Order Code RS22408
March 22, 2006

CRS Report for Congress

Received through the CRS Web

Mercosur and U.S. Trade Policy

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Summary

Mercosur is the Common Market of the South established by Brazil, Argentina, Uruguay, and Paraguay in 1991. By reducing barriers to trade and encouraging economic investment and sectoral collaboration, Mercosur was created to foster balanced economic growth, social development, and political stability in the region. Mercosur has succeeded on the political side and developed as a credible collective voice in the World Trade Organization and in talks on the Free Trade Area of the Americas (FTAA). It has survived difficult economic times and expanded on a limited basis to other Latin American countries, yet its success at economic integration is an open question. Mercosur also has elements of being both a complement and alternative to the FTAA in the quest for Western Hemisphere integration, so bears careful watching for how it may affect the direction of U.S. trade policy in Latin America.

Brazil, Argentina, Uruguay, and Paraguay signed the Treaty of Asunción on March 26, 1991, establishing the Common Market of the South (Mercado Común del Sur — Mercosur or Mercosul in Portuguese). Mercosur evolved from a series of bilateral agreements signed by Argentina and Brazil in the mid-1980s. Designed to foster new levels of political and economic cooperation in the region, they were expanded and institutionalized under Mercosur. Regional integration was also a collective response to concerns over economic stagnation, the 1980s debt crisis, and expanding economic integration efforts in the European Union (EU) and North America. Mercosur is an important economic bloc in South America; its collective voice affects regional and multilateral trade negotiations, perhaps most notably in its opposition to the U.S. version of the Free Trade Area of the Americas (FTAA). This report examines Mercosur's development and the implications the pact may have for U.S. trade policy in Latin America. It will be updated.

Formation and Institutional Development

The Treaty of Asunción called for the creation of a common market between Brazil, Argentina, Uruguay, and Paraguay for the stated purpose of accelerating economic development and social justice. The treaty was made under guidelines set out by the Latin American Integration Association (Asociación Latinoamericana de Integración — ALADI), the region's umbrella organization that oversees trade agreements of both "regional and partial scope." As emphasized in ALADI guidelines, Mercosur is administered with a sense of "gradualism, flexibility, and balance," and provides for the negotiated accession of other ALADI member countries. An important overarching goal of Mercosur is to improve living conditions in all countries through increased trade.

Mercosur envisioned an incremental path to a common market, beginning with a transition period (1991-95) in which it operated as an increasingly comprehensive free trade agreement (FTA) using a schedule of automatic tariff reductions. The formal jump to a common market was made on January 1, 1995, but in reality, Mercosur had transitioned only to a partial customs union at that point.[1] It adopted a common trade policy and a set of common external tariffs (CETs) that applied to 85% of tariff line items, but with some very important exceptions for sensitive sectors such as automobiles, capital goods, and computer technology products. The exceptions were to be phased out by 2006, but some have been extended to 2011. As shall be seen, the achievement of a full common market with the free flow of labor remains a distant goal.

The Treaty of Asunción also envisioned macroeconomic policy coordination and harmonization of policy legislation at the sectoral level (e.g. energy, agriculture, industry, technology). By proceeding on a sectoral basis, inter-country factor mobility could be achieved gradually, easing the adjustment process. All parties were also required to accept a common set of rights and obligations, with little allowance for special and differentiated treatment for smaller economies. There were many follow-on protocols. Among the most important was the December 17, 1994 Protocol of Ouro Preto, which formally established the common market and extended the institutional framework accordingly. Mercosur adopted a democratic commitment clause in 1996, and there were two protocols that clarified and expanded the dispute settlement process, the last being the Olivos Protocol signed on February 18, 2002, and implemented two years later.[2]

Intra-Mercosur Trade and Internal Policy Dynamics

As Mercosur lowered tariffs, it was expected that intra-Mercosur trade would grow relative to trade with third-party countries. As seen in **Figure 1**, this was the initial response from 1991 to 1998, with the percentage-point jump in intra-Mercosur exports also due to its growth from an initially small base, the decade's lengthy global economic expansion, and other economic reforms. There is, however, an equally evident and sudden collapse of this trend, with intra-Mercosur exports falling from 25% of total trade in 1999 to 13% in 2005 (by comparison it is 60% for intra-EU trade). This setback reflects a number of problems that the common market proved unable to resolve.

