SPRING 2012 HONORS CAPSTONE

Latin American Integration Experiments:

The Case of Mercosur

Christopher Dychala
4/30/2012
Advisor Dr. Robert Pastor
School of International Service

Latin American Integration Experiments: The Case of Mercosur

TABLE OF CONTENTS

ABSTRACT

While the notion of integration has existed in Latin America since the former colonies gained their independence, not until the last few decades has the region witnessed the proliferation of regional cooperative agreements and integration efforts. Mercosur specifically has been the subject of criticism in recent years, viewed by some as a regional integration experiment in irreparable decline. The existing literature, however, often fails to provide clear criteria by which to measure efforts towards regional integration. Therefore, this paper seeks to analyze regional economic and trade data to generate a series of economic indicators that evaluate the success of Mercosur's efforts towards its stated objectives as laid out in the Treaty of Asuncion and the Ouro Preto Protocol. This paper uses trade integration, foreign direct investment inflows, macroeconomic interdependence, macroeconomic coordination, people-to-people exchange, and income convergence as economic indicators for regional integration. The results show that the integration process in the developing world is highly vulnerable to international and regional financial crises, producing a volatile path towards closer ties among member countries.

INTRODUCTION

The concept of a unified and integrated Latin America has existed since the tide of independence movements swept across the region in the early nineteenth century. Simón Bolívar, the political and military leader instrumental in gaining independence from the Spanish Empire, dreamt of a united and free Latin America. Today, although the formation of a single Latin American nation in the near term is improbable, notable efforts towards regional integration have taken place. Prompted by the successes of the European integration project, the second half of the twentieth century witnessed a surge in both regional solutions to development challenges as well as efforts towards integration around the world and particularly in Latin America.

One must first begin any discussion of integration by clearly defining what is meant by integration rather than the more broadly defined regionalism. Prominent international relations scholar Joseph Nye defines a region as a "limited number of states linked by a geographical relationship and by a degree of mutual interdependence" and regionalism as "the formation of interstate associations or groupings on the basis of regions."[1] A first wave of regionalism, termed the "old regionalism," surged in the 1950s and 1960s with the creation of the European Coal and Steel Community, later to become the European Economic Community. Starting in the 1980s until the present day, a second era of "new regionalism" has occurred. Regional cooperative organizations have proliferated in Latin America and around the world. The Andean Community of Nations, for example, dates back to 1969, but it has been characterized by mistrust and dysfunction. More recently formed, the Community of Latin American and Caribbean States (CELAC) and the Union of South American Nations (UNASUR) are regional groupings that seek to address regional concerns and promote regional cooperation. UNASUR, a 12-nation

---

[1] Joseph, Nye, *Comparative Regional Integration: Concept and Measurement*, *International Organization*, Vol. 22, No. 4 (Sep., 1968), pp. 855-880.

regional framework for stability comprising a formally organized structure with a permanent secretariat, helps to mollify regional tensions and encourage dialogue among members. CELAC, formed in 2011, comprises all Western Hemisphere nations except the United States and Canada. These groupings advance regional interests but without greater mechanisms that enhance integration.[2]

To discuss integration is to discuss a deeper process defined by an attempt to coordinate policies between nations and eventually cede sovereignty to a supranational entity. Integration implies the erosion of national sovereignty and unilateral action to be replaced with more integrated social, political, and economic policies. Regional integration has varying levels of depth in terms of the interconnectedness of its members. On the most basic level, a region, such as North America in the North American Free Trade Agreement (NAFTA), can form a free trade area, which mandates the removal of all tariffs and barriers to trade. The next level of integration is a customs union, or a regional area with a common external tariff for all imported products. Third, a common market is a region that allows for the free flow of factors of production, including labor. Finally, a monetary union adopts a single currency and cedes control of its decision-making power over monetary policy. The European Union is the only regionally integrated bloc to have passed through all stages of integration in the adoption of its common currency, the euro.

The Common Market of the South (Mercosur), the focus of this paper, is not the common market that it claims to be. The European integration project, a model for Mercosur, developed over decades of negotiations, finally evolving to the complex array of supranational and intergovernmental political and economic structures that comprise it today. While the European

---

[2] Michael Shifter, *The Shifting Landscape of Latin American Regionalism, Current History,* http://www.the dialogue.org/ Publication Files/Shifter-CurrentHistory.pdf.

project was an attempt to prevent future conflict on the European continent between Germany and France, Mercosur was an attempt to attract investment and prevent marginalization in a changing post-Cold War world. The Mercosur project, the foundation of which will be discussed in more detail shortly, was incredibly ambitious, seeking to jump through the stages of regional integration that had taken Europe decades in just a few years. The process was largely led by intergovernmental negotiation and even more forcefully by visionary regional presidents without strong initial backing from business or labor groups.

Many claim that despite Mercosur's initial successes the regional bloc has stagnated and is in a state of irreparable decline, unable to fulfill its objectives of becoming a common market. Through an analysis of the goals of Mercosur laid out in the Treaty of Asunción and the Protocol of Ouro Preto and economic data, this paper attempts to evaluate the success or failure of the agreement in achieving its integration objectives. The first section of this paper seeks to tell the story of integration experiments in Latin America and how Mercosur's development is unique from the European integration process. It considers the aspects of regional integration specific to the developing world and discusses the regional bloc's impressive formation considering political and financial instability as well as vulnerability to international shocks and investment flows. In the following section, relevant economic indicators are selected to measure the success of Mercosur integration in meeting its established goals. These indicators include trade integration, foreign direct investment inflows, macroeconomic interdependence, macroeconomic coordination, people-to-people exchange, and intraregional income convergence. In the third section, given the results of the analysis, the data is used to generate a Mercosur narrative, which helps explain the regional bloc's highs and lows over time and examine its successes and failures.

Finally, the author offers thoughts on the future prospects of Mercosur and recommendations for revival.

BACKGROUND

Latin American Integration and ISI

Due to a legacy of colonial rule, underdevelopment, and dependency, the Latin American region has historically been economically vulnerable. A reliance on exports of raw materials and importation of finished goods from the industrialized world increased inequality and prevented the development of competitive domestic industries. During the second half of the twentieth century, integration efforts in Latin America first emerged to stem the effects of this asymmetric relationship to the global economy. Despite the impetus for cooperation, divergent goals among nations, susceptibility to global crises, and lack of trust and unity have inhibited the integration process. Ambitious and often unrealistic goals of Latin American integration experiments have too frequently led to their downfall.

Integration efforts first emerged after the ruinous financial collapse of the Great Depression through what was termed import substitution industrialization (ISI), a development tool that sought to "achieve greater independence from the more powerful and developed countries in the world economy," particularly the United States and Europe.[3] With high tariffs and industrial subsidies, Latin American governments hoped that domestic industries would have the opportunity to grow and in time break the cycle of dependency on the importation of industrial goods from the developed world. However, countries soon realized that small domestic markets, further limited by high levels of regional inequality, restricted the newly formed

[3] Jeffrey Cason, *The Political Economy of Integration: The Experience of Mercosur,* New York: Routledge, 2011, pg. 31.

industries' ability to export products and achieve economies of scale. Integration was a way to expand regional markets and achieve the goals of ISI by allowing the new industries to expand their markets. Despite the limited growth potential of this approach, the newly formed Economic Commission for Latin America (CEPAL), created in 1948 as an economic forum within the United Nations to research Latin American development policy, actively promoted ISI strategies.

The first significant Latin American integration project aimed at expanding markets under ISI and promoting intraregional trade was the Latin American Free Trade Association (LAFTA). LAFTA was "established by the Treaty of Montevideo, signed in 1960. In part inspired by the European Community's Treaty of Rome three years earlier, LAFTA aimed to create a free trade area in Latin America by 1973."[4] Progress was negligible, and by the time efforts were made to revive the integration process, the region became mired in a wave of political and financial crises: military dictatorships had begun to overtake much of the region and were followed by the "lost decade" of development of the 1980s, characterized by debt, banking, and currency crises resulting in instability and hyperinflation.

The failures of ISI and the economic vulnerabilities of Latin America that resulted in devastating crises led to profound structural reforms throughout the region in the 1990s. In the realm of the international political economy, the fall of the Berlin Wall and the end of the Cold War discredited state-led economic growth as free market neoliberal economics emerged victorious. Many Latin American countries made efforts to institute reforms of the famed Washington Consensus, espoused by John Williamson and the International Monetary Fund, including privatization of industries, deregulation, trade liberalization, and fiscal policy discipline. This prescription of financial remedies aimed to stabilize regional economies, bring down inflation, and promote greater efficiency and credibility in financial systems. Other notable

[4] Ibid., 34.

trends such as the move towards floating exchange rate regimes instead of pegged currencies as well as greater independence for central banks have improved monetary policy and financial stability in the region.

Cooperation and the Formation of Mercosur

Cooperation between Brazil and Argentina, and the subsequent foundation of Mercosur, began while both nations remained under military dictatorships. Cooperative agreements between the two governments, on issues such as hydroelectric resources and nuclear weapons, reversed a long-standing historical trend of competition, distrust, and rivalry. This increase in dialogue and collaboration made greater cooperation in the economic and political realm possible after their transitions to democracy. Following this transition, cooperative efforts were furthered with the goal of "consolidating democracy in two regimes that were still relatively fragile."[5] Similar to the European objectives of creating political cooperation through economic interdependence, the Argentine-Brazilian Economic Integration Program (ABEIP), signed by presidents José Sarney of Brazil and Raúl Alfonsín of Argentina, sought greater interdependence to prevent a renewal of historical rivalries.

Any attempts at integration were impressive, considering the highly unstable inflation rates in Argentina and Brazil in the 1980s and early 1990s. "In Brazil, for example, annual inflation went from an already high 248 percent in 1985 to what in most countries would be a hyperinflationary rate of 2592 percent by 1990. In Argentina, the performance was even more erratic; while Brazilian inflation accelerated more or less steadily over the second half of the 1980s, Argentina's rate went from 691 percent in 1985 to 78 percent in 1986 and then way back

[5] Ibid., 38.

up into hyperinflationary territory by 1989, when its inflation rate hit 3015 percent."[6] Although successful in establishing a framework for cooperation and increasing, albeit inconsistent, trade flows, the ABEIP was a final effort to promote integration through ISI tactics, a developmental method that favored high tariffs, quotas, and non-tariff barriers.

