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Integration in times of instability:

Exchange rate and monetary co-operation in Mercosur and the EU

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Abstract

The different strands of institutionalism in integration theories have made a great effort in theorising the cumulative or/and purposive nature of the integration process. In these rich and insightful theories, the question of how this regional institutionalised order copes with sudden and unexpected instability has tended to be somehow under-explored. Instability is an important aspect, since it might be the source for disruptive effects, putting substantial pressure on constitutive decisions. This is an issue that deserves careful comparative analysis. For this purpose, we have chosen two recent events in Mercosur and the European Union. The recent macro-economic crises in Brazil and Argentina have put considerable pressure on Mercosur's integration. With less drama, the EU has also experienced an unexpected situation. The newly launched single European currency, the Euro, suffered a constant loss of value against the US Dollar. In relation to this, some voices questioned how far the ECB had to pursue strictly its institutionalised objective of fighting against inflation. To a different extent, both events have put pressure on the institutionalised order of the regional arrangements. The paper will proceed as follows. It will first elaborate a succinct theoretical framework based on some recent advances in institutionalism and social-constructivism, trying to accommodate a perspective on ideational/cognitive factors without undermining the explanatory value of interests. After that, the paper will examine the institutionalisation process and the nature of macro-economic co-operation in Mercosur and the EU. This will allow us to examine the recent instability, its causes and its scale, and most importantly, the responses to it. The concluding remarks of the paper will again bring to the fore the question of instability in different integration processes.

Keywords: Regional integration, economic integration, institutionalism, integration theory, EMU, exchange rate and monetary co-operation.

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Introduction

The process of regional integration is essentially a process of institutionalising a new political and economic order. Either in the strong political variant of the EU's whator in the 'common market' version of Mercosur, regional agreements entail a partial restructuring of previously existing frameworks for socio-economic policy action. Firstly, because the decision to move a specific issue from national level to an international level means a partial reshuffling of authority by moving up the locus of decision-making, and a partial re-consideration of the nature of the state, as the solel regulator of socio-economic life. And secondly, because this entails a political re-negotiation of how civil society, the economy, and the relevant (new) level of public authority has to be organised, opening the door for political struggles among ideological/ideational alternatives. This is what it has fascinated social scientists' trying to explain the phenomenon of regional integration. Why and how do states agree to undertake such challenging political effort? And what are the factors that drive the integration process?

The endless literature dealing with these issues, mostly dominated by the EU case, has somehow tended to disregard the question of what explains continuity in times of instability. Why do states have the tendency to continue sticking to the co-operation agreement when the economic and political context has changed, and the conditions for the initial agreement might be different than at the onset? Once the decisions have been taken at a regional level, what makes them persist through time? As several authors have remarked, the political decisions enshrined in the treaty or formal agreement are not the end of story, but the beginning of it, as there is no guarantee that the arrangements will wither away by inaction. This is to say that the 'substance' and reality of a regional integration project comes with the almost daily political decision from each partner to hold on to the agreed decisions.

All this might be severely challenged by a great instability in the wider context of the regional arrangement. If the instability generates high uncertainties in the form of high risk prospects, and if the results of these uncertainties are asymmetrically distributed among partners, instability might put substantial pressure to the constituted order. Facing this situation, the actors have essentially two possible solutions, namely either they disrupt the established order by searching new political arrangements (collectively or individually, defecting or making a new arrangement stepping down the previous level of mutual commitment) or they stick to the existing one reinforcing the initial view that this is the best of all possible solutions. Tilting in favour of one or the other is essentially a political choice where material interests, societal demands, cognitive parameters and world-views all have a role to play. Hence, our research question here is not what factors drive further the integration process towards more integration, but rather what makes it hold in stormy and unstable times.

Instability and continuity in regional integration agreements deserve careful comparative analysis. For this purpose, we have chosen two recent events in Mercosur and the European Union. The recent macro-economic crises in Brazil and Argentina have put considerable pressure on Mercosur's integration. With less dramatism, the EU experienced also an unexpected situation. The newly launched single European currency, the Euro, suffered a constant loss of value against the US Dollar. In relation to this, some voices questioned how far the ECB had to pursue strictly its institutionalised objective of fighting against inflation. To differing extents, both events have put pressure on the institutionalised order of the regional arrangements. The paper will proceed as follows. It will first elaborate a succinct theoretical framework from some recent advancement of institutionalism and social-constructivism, trying to accommodate a perspective on ideational/cognitive factors without undermining the explanatory value of interests. After that, the paper will examine the institutionalisation process and the nature of macro-economic co-operation in Mercosur and EU. This will allow us to examine the recent instability, its causes and its scale, and most importantly, the responses to it. The concluding remarks of the paper will bring to the fore again the question of instability in different integration processes.

Regional integration and ideals: Theorising continuity in unstable times

We mentioned above that regional integration is an institutionalised political order. This focus helps understanding the elements at play in the integration process and the continuity of its arrangements. As Mansfield has asserted, "(I)nternational institutions create incentives for states to cooperate by reducing collective action problems; by lengthening the 'shadow of the future', thereby enhancing the prospects for states to engage in strategies of reciprocity; and by increasing the ability to link various issues, thereby increasing the costs for states of failing to comply with established rules and norms" (Mansfield and Milner, 1997), p.8). This quotation contains some of the most important elements that so far have been pointed to for understanding continuity, namely, reciprocity and issue-linking, both of them effectively rising the costs of non-compliance.

