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**NAVAL
POSTGRADUATE
SCHOOL**

MONTEREY, CALIFORNIA

THESIS

THE FUTURE OF MERCOSUR

by

Brian R. Peterson

December 2004

Thesis Advisor:
Second Reader:

Harold Trinkunas
Robert Looney

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THE FUTURE OF MERCOSUR

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Submitted in partial fulfillment of the
requirements for the degree of

MASTER OF ARTS IN NATIONAL SECURITY AFFAIRS

from the

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ABSTRACT

With the absence of a bipolar international system and the rise of globalization, there are two tracks of foreign diplomatic and economic policy that nation-states can pursue. These can be competing or complementary. The first is global integration. The other course is to concentrate on regional integration. The European Union is the best example of this today.

Latin America also faces a choice in its future. Mercosur, the “Common Market of the South” is an economic initiative that offers promise of economic development. Begun in 1991 as an economic agreement between four nations in the Southern Cone, Mercosur made large gains in regional trade during its initial years. As the global economy began lagging at the turn of the century, proponents for Mercosur have had a more difficult time arguing its benefits. Should Mercosur survive this test, it could emerge stronger and continue to expand along the same lines politically and militarily as the European Union.

This thesis will open by examining the evolution of Mercosur compared to the model of the European Union. The next chapter will focus on the problems the Common Market has faced since its inception and how the actors have dealt with them. It will offer the corrective steps necessary for the project to succeed. The final chapter will focus on economic nationalism. What is it and will it derail Mercosur? The answer may be startling to some. The conclusion will summarize the arguments made and make a prediction on the future of Mercosur, the “Common Market of the South.”

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I: INTRODUCTION

With the absence of a bipolar international system and the rise of globalization, there are two tracks of foreign diplomatic and economic policy that nation-states can pursue. These can be competing or complementary. The first is global integration. This is best exemplified by membership in the United Nations and the World Trade Organization. The other course is to concentrate on regional integration. The European Union is the best example of this today. Beginning as a series of economic agreements that were mutually beneficial, it later gave birth to an expanded legislative body, and now is implementing a common security and defense policy to include a rapid reaction force that threatens to infringe upon North Atlantic Treaty Organization commitments. This steady course toward supranational governance defies conventional wisdom that nationalism would prevent extensive integration.

Latin America also faces a choice in its future, particularly since the absence of security dilemmas leads countries in the region to prioritize development. Arie Kacowicz states that Latin American countries:

Have no plausible alternative to economic globalization and political liberalism...and the sweeping neoliberal economic reform packages and the political transformation from authoritarian to democratic governments [are] the most important changes in contemporary Latin America.¹

There are two specific economic initiatives that offer promise of economic development specific to the region. The first is the Free Trade Area of the Americas, an initiative to create a free trade zone between North and South America. The second is Mercosur, the “Common Market of the South”. Begun in 1991 as an economic agreement between four nations in the Southern Cone, Mercosur made large gains in regional trade during its initial years. As the global economy began lagging at the turn of the century, proponents for Mercosur have had a more difficult time arguing its benefits. Should Mercosur survive this test, it could emerge stronger and continue to expand along the same lines politically and militarily as the European Union.

¹ Arie Kacowicz, et al, “International Relations Theory and the New World Order”, *Mershon International Studies Review* 40, no. 2, (October 1996): 339-352.

There are several possible important outcomes for a unified Latin America. For example, what impact would a supranational political union or common security force have on democracy in Latin America? What effect would it have on current security issues such as counter-narcotics, terrorism, and poverty?

This thesis will open by examining the evolution of Mercosur compared to the model of the European Union. Two world wars of epic proportions gave rise to an economic alliance in Europe that would eventually evolve into the European Union. The history of Latin America has been much different. Somehow, they face the possibility of pursuing a similar end state. This first chapter will explain how different causal factors can lead to similar results as Mercosur develops economically, politically, and possibly militarily.

The next chapter will focus on the problems the Common Market has faced since its inception and how the actors have dealt with them. It begins with an examination of the Treaty of Asuncion, which created Mercosur. Next, it details the series of Protocols designed to “patch” inherent flaws in the original treaty. Finally, it discusses the disputes that have occurred between member states that emphasize the weakness of the agreement. The conclusion will offer the corrective steps necessary for the project to succeed.

The final chapter will focus on economic nationalism. What is it and will it derail Mercosur? The answer may be startling to some. The chapter challenges the traditional definition of ‘economic nationalism’ and offers a new one based on a thorough examination of historical examples. By applying this new definition, it will explain why economic nationalism can actually embrace liberal market reforms and could possibly provide a boon to Mercosur.

The conclusion will summarize the arguments made and make a prediction on the future of Mercosur, the “Common Market of the South.”

II: THE POLITICAL INTEGRATION OF MERCOSUR

A. INTRODUCTION

This chapter will examine the integration of the “Common Market of the South” as it developed economically and politically. Furthermore, it will speculate on prospects for further “deepening” and “broadening.” Is it feasible that Latin America will someday become as economically, politically, and militarily unified as the European Union is currently becoming? It will explain why this is relevant.

The chapter will be divided into three sections examining the economic, political, and potential military aspects of the agreement. It will be followed with an analysis of the domestic and international variables that the author considers critical to its past or future success. The conclusion will also discuss the implications that this further development may hold for U.S. foreign policy.

B. ECONOMIC UNION

Simon Bolivar’s dream of a “unified Latin America stretching from the Rio Grande to Cape Horn...remained quite elusive as nationalism took ever deeper root in the compartmentalized entities of the region”.² However, “after World War II, certain events intruded to shake the basic pattern”. Perhaps the most important initiative of the “Great Awakening” was economic development. Individual efforts yielded little results, as did foreign assistance. The United States in particular was too concerned about economic recovery in Europe and Asia to offer much assistance. Thus, Latin Americans would begin to look for a new option, which would take the form of “regional economic integration”.³

The prominent Argentine economist Raul Prebisch, in his role as Secretary-General of the Economic Commission for Latin America (ECLA), strongly advocated regional economic integration. He believed that industrialization had to occur in the region while protected by external tariffs, a model known as “import substitution industrialization”. The ECLA worked hard through the 1950s toward removing both

² Walter Krause and F. John Mathis, Latin America and Economic Integration, (Iowa City: University of Iowa Press, 1970), 2-3.

³ Krause, 3.

political and economic obstacles to integration. It would eventually be instrumental in creating the Central American Common Market in 1959 and the Latin American Free Trade Association in 1960. The United States, would eventually endorse Latin American development as well. Vice-President Nixon's 1958 tour of the region and developments in Cuba would inspire some re-evaluation of priorities. "Operation Pan America" would eventually help garner support for such projects as the Inter-American Development Bank.⁴

The Treaty of Montevideo created the Latin American Free Trade Association (LAFTA), between Argentina, Brazil, Chile, Mexico, Paraguay, Peru and Uruguay. It was to be implemented by 1972 but never got off the ground. The biggest obstacle to success was "the inherent contradiction between the idea of giving impetus to integration via trade liberalization and the protectionist logic of the import-substitution model".⁵ The Treaty of Montevideo was altered in 1978, creating the Latin American Integration Association (ALADI). Recognizing that LAFTA was too much too soon, it concentrated on less lofty goals with more precise timelines.

The divide-to-conquer strategy of forming smaller agreements proved more successful in taking the talks to the next stage. Examples of smaller agreements are: the Agreement of Cartagena which created the 'Andean Group' formed by Bolivia, Chile, Colombia, Ecuador and Peru; the 'Group of Three' or G-3, formed between Colombia, Mexico and Venezuela; the 'Free Trade Zone' or ZLC, formed between Mexico and the five Central American countries. Bilateral agreements were also signed such as those between Chile and Argentina, and between Mexico and Venezuela, as well as the trilateral agreement involving Venezuela, Argentina and Mexico.⁶

Late in 1979, the tripartite agreement was signed between Argentina, Brazil and Paraguay. It would solve the longstanding disagreement concerning the use of border water resources. The foreign debt crisis of 1982 still stunted any possibility of further cooperation for some time. Eventually, in 1986, Argentina and Brazil would sign the Program for Integration and Economic Cooperation (PICE). It was limited to "such areas

⁴ Krause, 3-4.

⁵ Riordan Roett, ed., Mercosur: Regional Integration, World Markets, (Boulder: Lynne Rienner Publishers, Inc., 1999), 8.

⁶ Joaquina Pires-O'Brien, "Latin American Integration and The Formation of Mercosur", *Contemporary Review* 276, no. 1613, (June 2000): 281.

as capital goods, food, technological cooperation, and the iron, steel, nuclear, and auto industries, among others”.⁷

By the 1980s, the nations of the Southern Cone would begin to adopt liberal trade policies. In November 1988, the Treaty on Integration, Cooperation, and Development was signed by Brazil and Argentina. It was designed to have a more comprehensive bilateral market in place within a decade. In mid-1990, Presidents Collor de Melo of Brazil and Menem of Argentina signed the Act of Buenos Aires moving the timeline up to 1995.⁸

Finally, Treaty of Asuncion was signed in March 1991. This formalized the Mercado Comun del Sur, or Mercosur, drawing Paraguay and Uruguay into the agreement. It provided for reduction of internal tariffs, common external tariffs as high as 20-35%, coordination of macroeconomic policy, and sectoral agreements.⁹ The system was up and running by the following November. “The trade during Mercosur's first eight years increased considerably, going from US\$4.7 billion in 1991 to US\$18 billion in 1998.”¹⁰ Its immediate success maintained momentum toward growth through the mid-1990s.

