will include my own thoughts and opinions on the information and research offered.
Section I: A Discussion of the Principles of Economic Integration

Economic integration is the joining of a group of nations in a geographical region to form an economic union or trading bloc.\(^1\) The group of countries joined together in a region promote free internal trade between member states while raising common tariffs against the products of nonmember states. The ultimate goal of economic integration is to reduce trade barriers and promote free trade. Integration itself is a delicate balancing act of national interests and community interests that must be brought together with the consent of all parties. With this principle in mind, one can imagine the road to achieving integration is slow and arduous, with many starts and stops.

When discussing economic integration it is important to make a distinction between multilateral approaches to economic integration and regional approaches to economic integration. Multilateral economic integration agreements are nations pursuing trade liberalization regardless of their location in the world. Within this form of economic integration, trade barriers are reduced simultaneously. Regional economic integration agreements are those economic agreements involving countries specific to a localized area or region of the world. For the purposes of this paper, when discussing economic integration we will be referring to regional agreements between contiguous countries.

Economic integration can be categorized into different levels of integration. Typically, economic integration is broken into six different areas. The six areas are as follows: preferential trading area, free trade area, customs union, common market,

economic and monetary union, and complete economic integration. In order to gain a working knowledge of economic integration, it is important to understand all levels of integration and the benefits and drawbacks to each.

In a preferential trading area (PTA), countries entering into an agreement offer tariff reductions (not complete eliminations) to other participating countries in certain, specified product areas. Preferential trading areas are considered the weakest form of economic integration as there are not complete eliminations of tariffs in all product areas between member countries. It is clear the benefits of entering into a PTA are to export and import specified products at a reduced tariff. The drawback to a PTA is there are limited long-term gains and no real movement towards free trade and trade liberalization.

A free trade area (FTA), is an agreement between a group of countries to eliminate trade barriers and tariffs between themselves while maintaining individual external tariffs with non-member countries throughout the rest of the world. For example: Country A and B are both members of an FTA, while Country C is not. Imports of bananas between Country A and Country B will have zero tariffs. However, Country C could have one tariff on imports of bananas from Country A, and a different tariff on imports of bananas from Country B. While an FTA is simple in concept and seems straightforward, in actuality FTAs can become very complex. The countries involved in an FTA must develop “rules of origin” in order to combat the varying external tariffs for non-member countries. These “rules of origin” would apply in the example above to prevent a non-FTA country from exporting bananas to the FTA country with the lowest

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tariff, and then reshipping the bananas to a country that would have typically imposed a higher external tariff for the non-FTA country.

The next level of economic integration is known as a customs union. When a customs union is formed between nations, tariffs between member countries are eliminated on all goods, and a common external tariff is created on all goods for non-member countries. A customs union eliminates the need for complicated "rules of origin" that are present in an FTA, but introduces the issue of having to coordinate and agree on the same external tariff rates between all member countries. The level of economic integration when engaged in a customs union agreement greatly increases the need for policy coordination on external tariffs.

Moving on, a common market is the next level of economic integration. A common market maintains the same foundations as a customs union, but adds a further degree of integration with the free mobility of labor and capital between member countries. A common market, while beneficial in promoting free trade, also has its drawbacks. With the free mobility of labor and capital, further coordination of policies are required to provide guidelines for movements between member states participating in a common market form of economic integration. In addition, industries and populations are transferred to new areas, changing the dynamics of member countries and bringing new ideas and traditions to various places. A more global melting pot is formed with these types of agreements with its own advantages and disadvantages.

Following a common market form of economic integration is the economic and monetary union. An economic and monetary union encompasses all the same principles.

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5 Ibid., p.2.
6 Ibid., p.2.
as a common market, but also delegates some fiscal responsibilities to a financial
decision-making body that is representative of all member countries. Furthermore, a
common currency is established among the member countries along with a central bank
in charge of monetary regulation and policy. 7 As one can imagine the policy-making,
implementation, and enforcement of such economic agreements are large and time-
consuming, and take vast amounts of coordination and agreement between different
member countries. The European Union, the largest and most successful economic
integration agreement in existence took decades to reach their current level of economic
stability and cooperation within member states.

Last, but not least, is complete economic integration. Complete economic
integration envelopes all the principles of an economic and monetary union, but includes
political considerations as well. With the vast amount of coordination and decision-
making involved in a highly integrated economic agreement, it is believed it is natural to
progress towards a political union as well. As countries become more interdependent it is
necessary to develop more governing institutions. With the free movement of labor and
capital goods, it is important to keep in tune with the wants and needs of the individuals
living and working within an integrated area. Thus, it is believed that economic and
monetary unions naturally develop into political unions.

As evidenced, the various levels of economic integration offer different
advantages and disadvantages. The overall advantage to engaging in any sort of
economic integration agreement, and the motivating factor behind economic integration,
is to develop economically in order to compete in the global economic market.

Economic integration agreements can allow developing nations to promote free trade and

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7 Ibid., p.2.
eliminate tariffs in order to gain creditability and legitimacy, as well as allow countries to engage in specialization. At the same time, economic integration agreements can help to develop stability in developing nations by growing together and ensuring free trade within their own region. By creating a regional trading area, the power of all member states increases based on the power that regional market holds in the global international market. Free movement of capital and labor, along with capital goods, are also motivating factors for economic integration.

