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Jaissy A. Lorenzo
Pace University

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Obstacles to Total Economic Integration in Regional Trade Blocs: The Case of Mercosur

By: Jaissy Lorenzo

1. Introduction

After several failed attempts of regional and economic integration among Latin American nations—exemplified by ineffective measures such as the Latin American Free Trade Association (1960), the Latin American Common Market (1965) and the current Latin American Integration Association (1979)—Mercosur was established as Latin America's Southern Cone Common Market by the Asuncion Treaty of 1991. As a subregional common market, Mercosur sought to not merely reduce tariffs but also promote free trade and movement of capital and resources among its constituents: Brazil, Argentina, Uruguay and Paraguay, with Chile and Bolivia as associate members. However, as the European Union has so notably demonstrated, the long road leading to economic integration is filled with complexities and obstacles. In fact monetary unification among EU members has taken more than 25 years (Dorruci, Firpo, Fratzscher and Mongelli, 2002). Yet although Mercosur should have expected challenges and growing pains similar to the EU, the lack of institutional and macroeconomic coordination among its members has hindered its primary goal to advance economic and monetary integration in the region, and therefore Mercosur's over-arching success.

This paper aims to explore the lack of institutional and macroeconomic coordination among Mercosur's members and its effects on Mercosur's primary goal to successfully achieve economic integration in the region. Using the framework presented by Dorruci, Firpo, Fratzscher and Mongelli (2002), who argue that this lack of coordination has been Mercosur's most detrimental downfall, I will show how this lack

of institutional integration among Mercosur nations has inhibited further economic integration in this sector of Latin America. Dorruci, Firpo, Fratzscher and Mongelli (2002) sustain that in order for a regional trade bloc to achieve full economic integration it must first achieve institutional integration; that is, in order for a sustainable common market to be successfully implemented on an economic basis, there must be a set of joint policies that outline, support and enforce the economic objectives of the countries in question. Accordingly, institutional integration is defined "as the outcome of joint policy decisions designed to affect the depth and breadth of regional integration over time" (Dorruci, Firpo, Fratzscher and Mongelli, 2002) and exemplified through the five stages of regional integration among regional trade blocs developed by Balassa (1961): Free Trade Area (FTA), Customs Union (CU), Common Market (CM), Economic Union (EUN) and Total Economic Integration (TEI). Mercosur is currently classified as an imperfect customs union or an FTA setting up common tariffs and quotas (if any) for trade with non-members (Balassa, 1961).

Furthermore, Dorruci, Firpo, Fratzscher and Mongelli (2002) measure the depth of economic integration in a regional trade bloc, based on the Optimal Currency Area Theory, according to the synchronization of the business cycle, convergence of inflation rates, exchange rate variability, trade openness and integration, convergence of interest rates, and income convergence between members of a regional trade bloc. We must address two significant caveats relative to these measures of economic integration. First, it should be discussed that "the integration process of real variables (business cycle, trade and income) is generally much slower than the integration process of nominal variables (exchange rates, inflation, interest rates, and financial markets)" (Dorruci, Firpo,

Fratzscher and Mongelli, 2002). That is, these variables must be analyzed with the knowledge that usually the nominal measures of economic integration will be stronger than the real variables according to the specific time period analyzed. Thus, the degree of economic integration in regional trade blocs is relatively quickly evident in nominal variables when compared to real variables. However, with respect to Mercosur, while the convergence of nominal variables since 1991 show significant increases in economic integration in the region, there is nevertheless much to be desired in regards to exchange rate, inflation and interest rate convergence, which will be actively discussed throughout the paper. Indeed the "correlation of nominal interest rates has been around 60% within the euro area during the pre-EMU period [when the EU was an imperfect customs union similar to Mercosur currently], but only around 30% for the Latin American countries" (Dorruci, Firpo, Fratzscher and Mongelli, 2002).

Secondly, there are various authors such as Busse, Hefeker and Koopman (2004), Larrain and Tavares (2003), and Belke and Gros (2002) who argue that the countries of Mercosur do not constitute an optimum currency area—thereby questioning the validity of applying the measures of economic integration to Mercosur—because "trade interdependence and intra-regional financial and labor market integration are low," (Busse, Hefeker and Koopman, 2004) and member nations exhibit a high degree of both asymmetric shocks and exchange rate variability. However, Dorruci, Firpo, Fratzscher and Mongelli (2002) explain that the endogeneity hypothesis—which states that monetary integration reduces trading costs much beyond the elimination of the costs arising from exchange rate variability— implies "that a group of countries adopting a single currency might develop into an OCA ex-post even if this group does not constitute

an OCA ex-ante". In other words, although Mercosur as an imperfect customs union is not in a stage where it can successfully adopt a single currency for member nations and be deemed an OCA, because an OCA can develop after the implementation and coordination of macroeconomic policies, we can apply the concepts and ideals behind the OCA theory in our analysis of Mercosur. In essence, while Mercosur does not currently consistently exhibit the characteristics of an OCA, it can develop these characteristics over time through the enactment of the proper institutional and monetary policies.

Hence, with these definitions of both institutional and economic integration in mind, Dorruci, Firpo, Fratzscher and Mongelli's (2002) main argument can be summarized as follows: institutional integration leads to deeper economic integration and economic integration further reinforces institutional integration in a circular fashion. Using the European Union as their comparative standard they propose:

> [t]he more institutional integration [goes] beyond the creation of a customs union and move[s] towards a common market and an economic and monetary union, the deeper economic integration turn[s] out. Increasing economic integration, in turn, corroborate[s] and sustain[s] the process of institutional integration (Dorruci, Firpo, Fratzscher and Mongelli, 2002).

While scholars such as Barry Eichengreen (2004) claim that the Mercosur and EU comparison is not viable due to the unique political, historical and economic circumstances behind the development of both regional blocs, because the EU is the most successful common market which Mercosur implicitly seeks to emulate—Mercosur seeks to become a common market in Latin America similar to the EU—for the development of this paper the comparison is valid and concrete. Thus, in order for Mercosur to succeed in economically integrating this subregional common market, like the EU, it must seek to

achieve institutional integration through the coordination of macroeconomic policies among its members (i.e. coordinating monetary and exchange rate policies), and strong political commitments to the goals in question from the nations involved (i.e. creating laws and independent supranational governing institutions to enforce Mercosur objectives).

Accordingly, this paper will explore the specific obstacles that hinder Mercosur's institutional and economic integration such as the differences in trade, exchange rate, price and inflationary policies, and the remaining tariffs and protectionist measures among member nations as result of lobbying interest groups (Baer, Cavalcanti and Silva, 2001). These differences are detrimental to Mercosur's success since Baer, Cavalcanti and Silva (2001) find these specific policies affect international trade and the allocation of investments among members of a trade area bloc. Furthermore, this paper will also discuss Mercosur's lack of authority—since the Mercosur Treaty does not preside over national governments being intergovernmental and not supranational in nature—and its critical effects on the institutional and economic integration between Mercosur member nations. Therefore, this paper will analyze the reasons behind the lack of institutional and economic integration in Mercosur, along with the unique economies and characteristics of Brazil, Argentina, Uruguay and Paraguay and the formation of Mercosur.