As the Cold War ended, some worried that the region would become increasingly marginalized in the global economy and foreign investment would be harder to attract. Elected in 1989, Brazilian president Fernando Collor de Mello and Argentine president Carlos Menem promoted the neoliberal guidelines of the Washington Consensus. In contrast to the slow development of integration that took place in Europe over decades, a truly state-led intergovernmental approach pushed the Mercosur integration effort forward, seeking to open trade and reduce barriers at a rapid rate. The formation of Mercosur, in fact "adopted over the objections of large segments of the business sector," was a product of the efforts of two forward-thinking presidents adapting to a changing world.[7] In March 1991, the presidents of Argentina, Uruguay, Paraguay, and Brazil signed the Treaty of Asunción, forming the Common Market of the South (Mercosur). This was later followed by the 1994 Protocol of Ouro Preto which set the guidelines for establishing a customs union with a common external tariff.

Objectives

The agreement had high expectations, attempting not just to liberalize trade but to eventually form a common market that allowed for the free flow of factors of production and macroeconomic coordination, particularly impressive during an era of incredible uncertainty and domestic economic instability. The Treaty of Asunción, acknowledging that the "expansion of their domestic markets, through integration, is a vital prerequisite for accelerating their processes

---

[6] Ibid., 43.
[7] Ibid., 4.

of economic development with social justice" states the following general objectives: "making optimum use of available resources, preserving the environment, improving physical links, coordinating macroeconomic policies and ensuring complementarity between the different sectors of the economy, based on the principles of gradualism, flexibility and balance."[8] This step in efforts to "gradually bring about Latin American integration" was a way to ensure the region's relative importance in the international economy and to "modernize their economies in order to expand the supply and improve the quality of available goods and services, with a view to enhancing the living conditions of their populations." Furthermore, Article 1 specifies that this common market shall involve:

- The free movement of goods, services and factors of production between countries through, inter alia, the elimination of customs duties and non-tariff restrictions on the movement of goods, and any other equivalent measures;
- The establishment of a common external tariff and the adoption of a common trade policy in relation to third States or groups of States, and the co-ordination of positions in regional and international economic and commercial forums;
- The coordination of macroeconomic and sectoral policies between the States Parties in the areas of foreign trade, agriculture, industry, fiscal and monetary matters, foreign exchange and capital, services, customs, transport and communications and any other areas that may be agreed upon, in order to ensure proper competition between the States Parties;
- The commitment by States Parties to harmonize their legislation in the relevant areas in order to strengthen the integration process.[9]

Integration can be measured as the extent to which these previously determined integration goals were met. For this reason, economic indicators that monitor trade integration, investment,

[8] Treaty of Asunción, http://idatd.eclac.cl/controversias/Normativas/MERCOSUR/ Ingles/ Treaty_of_Asuncion.pdf.
[9] Ibid.

macroeconomic interdependence and coordination, people-to-people exchange, and income convergence were selected to evaluate progress made in each area.

Mercosur Timeline

In its initial years, Mercosur achieved remarkable success. Given the absence of a financial crisis in Latin America, integration led to vast increases in trade, investment flows, and growth rates as well as an eventual stabilization of currencies which reduced uncertainty (however due to overvalued fixed exchange rate regimes that would cause problems in the future). A favorable economic environment allowed the integration project to flourish and attain levels of depth previously unknown in Latin America. This fast track integration approach led to the negotiation of a customs union, albeit imperfect, by the end of 1994 in the Protocol of Ouro Preto. However, "quite a number of products were left off the final list of goods where a common external tariff (CET) could be agreed upon, but it was agreed that more than 80 percent of all products would have a common import tariff in the region," an impressive achievement.[10] This high point for Mercosur achieved two notable goals of the agreement's original objectives: attracting foreign investment to the region as well as avoiding marginalization on the global economic stage. Some new institutional groups were created however integration did not extend beyond the commercial arena.

Even though the European Union served as a model for South American integration efforts, Mercosur began the process with a fundamentally different set of conditions. While objectives may be similar—as its name suggests, the Common Market of the South originally sought to establish the free flow of factors of production, including labor—the nature of the region's circumstances was quite different than that of Europe. Jeffrey Cason, in *The Political*

[10] Cason, 81.

Economy of Integration, argues that South American integration would always look different from European integration, given its feebler political structure, civil society, and influence in the global political economy. "Mercosur embarked on its integration project with a number of disadvantages, including weak political institutions, underdeveloped and clientelistic relationships between state and civil society actors, and heavy dependence on foreign capital for investment and the financing of current account deficits."[11]

This relatively weaker development status, in terms of strength of financial institutions and vulnerability to financial crises, meant that the agreement also was much more fragile than its European counterpart. Divisions occasionally occurred throughout the liberalization process. In the initial years of the agreement, as countries were lowering barriers, the Argentines placed a "statistical tax" on imports in order to stop the flood of Brazilian exports.[12] Crises like these were eventually resolved however, often due to the actions and negotiations of regional political leaders. At times, both nations would take unilateral measures for short term adjustments, and there were fundamental disagreements over how to regulate certain sectors, specifically automobiles and sugar.[13]

A series of crises in the international economy and in Latin America have presented the regional integration bloc with significant challenges that have inhibited cooperation. Mercosur's first challenge, which took place shortly after arrangements were being made for a common external tariff, was the Mexican peso crisis. Given the herd mentality of investors, the Mexican peso devaluation resulted in capital flight from much of the rest of Latin America. Most notably, the Asian financial crisis set off shock waves well beyond the Asian region to Russia and then to Brazil, which led to a currency devaluation and shift to a floating exchange rate regime in

[11] Ibid., 15.
[12] Ibid., 65.
[13] Ibid., 71.

January 1999. Furthermore, Argentina's financial collapse in 2001, the product of an overvalued and unsustainable peso pegged to the US dollar, led to a collapse in regional integration, trust, and trade. Today, intra-regional trade is a fraction of what it was at its peak in 1998, declining from 25 percent to 15 percent.[14]

Perceived stagnation has led to a decline of scholarly research on the viability of Mercosur, and this paper seeks to bring attention back to a regional trade agreement that has notable successes in meeting its integration goals despite setbacks that stem from the international financial climate. Cason argues that the experience of Mercosur can be described as vulnerable integration, a process of integration that would be similar for most countries in developing or emerging regions. A combination of underdeveloped political institutions and exposed positions in terms of foreign investment make the agreements much more fragile and more susceptible to outside forces. Today, Mercosur has brought its South American member nations closer together, but forces remain that pull the members apart. Furthermore, it has failed to reach the status of a full customs union with a common external tariff much less a common market.

Perhaps Mercosur was launched prematurely, at a time when domestic financial and economic institutions were weak and vulnerable to fluctuations in the international economy. Yet, given these difficult conditions, the regional trade bloc achieved unexpected success in its first several years in an international environment absent of financial shocks and regional economic crises. It is worthy to evaluate the success of Mercosur in attaining its integration goals and examine its viability as a model for integration in other emerging regions. This paper serves as a basic model to assess Mercosur's progress, including economic indicators that evaluate trade integration, investment, macroeconomic interdependence, macroeconomic coordination, people-

[14] Gordon Mace, et. al., *Inter-American Cooperation at a Crossroads*, New York: Palgrave Macmillan, 2011, pg. 86.

to-people exchange, and the intraregional gap. Many more indicators could have been included and the ones that have been selected could be measured in different ways; however, this analysis serves as a humble attempt to observe what has taken place in South America and as a foundation for further research on regional integration and Mercosur.

ECONOMIC INDICATORS AND DATA

Regional integration is a complex process, and a clearly defined system of indicators has not been created to analyze a regional grouping's level of interconnectedness. To evaluate Mercosur's progress in achieving its regional integration goals as laid out in the Treaty of Asunción, economic indicators that reflect these objectives have been selected. Intraregional trade as a percent of total trade has often been used to assess interconnectedness in various regional agreements, such as the North American Free Trade Agreement (NAFTA) and the European Union (EU); however, this indicator does not tell the whole story. In addition to trade integration, the following sections will examine foreign direct investment inflows, macroeconomic interdependence, macroeconomic coordination, people-to-people exchange, and the intraregional income gap.

Basic Indicators

Table 2.1 shows the basic data for each member nation of Mercosur, including population, current Gross Domestic Product (GDP), and each country's share of GDP in Mercosur. Brazil, by far, is the strongest single economic actor in the regional integration group.

Table 2.1

Mercosur Country	Population (millions)	GDP (current US$)	Share of GDP in Mercosur (%)
Brazil	194.9	2,087.9 billion	83
Argentina	40.4	368.7 billion	14.7
Paraguay	6.45	18.5 billion	0.01
Uruguay	3.35	40.3 billion	0.016

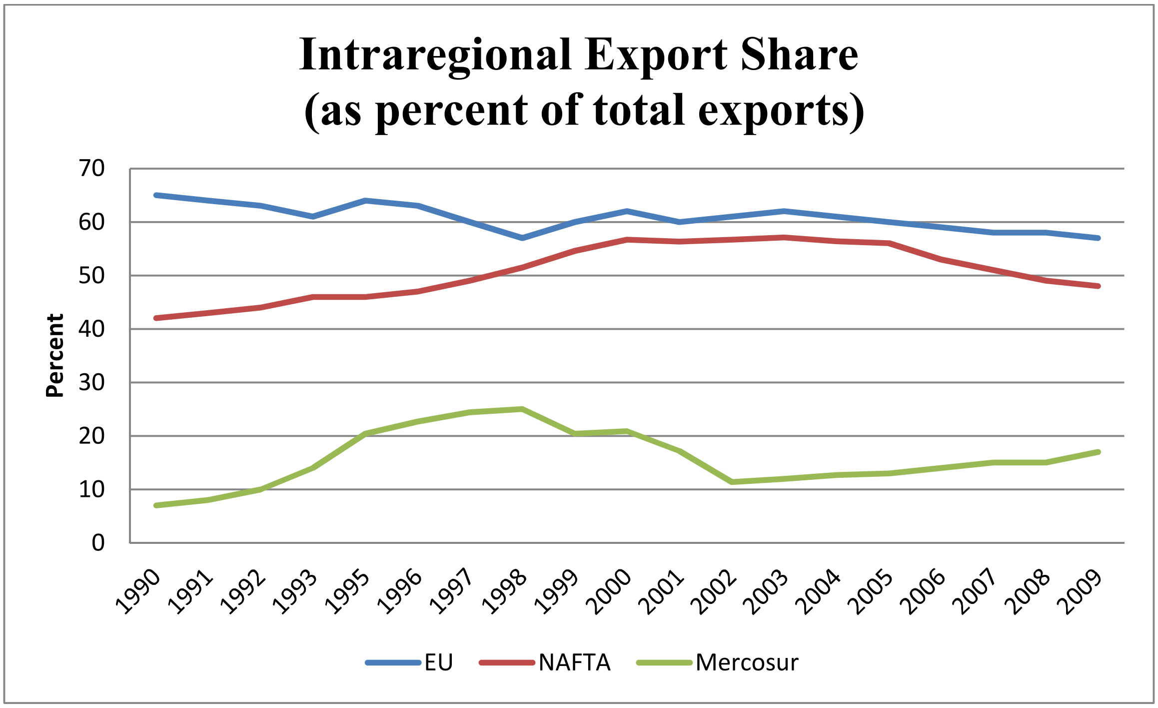
Source: World Trade Organization, Statistics Database, accessed in March 2012.