On the flip side, drawbacks to any sort of economic integration agreement are also present. While regional economic integration promotes free trade, at the same time it is believed it can increase the incentive for raising protectionist barriers against non-member countries. When protectionist trade barriers are raised against other regions not participating in an economic integration agreement, trade becomes intermittent with outside countries, thus causing a decline in free trade on the global international market. In addition, when engaged in an economic integration agreement with a high level of integration, such as a common market or economic and monetary union, you are dependent on the fluctuations of the regional market as a whole and the ways in which other countries choose to trade outside of that regional market.

As previously stated, since the end of World War II, many regions have been competing for economic prowess on the international stage. As a result, economic integration agreements have increased. Why is economic integration increasing? In order to develop and effectively compete in the global market, it is important to trade goods and services with other countries. This allows a country to earn profit on a good they have access to that may not be readily available in other regions, while at the same
time acquiring goods not readily available in their own country. An increase in a country’s ability to trade will directly increase the state of their economy. It is believed increased trade offers increased profits. In addition, attaining a stable economy allows for a better bargaining position on the world stage as you control more of the power of goods and services. With the technological advances in communication and travel, the world has become a smaller place. Goods and services travel much more quickly across borders. Individuals in one nation are able to view the goods available in another. What it takes to acquire those goods is less time consuming and expensive than in the past. Additionally, this has prompted countries to attempt to develop the same goods in their own area as a demand for a certain product, good, or service is recognized. The end of World War II left many areas of the world economically crippled. In an effort to begin to develop a more stable economy and produce and receive the goods in demand, many regions banded together economically in an effort to promote free trade and break down trade barriers.

In today’s world, there are several economic integration agreements in place. Most notable, and considered the most successful, is the European Union. The North American Free Trade Agreement (NAFTA), Latin American Free Trade Association (LAFTA), World Trade Organization (WTO), Andean Group, and The Common Market of the Southern Cone (MERCOSUR) are just a handful of the economic integration agreements present in today’s global international market. Several Third World or developing countries are also exploring the opportunities present in an economic integration agreement.
Typically, most economic integration agreements are begun by the recognition of a mutual trading need, and the signing of a treaty between two or more nations that eliminates tariffs and barriers to trade between member countries. The member countries agree to specific terms and conditions and a plan to implement the integration of their economies. As a region integrates and trade is opened up, along with the free movement of capital and labor, the economy develops and grows, creating a more stable economic environment and directly affecting the bargaining power of the countries involved within an agreement. This stability and bargaining power position lend creditability and legitimacy to the group in the global international market.

Section II: Latin America and MERCOSUR

As established, the formation of economic integration agreements have been on the rise since the end of World War II and the Cold War. Economic integration began to gain popularity in the Latin American region in the late 1980’s. Many experts believe this is due to the release of rule under authoritarian regimes, and the lack of international economic development prior to this time period in Latin American economic history. It is no surprise with examples like that of the European Union, plus the distinctness and cultural similarities of the region, Latin America moved towards economic integration to fulfill their hopes for international economic development.

The MERCOSUR organization is the most widely known and popular of the Latin American economic integration agreements. It is also one of the most controversial. While MERCOSUR integrated rapidly, the disputes between Argentina and Brazil in areas such as macroeconomic policies including exchange rates, and trade disputes such
as the automobile conflict and import financing have hindered MERCOSUR’s ability to achieve their desired goal of a full common market. In order to achieve a full functional common market, MERCOSUR needs to establish a governing and decision-making body, while working to harmonize the macroeconomic policies between Brazil and Argentina. With a focus in these areas, MERCOSUR will continue to see success in the future, as well as possible expansion to form a larger regional trading bloc.

MERCOSUR stands for the Mercado Comun del Sur or the Market of the Southern Cone, and became an official organization with the adoption and signing of the Treaty of Asuncion in 1991. The original member states of MERCOSUR include Brazil, Argentina, Paraguay, and Uruguay, and encompass a combined population of over 250 million individuals, a gross regional product of over one trillion dollars, and two official languages: Spanish and Portuguese. Since its formation in 1991, MERCOSUR has grown to include Chile, Bolivia, Peru, Ecuador, Mexico, and Columbia as associate member states. In 2004, Venezuela became a full-fledged member state of the MERCOSUR agreement.

The MERCOSUR organization formed as a spin-off of the Argentine Brazilian Economic Integration Plan (ABEIP) that was in place in the 1980’s. MERCOSUR, as other economic integration agreements, chose to form in an effort to increase foreign trade and create a larger voice on the international economic stage. At the time of the formation of MERCOSUR, the member states were faced with other regional trading blocs such as NAFTA and the European Union that were growing in both size and strength. The general consensus among Latin American leaders in the early 1990’s was that in order to continue to grow and compete, they needed their own regional trading
bloc to counteract the uneven distribution of economic power concentrated in the United States and Europe. The flexible ABEIP agreement in place between Brazil and Argentina was not enough to solidify such a position.

The Argentine Brazilianian Economic Integration Plan began as a project in 1986 between both Brazil and Argentina that initially lowered tariff barriers in specified industries. The ABEIP was brought about by concentrated efforts on behalf of both presidential leaders in Argentina and Brazil. At the time of the ABEIP, Latin America was newly free of former military dictatorships and moving towards a more democratic form of government. Historically, Argentina and Brazil were not only military rivals, but also economic rivals. With novice democratic governments in place in 1986, and little or no foreign trade, executives felt a need to create an economic bond between the two countries. This would not only help with foreign trade, but serve the dual purpose of potentially avoiding future flare ups between the two former rivals if the economic vitality of one was dependent upon the other. After the first protocol of lowering tariff barriers between the two states, the presidential leaders pledged to meet every six months to discuss further possibilities for future integration. At this point in the integration process, there was little or no input regarding economic wellbeing from the private sector of either Argentina or Brazil.

