Lecture 8
Brazil and Mercosur

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I have already contended that the economic reforms implemented by most Latin American countries in the 1990s cannot be labeled as a Washington-driven institutional model. Nonetheless, I have also pointed out that most Latin American reformer countries, particularly, Mexico and Argentina, enthusiastically accepted Bush 41 and Clinton Administration's support both to facilitate the access to international capital markets and to negotiate international trade agreements. However, Washington's influence on Brazil was by far less important than on the other Latin American nations. Brazil was not very enthusiastic regarding the FTAA and only asked for the IMF support to cope with the Real Plan crisis, but not before that moment.

Notwithstanding, the same economic ideas were simmering in Brazil as well. During the 1980s Brazil's economists and decision makers came to the same conclusion as their Latin American colleagues as to how to cure Latin America's maladies. They were also convinced that the market should rule over private sector decisions and fiscal discipline should rule over the public sector. They were part of the Latin American Consensus that had been building up at that time and that contributed the groundwork of the economic reform of the 1990s. Furthermore, Brazilian academicians helped to conceptualize this consensus in particular through the joint work of American academicians and Brazilian economists like Mario H. Simonsen. Chapter 22 of Rudiger Dornbusch book <u>Exchange Rates and Inflation</u> was back in 1988 the most complete elaboration on macroeconomic theory for open economies, and the economists who were designing and implementing the economic reforms would frequently refer to it. The chapter I am referring to is entitled "Inflation Stabilization: The Role of Income Policies and of Monetization" and was co-authored by Dornbusch and Simonsen.

Despite the intellectual contributions of its economists, Brazil implemented a lighter economic reform than its neighbors Chile and Argentina, and at a lower pace. In terms of pace and depth of the reform, Brazil's experience resembles that of Mexico. However, a major difference is rooted in the fact that Mexico entered NAFTA, but Brazil tried to lead its own trade agreement: MERCOSUR.

In 1960, South American nations and Mexico had created the Latin American Free Trade Agreement (known as ALALC from its Spanish name) which afterwards would be renamed Latin American Association for Integration (known as ALADI from its Spanish name). Block members had granted preferential treatment to their partners in the treaty on a case-by-case basis, and had signed several Economic Complementation Treaties on specific topics. Among those treaties, it stood out the 1985 Agreement signed by Argentina and Brazil aimed at fostering free trade on capital goods.

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This integration scheme was appropriate under an ISI growth strategy because it aimed at increasing the scale of production. As a matter of fact, in relation to the goods included in the treaty the regional market was treated, as it was domestic. However, in the same manner the protected industry sector opposed the openness of the economy; it rejected these agreements as well. Therefore, the integration process was a lengthy and difficult one.

By 1990, those governments that were working on the economic reforms realized that in order to succeed they would need to remove the anti-export bias created by the previous growth strategy. Hence, trade openness and the creation of investment opportunities were deemed as necessary tools towards that end. MERCOSUR, thus, was the outcome of initiatives aimed at fostering openness. From the beginning, the idea was to gain ground in regional openness but distinctively instead of case-by-case and sector-by-sector negotiations, the process would be general and automatic.

In March 1990, we talked about forming an Argentina-Brazil block for the first time. That year, during the Rio Group summit in Mexico City, the Mexican Chancellor informed that Mexico would propose the US the negotiation of a bilateral free trade agreement. As a consequence, Argentina and Brazil's Chancellors decided that it would be worthwhile to reevaluate the whole integration process in South America (namely ALADI without Mexico).

At that time, at the Ministry of Foreign Affairs I worked on the idea of enhancing a Latin American Free Trade block by using the PAR (Preferencia Arancelaria Regional – a generalized cut in intra-regional tariffs-), which was an instrument already approved by ALADI although it had never been applied. My proposal consisted of setting an initial PAR of 20%, which after five years would reach 100%. This PAR would be applied on the whole set of tradable goods and there would be only a few exceptions that would be disappearing over time. This PAR should be agreed on and applied by the 10 South American nations. Mexico would not be included as it was seeking a probably similar scheme but in North America.

There would not be commitments in relation to tariffs towards non-member countries. Each nation could individually decide the protection levels for its domestic production. However, the greater the protection towards non-member countries, the higher the preferred tariffs the trade partners would enjoy. I envisioned that this arrangement would foster openness in trade policy in each country.

Itamaratí, on the other hand, had a different stand on the matter. They preferred to deepen the bilateral integration process initiated in 1985. They thought of forming a custom's union and eventually a common market along the same lines of the European Union. Brazil's emphasis in relation to the custom's union had to do with Brazil's intent to prevent the opening process that Chile's experience had foster in Latin America.