Trade Integration

A commonly used tool to measure trade integration is the share of intraregional exports as compared to total exports, or intraregional export share. This indicator shows the relative importance of trade directed towards other member nations of the regional integration bloc compared to trade with the rest of the world. One objective of the Treaty of Asunción was the expansion of domestic markets through integration, acknowledging that this expansion was a "vital prerequisite for accelerating their processes of economic development with social justice."[15] Failed attempts at Import Substitution Industrialization revealed the constraints of small domestic markets, and the elimination of tariff barriers between Mercosur members and the formation of a customs union aimed to expand intraregional trade. Figure 2.1 shows the intraregional trade share for selected regional trade agreements during the period 1985 to 2008.

[15] Treaty of Asunción.

Figure 2.1



Source: World Trade Organization, Statistics Database, accessed in March 2010.

The graph shows that intraregional exports as a share of total exports remain quite low in Mercosur compared to NAFTA and the EU. Intraregional exports soared in the initial years of Mercosur as trade barriers were lowered, peaking at nearly thirty percent by 1998. A series of international and regional financial crises put pressure on the regional bloc, and the intraregional trade share fell steadily over the following years. Today, the Mercosur intraregional trade share stands at about 15 percent, while it remains nearly 50 percent in North America and nearly 60 percent in Europe.

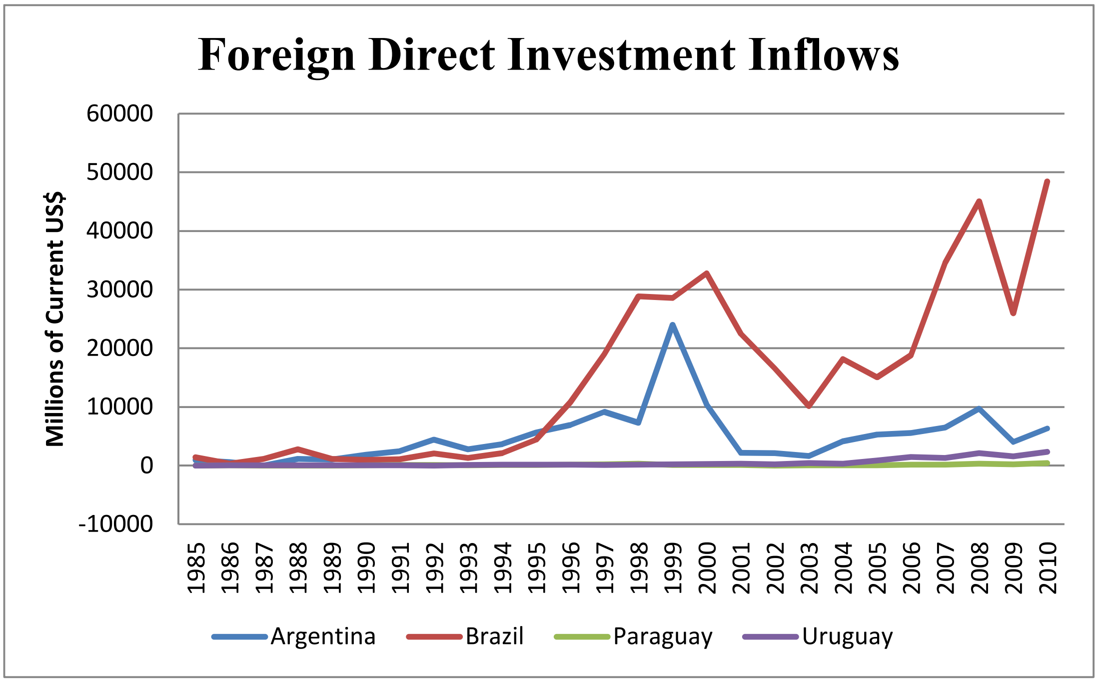
Foreign Direct Investment

Another explicit goal of Mercosur was to attract foreign direct investment to the region. The presidential leaders responsible for moving the integration process forward were particularly cognizant of the end of the Cold War and the resounding victory for free market capitalism. They feared that this environment would make it more challenging for nations in South America to attract investment inflows. The Preamble of the treaty specifically mentions an awareness of "international trends, particularly the integration of large economic areas, and the importance of securing their countries a proper place in the international economy."[16] Therefore, it is worthy to evaluate the foreign direct investment inflows to Mercosur member nations when considering the regional grouping's success in achieving its objectives. Figure 2.2 shows foreign direct investment inflows for the period 1985 to 2010.

---

[16] Ibid.

Figure 2.2

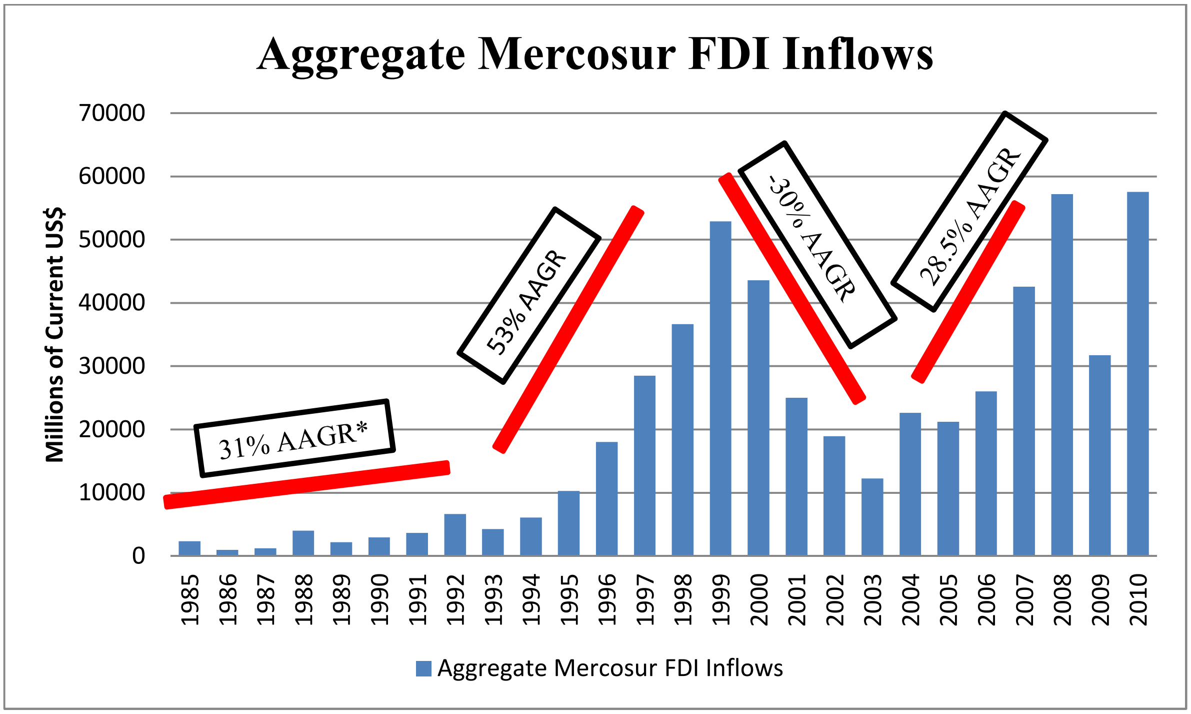


Source: UNCTAD, Comtrade, accessed in March 2012.

As the figure shows, foreign direct investment inflows remained quite low in the years preceding the formation of Mercosur. In the first half of the 1990s, FDI inflows notably began to increase and soared in Brazil and Argentina in the second half of the decade. By 2000, FDI inflows into Brazil surpassed an unprecedented $30 billion. The 2001 crisis in Argentina led to capital flight in both Argentina and Brazil. After several years, FDI investments began to recover and increases have been documented in all Mercosur countries in the second half of the 2000s. Confidence in Argentina remains relatively weak; however, FDI inflows into Brazil have surged to over $48 billion in 2010.

Figure 2.3 shows aggregate Mercosur FDI inflows for the period 1985 to 2010 along with average annual growth rates for selected intervals. This data also reflects a strong increase in investment inflows following the formation of Mercosur, a rapid decline following a peak in 1998, and a notable increase in recent years.