While Argentina and Brazil were able to overcome past rivals in the face of their newfound democratic governments, there were several factors working against the integration desired. At this point in the integration process, both Argentina and Brazil

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9 Ibid., p.26. A protocol denotes the rules governing an agreement. In this case, the protocol refers to the way in which the governments of Argentina and Brazil chose to go about lowering tariff barriers.
continued to face an economically unstable environment. This instability was due, in large part, to the exchange rate fluctuations that made planning for foreign trade and a new market practically impossible. Despite this, the protocols set forth in the original ABEIP continued. As the economic crises in Latin America continued to escalate throughout the late 1980’s, the ABEIP stalled with failed protocols in both the automobile and steel industries. With the failure of two important protocols fresh in the minds of executives, a more concentrated effort was made to focus on the integration process between Argentina and Brazil. This focus also spilled over to both Paraguay and Uruguay and led to the creation of the Treaty of Asuncion during the early 1990’s.

Before delving into a discussion of the Treaty of Asuncion, it is important to note the information learned at this point in the integration process between Brazil and Argentina. The historical factors present at this point in Latin America set future precedents that appear throughout interactions within the MERCOSUR organization. As mentioned, Argentina and Brazil were long time military and economic rivals in the Latin American region. The sheer size of Brazil, both geographically and economically, automatically placed Brazil in a position of power within the Latin American region. As a result, Brazil was used to making unilateral decisions to protect national security concerns, regardless of the consequences for those around them. The military dictatorships historically present in Latin America further encouraged unilateral moves as demonstrated by Brazil. Despite the MERCOSUR agreement and the structure set forth in the Treaty of Asuncion, Brazil has not overcome its history of unilateral moves. As one can imagine, this is a detriment to the integration process when more than one nation’s interests are at stake.
The original architects of the MERCOSUR agreement created the Treaty of Asuncion to establish not only their integration protocols, but also a plan of action for how the protocols were to be executed and achieved. As the Treaty of Asuncion formed the foundation of the MERCOSUR agreement, it is important to understand and review the document. The Treaty of Asuncion will be used as a basis for determining the successful and unsuccessful areas of the MERCOSUR agreement as it stands today.

Consisting of a total of six chapters and twenty four articles The Treaty of Asuncion sets forth the goals of the original architects of MERCOSUR as “securing a proper place in the international economy and integrating member states by making use of available resources, preserving the environment, improving physical links between member states, and coordinating macroeconomic policies based on the economic principles of gradualism, flexibility, and balance.”

The member states of MERCOSUR were to exist in a transitory state from March 26, 1991 until December 31, 1994 when the common market would be fully established. Goals of the agreement were to be the free movement of goods, coordination of macroeconomic policies, and harmonization of legislation between member states.

Included in the Treaty of Asuncion was the establishment of the governing bodies of the MERCOSUR organization. MERCOSUR consists of two main institutions that are responsible for creating, implementing, and enforcing policies within the organization. The first of such institutions is the Council of the Common Market or the CMC. The CMC is made up of the Ministers of Foreign Affairs, and the Ministers of the Economy of each member state. The main functions of the CMC are to take responsibility for political leadership and decision-making, and to ensure compliance with the time lines.

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and establishment of the common market as set forth in the Treaty of Asuncion. The CMC is required to meet at least once a year and include the Presidents of the State parties in their minimum annual meeting. One must note that none of the representatives of the Council of the Common Market are directly elected. (insert citation)

The second main institution of MERCOSUR as set forth in the Treaty of Asuncion is the Common Market Group or CMG. The CMG was established as the executive institution of MERCOSUR and is made up of four members and four alternate members of each original member state representing the Ministry of Economy, Ministry of Foreign Affairs, and the Central Bank. The CMG was tasked with creating rules of procedures within sixty days of the signing of the Treaty of Asuncion, as well as monitoring compliance with treaty objectives, enforcement of any decisions made by the Council, and the creation of policies to achieve the ultimate goal of economic integration and a full customs union.\textsuperscript{11}

The remaining areas of interest within the Treaty of Asuncion for the purposes of this paper are Chapter IV, article 20 and Chapter V article 22. These provisions of the treaty allow countries to apply for membership status or to withdraw from the MERCOSUR organization at any time.\textsuperscript{12} It is important to note for the purposes of this paper that the Treaty of Asuncion does not give detailed information for dispute resolution between member states of MERCOSUR. Rather, the CMG is tasked with creating these rules at a future point.

When compared with other economic integration agreements in both Latin America and throughout the world, the Treaty of Asuncion establishing the MERCOSUR

\textsuperscript{11} Ibid., p. 3.
\textsuperscript{12} Ibid., p. 6.
organization involved an aggressive timeline. MERCOSUR member states were hoping
to stabilize their individual economies, remove trade barriers, and create a full customs
union in a matter of a handful of years. This process took decades to achieve within the
most successful integration agreement today, the European Union. Knowing the goals of
the organization and the framework in which they hoped to accomplish those goals will
be beneficial in understanding the success of the MERCOSUR agreement throughout the
1990’s and up to present times.