2. Mercosur Explained: A Brief Overview

The international environment, specifically the combination of a series of forces including the computer revolution, advanced manufacturing technologies, and genetic engineering, paved the way for regional integration plans for Latin American countries that sought to achieve a "meaningful role in the international economic system" (Zerio,

1992). Indeed Mercosur was based on the notion of "open regionalism" and neoliberal economic reform, which were designed not to only facilitate trade but also to "enhance the potential for countries to attract foreign direct investment (FDI), as a result of the lure of larger markets to Multinational corporations (MNCs) eager to take advantage of economies of scale" (Phillips, 2003). However, Mercosur was not solely created as a strategic response to the globalization processes imminent in the international environment, but also to promote the national capitalist project in the domestic political economy of member nations; it involved "the relocation of decision-making authority and a consequent contraction in space for discretionary government policy" (Phillips, 2003). More specifically, in a hemispheric environment controlled by the United States, the Mercosur alliance was a response against the U.S. hegemony in the Western Hemisphere; Mercosur was also formed to resist and offset U.S. dominance (Phillips, 2003). In general, "regional integration was sought as a political tool to consolidate broader goals aimed at reversing the dark ages of authoritarianism, intraregional antagonism, economic crisis, and international marginalization" (Hirst, 1999).

However, many of these simplistic neoliberal assumptions concerning globalization and the formation of Mercosur are intricately complicated by the reasons behind each individual nation's entrance into the Treaty of Asuncion. Kaltenthaler and Mora (2002) discuss how the primary motivation for regional integration in South America was Argentina and Brazil's desire to end their century long trade and military rivalry and conflict, thereby dissolving the security dilemma and threat each nation presumed in one another. Indeed once an agreement was reached between the two nations—fostering a positive and non-threatening relationship—both nations, and the

regional bloc in general, aspired to strengthen democracy, democratic rule and the domestic economies of the region (Kaltenthaler and Mora, 2002). As a matter of fact, "Mercosur, like the European Community itself placed consolidating democracy and preserving peace in the Southern Cone among its paramount objectives" (Smith, 1993).

Besides promoting democracy, as the years progressed, for Argentina, Uruguay and Paraguay the motivation behind joining Mercosur and ensuring its success became economic gain—evident in Argentina's desire to widen and expand Mercosur. On the other hand, Brazil consistently emphasized political interests and the need to strengthen civilian democratic interests over economic gain (Kaltenthaler and Mora, 2002). Furthermore, while the economic motive was prevalent in Argentina, Uruguay and Paraguay, there were still important dissimilarities in the reasons why each of these members sought to create a regional trade bloc and common market. On the one hand, while Argentina actively pursued its economic interests through Mercosur after the Brazilian conflict was resolved, for Paraguay in particular the democratic imperative reigned supreme. Paraguay's primary and consistent motivation was the institutionalization of democracy; it sought "external support against persistent anti-democratic forces threatening the fragile regime" (Kaltenthaler and Mora, 2002) after more than three decades of General Alfredo Stroessner's authoritarian regime (1954-89).

Both Paraguay and Uruguay also pose a special case for analysis since as the smaller Mercosur partners, they "did not join the integration process until after Argentina and Brazil agreed in July 1990 (Buenos Aires Act) to establish a common market by the end of 1994" (Kaltenthaler and Mora, 2002). Uruguay in particular was not interested in regional integration efforts with Brazil and Argentina because it feared being "absorbed

economically by the two subregional giants" (Bizzozero and Lujan, 1992). In consequence, the impetus behind Uruguay's decision to join Mercosur was political in nature: President Luis Alberto Lacalle desired to "strengthen and enhance the power of the leadership on issues related to economic policy and integration" (Kaltenthaler and Mora, 2002). President Luis Alberto Lacalle and former Uruguayan foreign minister, Hector Gros Espiell, wanted to avoid the potential economic costs associated with Uruguay's lack of involvement in the Argentine-Brazilian integration (Kaltenthaler and Mora, 2002), especially since Argentina and Brazil were and remain Uruguay's largest trade partners. Basically, Uruguay's motivations "were largely of a domestic political and economic nature, initiated by political elites determined to achieve integration as a means of consolidating popular support for economic reform and democracy" (Kaltenthaler and Mora, 2002).

While Brazil, Argentina and Uruguay played an active role in the integration process, Paraguay was more of a passive observer in the establishment of Mercosur. Precisely because it was a weak and newly established democracy itself, it lacked the power and ability to become an active participant in the integration process (Kaltenthaler and Mora, 2002). Thus, "the improvisation and immobilism of Paraguay's foreign ministry and relative weakness and disorientation of political elites and societal groups (legacy of authoritarianism) contributed to Paraguay being 'dragged' by its neighbors (principally Uruguay) into the regional economic system" (Kaltenthaler and Mora, 2002). Accordingly, Paraguay had a minimal role, if any, in the long road leading to the Treaty of Asuncion. Consequently, due to the lack of knowledgeable experts on economic integration and negotiation in Paraguay's foreign ministry, Uruguay defined and outlined

Paraguay's interests in the process, although their interests and objectives did not always match (Simon, 1995; Mora, 2001). Conclusively, Paraguay's primary reason for attaining membership in Mercosur was to advance democracy in its domestic politics. Paraguay's President Andres Rodriguez's main foreign policy objective was to "re-insert Paraguay into the community of democratic nations" (Kaltenthaler and Mora, 2002). In essence, Mercosur offered Paraguay the opportunity to:

> (1) end Paraguay's international isolation from which it suffered during the latter years of the Stroessner regime (2) reactivate a ravaged economy by joining regional economic integration systems and attracting foreign investments; and (3) perhaps the most important objective, seek international support for his government (Kaltenthaler and Mora, 2002).

Mercosur provided an open door for the Paraguayan government to both legitimize its regime and re-introduce Paraguay into the democratic Latin American community for its advancement, growth and recovery from the Stroessner dictatorship. As these diverse motivations behind Mercosur's creation illustrate, Mercosur itself did not originate from economic or business sectors but from the governments or state elites who had their specific agendas and political inducements to create and join Mercosur (Kaltenthaler and Mora, 2002).

2.1 Mercosur's Main Provisions and Subsequent Successes and Failures

With the process of integration beginning as early as 1985-1986 through the advent of the Program for Integration and Economic Cooperation (PICE) between Brazil and Argentina, Mercosur was created through the Treaty of Asuncion in1991— when Uruguay and Paraguay joined the agreement. Mercosur seeks to create a common market with a common industrial policy, thereby coordinating the economic policies of member

nations while simultaneously harmonizing competition policy, national investment regimes, and achieving a set of coordinated social policies dealing with security, drugs, the environment and democracy for example (Phillips, 2003). Thus, the Treaty, based upon concepts of deregulation and integration efforts, hopes to achieve "the free circulation of goods, services, and production factors, reinforced by the attainment of a uniform external tariff (Arrighi, 1992). From its inception, with a population of over 220 million and a GDP in excess of USD 900 billion (Dorruci, Firpo, Fratzscher and Mongelli, 2002), Mercosur became the third largest trading bloc in the world after the European Union and the North American Free Trade Agreement, NAFTA (Carranza, 2003). In fact, Mercosur became second to the European Union in terms of the depth of the integration process (Kaltenthaler and Mora, 2002).