The industrial sector in Sao Paulo did not want to dismantle the protectionist scheme in place and, hence, had to find a way to prevent that Argentina implement a Chilean-style tariff scheme. If Brazil entered in a free trade agreement with Argentina, and Argentina was open to the world, Argentina's competition in Brazil's market would have been equivalent to allow an opening process faster than what Brazil was ready to accept.

Simply put, Brazil's emphasis in regards to the Custom's Union and its lack of interest in a free trade area has always been linked to its interest in controlling the processes of trade openness towards third parties.

As usually is the case in negotiation processes, the agreement went half way between both initial strategies. Argentina succeeded in enlarging the regional block by including Uruguay and Paraguay and leaving the door open to the other South American nations, and also making sure that the intra-regional tariff reduction would be fast and across the board. Brazil was able to impose the common external tariff to be negotiated in a four years period. The Asuncion Treaty, signed in March 1991, created MERCOSUR, only a few days before Argentina's Convertibility Law was passed.

Four years later, when the intra-regional tariffs had been eliminated, the Ouro Preto Treaty was signed, which set the External Common Tariff. By that time, Brazil had implemented the Plan Real and both Argentina and Brazil shared the view that negotiating as a block rather than individually with the US and the European Union would provide MERCOSUR countries an edge and thus, they would be able to gain access to those markets.

From 1994 to 1998 MERCOSUR gained prestige and its members enjoyed a significant trade growth not only among them, but also with the rest of the world. At that time, many thought that it was a better alternative to the free trade negotiation with the US because NAFTA, which had started January 1, 1993, had not shielded Mexico from suffering another deep crisis.

Truth is, MERCOSUR success was not rooted in the implementation of free trade mechanisms; rather it was the consequence of the simultaneous success of Argentina and Brazil's stabilization Plans: the Convertibility Plan and the Plan Real. The simultaneity of both stabilization efforts brought about a sort of monetary integration, whose expansionary effects overwhelmed the integration process.

In the aftermath of the devaluation of the Real in 1999, MERCOSUR entered a crisis, which has been unable to overcome despite the political statements with regard to the integrationist spirit of Argentina and Brazil. Argentina's crisis in 2002 seems to have recreated a climate of monetary integration, though. As a matter of fact, both countries announce monetary policies based on inconvertible national currency and similar inflation targets. However, Argentina's debt crisis and Brazil's high interest rates reflect a precarious situation, and thus it is not possible to envision MERCOSUR implementing clear rules to effect monetary and trade integration.

We have witnessed recently a sort of revitalization of MERCOSUR in the political arena; however, in the economic realm MERCOSUR still is a dying entity, which does not show any signs of recovery or improvement. At this point, the future of MERCOSUR and the role it play in fostering growth in Latin America very much depends on Brazil's decision and role and whether Argentina joins its trade partner in the effort.

Changes that only Brazil can introduce

To me, there are four changes Brazil has to bring about in order that MERCOSUR be part of a successful growth strategy.

Firstly, it has to emphasize and allocate resources to investment in integration-infrastructure. This infrastructure has to reach the Andean countries as well. To me, the inadequacy of infrastructure limits the ability of South American countries to integrate. As a matter of fact, it is easier to transport people and goods between any Latin American country and the nations in the Northern Hemisphere than among neighbor countries in South America. Hence, without a significant investment in transport, communications and energy infrastructure, each country will privilege its relationship with the US and Europe rather than the other countries in the region.

Secondly, Brazil has to give up its protectionist policy based on high tariffs in relation to the production of capital goods. If it aims at promoting this industry, it should do it through subsidies instead of tools that make those goods more expensive. Brazil's protectionist policy in the 1990s determined that within MERCOSUR goods such as transportation equipment, computers and machinery were very expensive. Therefore, as the other countries in the region are trying to reduce the investment cost, it will not be able to reach agreements with the other countries, if it keeps such a policy in place.

In order to have a successful integration process, a coordination of some sort regarding monetary regimes and policies is necessary. Otherwise any integration process based only on commercial agreements will be subjected to recurrent weakening monetary crises. Hence, thirdly, Brazil's own monetary and financial arrangements should succeed as those of Chile did in dramatically reducing the real interest rates in medium and long-run transactions. In my view, this is a necessary condition to gain the other countries will to coordinate monetary policies and regimes with Brazil.

Fourthly, Brazil should demonstrate that it is interested in that every MERCOSUR member has wider access to third countries markets. By the same token, it will not have to impede that its partners seek bilateral agreements that may widen their access to important markets. I my opinion, in case that the other countries think that through integration Brazil tries to obtain a leadership position only to advance its own interests without paying attention to its neighbors' interest, it will find it difficult to accomplish effective integration agreements.

I am aware that this would be a radical change in comparison with Brazil's policies and role from MERCOSUR inception up to the Argentine crisis.