Section III: Brazil as a Hegemon

Throughout the 1990’s, as MERCOSUR embraced its integration plans and
foraged ahead, there were several conflicts that arose between MERCOSUR’s two main
players: Brazil and Argentina. Why are Brazil and Argentina considered the two main
players of MERCOSUR? Size is the simple answer. Of the four original member states
of the MERCOSUR agreement, Brazil and Argentina had the highest populations, the
biggest areas of land, and the largest economies. Both Paraguay and Uruguay pale in
comparison.

The ways in which both the CMC and CMG handled the conflicts that arose
throughout the 1990’s set a precedent for future resolutions to disputes within the
organization. When reviewing the establishment of macroeconomic policies, the
automobile crisis of 1995, and the import financing crisis of 1997, it is easy to identify
the pattern of dispute resolution within the organization.

As mentioned previously, the Treaty of Asuncion established the following goals
for the member states of MERCOSUR: “coordination of macroeconomic and sectoral
policies of member states relating to foreign trade, agriculture, industry, taxes, monetary
system, foreign exchange and capital, services, customs, transport and communications, and any others they may agree on, in order to ensure free competition between member states."\(^{13}\) Let’s first review how Brazil and Argentina went about coordinating and establishing their macroeconomic policies.

Macroeconomics refers to the performance, structure, and behavior of a national economy as a whole. Macroeconomics provides a broader picture of a nation’s economy and looks specifically at such factors as inflation, unemployment rate, consumption, trade, international trade, international finance, national income, output, and investment. Macroeconomics also specifically refers to monetary and fiscal policies.\(^{14}\) Going into the 1990’s, both Brazil and Argentina were facing shaky, unstable economies with high inflation rates and devalued currencies. At the time the Treaty of Asuncion was signed, Argentina had an economic stabilization plan in place while Brazil did not. While it is clearly stated in the Treaty that member states of MERCOSUR will work to coordinate macroeconomic policies, Brazil still did not establish an economic stabilization plan as Argentina did. The result of this discord within the MERCOSUR agreement was an over-evaluation of the Argentine peso causing an influx of Brazilian imports to Argentina.

In terms of the coordination of macroeconomic policies within MERCOSUR, the most notable area of conflict between Brazil and Argentina was the argument regarding a fixed or floating exchange rate. To fully understand the state of macroeconomics within the MERCOSUR organization, it is important to understand the differences between the fixed and floating exchange rates, and the advantages and disadvantages to both.

\(^{13}\) Ibid., p. 1.

A floating exchange rate (also known as a flexible exchange rate) allows a currency’s value to fluctuate based on the foreign exchange market.\textsuperscript{15} A fixed exchange rate (also known as a pegged exchanged rate) matches a currency’s value to the value of another single currency, a group of currencies, or some other measure of value such as gold. As the value of the measure a currency is fixed to rises and falls, so does the value of the currency matched to that measure.\textsuperscript{16} In terms of economics, there are several arguments surrounding which type of currency regime is best.

Overall, a floating exchange is considered in most cases to be the most useful and beneficial type of currency regime. With a floating exchange rate, shocks to the economy are more easily absorbed by allowing the currency to fluctuate. This serves to automatically adjust the balance of trade when needed, unlike fixed exchange rates. When a floating exchange rate is in place and a trade deficit occurs, demands for foreign currency will rise, automatically making the domestic currency cheaper. Therefore the prices of foreign goods are not ideal and spending with the domestic currency increases. This in turn adjusts the trade deficit as domestic goods are purchased over foreign goods. In addition, the floating exchange rate allows a country to control their domestic economic policies as they are not dependent upon another country’s currency to measure their own.\textsuperscript{17} Therefore nations using a floating exchange rate are able to raise or lower their interest rates allowing for more or less spending, dependent on what is needed in an economy at a given time. Despite the preference of a floating exchange rate, this type of currency regime in newly emerging economies is not always ideal. Floating exchange rates are subject to more foreign exchange volatility. Unexpected depreciations of the

exchange rate deplete bank and corporate balance sheets must faster in emerging economies if they are financially fragile, thus upsetting the domestic stability of a nation’s economy.

The concept of a fixed exchange rate is much easier to understand, and has been ideal for most emerging economies due to its simplicity and potential for economic stability and clarity. Countries will typically maintain a fixed exchange rate by buying or selling its own currency on the open market. Reserves of foreign currency are maintained in the country’s utilizing a fixed exchange rate. This allows a government to buy its own currency in the open market if exchange rates are lower than the desired rate, thus pushing up the price of the currency as it is in more demand. 18 Countries employing a fixed exchange rate currency regime must also maintain confidence in capital markets as well as strict adherence to foreign economic policies, or a fixed exchange rate can fail. Unlike floating exchange rates, there is no automatic rebalancing if a trade deficit occurs, thus causing more potential for economic shocks if the trade deficit is not identified and corrected through the use of currency purchase with foreign reserves. The arguments surrounding fixed and floating exchange rates were prevalent in the attempts of Brazil and Argentina to coordinate their macroeconomic policies.

Argentina’s economic stabilization plan was known as the Convertibility Program and was established in March of 1991. 19 With the Convertibility Program a currency board was established within Argentina which took actions to fix the Argentine currency to the US dollar and establish the US dollar as a legal tender within Argentina. 20 At the

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20 Ibid., p. 1.
same time, Brazil continued with a floating exchange rate and ever increasing inflation rates. Once established, the Convertibility Program served to improve Argentina’s macroeconomic position by reducing monthly inflation rates from 95% in 1991 to 8% in 1993.\textsuperscript{21} The Convertibility Program also established strict regulations on Argentina’s fiscal policy and restricted the government’s ability to run annual deficits. The fixed exchange rate served to create stability within the Argentine economy.