Successfully completing its transition phase from 1991-1994—wherein import tariffs between member nations were gradually eliminated—it was decided in the Buenos Aires presidential summit of 1994 that Mercosur would become an imperfect customs union, diverting the bloc from its over-arching goal of creating a common market according to Carranza (2003). However, it is significant to understand that this was actually a step toward its final objective as indicated by the five stages of regional integration discussed in Section 1. Indeed, signifying advancement and growth, the Mercosur Trade Commission was established by the Protocol of Ouro Preto of December 1994, thereby creating an institution which administers trade relations between the members and serves as a forum of first instance for the settlement of trade disputes. Thus, the 1991 Free Trade Agreement—that entailed semi-annual, progressive, linear and automatic tariff reductions, lists of products temporarily excluded from such reductions,

to be reduced by the end of each of year, and the progressive elimination of non-tariff restrictions or equivalent measures (Dorruci, Firpo, Fratzscher and Mongelli, 2002)—became an imperfect customs union through the implementation of a Common External Tariff on imports from third countries ranging from 0 to 20% in January 1995. However, there were a great number of exception lists in this CET for Mercosur members, which explains why Mercosur is deemed an imperfect customs union. These exceptions include up to 300 tariff items for Argentina, Brazil and Uruguay until 2001 and 399 items for Paraguay until 2006, reflecting that a convergence process is needed for the CET (Dorruci, Firpo, Fratzscher and Mongelli, 2002)—as of now, the time periods have been extended. As a sign of success however, intra-regional trade in aggregate Mercosur exports rose throughout the decade from 9% in 1990 to 25% in 1998 (Dorruci, Firpo, Fratzscher and Mongelli, 2002). Demonstrating the magnitude of this increase, Brazil accounted for one third of Argentina's exports by the end of the 1990s, 40% of Paraguay's exports and 35 % of Uruguay's exports (Inter-American Development Bank, 2000). It is also imperative to note that in 1996 Chile and Bolivia became associate members of Mercosur, which was an "important step in expanding Mercosur markets while moving in the direction of broadening regional integration" (Kaltenthaler and Mora, 2002).

However, despite this success, due to the differing economic structures and political profiles of Mercosur members— the more industrial and diversified economic profile of Brazil (which also has a higher index of extra regional trade relative to the other Mercosur members) coexists with the agricultural specializations of Argentina, Paraguay and Uruguay (Phillips, 2003)—Mercosur has faced various challenges and

trade crises that have undermined its efforts in deepening both institutional and economic integration in the region. In fact, Mercosur's largest economies, Brazil and Argentina, have differing and to a large extent conflicting political goals: Brazil favors the idea of 'deepening' Mercosur while Argentina favors the "extension of the Mercosur and the construction of wider regionalist arrangements, reflecting its much greater relative dependence on regional markets" (Phillips, 2003). In essence, while Brazil desires to deepen the regional integration among Mercosur members, Argentina seeks to widen and increase Mercosur's membership because it depends more heavily on trade in the South American region than Brazil. Due to the differing economic profiles and political goals for Mercosur among its constituents—evident also in the diverse motivations behind each nation's entrance into the Mercosur Treaty discussed in Section 2—political tensions and fragility, exacerbated by the lack of supranational institutions in Mercosur, jeopardize its goal to harmonize economic policies and achieve a common market in the region. Basically, each member is pursuing the domestic and political agenda that is optimal for its domestic goals, while disregarding the effects these agendas inflict on Mercosur as a whole. This tendency to place the national goals and sovereignty over Mercosur objectives is explicitly exemplified in one of Mercosur's major underlying problems: its lack of macroeconomic and exchange rate policy coordination (institutional integration), which is also directly measured through the exchange rate variability in the region—one of the nominal variables representing the depth of economic integration between members of a regional bloc.

3. Macroeconomic and Exchange Rate Policy Coordination in Mercosur

In order for Mercosur to be successful as both a regional trade bloc and potential common market, it must synchronize the macroeconomic policies of member nations, particularly those of Brazil and Argentina. As the largest and most powerful Mercosur economies, macroeconomic coordination between Brazil and Argentina is essential for Mercosur's success as Latin America's southern cone market. This is especially significant since Uruguay and Paraguay will implement monetary policies in line with these subregional giants to sustain positive trade relations with both nations and advance economic integration in the region—also evident in both Uruguay's and Paraguay's reasons for joining Mercosur mentioned in Section 2.

Indeed coordinating macroeconomic policies is a prerequisite to sustain the "unhindered operation of market forces" (Zerio, 1992) in Mercosur. In fact,

> regional trade arrangements cannot flourish in the face of high levels of exchange rate and financial volatility. Sharp misalignments leading to import surges and distress for concentrated interests can provoke sharp reactions against liberalization, encouraging protectionist interventions that stymie regional integration (Eichengreen, 2004).

The effects of these misalignments in macroeconomic and exchange rate policies on both trade relations and economic integration in Mercosur, are highly evident in two important crises: Brazil's currency devaluation in 1999 and Argentina's subsequent recession and devaluation in 2001-2002. These events (which will be discussed in the following section) have significantly hampered both institutional and economic integration in the region—thereby threatening Mercosur's viability and existence—and exemplify the importance of synchronizing exchange rate policies between members of a regional trade bloc. Indeed, in comparison to the EU-6—which is the stage wherein the EU most resembled Mercosur's current status and progress—real exchange rate variability in

Mercosur was almost 7 times higher, while nominal exchange rate variability was nearly 10 times higher (Dorruci, Firpo, Fratzscher and Mongelli, 2002).

However, before we can accurately analyze and understand the workings and effects of the afore mentioned crises, we must further explore the nature of the divergent monetary policies pursued by Argentina and Brazil. Specifically, throughout Mercosur's progression both countries have operated under divergent exchange rate regimes and macroeconomic policies; Brazil has pursued a free-floating exchange rate regime while Argentina has followed a fixed exchange rate regime, pegging its peso to the U.S. dollar. Argentina's exchange rate regime in the 1990s was sustained and implemented by the Convertibility Law and Plan of 1991, which explicitly pegged the peso one-to-one to the U.S. dollar—the Argentinean central bank could only issue new currency if backed by U.S. dollars (Carranza, 2003). Simultaneously, Argentina also implemented 'far-reaching' economic goals in accordance to the Washington Consensus. The Washington Consensus is a very important agreement to understand since it also influenced Brazil's macroeconomic policy, which simultaneously adhered to and challenged the main provisions of the Washington Consensus. Specifically:

> [t]he Washington Consensus favors full reliance on market forces to allocate resources. It features three main areas of economic policymaking: macroeconomic stability ("fiscal discipline"), a reduced government role in the economy (deregulation and privatization of state enterprises), and greater openness to the outside: elimination of barriers to trade while attracting foreign direct investment (Williamson, 1990).