Figure 2.3

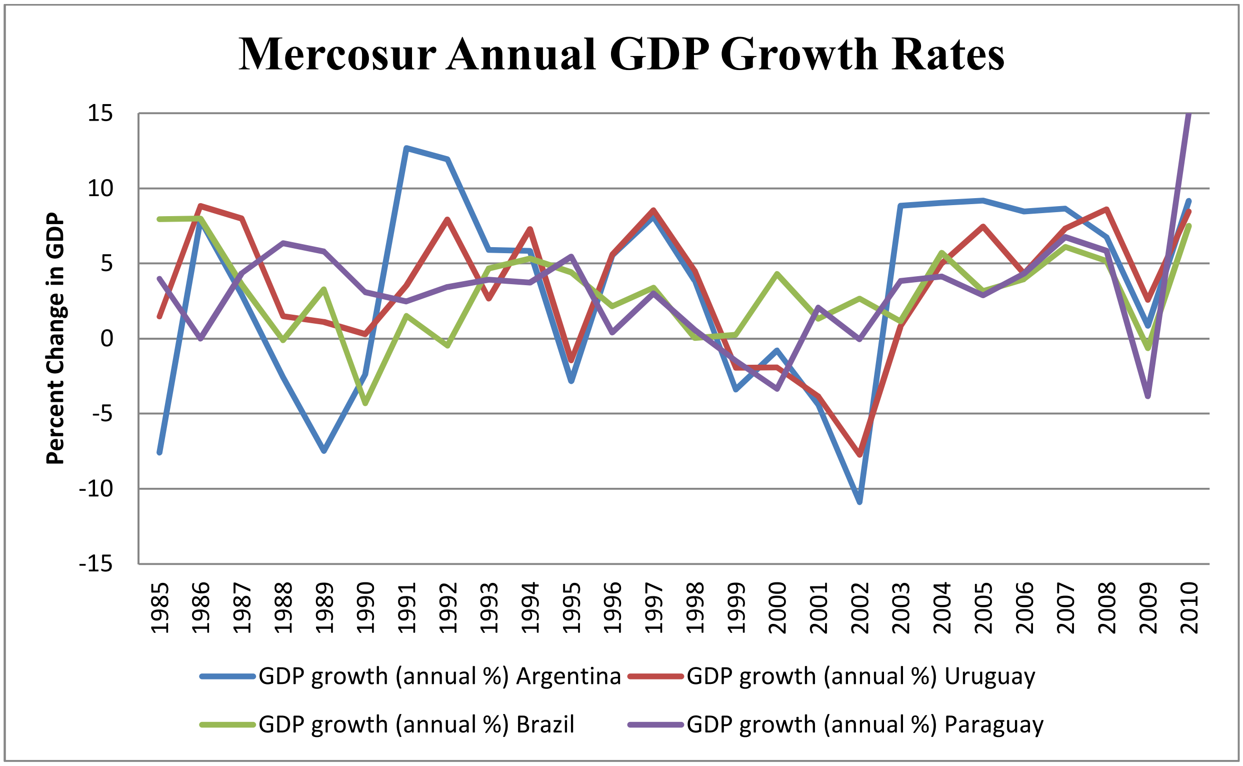


Source: UNCTAD, Comtrade, accessed in March 2012.
*AAGR – average annual growth rate

Macroeconomic Interdependence

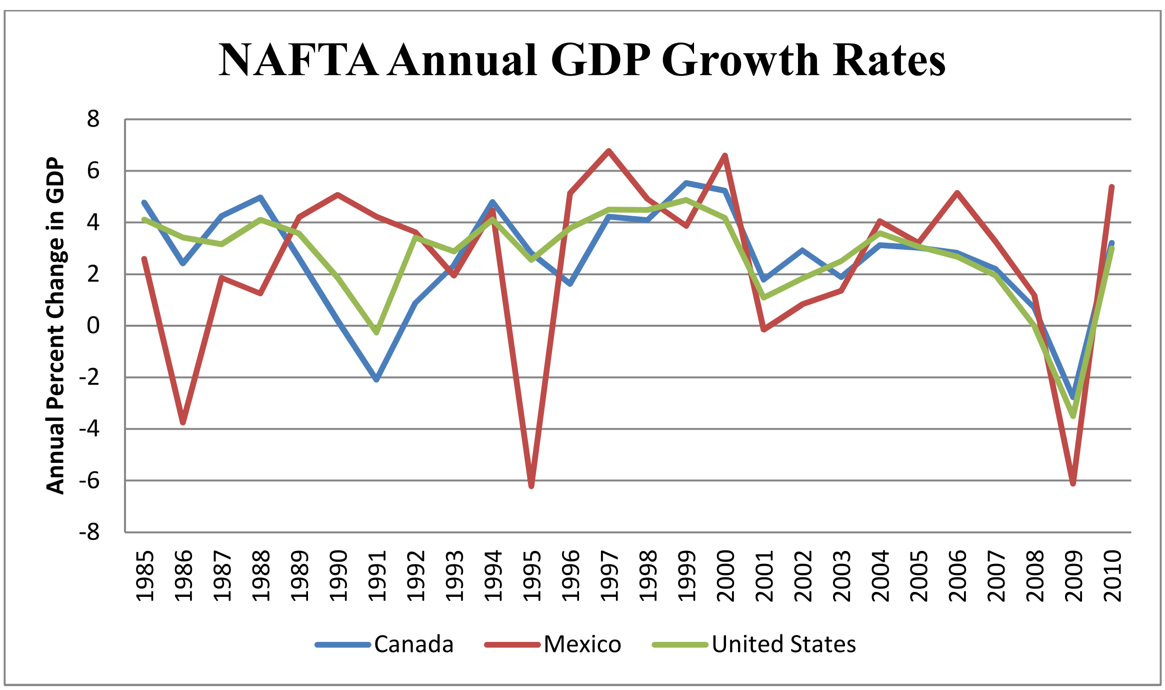
Highly integrated economies are susceptible to similar macroeconomic influences. It is well known that in tightly integrated North America, downturns in the U.S. economy have near immediate macroeconomic consequences in Canada and Mexico (see Figure 2.5). Business cycles among the three partner countries have become incredibly synchronized, moving in similar directions at the same time. Two economic indicators that measure macroeconomic fluctuations are the annual growth rates of Gross Domestic Product (GDP) and inflation rates. Figure 2.4 tracks annual growth rates of GDP in Mercosur countries for the period 1985-2010.

Figure 2.4



Source: World Bank, World Development Indicators, accessed in March 2012.

Figure 2.5

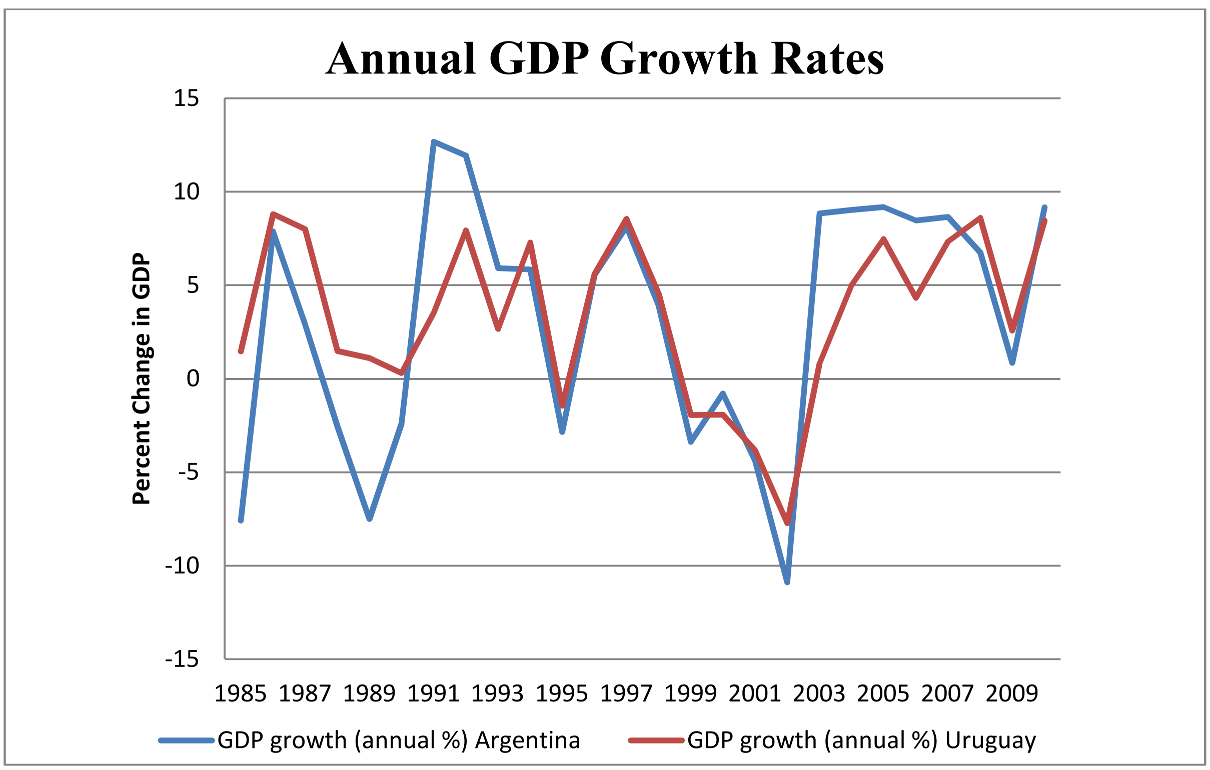


Source: World Bank, World Development Indicators, accessed in March 2012.

Prior to the formation of Mercosur and NAFTA, annual growth rates are quite erratic and do not reflect a strong sense of synchronization. Notably, however, in the mid-1990s, annual GDP growth rates increasingly start to move in tandem, and there is evidence of business cycle and growth synchronization, reflecting much greater interdependence in each region. Figure 2.4 shows a surge in growth rates for the period 1994 to 1997 for Mercosur countries followed by downward pressure on growth rates through 2001, with the exception of an upswing in the period 1999-2000. The year 2002 witnesses a strong increase in growth rates for all nations, followed by a steadying out of volatility and then the universal impact of the global financial crisis. In NAFTA, Figure 2.5 shows a highly correlated growth rate after the Mexican peso crisis of 1994-1995. Growth rates largely move together through 2010.