As Argentina continued to work on macroeconomic policies throughout the early 1990’s, Brazil maintained their floating exchange rate while continuing to enjoy success in trade due to the MERCOSUR agreement. MERCOSUR never directly addressed Brazil’s failure to coordinate their macroeconomic policies with Argentina. It is believed this is due to Brazil’s vast size and dominance within the market, including dominance within the MERCOSUR market. Eventually in 1994, Brazil did establish more solidified macroeconomic policies with the introduction of the Real Plan. The Real Plan was established as a result of the hyperinflation and instability in the Brazilian economy throughout the 1980’s and 1990’s, and its goal was the reduction of inflation within Brazil.\textsuperscript{22} The Real Plan also targeted a reduction in annual fiscal deficits within Brazil. While Brazil did eventually adopt an economic stabilization plan to reform their macroeconomic policies, it was not a result of the MERCOSUR organization. Brazil took that action on its own to continue to see economic success in the mid to late 90’s.

As MERCOSUR reached the mid 1990’s, a conflict specific to the MERCOSUR organization arose between Brazil and Argentina. This was the Automobile Crisis of 1995. Due to the Real Plan, Brazil faced a trade deficit in 1995 and made a decision

\textsuperscript{21} Ibid., p. 1.
affecting automobile manufacturing in June. Brazil announced that the import of
automobiles to Brazil within the second half of 1995 would be limited to 50% of the
imports allowed in the first half of the year.\textsuperscript{23} Unexpectedly, Argentina was not granted
exemption from this newly formed Brazilian policy concerning the automobile industry,
despite the MERCOSUR agreement. As expected, Argentina’s reaction was quick and
severe. Argentina felt slighted and refused to attend the upcoming summit between the
member states of MERCOSUR. Brazil, understanding the ramifications of non-
attendance by Argentina, quickly made gestures to attempt negotiation with Argentina to
develop a separate policy for trade between the states as concerned the automobile
industry. The policy regarding automobiles was suspended for 30 days in regards to
Argentina and the presidents of each nation gathered to come up with a suitable plan that
served the purposes of Brazil, Argentina, and MERCOSUR.\textsuperscript{24} It is easy to assume that if
not for the MERCOSUR agreement and the Treaty of Asuncion, Brazil would not have
felt the need to extend such an offer of negotiation to Argentina.

Eventually on January 22, 1996, Brazil and Argentina announced a new
agreement pertaining to automobile imports and exports that would remain in effect until
2000.\textsuperscript{25} In 2000, the MERCOSUR common external tariff would take effect in the
automobile industry and trade between Brazil and Argentina would be barrier free. The
interim agreement was designed to promote investment in the MERCOSUR auto
industry. Argentina maintained their current policy of requiring firms in the automobile
sector to export as much as was imported. Brazil was able to import as much as they

\textsuperscript{23} Cason, “On the Road to Southern Cone Economic Integration,” p. 30.
\textsuperscript{24} Ibid., p. 33.
\textsuperscript{25} Karen L. Remmer “Does Democracy Promote Interstate Cooperation?: Lessons from the MERCOSUR
were able to export with the added bonus of paying only half of the normal duty levied on finished automobiles. The final condition of the automobile agreement between the two countries was the provision that in order to be duty free within the MERCOSUR organization, 50% of the auto components had to be made in the exporting member state.26

The pattern that was established during the automobile conflict within the MERCOSUR organization was the allowance of Brazil to make a unilateral decision that directly affected the additional member states of MERCOSUR. Thus, the precedent was set that Brazil would make decisions and until a challenge to that decision was presented by another member state, regardless of the MERCOSUR agreement and provisions, no negotiation would occur. Once again the economic size and dominance of Brazil is accountable for the establishment of such a pattern of unilateral decisions on the part of Brazil.

Continuing with this trend was the import financing crisis of 1997. This, like the automobile crisis was a situation in which Brazil acted unilaterally and outside the scope of the MERCOSUR agreement, and only entered into negotiations with Argentina once a challenge to the continuation of MERCOSUR was presented. Brazil issued Media Provisoria 1569 on March 25, 1997.27 Media Provisoria 1569 required Brazilian importers to pay cash for the majority of imports into the country. The justification for this provision was to counteract the current practice of using loans in US dollars at low interest rates to purchase imports. When using the low interest rate loans, the credit extended was not expected to be repaid immediately. Brazilian import purchasers used

26 Ibid., p. 42.
the extended credit to invest the credit at higher interest rates, thereby making a profit by receiving credit at a low international interest rate and investing it at the higher Brazilian interest rate. The Media Provisoria 1569 affected 65% of Brazilian imports and included any imports from Brazil’s fellow MERCOSUR member states. Once the MERCOSUR member states issued vehement protests regarding the provision issued, Brazil agreed to negotiate. Once again, this negotiation affecting the Brazilian states occurred after a unilateral decision on the part of Brazil. Negotiations resulted in the following provisions for MERCOSUR member states: an exemption for the requirement of paying cash on imports for any shipments less than US $40,000. These shipments could be purchased with credits extended for a period of 90 days. The exceptions for the MERCOSUR member states would be in place until July 31, 1997.