Institutionalist perspectives on regional integration have recently gained ground. The overall success of neo-institutionalism stems from its willingness to strike a balance between the structurationist and the methodological individualist traditions. Institutions are supposed to constrain individual actor's behaviour but in a way that social action is not reduced to the mere expression of the given political-economic-social structures. However, not all institutionalists hold the same positions. The relatively crowded institutionalism reflects, though, important differences in conceptual and theoretical understandings of what institutions are. The liberal institutionalist tradition, to which Mansfield's quotation can be ascribed, holds a rather strict definition of institution, as the negotiated order resulting from the specific national interests and preferences, and the strategic choices of the bargain procedure (Moravcsik, 1995). Historical institutionalism, on the other hand, follows the neo-functionalist tradition in its transactionalism and in its perspective on institutions as historically and socially built conventions (Bulmer, 1994; Pierson, 1998). Last, sociological institutionalism, to which March and Olsen are leading figures, indicates a much broader interpretation of institutions, as the set of assumed norms and patterns of behaviour in the 'logic of appropriateness' that most actors chose instead of the 'logic of consequenciality'(March and Olsen, 1989; March and Olsen, 1998). Consequently, institutions are everywhere and are essentially constraining social devices to which individual actors adapt through behaving 'appropriately'.

Given the large differences about the conceptual breath of institution, any scholar is compelled to choose among them. Historical institutionalism seems the most balanced option, an option where the definition of institution has neat borders in a way that there is room for the role that interests (national and private) have in the integration process and its continuity, but where the former are not entirely subordinated to the latter. In other words, interests do not explain everything. Not at least why the different examples of regional integration have very different contents and patterns, and neither why regional arrangements tend to persist even in adverse conditions, when reciprocity is not straightforward and when issues might be de-coupled in order to keep the whole boat from sinking.

Historical institutionalism is also preferable to sociological institutionalism. This is so because the latter's interpretation of institutions is so broad that it renders any attempt to operationalise state behaviour in international relations an almost unachievable task. The reason is that states do not necessarily behave as individuals, and what might be true for sociology is not necessarily so in the rather unstructured world of international politics.

Apart from having a workable concept of institutions, historical institutionalism seems to us a reasonable theoretical starting point for another, even more salient reason. And it is that this tradition couples politics and political processes within a more complex set of historically-given context. All the norms, rules and patterns of social conventions that inform, constrain and enable single actor's actions have been long established beforehand. This is where the notion of 'path dependency' comes in, stressing the tendency that political actors generally show sticking to partly known patterns of action when confronted to a new situation. This means that change and transformation is normally a gradual (and even parsimonious) process. Radical change exists, but it is an anomaly in political life.

However, historical institutionalism needs further development as to how ideational cognitive parameters do form part of this historically-built path-defined forms of states' political action in an international arena (Borrás, 1999), aligning it to the growing social-constructivist approach (Christensen, et al., 2001) and identity focus (Higgott, 1998). Most particularly, the enabling role of ideas, which comes up in two related steps. Firstly, they define the political problem. Ideas have an interpretative ability, giving meaning to the situation. This is what we can call 'the ideational basis of problem-identification'. And secondly, they articulate political solutions. This is related to the ability of ideas to appeal to some commonly shared assumptions, and to suggest new courses of action on this basis. This is what we can call 'the ideational basis of political action'. Ideas might not be sharply defined or even uniformly interpreted by the different actors, in order to provide for change. This goes equally for the ideational basis of problem identification and of political action. The important thing is that *ideas are generally accepted as meaningful and suggestive*. Ideas have to be also commonly regarded as viable. Hence, ideas need a certain degree of relevance for the actors.

And here the notion 'state ideals' seems particularly well endowed. By state ideals we understand those fundamental values and preferential biases regarding public authority, modes of governance and public approaches to economic growth and distribution, which are dominant among national elites. State ideals are the fruit of history, and have an important enabling dimension as they operate as the 'ideational basis of problem-identification' and of 'political action' within the state context.

State ideals constitute the basis for the formation and articulation of 'regional ideals', that is, the patterns of perspectives and visions about regional integration. There might be contending regional ideals, the same as state ideals. And this contention is essentially an ideational-cognitive one, between alternative ideals, and is typically resolved within the borders of political space. This means that we can consider the EU and Mercosur as two cases of regional integration steaming from two different regional ideals, which have been developed on the basis of the historically constructed state ideals.

Hence, we predict that the institutional ensemble of a consolidated case of regional integration like the EU and Mercosur is subject to further more continuity and stability than that assumed by 'liberal institutionalists'. And this is so because stability cannot just be understood in terms of national interests' 'reciprocity' and 'issue-linkage', but also to in-depth cognitive parameters among national elites. These cognitive parameters are regional ideals. Hence, national elites' believe that the regional arrangements are the best possible political solution to the given context of world economy and politics makes them stick to the arrangements even in unstable times. But how unstable should those be? How resilient are these institutional arrangements binding state's interests and ideals into a collective action in the event of political-economic unexpected turmoil?

