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ECONOMIC INTEGRATION OF MERCOSUR

THE CASE OF BRAZIL AND ARGENTINA

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My gratitude
To my wife.
To Prof. Thomas Andrew O'Keefe, Ph.D.
To Prof. James Ferrer, Jr., Ph.D.
and the staff of IBI.

Summary

Index of Graphics, tables and figures

INTRODUCTION

Who is the best soccer player there ever was? The answer to that question depends a great deal on whether you live south or north of the Rio de la Plata, or if you speak Spanish or Portuguese. As a matter of fact, it depends really if you are Argentinean (and you would say he was Diego Armando Maradona, 'El Pibe de Oro') or Brazilian (then you would say that he certainly was Edson Arantes do Nascimento, 'The King Pelé'). Rivalry between Brazil and Argentina is not new and is not restricted to soccer. Even though they are countries that share a lot of common history, they are also very diverse, starting with colonization, continuing through how they achieved their Independence from the Colonizing Metropolis, and culminating in the process of industrialization they each experienced in the 20th century.

Argentineans have, throughout their history considered themselves the most civilized country in South America, praising their European ascendancy, their high rate of literacy and the enormous number of bookstores, libraries and cafes, even though these are located mostly in Buenos Aires and Córdoba. Brazilians, on the other hand, have always bragged about their openness, their ability and enjoyment for sports and music and their informal way of seeing life and passing through it, considering their "hermanos" to the south stiff and snobbish.

Of course all these generalizations are unfair and one cannot fairly describe nearly 40 million Argentineans and 165 million Brazilians in a sentence or two. But it is also as clear as water that the two major players in the MERCOSUR game don't get along very well.

Argentina and Brazil cannot be overlooked when one wants to know about South America. The land area they both cover is impressive and their boundaries are nearly endless, with huge populations (especially Brazil's) and their Gross National Product way above the others, making all of their neighbors somewhat spectators in the process of Southern Cone Development.

The main objective of this paper is to analyze the reasons that led Brazil and Argentina to integrate, their respective economic backgrounds prior to the creation of the MERCOSUR (which is the acronym for Common Market of the South and is also known as MERCOSUL in Portuguese), the results achieved by MERCOSUR and by its members, and, especially to examine the costs and benefits to each so as to resolve the debate between Brazilians and Argentineans in which each considers themselves to have gotten the weaker side of bargain under the Treaty of Asunción.

This paper will attempt to show that both countries have harvested much more benefits from the agreements than losses and that even after the January of 1999 maxi-devaluation of Brazil's currency, the Real, MERCOSUR is a much more successful program than the much publicized complaints of the Brazilians and the Argentineans would lead one to believe.

Of course the above mentioned devaluation, which almost led to the total failure of the Plano Real and, in a cascade effect, almost sank the Argentinean economic stability process, changed everyone's perspectives and everything now has to be analyzed trough a new prism, and this study intends to dedicate special attention to this new dynamic.

I intend to demonstrate my point of view by, first, describing briefly the economic situation that has led countries in all the continents towards various processes of integration. I will, then analyze the economic situation of South America, whose countries have been, since their births struggling against poverty, concentration of income, external debts, and a myriad of infra-structure problems have caused them to fall are way behind of the developed countries of the First World.

Next I will explain the Process of Integration itself, including its basic principles and theories. In that section I will also describe the strategies for achieving success in a process of integration and the consequences of the decision of sovereign countries to join forces in the pursue of economic and social welfare for their peoples.

A brief history of the attempts at Economic Integration in Latin America before MERCOSUR will be also presented, linking those attempts with the relationship of Brazil and Argentina and their domestic goals and aspirations.

In my paper I will also deal with the effective economic relationship between Argentina and Brazil, analyzing a series of macroeconomic variables not only after some of the instruments of integration were implemented, but also before, so that we can have a basis of comparison. Together, the two countries have had in the past 20 years more Ministers of Finance than most developed countries in their entire history. I will intend to show how both countries managed to keep their interest in Integration amidst turmoil of high inflation (even hyperinflation on certain occasions), slow growth, high interest rates, high unemployment and political havoc.

Finally, I expect that my study may contribute to a better understanding of the reality of the integration process between Brazil and Argentina and, as a consequence, of the whole MERCOSUR, showing that the area has a great deal of work to do and can expect lots of obstacles and hardships but has much to gain with the enhancement of trade and the openness of the member state's market among themselves and with others, making the division of work more than just an economic expression but rather a way of achieving sustained development and social growth for the people of the Southern Cone.

I – THE GLOBAL ECONOMIC CONTEXT

The XX Century has witnessed great happenings in the History of Humanity but what has really made the difference was the speed of the changes. Already in its first half, it saw two World Wars that involved the majority of the people of the Earth, an economic crisis that changed the whole concept of the role of the government in the Economy (this concept would change again much sooner than expected) and ended up in the Black Tuesday in 1929 and the Russian revolution of 1917.

All these events led to drastic changes in the world economic order, starting in 1945, with the end of World War II. To an array of authors the global economic order is directly linked to the transformations that occurred in the capitalist economies, usually in a cyclic pattern. The cycle that ended at the star of the 1990's has started at the end of the 40's. At the end of the Second World War, the winning side practically divided the World between the capitalist and the socialist nations, with Germany, in this case the defeated enemy, separated and declared the border, the dividing point between these two camps.

The capitalist side had its directions and goals fixed since its very birth. In 1944, at Bretton Woods, in New Hampshire, United States of America, forty five nations have signed the text that, among other things, created the International Monetary Fund, the World Bank and the International Trade Organization. Later, there came the Marshall Plan and the GATT (General Agreement on Tariffs and Trade). In fact, the GATT was the compensation for the fact that the idea of a International Trade Organization was never implemented since it was rejected by the United States Congress. Politically, a turning point in History was the creation, very much desired by the United States, of the NATO (North Atlantic Treaty Organization), that put together the nations where the "ideals of democracy and free initiative" were respected, which served as an advanced scout for the American foreign policy, especially where the USSR was concerned.

To stand up to NATO the countries under the influence of the Socialist System of the USSR created the pact of Warsaw, which managed to amass an enormous quantity of middle and long range nuclear weapons, what made Europe, and by consequence, the rest of the World walk for many years along a very delicate path.

The Cold War was the main issue of the second half of the XX Century. It influenced nearly every economic, political or social decision that almost every country in the World had to come to since the 50's. The bipolarization of the world made it nearly impossible for new markets and commercial relationships to arise across the bipolar divide, or, when it did arise, it stopped them short of its full potential, and the trade between the two 'sides' of the globe was difficult and sometimes nearly frozen.

Capitalism has found its way to succeed, though. The reconstruction of Europe and Japan and the industrialization of the Third World have shown us an unprecedented development of the system of rewarding the most able. “The growth in Capitalist Economies has based itself, mainly, in the increase of the productivity of labor, and that higher productivity was achieved thanks to: a)new automated equipment; b)new methods of organizing labor, like “fordism” and “taylorism”; c)working in shifts, what has allowed production 24 hours a day; d)the demands of the corporations for lower costs and e)the intensification of the bureaucratic work with the introduction of computers in the offices” (Monteiro, 1991, p.9-10). This does not mean that Capitalism’s triumph was complete, however.

According to Michel Beaud, in the “prosperity of the 60’s, we already had the seeds of the crisis of the 1970’s” (Beaud, 1987, p.322) A great number of factors were determinant in the slowing of the pace of economic growth in the capitalist nations during the 1970’s. First, the accumulation which followed the increase in productivity soon generated an exhaustion of markets. Another factor was the reaction of the United States to heightened competition from Japan and Europe, which led to the devaluation of the US Dollar and the export of American inflation to the rest of the World. Furthermore, according to Monteiro, yet another factor was the “opposition between the interests of the developed and industrialized capitalist countries and the Third World.” (Monteiro, 1991, p.13). The first manifestation of this came from the oil-exporting countries, which raised their prices as a manner of gaining a better share in the distribution of the total income that was generated across the world. At the same time, this development made the situation of the non-oil-exporting and undeveloped countries even more difficult, and they started demanding a new economic order that could rescue them for their seemingly unavoidable destiny of poverty and falling ever behind the leaders.

The most preeminent characteristic of this new international order that lasted from the end of the World War II to the 1990’s seems to have been the division of the World in blocks and political and/or economic alliances. Even though the first alliance that comes to one’s mind is the European Union, the desire for enlarging its market wasn’t a privilege of Europe alone. New blocks started popping up all over the World, some faded into oblivion early on, while others stood a better chance, but amalgamation as a manner of achieving common goals and objectives has been the dominating path over the past decade .

Meanwhile, the non-capitalist side of the world was having its own problems. The British magazine, The Economist gives a brief description of the amazing things that happened at the end of the 1980’s.

> “What happened in 1989, once a Russian leader had tried to reform the unreformable and lost his grip, was – still is – as dramatic as upheaval as the one in France exactly two centuries before, though a lot less bloody.”(Ten years since the Wall fell, The Economist, 11/06/99).

That leader was Mikhail Gorbachev and he tried to conduct the Soviet Union to a better level of Socialism through the Perestroika or ‘reform’. That was the signal to all the communist world that the Iron Curtain was rusting. What was once the main communist area, eight countries: the Soviet Union, the five countries of the Warsaw Pact, Yugoslavia and Albania, has become, again according to The Economist “...no fewer than 27, (28 if Montenegro leaves the Serb rump of Yugoslavia, as it soon may; 29 or 30 if Kosovo and Chechnya are counted).”(op.cit.) The socialist side lost the battle due to its own failures. Infra-structure and investment in a industrial system were sacrificed on the altar of the gathering mass destruction weapons. What was left was a completely rotten financial system, unprecedented levels of corruption, herds of *noveaux-riches* showing off Mercedes Benz and jewelry.

Most of those countries have been searching for an approach similar to that of the European Union over the past decade but the transition to Capitalism has hit these people very hard. Inflation, lack of basic social services, organized crime and political turmoil have been a constant in the 1990’s.

Anyway, with the collapse of the old soviet bloc, bipolarity is now gone, the balance (if there ever was one) is lost and Globalization has become the magic word in the end of the XX century.

II - THE ECONOMIC CONTEXT OF SOUTH AMERICA

What is the main characteristic the economies of the South American Countries? As we said before, one cannot stereotype a whole continent in a phrase or two, since we are talking about 13 different countries with more than 400 million inhabitants, however the External Debt has been a constant in those peoples lives.

The South American economies have always been very dependent on capital and goods from the developed world, and they suffered the burden of the Petroleum crisis in the late 1970's that led to an increase in international interest rates that has somewhat cushioned the impact of that same crisis on the developed and industrialized countries of the 1st world. According to Monteiro, that was due to the "role that underdeveloped countries play in the international division of labor." (Monteiro, 1991, p.14).

Pedro Paz (1987) cites two other reasons that explain Latin American dependency and, consequently, the foreign debts:

a) The pattern of accumulation that is defined by their level of industrialization and the action of the State;
b) The availability of excess capital in the international capital markets.

The deterioration of the terms of trade, created by the steep increase in the price of the energy sources so needed by countries struggling to industrialize and escape from their almost certain destiny of producing and exporting primary goods was already a hardship. But during the 1980's the South-American countries still had to face an even worst scenario. During the 1970's, the low Interest Rates due to an excess of capital, especially coming from the Oil-producing countries had kept the international interest rates at lower levels. The high level of productivity in the industrialized 1st world had kept prices and capital affordable. But suddenly, at the start of the 1980's, all the favorable environment that had previously allowed most of South America to try to finance their steady pace of growing in GDP no longer existed.

By the year of 1983, the Interest Rates had shot up to 19,5% which made most of the South American countries unable to pay off their foreign debts. The following table shows the rapid evolution of the interest rates at the end of the 70's, beginning of the 80's:

Table 1 – International Interest Rates – 1974/1984

Year	Rate (%)	Year	Rate (%)
1974	6,0	1980	14,2
1975	7,6	1981	16,6
1976	6,1	1982	17,2
1977	6,4	1983	19,5
1978	9,4	1984	14,0

Source: Monteiro, 1991, p.16

Countries like Brazil, for instance, had to face a cruel dilemma in the 1980's, either to keep growing, by borrowing and enlarging their debts or to adjust and adapt to the new situation, resulting in a recession that would have terrible effects in economies that had previously been growing at a rate of 14% a year (which had been the case of Brazil). The first option was the one Brazil chose, trying to continue Prof. Delfim Netto's policy of "growing at any price". Delfim had been Minister of Finance during most of the years of the so-called *'Milagre Brasileiro'* , the 'Brazilian Miracle' years of the late 1960's and early 1970's, and he faced political and economic pressure to maintain the course of the steady growth that had characterized the situation during the military dictatorship and distracted the public opinion from the human rights abuses and the lack of democracy that resulted from the Revolution, (*coup d'etat to some*) of 1964.

Table number 2 shows the evolution of Brazilian Foreign debt and its drastic increase in the decade following the first Petroleum crisis of 1973.

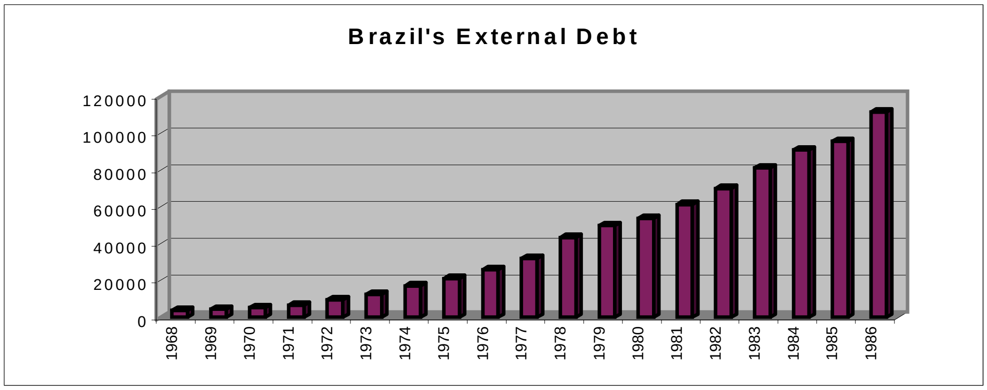
Table 2 – Brazil's External Debt 1968/86

Year	Registered Gross Foreign Debt U$ Million of 1986
1968	3861.0
1969	4403.0
1970	5295.2
1971	6621.6
1972	9521.0
1973	12571.5
1974	17165.7
1975	21171.4
1976	25985.4
1977	32037.2
1978	43510.7
1979	49904.2
1980	53847.5
1981	61410.8
1982	70197.5
1983	81319.2
1984	91091.0
1985	95856.7
1986	111759.0

Source: Central Bank of Brazil

As the above table shows, the growth of the debt was dramatic in those 18 years and was the direct result of the Second Oil Crisis of the 1980's and of the rise of the Interest rates. Graphic number 1 provides a more vivid illustration of the growth in Brazilian External Debt that molded the economic future of the country.

Graphic 1



Source: Central Bank of Brazil

The explosion in Brazil's foreign debt obligations led to a drastic economic adjustment and it nearly resulted in Brazil's default on debt payments at the beginning of the 1980's (*i.e.*, Brazil declared a temporary moratorium on its payments) and in the virtual bankruptcy of the country that prevented any kind of investment and led to a long and deep recession, that was called "A Década Perdida" the Lost Decade. In the other countries of Latin America the situation wasn't much different, and all of them faced very disappointing rates of growth in the 1980's, as is shown in Table 3.

Table 3 – Rate of Growth of GDP Per Capita in some Latin American Counties

Year	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**	**1980/89**
Brazil	6.5	-5.7	-1.5	-4.9	3.1	5.6	3.3	1.6	-2.0	1.4	6.8
Bolivia	-2.0	-2.2	-5.3	-9.0	-3.5	-4.3	-5.5	1.8	0.4	0.3	-26.1
Ecuador	1.8	0.9	-1.7	-4.0	1.8	2.0	0.2	-8.3	7.9	-2.0	-2.2
Mexico	6.1	5.5	-2.6	-7.5	1.0	0.0	-6.1	-0.5	-0.7	1.2	-4.4
Peru	2.5	1.7	-2.2	-14.0	2.1	-0.1	5.3	5.0	-11.2	-13.3	-23.9
Venezuela	-3.6	-3.9	-4.0	-8.1	-3.7	-3.2	2.6	2.9	3.7	-11.1	-25.8
Argentina	2.9	-8.5	-6.8	0.8	0.8	-6.1	4.4	1.2	-3.1	-7.4	-20.6
Colombia	2.6	0.1	-1.1	-0.2	1.6	-0.7	3.3	3.1	1.9	1.3	12.4
Chile	6.0	3.5	-14.5	-2.2	4.3	0.8	3.7	4.0	5.7	8.4	19.2
Paraguay	7.6	5.4	-3.9	-6.0	0.1	0.9	-3.3	1.1	3.3	2.8	7.4
Uruguay	5.5	0.8	-10.6	-6.7	-1.9	-0.9	5.9	5.2	-0.6	0.7	-3.8
Latin America[1]	3.8	-2.3	-3.1	-4.6	1.3	0.4	1.6	1.5	0.5	-1.6	-2.7

Source: IBGE (1987) and ECLAC (1988)
1 – Excluding Cuba

The very poor performance during the 1980's was consequence of the very large quantity of capital that was transferred from the developing countries to the developed ones, in various ways, such as through interest payments and amortization of loans, and that made all exporting effort useless in order to promote a surplus in the Balance of Payments of the developing countries.

