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Brazil in a Globalising World

AMAURY DE SOUZA

INTRODUCTION

Emerging market economies such as Brazil and Argentina face difficult times in today's globalising world. A combination of adverse circumstances in the world economy is likely to affect their potential for growth negatively in the near future. Oil prices have tripled since 1998; interest rates have been on the rise since 1999; investors have taken a flight to quality, and global economic growth is expected to slow. Furthermore, recent developments in security and global affairs do not bode well for international relations. This is especially true with the decision by the United States (US) to unilaterally repeal the Kyoto convention on global climate change and the international nuclear arms control regime, in order to have it replaced by a global missile defence.

Uncertainty regarding the evolution of the world economy has affected trade arrangements everywhere. Since the World Trade Organisation's (WTO) global trade round collapsed in Seattle, there has been a world-wide race to negotiate bilateral or regional free trade agreements. The US has concluded a free trade agreement with Jordan and plans similar deals with Singapore and Chile in addition to the proposed Free Trade Area of the Americas (FTAA). The European Union (EU) has negotiated bilateral agreements with Mexico and South Africa, and there are plans to incorporate Eastern European countries, as well as to form a free trade area with Mercosul. In Asia, Singapore's bilateral deal with New Zealand has been followed by ASEAN's ambitious design for a free trade area with China, Japan and South Korea. Such arrangements have become particularly attractive in relation to trade blocs, which now conduct over 40 per cent of global trade. Membership in sub-regional organisations, such as Mercosul, is increasingly viewed as a way to gain preferential access to markets, lest multilateral talks continue to limp along.

The proliferation of free trade agreements should encourage Brazil and Argentina to adopt a more aggressive stance towards sub-regional integration, and use it to expand their participation in world trade. This will not be a trivial pursuit. In the past two years, pessimism has enveloped the prospects for Mercosul and sub-regional integration. Since Brazil's sudden devaluation of the

currency in January 1999, Mercosul has been overwhelmed with squabbling. Chile's recent decision to negotiate a bilateral free trade agreement with the US did nothing to dispel fears that Mercosul may come to a halt and open the way for the eventual domination of trade arrangements in the hemisphere by the FTAA. The main Mercosul trade partners have traversed much less of the distance to sub-regional integration than is generally acknowledged. The fear of losing autonomy in domestic policy-making, the power of entrenched interests and bureaucratic inertia, have together stalled progress toward deeper integration. The consensus finally collapsed in the wake of Brazil's devaluation crisis, and it never recovered.

The best-case scenario for Brazil is to successfully 'relaunch' Mercosul by setting up effective macro-economic co-ordination mechanisms, and taking more decisive steps toward deepening the customs union. A renewed Mercosul can greatly expand the power of the participating nations in the more exacting FTAA negotiations. It would also be in a more favourable position to pursue a trade agreement with the EU in addition to gradually broadening the number of countries under Mercosul preferences in South America, thus moving towards a regional free trade area. As Chile's decision intimates, the worst-case scenario for Brazil is to see Argentina and other trade partners scurry to enter bilateral trade agreements with the US, with Mercosul drifting to the point of irrelevance. In any event, it is to Brazil's advantage to forgo its defensive role as a veto player, and take instead the lead in the negotiation process.

It is argued here that, from Brazil's point of view, such a move entails sharp dilemmas. The first problem is whether deeper economic integration may exact a loss of sovereignty. The other, is the extent to which the opportunities offered by world markets contribute to accelerate domestic economic development. As Rodrik¹ points out, the results of trade negotiations —bilateral, sub-regional, regional, or multilateral—should not be judged by whether the volume of trade is augmented, or market access overseas is increased. Rather, they should be judged by whether it 'contributes to the construction of a high-quality institutional environment at home (that can) spur unexpected levels of entrepreneurial dynamism and economic growth'. The focus of these notes is on recent developments that may constrain Brazil's leadership role, or conversely, provide the momentum for furthering Brazil's interests in its multiple agendas.

BRAZIL IN THE INTERNATIONAL SYSTEM

Much of the writing on Brazil emphasises its projection of itself as a regional power. Although Brazil faces no single overarching threat to its existence as a sovereign state, the aspiration to leadership in past decades has been accompanied by an acute sensibility to American unilateralism. In the context of Huntington's post-Cold War unimultipolar system,² unilateral action by the single superpower is restrained to a certain extent by its need to act in consultation with several major and secondary regional powers. Brazil's

preference for multilateral forums and institutionalised codes of conduct reflect the desire to limit the manoeuvring room enjoyed by the hegemon and other major powers. Simultaneously, it reflects the need to enhance the soft power of its international credibility.³ Huntington's metaphor also accounts for the often difficult relations that regional powers, such as Brazil, maintain with secondary powers in their sphere of influence, such as Argentina. From this point of view, Mercosul represents both a means to dilute traditional rivalries between the two nations and replace it with co-operation, as well as a means to boost Brazil's leverage in international negotiations.

A different issue of sovereignty is raised in the discussion about Brazil's insertion into the international economy. The vision of globalisation as 'the nemesis of national government',⁴ as Wolf aptly dubbed the notion that national sovereignty stands to lose by the increasing autonomy of market forces, has inspired the section of opinion in Brazil that opposes an increasing exposure to world markets. Rather than evidence of Brazil's increasing competitiveness, the long-running trade rows with Canada over aircraft subsidies, and with the US over drug patents, are seen as an omen of what is in store for Brazil in the FTAA. Scepticism reached a new pitch after Canada temporarily banned Brazilian beef imports for fear of infection by 'mad cow' disease. The effects went beyond Brazil's threat to resort to retaliatory measures if Canada did not withdraw the ban. Many Brazilian critics of trade integration felt vindicated when President Fernando Henrique Cardoso spoke of a trade war, and warned that the dispute might jeopardise the FTAA negotiations.