Instability is really the testing time for regional integration. Continuity will depend on:

- How ideational battles have been articulated: and what regional ideal has emerged out of it. How all-embracing the regional ideal might be, how it might appeal, and be accepted at national level.
- Also the structure of the elite: how corporate-political-administrative circles are articulated, and how autonomous all in all is it from specific demands.

Next sections examine this in the context of exchange-rates co-operation in EU and Mercosur.

One single currency in Europe

Creating the EMU

The creation of the European Economic and Monetary Union (EMU) is an unparalleled event in contemporary history. Certainly there have been previous examples of monetary unions, but never in the current conditions of advanced capitalist economies. No wonder, then, that most scholars have been fascinated by the political boldness shown by European leaders all through the complex exercise of setting up the EMU. Even if some commentators have pointed out that the relative success of the EMS (European Monetary System) was a 'de facto' union, the step ahead creating a single currency and of establishing an ensemble of new institutions to command it, is still rather stunning, especially when considering its effects upon national sovereignty. Hence, the EMU is an extraordinary upshot in the European integration process.

The idea of a single currency for Europe is an old aspiration of europeanists since the inception of the European Communities in the 1950s, and was never fully abandoned all through the more than forty years of European integration. Despite the failed attempts of the late 1960s to launch a Economic and Monetary Union, the ideas of the Werner report survived several decades. The rather successful European Monetary System, with a highly stable exchange rate system during more than fifteen years, gave a good basis for moving ahead into the EMU project again in the late 1980s. The Maastricht Treaty, ratified in 1993, created a three-phased process for achieving the EMU, the last of which was accomplished in January 1999. The European Central Bank works as the linchpin of this monetary integration, holding exclusive powers in monetary policy. The birth of the EMU means that we can no longer talk about European co-operation, but of a single European exchange rate policy designed and implemented by the ECB. However, the EMU has still a rather descentralised structure, since member states retain full powers in fiscal policy. In order to avoid distortions national policies are guided by the principles of the 'stability and growth pact' and those of the economic guidelines.

A seemingly endless literature in the field of political science has addressed the question about what conditions and factors made the EMU possible. The rich and diverse scholarly interpretations are based on alternative theoretical explanatory frameworks. Neo-neofunctionalists and transactionalists argue that the EMU is the political response to the growing interdependency of the European economies (indicated by rising levels of intra-EU trade). After three decades of political discussions, the EMU has finally addressed this essential economic imperative, responding to the tensions generated by the distinct national exchange-rate policies in this heavily interdependent economic scenario. In other words, the EMU is the necessary and unequivocally sole political move able to address the given economic reality (Cameron, 1998). Intergovernmentalists share partly this argument. While recognising the growing economic interdependency among EU members, they however subsume political decisions concerning the EMU to the hegemonic position of Germany in the political and economic concerted scenario of the early 1990s (Moravcsik, 1998).

Last, social-constructivists and cognitive institutionalists have stated that these two reasonaments tend to assume deterministic undertones. For, independently of how integrated the economy really was or of the hegemonic position of Germany, the main subjacent element during the course of the events leading to the EMU was the advancement of specific macro-economic policy ideas among political and economic elites. McNamara has stressed the increasing neoliberal policy consensus across European countries in relation to a widespread believe that the previous Keynesian approach failed to generate stable growth (McNamara, 1999); Verdun has pointed out the pivotal role of the Delors Committee, through which experts worked as a powerful epistemic community in a transnational context (Verdun, 1999); and Macussen has referred to the cyclical evolution of ideas related to the EMU (Marcussen, 1999). Consequently, the ideational background of elites are the clue to understanding the complex move towards the EMU in the late 1980s, and as Dyson and Featherstone have remarked, cognitive and strategic elements were both present in the long negotiations during and after the Maastricht Treaty (Dyson and Featherstone, 1999). Furthermore, Risse et al link these policy-ideas with identity patterns of national political elites. National identities are specially well-endowed to explain variation among national preferences regarding the single currency, most notably among those three countries that decided not to join the EMU (Risse, et al., 1999). This paper follows this latter strand of thinking, assuming the centrality of the cognitive dimension in the process of regional integration (both as a set of policy ideas, and as national identity constructions), while recognising that material interests (given by economic asymmetric interdependency) and strategic bargaining (present in the negotiation dynamics) do have also an important role.

The debates about EMU sustainability

The national elites' debate about whether the EMU is a sustainable economic exercise and whether it has positive consequences have been rather lively. On the one hand, supporters of the Euro had point to three possible economic benefits, namely, its ability to reduce transaction costs, increase price transparency and generate growth through stability. The Euro, is said, will unleash market forces within the Euroland, working as the natural complement of the single market in the EU post-national order. Furthermore, the size of the new currency will invariably generate a new international monetary system, characterized by the bipolarity of the US dollar and the Euro.