While Brazil chose to negotiate with its fellow MERCOSUR member states, they were still able to come out on top of the agreement and gain the economic advantage in the decisions that were made. Part of the success of Brazil during this negotiation phase of the import financing crisis was due to the support of not only the Central Bank, but also the economic team of Brazilian economic policymakers. Furthermore, Brazil presented an alternative to the Media Provisoria 1569 as a devaluation of the Brazilian Real as the only other alternative to the balance-of-payments deficit they faced if the credit policy remained in place. It was believed a devaluation of the Real would provide a much more negative and profound effect on the MERCOSUR organization than the agreed upon settlement in place until 1997 for the import-financing crisis.

\[28\] Ibid. p. 48.
\[30\] Ibid., p. 35.
\[31\] Carranza, “Can Mercosur Survive? Domestic and International Constraints on Mercosur,” pp. 84-86.
As MERCOSUR continued to grow and moved into the new millennium, several setbacks occurred. Despite this, the MERCOSUR organization remained. The most notable set back to the MERCOSUR organization was the devaluation of both the Argentine peso and Brazilian real.

MERCOSUR, like other economic integration agreements, was looking for economic growth, price stability, and exchange rate stability to become a strong economy with a voice on the international stage. A by-product of this would be increased trade between member states of the organization and overall economic stability. As evidenced through the discussion surrounding the lack of macroeconomic policy coordination in the MERCOSUR organization, as well as the lack of a strong and decisive dispute resolution system in MERCOSUR, it was not a surprise to many when the currency devaluations occurred within the organizations two main players. How did this come about?

Prior to 1999, with the enactment of the Real Plan, the money supply in Brazil was kept under close watch and tight rein. On January 12, 1999, Brazil abandoned their strict economic policy in terms of exchange rate and devalued the Brazilian Real by over 30%. The devaluation of a currency is a reduction in the value of a currency relative to other monetary units. Devaluations typically occur when trade deficits are present. In 1999, Brazil’s currency began to trade at its fair market value. Once devalued, despite Brazil’s raising of interest rates to stabilize the currency, the Real continued to decline. As a result of this devaluation, a recession occurred that spread from Brazil to Argentina. Consequently, bilateral trade within the MERCOSUR organization also declined. Both Brazil and Argentina were desperate to attract foreign investment in order

32 Ibid., p.95.
33 Ibid., pp. 95-96.
to boost their economies. As is typical of economic agreements in which economies are intertwined and interdependent, when one economy suffers or declines, this can rapidly spread to other economies. Argentine exports became less competitive on the Brazilian market as a result of the devaluation and Argentina was then forced to look to other markets in Latin America to offset this decline.

What further resulted from Brazil’s decision to devalue the Real were several restrictions placed by both Brazilian and Argentine governments on trade between the two countries. For example, Argentina imposed a 23% tariff on sugar from Brazil, while Brazil imposed border sanitary controls of Argentina products. Several other similar actions were taken by both parties. It seemed MERCOSUR had entered into a phase of petty trade rivalry between its two main players. As portrayed through discussions of the import financing crisis and the automobile crisis, dispute resolution was conducted mainly between the heads of state of Brazil and Argentina. In the late 90’s, stakes were clearly higher, and Brazil and Argentina were not as willing to negotiate and the heads of state were not able to continue to resolve disputes in the manner in which they had in the past. To further illustrate the desperation within the MERCOSUR organization at this time, one must note that 30% of all Argentina’s exports went to Brazil, while only 11% of Brazil’s total exports went to Argentina. In addition, 35% of Uruguay’s exports and over 40% of Paraguay’s exports went to Brazil. This further supports the argument that the economic integration organization of MERCOSUR was interdependent and when one member state is troubled this spreads to all member states.

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34 Cason, “On the Road to Southern Cone Economic Integration,” pp. 94-98.
True to form from past disputes, Brazil did not immediately negotiate with its smaller partners from MERCOSUR and actually pursued a free trade agreement with another Latin American trading bloc, the Andean Group. Furthermore, Brazil announced a suspension of all negotiations regarding the current trade war in place with Brazil. It seemed imminent that MERCOSUR would be dissolved once suspension of negotiations occurred. From 1998 to 1999, trade within the MERCOSUR organization rapidly decreased from $22 billion to $15.4 billion.\textsuperscript{36} Recognizing the impacts to economic stability, Brazil and Argentina were eventually able to come to a suitable agreement regarding their trade wars through negotiation between the presidents of the two member states, along with minimal input from the CMG of MERCOSUR. As a result, MERCOSUR continued. The crisis resulting from the devaluation of the Brazilian Real further supports the argument that a better dispute resolution system needed to be created and enforced within the MERCOSUR organization.

After 1999, with the continuation of MERCOSUR, Brazil's economy was able to rebound. Unfortunately not the same could be said for the Argentine economy. The strict adherence to a fixed exchange rate resulted in an overvalued peso, restricting Argentina's trade competitiveness. Attempting to learn from its previous lessons in 1999, MERCOSUR's Common Market Council (CMC) took an unprecedented move to reestablish some of MERCOSUR's basic economic goals. This consisted of common standards for fiscal responsibility, reports from each country on efforts to achieve economic stability, and a harmonization of national statistics of each member state to allow MERCOSUR decision-makers an easier method of economic comparison between

member states.\textsuperscript{37} This can be noted as MERCOSUR’s first attempt to be proactive rather than reactive to crises within the organization.