More realistically, elites in government have long recognised the importance of an expanding web of international commitments to safeguard and advance Brazil's national interests. Adherence to the principles of multilateralism is the central vision guiding Brazil's foreign policy. On the issues of trade, commitment to the WTO agreements and the multilateral trading system constitute the basic normative framework for Brazil's insertion into the global economy and the defence of its interests as a global trader. International rules established in multilateral forums, while constraining the range of policy choices that states can pursue, also reinforce their sovereignty by preventing stronger states from unilaterally imposing their will.

Mercosul is, in many ways, the crowning achievement of this strategic vision. The decision to share collective decision-making derived from the recognition that there may be no effective exercise of sovereignty in a globalised system, where the capacity of national states to shape events alone is diminishing. When Mercosul was founded, strategic and political goals played as large a role as possible to attract investment and improve market access conditions. 'While the latter have been damaged by the devaluation in Brazil', remarked Roett, 'the former remains an integral component of the association.'⁵

Major challenges confronted Mercosul at a relatively early phase of its development. Its engagement in an overly ambitious agenda of trade negotiations on a regional (South America), hemispheric (FTAA) and transatlantic scale (EU)

was partly motivated by exogenous circumstances. The commitment to create the FTAA and a free trade zone with the EU derived originally from Mercosul's reactive response to external initiatives. However, it also represented a response to the failure of multilateral organisations to attend to sub-regional needs. Brazil actively supports a new round of multilateral trade negotiations to correct trade distortions stemming from the Uruguay Round agreements, and to promote agricultural trade reform. Brazil has also been using the WTO more aggressively in order to remove barriers to its exports. However, the rise of protectionism in rich countries and the Seattle fiasco required both a change of posture, and a more serious consideration of regional integration arrangements.

Although Brazil continues to value global multilateralism, the turn to regionalism as the organising principle for multilateral action is consequential for the long-term prospects of Mercosul. The agenda for the negotiation of the FTAA, by the year 2005, includes WTO plus commitments that go far beyond border barriers, and trade in goods issues that had hitherto been the staple of Mercosul evolution. The US's attraction to the FTAA was based on the possibility of reaching agreement on issues and commitments not covered by multilateral rules: for example, protection of intellectual property rights, treatment of foreign direct investment, competition policy, trade in services, domestic regulations and government procurement, and labour and environmental standards.⁶ Thanks to its diversified economy, Brazil stood to gain the most from a preferential access to the US market. Other trade-offs, however, appeared to be rather less attractive. The potential for trade diversion might weaken Brazil's valued position as a global trader and increase its dependence on the US market for exports. In addition to that, the US was unwilling to reduce trade-distorting agricultural subsidies, or restrict trade dispute mechanisms that are often used to sideline foreign competition, rather than to ensure fair trade, such as antidumping actions, countervailing duty investigations, and cumbersome rules of origin. Another issue of contention was Brazil's fierce resistance to lower domestic trade barriers beyond the commitments made at WTO.

In this context, a free trade agreement with the EU offered Brazil a chance to retain as much autonomy as possible in the negotiation of a hemispheric free trade zone. For one thing, there are more similarities between the EU and Mercosul than between NAFTA and Mercosul. Like the EU, Mercosul has common political and foreign policy goals and, regardless of how remote the prospect appears to be today, there is at least an expectation that the sub-regional association will move towards supranationalism and a common market in the long run. To an extent, such differences mirror the divergent paths followed by the US and the EU. Daalder⁷ has persuasively argued that the two sides look at the world in increasingly different ways. The US is more concerned with security threats in Asia and the consolidation of democracy and free markets in the Americas, whereas the EU is more concerned with the 'new agenda' of issues like environmental degradation, world poverty, and the digital divide resulting

from globalisation. Likewise, the US appears to be more inclined to resort to unilateral actions and the projection of military power, while the EU relies on multilateral forums and international rules to settle problems. Notwithstanding such differences, the economic trade-offs involved in the negotiation of a preferential agreement with the EU seem to be less favourable to Brazil and to Mercosul, than hemispheric integration might offer.

International constraints are only part of the dilemmas faced by Brazil and Mercosul. The sub-regional economies remain volatile with mounting trade deficits and a dependence on foreign capital. Faltering rates of growth and social unrest have given a sense of urgency to the matter. Hence the need to step up the pace of reform to deal with these challenges, especially those reforms that are intended to lower the domestic costs of production and increase competitiveness at home and in global markets. However, frustration with the pace of sub-regional integration has led many to believe that progress will not be made without the towering threat of integration with a more competitive economy. Between 1991 and 1995, Mercosul progressed rapidly from a free trade area to a customs union, with a common external tariff. In the post-devaluation atmosphere, the conception of Mercosul as an inner core of countries that would move toward deeper integration seemed to command less consensus than it did in the past. The recent decision by Argentina to break, unilaterally, the common external tariff, raising import tariffs on consumer goods and eliminating duties on capital goods imports, has dealt a blow to expectations that Mercosul might remain a cohesive body in trade negotiations. Actually, Argentina's finance minister Domingo Cavallo, announced that Mercosul would be better off by reverting to a free trade zone, rather than seeking to consolidate itself as a customs union.

The issue at hand is how to achieve fast economic growth in the short run. However, behind these events lies the broader issue of the future of Mercosul. The possibility that Argentina may thwart Mercosul's bargaining strategy by unilaterally seeking a trade deal with the US over a deeper integration in Mercosul, has sobered up its trade partners. It may be up to Brazil to lead a change of strategy, quickening the pace toward a deepening of the trade bloc based on similar WTO-plus commitments. A difficult road lies ahead, but the determination to traverse it would reassure its partners that Mercosul has a future.