Sceptical national elites and economists point to different factors that might challenge the EMU's existence and future functioning. One of the most recurrent arguments is that the EMU is ill-fitted to cope with asymmetric shocks bound to happen given the largely diverse economic structures in Europe. Thus, the 'one size fits all' monetary policy of the ECB would invariably put different pressures on the 11 members (Feldstein, 2000). A second argument is that the actual challenge for the EMU lies at a medium-term perspective, in the fiscal burden coming with population ageing. The fiscal problems caused by generous social security and pension systems will need to be solved by raising taxes, reducing expenditures or printing money. All of them likely to generate intra-Euroland tensions with centrifugal effects upon the EMU (Ferguson, 2000). This is a structural fiscal problem that will need a new policy mix for structural reform, mainly through a tight fiscal and structural policy co-ordination (Dornbusch, 2000). A third argument about the challenges for the Euro has to do with its expected international role. Agnostic views about the likelihood and optimality of the Euro to become a central currency in a bipolar monetary system, counterbalancing the US dollar, have been raised. The Euro should instead focus on generating prosperity within Euroland and cast aside its international ambitions (Bismut, 1999).

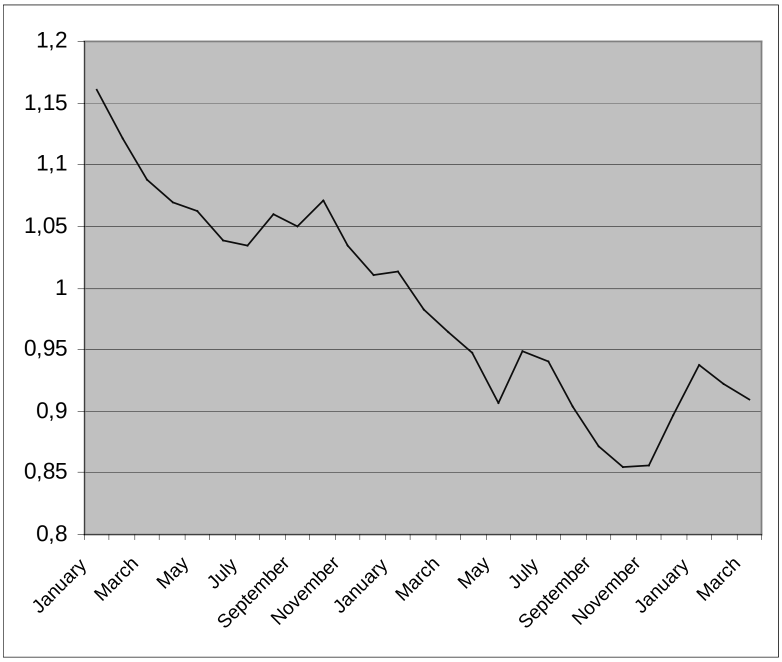
Counterarguments to these three sceptical views run that differences in the Eurozone, even if not inconsiderable, are not much greater than those already in large economies like the US. This means that given the high level of economic integration, asymmetric shocks will not be disproportionate, at least not more than what is already the case in the US. Likewise, the fiscal structural problem related to ageing population is pretty much the case for all the 11, and the instruments for economic policy co-ordination are already well defined in the EMU (Trichet, 2001). Last, the international role of the Euro will evolve piecemeal, as only occasionally has the international monetary system been completely remodelled fortnight (Eichengreen, 2000). Despite this contrast between the sceptic's and optimist's views, the plans for the Euro have evolved on schedule, with an overwhelming back up from most political and corporate elites in its 11 members. There is no doubt that at the elite level, the ideational battle was gained by Euro-supporters.

What has happened in the first 2 years of the Euro existence? Have the sceptics or orthodox forecasting been confirmed? How stable has the launch of the Euro proved to be? The launch of the Euro in 1999 has been an undeniable success. The well functioning ECB, and the growth of the European economy in the period seem to validate that fact. Nevertheless, amid the élan of its materialisation, the EMU faced a completely unexpected loss of value against the US dollar. This is an interesting topic. Neither sceptics nor orthodox economists ever imagined such situation. Quite the contrary, in the late 1990s, concerns were of a rapidly overvalued Euro in the aftermath of its launch. The outstanding depreciation of the Euro has been the sole staggering feature of its birth, but a rather bewildering one. Next section examines the economic consequences and political reaction that this situation generated.

The first two years of the Euro

In its first one and a half years of life, the Euro had lost 25% of its value against the US dollar. Economists have devoted significant amounts of effort trying to identify the factors that might explain this. But still, it seems to be rather complex. The conventional wisdom that it simply reflected the differential in the US and European economic performance seems puzzling, since the later was giving strong indications of a rapid recovery and relative improved performance (growth rates were increasing faster in the Eurozone than the US, the same about industrial production rates, and unemployment was decreasing faster). If the European economic 'fundamentals' were in order, the decline of Euro is explained by the great uncertainty about the true equilibrium value of the euro-dollar exchange rate (De Grauwe, 2000), and the uncertainties about the pace of two economies dealing simultaneously with the unknown effects of technical change and unprecedented monetary reform (Corsetti, 2000).

Figure 1: Euro-Dollar exchange rate, January 1999-March 2001



Source: ECB monthly data.

For some other authors, the explanation has to be found in a host of other factors: "(…) a high initial exchange rate, an unexpectedly strong US economy, a reviving yen, careless comments from policy-makers, and disappointment over the pace of European structural reform" (Cottrell, 2000) p. 78. The conjunction of these events triggered uncertainty in euro-investors, who disregarded the signs of recovery, and focused on the relative out performance of the US economy from a static point of view. In June 2000, the Euro bounced, as signs of a deteriorating US economy became very visible with the burst of the technology stock market bubble.