Unfortunately by 2001, the reestablishment of MERCOSUR’s economic integration goals by the Common Market Council was not successful. No attempts to meet the goals specified by the CMC had been made by member states except for a small restructuring of national statistics for harmonization. Conditions in Argentina continued to worsen during this time.

Facing a default on external debt up to $123.5 billion, Argentina managed to stay afloat with an International Monetary Fund (IMF) sponsored loan package for a small amount of time in late 2000.\textsuperscript{38} By 2001 factors such as Argentina’s inability to make debt payments, social unrest, and the continued backlash from the devaluation of the Brazilian currency spurred yet another trade war with Brazil. At the same time in early 2001, Brazil’s currency continued to face devaluation. In attempts to re-boost the Argentine economy, with support from the CMC, Argentina imposed a 35\% tariff on imports of consumer goods from all non-MERCOSUR member states. At the same time, tariffs on imports of capital goods from outside MERCOSUR were eliminated completely.\textsuperscript{39} It was the hope that these measures would encourage foreign investments in Argentina’s economy. Argentina, Brazil, and the CMC were fully aware that this violated the customs union agreement set forth in the Treaty of Asunción, but as Argentina had the support of the CMC, Brazil had little room for leveraging complaints and in the end agreed to such measures by Argentina. During this time there was talk of the possibility of creating just a free trade area between MERCOSUR member states.

\textsuperscript{37} Ibid., p. 33.
\textsuperscript{38} Cason, “On the Road to Southern Cone Economic Integration,” pp.37.
\textsuperscript{39} Ibid. p.39.
rather than continuing towards the achievement of a common market. As expected, the
Argentine economic crisis affected the state of trade and economic stability for all of
MERCOSUR’s member states.

October 8, 2001 brought about another official agreement between Brazil and
Argentina at the meeting of the Common Market Council. It was agreed that Argentina
could temporarily impose tariffs on any products that were proven to be affected by the
continued devaluation of the Brazilian Real.\textsuperscript{40} While the agreement between Brazil and
Argentina occurred during a MERCOSUR generated summit, the agreement would not
have been reached without the support of the heads of state of each government.

It is apparent that the economic crises in both Argentina and Brazil during the late
90’s and into the new millennium served to undermine MERCOSUR, and create
questions about MERCOSUR’s ability to survive. MERCOSUR is equally a political
and economic agreement, which has accounted for its inception, fast growth, disputes,
and continuance. Through the creation of the ABEIP, the Treaty of Asuncion, and
MERCOSUR itself, the heads of state of both Brazil and Argentina have been key. Their
continued commitment to creating economic stability in the Latin American region, as
well as the two governments continued negotiations to solve disputes have helped to
create and keep MERCOSUR alive. However, these same representatives of these two
member states have also contributed to the disputes. Ultimately the two governments
will resort to their own best interests if an agreement cannot be reached. For this reason,
it is imperative that an established, credible dispute resolution system be created for
MERCOSUR. This organization would be responsible for dispute resolution, while
keeping in mind the goals of the original architects of the MERCOSUR organization.

\textsuperscript{40} Ibid., p. 40.
As mentioned previously, the Common Market Group or CMG was tasked with the responsibility of creating rules of procedure within sixty days of the signing of the Treaty of Asuncion. Based on this, it was determined that the CMG’s basic duties consisted of: “cause compliance with the Asuncion Treaty, take resolutions required for implementation of the decisions made by the Common Market Council, initiate practical measures for trade opening, coordination of macroeconomic policies, negotiation of agreements with nonmember states and international agencies, and participating when needed in the resolution of controversies under MERCOSUR.”[41] As a supplement to the original Treaty of Asuncion, member states gathered and formed the Protocol of Ouro Preto to further explain the specific duties of each of MERCOSUR’s governing institutions. Within this document is the following information regarding dispute resolution: “An attempt to settle any disputes between member states will first be made through direct negotiations, which will be limited to 15 days as from the date one of the member states raises the matter, unless otherwise agreed to by the parties.”[42] To continue with this, if a complete and solidified agreement is not reached through direct negotiation, any member state may petition the Common Market Group to review the conflict. Based on the information the CMG learns regarding the dispute, the CMG will make recommendations to resolve the dispute. The CMG is allotted a total of 30 days to make their recommendations. If an agreement is still not reached, a member state can then apply for arbitration to settle the dispute. The arbitration path then establishes an ad hoc court to review the dispute and make a ruling. A decision will then be issued within

sixty days of the creation and establishment of the ad hoc court. If a dispute goes to the level of arbitration, a decision cannot be appealed and must be implemented within 30 days of being handed down.\footnote{\textit{Ibid.}, p. 7.}

The resolution of disputes within MERCOSUR already mentioned are for member states only, not private individuals operating firms within a member state. If a private individual has a dispute in need of resolution, they must file a claim and the Common Market Group will research the claim with a panel comprised of specialists. The specialists are tasked with determining if the claim is valid, and if so will hand down a decision within 30 days. \footnote{\textit{Ibid.}, p. 7.}

The Treaty of Asuncion and the Protocol of Ouro Preto were only in effect until 1994 when MERCOSUR agreed to the full establishment of their economic integration agreement. After such a time, the dispute resolutions took on the form of negotiation between heads of state. One must also note that the arbitration process in place for the MERCOSUR organization was also costly and cumbersome, with little success in permanently resolving disputes.