In 1993, Brazil proposed a South American Free Trade Area to include Mercosur, the Andean Pact, and Chile. In 1995, Mercosur opened trade talks with the European Community and in 1996 included Chile and Bolivia as associate members.¹¹ Bolivia had been originally barred for five years due to membership in the Andean Pact. Chile does not want full membership “because it does not want to raise its tariff to the planned Common External Tariff (from about 8 percent to 12 percent) of Mercosur”. However, the Mexico “Peso crisis” that soured popular opinion of NAFTA and caused the failure of the U.S delegation to gain ‘fast track’ authority to the Santiago FTAA summit in 1998

⁷ Roett, 9.

⁸ Pires-O'Brien

⁹ Roett, 10.

¹⁰ Pires-O'Brien

¹¹ Roett, 15.

has caused Chile to rethink their position and consider full membership.¹² Peru, also caught between ties to the region and the immense pressure of the U.S. economy, became an associate member of Mercosur in August 2003.

The collapse of the WTO round in Cancun seems to have reinvigorated desire for increased regional trade. The question remains which direction the agreement will go.

There is no such thing as static equilibrium in integration schemes, as the European experience has shown so clearly. One stage leads inexorably to another. PTAs [Preferential Trade Agreements] either break up or move towards customs unions. In the latter, the adoption of a common external tariff (CET) leads on to a single market; this in turn requires exchange rate harmonization, which- in the presence of capital mobility- implies monetary union. The process is only complete when- as is the case of Bismarck's Germany or the 19th century United States- economic integration leads to a single country.¹³

President Lula of Brazil optimistically predicted partial or full incorporation of the Andean Pact countries by the beginning of 2004.¹⁴

One major obstacle that Mercosur faces is the large disparity in size between the member states. While the German economy dwarfed that of France, security concerns following two world wars was impetus for Germany to give France favorable terms on an economic agreement, the European Coal and Steel Community, which would later evolve into the European Union. Furthermore, the United States fully encouraged this development.

Latin America does not share the same kind of security dilemma. Domestically, its motivation is purely economic. Its benefits are not equal among its members and would lead to the disputes discussed in the next chapter:

Nobody (except in France, maybe) can doubt that Germany is the European Union's paramount member. Yet its primacy is relative. Brazil, by contrast, towers over Mercosur...That could be a problem. Post-1945 Germany had strong political reasons to embrace European integration...In

¹² Victor Bulmer-Thomas and James Dunkerley, The United States and Latin America: The New Agenda, (Cambridge: Harvard University Press, 1999), 85.

¹³ Ibid, 95.

¹⁴ Juan Forero, "Brazil Pushes for South American Trade Pact", New York Times, (Sep 17, 2003)

contrast, Brazil and Argentina have never fought a war, nor does either see the other as a source of instability. That may make integration between them easier, but, at first sight, it also makes the need for it less compelling.¹⁵

The United States desires global free trade under the auspices of the World Trade Organization and only seems to pursue loose regional Free Trade Areas (FTAs) in areas where the WTO does not suffice. In Latin America, the United States would prefer to see the development of the Free Trade Area of the Americas or at a minimum, the extension of the North American Free Trade Agreement.

U.S. government support of Mercosur has been lukewarm. The mantra has been ‘Yes, the United States supports Mercosur as long as it meets the technical criteria set out in the World Trade Organization.’¹⁶

The European Union strongly encourages regional trading blocks, however, has given little direct support to Mercosur. The possibility of a EU-Mercosur free trade area is unlikely, due to major stumbling blocks on issues such as agriculture subsidies.¹⁷ The October 31, 2004 deadline for a EU-Mercosur trade agreement, which has been in the works for the past five years, has recently passed with only promises to continue negotiations.¹⁸

C. POLITICAL UNION

In 1822, Simon Bolivar began an initiative to unite Colombia with Chile, Peru, Mexico, and Central America in a military alliance and to bring them together into a political confederation that would meet in Panama. The purpose would be to help consolidate independence and protect against potential European intervention. Spain, for instance, refused to acknowledge independence of its former colonies. The threat would never materialize, whether due to Bolivar’s efforts or the Monroe Doctrine, which had tacit support of Great Britain, and support would dwindle. By the 1830s, he had all but abandoned his hope for a politically unified Latin America and resignedly turned his

¹⁵ Michael Reid, “A Lopsided Union”, *The Economist* 341 no. 7987, (Oct 12, 1996): p. S9.

¹⁶ Sidney Weintraub, Development and Democracy in the Southern Cone: Imperatives for U.S. Policy in South America, (Washington: The CSIS Press, 2000), xv.

¹⁷ Bulmer-Thomas, 93-95.

¹⁸ Anonymous. “The Americas: More Jaw-jaw, Mercosur and the EU” *The Economist* 373 no. 8399, (October 30, 2004): 68.

focus inward on Colombia. The question remains whether his dream of political union can emerge from an economic pact almost two centuries later. ¹⁹

The Treaty of Asuncion created the Common Market Council, composed of member country foreign and economic ministers and the Common Market Group. The former was to direct the process of integration while the latter would see to the details.²⁰ No permanent dispute resolution mechanism was established in Asuncion, although the need was identified. In 1994, the Protocol of Ouro Preto created the interim Mercosur Trade Commission and ad hoc arbitral panels to redress disputes rather than creating a supranational institution. Brazil and Uruguay would have to amend their constitutions in order to recognize supranational authority. This system has yet to be tried and all disputes have been settled through bilateral diplomacy to date. At this time, it was clear that Mercosur was committed to the consensus model for the foreseeable future. ²¹ This is a problem:

The Mercosur cannot simply rely on the parties to resolve their disputes. By definition if a dispute reaches the system it will be because the Mercosur parties could not reach a consensus on the meaning or operative effect of the Mercosur legislation or a country's compliance with it. The Mercosur needs, therefore, to have a neutral body for providing interpretation as well as enforcing the rule of law.²²

The lack of an effective arbitration mechanism would almost destroy Mercosur following a string of crises related to the Brazilian devaluation of the real in 1999. In order to deal with recession in Brazil, the government allowed the real to float. By no longer tying the real to the dollar, its value dropped significantly compared to the Argentine peso. This had devastating impacts on the Argentine economy, especially the auto industry. Cheap Brazilian imports flooded Argentina. Leaders in both countries postured and seemed unwilling to trust the cumbersome arbitration process. By 2001,

¹⁹ Martin Sicker, The Geopolitics of Security in the Americas: Hemispheric Denial from Monroe to Clinton, (Westport, Connecticut: Praeger Publishers, 2002), 16-27.

²⁰ Roett, 12.

²¹ Cherie O'Neal Taylor "Dispute Resolution As A Catalyst For Economic Integration And An Agent For Deepening Integration: NAFTA and Mercosur" *Northwestern Journal of International Law & Business*, (Winter 1996/Spring 1997)

²² Ibid., 46.

Argentina was getting the worst of it and threatening to withdrawal from the union. Brazil relented, allowing temporary quotas and tariffs in direct violation of the agreement. A common currency and an efficient supranational arbitration process could have avoided the worst effects of the crises.²³

After the Brazilian and Argentine devaluations, the deepening of Mercosur has become synonymous with survival, but there are several obstacles to achieving that goal. Argentina, Uruguay, and Paraguay have always favored the establishment of supranational institutions, but Brazil has always resisted them, preferring the intergovernmental model of 'light institutionalism.'²⁴

In February 2002, the presidents of the member states signed the Protocol of Olivos for Dispute Settlement. It was a direct result of the 1999-2001 crises and created a permanent tribunal five arbitrators. The tribunal will review award settlements by ad hoc tribunals and will have "binding final judgment".²⁵

A supranational institution that could negotiate on behalf of the collective member states would increase bargaining power internationally. This prevents larger economies such as the United States and the European Union from pursuing a 'divide and conquer' strategy.

Because one of the region's international objectives of Mercosur is to strengthen the region's international negotiating position, the perception exists that Mercosur's institutional mechanisms must be deepened to guarantee the group's visibility in the international arena.²⁶

On June 18, 2003, the presidents of the Mercosur member states met again in Asuncion. They made verbal commitments to a regional parliament, similar to the European Union's, inclusion of Peru and Venezuela, and negotiation toward the FTAA as

²³ Mario E Carranza, "Can Mercosur Survive? Domestic and International Constraints on Mercosur", *Latin American Politics and Society* 45, no. 2, (Summer 2003), 67.