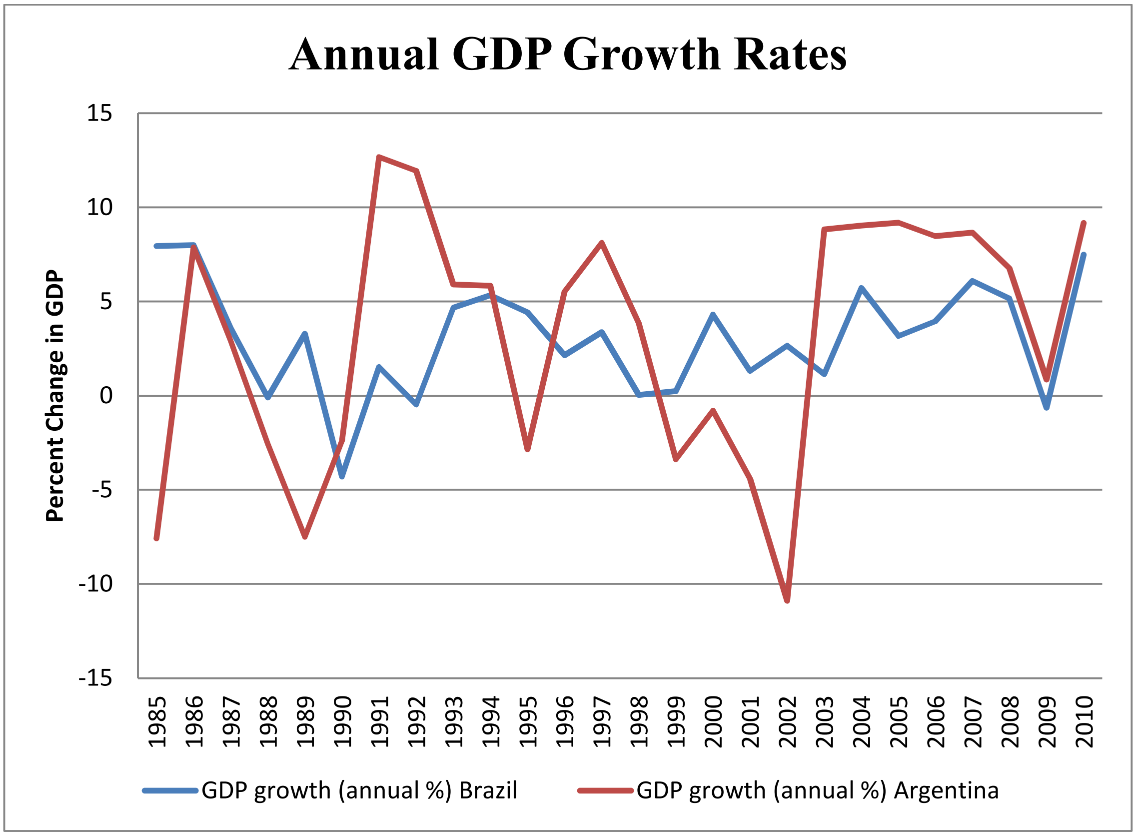
Figure 2.6 and 2.7 single out the movement of annual growth rates between Argentina and highly dependent Uruguay and Argentina and Brazil respectively. Historically, Argentina and Uruguay have had highly synchronized business cycles. The following figure shows the high volatility of the Argentine economy compared to that of Brazil. Increases and decreases in Brazilian GDP growth rates are followed by disproportionately larger effects in Argentina. The period 1996 to 2010 shows evidence of correlation in direction of growth but with Argentina's growth rate being much more volatile.

Figure 2.6



Source: World Bank, World Development Indicators, accessed in March 2012.

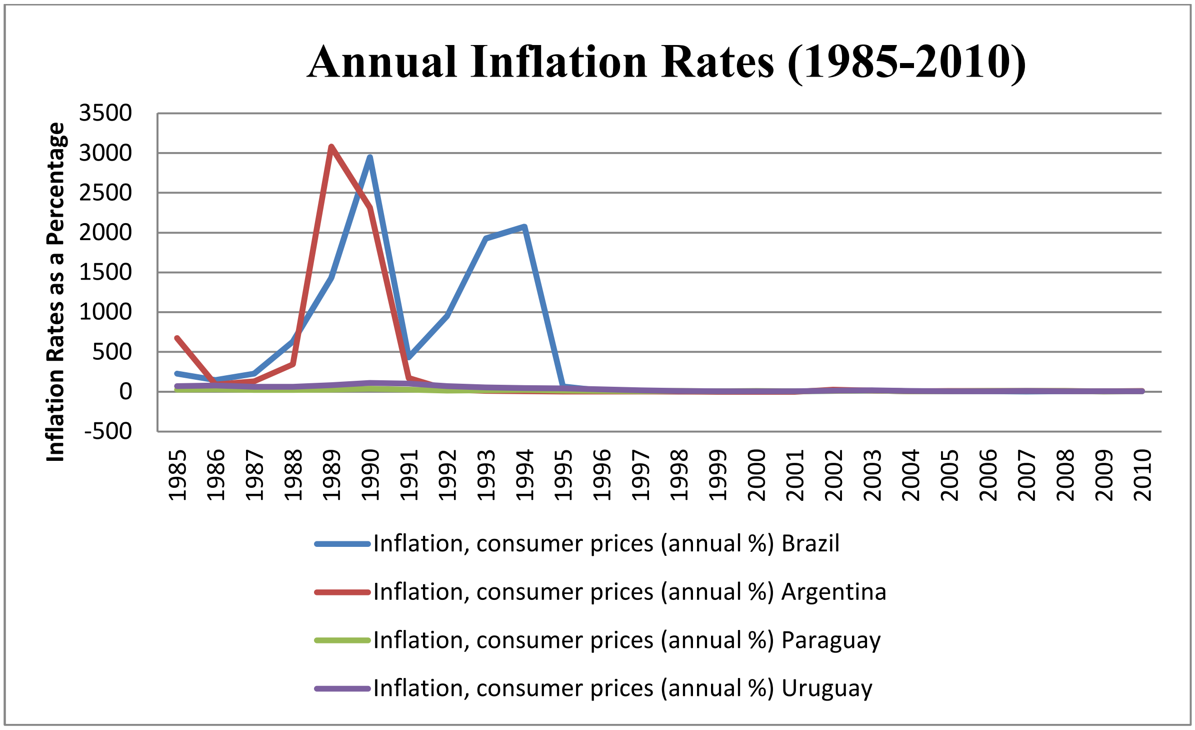
Figure 2.7



Source: World Bank, World Development Indicators, accessed in March 2012.

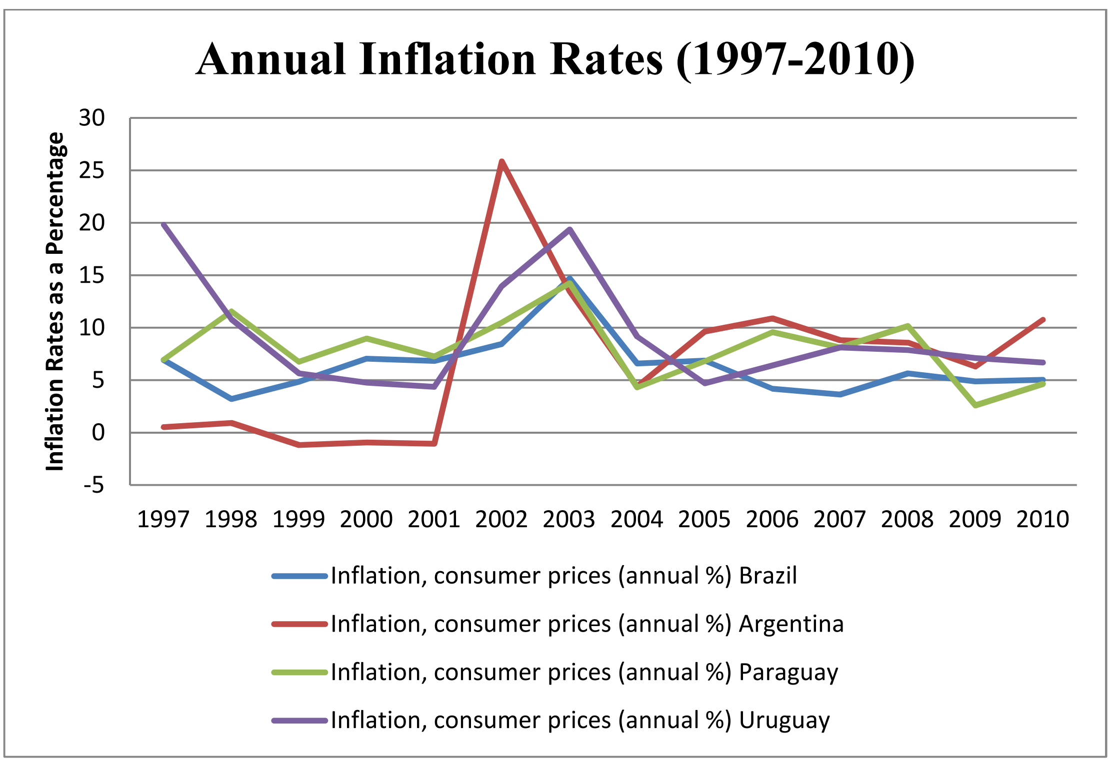
Another measure to observe macroeconomic interdependence is annual inflation rates. During the late 1980s and early 1990s, Latin America was known for unsteady inflation and bouts of hyperinflation (note the scale on Figure 2.8). Figure 2.9 shows annual inflation rates for the period after 1997, when many Latin American nations had adopted structural reforms and inflation targeting monetary policy. At the beginning of this period, Mercosur nations' inflation rates reached an all time low of single digit figures. Despite an upsurge in 2001, inflation rates have remained quite low and have moved together cyclically in the following years (Note: discussion of Argentine inflation statistics in Analysis section).

Figure 2.8



Source: World Bank, World Development Indicators, accessed in March 2012.

Figure 2.9

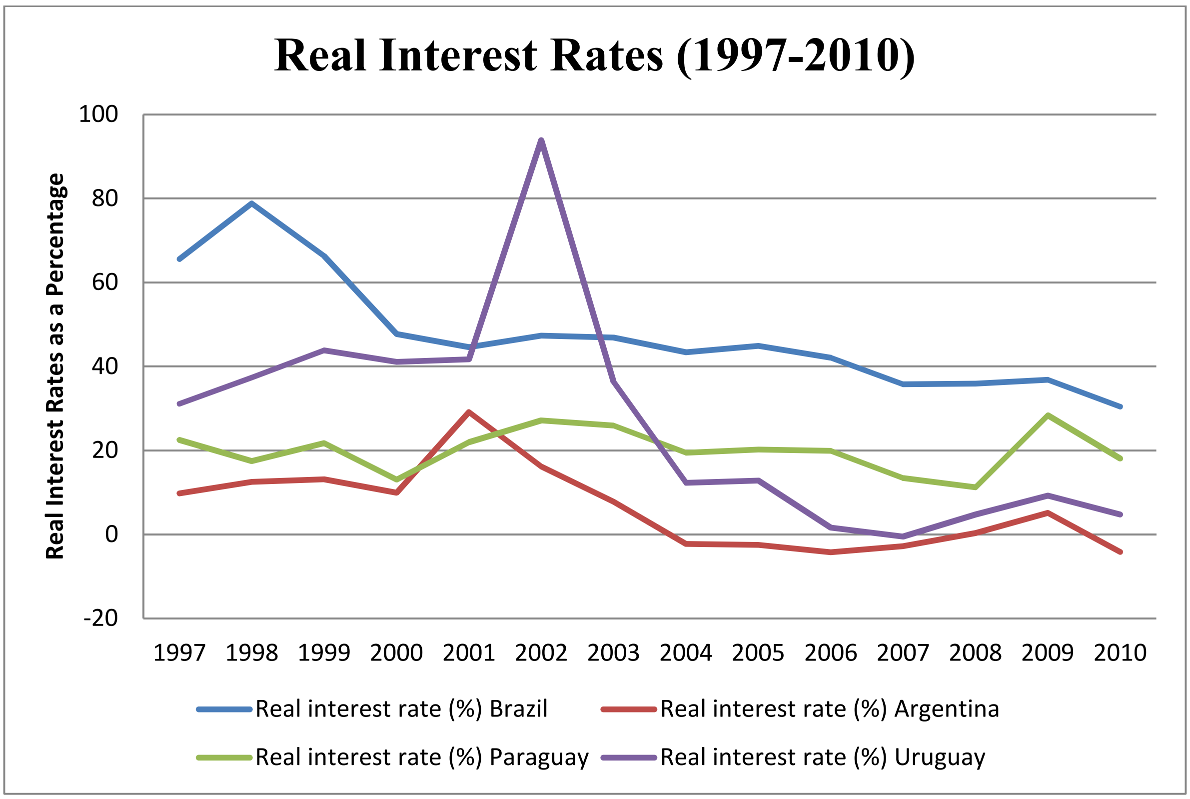


Source: World Bank, World Development Indicators, accessed in March 2012.