BRAZIL, ARGENTINA AND MERCOSUL

Brazil's currency devaluation and the adoption of a free floating exchange rate in mid-January 1999, forced Mercosul to face its hardest test ever. Trade within the bloc dropped about 30 per cent and the region slipped into recession, halting an intra-bloc trade growth trend that had grossed US\$22 billion in 1998, up from US\$4 billion in 1990. After having accumulated a trade surplus of over US\$5 billion with Brazil in the preceding four years, Argentina saw trade revenues evaporate. She reacted by imposing curbs on cheaper imports from Brazil and demanding

that safeguards be set to compensate for losses caused by the change of the exchange rate system by its trade partner. Brazil reacted to what was interpreted as Argentine protectionism, stating that safeguards were incompatible with the terms of the Treaty of Asuncion. The mounting tension was partly defused through skilled presidential diplomacy and voluntary arrangements negotiated directly by businessmen on each side of the border. However, the two countries have been locked in endless trade disputes over issues such as autos and textiles ever since. The election of new presidents in the participating countries who are supportive of Mercosul—Fernando de la Rúa, in Argentina, Jorge Batlle, in Uruguay, and Ricardo Lagos, in Chile—provided much-needed breathing space to consolidate the progress achieved thus far. However, the strength of commitments to Mercosul remains a matter of grave concern.

The crisis was not only an issue of different exchange rate regimes, even though that was the primary trigger. In 1994, Brazil installed the Real plan, a pegged-currency regime that brought annual inflation down from over 2,600 per cent in 1994 to about 6 per cent today. Under such a regime, the price of successful stabilisation is the risk of a balance of payments crisis. Ideally, such crises are avoided in floating and currency board regimes, because market mechanisms should automatically adjust exchange rate and monetary policies. In the former, monetary policy is set by the central bank and the exchange rate is allowed to float. In the latter, a currency board fixes the exchange rate and monetary policy automatically adjusts. If the current account deficit increases suddenly, money supply tightens to cool the economy and moves the system back towards equilibrium.

Under the Real plan, the central bank set both exchange rate and monetary policies, keeping an appreciated currency in order to lower domestic prices through cheaper imports. An undesirable upshot of the overvalued currency was Brazil's poor export performance from 1995 onwards. As long as high interest rates attracted sufficient capital to finance investments and the current account deficit, inflation was kept under control and the economy went through a booming period. However, the moment the confidence of foreign investors in the economic fundamentals dissipated, devaluation was the only way for the country to avoid bankruptcy. After Brazil's abrupt devaluation of the Real, the economy was expected to be in the clutches of a serious recession. Rather than contract, however, Brazil's GDP registered a minuscule, but positive, 0.5 per cent annual growth in 1999, and inflation remained comfortably within the central bank's 6–8 per cent target range. Moreover, the economy grew past 4 per cent in 2000, before expectations of sustained growth were again dashed by the energy crisis of 2001.

Furthermore, as the exchange rate was allowed to float, interest rates were no longer required to prop up the balance of payments and economic policy was 'set free from the imperative of acting in a procyclical manner'.⁸ Argentina, however, is still struggling to pull out of recession. To restore investor confidence and attract needed capital inflows to resume growth, the Argentine

government was compelled to act precisely in a procyclical fashion, cutting the fiscal deficit and deepening the recession. Although Argentina has already regained its trade surplus with Brazil (thanks in no small measure to trade restrictions negotiated by Brazilian companies with their Argentine counterparts with prodding by Brazil's government), charges of using currency devaluation to gain unfair trade advantage continue to poison bilateral relations.

The sense of vulnerability engendered by the crisis brought to light serious flaws in the operation of Mercosul, as well as the divergent ways in which the economies of the main trade partners have evolved since 1995. It is true that tariff barriers have been largely eliminated within the bloc. Non-tariff barriers, however, have thrived along with bureaucratic inefficiency, and many exceptions to the common external tariff still exist. Mercosul trade partners have also failed to establish shared guidelines on anti-dumping actions and to liberalise services and government procurement. To be sure, significant advances have recently been made with respect to macro-economic policy co-ordination. In April 2000, the presidents of member countries sought to 'relaunch' the Mercosul by grafting macroeconomic guidelines onto the regional trade agreement. The goal was to reduce economic volatility by promoting an enforceable code of macroeconomic conduct with common targets for inflation and public debt. To this end, the members have moved to harmonise economic statistics, and to set up a system to monitor each member's progress toward meeting their targets. Other developments, however, have the potential to thwart the consolidation of Mercosul as a customs union.

Mercosul and the transformation of Brazil's economy

The evolution of Mercosul can be viewed in three distinct phases. The first phase covers the years 1990 to 1995 and was characterised by a commitment to trade liberalisation. The Collor government's unilateral decision to open the Brazilian economy to international competition set the stage for the adoption of a tariff reduction timetable in Mercosul. Consequently, intrabloc trade surged and, in 1995, the trade partners decided to move towards a customs union, implementing a common external tariff.

The Collor government's decision set in motion a radical process of industrial re-structuring. However, no industrial policies were put in place to ease the transition, and thus, domestic industry was left to fend for itself. Between 1990 and 1994, according to Motta Veiga,⁹ 'trade liberalisation was practically the only major industrial policy initiative in Brazil'. Industry's initial reaction involved a major effort to streamline productive and organisational structures via rationalisation and extensive cost reduction. Investment in the expansion of industrial capacity came later. Although numerous national firms disappeared under the onslaught of foreign competition, many others were able to thrive once trade barriers, which kept the more efficient competitors at bay, were lifted.

Contrary to expectations, trade liberalisation did not de-industrialise Brazil. Actually, the opposite is closer to reality—to the extent that increased competition spurred rapid productivity growth and a swift restructuring and upgrading of the industrial structure. However, successful industrial restructuring was not accompanied by a surge in foreign trade, which was required to finance technology and capital goods imports necessary to sustain the modernisation drive. Brazilian industrial goods lost market share in most export markets while traditional commodities increased in importance. In fact, trade liberalisation made inward-oriented strategies more attractive to business. To survive in an open economy, firms engaged in a type of ‘trench war’ to defend their share of the domestic market, rather than seek new market niches abroad. The sheer size of the domestic market and the increased levels of consumption stimulated by an appreciated currency also made Brazil more attractive to multinational firms seeking to substitute imports. The domestic market was the main reason for the increase in direct foreign investment from US\$77.9 billion in 1995 to US\$116.9 billion in 1999.¹⁰