²⁴ Carranza

²⁵ Carranza

²⁶ Roett, 20.

a single body.²⁷ Although these measures are far from complete, it shows that the idea is surely still alive.

The process of creating a supranational political body is a challenging one. A gradual, minimalist approach is necessary. Early on, progress is dependent on consensus. Not only is it necessary to determine if this kind of integration is beneficial to the individual member states, but then it is necessary to convince the population at large that they stand to benefit. Europe is still selling their citizens on the advantages of integration. Latin American experiences with liberal market reforms have not been altogether positive, making it more of a challenge. Further political integration will depend heavily on Brazil's desire for global status. In order to gain clout internationally, they will have to invest a little of their sovereignty in a strong Mercosur.

Externally, the United States seems to passively oppose further political integration of Latin America. It is likely that Washington will make every attempt to play the spoiler in order to refocus on an economic union that includes the United States. This could place emphasis on the World Trade Organization, the FTAA, or a NAFTA "plus".

D. MILITARY UNION

The European Union has created a Rapid Reaction Forces and is formulating a Common Defense and Security Policy. If Mercosur were to follow suit by creating a peacekeeping force under Mercosur, the implications could be enormous for democracy and stability in the region.

"Mercosur...has placed consolidating democracy and preserving peace in the Southern Cone among its paramount objectives."²⁸ The most significant positive militarily cooperative step that members of Mercosur had agreed to was the 1990 bilateral arms reductions between Brazil and Argentina.²⁹ In 1996, Argentina and Brazil also agreed upon what would become the Rio Declaration. Not only was this a "strategic alliance" between the two countries, but it also added a "democratic clause" for

²⁷ World Press Review Online, "New Life for Mercosur", (accessed September 14, 2003); available from <http://www.worldpress.org/Americas/1204.cfm>; Internet.

²⁸ Jeffry Frieden, Manuel Pastor, Jr., and Michael Tomz, Modern Political Economy and Latin America: Theory and Policy, (Boulder: Westview Press), 2000, 188.

²⁹ Roett, 37.

Mercosur. Fear of exclusion would later deter non-democratic forces from seizing power in Paraguay.³⁰

Argentina strongly favors a Mercosur peacekeeping force and has the support of the United States in the endeavor.

The effort began in April 1997, when Presidents Carlos Menem of Argentina and Fernando Henrique Cardoso of Brazil signed an accord creating a Permanent Mechanism of Consultation and Coordination on Defense and Security Affairs, designed to discuss a common defense system for the MERCOSUR region.³¹ Concurrently, Argentina opposed Brazil taking a seat on the U.N. Security Council, suggesting instead a rotating Latin American seat.³²

Brazil has an opposing view regarding a regional peacekeeping force, although they are not against confidence building exercises with their neighbors. This has resulted in joint exercises, shared participation in U.N. peacekeeping operations, and common airspace control.

Brazil has supported a wider, not deeper MERCOSUR. It wanted other nations to join but did not want the European Union, with its supranational institutions, to be the model. As the region's giant, Brazil wants free trade to function but does not want to be disciplined by a bureaucracy composed of civil servants from smaller, weaker states. Its position regarding military affairs is similar. It supports military cooperation, but is still only lukewarm to Argentine proposals for security systems that would impose the potentially binding decisions of supranational agencies. Indeed, President Cardoso has seen no need for military alliances with states inside or outside the region because, in his view, Brazil has no enemies.³³

It will not happen without at least passive support by Brazil. Brazil does not seem to favor a regional security force at this time. Unconvinced of the benefit, it may oppose the Argentine movement for its creation. It should be noted, however, that should Mercosur expand, it would include some states that could benefit from a regional security force. Brazil may find itself in a position where it is economically advantageous to

³⁰ Roett, 41-42.

³¹ David Pion-Berlin, "Will Soldiers Follow? Economic Integration and Regional Security in the Southern Cone", *Journal of Interamerican Studies and World Affairs* 42, no. 1. (Spring 2000), 43.

³² Roett, 42.

³³ Pion-Berlin, 43.

compromise politically. Furthermore, Brazil has long desired a permanent seat in the United Nations Security Council. Sponsoring an active multi-national peacekeeping force could help their case.

Following the 2004 crisis in Haiti, South American states comprised the majority of the U.N. peacekeeping force. Brazil, Argentina, Uruguay, and Chile took the lead in the venture. This may signal a turnaround by President Lula da Silva in the Brazilian reluctance toward a regional security force.³⁴

Embroided in other military ventures around the globe, the U.S. would greet a Latin American security force with enthusiasm. However, the mere fact that the U.S. favors a regional security force may cause Brazilian pride to impede further progress. Nevertheless, as Latin American militaries become more professional, it is not impossible that more extensive cooperation will occur. There is an added incentive for Latin America, who has historically been the recipient of repeated U.S. intervention, to have an independent force capable of handling regional security issues such as narco-trafficking, terrorism, and immigration.

E. CONCLUSION

Economic integration within Mercosur marches forward slowly. Extensive Latin American political or military unification seems far-fetched in the short term. The quelling of bilateral disputes in the region surely contributed to the creation of Mercosur, but was not the priority. The dominant motivation, of course, was money. Member states may recognize the need for further political integration, but nationalism is holding them back. A common security and defense policy is merely an idea at this point, opposed by Mercosur's most dominant member. Brazil does favor broadening at this time, the faster the better. If Mercosur wishes to stay viable, deepening of supranational political institutions will have to occur as well. This will cost a portion of each state's sovereignty.

There are several possible important outcomes for a unified Latin America. Political stability is the most prominent. It speaks volumes that the mere threat of exclusion from an economic merger was enough to keep Paraguay at least officially

³⁴ Larry Rohter, "Brazil Is Leading a Largely South American Mission to Haiti," New York Times, (Aug 1, 2004).

democratic. The “Rio Declaration” demonstrates Mercosur’s commitment to democracy and economic prosperity can only help to alleviate poverty.

Should Mercosur expand to include the Andean Pact countries, it will encounter a new host of security issues that would threaten to restrict or undermine economic gains. A multi-national regional security force could assist with counter-narcotics or counter-terrorism within another country’s borders without raising the same degree of alarm that the armed forces of a single neighbor’s armed forces might.

Ultimately, the United States can only gain by increased trade with Latin America. The question remains whether Mercosur will broaden and deepen in order to present a unified front in FTAA discussion or the U.S. will successfully leverage bilateral negotiations to undermine Brazilian efforts.

U.S. promotion of a regional security force is a wise course based on a history of interventionism that has fostered distrust in the region. Ultimately everyone gains by stable, democratic regimes willing to tackle narcotics and terrorism within their borders.

The motivation for further integration is there. A gradual, minimalist approach may someday yield a stronger Latin American union. The next chapter will address specific setbacks to date in a theoretical perspective.

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III. ASUNCION TO OLIVOS: AN ANALYSIS OF ARGENTINE-BRAZILIAN ECONOMIC DISPUTES SINCE 1991

A. INTRODUCTION

The previous chapter discussed the evolution of Mercosur economically, politically, and militarily; and highlighted some of the advantages that further integration may bring. This chapter will focus on the shortcomings of Mercosur, where inadequate planning and Machiavellian diplomacy threaten to dismantle the project and the responses that these crises invoked.

The Treaty of Asuncion created Mercosur, the “Common Market of the South,” in 1991. Due to the immense impact of domestic politics involved, it is useful to evaluate the debate surrounding its creation using Robert Putnam’s “metaphor” of the two-level game. This chapter will open with a detailed analysis of what a two-level game is and then demonstrate its applicability by examining the events surrounding the creation of Mercosur. Furthermore, it will show the long term negative impact of Menem’s large win-set on the economic body. In the second section, this chapter will enumerate the various Protocols, or “patches,” to the Asuncion Treaty designed to address weaknesses in the dispute resolution system. These Protocols were a direct result of the asymmetrical bargain created at Asuncion. Outlining the basic tenets of the Protocols of Brasilia, Ouro Preto, and Olivos, it will demonstrate the apparent opposition to strengthening the institutions of Mercosur.

The third section will discuss the severe crises that have threatened to break apart Mercosur. Stemming from divergent macroeconomic policies, these crises were unavoidable with the existing dispute resolution system and the failure to attempt resolution through existing institutions demonstrated a lack of confidence in the institutional capabilities. Only concerted efforts at the highest levels were able to preserve Mercosur.

The conclusion will summarize the ideas presented and attempt to conclude whether the obstacles to integration between Argentina and Brazil, the giants of Mercosur, can be overcome.

B. TREATY OF ASUNCION

The politics of many international negotiations can usefully be conceived as a two-level game. At the national level, domestic groups pursue their interests by pressuring the government to adopt favorable policies, and politicians seek power by constructing coalitions among those groups. At the international level, national governments seek to maximize their own ability to satisfy domestic pressures, while minimizing the adverse consequences of foreign developments. Central decision-makers can ignore neither of the two games, so long as their countries remain interdependent, yet sovereign.³⁵

The essence of this assertion by Putnam is that there are two distinct yet interrelated aspects to negotiations by diplomats and national leaders. The first level is that of the international arena. While the rational actor in a realist system may try to maximize the interests of his country, he will be faced with a counterpart across the negotiating table that will be doing the same. The second level is the domestic arena. Even should a negotiator find a proposal acceptable, it must gain “ratification” of some sort by his constituents. Therefore, the negotiators must seek a “win-set.”