Table 4 shows the composition of that imbalance, supporting the idea that the outflow of funds drained whatever little capacity for sustained development that Latin American and Caribbean economies could have put together in order to preserve any early growth tendencies they may have had.

Table 4 – Latin America and The Caribbean – net flow of Capital and Percentage of Exports
U$ Billion and %

Year	Inflow of Capitals	Payments if Interest and amortization	Net Inflow or Outflow of Capital	Exportation of Goods and Services	Percentage of Inflow/outflow over exports.
1973	7.9	4.2	3.7	28.9	12.8%
1974	11.4	5.0	6.4	43.6	14.7%
1975	14.3	5.6	8.7	41.1	21.2%
1976	17.9	6.8	11.1	47.3	23.5%
1977	17.2	8.2	9.0	55.9	16.1%
1978	26.2	10.2	16.0	61.3	26.1%
1979	29.1	13.6	15.5	82.0	18.9%
1980	29.7	18.1	11.6	107.6	10.8%
1981	37.6	27.2	10.4	116.1	9.0%
1982	20.2	38.8	-18.6	103.2	-18.0%
1983	2.9	34.4	-31.5	102.4	-30.8%
1984	10.3	37.0	-26.7	113.9	-23.4%
1985	2.2	35.0	-32.8	109.6	-29.9%
1986	8.3	31.9	-23.6	95.4	-24.7%
1987	13.9	30.5	-16.6	108.2	-15.3%
1988	4.3	33.2	-28.9	121.7	-23.7%

Source: ECLAC

It can be easily seen that all the efforts made by the Latin American countries to export more and more, sometimes way above the capacity of their productive systems weren't enough to guarantee a sustainable position in the international markets. In addition, the necessity to increase emissions of their currency to pay domestic exporters for the foreign currencies they had earned led the great majority of them to something that, along with external debt and recession, became a new characteristic of the Latin American economics: extremely high levels of inflation. This phenomenom, combined with the virtual stagnation in GDP throughout Latin America gave rise to the concept of 'stagflation'.

In response, the IMF suggested its usual 'recipe' of measures that couldn't be avoided such as privatization, cuts in Projects and Programs, and very tough Fiscal Policy, intended to produce trade surpluses and a balanced Balance of Payments. According to Monteiro, the IMF pinpointed as causes of the crisis “internal ones such as mistaken economic policies, poor management of the external debt and public deficit, while it considered less important ‘adverse external conditions’” (Monteiro, 1991 p.18).

Slowly, the countries of Latin America, and among them, of course, “...Argentina and Brazil, identified regional economic cooperation as a major component of the process of economic and financial reform.” (Roett, 1999, p.3). These first steps of Latin America towards Economic Integration will be analyzed further in Chapter 4.

III – ECONOMIC INTEGRATION – CONCEPTUAL FRAMEWORK

To define the term Economic Integration, we will use the concepts created by to authors, who, with a difference of decades have studied it exhaustively and written and published a lot about it.

The late Bela Balassa, former Professor at Yale, proposed in the very first page of his book The Theory of Economic Integration that it should be defined "...as a process and as a state of affairs. Regarded as a process, it encompasses measures designed to abolish discrimination between economic units belonging to different national states; viewed as a state of affairs, it can be represented by the absence of various forms of discrimination between national economies." (Balassa, Theory of Economic Integration, p.1)

To the Argentinean economic advisor Cesar P. Castañeda, "...integration must be understood as a process – and this the dynamic notion of it – by which the tariffs are reduced in a discriminatory way, accompanying this reduction with the imposition of similar barriers against third countries, with the facilitation the flow of productive factors and the harmonization of economic policies”. (Castañeda, Evaluación y perspectivas de la integración, 1984, p.17)

As we have seen, the authors agree on the characteristic of Integration as being a process and not a fact frozen in time. It’s final goal has to be the establishment of a unified market, a symbiosis among two or more national economies, who will in time complete and complement themselves.

But there are no petrified rules and not even a orthodox way of accomplishing economic integration. There are, on the contrary, a series of forms that can be applied in various manners within different strategies and at different levels within the process.

3.1 – Forms of Economic Integration

There are, according to Balassa, basically five instruments or forms of economic integration, and they are: a Free Trade Area, a Customs Union, a Common Market, Economic Union and total Economic Integration.

3.1.1 – A Free Trade Area – This is a instrument that is intrinsic to the process of economic integration and sometimes it is considered as Economic Integration per se. It consists of the elimination of tariff and non-tariff barriers between the participating countries. Its goal is to achieve a more productive use of the productive factors through the more intensified use of the installed capacity, optimizing the economies of scale.

Others, especially Castañeda (op. cit.) consider that the increase in trade among the members allows them to pursue more efficiently their technological development, in a process of substitution of imports.

It is important to note that in a Free Trade Area "...tariffs (and quantitative restrictions) between the participating countries are abolished, but each country retains its own tariffs against nonmembers."(Balassa, op. cit. p.2)

3.1.2 – A Customs Union – The major step after a Free Trade area is the adoption of a Common External Tariff. This is the instrument that allows the determination of the margins of preference, prior to a Customs Union. It usually embraces the role of protecting the regional production, offering it an amplified market for its output and yet, protecting and cushioning it against extra-regional production, allowing an optimal allocation of resources. In order for a Customs Union to exist, some pre-conditions are required: there must be no large disparities among the economies involved and the Tariff Structure of the members must be similar.

3.1.3 – A Common Market – The adoption of a Common Markets has a sine-qua-non condition, that is: the abandoning of restriction on movements of factors of production. It is doubtlessly the one of the most difficult step in a process of Integration since it requires from the members some degree of abdication of their autonomy in economic policies as a whole. Yet it is a challenge that every group of countries that aspire to become completely integrated must undergo. Some basic conditions that must be met include harmonizing costs and prices of goods so as to maintain a satisfactory level of competition; initiating a process of harmonization of the internal taxes on goods and services; avoiding double taxation; harmonizing subsidies to exports and the use of Exceptional Regimes of Tariffs.

3.1.4 – Economic Union – An Economic Union is a natural follow-up to the Common Market. It corresponds to a more advanced and sophisticated level of integration, and includes the harmonization of other instruments of economic policy, such as Currency, Monetary and Fiscal Policies.

3.1.5 – Total Economic Integration – According to Balassa, total Economic Integration "...presupposes the unification of monetary, fiscal, social and countercyclical policies and requires the setting-up of a supra-national authority whose decisions are binding for the member states."(Balassa, op cit., p.2) He also considers that although social integration could also be mentioned as a further precondition for Economic Integration, and although it increases the effectiveness of the process, it is not required in the first forms of the process. Therefore he does not include Social Integration as a formal step in the way towards total integration of the member states.

According to Castañeda, "...the combined action of the market and of instruments of economic planning, more specifically industrial programming, should have as a goal the maximization of the benefits of the group coupled with an equal distribution of those benefits, which is understood as the participation of all the member states of the industrial development created by the economic integration."(Castañeda, op.cit.,p.99). Since one of the first measures adopted by the integrating countries is the reduction and further elimination of tariffs among the member states, the objective of integrated industrial planning should be managing the different levels of productivity levels resulting from the process.

3.2 – Strategies

Strategies adopted in the process of economic integration differ relatively to how advanced in the process the member states are, and the schedule they intend to follow as well as the pace they plan to keep with respect to implementation.

3.2.1- Short term – The first thing to be achieved in the short run is the enlarging of the intra-regional trade. Castañeda cites useful measures that should be adopted:

"1.Alonging the periods of compensation of payments and the enlarging of the bilateral lines of credit;

2.Obligatority of keeping all payments originated on the intra-regional tradein a system of checks and balances;

3.Creation of a guaranty fund to prevent eventual default by importers.

4.Multilateral use of all the bilateral credits and creation of documentary credits based on a single regional account". (Castañeda,op.cit.p.124)

3.2.2 – Medium term – The initial step in a medium term strategy is the liberalization of trade. One cannot think of convergence among the member states if there remain barriers to intra-regional trade and prevent the creation of an enlarged market. The more homogeneous and geographically linked the participants are, the faster and smoother the process is likely to be.

The second step is the adoption of a Common External Tariff and that constitutes a very delicate and complex matter, since less developed participants are prone to suffer from its application.

The third step goes toward economic union and it involves the harmonization of the economic policies.

3.2.3 – Long term – Strategy planning for economic integration over the long run will include unified planning in infra-structure development, agro-industrial business, services and energy generation. The unification of the transport system should be one of the goals of the process, together with joint systems disseminating market information and research. In a more advanced phase, there should be the effective harmonization of economic policies and the free movement of factors of production, especially labor and capital.

3.3 – Consequences of Integration

3.3.1 – Trade creating and trade diverting – Jacob Viner, in his *The Customs Union Issues* of 1950 describes the effects of integration on trade as either helping to create it or to divert it. The process has created trade when resources in an economy are transferred from the ones with the higher costs of production to those with lower costs. By diversion of trade, there is an opposite effect. According to Viner, the benefits of the economic integration will occur as trade creation surpasses trade diversion in the economies of the member states.

3.3.2- Economies of Scale – The size of the market is one of the main concerns of the developing countries. As an economy is able to lower its average unit costs it achieves the optimization of the productive factors and is able to produce more efficiently and less expensively. The enlargement of the possibilities of sale for its products has been one of the reasons why countries have wanted to become part of an integrated economic bloc.

3.3.3- Competition - The competition created by the enlargement of the market and the removal of tariffs will necessarily make of productivity a much more important part of the equation than it already is. That will happen at a different pace in each of the countries participating in the process, so it may be necessary to adopt policies to deal with those differences, in order to ensure a smoother period of transition.

3.3.4- Induced Investment – The expansion in production caused by the expansion of the market, the better level of productivity achieved and the new demand from importers will bring new investments into the area.

IV - EARLY ATTEMPTS AT INTEGRATION IN LATIN AMERICA

The will to integrate came soon to many South American countries and the idea was always present in their histories. As early as 1820, less than 5 years after Argentina's Independence from Spain, we saw the creation of the United Provinces of the Rio de la Plata, which was an attempt to reestablish part of the old Vice-Royalty of the River Plate (*i. e.*, Argentina, Paraguay and Uruguay) as a Republic.

Also in the XIX Century we saw Simón Bolivar's attempts at creating, as part of his dream of a united South America, the Republic of Gran Colómbia (consisting of present day Colombia, Ecuador and Venezuela). Bolivar himself was not very fond of the idea of a Federation, preferring the establishment of a continental Republic.

The initial agreement for a United South America, sponsored and put forward by Bolivar himself, had declared that the participants were to accept the following requirements:

a) There would be common navies and armies;

b) The member-states would automatically come to the defense of the other in the event of an outside attack;
c) There had to be free trade among them.

Bolivar thought that all the countries involved shared cultural affinities, which proved to be a myth, and needed to integrate in order to face Europe and prevent annexation by the United States. The republic of Gran Colómbia was a failure, especially due to the weak infra-structure, a dominant factor in the Andean region even today, which is characterized by a complex geography of mountains, deserts and swamps.

Keeling describes the end of the XIX Century and the beginning of the XX Century as the age of "informal imperialism" in Latin America. (Keeling, 1997, p.29). That led to the expansion of most of Latin American countries' agricultural economies, and brought, to some of them, first British investment, and later, the hegemony of the United States.

In the XX Century, we also had other experiences of integration, among them CARICOM which was the Caribbean Community, The Central American Common Market, and the Andean Pact, which was much more successful than the first two. But I intend to study in a deeper manner the attempts that involved Argentina and Brazil, just mentioning these other experiences to give a historical background as to what happened in the Southern Cone.

In the 1950's some of the best economic minds of Latin America were in Santiago, Chile, working with ECLAC (Economic Commission for Latin America and the Caribbean). The dominant idea at ECLAC or CEPAL, its acronym in both Portuguese and Spanish, was that the main engine of development was technology and this was concentrated in the developed countries. That led to a difference between the appropriation of the excesses of production by the First world and that of the periphery. In addition, the terms of exchange between the First World and the periphery were bound to deteriorate and primary products would loose their value in comparison with products with more value-added that dominate the output of the First World.

ECLAC's suggestion to cope with the above situation was to encourage a process of Industrialization in Latin America through Imports Substitution. However that process was not failure-proof due to the differences of productivity among the countries involved, which to ECLAC was due in part to the different sizes of the markets. According to Monteiro, the idea of ECLAC was that "...the only way to overcome this obstacle was the enlargement of the market, expanding reciprocal commerce through the liberalization of intra-regional trade"(Monteiro, 1991, p.33). That led to the first attempts at regional economic integration and to the creation of ALALC, the *Asociación Latino Americana de Libre Comercio*.

4.1 – The ALALC – Following the "*pensamento cepalino*" (the ideas of ECLAC) Argentina, Brazil, Chile and Uruguay attempted at the end of the 1950's to create a Free Trade Area. In 1960 they sign, along with Mexico, Paraguay and Peru, the Treaty of Montevideo, which gave birth to the LAFTA, Latin America Free Trade Association known both in

Portuguese and Spanish as ALALC. Bolivia, Colombia, Ecuador and Venezuela eventually joined later.

Monteiro (op.cit. p.34) says that the ideas of the ECLAC were far bolder than the conception and the model actually adopted by the ALALC. Basically its plan was to create two instruments of liberalizing the trade: the national lists and the common lists. The national lists were the exceptions each country was allowed to have in the goods it judged necessary to safeguard its position. They should come together with a schedule of tariff reductions, to be offered to all the member-states. Every three years "... a common list should be negotiated, which would consolidate all the national lists and whose concessions would be non-revocable." (op.cit. p.34). If the national lists were successful to a certain point, it was much harder to negotiate the common lists, and that was postponed to 1964. The new trade resulting from the common lists was pitiful and to make matters even worse, in 1969 the Protocol of Caracas was signed, diminishing the obligations of the member-states and changing much of the original Treaty of Montevideo.

The Treaty of Montevideo, in its Article 2, had allocated 12 years for the full implementation of the ALALC, but the Protocol of Caracas considering that deadline to ambitious, extended it by another 8 years, until 1980. Again according to Monteiro, ALALC's failure was due mainly to the heterogeneity of the participants which never allowed a larger level of reciprocity in their commercial relations and trade. "In those conditions, there would be no reason for a less developed country to divert its trade with the United States or Europe without a compensations in its exports."(op.cit. p.35)

Table 5 – Trade intra and extra ALALC (U$ million)

Year	Exports			Imports			Total		
	ALALC	World	%	ALALC	World	%	ALALC	World	%
1955	674	6,589	10.2	740	5,956	12.4	1,440	12,545	11.3
1960	568	7,350	7.7	656	6,794	9.7	1,224	14,144	8.7
1965	840	9,388	8.9	986	7,605	13	1,826	16,993	10.7
1970	1,278	12,619	10.1	1,354	12,056	11.2	2,632	24,675	10.7
1975	4,009	30,006	13.4	4,006	37,626	10.6	8,015	67,632	11.9
1980	11,003	79,558	13.8	10,353	84,463	12.3	21,356	164,022	13.0

Source: IDB

In 1975, due to the stagnation of the ALALC, the participants agreed on the necessity of a joint action to revitalize the process and on October 17th, the Convention of Panama was signed, creating the SELA, the "*Sistema Económico Latino Americano.*" That system was in fact a "...catalyst of common efforts with the virtue of congregating Latin American solidarity in the moments of crisis." (Santos, 1985 apud Monteiro, op. Cit. p.38) Actually, according to Monteiro if SELA had to be praised for coordinating and advising the same could not be said about its realizations in the area of regional cooperation.

In 1980, the deadline set by the Protocol of Caracas for the improvement and full implementation of the ALALC, a new Treaty of Montevideo was signed, creating its substitute, the Latin American Integration Association, the ALADI.