Brazil also failed to eliminate policies with a significant anti-trade bias. Although the Cardoso administration succeeded in modernising the economy through market deregulation and the privatisation of state assets, fiscal and tax reforms were only partly implemented. It also failed to remove a host of factors that are usually referred to as the ‘Brazil cost’. This terminology stresses the negative impact on the economy’s aggregate efficiency stemming from logistic factors, production chain bottlenecks and inadequate supply of physical infrastructure factors such as energy, transportation and telecommunications. Tax-induced distortions on economic activities also hamper Brazilian exports. Federal and state value-added taxes, which are applied on an origin basis with multiple rates, penalise business inputs. As argued elsewhere, the Cardoso administration’s efforts to balance the budget were light on expenditure cuts and heavy on tax hikes¹¹ (Souza, 1999). The overall tax burden currently reaches over 31 per cent of GDP. Faced with ballooning deficits and unable to cut constitutionally embedded spending such as intergovernmental transfers, the federal government created new taxes it did not have to share with other tiers of government. Such taxes hamper competitiveness because they tend to apply in cascade or are levied on payrolls. ‘Trade policy’, Mendonça de Barros summed up, ‘has been subordinated to the interests of fiscal policy.’¹²

Insufficient levels of investment are another major hindrance to building economies of scale that would allow industry to simultaneously satisfy domestic and foreign demand for goods and services. Between 1994 and 1998, industrial investment increased significantly, but it remained below the average rates of the 1970s and 1980s.¹³ Government deficits and the need to service a large public debt are the main reasons why national savings and investment rates remain low. Up to 1999, congressional resistance to slash Brazil’s massive deficit spending forced the government to keep high interest rates in order to attract much needed capital from abroad. The cost of money made the economy stall in 1996 and

1997 and brought it to a halt in 1998 in the aftermath of the Russian debacle. Fiscal and current account deficits are still high and interest payments on the public debt continue to crowd out private investment. A study conducted by the McKinsey Global Institute in 1998, indicated that the gap in investment rates between South Korea and Brazil in the past 15 years was largely derived from Brazil's lower public sector savings (51 per cent); higher prices of capital goods due to import tariffs (20 per cent); higher cost of financial intermediation (17 per cent), and lower private savings rate and net capital inflows (12 per cent).¹⁴

The second phase in the evolution of Mercosul began in 1994, with the successful implementation of the Real plan. In 1995, Brazil had its first trade deficit in over a decade. As the currency appreciated and foreign imports flooded the market, protectionism became the rallying cry of industry. To prevent further deterioration of the balance of trade, the Cardoso administration sought to restrain the flow of imports by raising tariffs while it tried to expand exports through subsidies, the elimination of the value-added tax levied on exports, and export loan guarantees. A telling sign of the new protectionism was Brazil's adoption of a new automotive regime in mid-1995, which sharply hiked the same import tariffs that had just been reduced in anticipation of Mercosul's common external tariff.

From 1996 onwards, the processes of trade liberalisation and subregional integration became gradually unglued and the original goal of 'open regionalism' that would turn Mercosul into a building block of free world trade faded away. As intra-bloc trade surged, Brazilian industry became more attracted to Mercosul's enlarged consumer market than in trade with third-world countries. 'Exports to the countries of Mercosul (and ALADI)', Motta Veiga remarked, 'performed an important countercyclical function in sectors affected by the considerable growth of imports in the domestic market, as in the case of machinery and machine equipment.'¹⁵ Mercosul was also instrumental in attracting sizeable foreign direct investment flows to Brazil. Access to the domestic market, as well as to other Mercosul markets, loomed large in decisions to invest in the country. At the same time, the country backed off from sub-regional initiatives that might have required an additional lowering of barriers to trade or reduce its policy-making autonomy. Rather than creating a permanent dispute settlement mechanism, Brazil insisted on a case-by-case approach to intra-bloc trade disputes, curbing progress toward the consolidation of Mercosul as a customs union. Moreover, Brazil did not shy away from negotiating a bilateral trade agreement with Mexico, to lower tariffs for the automotive industry, in order to halt the deterioration of the trade balance.

The near collapse of Mercosul after Brazil let the currency float in early 1999 opens a third phase in the evolution of the trade bloc. Brazil's speedy economic recovery in the aftermath of the devaluation crisis was stimulated by the Cardoso administration's commitment to fiscal discipline in line with the 1998 IMF agreement. The country has managed to secure a primary fiscal surplus in excess

of 3.1 per cent of GDP since 1999, opening the way for a substantial reduction of the benchmark interest rate and, hopefully, for a sustained path of growth.

Today Mercosul is at the crossroads. The brush with disaster in 1999 and more robust economic fundamentals, encouraged Brazil and Argentina to 'relaunch' Mercosul and revive the agenda to deepen the sub-regional association. There are signs that the consensus regarding the trade bloc may have worn down. 'From the strategic viewpoint of strengthening our bargaining position *vis-à-vis* the FTAA in 2005, Mercosul is dead', stated former Secretary of Economic Policy Mendonça de Barros.¹⁶ There are also reasons for cautious optimism. One reason is the extraordinary growth in intra-regional trade since Mercosul was founded. Another reason is the trade partners' common interest in strengthening Mercosul as a core strategy to deal with hemispheric integration along the lines set by the FTAA proposal.¹⁷ A cohesive bloc is also a prerequisite to engage the EU in the negotiation of a transatlantic free trade agreement. A stronger Mercosul may also become a platform for enhancing the participation of the trade partners in world trade. However, the key to progress is a shared vision of sub-regional integration. 'What is at stake is not what Mercosul is', suggested De la Balze 'but what Mercosul might be.'¹⁸

The initiative to 'relaunch' Mercosul

Many of the reasons why Brazil and Argentina pursued regional integration in the Southern Cone have gone astray over the years. Originally, the creation of a trade bloc related to a broader aspiration to enter the global economic market. Mercosul was expected to be a building block for international integration, providing a learning ground for economies that remained closed for too long a time. Trade diversion was expected, rather than trade creation, while intra-bloc trade relations fostered the economies of scale and a more efficient allocation of resources that domestic producers needed in order to compete outside the region. However, the promise of an 'open regionalism' remained somewhat unfulfilled. To a large extent, Brazil went on exporting manufactured goods to Mercosul and other neighbouring countries while its trade with the US and the EU remained limited and poorly diversified. In turn, Brazil became the destination of over a third of Argentina's trade, increasing her dependence, as well as Uruguay's and Paraguay's dependence, on Mercosul's largest market. Competitiveness and productivity gains were mediocre because investment in industrial production was targeted to the region rather than to the global market. In this sense, protectionism and a sharp rise in trade disputes were predictable outcomes of Brazil's currency devaluation.