When examining Putnam’s proposition, it is easiest to examine the desired outcome first and work backward. His dependent variable is simply an international agreement. This can be economic, military or other. For Putnam’s model to be useful, however, the agreement must be arranged by a single negotiator (Level I) and subject to ratification by domestic constituents (Level II).

The intervening variable is the win-set. He defines this as “the set of all possible Level I agreements that could ‘win’- that is, gain the necessary majority among the constituents- when simply voted up or down.”³⁶ The win-sets of both negotiators must overlap for an agreement (DV) to be concluded.

There are three determinants, or independent variables, that influence the “size” of the win-set. The larger the size, the more latitude the negotiator is given toward compromise. Coalitions, institutions, and strategies of the chief negotiator are Putnam’s independent variables. These define the myriad of possible solutions that comprise the win-set. Each will be discussed in turn.

³⁵ Robert Putnam, “Diplomacy and Domestic Politics: The Logic of Two-Level Games”, *International Organization* 42, (1988), 436.

³⁶ Putnam, 439.

The first independent variable is the “distribution of power, preferences, and possible coalitions among Level II constituents.” If the cost of no-agreement is unacceptable, the constituents will allow more concessions and a larger win-set. If the status quo is acceptable, they will insist the negotiator drive a harder bargain. Constituents with relatively homogenous interests often find themselves in the yes-or-no category. When constituents are polarized on an issue, the swing voters in the middle define the size of the win-set. This can get terribly complex, as options may have to be pursued that enables coalitions in support of the agreement. Abstention rate also must be factored in. The more politicized an issue becomes; the more constituents are likely to weigh in, further constricting the win-set. This is why diplomats prefer closed-door negotiations.³⁷

The second variable is the actual composition and ratification procedures of “the Level II political institutions.” This could refer to the political or legal process that an agreement is subject to. For example, international treaty ratification in the U.S. Senate requires a 2/3 vote. This is significantly more difficult than a simply majority vote and narrows a negotiators win-set. A dictator that requires no ratification has a larger win-set and may actually be at a disadvantage, assuming his counterpart knows this. Sometimes there may be multiple levels of ratification. For example, just because a president has the ability to push an agreement through the formal legal process, he may face sufficient repercussions in public opinion that would be unacceptable.³⁸

The third variable rests in the “strategies of the Level I negotiators.” The ultimate goal of every Level I negotiator is to maximize his opponent’s win-set while ensuring his expands just enough to overlap. This ensures that the agreement reached cannot only be ratified (due to the overlap) but is closer to his optimal outcome.³⁹

Using this model, we will examine the formation of Mercosur, the “Common Market of the South” and the process by which Argentina and Brazil entered the agreement.

³⁷ Ibid, 443-48.

³⁸ Putnam, 448-50.

³⁹ Putnam, 450-52.

Through the 1960s, Latin American governments had engaged in protectionist policies in order to industrialize. Economist Raul Prebisch, as the Secretary-General of the U.N. Economic Commission for Latin America (ECLA), advocated a model known as “import substitution industrialization” (ISI). By the late 1970s, this model was generally proven a failure. Through the 1980’s, neoconservative Latin American governments began to liberalize their economies, supported by the ‘Washington Consensus.’

Regional integration gained new momentum in 1991, with the creation of the European Union at Maastricht. Concurrently, four nations from Latin America would sign the Treaty of Asuncion, forming the “Common Market of the South,” creating the third largest trading bloc in the world, behind the European Union and the North American Free Trade Agreement. Brazil dominated the bloc, accounting for more than 70 percent of the Gross Domestic Product of the union. Argentina was the only real competitor. Paraguay and Uruguay had little choice but to join or risk being economically squeezed between the two. It is only fitting that divergent economic policies of Argentina and Brazil would almost lead to the breakdown of Mercosur between 1999 and 2001. The roots of the disagreement rest in the two-level game that created Mercosur.

The chief negotiators in Mercosur agreements and disputes have always been the presidents. The dependent variable in this case, the agreement that consummated Mercosur, was no exception. President Menem of Argentina and President Collor de Melo of Brazil signed it on March 26, 1991. Essentially, it would drop internal tariffs and non-tariff barriers while creating a Common External Tariff on imports.

In signing the treaty, President Collor had a much less scope in his win-set than President Menem. Subsequently, he achieved terms that would be favorable to Brazil. In fact, the terms were so lopsided; they would almost collapse Mercosur in 1999 and again in 2001.

President Menem strongly favored neo-liberal market reforms. He “enjoyed a solid majority in the legislature” as well as “much more autonomy from domestic forces.” Menem was able to open the national market by decree, “successfully neutralizing the political opposition of domestic industrial sectors, such as textiles, electronics,

automobile parts, and pharmaceutical laboratories, all of them threatened by foreign competition because of trade liberalization.” Menem had been given a mandate by the success of the Cavallo Plan, which pegged the peso to the dollar, thereby controlling hyperinflation. Menem’s independent variables; his strategies, the lack of a need for a coalition, and the lack of institutional restraint, gave him a very large win-set. By agreeing to accept the terms of Asuncion, he placed his nation in a position to be dominated by Brazilian industry and extremely susceptible to Brazilian macroeconomic policy.⁴⁰

Conversely, President Collor “had to form political coalitions while heeding to the demands of powerful domestic business organizations and negotiating with opposition parties in Parliament.” The “internationalist-proglobalization neoliberal coalition was weaker in Brazil than in Argentina.” Furthermore, “Brazilian industrialists...sometimes [had] veto power over decisions affecting their interests.” Collor’s independent variables; his need to form coalitions and his institutional constraints, constrained his win-set tightly.⁴¹

The final product signed in 1991 was closer to what Brazil wanted than what Argentina (or Paraguay and Uruguay, for that matter). It called for a high Common External Tariff to be implemented faster than the three dissenters wanted. It placed very limited controls on macroeconomic policy and had a weak arbitration policy. Brazilian devaluation of the real in 1999 (and again in 2001) would have devastating effects on the Argentine economy. Eventually, Brazil would have to allow certain temporary internal quotas and tariffs by Argentina to prevent them from withdrawing from the union. By this time, Brazil was using Mercosur to strengthen their bargaining position in “Free Trade Area of the Americas” (FTAA) negotiations and could not afford its dissolution.⁴²

The main provisions of the Treaty of Asuncion were an across the board tariff reduction within the union with the addition of a common external tariff. It allowed development of accords for specific sectors. The Council of the Common Market would consist of finance and foreign ministers from the member states. The Common Market

⁴⁰ Mario E Carranza, “Can Mercosur Survive? Domestic and International Constraints on Mercosur”, *Latin American Politics and Society* 45, no. 2, (Summer 2003), 67.

⁴¹ Ibid, 9-10.

⁴² Carranza, 11.

Group would be the executive institution of the arrangement. Annex III of the agreement provided an institutional framework to solve trade litigation, although as the next section will demonstrate, it was a grossly inadequate arrangement.⁴³

C. THE PROTOCOLS (ASUNCION 1.1, 1.2, & 1.3)

As even those of us who have been slow to embrace the high-speed world of the “digital age” have become aware of the term “patch.” This term is generally used to describe a temporary software fix, usually due to unforeseen problems. Often this is a result of rushing a program into stores before proper testing. The Treaty of Asuncion had some critical errors in it, most notably the lack of an effective dispute resolution system. This built-in weakness was a deliberate attempt by the member states to maintain sovereignty by minimizing the impact of a supranational arbiter to have jurisdiction over potential disagreements that could have a large impact on their economy.⁴⁴ Regardless, three “patches” would be introduced to Mercosur. The Protocols of Brasilia, Ouro Preto, and Olivos would make changes to the temporary arbitration process until the Permanent Dispute Resolution System was implemented, planned for January 2006.

The first “patch” was as early as December of 1991. The Protocol of Brasilia for the Solution of Controversies replaced a three-step system found in Annex III to the Treaty of Asuncion. It provided for suits between states or between a private party and a state. Parties would be given 15 days to work it out or go before the Common Market Group, comprised of appointees of the various ministries of foreign affairs. The Common Market Group had 30 days to come to attempt a solution. If this did not work, either state party could request a three-person ad hoc arbitration panel that would issue a binding decision by majority vote in 90 days. The major weakness under this system was a limitation that private parties could not progress to the final arbitration panel without state sponsorship.⁴⁵

⁴³ Luigi Manzetti, “The Political Economy of Mercosur”. *Journal of Interamerican Studies and World Affairs* 35, no. 4, (Winter 1993-1994), 105.

⁴⁴ Cherie O'Neal Taylor, “Dispute Resolution As A Catalyst For Economic Integration And An Agent For Deepening Integration: NAFTA and Mercosur” *Northwestern Journal of International Law & Business*, (Winter 1996/Spring 1997), 868.