4.2 – The ALADI – The Associación Latino Americana de Integracíon, known in English by its acronym LAIA, was built on the knowledge and experiences acquired by the members with their earlier attempts at integration and according to Dr. Monteiro it was far more realistic and flexible, limiting its objectives and goals to what was feasible. ALADI incorporated a new international legal framework to its own conception. While ALALC aimed at a Common market, ALADI prioritize the establishment of preferential trade systems (Lima, 1997, p.9)

ALADI was also much more active. As many as 55 bilateral agreements were signed under the auspices of ALADI, involving 11 nations and representing over 75% of the intra-regional trade of Latin America.

Still, despite the agreements it spawned, ALADI faced obstacles and one of the most important, according to Monteiro was the great differences between the tariff systems of the member-states, which presented a range of average 'ad valorem' tariffs going from 11% (i.e. Bolivia) to 89% (i.e. Paraguay). The consequence is that, until the 1990's, ALADI did little to the benefit of intra-regional trade as can be seen in Table 6. In fact, its major achievement was the fact that it nurtured and sheltered the economic agreements that originated MERCOSUR.

Table 6 – Trade intra and extra ALADI (U$ million)

Year	Exports			Imports			Total		
	ALADI	World	%	ALADI	World	%	ALADI	World	%
1980	11,003	79,559	13.8	10,354	84,464	12.3	21,357	164,022	13.0
1981	11,970	83,528	14.3	12,141	91,674	13.2	24,112	175,201	13.8
1982	9,883	79,412	12.4	10,468	68,486	15.3	20,351	147,899	13.8
1983	6,946	78,383	8.9	7,829	48,429	16.2	14,775	126,811	11.7
1984	8,290	89,032	9.3	8,468	50,776	16.7	16,759	139,807	12.0
1985	7,065	83,278	8.5	7,280	48,961	14.9	14,345	132,239	10.8
1986	7,593	72,248	10.5	7,767	56,280	13.8	15,359	128,528	12.0
1987	8,729	80,767	10.8	8,571	60,745	14.1	17,300	141,513	12.0
1988	9,637	91,669	10.5	9,897	67,269	14.7	19,535	158,938	12.2
1989	10,201	100,498	10.2	10,476	73,747	14.2	20,677	174,245	11.9

Source: IDB

The consensus was that there was the necessity of a harmonization of the Tariff Systems of the participants in the process. That fact and the similar political, military and economic circumstances both in Argentina and Brazil in the mid-1980’s caused both countries to start their first talks at seeking closer economic cooperation between them, and that will be the subject of the next chapter.

V – ARGENTINA AND BRAZIL

Brazil and Argentina saw the arrival of the XX Century in much different ways. By the beginning of the century, Argentina was the Superpower of Latin America, Buenos Aires was a modern city with amenities not known to the Brazilians, even those of the South and Southeast, the most developed areas of Brazil.

São Paulo and Rio de Janeiro, the largest cities of Brazil, paled in comparison with the 'Porteña' capital. " It is a city of great wealth. Of beautiful avenues (the most famous of which is the world-renowned Avenida Alvear with its open-air restaurants) of parks, residences and suburbs;..."(Whytbeck, 1940, p.276). Buenos Aires subway was built in 1913 and was the first in Latin America and one of the first in the western hemisphere. Only those of New York and Boston are older, and not by much.

Brazil has for five hundred years been "The Country of the Future", which today is a somewhat ironic self-depiction and Brazilians use this slogan to stress the tendency in Brazil to embark on projects that are never concluded. On the other had, Argentina did achieve its goal of becoming a rich country. In fact, it was the seventh richest economy of the World in the first decade of the XX Century. (Veja, 3/29/2000, p.24).

While Brazil was just freeing its people from slavery (The *Lei Áurea*, Golden law, had been signed by Princess Isabel in 1888) and had been a Republic (1889) for less than 15 years, Buenos Aires was one of the most luxurious cities in the World and its inhabitants used to bring architects from Europe to build overwhelmingly beautiful and sophisticated mansions.

After 1870, Argentinean President Domingo Sarmiento, nicknamed the 'school teacher president' had pushed forward a plan for free public education which lowered the level of illiteracy to around 13% in 1910's, a level achieved by Brazil only in the 1990's.

Of course this achievement led to a huge cultural disparity. According to the Brazilian magazine Veja, the assimilation of the European culture has made possible the birth of great writers in Argentina, like Jorge Luis Borges, Julio Cortázar and Adolfo Bioy Casares. The Agentineans have won five Nobel prizes. The number of newspapers per inhabitant is three times as high in Argentina as it is in Brazil, 123 newspapers for every one million inhabitants as against 40 for an equivalent number of Brazilians.

From its heyday in the beginning of the XXth Century, Argentina embarked on a huge downslide. By the 1970's Buenos Aires already looked more like Ciudad de Mexico than like Paris (Veja, 3/29/2000). Poverty surrounded the mansions of the rich ranchers almost the same way as the *'favelas'* surrounded the famous beaches of Ipanema and Copacabana in Rio de

Janeiro.

The early XXth Century dependency on exporting primary goods to the Northern European countries proved fatal to Argentinean economy. The depression of the 1930's and World War II led to British withdrawal of a bulk part of its investments in the country. The prices of the kind of commodities (foodstuffs and raw material) that were Argentina's specialty had fallen with the entrance of new exporters in the global market and the lack of demand for those goods. This was followed by a series of populist governments since Juán Domingo Perón and later his wife Eva Perón (Evita) and military dictatorships that prevailed until the 1980's have transformed the country in a highly state-run economy, inefficient, with no incentives to encourage investment, and falling behind the technological changes that were happening all around the developed World.

Figure 1 - Map of Argentina

Source: National Geographic Society

Brazil's situation was developing in a different direction. In the beginning of he century Brazil was a primary agrarian exporter economy, relying on sugar, coffee and cocoa, with virtually no industries and extremely poor infra-structure.

Figure 2 - Map of Brazil

Source: National Geographic Society

Brazil suffered the effects of the depression of the 1930's especially because its economy was in large part dependant on the export of coffee and the price of all commodities went down with the drop in demand. The Brazilian government took the controversial decision of burning excess coffee stocks to reduce the supply of the product and of devaluating its currency and subsidizing the coffee growers, so as to better remunerate the exporters and allow them to keep planting and harvesting.

The Depression led to an incipient process of substitution of importations that ironically favored Brazil with early recovery of the recession that engulfed the rest of the world. But politically the situation remained unstable and Brazil remained an agrarian country with the huge majority of its population living in rural areas with little, if any, access to basic infra-structure such as electricity, potable water and a sewage system.

In the 1950's President Juscelino Kubitschek was elected on the promise of making the country grow '50 years in 5' and launched a series of Target Plans aimed at the development of the national industrial system, with a clear emphasis on the automotive sector.

A second wave of substitution of importations began and it was followed by a third, concomitantly with the Petroleum Crisis of the 1970's and early 1980's. That led to a level of industrialization that was unseen in Brazil's history. However, even if economic growth was achieved, the same cannot be said about social development.

Actually, the fall of Argentina and the relative increase in Brazil's importance in South

America are credited by many authors to a series of wrong choices made by the Argentineans. While in Brazil, the Baron of Rio Branco, Brazil's chancellor, started a process of approximation with the United States, counterbalancing British hegemony in the region, Argentina was heavily dependent on British investment and imports, which we have seen already, declined in the first half of the XX Century. That and Argentina's decision to remain neutral in World War II, which was crucial in its relationship with the United States, while Brazil, an ally who has even sent troops to Italy, was rewarded with large investments that made possible the construction of the Volta Redonda power plant, very important to President Kubitschek's industrialization drive.

The military governments that took the power in both Argentina and Brazil in the 1960's did not make them closer as it would be expected despite the fact that they were both right-winged movements and very similar outlooks and theories. Instead, an undisguised search for hegemony in the region was the main goal of each military government. According to Monteiro (1991, p.44) that hegemony would only be a figure of rhetoric, since the trade with the other countries in South America was insignificant.

The quest for supremacy was the root of a new phase of mistrust that would last until the War of the Falklands (Islas Malvinas to the Argentineans). During that war, the Brazilians refuse to lend their Airbases to the Royal Air Force and took on, if not a strong position in favor of its neighbor, the role of a concerned ex-European colony and fellow Latin American sate, accusing Britain of neo-imperialism.

Ironically the only other precedent of close relations between the Argentina and Brazil had also been due to a war. Between 1865 and 1870, Argentina, Brazil and Uruguay fought the “War of the Triple Alliance” against Solano Lopez’s Paraguay.

One of the main obstacles to a closer cooperation between Argentina and Brazil was overcome with the signature, in October 19th, 1979, of the Agreement for Technical and Operational Cooperation of Itaipú and Corpus, which helped to solve the impasse created with the building of those two large hydroeletrical plants. As a vivid example of how high the level of paranoia was prior to that occasion, was the fact that many of the less educated Argentinean living in Buenos Aires, the *‘porteños’*, were afraid of the construction of Itaipú because the rumor was that Brazil could flood Buenos Aires by simply opening its gates.

In May of 1980, president João Baptista Figeiredo (the last military president of Brazil) who had always been fond of Argentina, having lived there for a while as a child while his father was exiled from Brazil, paid a visit to Buenos Aires and that visit was reciprocated by one to Brazil by president Jorge Videla (the general that, with his colleague Leopoldo Galtieri, led Argentina into the disastrous War of the Falklands in 1982) in August of the same year. The two giants of the South Cone had realized they had a much larger communion of interests among the periphery countries than among those and the developed countries of the 1st. World (Monteiro, 1991, p.45), and that opened a new era of understanding between them.

VI – The creation and development of MERCOSUR

On July 6, 1990, the presidents of Brazil and Argentina, in a perfect timing, because it would coincide with the end of their terms in office, signed the Act of Buenos Aires. That Act provided for a Common Market between the two countries by the year of 1995.

Fernando Collor de Mello of Brazil and Carlos Menem of Argentina were very similar in many aspects. Both of them had been elected representing change, they both had portrayed the ‘anti-status quo’ candidates, the break from traditional ‘politics as usual’. As a part of that mentality of changing, they had plans to change the tradition of the two countries of being very closed economies.

None of their terms actually ended in 1995. Carlos Menem, supported by the success of the Plan of Economic Stabilization in Argentina had proposed and gotten passed through Congress a Constitutional Amendment permitting reelection, which prior to the amendment was forbidden. He was easily reelected and, in fact, he even thought of a new amendment allowing him to run for a third term, but a steady decrease in his approval rates in his second term has made him change his mind.

Fernando Collor de Mello also did not leave office in the end of 1994. He actually left earlier, in 1992, after being impeached for his involvement in a scandal of corruption and use of excesses of campaign funds to support a life style that the salary of the president could not afford.

One important policy of both men was the importance they gave to the cooperation between their two countries even though they were not the first to have sought its accomplishment . In 1986, Presidents Raúl Alfonsin, of Argentina, and José Sarney, of Brazil, had created the Argentine-Brazilian Program for Integration and Economic Cooperation, known as PICAB.

The PICAB was not important as economic or political stability was concerned, having little effect on the actual economic situation of Brazil and Argentina, but it "...did initiate the steady rise in total Argentine-Brazilian bilateral trade that continues to the present." (O'Keefe, 1997, p.4-2)

It is also important to note that the PICAB contributed to dissipate the mistrust and tension that had been a constant in the relationship between the two countries since they were both colonies. (op.cit. p.4-5)

In 1988, Argentina and Brazil signed the Treaty on Integration and Economic Cooperation and the road to MERCOSUR was paved and ready to be used by Menem and Collor de Mello. When MERCOSUR was actually launched, in 1990, it did not share with the earlier PICAB experience the gradualism that was its main characteristic. It did not have to. The situation was favorable to a process of integration and the countries did not want to waste any time. According to Lavagna, the factors that were of crucial importance in the decision of committing to an effective process of integration included:

> "i) the data showed that trade had increased a lot in the 1986/1990 period, being nearly 100% larger than it was in 1985...
>
> ii) ...the recognizing by the rest of the world that the Argentine-Brazilian experience had great potential,
>
> iii) the weakening of both governments in 1988 and 1989 and te inauguration of new governments,
>
> iv) the growing difference in the external policies that arise in 1990/91 and
>
> v) ...the differences between the monetary, currency, industrial and trade policies of the two major actors in the process of integration."(Lavagna, 1998, p.144)

With that in mind, Menem and Collor designed, with the Act of Buenos Aires, the "...broad, general guidelines for the establishment of this common market, to be known as the Common Market of the South."(O'Keefe, 1997, p.4-1) The Act of Buenos Aires was incorporated to the ALADI as the Economic Complementation Accord no. 14, ACE No.14.

Fear of being left aside in the new economic dynamic of the Southern Cone caused Paraguay and Uruguay to officially request to join the agreement and resulted in a new meeting, this time in the capital of Paraguay, Asunción. The formal creation of MERCOSUR happened in March 26th, 1991 and the Treaty was signed by Argentina, Brazil, Paraguay and Uruguay. After its approval by all the legislature of the member-states, the Treaty of Asunción was incorporated to the framework of ALADI, as ACE No.18. According to O'Keefe (1997, p.4-1) it not only included Paraguay and Uruguay on the Common Market "...but also expanded on ACE No.14 by filling in some of the legal and institutional gaps found in the earlier document."

Figure 3 - MERCOSUR

Source: MERCOSUR Trade and Investment Report

The economic situation of the members was not similar from the beginning and that fact has not changed very much. Table 7 shows some macroeconomic variables of the four member states in 1990.

Table 7

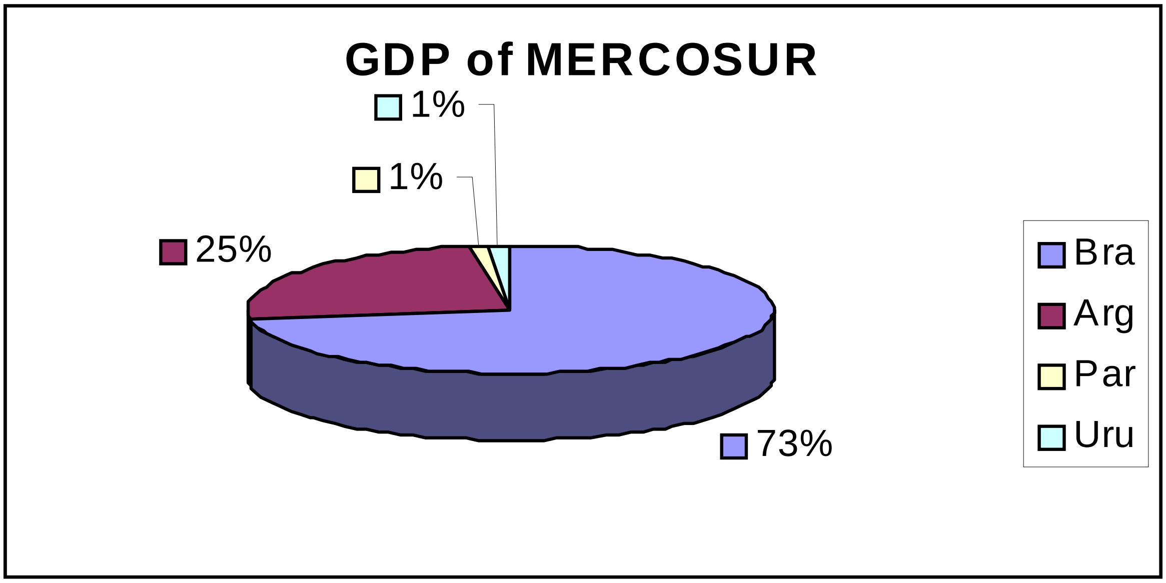
The members of MERCOSUR
(selected statistics)

	GDP (1,000 U$)	GDP/capita (U$)	Population (million inhabitants)	Unemployment %	Inflation %	Foreign Reserves (U$ million)
Argentina	141,352	4,343	32.6	6.3%	1,349.9%	6,010
Brazil	415,502	2,871	144.7	4.3%	2,937.7%	9,176
Paraguay	5,265	1,248	4.2	6.6%	38.1%	675
Uruguay	8,355	2,704	3.1	9.2%	112.3%	1,098

Source: Gobierno de Argentina

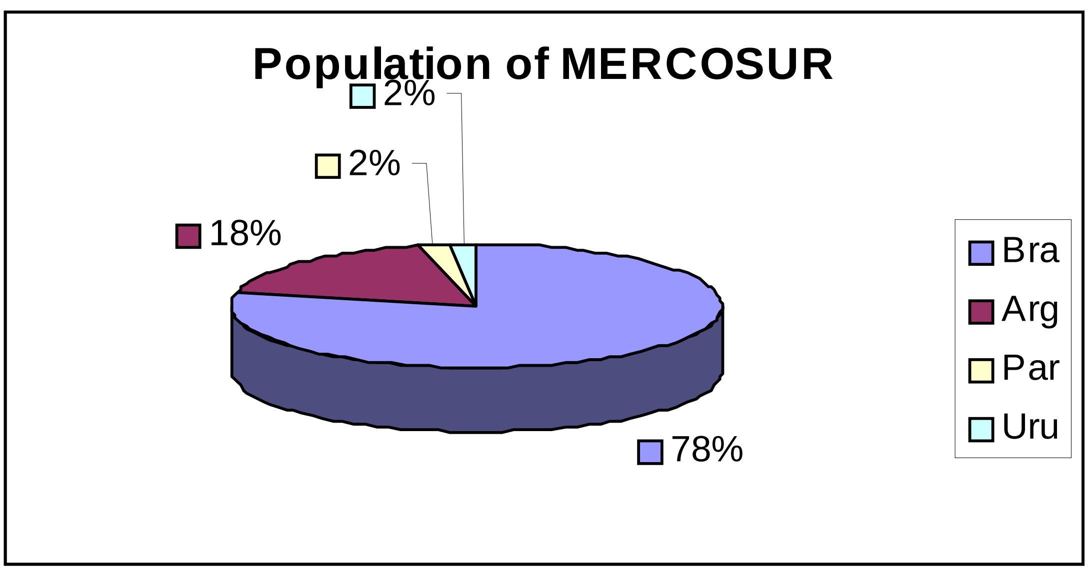
Argentina and Brazil were facing hyper inflation at the time and the Argentineans also suffered from a relatively high rate of unemployment. The GDP of both Paraguay and Uruguay were smaller than the GDP of some cities in their two larger and richer neighbors and partners. The disparity in the size of the members of MERCOSUR is better visualized in the following Graphics.