Thus, Brazil's decision to adopt a floating exchange rate "while maintaining state support for domestic industry and a long-term industrial policy" (Carranza, 2003) both supports and undermines the Washington Consensus. It is no wonder that the striking differences

between Brazil's free floating exchange rate regime and Argentina's fixed exchange rate regime would hinder Mercosur's goals of institutional and economic integration as a common market. Accordingly, Carranza (2003) explains:

> [i]ndividually, Brazil upheld an active industrial policy; but Argentina abandoned all state- sponsored industrial initiatives, partly for ideological reasons and for the fiscal restraints inherent in maintaining a fixed exchange rate. The simultaneous implementation of trade liberalization and opening of domestic financial markets made the four member states vulnerable to external crises, such as the Mexican "tequila" effect in 1995, without pursuing the minimum of "developmental protectionism" that would have allowed them to overcome technological obsolescence and become competitive in world markets. As Mercosur's exchange rate problem became increasingly unmanageable, what emerged as Mercosur's 'common industrial policy' was a set of ad hoc initiatives aimed at smoothing out the very erratic swings in the current account balance between Argentina and Brazil, especially given the two countries' lack of progress in achieving macroeconomic coordination.

Therefore, it is evident that the divergence between Argentina and Brazil's macroeconomic policies has been detrimental to Mercosur, making the regional trade bloc vulnerable to external crises due to its lack of solid and sustainable common policies and unified objectives—which prevent Mercosur from institutionally advancing from an imperfect customs union to a common market. Indeed if Mercosur is practically struggling to survive under the pressures and crises created due to the conflicting policies of Argentina and Brazil, it cannot actively advance neither institutional nor economic integration in the region. Here, we can see the circular relationship between institutional and economic integration once more: because there is a high variability in exchange rates (lack of economic integration) between Mercosur's two most powerful economies, the

regional trade bloc is unable to further integrate institutionally—and implement joint and harmonized fiscal and supra-governmental policies—into a common market.

Similarly, Baer, Cavalcanti and Silva (2002) discuss how uncoordinated macroeconomic policies lead to excessive price and exchange rate fluctuations that affect international trade and the allocation of investments among members of a regional trade bloc. They specifically classify two main channels through which international trade is affected:

> [f]irst, there is an increased level of risk in international transactions (risk channel), which induce producers to refrain from exporting or importing and, therefore, causing an allocation of resources different than what would be suggested from comparative advantage. [Second] it also stimulates lobbying for protection from imports when there exists a substantial increase in the import penetration ratio (lobbying channel) (Baer, Cavalcanti and Silva, 2002).

Thus, not only does the lack of macroeconomic coordination hinder institutional integration, but it also further inhibits economic integration as well, precisely because it distorts trade relations among Mercosur members by producing a framework that violates the theory of comparative advantage. Furthermore, these fluctuations in the real exchange rate "may increase or decrease the returns on investments and thus induce shifts in the location of new production plants and the reallocation of existing ones" (Baer, Cavalcanti and Silva, 2002). This is particularly important for Mercosur nations since this reallocation of investments may cause strains between Brazil, Argentina, Uruguay and Paraguay—because they heavily rely on foreign direct investment (FDI). Moreover, Argentina and Brazil's divergent exchange rate policies have hampered commercial integration, which results in and reinforces "the formation of lobby groups demanding the introduction of trade barriers (when the level of import penetration increases) to protect

domestic industry from external competition" (Baer, Cavalcanti and Silva, 2002). Indeed the effects of lobbying further shift trade volumes as changes in import penetration ratios "increase the demand for protectionist measures in order to decrease the adjustment costs of the loss of competitiveness" (Baer, Cavalcanti and Silva, 2002).

In essence, the uncoordinated macroeconomic policies between Mercosur's Argentina and Brazil serve as obstacles to institutional and economic integration by hindering trade relationships (causing trade imbalances), increasing the prevalence and uprising of lobbying interest groups and protectionist measures in member nations, affecting the flows of FDI to member nations thereby increasing strains among them, intensifying the effects of external and internal currency crises, and hindering the pursuit of unified goals, objectives and policies that promote and advance Mercosur's over-arching goal to become Latin America's southern cone common market. Here it is interesting to contrast that usually

> regional integration, in general, reduces the impact of exchange rate volatility on trade (Bevilaqua, 1997) by implementing policies to promote macro coordination. One of the stated purposes of the EU, for instance, was to reduce exchange rate uncertainty and to avoid exchange rate misalignment among European countries to promote intra-trade and investments (Baer, Cavalcanti and Silva, 2002).

Thus, simply the mere fact that Argentina and Brazil have pursued such divergent exchange rate policies illustrates the persistent lack of institutional and economic integration in Mercosur, and the long and difficult road Mercosur countries must travel in order to successfully become a common market.

4. Brazil's Real Devaluation and the Argentinean Crisis Explained

As previously mentioned the detrimental effects of the uncoordinated macroeconomic policies of Argentina and Brazil on Mercosur are particularly exemplified through the effects of both the 1999 devaluation of the Real and the subsequent Argentinean crisis in the early 2000s. Beginning with the Brazilian devaluation, in 1999 Brazil was considered the latest victim of the global financial crisis that had broken out in Southeast Asia in July 1997 and had spread to Russia in the summer of 1998 (Carranza, 2003). As a matter of fact, the crisis occurred in spite of a 41.5 billion economic support package announced by the International Monetary Fund (IMF) and the Clinton administration in November 1998 to prevent the 'Asian flu' from spreading to Latin America (Carranza, 2003). As Baer, Cavalcanti and Silva (2002) explain:

> [i]n January 1999 the Brazilian government had to terminate its policy of periodic small devaluations of the Real vis-à-vis the U.S. Dollar due to the accelerated loss of foreign reserves, resulting from a combination of capital outflows and trade deficits (Inter-American Development Bank, 2000). As result the Real was allowed to undergo a drastic devaluation of 40% vis-à-vis the U.S. Dollar, and hence the Argentinean Peso.

This devaluation had several important effects on Brazil, Argentina and Mercosur. Firstly, it spurred an economic recession in both Brazil and Argentina, which reduced the amount of trade between both countries thereby jeopardizing economic integration in the region (Carranza, 2003)—in the first eight months of 1999, Argentine exports to Brazil were down 28.4 % from the comparable period in 1998; Brazilian exports to Argentina were down 26.9% (LAWR 1999c). Thus, the devaluation devastated the Argentinean economy as Argentinean exports (particularly automobiles, steel, rice, and fruit) became less competitive on the Brazilian market—for example by August 1999, the giant auto plants in Argentina (such as Fiat) were operating at less than a quarter of their capacity

(Carranza, 2003). The devaluation "produced a much-feared 'flood' of cheap Brazilian imports to Argentina, from chickens to footwear" (Carranza, 2003). This led to implementation of protectionist measures from the Menem administration, which imposed a variety of restrictions on trade with Brazil such as a surcharge of US$410 per ton on imports of Brazilian iron, quotas for imports of five categories of Brazilian textile products, and prior licensing for imports of paper (LAWR 1999b).

