

Domestic Constraints on Regional Cooperation: Explaining Trade Conflict in MERCOSUR

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Laura Gómez-Mera
University of Miami
lgmera@miami.edu

This article seeks to account for the seemingly erratic patterns of conflict and cooperation observed in MERCOSUR since 1995. It argues that the marked deterioration of trade and diplomatic relations between Argentina and Brazil in the late 1990s and early 2000s is best explained in reference to domestic political constraints to inter-state cooperation. Two domestic-level dynamics shaped the national preferences for regional cooperation of Argentina and Brazil: state-society relations and intra-state cleavages. The recurrent instances of defection in the late 1990s reflected not only societal pressure but also the macroeconomic and political calculations of national policymakers. Tension among different state agencies sharing power over regional policy making further undermined the coherence of member states' behavior toward their regional commitments. This "second-image" explanation of conflict in MERCOSUR is illustrated with case studies of three major trade disputes between Argentina and Brazil: the 1995 automobile sector crisis, the 1999 footwear industry dispute, and the 2001 conflict over the common external tariff.

INTRODUCTION

In the early 1990s, the Southern Cone Common Market (MERCOSUR) was viewed as one of the most successful examples of the so-called “new regionalism” among developing countries. This perception stemmed from the unprecedented increase in levels of intra-regional trade that followed the signing of the Asunción Treaty in 1991, as well as from the effective negotiation of a common external tariff (CET) permitting the launch of the customs union in 1995. Yet, economic integration lost dynamism after 1995 and the implementation of liberalization commitments slowed down significantly. The tendency of the bloc’s two largest members, Argentina and Brazil, to behave opportunistically resulted in recurrent commercial and diplomatic conflict within the bloc. By the end of the 1990s, the severity of MERCOSUR’s “crisis” led many to cast doubt on its long-term sustainability. Yet, contrary to these pessimistic forecasts, partners made active efforts to restore cooperation after each conflict and to ensure the bloc’s continuity. The past five years have in fact witnessed a decline in the number and intensity of intra-bloc disputes.

This article seeks to account for the seemingly erratic nature of regional cooperation in the Southern Cone since 1995. I argue that the unstable patterns of conflict and cooperation in MERCOSUR have primarily reflected domestic political struggles. In trying to explain the marked deterioration in the quality of regional cooperation between 1995 and 2002 and its significant improvement since 2003, I focus on two domestic-level dynamics: state-society relations and intra-state cleavages. Recurrent defection from regional agreements in the second half of the 1990s reflected not only pressure from those societal groups that stood to lose from regional integration, but also the attempts by national policy-makers to neutralize growing distributional tension and to ensure the survival of their

domestic support coalitions. In addition, I emphasize the role that domestic institutions played in aggregating and translating divergent domestic interests into regional cooperation policy choices. Specifically, I show that tensions among different executive agencies sharing power over regional policy-making in the 1990s further undermined the coherence of member states' behavior toward their regional commitments.

While emphasizing the centrality of domestic-level factors, the empirical evidence suggests that external factors were not irrelevant in shaping patterns of regional conflict and cooperation. Global economic pressures worked to exacerbate domestic economic constraints and to intensify domestic distributional conflict, thus weakening state and societal support for MERCOSUR. Moreover, systemic imperatives and, in particular, partners' determination to strengthen the bloc in response to a threatening international environment, have played a central role in explaining the endurance of cooperation in the Southern Cone.¹ Yet, as the article shows, the impact of these systemic pressures on regional outcomes has been crucially mediated by domestic configurations of interests and institutions.

To illustrate this “second image” explanation of conflict in MERCOSUR, I use case studies of three of the most severe trade disputes between Argentina and Brazil during this period -- the 1995 automobile crisis, the 1999 footwear industry dispute, and the 2001 common external tariff conflict. Relying on interviews with key participants and other primary and secondary sources, I trace the process of national preference formation leading the Brazilian and Argentine governments to defect from their regional commitments. I also look at the domestic sources of the other state's reaction and negotiating position. Beyond arguing that domestic factors matter in explaining patterns of conflict and cooperation in

MERCOSUR, this analysis seeks to illuminate the specific mechanisms through which domestic interests and institutions interact to shape regional outcomes.

The article is structured as follows. The first section contains a brief overview of patterns of conflict and cooperation in the Southern Cone between 1991 and 2007. Section two first assesses the empirical fit of systemic theories in explaining the deterioration of cooperation in MERCOSUR, and then turns to domestic-level approaches. Section three contains the case studies. The final section summarizes the main findings and discusses their theoretical implications.

EVOLUTION OF REGIONAL COOPERATION IN THE SOUTHERN CONE, 1991-2007

A significant body of research has highlighted the increasing difficulties or “crisis” that MERCOSUR has faced since the late 1990s (Carranza, 2003; 2006; Phillips, 2003; Gómez-Mera, 2005a).² Yet, attempts to conceptualize and measure the extent of crisis within the bloc have been rare. Three indicators can be used to trace the evolution of the quality of cooperation since 1991: (1) the level of economic interdependence among members; (2) the extent of their compliance with signed agreements; and (3) the level of diplomatic tension between them. Following Grieco (1997), the level of economic interdependence can be measured in terms of the “trade encapsulation,” or the value of intra-bloc trade as a percentage of the value total trade conducted by all members. Trade interdependence grew rapidly in MERCOSUR between 1991 and 1995, as partners began trading more among themselves than with the rest of the world, and continued to grow at a lower rate until 1998. Trade encapsulation declined markedly between 1998 and 1999 and continued to contract until reaching a low of 11.7% in 2002. Since 2003, however, regional trade has experienced a

steady recovery, with intra-bloc trade flows more than doubling in 2003-2005 (IDB, 2007). While intra-bloc trade has grown faster than flows with the rest of the world, trade encapsulation in 2007 (14.3%) remained well below its value in the late 1990s (IDB, 2008).

[Figure 1 about here]

Declining levels of commercial interdependence in the late 1990s and early 2000s reflected at least in part a widening compliance and implementation gap within the bloc (Bouzas, 2001a). During this period, the tendency of partners to violate regional agreements by imposing restrictions to intra-regional trade and/or introducing unilateral changes in the common external tariff increased. In addition, the late 1990s saw a marked increase in the intensity of these disputes. While some of the unilateral measures introduced in the early 1990s were largely inconsequential, several of the violations after 1995 led to severe commercial and diplomatic crises. Table 1 presents the most consequential violations by the bloc's two main partners, Argentina and Brazil. The last column of the table uses a seven-point ordinal scale to measure and compare the intensity and degree of tension created by each of these violations. This "tension coefficient" takes into account whether a formal complaint was presented, the media coverage that the incident received, as well as the level of confrontation it triggered among partners, including the extent to which the dispute seemed to escalate to the point that the bloc's longer-term continuity came to be doubted. The tension coefficient is then used to construct a simple "crisis index," which aggregates the number of tension-weighted unilateral measures for each year, thus capturing the deterioration in these two dimensions of cooperation -- compliance and tension.³

Figure 2 shows that the crisis reached a high point in 1995, after Brazil defected from automobile agreements signed with Argentina in December 1994, and increased

progressively after 1996 to reach a peak in 1999 following the Brazilian currency devaluation. The period between January 1999 and June 2000 was characterized by almost constant sectorial conflict. Attempts to defuse tension and to “relaunch” the project in July 2000 would prove short-lived, as Argentina defected again in 2001, triggering another peak in tension. The extent of crisis remained significantly high until 2002, when the severity of the Argentine financial collapse led the Brazilian government to grant its weakened partner a number a number of temporary concessions. The recovery in regional trade levels following the rebound of the Argentine economy led in 2004 to renewed sectoral friction. Yet, these more recent controversies can be characterized as “quantitatively and qualitatively low-intensity, with weak media and political repercussion” (IDB, 2008: 61).

[Table 1 about here]

[Figure 2 about here]

Based on the evolution of these indicators, we can identify four different phases in the process of regional cooperation in the Southern Cone. The first phase, between 1991 and 1994, was characterized by growing levels of trade interdependence, high levels of compliance with regional trade agreements, and very low levels of diplomatic tension among partners. In the second period, between 1995 and 1998, trade interdependence was still growing but at a slower rate, and there was a decrease in the level of compliance, as evidenced by an increasing number of unilateral measures. In addition, some of these measures resulted in severe disputes, such as the automobile sector crisis in 1995, although the average intensity level was moderate. In contrast, the third phase was characterized by a marked deterioration in all indicators: an erosion of regional trade interdependence, a

significant increase in the number of unilateral measures that, in turn, resulted in recurrent -- and higher levels of-- bilateral conflict. Finally, since 2003 there has been a relative improvement in all of the indicators, although trade encapsulation has yet to return to its 1992 level and the establishment of the Bilateral Trade Monitoring Commission and the Competitive Adaptation Mechanism (CAM) has led to a “legitimization” of trade restrictions (Sanguinetti, 2007).