The devaluation crisis apparently strengthened the trade partners' resolve to preserve Mercosul. Recognition of its importance was buttressed by the quickening pace of the FTAA and the EU trade negotiations. To 'relaunch' Mercosul, however, a series of initiatives are required to complete the trade bloc's transition to a customs union. The top priorities are the co-ordination of

macro-economic policies to avoid new exchange rate shocks and the creation of more adequate conflict resolution mechanisms to handle trade disputes. In late 1999, the Montevideo meeting of Mercosul presidents approved a set of initiatives designed to consolidate economic stability and avoid abrupt policy changes within the trade bloc. The most important initiative is the decision to limit public spending and to establish common standards for fiscal responsibility. National statistics will be harmonised to allow for meaningful comparisons of economic outcomes and each country's effort to maintain economic stability will be closely monitored by the trade partners. Such measures are expected to lay the foundations for what president Cardoso called 'a mini-Maastricht', after the treaty that led to the creation of the euro. Needless to say, the eventual adoption of a single currency for Mercosul remains a highly controversial issue given Argentina's currency convertibility scheme. However, the simple mention of it indicated the depth of transformation required to put the Mercosul back on track.

Some sources of friction within Mercosul have been removed. Brazil's commitment to fiscal discipline apparently persuaded Argentina to drop antidumping charges against Brazilian firms who gained a significant cost advantage out of devaluation. The agreement regarding the automobile industry, stipulating that cars made in Argentina should have a certain proportion of locally manufactured parts, opened the way for industry-level negotiations to be ratified, *a posteriori*, by governments. Other issues seem to be less tractable, such as the adoption of common competition and fair trade practices policies. Lowering import duties to homogenise tariffs between Mercosul and the rest of the world is another hurdle. However, the bone of contention is the creation of a supranational tribunal to serve as Mercosul's permanent arbitration mechanism. Brazil has fiercely resisted the loss of autonomy it entails while Argentina seems to be equally determined to move beyond the existing *ad hoc* arrangement provided by the Brasilia protocol.

A primary focus on the region, and the relocation of some components of national sovereignty to supranational entities, run against the grain of Brazil's traditional foreign policy orientations. Regionalism, as Soares de Lima pointed out, 'is a second-best strategy for Brazil regarding the institutionalisation of multilateral arenas and rules'.¹⁹ In 1999, about 22 per cent of Brazilian exports went to the US, 14 per cent to the Mercosul members, 10 per cent to other countries in the hemisphere, 29 per cent to the EU, and 25 per cent to the rest of the world.²⁰ Being a global trader and a recipient of world-wide investments, Brazil prefers multilateralism to regionalism. Mercosul is the exception, not least because it represents a power resource to be used in the bargaining table against stronger contenders. It is probably inevitable that continental size nations, dubbed 'monster countries' by George Kennan, will always be engaged in dualtrack international negotiations, balancing the imperatives of international integration against the imperatives of national autonomy. In the ensuing two-level game of international negotiation, the risk is that Brazil's and Argentina's commitment to the future of Mercosul become the main casualty.

Dan Rodrik's provocative notion of a 'political trilemma of the world economy'²¹ may help to flesh out the implications for Brazil of deepening Mercosul or letting it languish in waiting while pursuing its own national interests. Rodrik's point of departure is the well-known economic impossibility of simultaneously choosing monetary autonomy, a fixed exchange rate and capital mobility. In the political realm, a similar 'trilemma' is set around three nodes: international economic integration (requires that national jurisdictions do not interfere with economic transactions); the nation state (whose sovereignty gives rise to a wide array of transaction costs); and mass politics (i.e. the extent to which political institutions are responsive to mobilised groups).

A country can opt to have, at most, two of the three elements. 'If we want true economic integration', Rodrik suggested, 'we have to go either with the nation-state, in which case the domain of national politics will have to be significantly restricted, or else with mass politics, in which case we will have to give up the nation-state in favour of global federalism.' To opt for national sovereignty while markets become international, requires that a country puts on a 'Golden Straitjacket'—that it abides by the rules of the international marketplace, implementing tight fiscal and monetary policies and market-oriented reforms in order to attract trade and capital. The price of wearing the 'Golden Straitjacket' to the concert of nations is that 'the ability of mobilised popular groups to access and influence national economic policy-making has to be restricted', regardless of the party that happens to be in power.²²

The alternative to what Rodrik dubbed the 'Argentinization of politics' is global federalism—a perfectly integrated world economy in which national jurisdictions do not entail additional transaction costs. Regional common markets are the closest we are likely to get to global federalism in the foreseeable future. As in the EU, national governments need not disappear, 'but their power would be severely circumscribed by supranational legislative, executive, and judicial authorities' and mass politics would simply shift to the federal level.²³ The price of joining a federation is of course the loss of a significant measure of national policy-making autonomy.