The Brazilian government in turn responded with similar countermeasures, such as a requirement of prior licenses for foodstuffs, boarder sanitary controls of Argentine products, and an import licensing system for industrial imports, which greatly hurt Argentina since 50% of Argentine exports to Brazil are manufactured goods (Carranza, 2003). Therefore, while Brazil threatened to go to arbitration over Argentina's 23% tariff on sugar and antidumping actions against Brazilian steel, Argentina, Uruguay and Paraguay were complaining over the newly implemented trade restrictions. This was especially serious because Argentina sells 30% of all of its exports to Brazil and 35% and over 40% of Uruguayan and Paraguayan exports, respectively, go to Brazil (Carranza, 2003). The crisis escalated to such a degree that Brazil threatened to dissolve Mercosur unless Argentina removed some of its tariffs. Fortunately, however, both countries were able to solve the disputes through the help of the industrial associations of both countries who set limits on mutually protectionist measures (Carranza, 2003).

However, while these issues were temporarily resolved, due to Argentina's fixed exchange rate regime and its lack of an independent monetary policy, it continued to suffer as a result of its overvalued peso. As Carranza (2003) describes, Argentina's fixed exchange rate regime "was a big obstacle to achieving macroeconomic harmonization in

Mercosur". In fact, the overvaluation of Argentina's real exchange rate and the devaluation of the Real in 1999, negatively impacted Argentina's automotive sector as they "caused both a switch in components purchases to Brazil and also a migration of FDI to the latter due to lower costs of production" (Baer, Cavalcanti and Silva, 2001)—thereby increasing tensions between the two countries. Specifically, as a result of the Brazilian devaluation and Argentina's over valued peso, Chrysler closed its plant in Cordoba and GM closed one of its Argentinean plants thereby concentrating its remaining production in Rosario (another Argentinean city) (Baer, Cavalcanti and Silva, 2001). Thus, Argentinean executives feared that the parent offices of multinationals would continue to transfer operations to Brazil, where production costs were 25 to 30% lower than in Argentina—especially since no new investment plans were made in the Argentinean automotive sector in the subsequent years following the Real's 1999 devaluation (Baer, Cavalcanti and Silva, 2001).

In general, by March 2001, Argentina's economy was on the verge of collapse, while the Brazilian economy entered its own recession. Furthermore, with the scarce ability to meet its debt payments, the Argentinean recession grew worse when Brazil once again devalued its currency by 32% in the first quarter of 2001. This economic crisis motivated another set of trade disputes as Argentina raised a tariff of 35% on imports of consumer goods from outside Mercosur, and eliminated tariffs on imports of capital goods from outside the bloc to encourage domestic investment (Carranza, 2003). These measures—supported by Mercosur's Common Market Council through December 31, 2002—clearly violated Mercosur's common external tariff, causing a temporary suspension of the customs union, once again threatening Mercosur's existence.

Consequently, a reduction in bilateral trade between both nations followed once more as a result of these protectionist measures —Argentinean exports to Brazil in September 2001 fell 26.7% ($447 million) from September 2000, while imports of Brazilian products fell 39.2% ($330 million) in the same period (Business and Information Community 2001). Further complicating the tensions between Argentina and Brazil, Domingo Cavallo—author of the Convertibility Plan, came to power on March 20, 2001, appointed by President De La Rua, as Argentina's economy minter. Cavallo undeniably preferred a trade agreement with the U.S. instead of completing the customs union precisely because Brazil did not want to dollarize its currency.

Therefore, due to Brazil's periodic devaluations and the negative impact on the Argentinean economy, political and economic tensions were high between Mercosur's most powerful economies. Yet after a meeting of the Common Market Council on October 8, 2001—following an informal Cardoso-de la Rua (the presidents of Brazil and Argentina during that period) summit—the disputes were resolved. Argentina and Brazil agreed to "create a 'temporary bilateral mechanism of safeguards inspired by the rules of the World Trade Organization' allowing Argentina to compensate Argentine industries by imposing temporary tariffs on any products that it could show to have been affected by a surge in imports caused by the Brazilian currency's fall" (Carranza, 2003). Though this served as a temporary solution to the trade disputes, the economic pressures of the overvalued peso were so high that in December 2001 Argentina's currency board collapsed and the peso was devalued in January 2002. As Eichengreen (2004) points out:

> [i]n Argentina, convertibility was regarded as a sacred contract between the government and the public and the linchpin of national economic policy, but when it came to be seen as incompatible with the pursuit of full

> employment and growth, it lost public support and then investor confidence.

Indeed, the Argentinean devaluation shows the difficulty in defending exchange rate bands or pegs in the face of highly liquid international financial markets (Eichengreen, 2004).

As these crises illustrate, it was precisely the lack of macroeconomic policy coordination that led to the profound conflicts among all four Mercosur nations and threatened Mercosur's existence. Exhibiting the detailed characteristics and effects of uncoordinated macroeconomic policies detailed in Section 3, we can clearly observe how these crises exacerbated and emphasized the lack of both institutional and economic integration in the region. By constantly questioning and making exceptions to the customs union, the regional bloc's institutional integration was persistently undermined along with its economic integration, as illustrated by the reduction in bilateral trade between Argentina and Brazil during these crises. As Carranza (2003) concludes:

> Argentina and Brazil have managed to iron out their trade disputes while upholding Mercosur as a 'strategic project'. Yet what is left of a customs union when member states can establish so many temporary exceptions to the common external tariff?

Furthermore, as Carranza (2003) explicitly discusses, these temporary resolutions were—as is customary for Mercosur—accomplished through presidential diplomacy. The presidential summits paved the way for reconciliation between the foreign and finance ministers of Brazil and Argentina, thereby ensuring Mercosur's survival. The following section will briefly discuss the power of presidential diplomacy in Mercosur's creation and survival.

5. Presidential Diplomacy in Mercosur

Presidential power and diplomacy have played a significant role in Mercosur's creation and survival in the face of various threatening critical crises exemplified in Section 4. Simultaneously hindering and promoting Mercosur's progress to become a common market, presidential diplomacy and involvement are consistently highlighted throughout Mercosur's most historically detrimental and significant moments. Specifically, through Malamud's (2005) detailed discussion of how the meetings between Argentinean and Brazilian presidents Menem and Cardoso respectively, were the impetus behind the temporary resolution adopted between Brazil and Argentina—after the Brazilian devaluation in 1999 threatened Mercosur's existence—we can see the important role presidents serve in Mercosur. In this respect, presidents employ the tasks that usually correspond to foreign ministers, chief executives, and supranational institutions—if they existed in the regional trade bloc. In fact, Malamud (2005) explicitly discusses how the final-dispute-settlement mechanism in Mercosur conflicts is inter-presidential bargaining.

However, Malamud (2005) also consistently emphasizes that "presidential interventions were successful because they were backed by institutional capabilities such as veto and decree powers and because the presidents were not accountable to the legislative branch". In other words, because the presidents of Brazil, Argentinean, Uruguay and Paraguay were capable of exercising their political will and power freely—for the benefit of Mercosur—due to the institutions in their national governments, Mercosur survived and surpassed its most detrimental moments. Indeed in order to solve the Argentinean-Brazilian crisis after the devaluation of the Real:

> Menem affirmed his supremacy vis-à-vis the cabinet and the diplomatic corps. Under his personal supervision, his

> right-hand man had gone above the heads of politicians and bureaucrats to arrange a meeting with the Brazilian president, one that incidentally also contravened the public position of the Brazilian foreign minister. Thereafter, the presidents settled the dispute alone (Malamud, 2005).