[Table 2 about here]

EXPLAINING TRADE CONFLICT IN MERCOSUR

What explains these patterns of conflict and cooperation in MERCOSUR? What are the sources of the marked deterioration in the quality of cooperation after 1995, especially between 1999 and 2002? This section considers the explanatory leverage of three competing theoretical perspectives on interstate cooperation: neorealism, neoliberal institutionalism, and domestic-level approaches.

Systemic Explanations

Systemic explanations highlight the international level influences that shape patterns of conflict and cooperation at the regional level. Neorealists emphasize the constraints that the anarchic nature of the international system places on the ability and willingness of states to achieve and sustain cooperative outcomes. Neorealism thus provides at least four main hypotheses linking the distribution of power at the regional and international levels with the likelihood of conflict among regional trade partners: regional preponderance, relative gains concerns, hegemonic stability, and balance of threat arguments.

The first three of these explanations focus on the distribution of power at the regional level, disagreeing on the extent to which power asymmetries promote or hinder regional cooperation. According to **regional preponderance** arguments, the existence and/or rise of a regional hegemon may lead to unconstrained, self-interested unilateral action by the latter, therefore eroding prospects for cooperation. This explanation is frequently used to account for problems in MERCOSUR. Analysts tend to highlight Brazil's unwillingness to act as a responsible regional leader, instead taking advantage of its relative strength to dictate the pace and scope of the process of integration (Da Motta Veiga, 1999, Cason, 2000). Brazil's individualistic behavior, according to these analysts, is at the root of recurring conflict in the bloc. Another neorealist argument emphasizes the role of **relative gains concerns** and states' fears that their partners might gain disproportionately from cooperation (Grieco, 1988). In the case of MERCOSUR, Manzetti (1994) has argued that asymmetries in market sizes have fostered perceptions among smaller partners that the bulk of the economic benefits of integration accrue to Brazil, thus relegating them to a position of suppliers of raw materials to Brazil's industrial sectors. Concerns about how the benefits of integration are distributed among partners, therefore, can be seen as the source of limited commitment by smaller partners. The deepening of asymmetries among regional partners to the advantage of the hegemon is expected to result in a weakening of commitment by smaller members.

While these two hypotheses posit an inverse relation between power asymmetries and cooperation, **hegemonic stability theory** (HST), in contrast, views the presence or rise of a preponderant power as a pre-condition for the maintenance of regional cooperation (Mattli, 1999). Only the existence of a state strong enough to promote compliance through positive incentives and to punish defection through punitive sanctions can ensure the

sustainability of regional commitments. A benevolent leader can also serve to ease tensions arising from unbalanced distributions of gains from regional cooperation (Mattli, 1999: 42). From this perspective, therefore, it is the *decline* of the hegemonic power that is expected to lead to a deterioration of cooperation.

How useful are these neorealist hypotheses in explaining cooperation problems in MERCOSUR? The empirical examination of the evolution of power disparities within the bloc, measured in terms of economic size asymmetries and of the concentration of regional income,⁴ suggests that these neorealist hypotheses are insufficient to explain unstable patterns of cooperation within the bloc. Table 3 shows that Brazil's economic predominance was relatively stable during the period under analysis, falling slightly in the third phase relative to the second, but remaining at a higher level than in the first phase. This contradicts the expectations of the HST hypothesis, which would predict the quality of cooperation to be the highest when the asymmetries of power are greater. The examination of the evolution of Brazil's relative position within the bloc also contradicts the regional preponderance hypothesis, which would have expected Brazil's weight to be greatest in the third phase, or the extent of crisis the highest in the most recent period. Moreover, regional preponderance explanations overlook the fact that Brazil played an important role in the resolution of conflicts in the late 1990s and early 2000s. Moreover, Brazil and Argentina have recently agreed to the creation of a Structural Convergence Fund in order to more effectively deal with the important asymmetries between member-states and related concerns over the distribution of gains from integration.⁵ While relative gains arguments could be used to explain the overall higher number of violations by Argentina, they are insufficient to account for the marked increase in violations in the third phase.

[Table 3 about here]

A fourth neorealist hypothesis can be derived from **balance of threat** arguments, which focus on extra regional power asymmetries. In the context of regional cooperation, these explanations suggest that conditions of threat from outside the region are more relevant than internal power imbalances in determining the prospects for regional cooperation. Along these lines, regionalism in the Southern Cone has been interpreted as a defensive attempt by relatively weak states to balance US power and influence in the region. In the mid 1980s, following the debt crisis, Argentine-Brazilian rapprochement was partly motivated by the increasing centrality of the US in the region (Hurrell, 1995a). The signing of the Treaty of Asunción has also been explained as a defensive response to the launch of the Enterprise of the Americas Initiative by the Bush administration in 1990, and to the approval of the North American Free Trade Area (NAFTA) in 1993. However, this explanation also faces empirical problems, given that there was little variation in the structure of hemispheric power during the period of analysis. A series of extra-regional developments during the third phase, namely, the decreasing relevance of the region after September 11, 2001, and the disappointing outcome of multilateral trade negotiations for developing countries, increased the relevance of bloc bargaining for South American countries. Balance of threat arguments are therefore useful for explaining the survival of cooperation in the Southern Cone, but not its decreasing quality (Gómez-Mera, 2005a).

If neorealist explanations are unable to shed light on the shifting pattern of conflict and cooperation in MERCOSUR after 1995, do institutionalist accounts fare better? For neoliberal institutionalists, institutions are joint responses by self-interested states to the externalities created by increased interdependence. Institutions perform a number of tasks that help states achieve and maintain cooperation. In trade relations, where incentives for

cheating tend to be strong, institutions play a crucial role as commitment devices.

Institutionalists have thus emphasized the importance of automatic and binding dispute settlement mechanisms providing centralized monitoring and third party enforcement in trade agreements (e.g., Downs, Rocke and Barsoon, 1996; Yarbrough and Yarbrough, 1997; Smith, 2000).

Several analysts have blamed the thinness of MERCOSUR's institutions for the recurrence of crisis in the bloc. For example, according to Peña (2001: 81), the "flaws in the institutional design of MERCOSUR have constituted an obstacle to its continuity, exacerbating friction between partners..." Criticism has concentrated on the absence of supranational institutions and on the ad hoc nature of the dispute settlement mechanism (DSM) established by the Protocol of Brasília (Redrado, 2000). Partly as a result of these deficiencies, it has been argued, MERCOSUR partners tend to rely excessively on presidential diplomacy for the resolution of conflicts. This has facilitated the "politicization" of commercial disputes (Redrado, 2000).

Institutionalist theories highlight the important consequences of weak institutions in MERCOSUR. Fragile monitoring and enforcement mechanisms undoubtedly facilitated unilateral behavior during the period under analysis. Yet, by taking state preferences as given, these explanations cannot account for the reluctance of partners to create more solid institutions as the level of regional interdependence increased in the mid-1990s.⁶ Nor do they shed sufficient light on the actual motivations for defection. Moreover, the arguments reviewed above neglect the fact that presidential diplomacy has played a greater role than formal institutions in the restoration and maintenance of cooperation in MERCOSUR (Malamud, 2005). The evidence presented in the case studies suggests that, in the absence of

presidential leadership and preference convergence among the Argentine and Brazilian presidents, intra-bloc conflict would be more likely.

Domestic Politics and Regional Cooperation

An alternative group of explanations relaxes the unitary state assumption, on which systemic theories rely, and examines the role of domestic political factors in promoting and/or hindering inter-state cooperation. Drawing on Putnam's 'two level games' metaphor, an extensive body of research has emphasized the importance of considering the interconnections between domestic and international-level influences when studying the prospects and nature of international cooperation (Putnam, 1988; Evans, Jacobson and Putnam, 1993; Milner, 1997). This work has found that, under certain conditions, domestic political dynamics may make international cooperative agreements harder to achieve and sustain. From this perspective, then, the failure of cooperation is less determined by states' relative gains concerns and systemic constraints than by "domestic political conflicts, which no single actor can control" (Haggard and Simmons, 1987:515).