Graphic 2



Source: Gubierno de Argentina

Graphic 3



Source: Gubierno de Argentina

In the 1980,s Argentina, Brazil, Paraguay and Uruguay had just been through what became known as “The lost decade” years of inflation and very disappointing rates of growth in their GDP. They saw MECOSUR as a chance of giving some new energy for their economies and as an alternative to trying to face alone the challenges of gaining some importance in the international trade and financial market. In the words of The Economist’s Michael Reid these four nations had decided to abandon the “beggar-thy-neighbor” policies they had previously adopted and that change has made all the difference from what had happened before. Back in 1970’s the countries of MERCOSUR were all ruled by military dictatorships and looked at each other with suspicion and hostility. Now they were planning their future together.

The period of transition that started with the Treaty of Asunción established a gradual schedule for the reduction until zero percent of all the tariffs and the elimination of all the non-tariff barriers among the members. A list of exceptions was created for the so-called ‘sensitive’ products and those had different rules for their convergence a zero percent. Another measure adopted by the member-states was the creation of a series of work groups to analyze and foresee the effects of Integration on various sectors of their economies and design policies that should optimize those effects, if positive, were cushion them, if negative.

The original schedule for the reduction of tariffs was as follows:

Table 8

Lifting off the tariffs in the MERCOSUR

Date	Percentage
June, 30th, 1991	47%
December, 30th, 1991	54%
June, 30th, 1992	61%
December, 31st, 1992	68%
June, 30th, 1993	75%
Dec, 31st, 1993	82%
Dec, 31st, 1994	100%

Source: LIMA, José L.

The list of exceptions that was agreed upon listed 1,627 items, being 950 of Uruguay, 427 of Paraguay, 221 of Argentina and 29 of Brazil. The composition of the list varied from country to country but the Argentineans were careful on protecting their iron and steel products, which accounted for over 56% of their excluded items. Brazil's main concern was its textile sector, corresponding to over 50% of the items it chose to benefit with exceptions. Paraguayans decided to protect their textile and shoes industries, and assigned to them over 50% of the items they were given the right to declare 'sensitive'. Uruguay had more varied choices, and the composition of its list of exceptions was: 28% consisted of textiles, 11% of chemicals, 10% of foodstuffs, 8% of iron and steel and 4% of paper.

The reduction of tariffs had an immediate effect on the trade among the member-states, and that is shown on Table 9.

Table 9

Trade intra and extra-MERCOSUR (the first years)

(U$ million)

	1990	1991	1992	1993	1994	1995
Exports intra-MERCOSUR	4,127	5,103	7,214	10,065	12,049	14,441
Exports to the rest of the World	42,306	40,808	43,272	43,981	50,078	56,054
Imports from the rest of the World	23,263	27,231	31,575	37,119	48,092	61,736
Balance with the rest of the World	19,043	13,577	11,697	6,862	1,986	-5,682

Source: Secretaria Administrativa del MERCOSUR

It can be easily seen that, if MERCOSUR brought to its members an increase of 250% percent in the intra-regional trade, that was not in detriment of their imports from the rest of the World. MERCOSUR's imports rose 165%, what shows that the need of imported supplies of capital and intermediary goods remained. That shows that MERCOSUR had from the beginning a tendency of being a trade creating process rather than a trade diverting one.

In December 17th, 1994, the Protocol of Ouro Preto was signed reaffirming the principles and objectives of the Treaty of Asunción. Those objectives were clearly stated in the articles of the Treaty itself. Article 1 is a brief description of what the members are committing to achieve. Free movement of goods, services an factors of prodction so as to reach the objective of the complete elimination of tariffs and non-tariff barriers in the intra-regional trade. The Treaty also foresaw and left a door opened for the entrance of other ALADI members into the MERCOSUR, so long as there was a consensus upon that entrance by the four core members.

The Institutional Framework of MERCOSUR was composed of the following entities:

a) The Common Market Council;

b) The Common Market Group;

c) The MERCOSUR Trade Commission;

d) The Joint Parliamentary Commission;

e) The Social-economic Advisory Forum and

f) The MERCOSUR Administrative Secretariat.

The dispute resolution system, according to the Protocol of Brasilia, was to follow a certain order: first an attempt of negotiation among the disputants, second the matter would be taken to the Common Market Group and if that was not enough to settle the question, an 'ad-hoc' panel would be formed with the specific purpose of analyzing the matter in dispute, its decision being final.

In December, 31^{st}, 1994, the transition period established by the Treaty of Asunción ended and the Common External Tariff was adopted starting January 1^{st}, 1995. In the beginning the CET of MERCOSUR was representative of the members' greatest concerns and it included 85% of all tariff line items found on MERCOSUR's harmonized tariff schedule. According to Lima (1997) it was based on 11 tariff levels, ranging from 0% to 20% in intervals of 2 percentage points. It averaged altogether 6.22 percent, even though its weighted average is actually closer to 14%.

The adoption of the CET started MERCOSUR's 'real life'. The increasing trade among members and between them and the rest of the World raised new questions each day that were more frequent, more complex and more difficult to deal with. This is the stage that saw a dramatic increase in bi-lateral trade between Argentina and Brazil, which shall be examined more deeply in the next section.

Table 10

Bilateral trade – Argentinean Exports (up to 1995) (U$ million)

Exports from Argentina	1990	1991	1992	1993	1994	1995
To Brazil	1,423	1,489	1,671	2,814	3,655	5,484
To MERCOSUR	1,833	1,977	2,327	3,684	4,804	6,770
Total	12,353	11,978	12,235	13,118	15,839	20,963

Source: Gobierno de Argentina

Table 10b

Bilateral trade – Brazilian Exports (up to 1995) (U$ million)

Exports from Brazil	1990	1991	1992	1993	1994	1995
To Argentina	645	1,476	3,040	3,659	4,136	4,041
To MERCOSUR	1,320	2,309	4,097	5,395	5,921	6,154
Total	31,413	31,622	35,976	38,597	43,558	46,306

Source: Ministério da Indústria e Comércio, Brasil.

VII- ARGENTINA, BRAZIL AND THE MERCOSUR AFTER 1995

It is undeniable that Argentina and Brazil are different countries today, comparing to what they were 15 years ago, in the beginning of the ‘Lost Decade’ . In this section it is my intention to show data that will back up this affirmation and try to forecast some consequences on the economies of the two countries, due to the instability of the rest of the economic World.

Argentina’s and Brazil’s greatest asset is also one of their greatest burdens. The countries are very large. Together, the area of the two represent over 63% of the area of South America and over 95% of the area of MERCOSUR. And all that area is not homogenous.

Argentina has a total area of 2,766,890 Square Km. Its boundaries reach 9,665 km an its neighbors are: Bolivia (832 km), Brazil (1,224 km), Chile (5,150 km), Paraguay (1,880 km) and Uruguay (579 km). The Argentinean coastline has 4,989 km. It spreads itself from latitude 60° South to latitude 20° South, being crossed by the Antarctic Polar Circle and by The Tropic of Capricorn. That has, logically, influence on its climate: it is mostly temperate, but it is arid in the southeast and subantarctic in southwest.

Argentinean terrain is also varied: rich plains of the Pampas in northern half, flat to rolling plateau of Patagonia in south, rugged Andes along western border. The lowest point is the Salinas Chicas, -40 m (located on Peninsula Valdes) and the highest point is the Cerro Aconcagua, with 6,962 m.

Argentina has a lot of natural resources: The plains of the pampas are very fertile, and its mineral assets include lead, zinc, tin, copper, iron ore, manganese, petroleum and uranium.

As for natural hazards, Argentineans are subject to earthquakes in the areas of San Miguel de Tucuman and Mendoza, in the Andes. the Pampas and northeast can be struck bu *pamperos* which are violent windstorms with heavy flooding.

Brazil, on its side, has even more impressive numbers: Its area covers 8,511,965 Square Km, and it is larger than the continental United States. Its boundaries are as long as 14,691 km and it borders every country in South America but two: Chile and Ecuador.

Brazilian neighbors are Argentina (1,224 km), Bolivia (3,400 km), Colombia (1,643km), French Guiana (673 km), Guyana (1,119 km), Paraguay (1,290 km), Peru (1,560km), Suriname (597 km), Uruguay (985 km), and Venezuela (2,200 km).

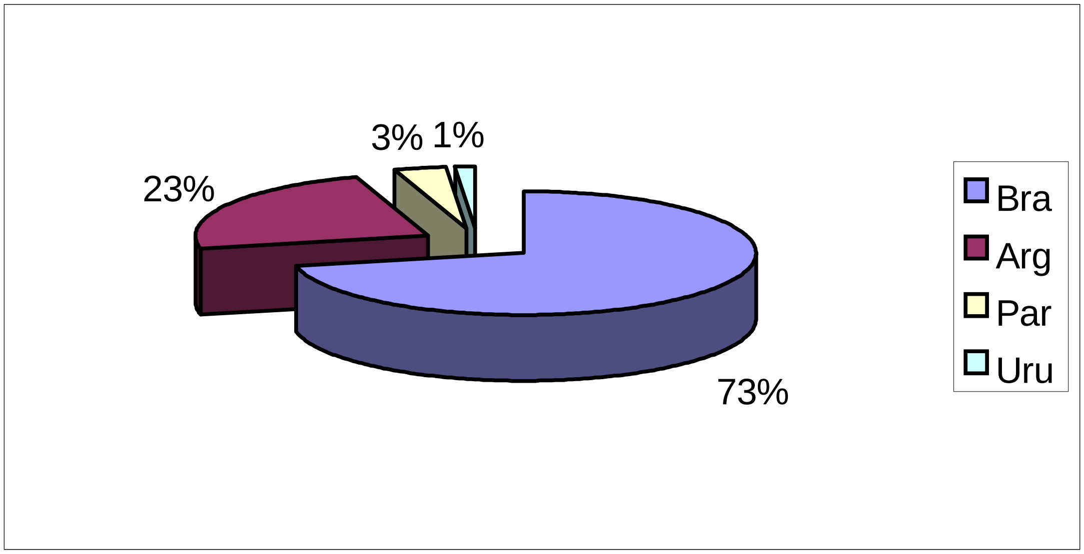
The total coastline of Brazil reaches 7,491 Km. Arroio Chui, Brazil's southernmost point is located at a latitude of 35° South while Arroio Oiapoque, the northernmost point is located in the northern hemisphere, at 7° North.

Brazil has four different time zones and completely different climate and terrain from one region to the other. The South has a temperate climate, and high 'plateaux' where it even snows sometimes. The southeast has a tropical climate. The Northeast faces temperatures that never fall below the 80 degrees Farenheit and some areas are dry as the Saharan desert. The Amazon is an area that is larger than most of the countries in the World. It has an Equatorial weather and it is completely covered by the Amazon Forest. The natural hazards include recurring droughts in the Northeast and floods and occasional frost in the South. Brazil does not suffer from earthquakes, hurricanes or other natural catastrophes.

Brazil's natural resources include bauxite, gold, iron ore, manganese, nickel, phosphates, platinum, tin, uranium, petroleum, hydropower and timber.

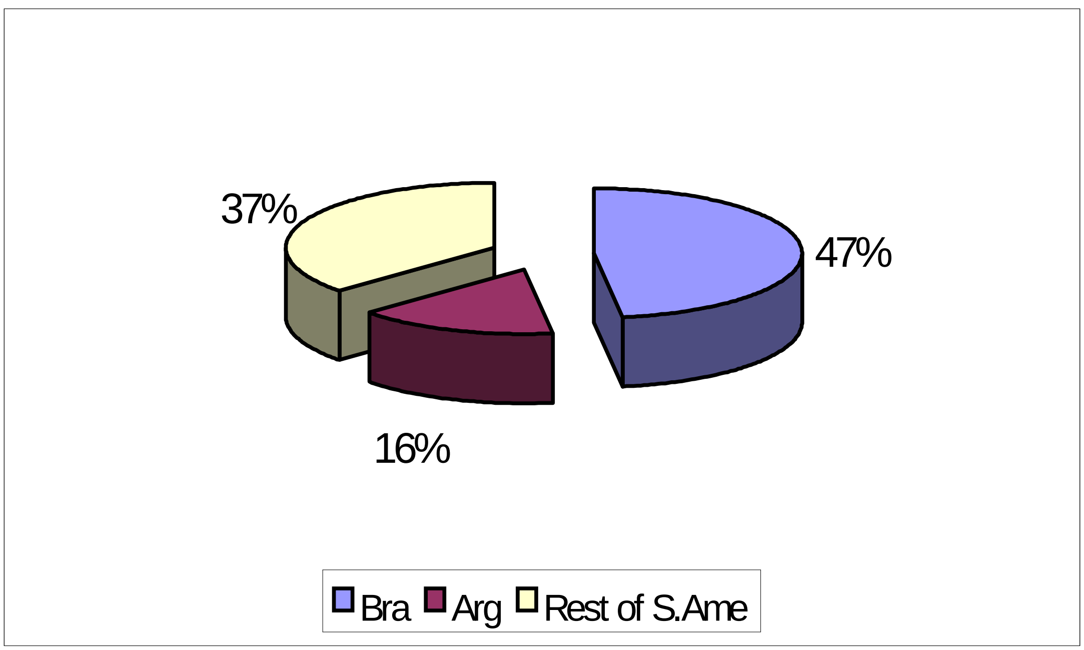
Graphics 4 and 5 show the proportion of the Area of the two countries in relation to that of MERCOSUR and also to that of South America.

Graphic 4 **Area of MERCOSUR members**



Source: National Geographic Society

Graphic 5- **Comparison with the rest of South America**



Source: National Geographic Society

Both Argentina and brazil had comparative advantages of their own to face a new structure of bilateral trade. If Argentina has a higher rate of literacy (96,2% as compared with the 86% of its neighbor to the north) Brazil has a much larger market, being the 9th largest economy of the world.

The corporations and businesses of both countries realized the benefits they could have from the new openness of the market and many of them soon crossed the border. Argentinean cars were being exported to Brazil, but most of their parts were of Brazilian manufacturing. Brazilian foodstuffs were being exported to Argentina, some them using in their making, Argentinean dairy products and wheat. The following table shows the increase of the bilateral trade among the two partners.