Furthermore, as explored in Section 2, it was the presidents of Brazil, Argentina, Uruguay and Paraguay that spurred the creation of Mercosur and their respective nations' involvement in the regional trade bloc and the Treaty of Asuncion. As Malamud (2005) describes, "Mercosur arose from the political will of national governments, and only thereafter generated public demand for further integration." As a result, Mercosur presidents have acquired the popular legitimacy and determination to intervene in Mercosur issues in order to promote regional integration in the southern cone. Specifically:

> [w]hile increasing interdependence has created the need to manage a growing number of crises and coordination problems in Mercosur, transactors seem to demand particular decisions rather than general rules. For such a task, by and large, national presidents have been perceived as more able—more accessible, more responsive, more effective, faster—than any other actors to reach decisions (Malamud, 2005).

By delegating such power and influence on Mercosur to the national presidents, it is obvious that Mercosur presidents are sovereign as policy-crafters and decision-makers—presiding over both Mercosur as an institution itself and any other regional institutions that might be created to support Mercosur and further integration in the region. According to Malamud (2005) Mercosur presidents have been successful as chief executives and decision makers of the bloc because:

> the constitutional capabilities of the presidents vis-à-vis other actors have made it credible that their polices would not be blocked, [and secondly] the preeminence of the

> presidents has provided social actors with a single, non-bureaucratic target through which to channel their interests, allowing for a faster decision-making process.

Consequently, presidential intervention in Mercosur conflicts and activities "has become a structural element of the integration process" (Malamud, 2005). Indeed as critical actors in the integration process, oftentimes presidents were even able to compromise national sovereignty without facing serious vetoes from other relevant actors for two reasons. Firstly, "a high degree of concentration of power in the hands of the chief executives enabled them to overcome or circumvent potential veto players" (Cheibub and Limongi 2002; Figueiredo and Limongi 2000; Malamud 2001). Secondly, "foreign policy typically offers chief executives more room to maneuver than domestic politics do (Rogowski 1999; Schlesinger 1974, Silva, 1989).

Precisely because presidents have played such a crucial role in Mercosur negotiations from its inception, it is no wonder that they are "also reluctant to build up regional institutions or to relinquish their competencies to the regional institutions that do exist" (Malamud, 2005). This unwillingness to create regional institutions for Mercosur further illustrates and explains not only the lack of macroeconomic and fiscal policy coordination in the region, but also the lack of supranational governing institutions that would help advance economic and institutional integration. Certainly, while presidents have advanced integration in Mercosur by refusing to give up their sovereignty, they have also hindered the process—exemplified in the lack of effective supranational institutions in Mercosur and the lack of appeals to the institutions, such as the Protocol of Brasilia, already in place (Malamud, 2005). Indeed as Kaltenthaler and Mora (2002) proclaim:

> [r]ather, loose regulations and shallow institutionalism have been maintained at a relatively low political cost. The

> trepidation of political elites is due to their unwillingness to cede any domestic policy autonomy that a harmonization of macroeconomic policy and supranational institutions would produce.

In this case, we see the real objective political elites and national presidents sought through regional integration; they sought to "strengthen the power and authority of elites and their fragile states that faced significant domestic political and economic challenges" (Kaltenthaler and Mora, 2002). Thus, societal and state elites will continue to hamper the integration process—by impeding the coordination of macro and fiscal policies and obstructing the creation of supranational institutions—for fear of losing their autonomy and power to Mercosur.

Basically, Mercosur nations and presidents seek to obtain the benefits of both worlds: "the member states of Mercosur want the maximum economic and political benefits from integration while foregoing as little sovereignty as possible" (Kaltenthaler and Mora, 2002). Conclusively, Mercosur's strong reliance and dependence on presidential diplomacy as a final dispute settlement mechanism reflects the fear member nations experience from the possibility of losing national autonomy and sovereignty to Mercosur. However, this fear inhibits the integration process among Mercosur's members as Zerio (1992) accurately portrays:

> The stark reality is that as long as the integration effort rests solely on the initiative of presidents and a few ministries, Mercosur's success will be linked too directly to the fortunes and misfortunes of the individual administration that is attempting to implement the process.

This further explains why over a decade later, Mercosur has yet to achieve total economic and institutional integration among its constituents. As previously mentioned, this precise desire to have the best of both worlds is a primary reason why Mercosur lacks

supranational institutions that would further advance both institutional and economic integration in the region, which will be explored in greater depth in the following section.

6. Mercosur's Deficiency: The Lack of Supranational Institutions

Mercosur's lack of supranational institutions is another one of the main reasons—besides the lack of synchronized macroeconomic and fiscal policies among member nations—that Mercosur has failed to fully achieve its common market status. Historically, whereas the Europeans created supranational institutions to avoid the threat of declaring war against one another, Mercosur nations, specifically Brazil and Argentina, overcame their security dilemma—discussed in Section 2—without the need nor desire to surrender their sovereignty to supranational institutions (Kaltenthaler and Mora, 2002). Accordingly, as detailed in Section 5, Mercosur has relied on presidential diplomacy to stay afloat during its most difficult times instead of relying on supranational institutions to effectively solve disputes between member nations and advance regional integration. Part of the reasons for this phenomenon, also discussed in Section 5, is the desire of political and states elites to retain and consolidate their autonomy and power. These conflicting interests—Mercosur members seek to advance institutional and economic integration while retaining individual power—serve as significant obstacles to the creation of a 'mini-Maastricht', in European terms, and supranational institutions.

However, these supranational institutions are necessary to advance both economic and institutional integration in the region. Indeed the differences between member nations and their divergent and uncoordinated macroeconomic policies are exacerbated by the lack of supranational decision-making authority, "which necessitates the transfer of

legislation entirely to the national level" (Phillips, 2003). As Mercosur lacks these institutions to enforce a code of set standards and regulations to further integration between Mercosur members, it is no wonder that laws pertaining to Mercosur must be enforced and created at the individual national levels. Undoubtingly, this inspires conflicting and divergent perspectives, laws, and polices between member nations that lack the capability to coordinate and enforce their laws without supranational institutions. Precisely because the Treaty of Asuncion is intergovernmental in nature, not supranational, "Mercosur's decisions have no force as such and need to be implemented by corresponding national measures, with no obligation for member states to comply with common market rules" (Dorruci, Firpo, Fratzscher and Mongelli, 2002). There is indeed no supranational court through which "either a member country or the Mercosur Secretariat can enforce treaty provisions on another member or a private party" (Dorruci, Firpo, Fratzscher and Mongelli, 2002). The lack of an institution, similar to the European Commission, that would serve to hold Mercosur members accountable to Mercosur laws and policies prevents the convergence of interests, fiscal and economic policies between Brazil, Argentina, Uruguay and Paraguay (Arrighi, 1992; Eichengreen, 2004). Thus, any possible solutions to the uncoordinated macroeconomic polices of Mercosur nations will be greatly undermined due to the lack of a supranational body to preside over Mercosur.