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\textbf{Section IV: The Future of MERCOSUR}

Aware of the failing of the MERCOSUR organization in terms of dispute resolution, and the blatant hegemony of Brazil throughout the mid to late 1990's,
MERCOSUR eventually took steps in 2002 to establish a more successful and permanent method of dispute resolution. Modeling the MERCOSUR organization after the European Union, MERCOSUR finally established the Protocol of Olivos for Dispute Settlement. Created on February 18, 2002, the president of each member state signed the Olivos Protocol. The Olivos Protocol encompassed the issues of trade disputes, and addressed any infraction regarding the interpretation, enforcement, or non-fulfillment of the Treaty of Asuncion. Like the EU’s European Court of Justice, a permanent tribunal comprised of five arbitrators was established. The permanent tribunal was tasked with reviewing the decisions handed down in previous arbitration by the ad hoc courts established for each specific dispute.\(^4^5\)

While the Olivos Protocol is a step in the right direction for the MERCOSUR organization, further steps need to be taken. The Treaty of Asuncion established that MERCOSUR would begin the relationship between member states by first targeting free-trade zones and a Common External Tariff, then following that up with a move towards custom unification and eventually a common market. Included in these provisions of the Treaty of Asuncion, were the free movement of labor and capital between MERCOSUR member states.

At the time of the creation of MERCOSUR, the exchange rate issue was not identified as an issue in harmonizing the macroeconomic policies of the member states. However, it quickly became clear as MERCOSUR integrated and grew that it was a concern. Brazil consistently readjusted their currency regime to serve its own best interests and to remain at the top of the economic letter within MERCOSUR. On the

other side of the fence was Argentina refusing to deviate from their strict fixed exchange rate, despite warning signs that is could potentially cause issues. As a result, the exchange rate issue between Argentina and Brazil was both a political and domestic issue that only grew over time. It seems obvious that the Common Market Council should have stepped in and taken measures to come to a compromise for the overall good of the MERCOSUR agreement. For MERCOSUR to continue to succeed, it will be important to be proactive rather than reactive. The Common Market Council attempted to enact such measures with the reestablishment of MERCOSUR’s basic economic goals in 1999. As is known, the reestablishment did not have any positive outcomes. When making such decisions, the CMC should issue timelines and action plans for the establishment of policies. In addition, consequences for not complying should be issued in order to gain the support and cooperation of member states. Such actions would hold each member state accountable, with repercussions if there is no compliance.

In addition, as MERCOSUR continues to move towards its goal of a complete common market, domestic policies in each member state will need to be accounted for. The continued reliance on heads of state to negotiate and resolve disputes, as well as form agreements for continued economic success will need to address domestic policies. If the goals of each individual member state are not somewhat similar and cohesive, MERCOSUR cannot continue to succeed and grow. At the time of inception, the MERCOSUR states were moving towards democracy as whole with common goals. Over time, the common goals deteriorated as the two largest and powerful member states began to act unilaterally, most notably Brazil. The member states of MERCOSUR need to reestablish their common goals, take corrective measures to achieve these goals within
a specified timeline, have a strong executive organ to oversee this process and line up domestic policies. This will help to more fully integrate. Overall, MERCOSUR needs to establish supranational institutions to oversee its continued integration. While it is worthy and notable that the heads of state have been moderately successful in negotiating and integrating MERCOSUR member states, the time has come for a stronger central party that includes domestic input from private sectors operating in MERCOSUR member states to oversee the integration process. Furthermore, it will be important for MERCOSUR to continue to focus on growing stronger, rather than expanding. By growing stronger, they will inherently grow larger as their success continues. A stronger, more centralized MERCOSUR would serve to be more appealing to other nations, thus increasing the size of MERCOSUR. As MERCOSUR becomes stronger and eventually grows, the presence of other member states will help in some ways to diminish the overall dominance of Brazil as the remaining member states begin to gain in economic size and stability.

Despite the disputes and issues discussed, overall MERCOSUR has made great strides in integrating. It must be remembered that they have accomplished a level of integration in a few short years compared to other integration agreements such as NAFTA and the EU. By 2000, 90% of all goods between MERCOSUR member states were duty free and 80% of goods have an agreed upon external tariff.\textsuperscript{46} In addition, MERCOSUR is evolving to be more private led than state led as more firms and businesses participate in the economic agreement. As the private sector is more involved, MERCOSUR is more likely to survive as the failure of such integration would have a more profound and wider spread affect at the domestic level.

\textsuperscript{46} Cason, “On the Road to Southern Cone Economic Integration,” p.40.
Today, MERCOSUR consists of member states Brazil, Argentina, Uruguay, and Paraguay, as well as associate member states of Bolivia, Chile, Columbia, Ecuador, Peru, and Venezuela. In December of 2004, MERCOSUR also negotiated with the Andean Group to sign a pact moving towards the integration of South America as a whole. One must also note that in December 2007, MERCOSUR also signed a free trade agreement with Israel.

Regardless of the numerous obstacles in terms of economic stability, the Latin American region as a whole, and the trade disputes between member states, MERCOSUR continues to be recognized as an integration agreement and currently has the fifth largest economy in the world with a population of over 263 million people. Even in the face of economic crisis in 2001 and the possible collapse of the integration agreement, MERCOSUR has persevered. That alone calls out the success of MERCOSUR. Another accomplishment in favor of MERCOSUR is the continued commitment of former economic and political rivals to integrate and maintain their goals over an extended period. MERCOSUR and Latin America has truly come a long way since inception in 1991.
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