Macroeconomic Coordination

The Treaty of Asunción clearly establishes the intention to coordinate macroeconomic policies over time. The Preamble states the objective of the "coordination of macroeconomic and sectoral policies between the States Parties in the areas of foreign trade, agriculture, industry, fiscal and monetary matters, foreign exchange and capital, services, customs, transport and communications and any other areas that may be agreed upon, in order to ensure proper competition between the States Parties." While the scope of this list is broad, the measure most relevant to show economic integration is monetary policy coordination as expressed by the interest rate. Figure 2.10 compares the interest rate across Mercosur member countries for the period 1985- 2008.

Figure 2.10



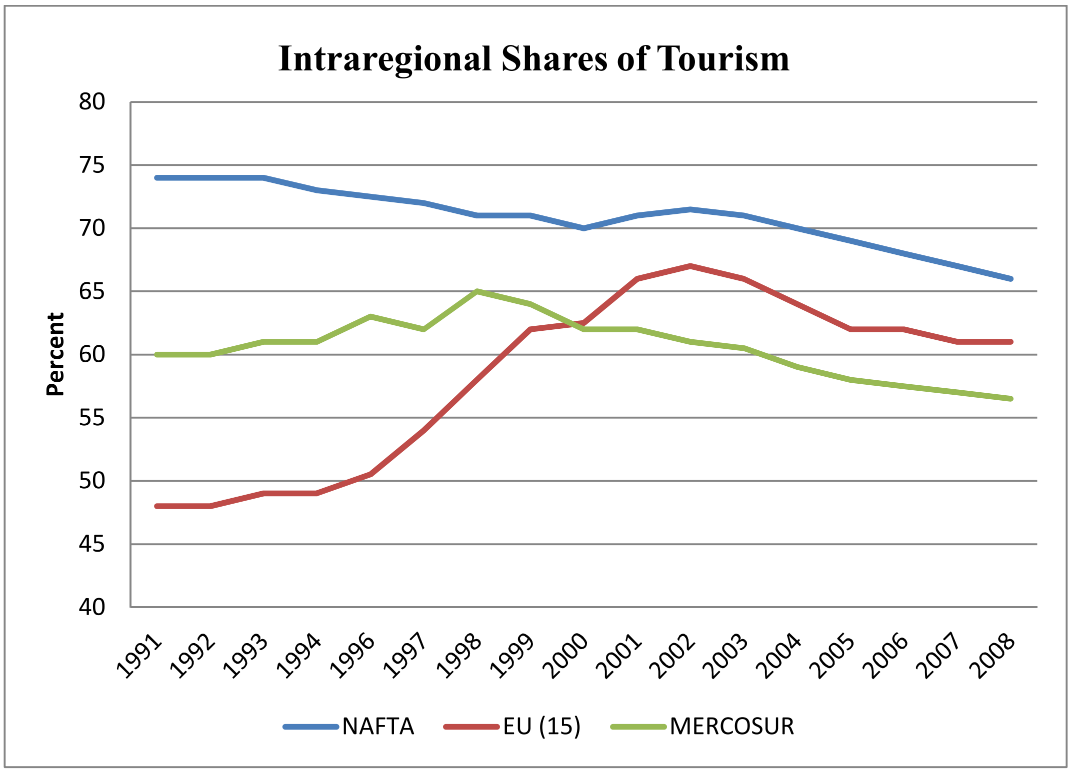
Source: World Bank, World Development Indicators, accessed in March 2012.

This figure shows real interest rates for the period that data was available for all Mercosur countries. There is evidence of macroeconomic coordination to some degree among Mercosur countries, with interest rates peaking between 2001 and 2002, followed by a steady decline until an increase during the financial crisis of 2008-2009.

People-to-People Exchange

The goal of a common market, a status which Mercosur never attained, is to allow for the free flow of factors of production, including labor. One indicator of regional integration would be this intraregional flow of labor migration, monitoring movements of workers between member nations. However, there is no well documented data set that consistently quantifies labor flows across countries. Data reflecting the intraregional flows of tourism (calculated as the share of tourists from member nations visiting other nations within the bloc as compared to total out of country travel) is used as a proxy indicator for people-to-people exchange. Figure 2.11 shows intraregional shares of tourism for selected regional groupings for the period 1991-2008.

Figure 2.11



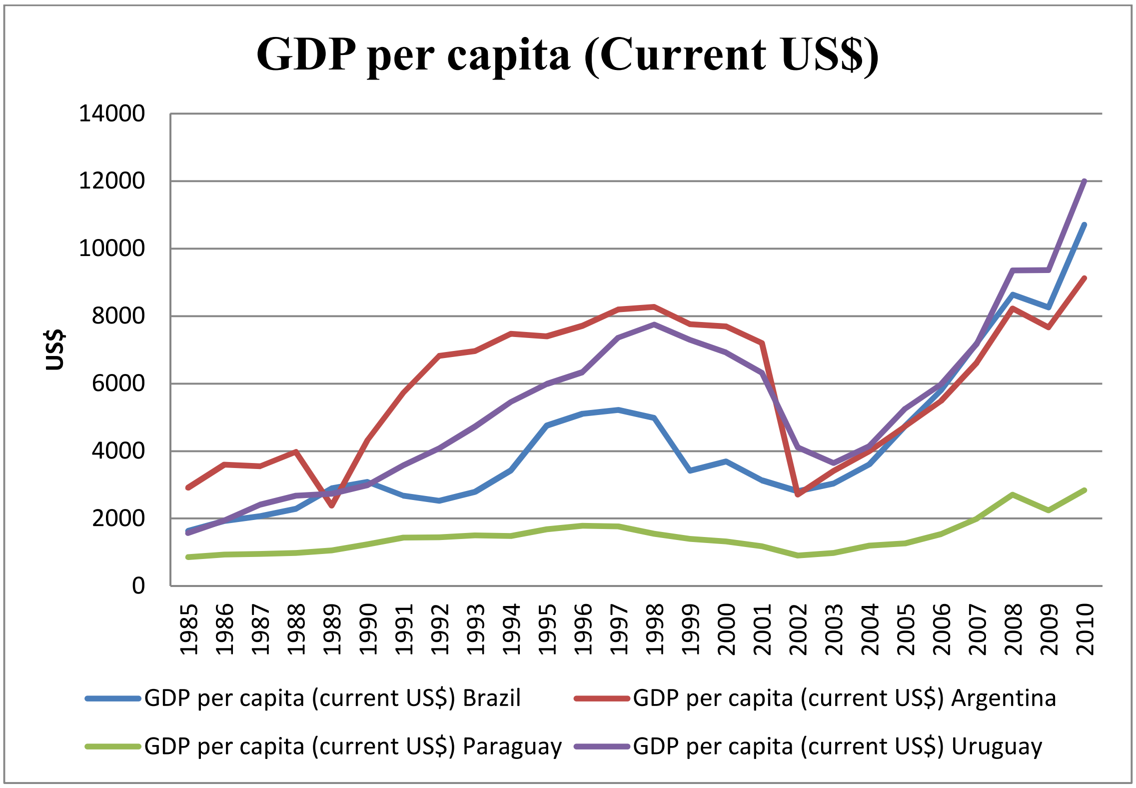
Source: United Nations World Tourism Organization, accessed in March 2012.

This figure shows high levels of intraregional tourism flows for all selected regions. Intraregional tourism has declined for all three regional groupings since 2002; however, the percentages still reflect overall high volumes of tourists traveling within their regional grouping.

Intraregional Income Gap

Finally, in addition to attracting investment and expanding markets, integration through the formation of Mercosur sought to "modernize their economies…with a view to enhancing the living conditions of their populations." The income gap between higher income and lower income countries tends to decline in a process of regional integration. To measure income convergence, Figure 2.12 shows GDP per capita for each member country for the period 1985 to 2008.

Figure 2.12



Source: World Bank, World Development Indicators, accessed in March 2012.

This figure shows large gaps in GDP per capita between member nations during the period 1990 to 2000 despite overall increases in GDP per capita during the period 1990 to 1997. The 2001 crisis in Argentina reduced the income gap however by bringing GDP per capita in the highest income countries sharply down. Since 2002, the income gap in the highest income countries (Argentina, Brazil, and Uruguay) has been low. Paraguay remains an outlier with a much lower regional GDP per capita; however, upward progress has been noted since 2002. Table 2.2 provides the GDP per capita for each member nation for the period 1985-2010.