Table 11- Argentinean exports to Brazil, to MERCOSUR and total (U$ million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
To Brazil	1423	1489	1671	2814	3655	5484	6615	8127	7946
To MERCOSUR	1833	1977	2327	3684	4804	6770	7916	9558	9411
Total	12353	11978	12235	13118	15839	20963	26430	26434	26434

Source: Gobierno de Argentina

Graphic 6

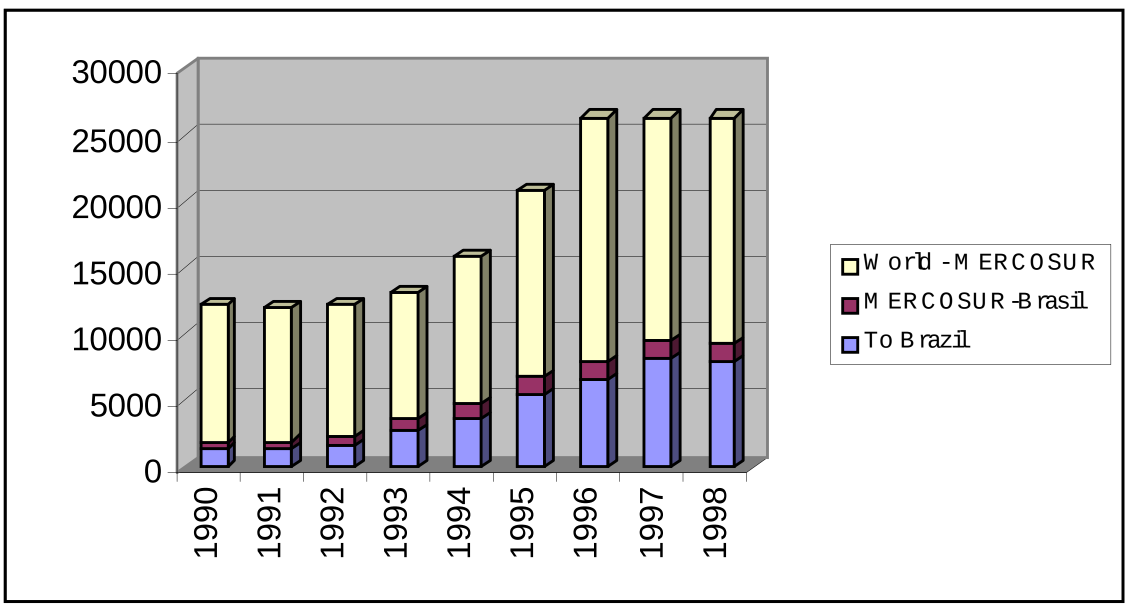
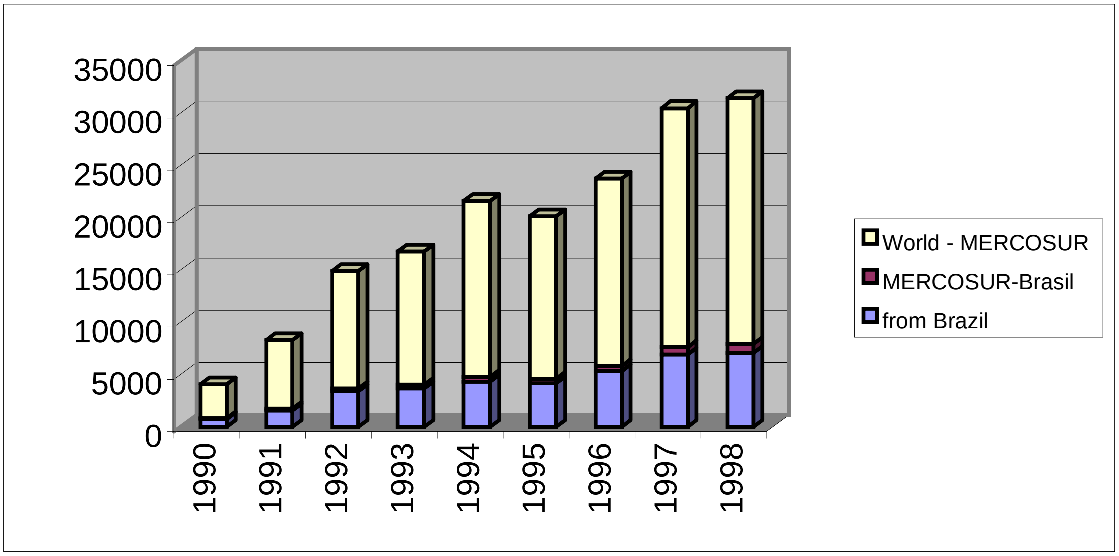


Table 12- Argentinean imports from Brazil, from MERCOSUR and total. (U$ million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
From Brazil	715	1532	3367	3664	4325	4175	5326	6914	7051
From MERCOSUR	833	1738	3676	4029	4784	4594	5800	7604	7927
Total	4077	8275	14872	16784	21590	20122	23728	30450	31405

Source: Gobierno de Argentina

Graphic 7



The importance of MERCOSUR and especially of Brazil in the External trade of Argentina is easily seen in the above Graphics and Tables. The fact that Argentina pegged its currency to the United States dollar in the beginning of the decade had immediate effect on its imports and that together with the opening of the economy and lower import duties have made imports soar from roughly 715 million US dollars in 1990 to 10 times that much in 1998.

Even though Argentine exports suffered in the beginning, the arrival of imported capital goods and intermediate products (parts and supplies) were successful in making the exporting sector of Argentinean economy more competitive and catch up a little bit after 1995. Not coincidentally 1995 is the first year of Brazilian experience with a crawling currency peg, since the Real did not have its value fixed to the dollar as in Argentina.

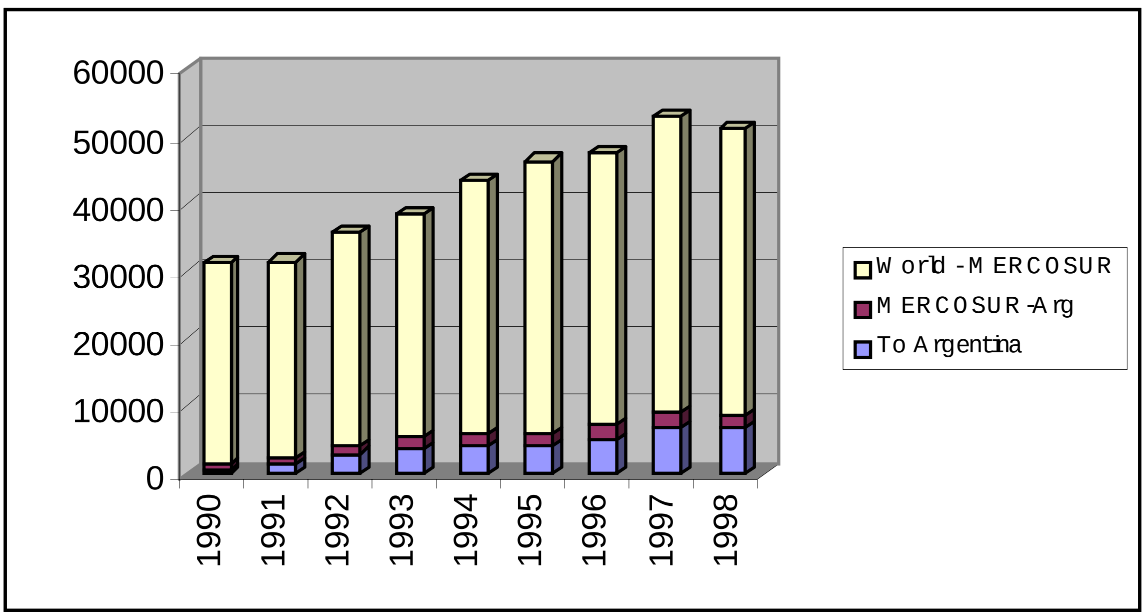
Actually in the first two years, the Real was worth, in nominal value, even more than the US dollar. That had its effect on Brazil's exports and imports, as shown in the following Charts.

Table 13- Brazilian exports to Argentina, to MERCOSUR and total. (U$ million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
To Argentina	645	1476	3040	3659	4136	4041	5170	6767	6747
To MERCOSUR	1320	2309	4097	5395	5921	6154	7305	9043	8877
Total	31413	31622	35976	38597	43558	46506	47747	52986	51120

Source: Ministério da Indústrua e Comércio/Brasil

Graphic 8



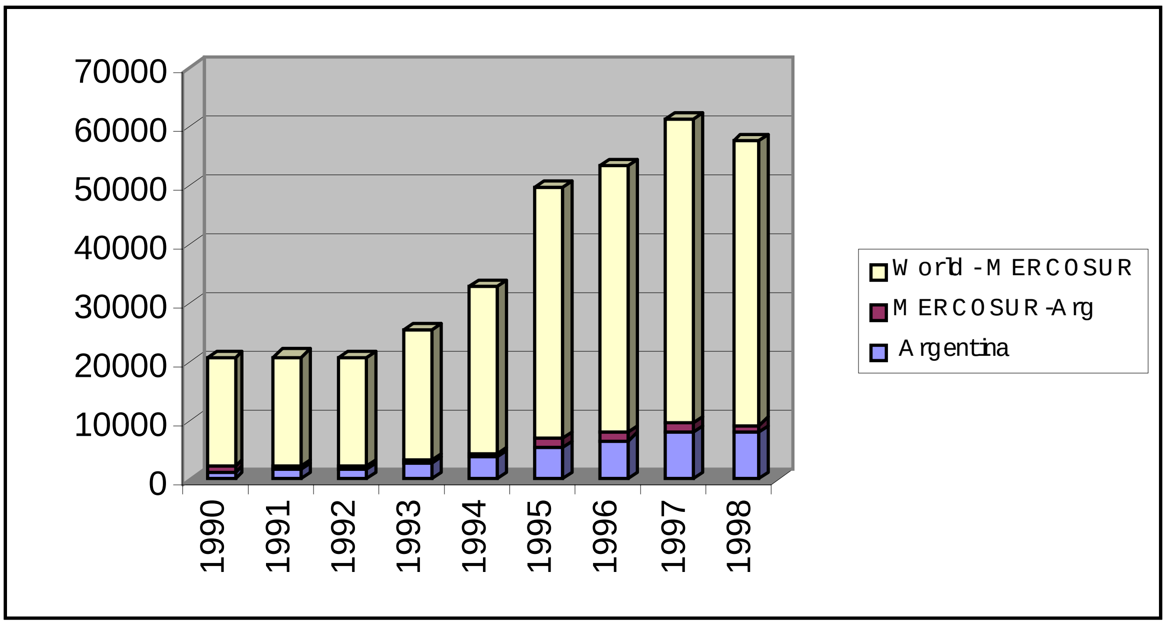
Brazilian imports were dramatically affected by the establishment of the 'moeda forte' the strong currency, Real.

Table 14- Brazilian imports from Argentina, from MERCOSUR and total. (U$ million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
From Argentina	1400	1614	1721	2646	3661	5570	6775	8111	8028
From MERCOSUR	2306	2267	2248	3352	4581	6821	8257	9618	9425
Total	20536	21041	20554	25460	33078	49583	53286	61347	57549

Source: Ministério da Indústrua e Comércio/Brasil

Graphic 9



Brazil had been through the 1970's and the 1980's a country that had based its own economic survival in a process of Substitution of Imports. That was a fixed idea in the mind of Brazilian government and business men. In the 1970's all Brazilians grew used with the slogan "To export is what imports" a game with words to emphasize the exporting vocation of a country struggling to repay the huge debt it knowingly fell into when it decided to finance its growth, despite of the high oil prices, by borrowing overseas.

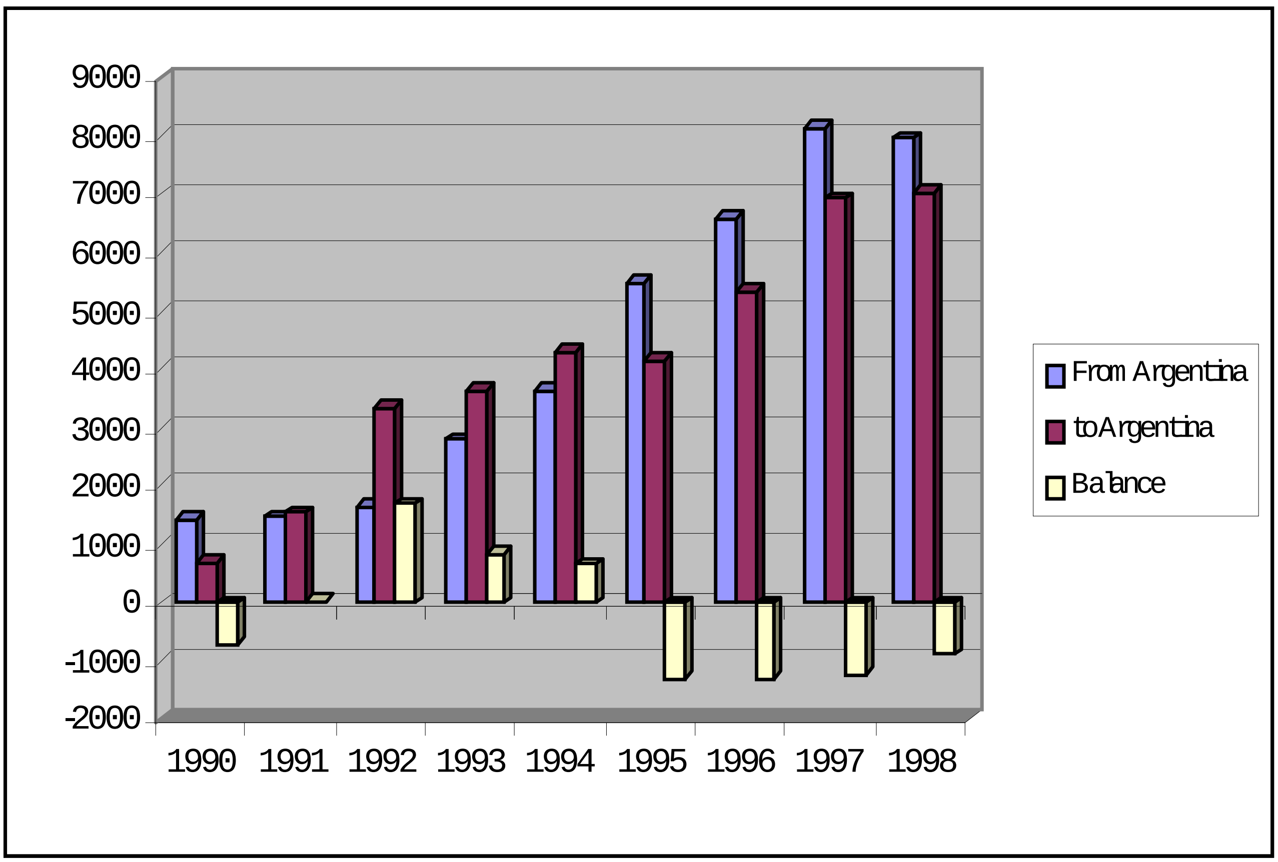
The Real changed that situation since it became overvalued from the beginning and MERCOSUR helped. The constant surpluses in Brazilian Foreign Trade Balance were replaced with growing deficits. The following table shows the bilateral trade between Brazil and Argentina, and the effects of the economic changes both eperienced in the 1990's.

Table 15- Brazilian Trade to Argentina (U$ million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
From Argentina	1423	1489	1671	2814	3655	5484	6615	8127	7946
to Argentina	715	1532	3367	3664	4325	4175	5326	6914	7051
Balance	-708	43	1696	850	670	-1309	-1289	-1213	-895

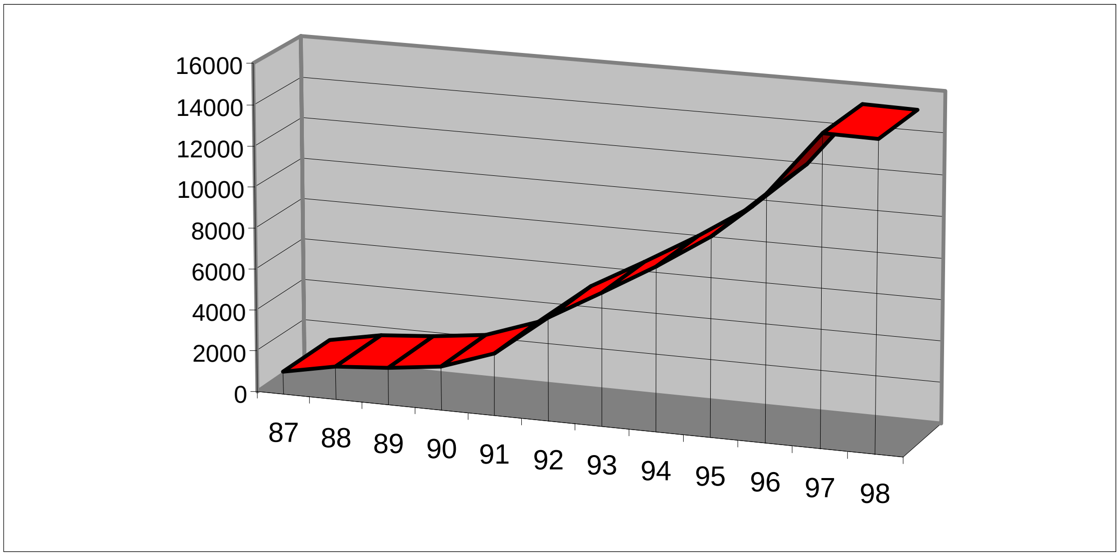
Source: Gobierno de Argentina and SECEX/MIC/Brasil

Graphic 10



The total amount of trade between Argentina and Brazil soared after years of stagnation. It had never reached the level of U$ 2 billion before 1990, and by 1998 it amounted nearly 15 billion dollars.