Rodrik's ideal world integration landscape is nowhere to be seen, but it serves to map the range of alternatives open to Brazil in Mercosul. From the point of view of international economic integration, a sub-regional trade bloc is compatible with multilateralism as long as it seeks to foster internal competitiveness as a means to increase trade with the rest of the world. In this sense, domestic reforms are the key adjunct to intergovernmental policies designed to exploit economies of scale and gains from productive specialisation. The issue is that 'Brazil's bargaining power will become increasingly dependent on its acceptance of the concept of qualified sovereignty with respect to Mercosul.'²⁴

MERCOSUL, SOUTH AMERICA, FTAA AND THE
EUROPEAN UNION

Of the various parts of Brazil's many-pronged agenda, Mercosul is the indisputable priority. Furthermore, the resolution of the issues that currently confront the sub-regional association is a prerequisite for entering negotiations leading to the creation of the FTAA and the establishment of a trade agreement with the EU. Araújo Jr correctly remarked that 'the future of Mercosul hinges more on the consistency of its internal policies than on external challenges'.²⁵

Mercosul

Deepening and broadening are the central dimensions of choice for Mercosul. Focusing on these dimensions, De la Balze²⁶ sketched out three suggestive scenarios for the negotiation of Mercosul's future. The first is the consolidation of a 'genuine customs union' involving a greater opening toward the world economy and the creation of supranational institutions, such as a permanent tribunal, a macro-economic co-ordinating commission, and a permanent commission for international negotiations. Deeper integration of the trade partners would form a 'critical mass' able to negotiate access to other markets under more favourable conditions than each country would have if they were to act in isolation.

From the viewpoint of losing autonomy over decisions that affect the national interest, this scenario appears to be the least appealing for Brazil, although it does maximise the country's clout at the FTAA's bargaining table. However, there is a risk. A genuine customs union must see globalisation as an opportunity for integration into the world economy. However, if protectionism and the desire to substitute imports on a regional scale prevail, Mercosul may find itself transmuted into a 'closed and introspect regional bloc', frustrating the trade partners' aspiration to become increasingly integrated in the world economy.

The second scenario envisages the transformation of Mercosul into a 'full-fledged free trade area' along the lines of NAFTA. The common external tariff would be abolished and the trade partners would regain a considerable measure of autonomy in the management of their respective trade policies. Participating countries would be free to unilaterally reduce protection levels, as well as to enter bilateral free trade agreements with other countries and regions, as Mexico did recently. This feature should practically eliminate the risk of a closed regional bloc; but it would also leave each member to fend off by itself in hemispheric negotiations.

The third and least desirable scenario is what De la Balze calls the 'imperfect integration scenario'.²⁷ It is essentially a return to the situation that existed before Brazil's currency devaluation, 'a *sui generis* combination between an "incomplete free trade area" and an "incomplete customs union", with a low degree of institutionalisation and a *de facto* pre-eminence of Brazil in the

management of the region'. De la Balze believes that Brazil stands to profit more from the last scenario. In the absence of compensatory mechanisms that exist in genuine customs unions or in fully fledged free trade areas, the largest partner can attract the lion's share of investment flows. This scenario also dovetails with Brazil's aspiration of regional leadership without a loss of national autonomy. To keep its decisional power intact, Brazil chose, thus far, to keep Mercosul at a minimal level of institutionalisation, operating on the basis of intergovernmental, rather than supranational, mechanisms. 'The Mercosul style has been one of informality and consensus,' remarked Roett (1999b), 'with no central secretariat that has the power to enforce decisions, and practically no conflict-solving mechanisms.'²⁸ In the long run, this may leave the sub-regional association in a weaker bargaining position and lower its credibility to enter agreements. Institutionally fragile arrangements may also encourage Brazil's partners to act unilaterally. Argentina's search for a special trade relationship with the US and Chile's reluctance to commit itself to full membership, exemplify the difficulties arising from Mercosul's ambiguity regarding its own future.

The free trade area of South America

Broadening Mercosul poses similar dilemmas. As described by Rios,²⁹ in the late 1990s Brazil's optimal strategy to implement its foreign trade agenda appeared to be a concentric pattern of trade liberalisation, with the consolidation of Mercosul standing at the centre. The next step would be to consolidate a South American Free Trade Area (SAFTA) while striving to advance agricultural trade liberalisation in a new WTO round of negotiations. Only afterwards would Mercosul implement the FTAA and the free trade agreement with the EU.

Seeking to forge a new diplomatic role in the region, Brazil also introduced a geo-political distinction between South America and Latin America (which also takes in Mexico, Central America and parts of the Caribbean). This occurred during the first Summit of South American presidents, convened in 2000, to move toward a potential free trade zone in the region. These claims are still unpersuasive.

The broadening of Mercosul to create the SAFTA was originally proposed by Brazil in 1993. The task would be accomplished by substituting Mercosul agreements for the old ALADI arrangements. Before Mercosul turned into a customs union, its members were signatories to bilateral preferential agreements with several Latin American countries under the aegis of ALADI. To prevent a perforation of the common external tariff adopted in 1995, pre-existing bilateral arrangements would be replaced by new preferential agreements signed by Mercosul.³⁰ In 1996, Mercosul signed free trade agreements with Chile and Bolivia, who were granted an associate membership status. The negotiation of a preferential agreement with the Andean Community (Bolivia, Colombia, Ecuador and Venezuela) proved to be more difficult than was originally

anticipated. In any event, the SAFTA should be the end result of Mercosul's own network of free trade agreements throughout the region.

There are good arguments in favour of this initiative. The South American region might benefit from the potential synergy between diplomacy and economic geography. Assessing the Southern Cone experience, Araújo Jr observed that 'the extraordinary growth of regional transactions in the Mercosul region after 1985 can be seen as an economic geography phenomenon. As soon as barriers were lifted, Mercosul firms began to carry out a volume of transactions that was compatible with the region's level of affluence.'³¹ South American countries already constitute the principal market for Brazilian industrial goods, accounting for over 40 per cent of exports in 1998. Broadening Mercosul to include the rest of South America is also consistent with geo-economic trends that are shaping contemporary Brazil, with the gradual shift of people and capital towards the interior of the country and the new agricultural frontiers in the west and the north. Industrial deconcentration is also changing the economic landscape as firms leave the southeast in search of low-wage labour and locational advantages in the less developed regions.³²