Table 2.2

GDP Per Capita	Brazil	Argentina	Paraguay	Uruguay
1985	1636.32	2912.83	855.19	1571.70
1986	1928.36	3600.48	931.28	1940.66
1987	2074.06	3553.15	953.67	2416.40
1988	2286.96	3977.63	982.03	2677.01
1989	2893.46	2380.98	1055.55	2732.72
1990	3086.88	4330.32	1240.52	2990.82
1991	2677.27	5732.83	1435.08	3578.95
1992	2526.60	6821.09	1443.63	4083.30
1993	2791.97	6967.02	1502.65	4722.06
1994	3426.84	7479.29	1481.37	5460.22
1995	4751.07	7402.98	1682.00	5986.74
1996	5109.35	7712.44	1782.70	6340.64
1997	5220.86	8199.90	1769.24	7361.30
1998	4980.98	8273.18	1544.70	7754.32
1999	3413.26	7759.03	1393.31	7292.57
2000	3696.15	7695.59	1323.33	6914.36
2001	3129.76	7203.26	1181.86	6316.97
2002	2812.33	2709.71	906.70	4112.55
2003	3041.68	3410.34	978.13	3646.28
2004	3609.88	3993.91	1200.96	4145.20
2005	4743.26	4735.98	1267.12	5252.37
2006	5793.40	5485.52	1543.66	5974.49
2007	7197.03	6623.86	1997.35	7183.34
2008	8627.99	8225.67	2708.27	9351.05
2009	8251.06	7665.07	2245.33	9364.12
2010	10710.07	9124.34	2840.35	11995.82

Source: World Bank, World Development Indicators, 2010.

Finally, Table 2.3 shows GDP per capita in each member nation as a share of total Mercosur GDP per capita (measured by total regional GDP divided by total population).

Table 2.3

	Mercosur GDP pc	GDP per capita as % of Mercosur GDP per capita			
		Brazil	Argentina	Uruguay	Paraguay
1986	2198.7	87.70%	163.80%	71.50%	38.90%
1990	3258.0	94.70%	132.90%	91.80%	38.10%
1994	4105.5	83.50%	182.20%	133.00%	36.10%
1998	5497.2	90.60%	150.50%	141.10%	28.10%
2002	2767.3	101.60%	97.90%	148.60%	32.80%
2006	5637.0	102.80%	97.30%	106.00%	27.40%
2010	10259.1	104.40%	88.90%	116.90%	27.70%

Source: Author's calculations based on data from World Bank, World Development Indicators, accessed in 2012.

ANALYSIS

Integration in Latin America has fundamentally differed from integration projects in the industrialized world, primarily due to the inherent structural weaknesses and vulnerabilities that are characteristic of developing nations. To say that Mercosur has had no effect on its South American members nations would be a misstatement, but it would also be incorrect to say that it has fulfilled its objectives of forming a common market or even a fully-fledged customs union.

Presently, South America as a whole is largely more stable and prosperous due to economic and political reforms that have taken place over the last two decades. It can be difficult to separate the benefits that these reforms have brought to Latin America from the perceived benefits of integration. Telling the story of Mercosur requires a close look at its trajectory, its highs and lows, using the economic indicators previously discussed.

The Mercosur narrative is one of near constant external pressures and internal challenges that have worked against regional integration; however, this narrative serves as a useful lens to view these economic indicators over time. One common trend throughout Mercosur’s twenty year history is that the biggest threats to the integration process have been internal and external financial crises. These crises lead to unilateral behavior and economic nationalism as member nations seek to protect their own industries, people, and wealth and distract from a sustained, uninterrupted process of integration. Despite this uneven evolution of integration, Mercosur has brought member nations closer together but has waned since a peak in the second half of the 1990s.

The Good Years

As the background section discusses, Mercosur was largely formed by the efforts of forward-thinking presidents during a time of global political change and financial uncertainty.

Support for the integration process was consolidated during the initial years of its implementation as intraregional trade soared and foreign direct investment came to the region (see Figure 2.1 and Figure 2.2 1991-1998). For Mercosur and the region, this was a period not just of structural economic reform but also a climate free from profound international crises that could send damaging waves to the still fragile Mercosur.

The intraregional trade share increased to nearly 30 percent from a negligible five percent in the years before Mercosur's implementation. This is notably lower than NAFTA and the EU but still representative of remarkable progress for a newly formed grouping in a developing region that sought a fast track approach to integration (the European Union developed high levels of intraregional trade only after decades of integration, cooperation, and negotiation). Despite fears of capital flight after the Mexican peso crisis of 1994, foreign direct investment inflows truly began to pick up in 1995 with aggregate Mercosur inflows more than quadrupling by 1999, at an average annual growth rate of 53 percent (Figure 2.3).

The evidence of macroeconomic interdependence as measured by annual growth rates in the initial years is less clear; however, one can discern a general upward growth trend through 1994 in the first few years of Mercosur's creation and a downward trend from this point through 2001 with some variation in between. Inflation rates were highly volatile in the pre-Mercosur years, but the drastic declines from near hyperinflationary levels are largely explained by economic reforms rather than Mercosur (Argentina introduced a one-to-one dollar-peso peg in 1991 and Brazil implemented a similar measure a few years later) (see Figure 2.8).

These initial years also witnessed an increase in the intraregional tourism share as well as vast increases in GDP per capita. The intraregional tourism share expanded from 60 percent to about 65 percent, a level comparable to the level of integration in North America and the European

Union. Additionally, a notable increase in GDP per capita took place, improving quality of life and raising income for the regional bloc's citizens. Paraguay remains a bit of an outlier but upward progress was still noted. This was the high point of Mercosur, and many believed that integration was beneficial and creating many real world gains across the economic spectrum.

Crisis Strikes

Nothing, however, lasts forever. Despite weathering the Mexican peso storm, Mercosur's success proved not to be eternal. A series of crises created significant challenges for the regional integration project, the first beginning outside of the region. Financial turmoil in Asia in 1997 spread to Russia, Latin America, and the world, resulting in the eventual devaluation of the Brazilian real from its managed exchange rate regime. This devaluation led to increased protectionism and unilateralism within Mercosur as nations scrambled to defend themselves financially rather than defend the integration process. The weaknesses of the pact were revealed.

Before the regional pact could recover, the next financial catastrophe, this time internal, was developing. In 1991, Argentina had pegged the peso at a one-to-one exchange rate with the U.S. dollar, in hopes of bringing down rampant inflation. While successful in bringing down inflation, the peg was largely unsustainable as Argentina racked up exorbitant amounts of debt. In 2001, Argentina suffered the second largest sovereign debt default in history (Greece has recently stolen first place), sending over half the population below the poverty line and causing investors to flee from the region. Foreign direct investment fled from the Mercosur region, declining an average of 30 percent annually, and dropping to almost pre-Mercosur levels. The intraregional trade share fell substantially to almost as low as ten percent as all partners were impacted by Argentina's financial meltdown.

During the crisis years, annual average growth rates declined, with Argentina and highly dependent Uruguay suffering the most. Inflation spiked in 2001 (Figure 2.9) but not to a level comparable to the high inflation rates of the 1980s and early 1990s. GDP per capita levels collapsed bringing the intraregional income gap to the lowest point since Mercosur was established however through a painful downfall in income in the highest earning countries (Argentina, Uruguay, and Brazil). The magnitude of Argentina's breakdown caused financial stress in all Mercosur countries, forcing governments to act on their own and think less about regional goals and the benefits of integration. This is a significant moment in the history of Mercosur, raising concerns about overreliance on regional partners.

Recovery

After Argentina's economic collapse and the damaging effects on integration, the only way to move was up. Intraregional trade steadily recovered through the rest of the decade however only reaching about 15 percent, much lower than its 28 percent peak in 1998. Once the economic situation stabilized, investors began to return to the region however with a cautious eye on Argentina. After 2003, foreign direct investment inflows to Mercosur returned to an average annual growth rate of about 28.5 percent with much more investment going to Brazil than Argentina. Average annual growth rates of GDP saw a strong recovery to the peso crisis, and overall positive growth has been experienced leading up to the global financial crisis of 2008. Not until the recovery years does one witness clear evidence of macroeconomic synchronization, with greater correlation of growth levels across member nations. Overall inflation rates have been low and synchronized in the five to ten percent range. Inflation targeting and floating exchange rate regimes have replaced unsustainable fixed exchange rates. However, concern over

Argentina remains as the International Monetary Fund has chosen to calculate its own inflation rates for Argentina, estimated at around 25 percent, due to falsification of inflation statistics.

Evidence of strong macroeconomic policy coordination however is lacking. Communication among Finance Ministers and Central Bank Presidents is minimal, and wholehearted efforts to make coordinated policy decisions do not occur. While interest rate percentages have not been coordinated in terms of percentages, similar trends across Mercosur can be observed: a downward trend since their peak after the Argentine financial crisis and a slight increase in recent years. Since 2000, the intraregional share of tourism has steadily declined and has fallen below that of other regional groupings; however, there is a notable downward trend for all regional integration areas. Most impressively, GDP per capita has recovered rapidly, with significant increases occurring at highly synchronized rates among the three leading economies.

An Uncertain Future

Recent years have witnessed a return to financial crisis but one that was global in scale and which no region was able to wholly escape. South America endured the crisis relatively well and was able to recover quickly through high commodity prices. Across the board, the annual average growth rate, GDP per capita, and foreign direct investment declined in 2009 but the downfall was short-lived and most member nations had recovered by 2010.

The Mercosur narrative shows that the regional integration project has experienced periods of highs and lows but has ultimately survived. The effects of integration have been disparate, and one cannot argue that Mercosur has been either fruitless or a resounding success. What is important is that it has achieved some of the objectives it set out to accomplish despite failures in other areas. It has not become the common market that was laid out in its foundational treaty (and still acknowledged in its formal name), so what has it accomplished relative to the selected economic indicators?

- **Trade Integration:** Mercosur has expanded markets for exports and promoted a larger intraregional trade share. The intraregional export share may have declined since 1998 due to the crises discussed, but in the aggregate (comparing pre- and post-Mercosur levels), trade integration has expanded.
- **Foreign Direct Investment:** Mercosur unequivocally received greater foreign direct investment inflows following the formation of the regional bloc. However, following the Argentine collapse of 2001, FDI inflows in the region seem to be better explained by Brazil's sound economic policy decision-making and impressive growth rather than solely the result of Mercosur.
- **Macroeconomic Interdependence:** Much like in NAFTA, Mercosur appears to have led to a higher level of macroeconomic interdependence and business cycle synchronization. Chaotic growth rates have tended to converge over time, showing more tightly linked and integrated economies.
- **Macroeconomic Coordination:** Evidence of macroeconomic coordination remains weak, and in terms of its goals laid out in the Treaty of Asunción, Mercosur has been least successful in this area of policy coordination. This is largely the product of continued tendencies toward economic nationalism and unwillingness to cede sovereignty to a regional supranational entity.
- **People-to-People Exchange:** The intraregional tourism share increased in the initial years of Mercosur, attaining levels comparable to other regional integration areas. It has declined since, but there is a similar trend in NAFTA and the EU.
- **Intraregional Income Gap:** The impressive income convergence that has taken place in the region (with the exception of Paraguay despite rising income overall) and the rising standard of living is likely the product of several factors working in tandem of which Mercosur certainly plays a role. Despite varying levels of economic reform and responsible political leadership, Mercosur countries have made a strong synchronized recovery from the 2001 crisis.