Graphic 11 - The growth of the bilateral trade – Argentina x Brazil (U$ million)



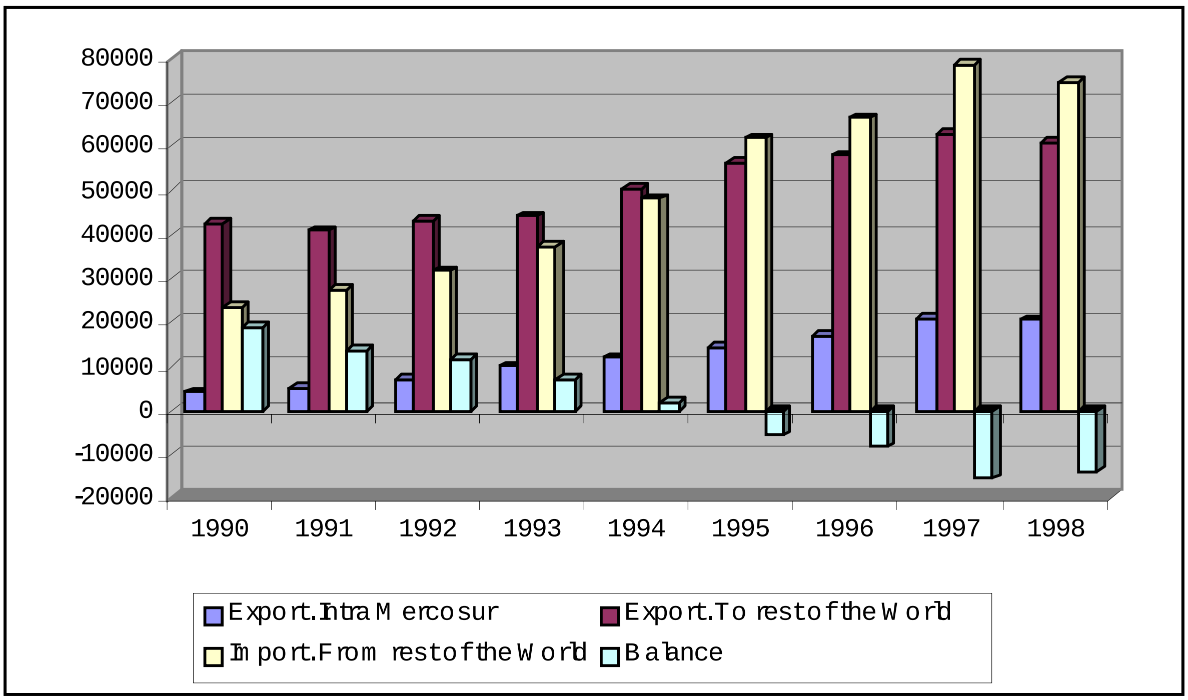
Source: Gobierno de Argentina and SECEX/MIC/Brasil

As was mentioned earlier in this paper, trade creation occurs when domestic production of one member nation is replaced by lower-cost imports from another member nation, while trade diversion happens when the lower-cost imports of a non member nation are substituted by high-cost imports from a member nation.

While trade creation produces efficiency gains, with the eventual specialization of member countries in products for which they have a comparative advantage, trade diversion (preventing imports from nonmember by tariff or nontariff barriers) is a way of perpetuating inefficiency and diminishing economic well being since it shifts production from the more capable producer from outside the area of the agreement to the less capable ones inside.

It is a commonly accepted opinion among most economists and analysts that MERCOSUR has created trade and that is corroborated by the data shown in Tables 13, 14 and Graphic.

Graphic 12- Trade intra and extra MERCOSUR



Source: Secreataria Administrativa del MERCOSUR

Even though trade intra-MERCOSUR has experienced a very accentuated climb over the 1990's that did not happen to the detriment of imports from the rest of the World. Actually from being a net exporter until 1994, MERCOSUR has become a net importer after that year.

That is due mainly to the creation of Brazil's currency, the real, which, being overvalued through most of the second half of the decade has really hurt the trade balance of the biggest exporter and importer in the region.

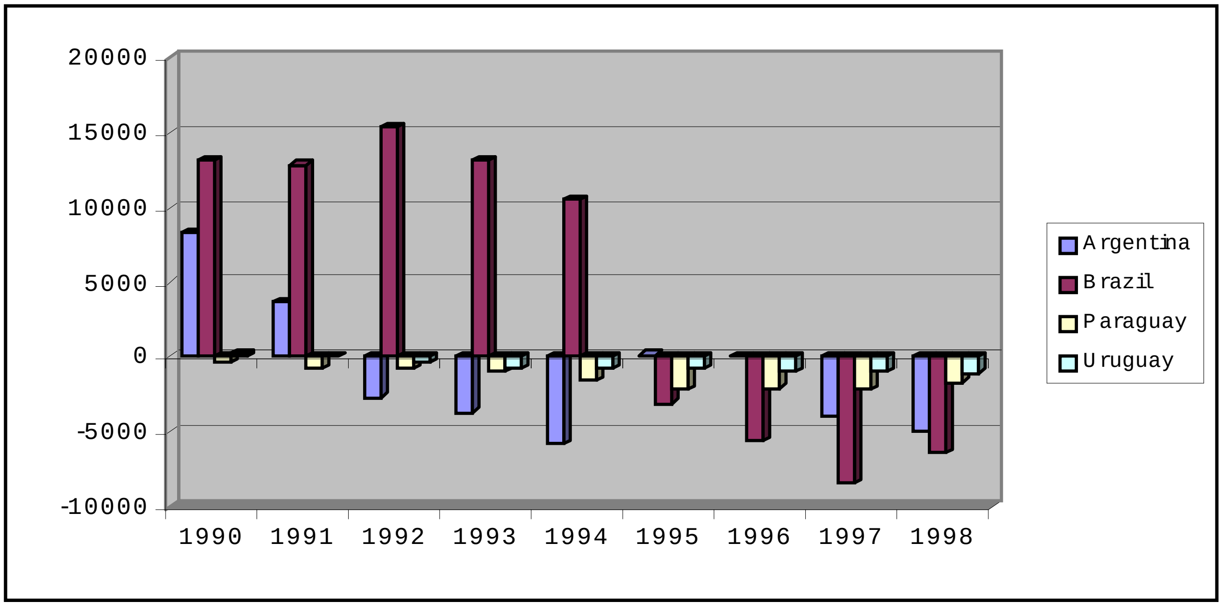
But all the member countries of MERCOSUR have become net importers. That was due to the openness of their markets to their partners and to the World and also to the fall in the prices of commodities, of which all of them are traditional producers, such as beef, wheat, coffee, sugar and rice, among others but one of the reasons was the change in the composition of their production and exports.

The fours countries, especially Brazil, have increased the production of manufactured and value added goods, for which, prior to the adoption of free market policies they could not make, because they did not have either enough capital goods to produce them, or did not have access to the intermediate goods that were necessary for their manufacturing.

More than importing consumption goods in a post-Real euphoria, Brazil's trade deficits were also due to the imports of machinery (especially from Italy) as well as parts and components.

Graphic 13 shows that the deterioration of the Trade Balance was not happening only in Brazil. Actually Argentina was the first to experiment that effect, due to its early adoption of the Dollar-pegged system for the Peso, in 1992.

Graphic 13- MERCOSUR members – Trade balances



Source: Secretaria Administrativa del MERCOSUR

Actually, despite of some protests in Argentina, the situation of the countries international trade has improved after the creation of Brazil's Real. The constant deficits Brazil has been facing in its bilateral trade with Argentina have compensated to some extent the difficult situation that Argentina has fallen into, since its products have lost most of their competitiveness in the international market. That situation is shown in Graphic 10.

But why do countries decide to create a Free Trade Area, or participate in any Process of Integration, for that matter?

Analyzing each of the commonly accepted reasons that lead to the aspiration of a Free Trade Area and what happen in MERCOSUR, I intend to show the viability and probability of success of that Process.

The first thing that has to be taken into consideration is the enlargement of their market, with the consequent creation of Economies of Scale. That has effectively happened in MERCOSUR, which became a giant occupying over 11 million square kilometers, with a population of 206 million inhabitants and a GDP that goes over 1 trillion dollars, what give us the very fair GDP per capita of U$5,000.

Another thing which countries that commit to integrate achieve is a stronger geo-political position that will give them more importance in their relations (commercial and political) with the rest of the World. MERCOSUR has been recognized as one example of a Integration Process that has a good chance of reaching its goals and has attracted the interest and the investments of Europe, Asia and the United States. It also attracted the interest of Chile and Bolivia, which became associate members.

Peter Hakim, of Inter –American Dialoque, a Washington based organization, argues that if Brazil were to grow at over 5% in GDP for three or four years in a row, the United States' interest in a deal with MERCOSUR would soar.(The Economist, Oct.12,1996)

Last but not least, it is expected that countries participating in an integration project will benefit from technological cooperation, lower prices and more competition. There is data showing that costs of intra-MERCOSUR trade are today 15% less expensive when it comes to transportation and handling costs, due to the proximity and large borders among the members. That situation tends to get even better since it has draw the attention to the necessity of building more roads and bridges between the four countries and the improvement in coastal navigation has become a common goal.

Rosson, Runge and Moulton, in an article called Preferential trade Agreements – Gainers and Losers from Regional Trading Blocs, published in Philip King's book of 1999 International Economics and International Economic Policy quote Luther Tweeten stating the integration will most likely lead to trade creation and increase economic well-being of the member nations under specific conditions:

"1- High pre-PTA barriers increase the probability that trade will be created among the members, rather than diverted from nonmembers to members.

2- The more countries included in the PTA and the larger their size, the more likely that low-cost producers will be found among member nations.

3- A PTA formed by competitive, rather than complementary, economies is more likely to produce opportunities for specialization in production and trade creation.

4- When member nations are in close proximity to one another, transportation costs become less of an obstacle to trade creation.

5- If the free trade area contains countries with the lowest cost source of goods and services consumed by member nations, trade diversion is less likely to occur."

(King, 1999, p.170)

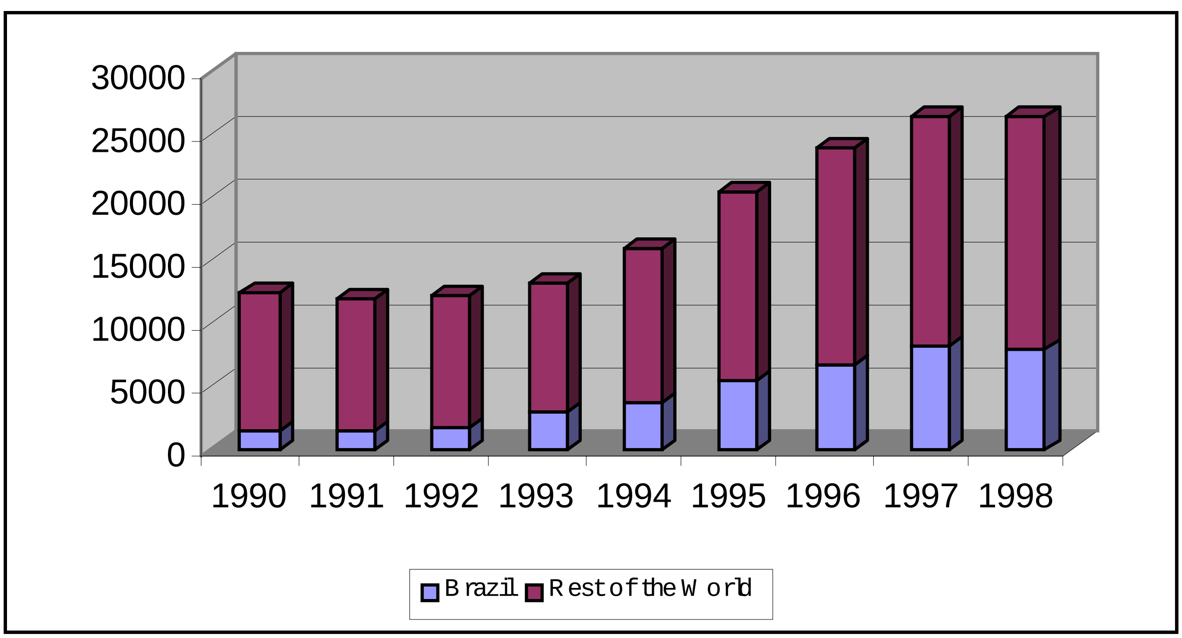
The authors also quote Dominick Salvatore saying that the benefits are expected to be greater over the long term. In fact it has been estimated that the long term gains of forming a Free Trade Area often exceed the short term gains by a factor or five or six. (Op. Cit. p.171)

What is it about MECOSUR then that is of benefit for both Argentina and Brazil? For Argentina the benefits are easy to see, when one analyzes the destination of Argentinean exports. Table 16 shows that Argentine exports to Brazil are now over 30% of the total exports of the country, which have also grown.

Table 16- Argentinean exports- total and to Brazil (U$ million)

Total	12353	11978	12235	13118	15839	20263	23760	26430
Brazil	1423	1489	1671	2814	3655	5484	6615	8127
Share	11,5%	12,4%	13,7%	21,5%	23,1%	27,1%	27,8%	30,7%

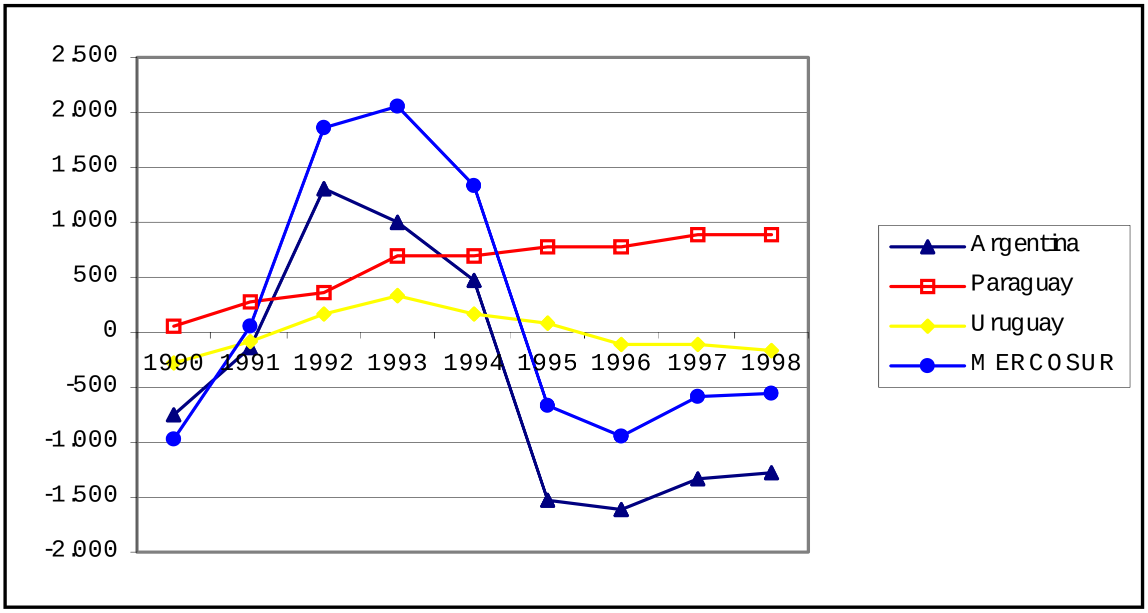
Graphic 14



Source: Gobierno de argentina

What does Brazil gain in being a part of MERCOSUR if it has had deficits in its trade balances with Argentina and Uruguay and its surplus in bilateral trade with Paraguay is not large enough to compensate that?