Second-image explanations provide a series of illuminating insights on the domestic sources of cooperation and conflict in regional trade agreements like MERCOSUR. One set of arguments explains "national preferences" for regional cooperation in reference to the demands of societal actors. Preferential trade agreements have domestic distributional implications – they create winners and losers, which may become supporters and/or opponents of these policies. Consumers, exporters and firms that can exploit economies of scale and production-sharing across borders in intermediate goods when gaining access to an enlarged regional market are expected to benefit from and hence to support regional trade agreements (Moravcsik, 1998; Solingen, 1998; Milner, 1997). In customs unions, domestic

industries that are protected from third-country competitors by the CET are also likely to support regional trade integration. By contrast, less competitive import-competing sectors will typically oppose trade integration. The stronger and better organized these groups are relative to internationally-oriented coalitions and consumers, the less likely a government will be to sign and implement regional liberalization agreements.

Implicit in these interest-based accounts is the assumption that state actors are “passive registers” of groups’ preferences and play little autonomous role in the policy-making process. State-centric approaches challenge these premises, asserting that policy-makers not only have independent policy objectives, but can also act to influence the mobilization and configuration of interest groups in society (Ikenberry, Lake and Mastanduno, 1988). While government officials cannot completely ignore societal demands if they want to remain in office, they can rely on various mechanisms to construct coalitions that support their preferred policies.⁷ When signing regional trade agreements, for example, governments may use exemptions to gain the support of adversely-affected sectors, thus increasing the political viability of the agreement (Grossman and Helpman, 1995).

This perspective, thus, shifts the attention to the preferences of governments. The literature on regionalism has highlighted several types of domestic economic and political motivations for governments to sign regional trade agreements (Mansfield and Milner, 1999; Hurrell, 1995b). Yet, governments also face costs from participating in these agreements. Specifically, political leaders confront the loss of unilateral control over trade policy instruments (Milner, 1997). The value of relinquishing trade policy autonomy depends on a number of factors, particularly, the economic and political contexts that policy-makers face. For leaders confronting unemployment and recession in an electoral year, for example, this opportunity cost might be higher. The greater the domestic usefulness of trade policy

instruments, the lower the willingness of national leaders to give them up in a cooperative agreement (Milner, 1997).

A second group of statist explanations focuses not on the preferences of states, but on the role of domestic political institutions in aggregating societal and state interests and translating them into policy outcomes.⁸ Domestic institutions condition the access of different actors into the policy process, thus having a critical impact on the formation of the national interest. Apart from influencing the relative autonomy of state actors from societal pressures, institutional structures determine the distribution of decision-making authority among different governmental actors. Thus, institutional arrangements that empower the losers from trade cooperation, or the state actors representing their interests, are more likely to result in uncooperative policy choices (Goldstein and Martin, 2000). In addition, institutionalist scholars have emphasized the difficulties that may arise when several governmental actors share power over the same policy instrument, particularly if their preferences diverge. Mansfield, Milner and Pevehouse (2007) argue that a greater number of veto players, or “institutional actors whose assent is necessary to change existing policies,” makes trade cooperation less likely.

Both societal and state-centric approaches are useful for making sense of patterns of conflict and cooperation in MERCOSUR, each emphasizing a different domestic political constraint on the maintenance and stability of regional cooperation. While there is widespread consensus on the centrality of state actors and the limited participation of societal groups in MERCOSUR, several scholars have emphasized the role of the private sector in moderating the pace and extent of integration. Indeed, the conventional explanation for conflict between Argentina and Brazil in the late 1990s tends to highlight protectionist pressures in the face of competitiveness asymmetries resulting from the

absence of macroeconomic coordination. According to Carranza (2003: 82), for example, “...domestic politics gained centre-stage” in MERCOSUR after the Brazilian currency devaluation in January 1999. The vulnerability of Argentine industries to Brazilian competition after the devaluation led to the emergence of a new multi-sectoral group, which pressed strongly for a revision of Argentina’s position in MERCOSUR. From this perspective, increased conflict was a direct consequence of the ability of industrial lobbies in Argentina to “seize control of [...] trade agendas” following the Brazilian devaluation (*The Economist*, 11/12/99).

The empirical evidence presented here lends support to such interest-based explanations, showing that the most consequential unilateral measures taken by Argentina and Brazil were preceded by intense lobbying by those sectors that stood to benefit from the violations. Yet, a closer look at the specific cases reveals several shortcomings in a purely interest-based account. First, the assumption that the Argentine and Brazilian governments behaved as “passive registers” of this sectorial activity is problematic. The case studies show that state actors shared an interest in defecting and that they engaged in unilateral violations in strategic ways, as part of their attempts to prevent the unraveling of their domestic support coalitions. Second, the empirical analysis highlights the important mediating role that played the institutional configuration within each country in aggregating and translating divergent domestic interests into regional cooperation policy choices. Both qualifications suggest that a more accurate explanation of conflict in MERCOSUR is obtained by complementing societal explanations with insights from state-centric and institutionalist approaches to foreign economic policy.

a) State incentives for defection

State-centred explanations of regional trade cooperation focus on the preferences of state actors, predicting that government officials will support cooperation as long as the perceived benefits of integration outweigh the costs of giving up control over trade policy instruments. In the early 1990s, for Presidents Carlos Menem (Argentina) and Fernando Collor de Mello (Brazil) this trade-off was strongly positive. On the one hand, since both governments were embarking in ambitious programs of unilateral and multilateral trade liberalization, intra-regional liberalization did not result in significantly greater reduction in their autonomy over trade policy. Moreover, intra-regional trade liberalization was gradual and incomplete, allowing governments to maintain exemptions for those sectors that stood to lose the most from integration (Olarreaga and Soloaga, 1998).

The benefits of cooperation, on the other hand, were multifold. Apart from contributing to the convergent foreign policy and strategic agendas of the two administrations, the enlarged market presented important economic and developmental opportunities for all members-states. Regional integration facilitated the achievement of economies of scale and the rationalization of investments within the enlarged market, thus enhancing the competitiveness and efficiency of domestic industry (Manzetti, 1994; Kaltenthaler and Mora, 2002). Argentina, like smaller members Uruguay and Paraguay, also benefited greatly from free access to the large Brazilian market, which soon became the major outlet for their exports. In addition, economic policy-makers saw MERCOSUR agreements as an effective tool for “locking-in” liberal reforms and protecting them from potential domestic challengers (Solingen, 1998). Finally, MERCOSUR contributed in important ways to the success of the exchange rate-based stabilization (ERBS) programs introduced in Argentina and Brazil in the early 1990s.⁹ Apart from acting as a magnet for much-needed foreign investment, increased import competition at the regional level worked

as a mechanism for price containment. This complementarity between trade liberalization and macroeconomic stabilization was crucial in explaining the support of Argentine and Brazilian economic elites for MERCOSUR in the first half of the 1990s (Da Motta Veiga, 1999).

Yet the balance of benefits and costs from cooperation shifted after 1995, and especially toward the end of the decade, as international and domestic circumstances changed and the perceived domestic usefulness of trade policy instruments increased. Here, exchange rate policy played an important intervening role. Both the Convertibility Program in Argentina and the Real Plan in Brazil had unprecedented success in containing inflation, while promoting moderate economic growth. In addition to important electoral dividends for Presidents Carlos Menem and Fernando Henrique Cardoso, successful stabilization allowed these leaders to broaden their support coalitions to include important sectors of the urban lower-middle class and smaller, less competitive private sector groups (Starr, 1997; Díaz-Bonilla and Schamis, 2001; Kingstone, 1999; Wise, 2000).

Nevertheless, the ERBS were not without weaknesses. In both countries, the pegs resulted in overvalued currencies, deepening current account deficits and external vulnerability. The negative shifts in the international economic environment in the second half of the 1990s exacerbated these problems and, in the context of inconsistent fiscal policies, weakened the credibility and sustainability of the peg itself. The deterioration of external conditions also intensified the adverse domestic political implications of the ERBS. The overvalued currency, when combined with aggressive trade liberalization, imposed a heavy burden on the tradables and import-competing sectors, gradually eroding their support for trade and macroeconomic reforms.¹⁰ In the case of Argentina, where the private sector held large dollar denominated debts, and where the experience of hyperinflation had

been particularly traumatic, open criticism of currency policy was late to come. Instead, at least until 2001, rising social discontent translated into widespread demands for compensatory measures, including trade protection. In Brazil, by contrast, industry was openly critical of the peg as early as 1995.