⁴⁵ Thomas Andrew O'Keefe, “A Resurgent Mercosur: Confronting Economic Crises and Negotiating Trade Agreements”. *The North-South Agenda* 60, (January 2003): 20.e, 9-10.

The Protocol of Ouro Preto was signed December 17, 1994 and put into effect in December 1998 by Common Market Decision 17/98. The Protocol “established an imperfect customs union with a common external tariff covering 85% of goods traded by the bloc with third countries.”⁴⁶ Furthermore, in a small move toward deeper institutions, the Mercosur Trade Commission was created and was given authority to review complaints. Technical committees within the Commission would attempt to work out a solution. If it could not be resolved in 30 days, it would be forwarded to the Common Market Group and then on to binding arbitration. Between its implementation in 1998 and May of 2002, eight cases went to arbitration. Although all the parties seemed to accept the decisions of the panels, it is worth noting that none of the cases involved the sizeable automotive sector.⁴⁷

The Protocol of Olivos for Dispute Settlement was signed February 18, 2002 by the presidents and foreign ministers of the four Mercosur countries. Brazil was the final country to ratify it in February 2004.⁴⁸ Brazil will still have to amend their constitution to make it legal.⁴⁹ Still transitional in nature, Olivos will maintain the same basic structure of the Brasilia Protocol, but will create the Permanent Tribunal of Review, will allow better oversight for arbitration panels to ensure compliance, and will streamline the resolution process bypassing the highly political Common Market Group.⁵⁰

The dispute resolution process within Mercosur to date has been “cumbersome” and infrequently used.⁵¹ The biggest challenges to the union have been settled through presidential diplomacy avoiding the flawed system altogether. However, the Protocol of Olivos and the pending Permanent Dispute Resolution System should provide an effective means for both private and state parties to address grievances in the future.

⁴⁶ Carranza, 3.

⁴⁷ O’Keefe, 10-14.

⁴⁸ <http://www.guedesepinheiro.com.br/ing/>

⁴⁹ Taylor, 850.

⁵⁰ O’Keefe, 11.

⁵¹ Carranza, 15.

D. THE MERCOSUR CRISES

Since 1994, Mercosur has weathered a series of crises that highlight the lack of a harmonized macroeconomic policy. Disputes within the \$15 billion per year automotive sector began in 1995, threatening to dissolve the union. Brazil devaluated the real in 1999 and 2001 while the Argentine peso remained pegged to the U.S. dollar. In a strange twist, the Argentine financial crisis of 2002 may have had a somewhat positive effect on Argentine-Brazilian relations.

President Cardoso first introduced the Real Plan in 1994. Similar to the Cavallo Plan, it “tied the Brazilian currency, the real, to the nation’s dollar reserves and kept a tight rein on the money supply.”⁵² However, by keeping the real artificially high, it exacerbated the trade deficit for Brazil for the next few years.⁵³ In June 1995, in response to this and to minimize the “tequila effect” of the Mexican peso crash, Brazil:

...established a temporary quota for automobile imports, without exempting Argentina from the new regime. In addition, it reduced from 18 percent to 2 percent the tariff on imports of capital goods, components, and raw materials for the sector, thereby matching the benefits of the regime granted by Argentina to automobile manufacturers operation in Argentina, which interpreted these measures as a violation of the customs union agreement.⁵⁴

The resulting crisis would persist through 1999 and eventually threaten the economic union. Resolution was attempted at the highest levels by exempting vehicles from tariffs based on the proportion of local parts, requiring 60% to qualify as locally manufactured. The common external tariff for automobiles would be set at 35% at the end of 1999. This was a drop from 49% for Brazil and an increase from 33½% for Argentina. Furthermore, Brazil would agree not to add new subsidies after 1999 without consensus among the four Mercosur partners.⁵⁵

⁵² Carranza, 10.

⁵³ Helio Jaguaribe and Alvaro De Vasconcelos, The European Union, Mercosul and the New World Order. (Portland, Oregon, Frank Cass and Co., 2003), 186.

⁵⁴ Carranza, 10.

⁵⁵ Peter Fritsch, “Latin Nations Take Big Step On Car Tariffs”. *The Wall Street Journal*, (December 11, 1998), 1.

“The true nature of the dispute was made clear when Brazil announced its new quota policy.” Carlos Magarinos, the Argentine industry secretary observed, “The real dispute is over investments.” Concerned with unlimited imports of autos from a more business-friendly Argentina, Brazil was forcing transnational manufacturers to stay invested in Brazil. The director of Toyota Argentina, upon learning of the quotas, said “the only people surprised at what happened are those who don’t understand the traditional policies of Brazil, which have been, if not imperialistic, at least overwhelming.”⁵⁶

On January 12, 1999, Brazil would devalue the real by nearly 40% with devastating effects on the Argentine economy. Three days later it was floated at market value. “In a desperate attempt to stabilize the real and keep foreign investment from leaving the country, the government raised interest rates several times that month, but the currency continued to decline.” The real would drop as low as 2:1 to the dollar (and subsequently the Argentine peso, pegged at 1:1).⁵⁷

This would reopen and expand the auto crisis, threatening the industry that accounted for 8% of Argentine manufacturing. Auto production in Argentina had grown from 64,000 vehicles produced in 1988 to 457,000 in 1998.⁵⁸ In February 1999, The Wall Street Journal reported:

Brazilian devaluation will slash auto production in neighboring Argentina between 20 and 50% this year, put several Argentine parts suppliers out of business and could undermine the trade ties crafted by the two countries in the past four years, auto executives and union officials say.⁵⁹

The crisis would escalate, expanding to include a broad spectrum of cheap Brazilian goods pouring into Argentina. Menem would respond with a series of retaliatory tariffs, quotas, and threats. Brazil would respond in kind. By July 1999, Brazil suspended negotiations and threatened to dissolve Mercosur. President Menem

⁵⁶ Jeffrey Cason, “On the Road to Southern Cone Economic Integration”. *Journal of Interamerican Studies and World Affairs* 42, no. 1, (Spring 2000), 6.

⁵⁷ Carranza, 10.

⁵⁸ Anonymous. “Argentina’s Motor Industry: Update on a Crisis”. *The Economist Intelligence Unit Motor Business International*, (Second Quarter 1999), 28-31.

⁵⁹ Craig Torres, “Brazilian Turmoil Threatens Argentine Car Exports: Volkswagen, Fiat Cut Production”. *The Wall Street Journal*, (February 1, 1999), 1.

would meet with President Cardoso in a “desperate attempt to solve the crisis.” By the end of the year, the panic subsided on its own due to expiring tariffs, voluntary export restrictions, and some arbitration. There was even a partial recovery in 2000.⁶⁰

A final automotive regime was established only at the June 2000 presidential summit in Buenos Aires. The agreement creates and Automotive Committee, which will administer the regime at the end of a “transition phase” (in 2003).⁶¹

Argentina’s lack of flexibility under the Cavallo Plan would only serve to drag their economy further into a hole. In order to pay its mounting debt, Argentina took \$39.7 billion aid package from the International Monetary Fund in December 2000. As the Brazilian economy slowed in early 2001, the real dropped another 32%. By August, the IMF would approve another \$8 billion to Argentina to prevent default on the \$150 billion already owed. Domingo Cavallo, in a return as economy minister, sought stronger ties with the U.S. and wanted to revert Mercosur to a free trade area.⁶²

This time, Brazil would make concessions to keep Mercosur alive. The Common Market Council voted to allow Argentine tariffs that were in clear violation of the customs union until the end of 2002. The intent was to give Argentina time to recover by a temporary “suspension” of the union. The ongoing FTAA negotiations provided Brazil with further incentive to placate their partner. Eventually, President Cardoso de la Rúa agreed to create a “temporary bilateral mechanism of safeguards inspired by the rules of the World Trade Organization.”⁶³

In December 2001, Argentina was forced to default on the \$30 billion due in foreign loans. In January 2002, Argentina finally came off the pegged exchange rate. The overvalued peso coupled with excessive foreign debt plunged Argentina into a deep financial crisis.⁶⁴

⁶⁰ Carranza, 12.

⁶¹ Ibid, 12.

⁶² Ibid, 13.

⁶³ Carranza, 14.

⁶⁴ Martin Feldstein, “Argentina’s Fall”. *Foreign Affairs* 81, no. 2, (March/April 2002), 3.

Harvard economics professor Martin Feldstein asserts that the shift from the pegged rate should have happened sooner. It was held too long due to fear of returning to hyperinflation. Furthermore, it still would have worked if the peso had become more competitive by productivity increasing faster than wages. This would have permitted Argentine prices to decline relative to those abroad. Initially, from 1991-1994, Argentina experienced 7% growth. However, a combination of rigid labor laws and strong union pressures prevented further reduction in production costs. Also, the dollar strengthened from 1995 to 2000 bringing the peso up with it. The Brazilian devaluation in 1999 was the fatal blow. The government was forced to raise interest rates, causing recession. Unemployment climbed to 15%. Still unions refused to cut wages.⁶⁵

Ironically, the Argentine financial crisis may have had a long-term positive effect on Mercosur. By unfairly blaming Washington, Argentines have found common cause with Brazil in their time of trouble.