Common for these explanations is the understanding that the Euro`s loss of value represents the cautious reaction of the international financial forces on the new currency, in a context of unstable global economic outlook. Several political and economic consequences can be pointed out. Firstly, it gave a bad public image of the EMU. The more the Euro was falling, the more it spread the notion of a relative wrecked European economy among investors. For the general public, a falling Euro contrasted sharply with the fanfare at its onset. And it certainly did not help to get a Danish 'yes' in the national referendum in September 2000. Secondly, the weak Euro doomed to futility the prospects of the prompt emergence of a bipolar international monetary system. Thirdly, and most importantly, there was a generalised feeling of uncertainty among economic actors.

Regional ideals and uncertainty

Instability might not be the right word to describe the two first years of the single European currency. However, the unexpected situation of fast and insurmountable loss of value generated a high degree of uncertainty among economic operators and political elites as to the position of the Euro in the international financial markets, and the EU performance in international trade.

The interesting point is that one might have expected that this uncertainty could have unleashed distinct national political pressures for tackling the situation. All this putting in bold relief the distinct traditions of national macro-economic policies and central banking that have developed in the 11 Euro states since the post-war period. In other words, the uncertainty of the first two years of the Euro could have enhanced the different state ideals as to macro-economic policy. For example, the Germans not being happy with a weak currency because their model of macro-economic management was based on a combination of stable currency and inflation control, while the Euro has been rather unstable as a currency. On the other hand, the French could equally have been putting pressure to make the ECB more politically accountable, and tackle more directly the loss of value as a question of prestige. The uncertain Euro smashed the French expectations to create a bipolar international financial system of the Euro and the US dollar, and more clear-cut pressures from the French government to the ECB in order to intervene more strongly willing to redress the situation could have been expected on this basis.

However, nothing like this happened: Euroland members showed rather cold blood all through the turmoil, and no real cross country alternative visions were put forward. How can we understand this situation? How can we understand the lack of political debate about how to tackle/ or whether to tackle the situation, and the apparent apathy of national elites in this regard? Our suggestion is that this sort of 'consensuated non-politization' is because the Euro represents a very strong regional ideal. A regional ideal that has existed all through the forty years of European Communities/Union, and that has slowly but invariably permeated into most of the different national elite's world view. In the 1990s, when the monetarist paradigm gained a firm foothold among central bankers and ministries of economy, the regional ideal of a single currency becomes strongly coupled to the German model of the Bundesbank and the success of its macro-economic policy driven by stability and inflation-fighting strategies. This means that the cognitive-ideational strength of the Euro and the overall EMU project is such that the uncertainty generated by its deceiving performance vis-à-vis the US dollar in its first two years, is not perceived as politically problematic by the different national elites, but rather as a temporary situation.

Two further phenomena support this argument. One is that the adaptation of national institutions took place in a relative long period of time, aligning them with the dominant monetarist paradigm in national macro-economic circles. So, institutional adaptation goes relatively smoothly and in a rather extended period of time, and this time has helped avoiding for most of the cases, the political backlash of some elite. The second one is the long and stable story of the EMS experience, which has provided national elites with a clear historical anchor about the positive effects that macro-economic co-operation is able to bring. Also this successfully preventing political backlash against further macro-economic integration.

Exchange rate re-alignment and Mercosur integration

Mercosur's launch was intrinsically linked to successful monetary stabilisation in the two dominant economies of Argentina and Brazil. The Treaty of Asuncion signed in March 1991, only went into force after Brazil had instigated its `plan Real' in 1994. Even if Mercosur has no stated common monetary policy, macro-economic co-operation in terms of exchange rate re-alignment has always lain at the heart of this model of regional integration.

In both countries monetary stabilisation involved a peg mechanism vis-à-vis the US Dollar. In itself, this did not represent a break with past policy trajectories. Yet in light of previous instability and the grotesque inflation rates characteristic of the eighties, the new `hard-peg' monetary regimes installed were novel in their severity and the consequent restraints they posed on economic policy choices.

Southern Cone Currencies and Trade Policy

Currency pegs have been the monetary policy choice of Southern Cone countries subjected to the reign of 'liberal' export-oriented elite's, already since the turn of last Century. Hence Brazil maintained a fixed exchange rate until the 1929 Wall Street crash provoked a major political-economic re-configuration under Getúlio Vargas. Although Argentina was not as severely affected by world recession as other Southern Cone Countries, it also suffered a retreat from previous policy principles.

A move towards monetary realignment was made under the first wave of regional integration in the post war period. On March 26 1991, the treaty of Asuncion establishing the Mercosur was signed in Paraguay by the heads of States and Governments of the four founding members; Argentina, Brazil, Paraguay and Uruguay. Coming into operation on December 31rst, 1994, Mercosur comprises a vast array of legal provisions and joint policy making bodies designed to bring about economic - and political - integration of South Americas largest and most advanced economies.

With the debt crises looming the question of monetary stability and convertibility was not seriously addressed by the governments of Argentina and Brazil before power had been handed over to civilian administrations. Austral (1985) and Cruzado (1986) were 'heterodox' schemes launched by the transitory administrations of respectively Alfonsín of Argentina (1984-89) and Sarney of Brazil (1986-90). The latter was modelled after the former and ultimately shared its fate!