Future Prospects

Completely unraveling the thread of integration in Mercosur is unlikely. The case of Greece and the Euro crisis show that undoing integration is difficult (since the expectation of constant forward progress does not lead to the creation of a viable exit mechanism or strategy to leave a regional integration pact). Obviously, it would be simpler to leave Mercosur, which does not have a common currency, but no member nation is actively seeking to opt out.

However, challenges, some which have already been mentioned, certainly remain. In Argentina, irresponsible economic policies, the rise of populist politics, and government interference with inflation statistics reduce investor confidence in the economy. Furthermore, integration within Mercosur is weakened by the lack of efforts to create strong supranational institutions that can move the process forward. Deference to intergovernmental negotiation and institutions, such as the Common Market Group and Common Market Council, increase the likelihood of economic nationalism. Finally, some progress has been made on stronger arbitration procedures, with the Protocol of Olivos coming into force in 2004. However, it is only open to state actors, excluding the possibility for individuals or companies to make their cases before a tribunal, and is still not fully trusted by member states.

On the other hand, Latin America and particularly South America is living through a period of strong growth and political and economic stability unlike previous decades. Brazil attracts vast amounts of foreign direct investment and has recently replaced the United Kingdom as the world’s sixth largest economy. Regional prosperity reinforces stability that can allow regional integration to flourish, unmarred by periods of financial crisis. Emerging as a wealthier and more resilient region, several possible paths forward for Mercosur are likely:

- **Stagnation.** The importance and relevance of the regional grouping erodes further without dissolving entirely. Governments no longer place integration as a priority, and Mercosur remains a regionalist group rather than integration project.
- **Deepening.** In a climate of greater financial stability, governments recommit to regional integration, aware of the benefits and gains from closer ties. Leaders seek ways to increase the depth of integration through the creation of a supranational body that has more power above just the intergovernmental level. However, a renewed commitment to the establishment of a fully-fledged common market is unlikely.
- **Expansion.** Unwilling to lose sovereignty, member nations allow for the expansion of the regional grouping to include more regional partners, potentially including the currently pending admission status of Venezuela. Expansion is seen as an alternative to making greater commitments in terms of depth of integration.

Predicting the future is near impossible, but it seems unlikely that Mercosur will disappear. Unlike other regional groupings in Latin America, Mercosur has not vanished. Given the asymmetrical relationship of Brazil and its influence within Mercosur, the creation of an influential supranational body will largely be the decision of Brazil's leaders (which seek to have a leadership role regionally). The inclusion of Venezuela is uncertain due to requirements that all member nations be democratic and concerns over Hugo Chavez's rule. Greater regional cooperation and partnership are most likely; however, renewed efforts towards integration are possible but would again require strong leadership that makes integration a priority much like when Mercosur was originally formed.

RECOMMENDATIONS

While Mercosur has not faded from relevance, it seems to have diminished in recent years as a priority on the regional leadership's agenda. This is primarily because Mercosur is currently stuck: entrenched in uncertainty of its future, suffering an identity crisis over its purpose and battered by financial crises. What is the best way forward: broadening, deepening, forming and joining other regional forums? The crux of the matter that must be resolved before progress towards integration can be reinitiated is the divide in economic policy decision-making in Mercosur's two largest members: Brazil and Argentina. Since the crisis of 2001 and the election of the Kirchners, Argentina has been unwilling to participate fairly and openly in the international financial system. Despite high rates of economic growth in recent years and soaring government revenues, Argentina has proven unwilling to finish paying its debt obligations from its massive sovereign default. Since the election of Cristina Fernandez de Kirchner to a second term, Argentina has acted as a regional bully over the Falkland Islands, falsified inflation statistics, and, at the time of this writing, scared investors by pursuing the nationalization of the oil company Yacimientos Petroliferos Fiscales (YPF), one of the largest nationalizations in modern history and breaking a number of international standards and regulations.

On the other hand, Brazil is struggling with rapid currency appreciation due to the vast amount of capital and foreign direct investment it has attracted through a transparent and pragmatic economic policy. It seeks to be respected internationally as a great power, desires a permanent seat in the United Nations Security Council, and has recently surpassed the United Kingdom to become the world's sixth largest economy. This divide between responsible and nationalistic economic policy making will strain the relationship between Mercosur's most important members. As long as Argentina continues to scare investors and self-inflict economic damage in terms of fewer foreign direct investment inflows, economic sanctions from Spain and perhaps the European Union, and in other ways yet to be seen, integration efforts will suffer.

When Argentina's politicians return to play by the rules and become responsible actors in the international system, there is a path forward for reviving Mercosur and integration efforts. Mercosur must first become a priority on the agenda of political leaders. Historically, Mercosur was brought about by intergovernmental negotiation, and this will again be necessary to move forward with the integration process. Furthermore, deepening and consolidation of the trade bloc to ensure its continuation should be pursued before it broadens. The designation of a clear purpose and goal for the bloc—should it consolidate its status as a customs union or pursue the objective of a common market?—will then serve as a credible model and incentive for other nations to join.

In the short term, leaders of member states should focus on strengthening ties and continue rule building. A more definitive agenda and focus will prove Mercosur's efficacy and value. Deepening ties within the bloc will be the best way for Brazil to gain a regional leadership role and prevent perception as a regional hegemon by encouraging economic growth in neighboring economies concurrently with Brazil's economic growth. In contrast, broadening the regional bloc should be postponed at a time when Venezuela is on the verge of joining. Venezuela has become increasingly isolated regionally in recent years, and its admission would call into question Mercosur's commitment to a grouping of democratic members that promotes democracy and political stability. Closer ties and more frequent communication among leaders promote good relations and minimize potential conflicts. Mercosur has served as a forum to expand the regional agenda beyond economic coordination to include promotion of human rights, energy policy, and environmental issues. Mercosur can be a path towards prosperity and peace but only if it receives the attention it deserves to build upon its successes, expand its mandate, and deepen its ties.

CONCLUDING REMARKS

Latin American experiments in integration and Mercosur particularly have had a turbulent history. Born in an era of global political and economic change, Mercosur initially thrived in an environment free from international crises. The political leaders who were instrumental in negotiating the regional grouping were soon able to easily convince the business sector and others of the benefits of integration. A series of financial crises put pressure on the fragile trade bloc comprised of developing countries, already far more susceptible to fluctuations in the international economy. External and internal pressures led to economic nationalism, protectionism, and a short memory in terms of the gains from linking economies more closely together. Throughout all this, Mercosur has remained intact and has attained notable successes even if it has declined from its peak at the end of the twentieth century. Mercosur has withstood its greatest challenge thus far: survival in a volatile world. Its future, however, is uncertain and dependent on the efforts of regional political leaders to come together and make integration a priority again. Only time will tell if Mercosur can again make great strides toward regional integration or if it will be overshadowed by UNASUR and other emerging regional cooperative agreements.

Bibliography

Abínzano, Roberto. *Mercosur: Un Modelo de Integración*. Posadas: Universidad Nacional de Misiones, 2000.

Angeles-Castro, Gerardo, et. al. *Market Liberalism, Growth, and Economic Development in Latin America*. New York: Routledge, 2011.

Capannelli, Giovanni, Jong-Wha Lee, and Peter Petri. *Developing Indicators for Regional Economic Integration and Cooperation*. Asian Development Bank Working Paper Series on Regional Economic Integration, No. 33 (Sep. 2009), pp. 1-41.

Carranza, Mario. *Clinging Together: Mercosur's Ambitious External Agenda, Its Internal Crisis, and the Future of Regional Economic Integration in South America*. *Review of International Political Economy*, Vol. 13, No. 5 (Dec., 2006), pp. 802-829.

Carranza, Mario. *Can Mercosur Survive? Domestic and International Constraints on Mercosur*. *Latin American Politics and Society*, Vol. 45, No. 2 (Summer, 2003), pp. 67-103.

Cason, Jeffrey. *The Political Economy of Integration: The Experience of Mercosur.* New York: Routledge, 2011.

De Lombaerde, Philippe, and Luk Van Langenhove. *Indicators of Regional Integration: Conceptual and Methodological Issues.* Institute for International Integration Studies Discussion Paper No. 64 (March 2005), pp. 1-28.

Gardini, Gian Luca. *The Origins of Mercosur: Democracy and Regionalization in South America.* New York: Palgrave, 2010.

Kaltenthaler, Karl, and Frank O. Mora. *Explaining Latin American Economic Integration: The Case of Mercosur. Review of International Political Economy*, Vol. 9, No. 1 (Mar., 2002), pp. 72-97.

Mace, Gordon, et. al. *Inter-American Cooperation at a Crossroads*. New York: Palgrave Macmillan, 2011.

Maira, Luis, et. al. *La Integración en América Latina: Situación y Perspectivas.* Asunción: Facultad Latinoamericana de Ciencias Sociales, 2007.

Mecham, Michael. *Mercosur: A Failing Development Project?*. *International Affairs (Royal Institute of International Affairs)*, Vol. 79, No. 2 (Mar., 2003), pp. 369-387.

Nye, Joseph. *Comparative Regional Integration: Concept and Measurement*, *International Organization*, Vol. 22, No. 4 (Sep., 1968), pp. 855-880.

Pastor, Robert. *The North American Idea.* New York: Oxford University Press, 2011.

Sampson, Gary, and Stephen Woolcock. *Regionalism, multilateralism, and economic integration: The recent experience.* New York: United Nations University Press, 2003.

Shifter, Michael. *The Shifting Landscape of Latin American Regionalism, Current History,* http://www.thedialogue.org/PublicationFiles/Shifter-CurrentHistory.pdf.

Treaty of Asunción, Full Text, http://idatd.eclac.cl/controversias/Normativas/MERCOSUR/Ingles/Treaty_of_Asuncion.pdf.

World Trade Organization. *The WTO and Preferential Trade Agreements: From Co-Existence to Coherence.* World Trade Report 2011.