In sharp contrast to the perceived callous indifference of the United States to Argentina's plight, Brazil announced in February 2002 that it would open its market to Argentine imports by immediately eliminating any remaining tariff and nontariff barriers.⁶⁶

Brazil also agreed to set a 2:1 vice import-to-export ratio for autos vice the previous 1:1 ratio. Furthermore, "Argentine devaluation allowed Argentina and Brazil to discuss their bilateral problems in a common language, raising hopes that Mercosur would be 'relaunched' in 2002".⁶⁷

E. CONCLUSION

This chapter has discussed the agreements that created and modified Mercosur and the handling of subsequent disputes. By framing the events at Asuncion as a two-level game, it helps us determine whether these disputes are an obstacle to further integration or a chance for the states to draw closer by working toward a shared goal.

The realist model presumes that states are the dominant actor in an anarchic world and concerned with maintenance of sovereignty. The two-level game necessarily

⁶⁵ Feldstein, 4-7.

⁶⁶ O'Keefe, 8.

⁶⁷ Carranza, 3.

includes a domestic level of analysis, introducing an element of the broad liberal paradigm. However, it does assume the rational actor is in pursuit of his own best interest, a theme sufficiently demonstrated in this section as well as the ensuing parts of the paper. The various Protocols demonstrate an apparent effort to be noncommittal regarding supranational authority. This is almost certainly in keeping with the realist tradition.

The final section concerns the crises that threatened the arrangement. Initially, they all support the tendency toward realism. Manzetti observes that according to the “realist definition...decline should accelerate.”⁶⁸ Indeed, that appears to be the case:

Problems of relative gains have begun to arise. Thus far the four countries have been able to address most of the disputes that have arisen more or less successfully, either through new internal arrangements or the offer of side payments.”⁶⁹

However, the ostensible reversal of Brazil’s policy toward Argentina in 2001 and the perseverance of Mercosur in the face of apparent doom make an uncomplicated conclusion impossible. The realist can only offer one other explanation. Mercosur is more useful to Brazil alive than dead. Roett’s summary of Brazilian motivations supports this.

Brazilian concerns are geared less to Argentina than to the United States, which is perceived as a major constraint on Brazil’s pursuit of its national interest...Argentines center their apprehensions on the expansion of Brazilian power, with beliefs about Brazil falling into two camps...[the first believing Mercosur is] not a zero-sum game so long as common interests are preserved. The other side, however, endorses the idea that political alignment with the United States must be maintained to counterbalance the expansion of economic ties with the Brazilian economy.⁷⁰

So with this explanation comes the traditional balance of power theory. Despite aspects of liberal explanations, Thucydides could easily have explained Argentine-Brazilian international relations since 1991 in the ‘realist’ tradition. This implies that the

⁶⁸ Manzetti, 120-121.

⁶⁹ Ibid, 130.

⁷⁰ Roett, 42.

individual states will only pursue further integration if it is their own best interest. This is a difficult question and is outside the scope of this thesis. If the member states believe this is the case, Mercosur has a bright future. However, even if this is the case, could nationalism still serve as an impediment to further integration? The next chapter will address this.

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IV: ECONOMIC NATIONALISM AND MERCOSUR: COMPLEMENTARY OR CONTRADICTION?

A. INTRODUCTION

The term “economic nationalism” is traditionally used to describe macroeconomic policies that are diametrically opposed to liberal economic policies. This may not necessarily be the case. In fact, this chapter begins by examining Eric Helleiner’s argument that this statement is untrue. Dr. Helleiner is a graduate of the London School of Economics and a professor of international political economics at Trent University. By his definition, economic nationalism can sometimes actually endorse liberal macroeconomic policies. He makes a very convincing argument that suggests further integration of Mercosur could be assisted by economic nationalism.

Helleiner makes two critical assertions. First, he states “economic nationalism is most properly defined by its nationalistic content rather than as a variant of realism or as an ideology of protectionism.”⁷¹ This is important because it places the interest of the nation above that of any individual sector within a national economy by attempting to define the *national* interest.

Based on this premise, Helleiner further proposes that “[economic nationalism] can be associated with a wide range of policy projects, including the endorsement of liberal economic policies.”⁷² This is a major departure from conventional wisdom.

The second section will further examine Helleiner’s four “strands” of economic nationalism throughout history. They are infant-industry protection, macroeconomic activism, autarchic economic nationalism, and liberal economic nationalism. Each strand will be examined to see if it fits the new definition using examples from Latin America. Each case will highlight the fact that economic nationalism can, in fact, lead to liberal economic policies.

The final section will focus on Mercosur, where this new perspective has enormous consequences for framing the debate on further integration. While the free

⁷¹ Eric Helleiner, “Economic Nationalism as a Challenge to Economic Liberalism? Lessons for the 19th Century”. *International Studies Quarterly* 46, (2002), 307.

⁷² *Ibid*, 307.

flow of goods within the common market is a hallmark of liberal economic policies, detractors will argue that a tradition of protectionism and “economic nationalism” in the region guarantee a short life expectancy for this experiment. Furthermore, differences in currency have caused great schisms within Mercosur. Can that be rectified by a common currency?

The conclusion will attempt, if possible, to determine whether Mercosur is will face another obstacle in economic nationalism.

B. ECONOMIC NATIONALISM DEFINED

There does not seem to be a consensus definition of economic nationalism in practice today. The term “economic nationalism” first appeared between the two World Wars of the 20th century.⁷³ This ambiguous concept was generally applied as the root of all tariffs, quotas, subsidies, restrictions on foreign direct investment, and economic autarchy. This broad usage only muddied the meaning further until the term was not functional. In fact, Michael Heilperin noted, “at best economic nationalism is an indefinite term, used by its opponents, more than by its proponents.”⁷⁴

In the 1970s, as the field of international relations took more interest in international political economy, economic nationalism was neatly positioned in the realist milieu. Robert Gilpin suggested that economic nationalists were actors within the state that assumed that the “world market economy operates to the disadvantage of the economy and domestic welfare.” Furthermore, while all realists might not be nationalists, all nationalists were realists.⁷⁵

This had two effects. The first was a step in the right direction by reminding economists that there are important sub-actors in the global economy. Previously, David Ricardo and Richard Cobden portrayed economics with a very “cosmopolitan”⁷⁶

⁷³ Helleiner, 308.

⁷⁴ Ibid, 309.

⁷⁵ Robert Gilpin, The Political Economy of International Relations, (Princeton, Princeton University Press, 2001), 14.

⁷⁶ Worldly or global.

perspective.⁷⁷ They were correct that the world market balances itself, however, it often does so at the expense of one or more national economies. As the electoral franchise expanded in the 20th century, governments were forced to be more activist.⁷⁸ No government could allow their national economy to be the loser when the unemployed had a right to vote. By recognizing the importance of nations as actors in the global economy, it is easier to understand the impact of economic nationalism.

The second effect of equating economic nationalism with realism is the risk of oversimplification. Helleiner's definition of economic nationalism does not equate the goals of the state with that of the nation. The "state" usually is viewed as "the political institutions...government...geographical boundaries, and the monopoly over use of force within those boundaries."⁷⁹ The "nation" represents a group of people "that share a common identity, and usually a common language and history," who grant political legitimacy to the state.⁸⁰ George Crane concurs that the "state and nation may overlap in various ways but the national identity is not simply an expression of state interest."⁸¹ Rawi Abdelal adds "economic nationalism should describe a perspective more concerned with the influence of national identities and nationalism on economic policy."⁸²

One can sum up Helleiner's definition of economic nationalism as a "set of policies that result from a shared national identity, or from the predominance of a specific nationalism in the politics of a state."⁸³ This definition provides a lens to examine the "strands" of economic nationalism.

C. THE FOUR STRANDS

Helleiner has identified four strands of economic nationalism throughout modern history. They are infant-industry protection, macroeconomic activism, autarchic economic nationalism, and liberal economic nationalism. Each will be examined in turn.

⁷⁷ Helleiner, 313.

⁷⁸ Ibid, 317.

⁷⁹ Stephanie G. Neuman, International Relations Theory and the Third World. (New York, St. Martin's Press, 1998), 6.

⁸⁰ Ibid, 219.

⁸¹ Helleiner, 309.

⁸² Ibid, 309.

⁸³ Ibid, 310.

Infant-industry protection calls for protective tariffs or subsidies until the new industry becomes competitive in the world market. Taken too far, this creates an inefficient industry by allowing excesses that would normally be corrected in response to normal competition. As long as these trade barriers remained in place, this practice met the traditional definition of economic nationalism. If it served the nation as a whole, then it would meet Helleiner's standard as well.