Alfonsin's radical party government had opted for a heterodox set of measures to counter inflation. These included a price and wage freeze accompanied by the introduction of a new currency; the Austral. After some initial success the situation deteriorated rapidly as inflation once again was running into four digit figures by

1987. Argentine monetary stability was achieved in a highly volatile macro-economic environment. De-regulation of the banking industry initiated during military rule and further enhanced by the Alfonsin administration, left the economy exposed to global financial markets. This proved incompatible with heterodox stabilisation programmes neglecting deep-rooted problems in the fiscal realm. Government budgets thus witnessed no real improvements before the Menem administration under the direction of economy minister Cavallo's first turns introduced an orthodox convertibility plan in - March/April - 1991 including austerity measures and privatisation aiming to balance public sector budgets. A new currency, pegged to the dollar on a one to one basis by law, was introduced fully backed-up by central bank dollar reserves.

This plan has proved a success as Argentina has enjoyed monetary stability. In the period between the plans introduction in 1991 and the Mexican Peso-crises, Argentina in addition enjoyed enviable growth rates. The Mexican crash severely challenged the system which was amended in a number of ways. Changes related to the role of the central bank vis-à-vis the domestic financial system and the composition - on various type of financial instruments - of commercial bank reserve requirements. Yet convertibility and the peso value was maintained both domestically and internationally!

Brazil`s Crusado plan was undermined by a similar lack of commitment to address the havoc in the fiscal realm as suffered by the Austral plan. Unlike Argentina, Brazil`s financial system was largely sheltered from global markets and the government exercised rigours capital controls. The Brazilian growth regime relied less on the influx of foreign capital then that of Argentina. The country nonetheless managed to accumulate the largest foreign debt in the third world.

Although the Cruzado plan quickly proved incapable of keeping inflation in check, it was not replaced by effective stabilisation measures until June 1994. Failed attempts in 1987 and 1988/89 to rejuvenate the heterodox scheme did not prevent high inflationary pressures. Finally, in autumn 1991 (our spring!) the rate of inflation steadily climbed up to around 40% prompting minister of finance, Fernando Henrique Cardoso, to launch his plan Real in July 1994. Its success carried him all the way to the top-job, which he still holds.

Under the Real regime Brazil has maintained capital controls and a sheltered banking industry. The currency is pegged to the dollar within a self-imposed band. Austerity measures have - including improved tax collection and privatisation - made public finances historically sound.

At the Mercosur level the adoption of the Real plan fuelled the expectation that 'spontaneous' convergence would pre-empt the need for excessive joint institutionalisation of the integration process. This explains why progress in the realm of financial integration has been so modest. Beside loose frameworks of macro-economic co-ordination and informal consultation, financial market initiatives have so far been limited to the adoption of a common framework for investments in the stock market, agreement on eventually applying the Basle rules for financial institutions and a joint investment protection agreement.[1]

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1 Porcile, Gabriel: **op. cit.**, 1995. p. 233.

Yet the depth of the current crises seems to counterveil the perception that Southern Cone governments consider national developments to be in tune to an extent rendering thorough joint regulation unnecessary. As shall be argued in the section to come, these expectations are likely to prove wrong.

The Asymmetries of the Brazilian and the Argentine Crises

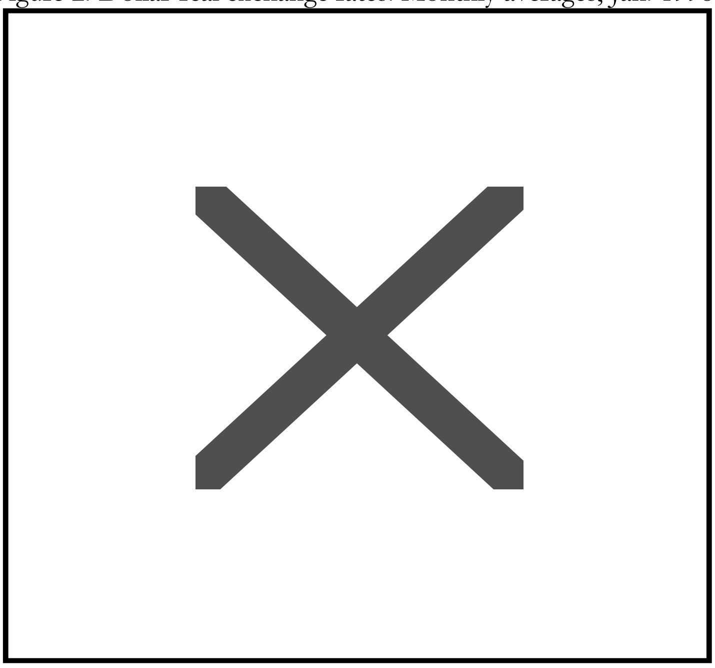
Argentina's convertibility plan involved the setting-up of a currency board monitoring that peso circulation was backed-up by dollar reserves. In effect, the dollar is accepted as tender in nearly all commercial transactions in Argentina, and Argentine residents and companies can have dollar accounts.

