Brazil's Mercosur Economic Strategy: From Destiny to Impairment

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CARLOS PIO, OCT 28 2011

"Mercosur is Brazil's destiny; the FTAA and the EU are options"
President Fernando H. Cardoso, 2002.

Mercosur is a government-led customs union created by Argentina, Brazil, Paraguay and Uruguay in the second-half of the 1990s. In its first years, intra-Mercosur trade grew significantly due to the fact that its major associates – Argentina and Brazil – were experiencing an unusual period of price and exchange rate stability. Over the years, instead of deepening integration, Mercosur-countries have agreed to revert part of the previous liberalization of trade, a path still under way. Increasing macroeconomic difficulties in Argentina and Uruguay, especially after Brazil abandoned its crawling-peg (managed) exchange rate regime in January 1999, led to further postponement of the completion of both the free trade area and the common external tariff and trade defence structures that had been agreed upon in the Asunción Treaty and Ouro Preto Protocol, signed in 1991 and 1994, respectively. Today, Mercosur is more of a dysfunctional set of rules, decision-making procedures and abstract principles that never materialise for the benefit of the more competitive industries and firms in the region than a well-functioning case of open regionalism. This short piece addresses some of the causes for Mercosur's failure as well as the current Brazilian strategy towards it.

Notwithstanding President Cardoso's opinion, a quick look at Brazil's trade statistics will *not* support his idea that increasing commercial interdependence within Mercosur is Brazil's (manifest) destiny. The reality is that, despite large increases in volume and absolute figures, the relative weight of trade with Mercosur countries in Brazil's total trade has in fact fallen. In 1994, the year before the scheme came into existence, Brazil's exports to future Mercosur partners accounted for less than $6 billion (13,6% of total), and its imports were $4,5 billion (13%); last year, figures were $22,6 billion (an absolute increase of more than 370%) and $16,6 billion (360%), respectively. During the same period, Brazil's total exports increased even more, from $43,5 to $163,3 billion (375%), and imports from $33 to $148,6 billion (450%) as a result of the dismantling of trade regulations from the import substitution era.

The causes for these trends are the Argentine peso crisis of 1999-2001 and the increasing importance of Brazil's trade relations with China. The peso crises had deep domestic roots in the strong inflationary pressures resulting from fiscal indiscipline at both the federal and provincial levels of government, combined with a Constitutional provision imposing currency convertibility at a fixed parity. The resulting currency appreciation made Argentinean companies uncompetitive, and the trade account structurally negative. In January 1999, Brazil's decision to let the exchange rate float (and devalue) made a bad situation worse. In response to increasing imports and capital flight, Argentine desperately increased protection for its domestic industries, especially manufacturing. Although urgently needed, the final abandonment of the fixed exchange regime, in early 2001, was catastrophic: a 400+ percent devaluation of the peso paralysed the entire country, both financially and politically. Since 2003, under the presidency of both Néstor (2003-2007) and Cristina Kirschner (2007-present, and recently re-elected), Argentina has espoused populist economic policies that resemble those practiced in the 1950s-80s (*developmentalism*). As a result, inflation and imports are on the rise again as well as pressures for protection. In particular, bilateral trade with Brazil went from a structural surplus to a deficit that has now lasted for years. Increasing dependence on imports from Brazil is again a trendy subject in political gossip.

As a result of the pro-market reforms partially pursued throughout the 1990s, Brazil has managed to keep inflation at a historical low, let the exchange rate float and induce firms to specialize and gain productivity. The impact of such changes on the country's trade with both Mercosur and non-Mercosur partners was substantial as both imports and exports rose sharply in the following decade. In particular, commercial relations with China boomed – exports went from $2,5 billion (4% of total) in 2002 to $30,7 billion (15.3%) in 2010, while imports rose from $1,5 billion (3% of total) to $25,6 billion (14%) – and now make the largest slice of the country's trade.

The decreasing relative importance of Mercosur in Brazil's trade accounts around the time President Lula rose to power (2003) coincided with the country's ascension to the highest tier of the global governance structures. Its foreign policy rhetoric depicted an image of Brazil as a natural and benevolent leader of South America. Yet, some of Brazil's neighbours did not subscribe to that view due to old-time disputes (Argentina), distinctive historical paths (Chile and Venezuela), and recent disagreements (Paraguay and Bolivia). The perceived need to spread and consolidate such international *persona* justified a populist strategy towards the region, in general, and for the weakest-members of the Block in particular.

Allegedly, the new strategy was expected to foster a different sort of international or regional cooperation – this time among equals, "horizontal". According to Brazilian government officials such a strategy should involve the creation of new institutions encompassing all South American countries (e.g., the Union of South American Nations, UNASUR), the political and membership build-up of Mercosur (e.g., Venezuela's full-membership), and the adoption of innovative guiding-principles at Mercosur. Chief, among those, were: correcting structural asymmetries among member-countries; deepening the integration of all countries' productive structures; building a transnational infrastructure network (oil and natural gas pipelines, electric energy transmission lines, roads, etc.); and establishing trade settlements in local currencies.

In the realm of Mercosur, none of those plans have really worked out at all. In the regional context, only one important infrastructure project has progressed according to plan: the Interoceanic Highway linking Brazil's westernmost region to the Peruvian port-city of San Juan de Marcona, south of the capital, Lima. For the most part, this project is being financed by the Brazilian National Economic and Social Bank-BNDES and executed by giant Brazilian contractors. There are similar plans to start building a road cutting through Bolivia's Amazon region – which is being harshly contested by Bolivian indigenous movements – in order to allow Brazilian commodity exporters to reach the Chinese market via northern Chilean ports.

The reasons for most of the fiascos in such "developmental" projects are old and well-known: a combination of scarcity of public financial resources, poor regulations that fail to attract private capital, domestic political rows in most countries (Bolivia, Argentina, Ecuador, and Venezuela, to name the most striking ones) and a lack of domestic political support for the involvement of the national governments in projects to be developed abroad. In the end, the crude reality is that outcomes tend to fall short of the populist promises.

In conclusion, it is important to note that, as a customs union, Mercosur tends to limit all member-states' sovereignties to negotiate trade deals with non-members. The level of trade protection imposed against more efficient non-Mercosur suppliers for everything that is produced in one of the other members' territory has been a key explanation for Mercosur's low enthusiasm for trade negotiations with other blocks or countries, particularly with the EU. Openness to the outside world, even if unilateral, could boost local productivity, foster capital accumulation and promote positive specialization in each country, then increasing wealth and prosperity. That the only negotiation accomplished to this date has been a free trade agreement with Israel says a lot about the Block's poor functioning and unrealised potential.

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