Nineteenth century economist Friedrich List is best known for advocating infant-industry protection, however, Ricardo's close friend John Stuart Mill also accepted the case for it. List did not necessarily disagree with economic liberals, but recognized the preeminence of the nation. List argued that the "goal of economic policy must not be limited to wealth maximization but must also include the development of a nation's culture and power." 84

The Brazilian space program might demonstrate List's corollary. While there does not seem to be an economic or a truly military benefit to balance the enormous costs of the program, it has a direct impact on national prestige by making Brazil one of an elite group of international space explorers. Furthermore, Brazil announced in June 2003 that it would migrate a majority of their government computer systems from Microsoft to Linux. The given rationale was that open source software would save money, but one can also assume that many Brazilians took pride in rebuffing the U.S. software giant.

Raul Prebisch's pessimistic "dependency theory" gave rise to infant-industry protection taken to an extreme to which List might not have approved. It essentially stated that the "periphery states" could never compete against the "core" states. The East Asian NICs, who managed their economies far more efficiently than their Latin competitors and progressed to 'first-world' status, invalidated this idea in the 1980's.⁸⁵

Although lack of competition may be appealing for a particular industrial sector, it is often not in the national interest. For example, Thomas Friedman examines the case of facsimile machine technology in Brazil. When both Taiwan and Brazil entered the facsimile market in the 1980's, the Brazilian Congress protected their fledgling industry

84 Helleiner, 311.

85 John H. Dunning and Khalil A. Hamdani, The New Globalism and Developing Countries. (New York, United Nations University Press, 1997), 262.

while Taiwan forced its to compete. By 1994, Taiwan was the world's leading manufacturer of fax machines. At the same time, Brazilian fax machines were outdated and overpriced. In 1995, Brazil in effect conceded their error and dropped the tariffs.⁸⁶ The "national" interest in this case was a liberal economic policy that would favor the Brazilian consumer.

Macroeconomic activism is another strand of economic nationalism. In this case the state exerts influence on the national economy. According to Helleiner, if this serves the national interest, it is economic nationalism. This section will examine one of the government's most effective tools of economic manipulation, currency.

The government can wield immense influence on the national economy simply by printing more or less currency, a fact more or less neglected by Adam Smith's worldview. By tying the national medium of exchange to gold or dollars, the government cedes much control over the national economy. The critical determiner of nationalist intent in this case remains the national interest. Although in many cases the two are inextricable, the good of the nation does not always reflect the good of the state.

In the 19th century, the gold standard was praised by free traders, but deemed as a threat by many "economic nationalists." The apparent advantage for the world market was international currency equilibrium with a minimum of government interference. In the early 19th century, at a time when his native Britain dominated world trade, Thomas Attwood was a vociferous critic of the gold standard. He advocated an inconvertible national currency to promote national prosperity, based on the belief that government could control depressions and unemployment through manipulation of the cash pool. Attwood, an early predictor of Keynesian deficit spending, lectured on the necessity of retaining control of the nation's currency.⁸⁷ This imposes a responsibility on the state institutions to care for the nation.

⁸⁶ Thomas L. Friedman, *The Lexus and the Olive Tree*. (New York; Farrar, Straus and Giroux, 1999), 184.

⁸⁷ Helleiner, 315.

It [money] alone supports and maintains all the great processes of production, distribution, and consumption; it feeds the hungry and clothes the naked, and breaks open prison doors, and saves families from ruin.” 88

In the late 19th century, Canadian businessman Isaac Buchanan offered another reason for inconvertible currency. He argued that it breeds national allegiance. A man who has his fortune invested in a national currency that is worthless in the rest of the world “has an incentive to support its institutions, in addition to his patriotism, because he knows that if the country goes down his money will be valueless.” 89

The previous cases assume that the gold standard was detrimental to national interest. However, in some cases it may not be. Bismarck used the gold standard to unite a number of smaller economies while consolidating Germany in the 1870s.⁹⁰ Many “late developing countries” favored the gold standard because it attracted foreign investment by “creating a more credible and stable standard of value.” Furthermore, adopting the gold standard became a “source of national prestige.”⁹¹

By the late 20th century, U.S. dollars would replace gold as the standard for international currency. In Latin America, Ecuador, El Salvador, and Panama went so far as to “dollarize,” assuming the U.S. dollar as their national currency.⁹²

Some countries merely fixed the exchange rate with the dollar to slow inflation. In the mid-1990s, Argentina instituted the Cavallo Plan, a currency board that locked the peso into parity with the U.S. dollar. In the short term, this curbed hyperinflation, much to the relief of the Argentine nation. However, failure to flex the standard once inflation was arrested would eventually lead to an overvalued peso and a collapse of the Argentine economy in 1999.⁹³ Had Argentina decoupled its currency at the proper time, it might

88 Ibid, 316.

89 Ibid, 316.

90 Helleiner, 321.

91 Ibid, 321.

92 Pedro-Pablo Kuczynski and John Williamson, After the Washington Consensus: Restarting Growth and Reform in Latin America. (Washington, D.C., The Institute for International Economics, 2003), 128.

93 Ricardo Ffrench-Davis, Financial Crises in “Successful” Emerging Economies. (United Nations, Economic Commission on Latin America and the Caribbean, 2001),19.

have avoided financial tragedy that adversely affected the entire nation.⁹⁴ This is a situation where, in hindsight, an astute economic nationalist might have endorsed a policy that allowed the peso to float once hyperinflation had been arrested.

Autarchy, the intense government regulation of a closed economy, seems to epitomize the traditional definition of economic nationalism.⁹⁵ In this situation, the state essentially cuts off commerce with the international community and attempts economic self-sufficiency. This extreme measure has rarely been truly implemented. Adam Muller, a conservative Prussian in the early 19th century was one advocate, criticizing the liberal economic policies of Metternich's Austria.⁹⁶ Around the same time, Johann Fichte wrote The Closed Commercial State, advocating an extremely interventionist government that fixed prices and wages, discouraged foreign trade, and abolished gold or silver as currency. After the collapse of the world economy in the 1930s, the Nazi party briefly resurrected some of Muller's ideas while searching for a more nationalistic economic policy. Surprisingly, in 1933, even John Maynard Keynes made the point that a certain degree of economic autarchy was necessary for successful national economic planning.⁹⁷

The most obvious example of economic autarchy in the western hemisphere today is that of Cuba. When Fidel Castro chose the communist road, he placed the nationalistic concerns of the state over the economic concerns of the nation. His choice of the revolutionary "Che" Guevara as Minister of Industries and president of the National Bank of Cuba highlights this. Only close ties with the Soviet Union kept the economy remotely viable. In the mid-1990s, after the collapse of the U.S.S.R., the economic situation became dire. Cuba has reluctantly begun preliminary liberal economic reforms, including liberalizing farm markets, legalizing possession of U.S. dollars, and opening certain sectors to foreign direct investment.⁹⁸ Helleiner's definition of economic

⁹⁴ Martin Feldstein, "Argentina's Fall". *Foreign Affairs* 81, no. 2, (March/April 2002): 10.

⁹⁵ Helleiner, 317.

⁹⁶ Ibid, 318.

⁹⁷ Ibid, 319.

⁹⁸ Javier Corrales, "The Gatekeeper State: Limited Economic Reforms and Regime Survival in Cuba, 1989-2002". *Latin American Research Review* 39, no. 2 (2004): 31.

nationalism in this case would denounce Castro's autarchic practices and embrace the recent exceptions as being in the best interest of the nation.

Liberal economic nationalism endorses free trade for nationalistic reasons. The most successful free traders of the 19th century, the British Empire, did so for nationalistic reasons. Arguments for free trade in British Parliament cited such goals as "bolstering British wealth and international power"... "rendering the world a tributary to [Britain]"...as well as "supply[ing] the whole world with manufacturers, and [having] almost a monopoly of the trade of the world."⁹⁹

Ukrainian nationalists support liberal market reforms as a means of emphasizing their separation from the former Soviet Union. Quebec nationalists have long supported free trade as a means of minimizing their dependence on the Canadian central government.¹⁰⁰

In Latin America, the initial impetus after independence was to introduce liberal economic policies. Nationalists, who recently shed the yoke of colonialism, associated trade restrictions with Iberian tyranny. They espoused the British model in hopes that it "offered both the possibility of growth in poor, sparsely populated agricultural countries and a vehicle for nation-building in states still struggling to assert their sovereignty domestically and internationally."¹⁰¹

In sum, there are many aspects to protectionism, but they are not necessarily economic nationalism. Infant-industry protection is protectionist, but if not implemented wisely can have adverse effects on the national economy, as demonstrated by the Brazilian fax case. Control of currency is a state prerogative, but the state must know when to peg currency and when to float it, as was the case in Argentina. The economic impact will determine whether the policy was nationalistic or not. Autarchy in the extreme is rarely good for a national economy and is especially detrimental in today's globalized market. Even autarchic Cuba has begun to make liberal economic concessions. Free trade can at times be the embodiment of economic nationalism. Great

⁹⁹ Helleiner, 320.

¹⁰⁰ Ibid, 310.

¹⁰¹ Ibid, 320.

Britain espoused the national advantages in the 19th century and the recently independent Spanish and Portuguese colonies chose free trade as the best course for their new nations.