Furthermore, the actual institutions created by the Treaty of Asuncion are also "intergovernmental organs where decisions are made by consensus" (Kaltenthaler and Mora, 2002). Specifically:

> [t]he Common Market Council (CMC) is composed of ministers of foreign affairs and economy; it is the highest-ranking body, responsible for political direction. [Furthermore] in December 1994, the Joint Parliamentary

> Commission made up of legislators from the member countries and the Advisory Forum on Economic and Social Matters were created. Neither body has the power or capacity to make decisions; they only have responsibility for monitoring and making recommendations (Kaltenthaler and Mora, 2002).

Evidently, these institutions themselves lack decision-making and coordinating power thereby sustaining the decision-making powers of the presidents and foreign economic ministers in Mercosur. Indeed the lack of supranational institutions exacerbates Mercosur's complicated arbitration process—implemented when the Common Market Group cannot solve the dispute in question. In fact, since private companies cannot get involved in Mercosur trade disputes, when they have a complaint against a member state,

> they can only resort to the national agency of the concerned regional organ, such as the National Section of the Common Market Group and the Mercosur Trade Commission (MTC). Should they wish to move further to the arbitral phase, they need the support of their own state… (Haines-Ferrari 1998, 275)

Therefore, in order to successfully achieve economic and institutional integration in the region, Mercosur must create supranational institutions to support the regional trade bloc and imperfect customs union.

7. Possible Solutions to Diverging Macroeconomic Policies

Various scholars have proposed diverse solutions to solve Mercosur's problems arising from the lack of macroeconomic policy coordination among its four members. Some, specifically Busse, Hefeker and Koopmann (2004) have incorporated their understanding of the prevalence of fixed exchange rate regimes in Latin American nations into their solutions. Evident in various examples ranging from El Salvador's full

dollarization regime to Argentina's Convertibility Plan, it is significant to discuss these nations' preference for fixed exchange rate regimes over free floating regimes. One, if not, the most significant reason for this tendency and preference is that fixed exchange rate regimes lead to more stable exchange rates. On the other hand, free floating regimes imply, encourage and produce a higher degree of exchange rate variability, thereby leading to risk and adverse economic effects on foreign investment and trade between significant external trade partners for the region—such as the United States and the European Union. Accordingly, "stable exchange rates are also important for the sustainability of deep integration as the vulnerability of trade and investment flows to exchange rate movements grows in line with rising interdependence among partner countries" (Busse, Hefeker and Koopmann, 2004). Consequently, one can conclude that stable exchange rates are known to foster healthier and more prosperous relationships among and between trade partners. It would follow then that achieving a stable exchange rate through diverse degrees of dollarization, as evident in Argentina's case, would favor trade relations with the U.S.

Latin American nations such as Argentina have also leaned towards a stable or fixed exchange rate regime in order to "import monetary stability" (Busse, Hefeker and Koopmann, 2004). That is, by pegging their currencies to a more established and credible currency such as the U.S. Dollar, these countries hope to increase the credibility of their own currency and monetary policy in order to avoid higher expected inflation and interest rates—caused by a lack of credibility in a country's monetary policy (Busse, Hefeker and Koopmann, 2004). However, though there is some validity to this theory "today it is often stressed that fixed rates provide a natural target for speculators whereas flexible

rates, at least under (nearly) full capital mobility, appear less inviting to speculators" (Busse, Hefeker and Koopmann, 2004). Thus, though fixed rate regimes may seem appealing, especially since "capital inflows to emerging markets are typically denominated in foreign currencies" (Busse, Hefeker and Koopmann, 2004)—most long-term debt in these nations has been issued in U.S. dollar or euro terms— the threat of speculation may undermine the very purposes and goals of monetary and exchange rate stability these nations are seeking. These ideals explain the motivations behind Argentina's Convertibility Plan and the subsequent devaluation of the Argentinean peso after the currency board collapse in December 2001.

In fact, according to Busse, Hefeker and Koopmann (2004) because Mercosur nations are greatly dependent and linked to both the U.S. dollar and the euro—demonstrating the ill approach of the Convertibility Plan which only considered the U.S. as Argentina's principal trading partner—Mercosur should implement a dual currency board that "could at the same time provide a stabilizing anchor to domestic policy, be credible, and solve the problem that trading patterns do not accommodate a single currency peg to either the dollar or the euro". Busse, Hefeker and Koopmann (2004) propose that such a dual currency board could further contribute to the stabilization of exchange rates within Mercosur. In this sense, a dual currency will both favor trade relations and agreements between Mercosur and its two largest trading partners, and contribute to further economic integration between Mercosur members. Indeed the benefits of a dual currency board are highlighted through the significant figures that demonstrate Mercosur's deep trade relations with Europe and the U.S.: nearly 50% of the region's total trade is with the EU, with regard to Mercosur's own total trade (including

internal trade) nearly one-fourth of its trade is with the EU and one-fifth of its overall trade is with the U.S., the U.S. being its second largest trading partner (Busse, Hefeker and Koopmann, 2004). Thus, a dual currency board would lend higher credibility and promote further regional integration in Mercosur since the currency board

> should be less vulnerable to exchange rate movements between the currencies of main trading partners, i.e. the dollar-euro rate, than a standard currency board [and] it should restrict exchange rate movements between the members of Mercosur to a significant degree" (Busse, Hefeker and Koopmann, 2004).

Furthermore, because both major international currencies will be considered, there will be no problems with financial flows (Busse, Hefeker and Koopmann, 2004) thereby making a strong case for the dual currency board.

Whereas Busse, Hefeker and Koopmann (2004) advocate a dual currency board, Malamud and Label (2002) argue for the implementation of the Merco as a common currency for Mercosur. Malamud and Label (2002) support the idea of "a floating currency that leaves room for independent monetary policy and wage and price flexibility", while maintaining monetary discipline. Malamud and Label (2002) discuss how "a flexible rate regime averts the currency crisis that besets target zone and crawling peg arrangements"—i.e. the Argentinean crisis. Presenting, a path for total monetary union in the region, Malamud and Label (2002) propose, "when managed by an independent central bank committed to holding down inflation, this alternative affords the stability advantages of dollarazation." In addition, they argue that as a floating currency, the Merco's flexibility vis-à-vis other currencies provides a cushion against external shocks, a cushion that dollarization lacks. Malamud and Label (2002) also discuss additional advantages of the Merco, which will also serve to secure seignorage

revenues—purchasing power that a government secures by creating money at essentially no cost that it can use to buy real things—for the members of the Merco zone. However, realizing that the Merco cannot be instituted overnight, Malamud and Label (2002) also describe a process similar to Busse, Hefeker and Koopmann (2004) whereby:

> Argentina would tie its peso to a shrinking basket of dollars and euros while Brazil retains an inflation targeting—floating exchange rate regime with an inflation target somewhat above the U.S.—euro zone average. With the peso tied by formula to the dollar and the euro and the real linked more loosely to these currencies, narrow spreads between Argentine and Brazilian inflation rates and interest rates should maintain over time. Brazil would adjust its inflation target to achieve convergence with Argentina before a common currency is inaugurated. The suggested path offers Argentina an exit strategy from its current hard fix to the dollar. Other Merco zone candidates could follow similar paths as Argentina (Malamud and Label, 2002).