From the outset, Mercosur struggled to reconcile a basic inconsistency of partial economic union: how to achieve trade integration, while also ensuring that the benefits would be balanced among members, and that each country would retain some control over

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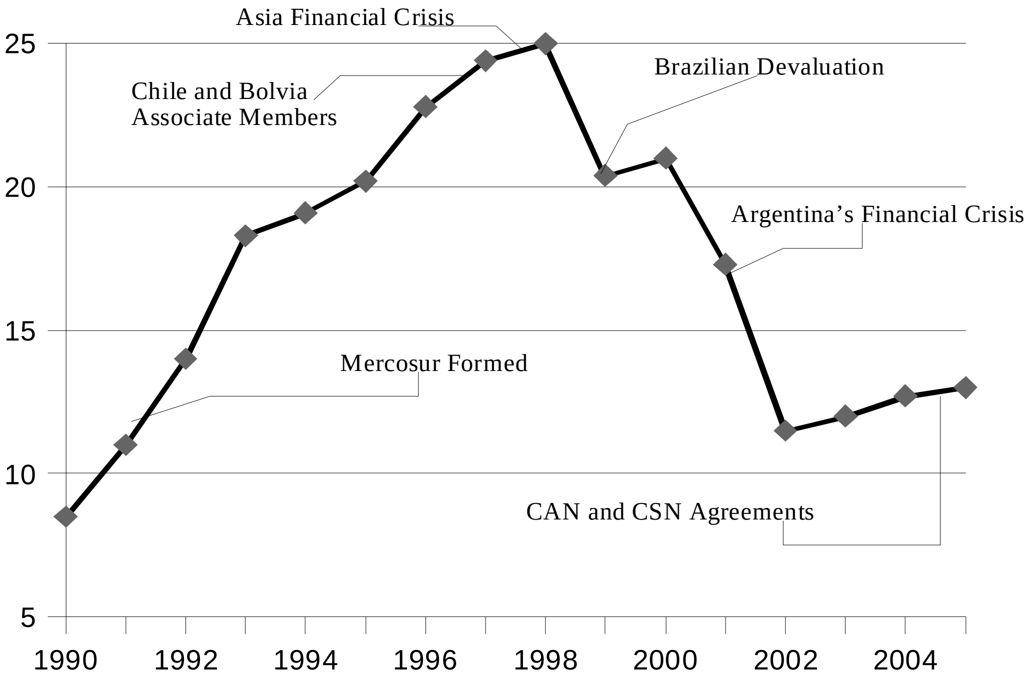
[1] A free trade agreement (FTA) eliminates tariffs on goods traded among participating countries. In a customs union, the members also adopt a common external tariff (CET) and common trade policy toward third-party countries. A common market takes the next step of allowing for the free flow of all factors of production (capital and labor) among the countries.

[2] For details on the legal documents, see Porrata-Doria, Jr., Rafael A. *MERCOSUR: The Common Market of the Southern Cone.* Durham: Carolina Academic Press. 2005.

its trade, production, and consumption structure. At the heart of the problem are the "natural asymmetries" that exist among four economies with inherently large discrepancies in size, structure, resource endowment, and level of development, perhaps most noticeable between Brazil and Paraguay. These differences can be compounded by "policy asymmetries" that arise from incongruities in fiscal, monetary, industrial, exchange rate, and other policies. Either type of asymmetry can distort trade flows, causing large imbalances that threaten the stability of the agreement.[3] When they operate in tandem, and at times when the countries are facing external economic shocks, the Mercosur policy adjustment framework has proven to be vulnerable.

Figure 1. Intra-Mercosur Exports as Percent of Total, 1990-2005



Data Source: Inter-American Development Bank, *MERCOSUR Report,* February 2006, p. 21.

This situation occurred in the late 1990s and is reflected in the decline in intra-Mercosur trade after 1998 shown in **Figure 1**. The first shock was the mid-1997Asian financial crisis, followed by the Russian default in 1998. Fear over sovereign financial vulnerability then spread to Brazil, causing prolonged capital flight, a steep devaluation of Brazil's currency in January 1999, and the loss of its fixed exchange rate program. With Argentina's strict dollar convertibility regime still in place at the time, the two countries faced a significant "policy asymmetry." It was compounded by Argentina's lengthy recession that also began in 1998, leading to its own, far more serious, financial crisis. Brazil's devaluation exacerbated Argentina's crisis, which ended with the loss of its fixed exchange rate in December 2001. Each crisis diminished economic growth, which in turn caused a precipitous fall in trade from 1998 to 2002 between the two countries that account for 90% of intra-Mercosur trade.[4] Relations became increasingly

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[3] For details, see Inter-American Development Bank. Integration and Regional Programs Department. *MERCOSUR Report: 2004-2005*. No. 10, February 2006. pp. 39-41.