Despite the increasingly obvious economic and political costs of the pegs, Brazilian and Argentine policy elites were determined to defend them and avoid devaluation. In a context of deepening domestic and external crisis, and given the rigidities created by the anchor, trade policy instruments acquired special macroeconomic and political value. They could not only be used to contain current account deficits, but also to compensate those groups that were harmed by the **strong currency and tight monetary policies. Thus, in the second half of the 1990s, the willingness of Argentine and Brazilian policy-makers to defect from regional agreements reflected not only an intensification of domestic sectoral demands, but also, the increasing opportunity costs of surrendering control over trade policy instruments.**

This shift in the perceived trade-off from cooperation, however, was only temporary and did not signify a total erosion of either government's overall commitment to MERCOSUR. In the longer term, as the case studies show, these domestic political and macroeconomic incentives for defection were more than offset by the perceived strategic and political benefits of maintaining the bloc. This is evidenced in the swiftness with which the recurrent disputes were resolved. In critical moments, national executives chose to make the regional project a priority over domestic political agendas.

b) Domestic institutions and the coherence of regional policy

Argentine and Brazilian preferences and choices concerning integration were also shaped by institutional factors, and particularly, by the distribution of decision-making power among

governmental actors. The empirical evidence suggests that, in line with institutionalist explanations of foreign economic policy, the number of actors sharing power over regional integration, the extent of preference divergence and the degree of coordination among them, affects the stability and coherency of partners' trade policy choices, and hence the nature of regional cooperation.

In both countries, executives have played a central role in the formulation, negotiation and implementation of regional integration policy, with very limited participation by the legislatures. In the 1980s, when the first steps in Argentine-Brazilian cooperation were taken, decision-making authority was concentrated in the presidents and foreign ministers. This changed in the early 1990s, as Finance Ministry and Central Bank officials gained centrality within the Argentine and Brazilian executives. As foreign policy elites came to share decision-making authority over regional trade policy with economists, coordination between the two sets of actors became an essential yet elusive goal.

In Argentina, the high level of fragmentation and the deficient coordination between the Ministry of Economy (ME) and the Ministry of Foreign Relations and International Trade (MRECIC) severely affected the implementation of international trade policy (Jordana and Racint, 2002; Bouzas and Pagnotta, 2003). In Brazil, by contrast, there was better coordination and less fragmentation between the different executive branch agencies involved in regional cooperation - the Ministries of Foreign Relations (MRE), Finance (MF) and Development, Industry and Trade (MDIC) (Jordana and Racint, 2002). In both countries, moreover, the temporary strengthening of "hawkish" elements within the economic bureaucracy worked to undermine regional cooperation.

[Table 4 about here]

CASE STUDIES

The Automobile Crisis

The automobile industry has been one of the most controversial sectors in MERCOSUR, and a source of recurring conflict since the creation of the bloc. Both the Treaty of Asunción and the Ouro Preto Protocol granted the automobile industry special treatment, excluding it from the process of intra-regional liberalization and allowing partners to maintain their own domestic regulations and external tariff levels until a common automobile policy was agreed upon (Comin, 1998; Candia-Veiga and Vigevani, 1997). Decision 29/94, signed in December 1994 at Ouro Preto by Argentina and Brazil, called for the establishment of a common automobile policy (CAP) by January 2000. In the meantime, bilateral exchange would be subject to previous agreements and domestic regulations, which both parties agreed not to modify unilaterally (Haar and O'Keefe, 2001).

In June 1995, however, Brazil violated this agreement by introducing a new automobile policy, which closely mirrored the interventionist policy prevailing in the Argentine auto sector since 1991. The new regime contained incentives to investment and exports in the automobile sector, specifically targeting foreign-based assemblers producing in Brazil.¹¹ In addition, it established quantitative restrictions on automobile imports from any destination, including MERCOSUR countries.

This measure triggered one of the most serious crises in the history of MERCOSUR. The Argentine government reacted immediately, claiming Brazil had contravened Dec. 29/94 and demanding its reversal. Brazil ignored the demand and offered instead to begin negotiating the CAP. In response, Buenos Aires threatened to interrupt all bilateral negotiations (*Clarín*, 16/6/95). In addition, Argentine Minister of Economy Domingo Cavallo announced his decision to seek a bilateral trade agreement with Chile. Tension

reached unprecedented levels when President Menem threatened to boycott a MERCOSUR Summit to be held in São Paulo during the World Economic Forum in June 1995.¹²

Notwithstanding its attempts to play hardball, Argentina eventually had to accept the Brazilian regime. While the immediate crisis was resolved through presidential diplomacy, protracted negotiations over the MERCOSUR CAP continued over the next decade.

Although partners had agreed to liberalize automobile trade by 2006, an agreement signed in July that year further postponed the opening of borders until June 2008 (IDB, 2007).¹³ In May 2008, however, partners agreed to extend the temporary agreement until 2013 (*Página12*, 31/05/08).

Brazil In line with societal explanations, Brazil's controversial measure was partly a response to increased pressure by the automobile sector. The powerful and well-organized National Automobile Assemblers Association (ANFAVEA) had rejected the Ouro Preto agreements, claiming that they institutionalized an asymmetry in competitiveness between the two countries and that Brazilian negotiators had been "careless" in signing them.¹⁴

However, an interest-based interpretation fails to explain why this group was unable to influence policy decisions *before* June 1995. Empirical evidence shows that while there might have been an intensification of pressure after Ouro Preto, ANFAVEA had been aggressively lobbying the government for protection since the early 1990s.¹⁵ But since the appointment of Cardoso as Finance Minister in 1993, their demands had been largely ignored. Given the emphasis that Cardoso's team of neoliberal economists placed on trade liberalization and macroeconomic stabilization, they resented the continued increase in automobile prices during 1994 (*Gazeta Mercantil*, 6/9/94). In an attempt to curb rising prices, the economic team decided in September 1994 to anticipate the implementation of the MERCOSUR CET (initially envisaged for January 1995), thus effectively reducing the

tariff on automobile products from 35 to 20 percent (Galperín 1995). Despite strong complaints by ANFAVEA, the economic team went on to sign Dec. 29/94 later that year.

Thus, the abrupt shift in the direction of automobile policy in mid-1995 resulted from more than just an intensification of business pressure. It also reflected the political and macroeconomic calculations of Brazilian policy-makers. In 1995, a combination of external and domestic developments increased the economic and political utility of trade policy autonomy, thus raising the costs of observing regional commitments,

First, the deterioration in the external financial environment following the December 1994 Mexican devaluation created independent macroeconomic incentives for the economic team to support the interventionist automobile policy. The combination of aggressive trade liberalization and overvalued exchange rate had resulted in a deepening current account deficit toward the end of 1994. The reversal in capital flows triggered by the Mexican Crisis put additional pressure on the balance of payments and threatened the sustainability of the exchange rate anchor. In March 1995, the exchange rate was devalued 6% and the real was allowed to float in a band of 5% (Bonomo and Terra, 2000). Given their concerns with external credibility and inflationary pressures, policy-makers were reluctant to further adjust the exchange rate. They preferred to rely instead on trade measures and investment incentives to mitigate balance of payments problems, even if this entailed renegeing on regional commitments.

A second domestic political dynamic temporarily altered the perceived trade-off from regional cooperation. The decision by the newly-elected President Cardoso to appoint José Serra, a leading political figure from the Brazilian Social Democratic Party (PSDB), as Minister of Planning resulted in important divisions within the economic team. Unlike the technocrats at the MF and the Central Bank (CB), Serra had a long career as a politician

from the state of São Paulo. His developmentalist economic ideas were also at odds with the neoliberal views of the main economists in the cabinet. Both factors made him closer and more permeable to the industrial sector's demands. His appointment resulted in the strengthening of a broad coalition of state and business actors that rejected the economic team's neoliberal policies and the priority given to stabilization over trade, industrial and social objectives.¹⁶

Serra soon became a spokesman for this developmentalist coalition. He rejected the economic team's policies of high interest rates and overvalued currency, strongly advocating for a devaluation. He was also critical of MERCOSUR,¹⁷ and particularly of the Ouro Preto automobile agreements, claiming they established "a crazy asymmetry," which "had to be corrected."¹⁸ To address it, he led an inter-ministerial team that worked closely with ANFAVEA representatives in the design of the new automobile policy established in June 1995.¹⁹

The economic team initially rejected this highly interventionist policy (*Jornal da Tarde*, 10/6/96; *Gazeta Mercantil*, 9/6/95). Their decision to eventually endorse it must be understood partly in reference to the macroeconomic concerns referred to above. But in addition, economic officials saw the regime as a strategic concession to Serra's coalition, through which they expected to neutralize their growing criticism. In the words of Gustavo Franco, then CB Director of International Affairs, "in this way our internal opposition would be weakened by the fact that the auto industry would be happy with our tariff policies. And then they would not fight for a change in the exchange rate..."²⁰

Argentina Argentina's position during the automobile crisis was also shaped by domestic political factors. The strong initial reaction to the Brazilian measure reflected, first of all, pressure by the local automobile sector, the main loser from the establishment of the

Brazilian regime. Both Argentine assemblers and auto parts producers saw Brazil's move as a "hard blow."²¹ The new policy imposed quantitative restrictions on Argentine sales to Brazil, at a time when the producers were facing a collapse of internal demand, due to the so-called "Tequila effect" of the Mexican crisis. Assemblers had expected to compensate for this deterioration of conditions in the Argentine market with sales to Brazil (*Clarín*, 14/6/95). In addition, the auto sector feared that the various incentives offered by the Brazilian regime would deepen structural asymmetries between the two markets. The Argentine Automobile Producers Association (ADEFA) thus demanded a "vigorous response" (*La Nación*, 14/6/95).