Graphic 15- Brazilian balance in the intra-MERCOSUR trade



Source: SECEX/Ministério da Indústria e Comércio/Brasil

Brazil has modernized and updated its production. From an essentially agrarian country at the beginning of the century until the 1970's, Brazilian industry has learned to diversify and meet requirements in its export markets. Table 17 gives us an idea of the composition of Brazilian exports in the last 7 years. Government and businessmen realized that there was no future in sticking to the commodities (the prices of the commodities that Brazil was specialized in having gone down through the whole decade), and that they should produce goods with more value added. Programs were launched with that objective but as far as exporting to the rest of the World, there were no significant results.

Table 17-   Composition of Brazilian exports

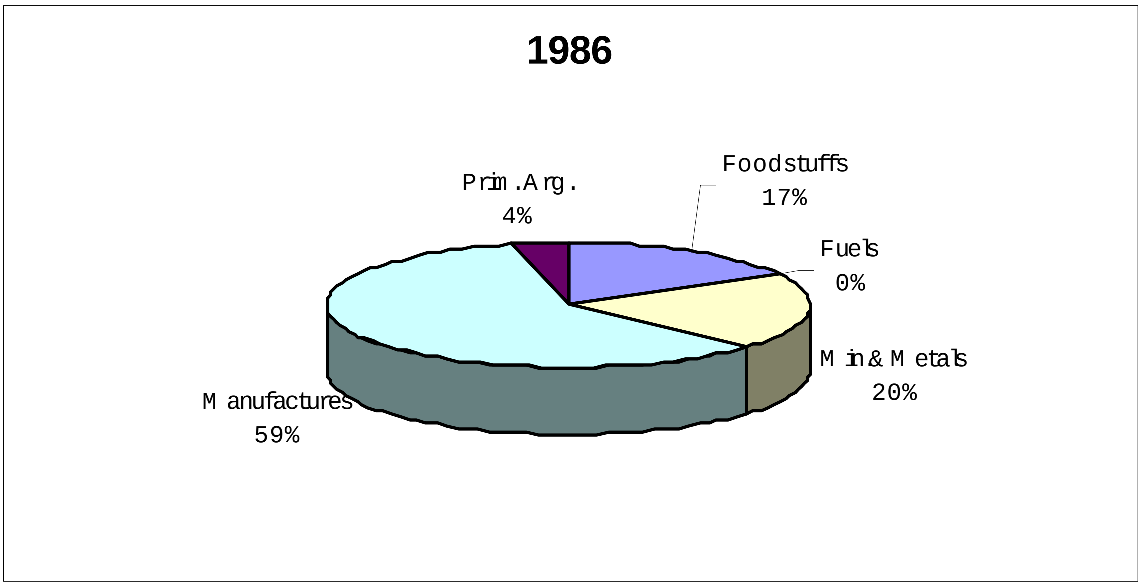
	Commod.	Semi-manuf.	Manufactured	Special	Total
1st quarter 93	1.947	1.475	5.934	59	9.415
2nd quarter 93	2.654	1.248	5.411	57	9.371
3rd quarter 93	2.720	1.417	5.555	82	9.773
4th quarter 93	2.252	1.426	6.245	116	10.038
Total 1993	**9.573**	**5.565**	**23.145**	**314**	**38.597**
1st quarter 94	1.829	1.316	5.614	117	8.876
2nd quarter 94	3.067	1.706	6.275	177	11.225
3rd quarter 94	3.345	1.971	6.695	184	12.195
4th quarter 94	2.817	1.900	6.388	157	11.262
Total 1994	**11.058**	**6.893**	**24.972**	**635**	**43.558**
1st quarter 95	2.133	1.720	5.720	158	9.731
2nd quarter 95	3.125	2.183	6.119	291	11.718
3rd quarter 95	3.068	2.700	6.756	205	12.729
4th quarter 95	2.643	2.643	6.870	172	12.328
Total 1995	**10.969**	**9.246**	**25.465**	**826**	**46.506**
1st quarter 96	2.085	1.887	6.073	257	10.302
2nd quarter 96	3.639	2.100	6.688	210	12.637
3rd quarter 96	3.537	2.339	6.879	164	12.919
4th quarter 96	2.923	2.047	6.730	189	11.889
Total 1996	**12.184**	**8.373**	**26.370**	**820**	**47.747**
1st quarter 97	2.591	1.849	6.005	212	10.657
2nd quarter 97	4.928	2.067	6.930	205	14.130
3rd quarter 97	4.265	2.366	8.049	218	14.898
4th quarter 97	2.69	2.196	8.206	209	13.301
Total 1997	**14.474**	**8.478**	**29.190**	**844**	**52.986**
1st quarter 98	2.551	2.035	7.142	173	11.901
2nd quarter 98	4.146	2.084	7.640	196	14.066
3rd quarter 98	3.686	2.067	7.592	148	13.493
4th quarter 98	2.587	1.928	7.006	139	11.66
Total 1998	**12.97**	**8.114**	**29.380**	**656**	**51.120**
1st quarter 99	2.269	1.778	5.801	194	10.042
2do. trim 99	3.433	1.947	6.807	217	12.404
3er. trim 99	3.297	1.978	7.092	214	12.581

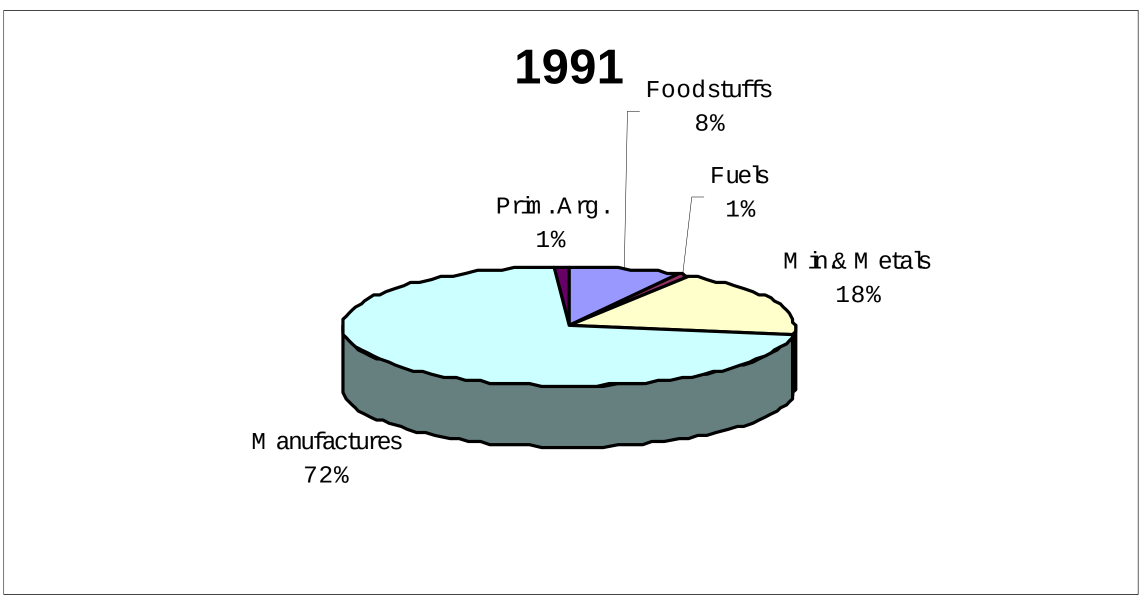
Source: SECEX/MIC/Governo do Brasil

The data goes up to the 3rd quarter of 1999 shows us that Brazil has struggled to change its profile from a agrarian exporter to a leader in manufactured and semi-manufactured goods exportation in Latin America.

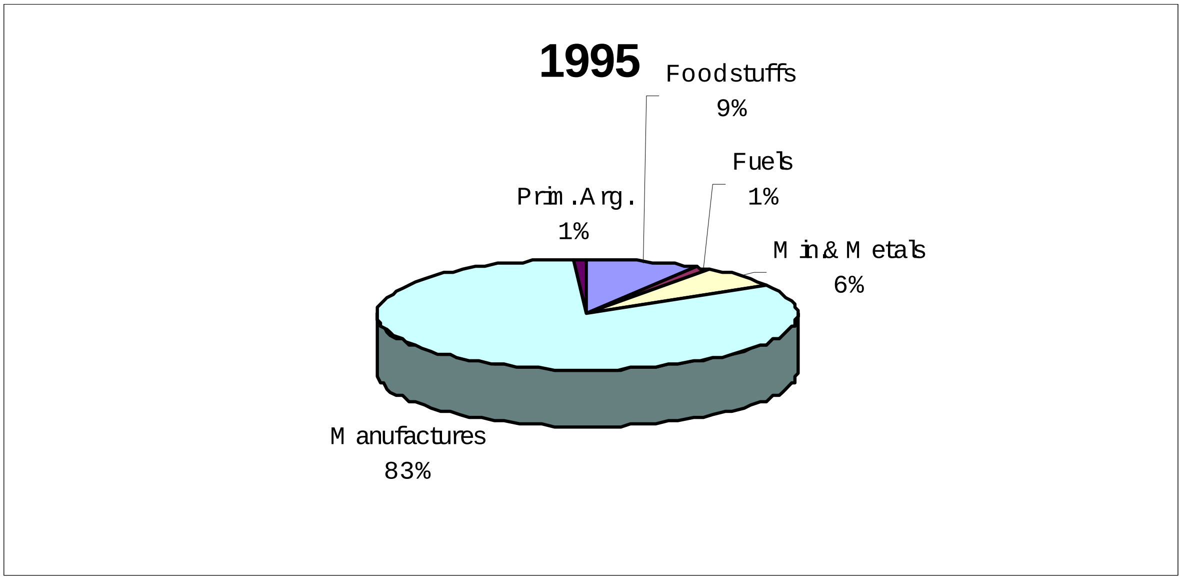
That was achieved within MERCOSUR. The composition of Brazilian exports to Argentina show a clear change in the pattern.

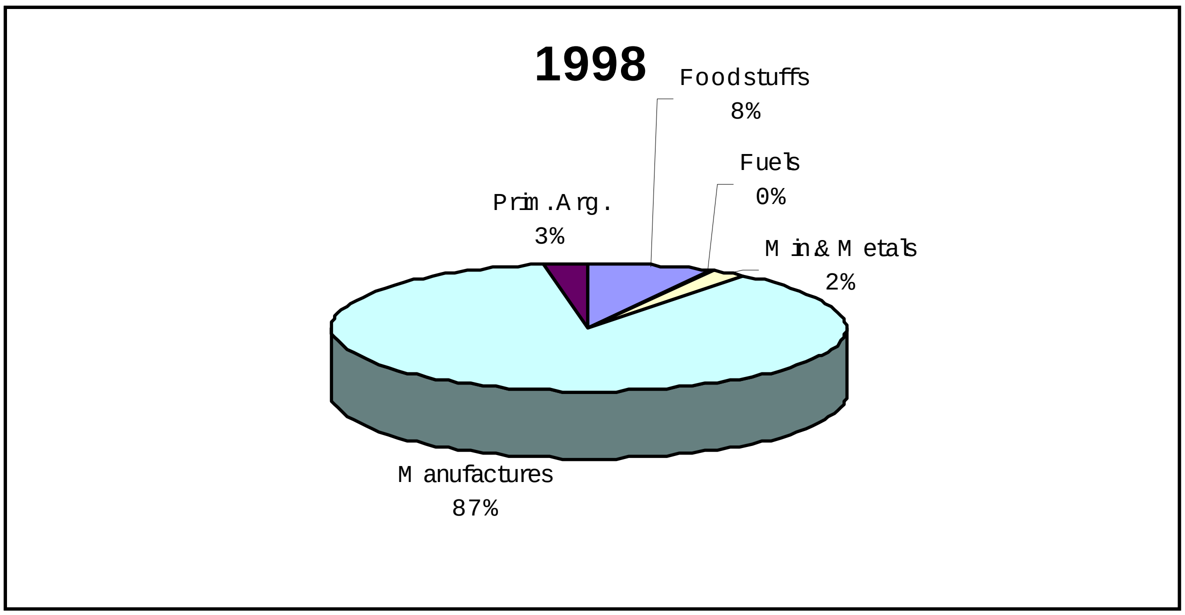
Graphic 16- Composition of Brazilian exports to Argentina





Graphic 16b- Composition of Brazilian exports to Argentina



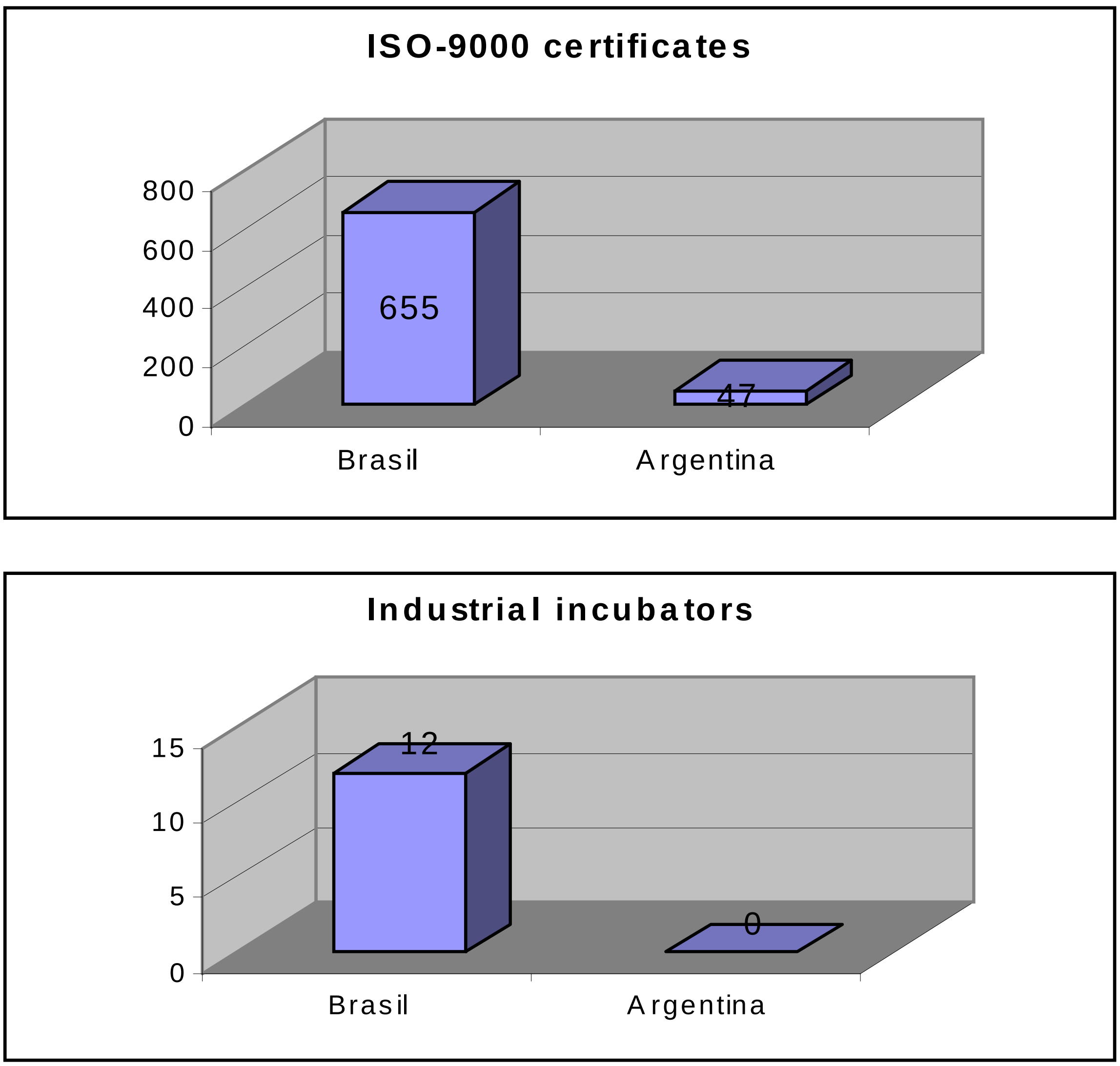


Source: O'Keefe (1997) and ECLAC

Manufactured goods corresponded in 1998 to nearly 90% of all Brazilian exports to Argentina. This growth in manufactured exports from Brazil was due to a commitment of Brazilian industries to improve the competitiveness of their products and was helped by the fact that, while the Brazilian currency, the Real was devaluating (slowly, but steadily) vis-a-vis with the United States Dollar, Argentinean currency, the Peso, had its value pegged to the American currency in a 1 to 1 rate.

The next Graphic (17) shows us what might have been one of the causes for the differentiation one sees in the exports of the two countries.

Graphic 17- Improvement in Industrialization (data of 1993)



Source: Lavagna (1998)

Brazil has been preparing itself for a much needed change in its way of doing business with the rest of the World. That will help explain why the country did not collapse after it was forced to undergo a devaluation of its currency in January of 1999, that took its currency from the level of R$ 1,12 per U$ to nearly R$ 2,20 per U$, in a process overshooting that has made many a good economist forecast Brazils economic doom. I intend to analyze the devaluation and its effects a little deeper towards the end of this Chapter.