Thus, both models, the dual currency board and the Merco, reflect the importance of achieving some form of reconciliation between the Euro and the U.S. dollar necessary to stabilize the high exchange rate variability in Mercosur. Indeed as Zerio (1992) foreshadows: "unless the economies of Argentina and Brazil succeed in controlling inflation, and put in place monetary policies that maintain a certain level of currency parity, integration is unlikely to be successful".

On the other hand, rejecting monetary union in the region while simultaneously favoring the synchronization of macroeconomic policies between Mercosur members, Barry Eichengreen (2004) advocates a common policy of inflation targeting for Mercosur members. Arguing that it is not likely for Mercosur countries to forego their individual sovereignty through the adoption of a single currency, such as the Merco proposed by Malamud and Label (2002), he argues that the best alternative for Mercosur nations is

harmonized inflation targeting. Barry Eichengreen (2004) contends that inflation targeting would "reduce exchange rate volatility to levels more compatible with the operation of their free trade areas, but would not require ambitious commitments to coordinate policies that, at the end of the day, cannot be successfully met". Thus, Mercosur nations would be able to solve the problems resulting from unsynchronized macroeconomic policies while both retaining their national sovereignties, and employing reachable goals and objectives regarding both institutional and economic integration in the region. In essence, through harmonized inflation targeting, Mercosur nations will resolve the problems dealing with exchange rate instability while reconciling monetary autonomy with economic integration. Furthermore, discrediting the basket-peg or dual currency board approach endorsed by Busse, Hefeker and Koopmann (2004), Eichengreen (2004) sustains that, as the Argentinean case exemplifies:

> If there is one clear lesson in international financial history, it is that so-called adjustable pegs grow rigid in an environment of high capital mobility. That rigidity, in turn, limits the scope for foreign support. And with absent foreign support, the defensibility of such pegs is dubious.

Thus, Eichengreen (2004) argues that instead of promoting institutional and economic integration in Mercosur, such an approach would undermine regional integration in its entirety. The main provisions of inflation targeting are:

> an institutionalized commitment to price stability as the primary goal of monetary policy; mechanisms rendering the central bank accountable for attaining its monetary policy goals; the public announcement of targets for inflation; and a policy of communicating to the public and the markets the rationale for the decisions taken by the central bank (Eichengreen, 2004).

In summary, as a policy framework, "inflation targeting is designed to provide a clear and credible anchor for monetary policy that stabilizes both expectations and foreign exchange markets themselves" (Eichengreen, 2004)

However, while these three viable solutions for Mercosur's unsynchronized macroeconomic policies have great validity, it is nevertheless important to note that the fiscal policies of these nations must also be coordinated—and institutional integration enhanced in the regional trade bloc—in order for such frameworks to produce their desired effects. Specifically in terms of the three solutions, all authors respectively mention and discuss the importance of institutional and fiscal integration: Firstly, Busse, Hefeker and Koopmann (2004) discuss:

> It is clear, however, that a dual currency board cannot solve [all] of a country's macroeconomic problems. A currency board alone does not force politicians, as the Argentine example demonstrated, to run prudent fiscal policy. It does not avoid that countries run up debts that are ultimately not consistent with a fixed exchange rate, and it does not solve the free-rider problems of fiscal federalism. Hence, currency boards will only survive if these problems can be solved.

Similarly, Malamud and Label (2002) also proclaim:

> Following the euro zone's example, cross currency exchange rates should be stabilized and inflation rates, interest rates, and government debt to GDP ratios should converge before a common currency is instituted. Uniform financial regulations must also be designed and a credible commitment to low inflation must be demonstrated.

Accordingly, Eichengreen agrees that Mercosur countries:

> [m]ust follow prudent fiscal and financial policies, not just adopting appropriately balanced budgets but also minimizing their dependence on short-term, foreign currency-denominated and indexed debt. With such

> policies in place, exchange rate volatility can be reduced to levels compatible with regional integration.

As demonstrated in the preceding statements and as supported by Dorruci, Firpo, Fratzscher and Mongelli (2002), in order to achieve economic integration through macroeconomic policy harmonization, Mercosur members must advance institutional integration through the synchronization of fiscal policies in order to further promote regional integration among Mercosur's constituents—again showing the circular relationship between institutional and economic integration.

8. Conclusion

This paper has shown the intricate and inter-related reasons and obstacles that prevent Mercosur from successfully implementing a common market in Latin America's southern cone. Discussing the historical and diverse motivations for Mercosur's creation from the perspective of Brazil, Argentina, Uruguay and Paraguay, along with the inherent differences in their economic profiles, we can clearly observe some of the fundamental reasons why Mercosur has been unable to achieve total economic integration among its constituents similar to the European Union. By using the framework provided by Dorruci, Firpo, Fratzscher and Mongelli (2002), this paper has demonstrated that Mercosur cannot achieve its goal of total economic integration in the region unless it makes the efforts to achieve institutional integration through the coordination of currently divergent macroeconomic and monetary polices, and the implementation of a successful common market through the creation of supranational institutions. In fact, unless Mercosur nations take the necessary measures to reduce the role of presidential diplomacy during Mercosur

crises, implement supranational institutions, and coordinate fiscal policies among its members (institutional integration), the solutions discussed in Section 7 will be ineffective and incapable of resolving Mercosur's uncoordinated macroeconomic policies—thereby hindering the region's economic integration. Yet as Dorruci, Firpo, Fratzscher and Mongelli (2002) discuss, in order for institutional integration to further advance in the region it must be supported by economic integration, which has been deterred as a result of the lack of institutional integration in the first place—evident in the Brazilian and Argentinean economic crises wherein the lack of macro coordination hindered economic integration.

However, Mercosur has made substantial process in these issues as well. During a Mercosur summit on December 15, 2000 a Macroeconomic Monitoring Group (GMM) was established to monitor the compliance of member nations to a set of macroeconomic convergence targets endorsed by Mercosur (Eichengreen, 2004). Indeed, currently all Mercosur nations have adopted a free floating exchange rate regime. Furthermore, the implementation and creation of the Protocol of Olivos for Dispute Settlement, signed by the presidents of the bloc's member countries on February 18, 2002, also shows signs of advancement for institutional integration in the region. Through this agreement, a permanent tribunal, made up of 5 arbitrators, was created to review the awards issued by ad hoc arbitration tribunals. This tribunal's awards are considered 'final judgment' and 'will be binding on the state parties involved in the dispute' (INTAL 2002, 7; Carranza 2003). In essence, while Mercosur has the power to become irreversible if it continues on the right path towards achieving full economic and institutional integration, if it fails to overcome and resolve the obstacles that impede these processes, "the Mercosur customs

union risks becoming an empty shell, even if it remains politically important as an instrument to negotiate free trade agreements with European Union and the United States" (Carranza, 2003).

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