Pressure by the automobile lobby undoubtedly influenced the government's initial position. Yet, like in the Brazilian case, to fully account for Argentina's position during the crisis it is necessary to consider state preferences. As in Brazil, there were divergences among different executive actors, and particularly between ME and MRECIC. The ME coincided with the automobile sector regarding the importance of adopting a tough stance against Brazil. Minister Domingo Cavallo shared the industry's concerns with the effects of the quotas on Argentine exports. Primarily, though, Cavallo feared the potential impact of the regime on the direction of investment flows (*Clarín*, 16/6/95).

By contrast, the MRECIC adopted from the beginning a more conciliatory stance. This "dovish" position reflected the agency's historical commitment to the process of regional integration. Unlike Cavallo, who favored a strategy of unilateral liberalization and bilateral free trade agreements (potentially, with the United States), MRECIC representatives saw MERCOSUR as the best option for Argentina's international insertion. Menem, who viewed MERCOSUR as his own political achievement, endorsed MRECIC's position. The eventual softening of Argentina's position -- crucial in the restoration of cooperation --

reflected the predominance of these views and the importance of long-term strategic priorities in explaining the survival of MERCOSUR. As Miguel Cuervo, then Secretary of Industry, put it, “The instruction was that MERCOSUR was the priority... and in the end this position triumphed.”²²

The Footwear Industry Dispute

The January 1999 devaluation of the Brazilian currency marked the beginning of a highly conflictive period in Argentine-Brazilian relations. Between April 1999 and June 2000, MERCOSUR was jolted by recurrent trade disputes, triggered by a succession of unilateral measures that violated regional commitments. Among these, two were particularly consequential, resulting in significant diplomatic animosity between the two governments. In July 1999, Argentina passed a resolution allowing the use of the Latin American Integration Agreement (LAIA) safeguard measure system within MERCOSUR. Although the measure did not have immediate consequences, it set the stage for the future implementation of safeguards on intra-regional imports. In response, Brazil suspended its participation in regional negotiations and postponed a scheduled official visit by Menem to Brasília. The crisis was resolved when, in a meeting with Cardoso a few days later, Menem agreed to withdraw the measure (IDB, 2001).

A few weeks later, the ME imposed two new controversial measures that re-ignited bilateral tension. Resolution 508/99 required all footwear products entering the country to include a label with information on the production process. Resolution 977/99 introduced a system of non-automatic import licenses for footwear imports. Brazil strongly rejected them, citing their incompatibility with MERCOSUR rules. Argentina insisted that the bloc’s legal framework allowed the application of non-automatic licenses until 2000. In response, Brazil

threatened to retaliate by re-imposing import licenses on more than four hundred Argentine products (*O Estado de São Paulo*, 18/9/99).

Despite their initial confrontational stances, both governments were soon eager to moderate tensions. Unable to reach a mutually beneficial solution at the political level, Argentine and Brazilian representatives encouraged the Argentine and Brazilian footwear associations to negotiate a voluntary export agreement. By the end of September, the Argentine Footwear Industry Chamber (CIC) and the Brazilian Footwear Industries Association (ABICALÇADOS) announced a deal had been reached, leading the Argentine government to withdraw the unilateral measures. In response, Brazil dropped retaliatory threats. While the private sector agreement contributed to the normalization of diplomatic relations in the short-run, due to the lack of adequate oversight of commitments it failed to eliminate commercial friction in the sector (IDB, 2007).

Argentina Argentina's uncooperative measures in 1999 also had domestic political roots. They were, at least in part, a response to intensified pressure by the domestic industrial lobby, following the Brazilian devaluation. CIC was one of the sectorial associations that had demanded "compensatory" mechanisms more vigorously after the Brazilian crisis.²³ Apart from fearing the "avalanche" of Brazilian imports, in 1999 CIC members faced the end of the special regime of exemptions from intra-regional liberalization established in 1994. In addition, and despite benefiting from a variety of protectionist measures during the 1990s, the footwear industry reached the end of the decade in a critical situation (INTAL, 1998; Ablin and Lucangelli, 2000). Heavily indebted, the main two firms in the sector, Alpargatas and Gatic, closed down several plants, dismissing over 3000 workers. In July 1999

representatives from the footwear and leather industries organized a demonstration outside MRECIC and demanded urgent measures of relief (*La Nación*, 30/7/99).

Yet, the measures were not only concessions to these specific sectoral lobbies. They also reflected the government's own macroeconomic and political calculations. In 1999, a number of contextual factors increased the perceived domestic utility of trade policy instruments, thus raising the economic and political costs of observing regional agreements.

First, the footwear restrictions, like the 1995 Brazilian automobile regime, were used to appease the increasing discontent of the industrial sector with the government's macroeconomic policies. Indeed, frustration with the costs imposed by the convertibility regime on the competitiveness of domestic producers led to the gradual emergence in the late 1990s of a nationalist "producers" coalition, which intensified its protests after the Brazilian devaluation (Gaggero and Wainer, 2004). In contrast to Brazil's developmentalist coalition, this group did not directly demand a devaluation. Instead, they chose a more effective tactic: they openly criticized the currency board and its effects on the industrial sector and then demanded "compensatory" measures, such as reduced employment retentions, subsidies and import restrictions. This group, moreover, sought to exploit the fact that 1999 was an electoral year. In response to the government's initial reluctance to give in to demands for compensation, the producers coalition forged links with the Peronist candidate, Eduardo Duhalde, thus managing to place their demands on the electoral debate (*La Nación*, 11/7/99).

Second, as in Brazil in 1995, the deterioration of external and domestic economic conditions temporarily increased the economic costs of giving up trade policy autonomy to the regional level. The ME not only feared the consequences of the "avalanche" of Brazilian products for the much-deteriorated Argentine balance of payments. In addition, they were

concerned about the financial effects of the Brazilian devaluation on the stability of the Argentine currency, which had come under increasing speculative attacks following a succession of international financial crises in the late 1990s. Rumors that Argentina would follow Brazil in abandoning the anchor intensified in the second half of 1999, resulting in a marked increase in country risk and exacerbating Argentina's delicate debt position. In this context, the unilateral measures should also be interpreted as attempts to signal this commitment to international markets, and as Higgott and Phillips (1999: 28) have put it to "differentiate (...) from the troubled partner." Finally, according to Roque Fernández, then Economy Minister, the measures were also designed to remind Brazil of the importance of coordinating macroeconomic policies and jointly addressing the financial effects of the Brazilian devaluation.²⁴

Nevertheless, like in 1995, there were significant divergences between ME and MRECIC officials (IDB, 2001). In contrast to the ME, the MRECIC opposed any unilateral action that could upset relations with Brazil, and blamed Argentine firms for their competitiveness problems (*La Nación* (13/5/99)). In response, the private sector complained that the diplomats seemed to be "working for the Brazilians."²⁵ Yet, as Jorge Campbell, then Argentine Secretary of International Economic Relations, would put it, "our role is to achieve a balance between the defense of local industry's interests, and MERCOSUR's stability."²⁶ To a significant extent, Argentina's ambivalent position during the crisis—first imposing safeguards and then withdrawing them, but only to once again resort to unilateral NTBs a few weeks later, followed by support for a voluntary export restraint (VER) agreement—reflected the tension between these divergent bureaucratic stances.

Brazil The strong and defensive position adopted by Brazil in the footwear dispute reflected not only intense pressure by domestic firms, but also the convergence of preferences on the part of MRE and MDIC.