This section has examined the traditional meaning of economic nationalism and extricated a practical definition. By making a distinction between the state and the nation, as well as distinguishing between an ideology of protectionism and a true concern for the welfare of the nation, it is possible to speculate whether it is an enabler or a hindrance to regional integration. The next section will now examine Mercosur armed with this definition.

D. ECONOMIC NATIONALISM AND MERCOSUR

Latin American countries have shifted macroeconomic strategies since the 1980s to focus on export-oriented trade.¹⁰² While abandoning the *dependencia* model, they have also sought an effective approach for protecting national interests and gaining a competitive edge internationally. One such model is that of regional cooperation. With the apparent success of the North American Free Trade Area and the European Union, nations of the Southern Cone put their faith in the Mercosur, or the Common Market of the South. If it were possible to demonstrate across-the-board economic growth for the member nations, it would be easy to surmise that the liberal economic reform that resulted from regional integration is within the bounds of Helleiner's economic nationalism.

In 1996, Alexander Yeats of the World Bank earned the ire of Brazil when he criticized Mercosur as protectionist and concluded that it was failing in its stated goal of trade creation. In 1997, Edward L. Hudgins of the Cato Institute disputed that claim on the assumption that internal free trade was a step in the right direction.¹⁰³ A 2000 study by Anaam Hashmi also tempered the criticism, but supports the assertion that trade diversion vice creation has been the result.¹⁰⁴

¹⁰² W. Andrew Axline, The Political Economy of Regional Cooperation. (London, Pinter Publishers, 1994), 4.

¹⁰³ Edward L. Hudgins, "Mercosur Hasn't Caused Trade Diversion". *Wall Street Journal* (March 25, 1997).

¹⁰⁴ M. Anaam Hashmi, "Role of Mercosur in Regional Trade Growth". *Managerial Finance* 26, no. 1, (2000), 41-52.

This might imply that there is a better way to increase prosperity in the region, and perhaps this is the case. The United States would like to see the Free Trade Area of the Americas in place. This model in many ways would merely resemble a bigger Mercosur where the United States assumes Brazil's role as the dominant member. Alternatively, Mercosur could dissolve and member states could either pursue their needs through the World Trade Organization or withdraw from the world economy completely. The former is unattractive because they lose the benefits of collective bargaining. The latter idea borders on the ridiculous. Therefore, it seems that the present trade status quo should meet the economic nationalist's need for benefiting the nation once an adequate dispute resolution system is put into place to address sectoral grievances.¹⁰⁵

The most pressing disparity within the common market is individual fiscal policy concerning currency. While Argentina chose to stick with their currency board, Brazil boldly devalued the *real* in 1999. Although the resulting friction with Argentina threatened the foundations of Mercosur, the net result for Brazil was impressive. "Brazil began 2002 with a solvent banking system and strong capital inflows [with] the recovery...in full swing."¹⁰⁶ The trade deficit reversed sharply to a surplus.

Some have proposed a common currency, tentatively named the *Merco*, similar to the *Euro*.¹⁰⁷ European integration is far more advanced than that of Mercosur, and the decision to use a common currency was laden with political motivations. For the member states of Mercosur to forfeit control of interest rates, seigniorage,¹⁰⁸ and exchange rates for a harmonized macroeconomic policy and minimized transactions costs seems unlikely in the short term. Barry Eichengreen recommends harmonized inflation targeting as an alternative.

Ironically, the Macroeconomic Marketing Group (GMM) was created in December 2000 with the goal of targeting inflation (under 5%), fiscal deficits (under

¹⁰⁵ Mario E. Carranza, "Can Mercosur survive? Domestic and International Constraints on Mercosur". *Latin American Politics and Society* 45, no. 2, (Summer 2003): 67.

¹⁰⁶ Christopher Whalen, "The Real Thing". *Barron's* 82, no. 14, (April 2002): 22.

¹⁰⁷ Bernard Malamud and Wayne A. Label, "The Merco: A Common Currency for Mercosur and Latin America". *American Business Review* 20, no. 2 (June 2002): 8.

¹⁰⁸ Seigniorage is the revenue that results from the difference in the actual cost of money printed and its value.

3.5% of GDP), and public debts (less than 40% of GDP). Unfortunately, the GMM seems inactive in the wake of the Argentine crisis. These benchmarks seem to be sound fiscal goals for the individual nations as well as the larger common market.¹⁰⁹

Finally, it seems like the nations of Mercosur can best ensure their prosperity collectively through free trade and sound, coordinated fiscal planning. If this is true, then it is in the interest of the member nations to maintain active membership in the common market.

E. CONCLUSION

Traditionally, the term “economic nationalism” has encompassed any policy that opposes economic liberalism. Helleiner asserted that it should be redefined by using the interests of the nation as a determiner. This in turn opened the door for a new sort of heresy, that economic nationalists could actually endorse liberal economic policies.

Examining economic policies in the last two centuries supports this conclusion. Infant-industry protection was acceptable to economic liberals like J.S. Mill if used in moderation. The case of Brazilian fax technology in the 1980s and 1990s demonstrates that protectionism was not in the best interest of the nation, and therefore not nationalist in nature. Macroeconomic activism in the form of the Argentine currency board recently drove the country into a recession when “floating” the currency would have been in the national interest. Autarchy in Cuba has devastated the economy to the point where Castro is beginning to see capitalism as the answer to avoiding crippling poverty. Finally, liberal economic nationalism is revealed to have always existed, furthering the interests of a nation through trade, whether by the British Empire or the fledgling independent nations of Latin America.

Based on this theory, one can now attempt to scrutinize the integration of Mercosur. Applying the new understanding of economic nationalism, does further integration fit each member’s economic nationalist agenda? Either it is better for individual member nations to embrace or withdraw from the common market. Unfortunately, in the cases of Argentina and Brazil, the evidence is inconclusive. Although more liberal trade and a common currency may lead to economic prosperity, it

¹⁰⁹ Barry Eichengreen, “What Macroeconomic Measures Are Needed for Free Trade to Flourish in the Western Hemisphere?”. *Latin American Politics and Society* 46, no. 2 (Summer 2004): 27.

would require a sacrifice of sovereignty and the last vestiges of economic autarchy that is unlikely to be acceptable to the states. To withdrawal would seem counterproductive and certainly not within the member's national interests. While relative-gains issues and dispute resolution may plague further integration, it would appear that the nations are committed to the path of economic liberalism and cooperation holds the best prospects for the prosperity of their respective nations. While it is difficult to determine whether economic nationalism will encourage further integration, it is clear that it will not inhibit it.

V. CONCLUSION

The four nations of Mercosur seem to be committed to their decade-plus experiment with regionalism. This thesis opened with an examination of the potential this arrangement carried in three domains: economic, political, and military. It compared its development with that of the most successful regional arrangement to date, the European Union and concluded that although the means may differ, the result could eventually be strikingly similar.

The next chapter examined the treaties that created Mercosur through the theoretical lens of Robert Putnam and then tested his theory by examining the disputes that have threatened to dissolve Mercosur. It concluded that the negotiations surrounding Mercosur could be classified in the realist tradition. This means that the member states must believe it is in their individual interests to strengthen Mercosur, a crucial assumption for the next chapter to be relevant.

The last chapter addressed economic nationalism. If one assumes that states are nationalistic, does this present an obstacle to further integration? The answer is once again 'no'. By accepting Helleiner's theory, national interest once again determines whether economic liberalism is nationalistic.

So Mercosur has a path in front of it. Barring obstacles, it could develop along the same lines as the European Union. This would mean more economic integration, stronger supranational institutions, and possibly a standing multi-national peacekeeping force.

The obstacles examined here seem to be superceded by the national interest, a subjective conclusion that cannot be fully examined in this thesis. What is important is whether or not the member nations believe that a stronger Mercosur is in their national interest.

There are strong motivations for further integration that have been noted in this work. Increased bargaining power within the international system is a powerful one. This could physically manifest itself with a seat for Brazil on the U.N. Security Council. On the economic front, Mercosur has already attempted to leverage its market for

favorable terms of trade from the European Union and the North American Free Trade Area. Solidarity is essential to this end.

Strategically, Mercosur appears to be in the interests of its member states. We can expect to see further broadening and some deepening of its institutions. Its success will be determined by its ability to carve out a significant niche in the new international system.

This development should have a major impact on U.S. policy toward the region. The 'divide and conquer' strategy of pursuing bilateral trade agreements will undermine the bargaining position of Mercosur and ensure terms favorable to the U.S. This may not be the wisest course due to a long history of resentment aimed at the United States in the region. Ultimately, political stability and physical security in the region benefits actors in both North and South America. By making economic concessions and dealing directly with Mercosur, the U.S. could insist on a regional peacekeeping force and a democracy clause. It is only a matter of time before the WTO undermines agricultural subsidies. Offering this compromise saves the U.S. government billions and would be seen as a major concession in South America. Done properly, this process could soothe relations in the Western Hemisphere, gain favorable access to a vast market for goods, and gain valuable allies at a time when the dominant superpower is the perpetual target of criticism.

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