7.1- The resistance to MERCOSUR

Heckscher and Olin developed a concept that labor abundant markets will be prone to export goods that are labor intensive. But the opposite is also true. Countries that are not labor abundant will experience a decrease in the domestic production of labor intensive goods, relying on the comparative advantages of importing from countries that have an abundance of that factor.

Stölper and Samuelson add that a fall in the demand for a factor will lower the real income of that factor. That is the reason Unions and workers are usually against trade liberalization and opening of the markets through integration.

That is not true only in South America. A Time-Warner poll has shown that 56% of Americans oppose NAFTA.

In Brazil a similar poll questioning about the necessity of imposing barriers to Argentinean trade had the following results: 49% said Brazil should increase the restrictions, 33% answered Brazil should diminish its restrictions while 18% said they did not know. (Veja, 09/12/2000)

Luís Inácio “Lula” da Silva, leader of Brazilian *Partido dos Trabalhadores* (Workers Party) has been cautious about the subject. The fact that, even though Brazil has faced deficits in its bilateral trade with Argentina, the exports of manufactured goods to that country has increased has been a cushion to the fears of workers of the metropolitan areas of the big cities, where the great majority of PT voters reside.

The fear of huge layoffs in the area known as ABC (because of the cities of Santo André, São Bernardo and São Caetano, location of inumerous automobile and auto-parts industries), in the state of São Paulo is not as present as it used to be, since there was an increase in the production of auto parts and automobiles(especially to Argentina) and Brazilian stability (and state taxes exemptions) attracted a series of new industries, like Mercedes Benz, Renault, Peugeot, Honda and other, besides the construction of new plants by firms that were already in Brazil, like GM and Ford.

But in Argentina there is more discontentment with the situation of MECOSUR, especially after the devaluation of the Real in 1999.

7.2 - The devaluation of the Real and its effect on Argentina

In January of 1999, after loosing nearly U$ 40 billion in foreign reserves following a speculative attack to its currency, the Brazilian BACEN (Central Bank) had no alternative but to let the currency float. The idea of BACEN's Gustavo Franco was to keep the fluctuation under control for political and economic reasons. The stable Real had assured the reelection of President Cardoso in the First Round of the presidential election realized only three months before.

Franco's strategy was not accepted by the investors and in one single day Brazil lost over U$ 4 billion in foreign reserves, Franco was substituted by Francisco Lopes and BACEN tried to fix the upper edge of the band in R$1,32 per U$, when it had been R$ 1,12 until then. That was not enough to the international financial markets and the huge amount of money that kept flowing out of Brazil made the last attempts of controlling the devaluation of the currency futile. As a result, the Real was set loose for the first time since its adoption in 1994.

In the beginning it seemed like Brazil would go bankrupt. Overshooting took the Real to its lowest value ever. By the beginning of March, the exchange rate had reached its all time high of nearly R$ 2,3 per U$, nearly half of its value at the beginning of 1999. Dark predictions that the cost of the U$ would exceed 3 Reais, with inflation going over 50% and a recession that could be as tragic as a 6% drop in GDP were popping up everyday in the news.

Lopes was soon substituted by Armínio Fraga, an expert in the international markets and a former employee of mega-investor George Soros. The Real began its long and surprising resurrection, and ended the year at an exchange rate of R$ 1,80 per U$, signifying a devaluation of over 30% but much more mild than the drastic forecasts made in March of 1999.

Prior to the devaluation of the Real, Argentina had been exporting to Brazil over 30% of its total exports. It comes as no surprise then that the devaluation has hurt the Argentineans very profoundly. The situation was not worse because the higher value of the Dollar and consequently the rise in the price of imported intermediate and capital goods has kept Brazilian industries from taking advantage of the weakness of their own currency and what otherwise would be a new level of competitiveness of their products in the World market.

But Brazilian exporters spent most of 1999 figuring out a way of lowering costs, substituting foreign parts and components with domestic ones, and finding new suppliers that could offer better relation cost-benefit ratios.

As a result, industries that had plants in Argentina have begun a process of moving production to Brazil. Others that did not have plants in Brazil have started building new ones there. That has created a wave of xenophobia in Argentina that is reaching dangerous levels for the MERCOSUR and for Argentina itself.

Buenos Aires Province Governor, Carlos Ruckauf has echoed the protests heard on the streets. “Brazil is like a bad neighbor that comes into our home and steals our furniture”.(Veja, 03/29/2000)

The streets of Buenos Aires have been seeing more and more demonstrations where the sign “Made in Brazil, NO!” is frequently seen. Actually, a poll by El Clarín, Argentina’s largest newspaper, reveals that to 63% of the Argentineans, the transfer of industries to Brazil is the country’s biggest economic problem, even though less than 20 industries, mostly multi-nationals, have done that.

Osvaldo Rial, chairman of UIA (Argentinean Industrial Association) recently released a report noting that over 100 industries had closed their doors in Argentinean soil and moved to Brazil. “MERCOSUR as it is now is not good for us” he says. He did not reveal the name of the industries, arguing that the list was confidential.

In reality, most of the industries that have recently left Argentina already had plants in Brazil. A great number of them, like Goodyear and Pirelli are multi-nationals of the automotive and auto-parts sector.

In addition, it is a fact that Brazil is the only large market with whom Argentina maintains a trade surplus. Between 1995 and 1999, while having a deficit of over 32 billions of Dollars in its trade with the US, Europe and Japan, Argentina has exported to Brazil U$ 5 billion more than it has imported.

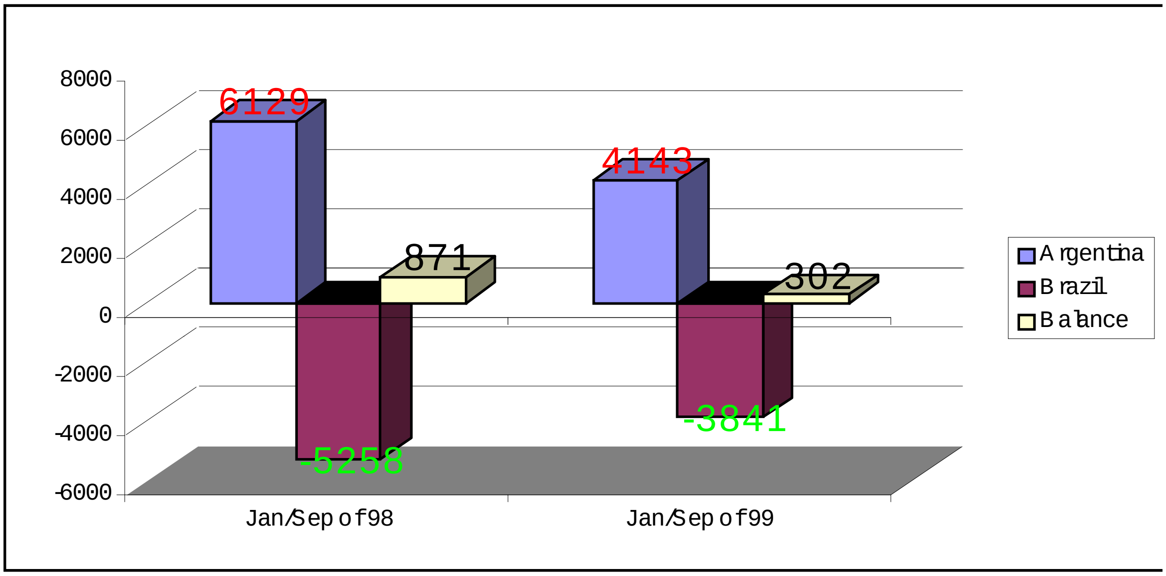
According to the Brazilian ambassador in Buenos Aires, Sebastião do Rêgo Barros, it is "both unfair and amazing that the Argentinean should blame Brazil, forgetting that their [international] competitiveness is less than mediocre". (Veja, 03/29/2000)

"The emptiness created by the apparent failure of MERCOSUR in 1999 has been occupied by opportunist politicians, incompetent business men and poorly competitive sectors" analyzes Roberto Lavagna, an expert in Integration, ex Secretary of Industry and Commerce in the Government of Raúl Alfonsín and the director of Ecolatina, which advises those interested in dealing with MERCOSUR.

To Rosendo Fraga, Argentinean economist "...to blame Brazil became a media and politics phenomenon, since it is easier to argue over that than to discuss the pegging of the Peso to the Dollar, which no one wants to talk about".

The following Graphic shows that the effects of the devaluation in 1999 were not as hard to Argentina as it had been expected, even though the predictions for 2000 are much less optimistic. 1999 saw more a shrinking of trade as a whole rather than a decrease in the Argentinean surplus with Brazil.

Graphic 18- Trade Argentina x Brazil in 1999



Source: Gobierno de Argentina

The question of the uncompetitiveness of the Argentinean currency has become the center of attention last year and that was accentuated by the prospect that the worst was yet to come. A common currency for the MERCOSUR, which had been thought about in 1987 and which had even been given a name, the Gaucho, a cowboy of the 'pampas' a typical figure from Argentina and also from the South of Brazil, has become, again, a matter worth discussing.

CONCLUSION

The discussion of whose economy, whether the Argentine or the Brazilian, has benefited most from MERCOSUR, can lead to misjudgments based on wrong assumptions. In the broad view to me it seems clear to me that, at the end of the day, MERCOSUR's effects will be positive, as it is usual to expect with a process of liberalizing trade and allowing efficiency to come out from the places it had been kept hidden.

The myth of an invasion of the Argentinean economy by low cost Brazilian products is not sustained by looking at the data showing constant Argentinean surpluses in its bilateral trade with Brazil over the last 10 years. Even after the devaluation of the Real in January of 1999 Argentina still exported more to Brazil than it imported. That might be reversed in 2000 but then the discussion should focus on the overvaluation of the Peso and the convenience of s pegging it to the US Dollar, which currently makes most of the Argentine production automatically expensive to its usual clients, will have to take place.

Brazil has not had surpluses with MERCOSUR and its not likely it will in the short run, so was MERCOSUR worse for Brazil? Not in my opinion. MERCOSUR has become a ‘bloc’ worthy of some consideration and Brazil has established beyond doubt its leadership within that ‘bloc’. In addition, Veiga says in Roett’s MERCOSUR that Brazilian exports to Argentina show a “pattern qualitatively superior to that observed for exports t the rest of the world.”(Roett, 1999)

In fact the everlasting competition of Argentina and Brazil for the hegemony within South America has come to a near ‘finale’ because Argentina have, deep inside, accepted the fact that, as the situation stands now, Brazil is the engine of South American growth, and they would do better integrating more with Brazil and getting the positive spillovers from a eventual Brazilian jump towards development rather than engaging in a hurting policy of “impoverishing the neighborhood’’.

The data shown on the previous sections of this paper describes a little over 10 years of the effects of the economic integration on the macroeconomic variables of Argentina and Brazil.

The intention of the paper was to show that none of the two countries can make the argument that MERCOSUR as a whole had been bad to it, even though that could have been said of some areas of their economies.

The fact is that most of the variables show effective improvements in Argentina as well as in Brazil. Both are better fit economically now than they were in the beginning of the 80's when military dictatorships in both countries have prevented an unavoidable closeness and cooperation that would have helped then to start the struggle towards development and economic well-being a lot earlier.

Table 18- Argentina and Brazil – then and now

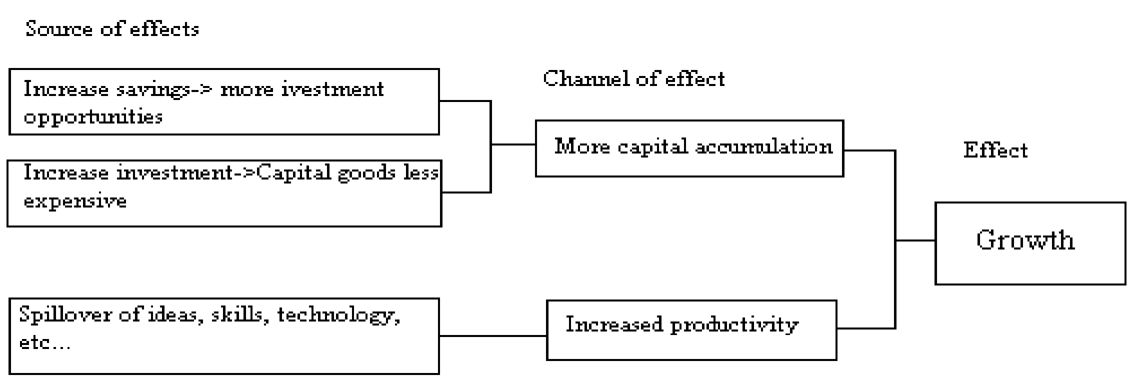
	Argentina			Brazil		
	1980	1990	1998	1980	1990	1998
GDP (U$ millions)	168,779	141,352	288,195	410,169	415,502	776,614
GDP per capita (U$)	5,888	4,343	7,978	2,735	2,715	4,809
Inflation (percentage)	104.5%	1,343.9%	0.7%	110.2%	2,937.7%	0.4%
Foreign Reserves (U$ millions)	6,013	6,010	26,941	6,912.6	9,176	44,523
Unemployment (percentage)	2.6%	7.5%	12.4%	6.3%	4.3%	7.6%
Literacy (percentage)	94.5%	95%	96.2%	77%	81%	85.1%
Life expectancy (years)	68.0	71.0	74.76	61.9	65.6	68.0

Source: World Bank

The advantages countries get from the enlargement of their markets are widely known. Among them I would cite:

1- More technical efficiency;
2- Better allocation of that efficiency;
3- Decrease of the indirect costs of intervention (rent seeking);
4- Possible dynamic effects, that will be seen ahead.

Graphic 19 - Dynamic effects of trade



Assuming A as a 'proxy' for productivity and technological changes and considering Production a function of the amount of capital we have $Y = A K$, where both A and K should increase by the effect of trade. Thus it is fair to suppose that increasing rates of growth can be expected by countries that practice a freer trade.

In the case of Argentina and Brazil, we have observed the following:

1- Their GDP is higher today than when liberalization began at the start of the 1990's;
2- Their GDP per capita is higher;
3- Their inflation is under control;
4- Their social indicators have, in most cases, improved;
5- They face a more comfortable situation regarding the international markets than anyone would expect, considering the fact that both have abandoned decades of protectionism and artificial measures to keep their industries breathing.

Their bilateral trade has also increase but, more than that, their trade as a whole has increased also. The argument that MERCOSUR could be diverting trade instead of creating in it, brought by, among others, Alexander Yeats, is not supported by the data that was shown in various of the previous Tables and Graphics. Although it is true that the increase in the intra-MERCOSUR trade's share of the total trade was higher, this is to be expected, first because the intra-regional trade had historically been at very low levels, and second, because studies have shown that the transportation costs of intra-regional can be as much as 15% lower than the costs of trading with non regional partners.

MERCOSUR has become too important to be overlooked, either by the rest of the World, or, especially, by its own members. It is to big a part of each members' trades for them to loose interest or change their policies regarding the integration process.

The proof that MERCOSUR was a good option for all the members is also its greatest challenge. Real's devaluation last year almost destroyed all the efforts of the past decade but, except for a few irrational demonstrations of xenophobia, especially in Buenos Aires, the intention of improving the process remains.

The devaluation brought to the discussion table the idea that had been put aside for more than a decade, the common currency of the MERCOSUR.

Despite all the difficulties presented in creating a common currency because of the different monetary policies adopted by the countries, the different situation of the governments accounts and last but not least, the cultural barriers, these appear to be less of an obstacle today than was the idea a decade ago when even the thought of a MERCOSUR common currency was itself improbable. Some economists see in the adoption of a common currency the future of MERCOSUR, more specifically, that of Argentina.

Thomas Andrew O'Keefe, professor at George Washington and president of MERCOSUR Consulting Group Ltd., argues that "if the member states are really serious about turning MERCOSUR into an effective negotiating tool for extracting trade concessions, however, they must convert it into an earnest endeavor at regional trade integration. One of the most effective ways to do that is to adopt a common monetary policy and currency." (The Journal of Commerce, Feb.10,2000)

If the FTAA seems to be the most probable fate of this hemisphere, it is in the best interest of Brazil and Argentina that they should be a part of a larger and more powerful 'bloc' and not negotiate by themselves.

That might help them to have a more active voice in the dynamics of what is to come and, rather than just be interested spectators, become substantially active members with substance and not only guests at the FTAA party.

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