[4] Bouzas, Roberto. Mercosur After Ten Years. In: Tulchin, Joseph S. And Ralph H. Espach, eds.
(continued...)

strained, with Argentina applying temporary restrictions on imports from Brazil on multiple occasions, further reducing trade.

Since 2002, intra-Mercosur trade has rebounded slightly. This parallels a trend toward export growth in all four countries as they recovered from the Brazilian and Argentine economic setbacks and benefitted from the forced convergence of their exchange rate systems. Argentina's prolonged recession reduced demand for imports, and so it maintained a small trade surplus with Brazil even after the Brazilian devaluation. With Argentina's economic recovery in 2003, however, it began to run large trade deficits with Brazil, mostly in industrial goods. Argentine exports fell from 13% of Brazilian imports in 1998 to 8% in 2004. Brazilian exports, in contrast, rose from 22% to 34% of Argentine imports. The growing imbalance resulted from numerous factors: 1) new exchange rate equilibriums that favored Brazilian goods in the Argentine market over U.S. and European products; 2) a post-recession jump in Argentine aggregate demand; and, 3) Brazil's export promotion policy emphasizing more use of domestic inputs.[5]

Mercosur was meant to achieve balanced gains for its members, but there was no enforceable mechanism to guard against suddenly large trade imbalances. In 2003, Argentina once again called for a managed solution to the growing and, what some feared may be, a structural bilateral trade imbalance with Brazil. By June 2004, Argentina had raised trade barriers on Brazilian appliances to protect its domestic production against what it considered to be Brazil's unfair mechanisms to develop its industrial capacity. This was done in the context of Argentina's decision to "re-industrialize" its own economy, a policy that the sudden increase in Brazilian exports threatened.[6]

By February 2006, over the objections of Brazilian industry groups, Brazil finally agreed to a Competitive Adaptation Mechanism (CAM) with Argentina. It allows for the application of tariffs and quotas in cases where sudden increases in imports of one country are deemed to hurt the industry of the other (safeguards). The CAM represents a major shift in Mercosur internal policy and raises multiple issues. First, it is a bilateral arrangement between Brazil and Argentina established under the ALADI system. It is not governed by Mercosur nor does it involve Uruguay and Paraguay, which are the two economies most dependent on the Mercosur trade relationship. Second, import restrictions represent a retreat from the free trade philosophy of Mercosur, increasing doubts about its ability to proceed toward a common market. Third, the CAM has no enforcement mechanism under ALADI. In short, it presents serious administrative and judicial problems and may end up undermining the Mercosur agreement even as it attempts to restore balance to the largest bilateral relationship within it.[7]

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[4] (...continued)
Paths to Regional Integration: The Case of Mercosur. Woodrow Wilson International Center for Scholars. Washington, D.C. 2002. p. 120.

[5] Inter-American Development Bank, *MERCOSUR Report: 2004-2005*, pp. 30-32.

[6] Ibid., p. 47.

[7] Haskel, David. Bilateral Agreements: Argentina, Brazil Start Safeguard System To Shield Industries from Mutual Imports. *International Trade Reporter*. February 7, 2006. p. 247, and Inter-American Development Bank. *Southern Common Market: New Integration and Co-*
(continued...)

Relaunch and Expansion

Mercosur's weaknesses were exposed by the 1998-99 macroeconomic setbacks in Argentina and Brazil. In May 2000, the four member countries responded with the "Mercosur Relaunch" program by formally reaffirming those policies that had so far proved elusive, but were still necessary to reach the common market goal. They agreed to take the first steps toward macroeconomic coordination by harmonizing their statistics and establishing "convergence criteria" on fiscal policies, prices, and public debt. They disallowed adoption of measures that would restrict reciprocal trade and reinforced those that would limit recourse to antidumping investigation and improve dispute settlement. This renewed enthusiasm, however, did not last. The trade imbalances that ensued challenged the relaunch effort and macroeconomic coordination was still in the early stages. The relaunch effort dissipated and Mercosur shifted emphasis from deepening to expanding the arrangement.

To date, Mercosur has been most successful in expanding in South America, where it worked with other countries under the ALADI system. In 1996, Chile and Bolivia became early additions as "associate members;" Peru followed in 2003 (not implemented), and Venezuela and Mexico in 2004. Associate members have no voting rights and need not observe the common external tariff. In October 2004, after years of talks, Mercosur and the Andean Community of Nations (Comunidad Andina de Naciones — CAN) signed a trade pact, giving all Andean countries the equivalent of associate membership. This breakthrough led directly to creation of the South American Community of Nations (Comunidad Sudamericana de Naciones — CSN) two months later in a pact that included 12 countries (those in Mercosur, CAN, along with Chile, Guyana, and Suriname). In December 2005, Mercosur agreed to the accession of Venezuela as a full member of the pact, but the process may take some time to finalize.