This hard peg approach quickly reduced inflation and commercial interest rates in Argentina are close to OECD levels. This approach has occasionally produced credit and liquidity squeezes in the Argentine economy, particularly in the provinces. But the orthodoxy of the plans has ensured a rapid reduction of inflation and interest rates.

By contrast Brazil`s Real Plan combined orthodox and heterodox measures leaving a much wider span of discretion and autonomy for monetary policy makers. This was achieved, however, at the expense of a much higher interest rate. More importantly, the rate of inflation was reduced over a longer time period and has consistently been higher than in Argentina and the United States of America.

This caused Brazilian goods to become more expensive on export markets as inflation was not adjusted via currency rate alignment. Brazil thus accumulated a trade deficit which was inconsistent with its enormous debt burden. In spite of heavy central bank lending with a view to amass sufficient reserves to withstand runs on the Real, Brazil had to succumb and loosen the ties between the overvalued Real and the Dollar. This produced a 40% devaluation largely as a one-off effect in the first months of 1999.

Figure 2: Dollar-real exchange rates. Monthly averages, Jan. 1998-Mar. 2001



Source: Federal Reserve Statistical Release

As a result of Mercosur integration, Argentina had grown increasingly dependent on the Brazilian market. As Argentina had opted for a hard-peg, devaluating the Peso was inconsistent with the established monetary regime. Moreover, the economic fundamental did not dictate a such step since inflation had been kept in check and interest rates were competitive.

The Brazilian devaluation left the Argentine elite shocked and locked up with no immediate possibilities to adjust to the radical deterioration of its competitive position on the Brazilian market. The country had barely recovered from the Mexican and later the Asian crises and the Russian default as it slipped into a prolonged recession with soaring unemployment and depressed property markets.

Argentina is in many ways a fairly prosperous country and as such able to sustain slumps in demands for it exports over sustained periods. The factor which had made the Argentine crises so dramatic is the manner in which it has financed its sizeable foreign debt.

Unlike most non-OECD countries, Argentina issues foreign currency bonds on the international market and expresses no preferences as to whether they are bought by international or national investors. This is done to avoid crowding out local markets and to reap the benefits of the efficiency of international capital markets. Still, it has been estimated that half of the bonds issued in 2000 were purchased by domestic investors (FT March 19. 2001). Argentine debt account for between 1/4 and 1/5 of all tradable emerging market debt (FT November 19, 2000).

So market reactions to changing fortunes are prompt due to the transparency of the financing scheme. In good times this secures Argentina, which has an annually financing requirement (not including rescheduling) of 26.6 billion USD cheaper finance then Brazil which has an annually financing requirement (not including rescheduling) of 159.4 billion USD (Figures for 2000, source FT March 19. 2001).

In the view of the international financial community, the Brazilian crises compounded the ill effects Argentina had suffered from the Mexican, Asian and Russian crises. Still, in July 2000 prospects still seemed relatively bright for getting Argentina out of the prolonged recession as tax collection contributed to a significant improvement of public finances. Yet a sentiment of crises has been accelerated by political instability in Argentina. Hence the resignation of vice-president Carlos Alvarez nearly brought the Radical Party and the leftwing Frepaso coalition behind President Rúa down. As a result interest rates on bonds rose leading to the near default in December 2000 as the country was about to reschedule debt worth of 19.5 billion USD.

A rescue package and a change in government with important policy implications have been the immediate effects of the December 2000 crises. The IMF together with USA assistance rallied support among creditors for a package containing rescheduling of 40 billion USD worth's of debts. In early 2001, following the bail-out, a number of swift tenures paved the way for a return of Domingo Cavallo as minister of Economics.

Cavallo's return was preceded by the brief but controversial spell of Ricardo López Murphy term as Minister of Economics. The latter's austerity programme had prompted the resignation of 6 cabinet ministers and fierce opposition from students, teachers and unions. Murphy's plan called for spending cuts of 2 billion USD. Cavallo initially planned to increase that from 2 to 3 billion USD stating that additional cuts was to affect bureaucracy only.

Soon Cavallo redirected the main thrust of his rescue efforts as he introduce tariffs cuts for capital goods and tariff increases for consumer goods. This was directly at odds with Mercosur policy which on Brazilian insistence included fairly large tariffs for capital goods in order to protect the Brazilian engineering industry.

Brazil was consulted by Cavallo on the matter and surprisingly accepted this deviation on what had hitherto been declared a strategic element of the Mercosur venture – that is ensuring trade liberalisation and exposure to globalisation in a manner not jeopardising the development of a diverse Brazilian industrial base.

State Ideals, Regional Ideals and the Viability of Mercosur Integration

Currency pegs in the Southern Cone have historically been associated with liberal export-oriented political-economic regimes. These regimes were challenged domestically in wake of the 1929 crash in both Argentina and Brazil. Proponents rallied around what was to be termed the 'developmental state ideal'. The developmental state ideal both had democratic and authoritarian expressions. Most notably the authoritarian expressions are associated with the likes of Juan Peron of Argentina and Getúlio Vargas of Brazil.

In Argentina the developmental state ideal only gained prominence for a limited period and faced stiff opposition from proponents of more liberal ideals. In Brazil the developmental ideal has been absorbed in the overall state ideal.