Brazilian footwear producers reacted rapidly to the Argentine measures, interrupting negotiations with CIC and threatening to resort to dispute settlement procedures (*O Globo*, 3/9/99). ABICALÇADOS argued that Argentina's restrictions blocked the entry of the two million pairs of Brazilian shoes that had already reached the Argentine border when the measures were announced, causing an estimated loss of US\$80 million. The Argentine restrictions came at a time when Brazilian producers were expecting an export boom to Argentina, given the post-devaluation competitiveness scenario (Anderson, et. al., 2001).

From the MRE's perspective, the footwear crisis signaled the exhaustion of diplomatic channels and the need for more decisive action in response to Argentina's recurrent violations. Despite their strong strategic commitment to MERCOSUR, thus, Brazilian diplomats chose to play hardball by threatening retaliation.²⁷ But this aggressive position also reflected the political calculations of the recently restructured and renamed MDIC. A historically powerful actor within the Brazilian state bureaucracy, this agency had been severely weakened during the 1990s. In an attempt to signal renewed commitment to development during his second term, Cardoso had given this agency a central role in the restoration of industrial growth. In 1999, and given Brazil's new favorable competitiveness position, the MDIC's priority was to promote and support the expansion of exports. Yet, these efforts proved futile in the face of the stringent monetary policies maintained by the MF and CB. This situation increased frustration among industrial groups, which had expected the devaluation to reverse a decade of poor export performance. According to Mário Marconini, then Secretary of Trade, "I was asked every fifteen minutes why exports

were not growing (...) The impression was that the government was incompetent.....” In this context, it was “politically unfeasible” for MDIC to accommodate Argentina’s demands for compensatory mechanisms.²⁸

The Common External Tariff Crisis

After a highly conflictive 1999, MERCOSUR partners agreed in July 2000 to “relaunch” the bloc, pledging to work together to resolve sectoral impasses and make progress towards the complete implementation of regional commitments. However, the first quarter of 2001 saw the re-emergence of commercial and diplomatic tensions. A new conflict was triggered by the Argentine government’s decision in March 2001 to revise import tariff levels, thus effectively violating common external tariff agreements. This move included an increase in the external tariff on a series of consumer goods (textiles, foodstuffs, photographic products and paints and varnishes) and the elimination of tariffs on capital, information technology, and telecommunication goods (IDB, 2003). Bilateral tension was further exacerbated by controversial public statements made by the recently re-appointed Economy Minister Domingo Cavallo, as well by his repeated calls for downgrading MERCOSUR into a free trade area (e.g., *La Nación*, 31/3/01; *Cronista Comercial*, 22/5/01).

Aware of the fragile economic and financial position of its neighbor, Brazil reacted with moderation. Brazilian officials expressed their willingness to support Argentina in overcoming the crisis. In April, they agreed to grant Argentina a temporary “waiver” to apply the new CET exceptions until the end of 2002 (IDB, 2003). Yet, Argentina’s decision to include cell phones, telephones and computers in the list of capital goods covered by the negotiated waiver angered the Brazilian authorities and private sector. Brasilia reacted more emphatically, suspending negotiations over the common automobile regime and threatening to resort to retaliatory measures, this time by restricting imports of Argentine wheat and

petroleum. After a bilateral exchange with his Brazilian counterpart, Argentine President Fernando De la Rúa agreed to instruct Cavallo to exclude information technology and telecommunication goods from the waiver.

As the crisis in Argentina deepened, the government insisted on the importance of establishing compensation mechanisms to manage imbalances in bilateral trade. In October 2001, Brazil finally gave in to this long-standing Argentine demand and agreed to the temporary establishment of a safeguards system (*Clarín*, 10/10/01). In exchange, the Argentine government pledged to drop talk of transforming the bloc into a free trade area.

Argentina Compared with the two previous examples of defection, Argentina’s violations in 2001 were driven less by specific sectoral pressures than by the political and macroeconomic calculations of state actors. The severity of the domestic economic and political situation significantly increased the opportunity cost of relinquishing control over trade policy instruments. Thus, the unilateral measures established in April 2001 had a clear macroeconomic rationale. They were part of a broader package—the so-called “competitiveness program”—introduced by Cavallo in response to the deepening recession plaguing the Argentine economy since 1998. Both the increase in consumer goods tariffs and the elimination of duties on capital goods sought to improve the competitiveness of the Argentine industry, which had been markedly eroded by nearly a decade of currency overvaluation.

Like in the other two cases, however, Argentine policy makers also used MERCOSUR violations to neutralize growing private sector discontent with prevailing macroeconomic policies, in a context of deepening domestic crisis. Because a significant number of Argentine firms held large dollar-denominated debts, they continued to share the government’s stubborn determination to avoid the collapse of the convertibility regime. Yet,

by 2001, key members of the backlash producers' coalition had become openly critical about the costs of the currency board for domestic industry. In this context, the competitiveness regime must be understood as an attempt by the Argentine government to strike a political compromise between these conflicting interests, ultimately seeking to ensure the domestic political sustainability of the currency board.

At the same time, from the industrial sector's perspective, the progressive depreciation of the Brazilian currency raised the costs of participating in MERCOSUR. As a result, 2001 saw an increasing mobilization against the bloc. For the first time in ten years, the private sector actively called for a revision or temporary "suspension" of MERCOSUR agreements (*Página 12*, 08/08/01). These demands converged with Cavallo's own views about the strategy of regional integration. Since his return to the government, Cavallo advocated for the elimination of the CET, claiming that this would allow Argentina "to recover the freedom to eliminate tariff imports on capital goods and all types of restrictions on modernizing investment..." (*Clarín*, 28/9/01). More importantly, turning MERCOSUR into a FTA would allow Argentina to negotiate a bilateral trade agreement with the United States.

Cavallo's "hawkish" position not only fueled an intense debate on Argentina's insertion alternatives,²⁹ but also worked to deepen cleavages within the De la Rúa government (*La Nación*, 08/05/01). In contrast to Cavallo and other ME officials, the MRECIC continued to see the consolidation of MERCOSUR as a long-term priority. This position reflected the strategic belief that Argentina's national interest would be maximized by negotiating access to the FTAA jointly with MERCOSUR partners (*La Nación*, 16/09/01). In the words of Vice-Minister of Foreign Relations, Horacio Chighizola, "We want to deepen and strengthen the bloc so that it can have a single voice vis-à-vis third

countries” (*La Nación*, 07/04/01). While the MRECIC was unable to stop the establishment of the unilateral measures, its more conciliatory position worked to moderate the latter’s defiant stance during negotiations with Brazil.

Brazil In 2001, the Brazilian government faced a delicate balance. From the start of the conflict, it was clear to Brazilian officials that, given the severity of the Argentine crisis, they had little option but to be flexible with their neighbors. Yet, Brasília faced strong pressure from the private sector, and particularly from the capital goods industry, which saw its preferential access to the Argentine market eroded as a result of Cavallo’s measures. The Brazilian Machinery and Equipment Industries Association (ABIMAQ) criticized the measures, claiming they would result in heavy losses for Brazilian producers (*La Nación*, 25/03/01). ABIMAQ was particularly critical of Cavallo’s decision to treat information technology and telecommunication products as capital goods, which threatened sales of Brazilian-made cellular telephones, computers and ink jet printers.³⁰ Instead, the increase in Argentina’s tariffs on consumer goods deepened regional preferences and worked to the advantage of more competitive Brazilian producers of consumer goods. Beyond the specific distributional implications of the Argentine measures, the Brazilian private sector resented Cavallo’s aggressive statements against Brazil and MERCOSUR.³¹

Cavallo’s attempts to modify and suspend the CET were also ill-received by Brazilian foreign policy makers, for whom the CET had special strategic and political value. Cavallo’s measures were seen as weakening MERCOSUR as a customs union and undermining its ability to sustain a strong and consistent position in external negotiations (IDB, 2003). Nevertheless, it was also in Brazil’s interest to prevent the Argentine crisis from spreading within the region, particularly given the difficulties that the MF faced in 2001 in maintaining

the parity of the real. Overall, then, and despite the strong business pressure, Brasilia agreed to yield to Argentina's demands for compensation mechanisms.

CONCLUSIONS

This article has sought to account for the seemingly erratic patterns of conflict and cooperation observed in MERCOSUR since 1995. While shedding some light on important aspects of cooperation in MERCOSUR, systemic approaches are insufficient to explain the high instability and marked deterioration of trade and diplomatic relations between Argentina and Brazil in the late 1990s and early 2000s. Instead, I argue that recurrent conflict between these two countries is best explained in reference to domestic political factors.