Physical integration through the implementation of cross-border infrastructure projects also looms large in the prospects for regional integration. As Lafer pointed out, the role of geography can be magnified 'if three vectors—logistics/transportation, telecommunications, and energy—are simultaneously developed to add value and reduce costs, thus expanding comparative advantages in a process of competitive insertion into the world economy'.³³ In 1999, Brazil designed the National Integration and Development Axes programme, an ambitious developmental blueprint that identified bottlenecks and missing links in infrastructure (energy, transport and telecommunications), social needs (education, health and housing), scientific and technological information, and environmental management. The programme developed a portfolio of 385 investment projects, which are expected to cost some US\$181 billion over the next eight years. Given Brazil's increasing dependence on regional supply of oil and natural gas, economic integration with neighbouring countries via investment in joint infrastructure projects has been assigned top priority.³⁴

To paraphrase Paul Krugman, the goal is 'to eliminate international economy and replace it with economic geography'.³⁵ What is lacking are the means to translate lofty objectives into reality. Broadening Mercosul preferences to South American countries might yield economies of scale and augment the economic efficiency of domestic producers, and hence attenuate the adjustment costs of entering a hemispheric free trade agreement at a later date. However, this possibility hinges crucially on the economic dynamism of the Mercosul partners, notably Brazil.

The Free Trade Area of the Americas (FTAA)

Taking full advantage of economies of scale to grow, however, is a viable possibility for Brazil in the context of a hemispheric free trade agreement. Differently from most countries in the Americas, Araújo Jr observed that

Brazil and the United States have a variety of trade partners world-wide. Therefore, access to the European market, the dialogue with strategic partners such as Japan, and the strengthening of the WTO as a multilateral forum of negotiation are important priorities for both countries. On the other hand, the competitiveness of their respective export industries is particularly sensitive to economies of scale to be generated by hemispheric integration.³⁶

Existing complementarities can be gleaned from trade statistics. Between 1997 and 1999, about 20 per cent of Brazil's exports went to the US. In 1999, 70 per cent of Brazilian exports to that country were manufactured goods, notably aeroplanes and motor vehicles. In contrast to the past, Brazil has been able to export more dynamic products for which demand is on the rise in the North American market. This change notwithstanding, Brazil's relative share of US imports has dwindled in recent years. In 1991, Brazil accounted for 1.4 per cent of total US imports and ranked as its 13th largest trade partner. Since 1997, Brazil's share was reduced to 1.1 per cent, precisely when the American economy was booming. Two other factors appear to be equally important. The first is the establishment of a preferential trade treatment with Mexico (through NAFTA) and China. From 1991 to 1999, Mexican exports jumped from 6.3 per cent to 10.5 per cent and China increased its volume of trade, going from 3.6 per cent to 7.9 per cent over the same period. The second factor is the intensification of antidumping suits and the imposition of tariff and non-tariff barriers against Brazilian exports, especially steel, sugar and orange juice. From Brazil's point of view, the FTAA is attractive only to the extent that it can assure the same preferential trade treatment that is already granted to its main competitors in the US market, and avoid the imposition of barriers to Brazil's exports.

Another source of concern for Brazil and Mercosul is that the FTAA goes beyond a traditional free trade arrangement seeking only tariff and other border barrier reductions to include 'agreement on domestic rules of the game—intellectual property rights, product standards, internal competition policy, government procurement and, to a lesser degree, labour and environmental standards'.³⁷ (Birdsall and Lawrence 1999:128). However, the FTAA model provides no space for trade partners to share in decisions regarding the management of trade relations other than through traditional conflict resolution mechanisms. The US is pushing for a hemispheric integration model that would essentially extend to the countries south of Mexico the rights and obligations already conferred by NAFTA.³⁸ Actually, differences between NAFTA and

Mercosul are large enough to be considered as distinct models for integration. As described by Bernier and Roy 'NAFTA represents a mostly contractual approach based on legal dynamics, and Mercosul represents a participatory approach based on political dynamics. The contractual approach focuses primarily on rules that place rigid controls on the behaviour of members, restricting government powers.'³⁹ How to preserve Mercosul as a preferential system within FTAA is a matter of concern. However, it only compounds the more general preoccupation that the FTAA framework might provide the US and the other NAFTA partners, with the possibility to manipulate domestic standards in order to gain a competitive advantage.

The reluctance of the US Congress to grant fast-track authority to the president has slowed progress on the FTAA negotiation. While the goal of reaching a hemisphere-wide free trade agreement by 2005 remains in force, a speedy conclusion of negotiations seems unlikely. Resistance to the FTAA has surfaced in the US as labour and environmental lobbies intensified efforts to include social and environmental clauses in the free trade agreement. Likewise, business and congressional leaders expressed strong opposition to Mercosul's demand that the US antidumping legislation be revised in the course of FTAA negotiations. In Brazil, the FTAA has also met with growing scepticism given the persistence of trade barriers to Brazil's most competitive export products.

However, it would be misleading to conclude that the FTAA is seen solely as a threat on both sides of the border. As in any complex two-level game of international negotiation, a significant part of the American and Brazilian business communities expect to benefit from wider access to each nation's respective market. Work on the FTAA negotiation clauses has proceeded rapidly since the second summit of the Americas held in Santiago in 1998.⁴⁰ However, the uncertainty surrounding the FTAA's timetable in the absence of fast-track authorisation provides an important window of opportunity for Mercosul to regroup, seek to consolidate ties to the EU, and move toward the deepening of Mercosul as leverage in the hemispheric negotiation. If these tasks are successfully accomplished, Mercosul will be in a stronger bargaining position when the FTAA negotiations reopen in 2002.

The European Union

Having been partly inspired by the Europeans' ground-breaking experience of regional integration and unification, the Mercosul partners have been more agreeably inclined to advance trade negotiations with the EU, than with the US. What matters here is that the two sides share a basic orientation towards multilateralism, they are driven by a similar vision of a multipolar international system, and that they have a keen interest in emerging borderless issues such as global warming and human rights. They are also bound by more tangible entanglements. Since 1996, the EU has been the principal source of foreign direct investments in Mercosul.