The CAN and CSN are limited trade pacts and in some ways not true regional agreements. Although there are common rules adopted by Mercosur and the CAN, details on market access and other specific provisions are bilateral arrangements between each Mercosur country and the CAN. Brazil also granted numerous unilateral concessions to ensure the agreement would be completed.[8] These agreements do, however, offer the potential for important political integration for the entire continent, arguably Brazil's main reason for establishing Mercosur. They are also a potentially competing integration process to U.S. bilateral initiatives and the Free Trade Area of the Americas (FTAA). Sectoral initiatives, such as the proposed South American gas pipeline, already reflect a growing attitude of cooperation and collective self-determination that is taking hold in the region, and which now has an institutional presence in the CSN.

Mercosur's other negotiations have had mixed success. Trade talks with the European Union and for an FTAA have both come to an impasse over the inability to reach an agricultural agreement acceptable to Brazil. Brazil has also declined U.S. and EU overtures on market access for industrial goods, services trade, enforceable intellectual property rights, and investment provisions. Speculation has also turned to

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[7] (...continued)
operation Agreements Between Argentina and Brazil. [http://www.iadb.org/intal]

[8] Inter-American Development Bank, *MERCOSUR Report No. 10, 2004-2005*, p. 93.

dwindling interest by the EU given the stalemated FTAA, the growing EU perception of Mercosur as less than a credible collective negotiating authority, and the desire by all parties to wait for the conclusion of the Doha Round. So-called South-South trade pacts have progressed only in limited form. Mercosur has begun preliminary discussions with a host of countries that include China, India, SACU, Canada, the Russian Federation, Korea, Egypt, Morocco, and Pakistan. None have progressed beyond a simple framework agreement, but Mercosur continues to pursue limited agreements with much of the world.[9]

Outlook and Implications for U.S. Trade Policy

In pursuit of balance, Mercosur seems to have retreated from deeper economic integration, placing greater emphasis on enhancing political cohesion. First, its internal integration process has stalled, and may even have taken a step backward with the bilateral safeguards agreement between Brazil and Argentina. Second, despite entering so-called "economic complementarity" agreements with the rest of South America, its outreach to the region and to other developing countries is limited largely to market access agreements that will take a long time to implement, with the possible exception of Venezuela. Third, trade talks with developed countries are on hold. These same trends, however, may be interpreted as being politically advantageous if seen as accommodating Argentine interests, deepening formal ties with Venezuela, leading efforts to coalesce South American interests, and reaching out to extra-regional developing countries.

The United States has a strong interest in pursuing an FTAA that includes Mercosur and there is also little doubt that Mercosur, under Brazil's leadership, will influence the FTAA's final outcome. The United States and Mercosur, however, are at odds over how to proceed with Western Hemisphere integration, with the stakes raised by concerns over each others' broader influence in the region. With the FTAA negotiations stalled, Brazil has opted to offer, in its stead, bilateral market access talks between the United States and Mercosur, an overture the USTR has repeatedly rejected. Brazil and Mercosur are pressing for gradual, "partial scope" ALADI-type framework agreements that address their market access priorities, whereas the United States is negotiating for more comprehensive agreements that accommodate its broader interests — competing visions that have yet to be reconciled.[10]

Mercosur's future seems less clear given recent developments, yet its progress, or lack thereof, will likely affect the direction of U.S. regional trade policy. It is quite possible that Mercosur's heightened politicization, particularly the possible accession of Venezuela as a full member, will increase the sense of competition between the two models of Western Hemisphere integration, thereby constraining progress on the FTAA. Alternatively, the new bilateral safeguards policy may weaken Mercosur's unification, increasing the possibility that its smaller members may reconsider various alternatives, including negotiating with the United States for either deeper bilateral FTAs, or joining the FTAA separately.

[9] Ibid., pp. 90 and 96-100.

[10] For more, see CRS Report RS20864, *A Free Trade Area of the Americas: Major Policy Issues and Status of Negotiations*, CRS Report RL33258, *Brazilian Trade Policy and the United States*, by J. F. Hornbeck, and CRS Report RL33162, *Trade Integration in the Americas*, by M. Angeles Villarreal.