The second-image explanation I propose emphasizes the interaction of domestic interests and institutions in shaping the national preferences and choices of Argentina and Brazil regarding regional cooperation. While acknowledging the relevance of societal pressure in explaining defection, my argument underlines the role of supply-side factors, such as the calculus of national policy-makers and the distribution of power within the government. In the second half of the 1990s, changes in external and domestic economic conditions worked to increase the domestic usefulness of trade policy instruments, thus temporarily eroding policy-makers' support for cooperation. The strengthening of state actors and agencies that were less committed to integration, such as Serra in Brazil and Cavallo in Argentina, also contributed to uncooperative behavior. In addition, Argentina's ambiguous behavior toward the bloc between 1995 and 2001 reflected the ongoing cleavage between ME and MRECIC officials. In Brazil, by contrast, intra-state divergences concerning MERCOSUR were not only less frequent, but also more effectively managed,

allowing the government to present a more stable and unified national position.

Nevertheless, as the case studies demonstrate, this opportunistic behavior did not reflect a weakening of governments' political commitment to the integration project. In the longer-term, both chose to prioritize their strategic partnership over domestic considerations.

This domestic-level explanation is also useful for making sense of the relative improvement in the quality of cooperation in MERCOSUR since 2003. Auspicious external economic conditions have certainly contributed to the impressive recovery in intra-regional trade observed in the past five years. Yet, these systemic changes have been mediated by shifting configurations of domestic interests and institutions. Specifically, the strengthening in both countries of "nationalist" state-society coalitions that place greater emphasis on domestic production and employment than on stabilization and liberalization has fostered regional cooperation in a number of ways.

First, the convergent political and ideological orientations of Presidents Lula in Brazil (2002-present) and Néstor and Cristina Kirchner in Argentina (2003-07 and 2007-present, respectively) have facilitated bilateral communication and collaboration. In 2003, Lula and Kirchner agreed to "re-launch" MERCOSUR and signed the "Buenos Aires Consensus," in which they pledged to jointly address social and distribution issues, as well as to prioritize domestic social concerns over external financial commitments (*La Nación*, 17/10/03). In fact, Lula and Kirchner strengthened MERCOSUR's autonomous and developmental dimension (Carranza, 2006), using it as a vehicle for challenging the US-led process of hemispheric integration.

Second, the shift in domestic economic conditions resulted in a weakening of finance ministers within national cabinets relative to the 1990s, particularly in Argentina. The more competitive exchange rates in both countries has also led to a strengthening of those

agencies in control of export promotion and market access negotiations, typically within the foreign ministries. Thus, the latter have regained centrality in the process of formulation, negotiation and implementation of policy toward MERCOSUR. Greater concentration of decision-making authority and lower levels bureaucratic fragmentation over integration have increased the coherency of partners' behavior towards their regional commitments.

Third, the maintenance in the two countries of more flexible exchange rate regimes, which allows them to respond to external imbalances and domestic redistributive pressures via currency policy, has made relinquishing control over trade policy measures less costly. This is clearer in Argentina, where the maintenance of a competitive exchange rate has worked to alleviate the distributional burden and hence to facilitate the political sustainability of regional trade liberalization.

Finally, the decline in the number and intensity of trade conflicts in the period 2005-2007 resulted also from the establishment of institutional mechanisms, such as the Bilateral Trade Monitoring Commission and the CAM, which by promoting the negotiation of "voluntary" restraint agreements, make unilateral trade measures unnecessary.³² These arrangements have allowed governments to bolster the political viability of MERCOSUR, thus striking a more stable balance between domestic political concerns and strategic imperatives. Yet, as critics note, they also constitute "a step backward in the process of economic cooperation" (IDB, 2007), raising questions about MERCOSUR's longer-term coherence and sustainability.

While emphasizing the domestic political sources of conflict in MERCOSUR, the evidence presented in this article points to the enduring political and strategic rationale of regional cooperation in the Southern Cone. These findings have theoretical implications. In particular, they suggest that a comprehensive explanation of regional dynamics in South

America can only be achieved by combining insights from systemic and domestic-level theoretical perspectives.³³ Future research on MERCOSUR and other regional integration agreements can benefit significantly from a disciplined focus on the various ways in which systemic exigencies interact with domestic interests and institutions to shape national preferences and choices regarding regional cooperation.

TABLE 1: Trade Disputes between Argentina and Brazil, 1991-2007*

<i>Date</i>	<i>Product</i>	<i>Measure by</i>	<i>Type of Measure</i>	<i>Level of Tension</i>
1992	Various	Argentina	Increase in statistical tax	1
1993	Paper	Argentina	Quotas	1
1995	Automobiles	Brazil	Quotas, incentives, etc.	5.5
1997	Multiple	Brazil	Import financing requirements	1.5
1997	Automobiles	Brazil	Subsidies	2
1997	Sugar	Argentina	Import restrictions	2
1998	Milk	Brazil	Import licenses	1.5
1998	Agribusiness	Brazil	Import licenses	1.5
1998	Pork meat	Brazil	Subsidies	3
1999	Cotton textiles	Argentina	Quotas	4
1999	Iron & steel	Argentina	Antidumping	2.5
1999	Multiple	Argentina	Safeguards system	4.5
1999	Footwear	Argentina	Labeling requirements	5
1999	Garlic	Brazil	Import licenses	1.5
2000	Sugar	Argentina	Extension of special regime	4
2000	Poultry	Argentina	Antidumping	4.5
2000	Rice	Brazil	Import restrictions	2
2001	Capital goods	Argentina	Decrease in CET	4
2001	IT goods	Argentina	Decrease in CET	5
2001	Foodstuffs	Brazil	Import restrictions	2.5
2002	Wheat	Argentina	Changes in CET	1
2002	Rice	Brazil	Changes in CET	1
2003	Various	Brazil	Domestic taxes	1
2004	Cotton textiles	Argentina	Import licenses	1.5
2004	Washing machines	Argentina	Import licenses	1.5
2004	TV sets	Argentina	Tariffs	1.5
2005	PET resin	Brazil	Antidumping	0.5
2006	Wheat/wheat flour	Brazil	Labeling and technical requirements	0.5
2006	Textured polyester	Brazil	Import licenses	0.5
2006	Wine	Brazil	Import licenses	0.5

*No unilateral measures triggering Argentine-Brazilian disputes were registered in 2007. Sources: Official documents, reports from the MERCOSUR Secretariat, systematic examination of press reports (from main newspapers in Argentina and Brazil, and interviews with policy-makers and business representatives from both countries.

TABLE 2: Quality of Cooperation in MERCOSUR, 1991-2007

Phase	Indicators			Quality of Cooperation
	(1) Interdependence	(2) Compliance	(3) Tension	
(1) 1991-1994	Rapid increase	High	Low	High
(2) 1995-1998	Slower increase	Moderate	Moderate	Moderate
(3) 1999-2002	Decrease	Low	High	Low
(4) 2003-2007	Increase	Moderate	Moderate	Moderate

TABLE 3: Evolution of Hegemonic Leadership in MERCOSUR (Brazil)

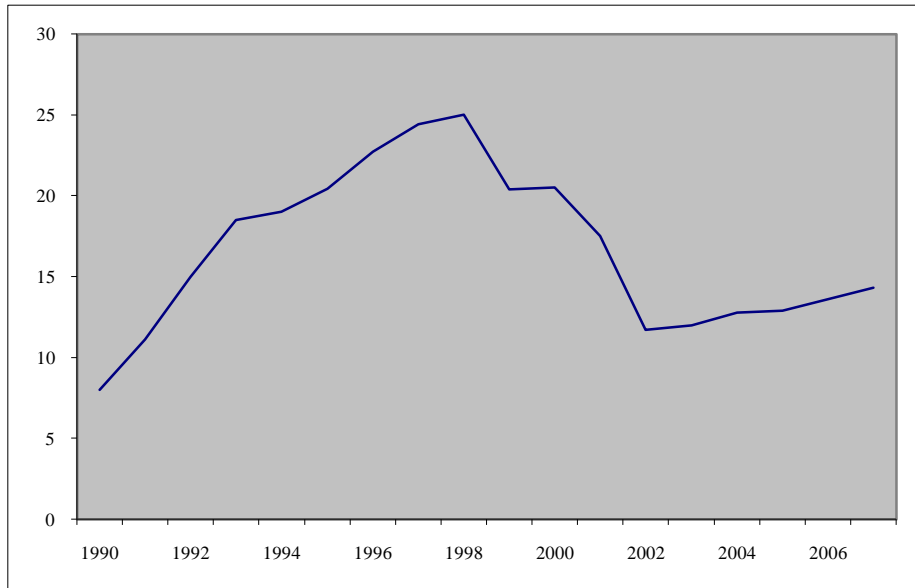
Period	Overall Capabilities Method: Brazil's GDP/Regional GDP (%)*	Concentration Ratio
1991-1994	64.12	.60
1995-1998	71.27	.65
1999-2002	68.01	.63
2003-2007	78.2	.72

*Four year averages. Source: Centro de Economía Internacional (Buenos Aires).