Yet, the actual conduct of trade negotiations with the EU is bound to be disappointing for Mercosul. For one thing, the EU has erected a formidable wall of protectionism, which is at least as effective as North America's. Within the EU, Mercosul exports are subject to numerous non-tariff barriers such as sanitary and phytosanitary restrictions, quotas, subsidies, anti-dumping and countervailing duties, and technical barriers in addition to relatively high tariffs. This is particularly true with respect to agricultural trade in which Mercosul has a special interest. Average tariffs on manufactured goods are around 4 per cent, whereas agricultural tariffs are in the range of 40 per cent to 50 per cent. In a free trade environment, the Mercosul industry is also likely to face competition from the EU as stiff as North America's. Since 1990, Mercosul has been the fastest growing export market for the EU. From 1990 to 1997, exports to Mercosul grew annually by 19.7 per cent, almost three times as fast as European exports to the rest of the world. However, imports from Mercosul grew a meagre 3.7 per cent annually over the same period, compared with 17.4 per cent from China. Moreover, Mercosul exports mostly farm products and raw materials to the EU while it imports mostly high value-added products such as machinery, chemicals and equipment.

The consequence of overly ambitious diplomacy, the Mercosul's interest in a trade deal with the EU serves, to a large extent, as a counterpoise to the push by the US toward the FTAA. The novelty is that it is a negotiation between regions, a new form of international relations that Grabendorff dubbed an interregional association.⁴¹ This new type of alliance goes beyond a free trade area, involving co-operation over a wide range of policy issues such as the environment, international crime, and the development of new technologies. It is also more difficult to negotiate because 'each bloc has a distinct external agenda and both blocs face the issue of widening and deepening, an issue that is not easily reconciled either in the European Union or in Mercosul'.⁴² The obvious advantage is that such an association is bound to increase both regions' bargaining power in the international system as well as in multilateral forum.

Progress to date has been slow. Formal negotiations were finally initiated in mid-1999, but there are wide areas of disagreement regarding the removal of non-tariff barriers and domestic farm subsidies that bar access of Mercosul agricultural products to the EU market. Another issue is the opening up of Mercosul to European services and industrial goods. It is unclear how these claims will be balanced in the negotiation process. It is equally unclear whether Mercosul will be able to pursue parallel negotiations with the EU and FTAA, giving similar preferences and market access to both.

CONCLUSION

The core question is whether Brazil and other South American nations can effectively manage their economies in a globalised world. Brazil's entanglement in multilateral trade disputes has greatly increased, as the country seeks to

expand market access for its products. The bitter trade conflicts with Canada illustrate the difficulties that Brazil faces to overcome barriers that block its exports to world markets, ranging from commodities (beef) to high-tech products (regional jet planes). From this viewpoint, Brazil's best chances lie in a new WTO trade round. No hemispheric or transatlantic free trade agreement could offer greater potential gains for the country's negotiating efforts than a new round to liberalise world trade. However, reaching an agreement at WTO to launch a new round, hinges on factors beyond Brazil's reach.

Regionalism has been the response, but Mercosul's slow progress casts doubts as to the trade partners' ability to sustain a unified front to negotiate more favourable terms in a hemispheric integration process under the FTAA, or in a free trade area with the EU. By binding themselves to one another, Brazil and Argentina, and to a lesser extent Uruguay and Paraguay, expected that they would be better off integrating their economies and forging common stances on a range of issues than trying to fend for themselves in an adverse international environment. Despite its success as a trade bloc since its founding in 1991, Mercosul has been floundering under economic frustration and bitter trade disputes between Brazil and Argentina. Little progress has been made in liberalising intra-bloc trade or consolidating the customs union and still less in making Mercosul a competitive platform in world trade.

'The FTAA is a choice, but Mercosul is destiny', proclaimed president Cardoso at the April 2001 FTAA summit in Quebec. That is why the initiative to 'relaunch' Mercosul represents a crucial effort, not only to overcome the trade bloc's institutional fragility and avoid a loss of power at the bargaining table, but also to unlock the trade partners' economic potential by widening and deepening their union. A rejuvenated Mercosul is a prerequisite for increasing power in international negotiations, as well as to foster the development of competitive economies in the Southern Cone. It is conceivable that the dynamics of hemispheric trade liberalisation might accelerate the speed of sub-regional integration. Motta Veiga suggested that 'the pressure to negotiate the FTAA could lead Brazil to adopt a position less resistant to issues that so far have been considered to have low priority. In fact, Brazil's proposal to make sub-regional integration schemes the building blocks of the FTAA requires that Mercosul take up the issues and subjects pertaining to the agenda for deepening the customs union.'⁴³ However, as important as endowing Mercosul with the institutional backbone that will allow the trade bloc to effectively co-ordinate macro-economic policies and settle trade disputes, is also the need to increase competitiveness by simultaneously increasing the exposure of the subregional economy to international competition and the export coefficient of domestic industry. Keeping a high common external tariff will hardly pay off as a tactic for achieving a stronger negotiating position *vis-à-vis* FTAA or the EU if it keeps Mercosul from augmenting its competitiveness. What matters in the upcoming trade negotiations is to assure that Mercosul will compete on a level playing field

with other preferential trade partners of the US and the EU, and that decisive action to remove non-tariff barriers to its products be taken.

As the Southern Cone's largest nation, Brazil holds the key to the future of Mercosul. Brazil's poor export performance and its vulnerability to outside events threaten to retard growth and unravel sub-regional integration. A chronic trade imbalance and mounting current account deficits, however, are only part of the problem. A significant growth boost is unlikely to follow from a more aggressive involvement in the international political economy alone. What is needed, as Rodrik (1999) argues,⁴⁴ is a strategy that uses trade liberalisation to allow the forces of comparative advantage to push the economy toward sustained growth. After decades of high trade barriers and import substitution policies, economic and institutional reform is required to increase domestic savings and investment, create conglomerates with economies of scale, and breed an outward-looking corporate attitude. It should be stressed that Proex, the export-financing mechanism that triggered the trade row with Canada over Embraer, was set up to compensate for Brazil's high capital costs that reduce the competitiveness of otherwise efficient companies, rather than to prolong. The key, therefore, is to combine the aggressive pursuit of world trade opportunities with an equally aggressive economic and institutional reform strategy at home.

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