Argentina's currency policy and the accompanying measures accordingly reflect this more thorough adherence to liberal ideals in all its gung-ho orthodoxy. Likewise, the softer Brazilian regime combines orthodox and heterodox measures leaving more room for policy discretion and ultimately contributed to the devaluation of the Real.

In short, underneath the surface of the remarkable level of policy co-ordination in the realm of currency stabilisation fuelling the creation of Mercosur, was rooted in partly divergent state ideals.

Yet the Mercosur project draws on preconceived ideas nurtured simultaneously among Argentine and Brazilian elite's. Furthermore, the process has in itself further strengthened a shared understanding among elite's on the desirability, aim and overall direction of the Mercosur venture. As such we may speak of a regional ideal which reinforces integrative efforts even when particular events would seem to make it advantageous for member states to defect at least in part.

The regional ideal linking partly divergent state ideals across Argentine and Brazilian elite's has three dimensions. One is economic. In spite of developmental tendencies among Brazilian policy, administrative and corporate elites, there is a strong belief in monetary stability, sound public finances and free product markets.

The other dimension is of a political nature. Mercosur aims to consolidate the principle of democratic government. A case can certainly be made for the importance of civilian rule as countries join forces to the extent witnessed in Mercosur. Hence the formation of Mercosur was a state-led process. It was national executives rather then legislators, government rather then business and national elite's rather then the populace which provided initial impetus for the integration process. Mercosur consequently serves to underpin a liberal state ideal at the expense of an authoritarian-bureaucratic developmental state.

Finally, Mercosur also provides a globalisation safeguard. Rather then seeking immediate integration with world markets the regional initiative is designed to shelter the Southern Cone states from the on-slough of liberalisation - ideally enabling them to follow re-structuring at their own pace, and devising a societal model in tune with their cultural, institutional and political preferences.

These shared ideals constitute an important element in explaining the willingness of Argentina to remain within the Mercosur framework in spite of the high costs imposed upon her by Brazil`s devaluation. Likewise Brazil`s willingness to accept Argentina's unilateral abolition of the capital goods duty which is a strategic element of the Mercosur construct viewed from Brasilia, must be seen in light of the overall importance attached to the integrative venture at the ideational level.

Concluding remarks: Bringing in the cognitive dimension

The continuity of regional arrangements in times of instability is a phenomenon that deserves careful analysis. Our study is a preliminary attempt to address such an issue, and in some occasions it raises more questions than it is in a position to answer. Nothing daunted, though, the two cases have provided a concrete starting point for such a line of analysis. The most significant conclusion steming from them is that we need to bring in the cognitive-ideational dimension. This perspective is already been extensively used when addressing the historical process for the set up of new regional arrangements, but has not been so much used for understand the persistence of these institutions. Regional institution's resilience might be related to the relative high costs of defection, as liberal institutionalists suggest. Yet, states might be willing to pay those costs if there is a generalised conviction among national elites that the initial institution does no longer serve national interests. Worse, rather than paying the costs, regional arrangements might instead wither away by states inaction or apathy in an unilateral or collective way.

Continuity is not a futile matter in regional integration, especially in times of instability. Here the conditions for reciprocity and issue linkage might have transformed in a way that co-operation seems difficult. This was what happened in the EMU and exchange-rates' crises of Mercosur. As we have discussed in detail in the paper, the strong loss of value of the Euro in its first two years does not constitute a truly institutional instability of the overall EMU project, but it has certainly introduced an important element of uncertainty that does not need to be disregarded. The 'heavily institutionalised' EMU has never been under inter-state attack, and the degree of reciprocity and commitment is extremely high. In any case, the EMU has followed closely the German model, where there is a strong detachment between monetary policy and other macro- and micro-economic policies. Hence, continuity cannot be strictly related to the 'issue-linkage' of other policy areas. What surprises in the Euro case is that the uncertainty generated by its depreciation vis-à-vis the US dollar has not triggered political tensions between the different state ideals about monetary policy, most particularly between Germany and France. This lack of political discussion might be, perhaps, explained because the policy rationale of the EMU has now permeated so deeply in the political-economic elites that previous state ideals have been significantly transformed. This might be particularly true to those states with strongest 'Keynesian' tradition. So, cognitive battles and cognitive transformation have effectively de-politicised the weak Euro.

The crises of the exchange rates in Brazil and Argentina is another more dramatic story. The situation was rather asymmetric, Argentina suffering important loss of economic growth and industrial output. This relates to a partial but important lack of reciprocity, especially when Brazil has repeatedly devaluated smashing any attempt of the Argentinean government to redress the deteriorating situation while still pegged to the US dollar. Even if the overall Mercosur initiative was strongly linked to exchange rate stability projects in both economies, did not prevent that reciprocity was put into pressure. There are two striking things. One is that Argentina did not devaluate. And the other one is that Mercosur has survived the turmoil, as it is still is a relevant point of reference for the four member states, and keeps on constituting so far the most successful case of regional integration in Latin America. This, we argue, has to do with the way in which both countries' elites cognitive parameters have been put together. Even if state ideals continue to show differences, which are constrained and defined historically, the regional ideals emerging in both, the EU and Mercosur, are so strongly embedded in national elites' consciousness and world views. And this is what explains the elasticity of regional agreements, even when reciprocity and issue-linkage is not perfect nor neatly defined.

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