TABLE 4: Summary of Hypotheses

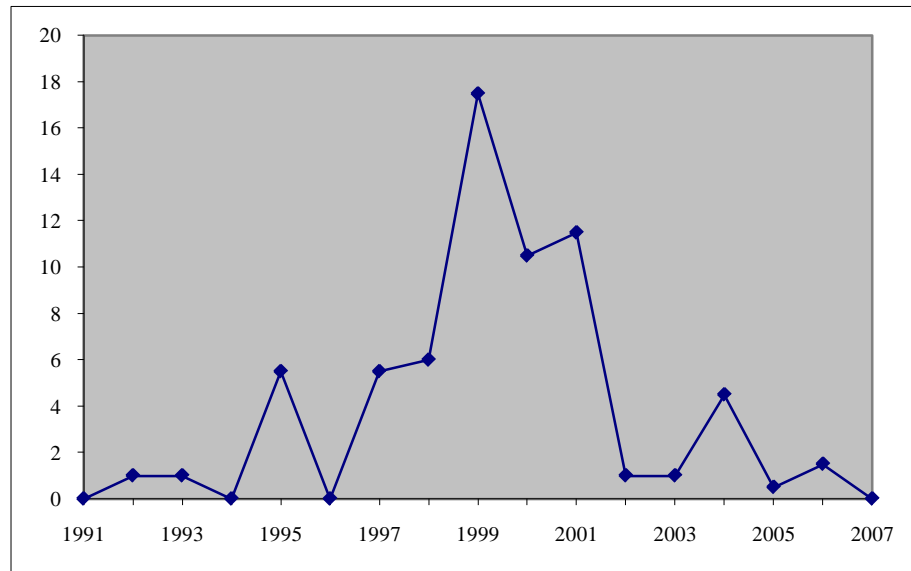
Theory	Hypothesis	Prediction: Increasing conflict in MERCOSUR a result of:	Test
Neorealism	(1) HST	Declining Brazilian preponderance	No significant changes in regional disparities.
	(2) Regional preponderance	Deepening of Brazilian preponderance	
	(3) Relative gains concerns	Declining position of smaller partners	A series of external developments (e.g. post-911 external environment characterized by renewed US centrality, stagnation in WTO negotiations) underlined incentives for regional unity
	(4) External threat	Declining relevance of external commercial and security threats	
Neoliberal Institutionalism	(5) Functional	Weak enforcement mechanisms, in a context of increasing interdependence	Partners' reluctant to modify DSM (until 2004) despite increasing interdependence and negative externalities.
Domestic politics	(6) Interest groups	Growing interest group pressure	Highlights part of the puzzle but overlooks supply-side dimension (preferences and role of state actors)
	(7) Statist	Increasing cost of giving up autonomy over trade policy instruments (from government's perspective)	Explains the increasing tendency by Brazil and Argentina, to defect from regional commitments, in the face of a deteriorated external and domestic environment, and given the rigidities created by fixed exchange rate systems.
	(8) Institutional	Growing divergence and poor coordination among state actors sharing power over regional policy	Partly explains sources of ambivalence and instability in partners' behavior.
		Concentration of power in more "hawkish" state actors	
	(9) Presidential diplomacy	In the absence of presidential leadership and preference convergence between Argentine and Brazilian presidents, intra-bloc trade disputes are more likely	The most salient disputes in MERCOSUR were resolved only after protracted negotiations at the presidential level.*

FIGURE 1: Trade Encapsulation in MERCOSUR, 1991-2007*



*Intra-bloc exports relative to total exports. Source: Author's calculations based on data from IDB/INTAL and CEI

FIGURE 2: Crisis Index for MERCOSUR, 1991-2007



¹ I develop this point more fully in Gómez-Mera (2005a), which examines the sources of MERCOSUR's survival despite its recurrent crises. In this article, instead, I concentrate on explaining the occurrence and recurrence of intra-bloc conflict.

² For a more detailed account of the origins and early stages of MERCOSUR, see Hurrell (1995a; 1998) and Manzetti (1994).

³ Crisis Index for year $j = \sum [v_i t_i]$, where v_i = each violation in year j and t_i = the tension coefficient for the dispute triggered by that particular unilateral measure.

⁴ The “concentration ratio” (Smith, 2000; Haftel and Thompson, 2006) takes into consideration the relative weight of all members. A higher index (between 0 and 1) would indicate a greater asymmetry of economic capabilities within the bloc.

⁵ See IDB (2008).

⁶ Only in 2002, with the signing of the Protocol of Olivos, MERCOSUR members agreed to the creation of a permanent review tribunal, which was first used in 2004.

⁷ An extensive literature looks at coalition building by states in Latin America. See, for example, Etchemendy (2001), Corrales (1998) and Kingstone (1999).

⁸ For a good overview of this literature, see Milner (2002).

⁹ For an overview of the Convertibility Plan, see Díaz Bonilla and Schamis (2001) and Wise (2000). For a description of the Real Plan, see Amman and Werner (2003).

¹⁰ On the politics of exchange rate choices, see Bernhard, Broz and Clark (2002).

¹¹ For a detailed discussion of the regime, see Meira Zauli (2000).

¹² Interviews with Luiz F. Lampreia, former Brazilian Foreign Minister, Rio de Janeiro, December 2002; and with Guido Di Tella, former Argentine Foreign Minister, Oxford, July 2000.

¹³ In the meantime, exchange in the sector will be regulated by the 35th Additional Protocol to Economic Complementarity Agreement 14, signed in 2006. For a detailed discussion of the provisions of this agreement, see IDB (2007).

¹⁴ ANFAVEA's President, Silvano Valentino, quoted in *Jornal da Tarde* (29/10/94).

¹⁵ Telephone interview with Silvano Valentino, September 2000.

¹⁶ Interviews with MF officials, Brasilia, November 2002.

¹⁷ For example, see *Jornal da Tarde* (10/6/95).

¹⁸ Interview with José Serra, Brasília, August 2000.

¹⁹ Interview with Alfredo Graça Lima, former Economic and Trade Advisor to the Foreign Minister, Brasília, August 2000.

²⁰ Interview with Gustavo Franco, Rio de Janeiro, September 2000.

²¹ Interview with Horacio Losoviz, former president of ADEFA, Buenos Aires, August 2000.

²² Interview with Miguel Cuervo, Buenos Aires, August 2000.

²³ Interview with Felix Peña, former Secretary of Foreign Trade, Buenos Aires, October 2002.

²⁴ Interview with Roque Fernández, Buenos Aires, October 2002.

²⁵ Interview with Carlos Litzman, CIC Manager, Buenos Aires, October 2002.

²⁶ Interview with Jorge Campbell, Buenos Aires, October 2002.

²⁷ Interview with Lampreia.

²⁸ Interview with Mário Marconini, Rio de Janeiro, October 2002.

²⁹ See, for example, Bouzas (2001b).

³⁰ Interview with Mário Mugnaini, former vice-president of ABIMAQ, São Paulo, November 2002.

³¹ Interviews with FIESP, IEDI and CNI representatives, São Paulo and Rio de Janeiro, November 2002.

³² See IDB (2006) for a detailed explanation of the Commission's functions and operations.

³³ See Gómez-Mera (2005b).

LIST OF ACRONYMS

ABICALÇADOS	Brazilian Footwear Industries Association
ABIMAQ	Brazilian Machinery and Equipment Industries Association
ADEFA	Argentine Automobile Producers Association
ANFAVEA	Brazilian National Automobile Assemblers Association
CAM	Competitive Adaptation Mechanism
CAP	Common Automobile Policy
CB	Brazilian Central Bank
CET	Common External Tariff
CIC	Argentine Footwear Industry Chamber
ERBS	Exchange Rate-Based Stabilization
HST	Hegemonic Stability Theory
LAIA	Latin American Integration Agreement
ME	Argentine Ministry of Economy
MERCOSUR	Southern Cone Common Market

MDIC	Brazilian Ministry of Development, Industry and Trade
MF	Brazilian Ministry of Finance
MRECIC	Argentine Ministry of Foreign Relations and International Trade
NAFTA	North American Free Trade Area
PSDB	Brazilian Social Democratic Party

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