How to rescue the trade agreement between the EU and MERCOSUR[1]

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The successful conclusion of any agreement requires the simultaneous will of both parties. And this is obviously true for a trade agreement between two trade blocs. In this brief essay I will develop the constraints faced by the EU and MERCOSUR to obtain such a basic condition. For that we need a deeper understanding of the economic and political effects associated to this agreement.

I will develop three main ideas:

(a) Distribution of trade diversion cost in South-South Regional Integration Agreements (RIAs) and the global negotiation position in trade agreements with third countries;

(b) The interdependence of the offer positions of each partner must take into account the link between the preference to open own markets to the opening of the other partner

(c) The cooperation between the EU and MERCOSUR.

While these three issues could be certainly linked, I will present them separately. The two first issues are strongly related with the application to this case of theoretical general ideas of the modern literature of international trade. The last one is an open thought about the orientation and the potentiality of the cooperation dimension of the agreement. The first consider the pure economic dimension, the third one is oriented to a political dimension and the second one is in between with an analysis of the political economic dimension of the agreement.

The restrictions that are pointed out in this paper are balanced between the different sides of the negotiations: the first is oriented to the MERCOSUR side, the second one to the EU and the third to both.

A) **UNEVEN DISTRIBUTION OF TRADE DIVERSION COSTS AND NEGOTIATIONS WITH THIRD COUNTRIES**

As Venables (2003 and 2005) shows using a conventional trade model (HOS), the costs of trade diversion could be unevenly distributed across members of a regional integration agreement (RIA). In particular, in a RIA between developing countries (South), the poorer countries (or rather the least capital intensive, which is probably more relevant for the case of MERCOSUR) are the ones that bear the costs of trade diversion, which magnifies initial income disparities.

MERCOSUR is an example of South-South agreement with an uneven distribution of trade diversion costs. In this case, comparative advantages are more

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associated with the size and economic complexity of each country than with their level of development. Evidence shows that MERCOSUR fits well into what Venables call the phenomena of winners and loosers from regional integration agreements in South-South RIAs (Venables, 2003).

An analysis of intraregional patterns of trade shows that a relevant share of Brazil´s exports to MERCOSUR members is concentrated in products in which Brazil does not have a global comparative advantage. The opposite scenario arises in the case of the other three countries, especially Paraguay and Uruguay, where most of their intra-MERCOSUR exports correspond to goods in which they do have a global comparative advantage.

In an econometric exercise using a model with product differentiation *à la* Krugman, Moncarz and Vaillant (2006) show that for some MERCOSUR members, the ratio of intra-MERCOSUR imports over imports from the Rest of the World (ROW) is positively associated with the level of tariff preferences for those goods in which MERCOSUR countries do not have global comparative advantages while the ROW does. This is the case of smaller countries where intra-regional trade liberalization promotes the substitution of efficient imports from the ROW by more inefficient production from a regional partner (trade diversion). This is not the case for the regional leader where inefficient domestic production is substituted by efficient production of other MEROCOSUR members (trade creation). This behavior is partially explained by the fact that MERCOSUR´s Common External Tariff is mainly a reflection of Brazil´s political economy –or protectionist— interests of Brazil, and to a much lesser extent those of the smaller members.

The other piece of evidence is associated with the pattern of relationships with third countries that MERCOSUR could develop as a bloc. In this case, and according to the predictions of theoretical models, the economic incentives of the leader country –the one with the largest bargaining power– is a key element to take into account. In the case of MERCOSUR **the relationship with third countries is biased towards signing trade agreements with other South countries. Since 1995, MERCOSUR has signed 22 trade agreements, none of which involved North (developed) countries (Vaillant, 2005 y 2006).**

This South-South bias is concentrated on agreements with South American countries, with no relevant results. In addition to the biases in terms of the agreements signed, these later agreements (with South America) tend to be less beneficial for the smaller countries. For example, its agreement between with Andean countries, MERCOSUR granted wide exception lists to the Andean partners. Smaller MERCOSUR members are adversely affected by the agreement since such lists mainly include the goods in which they have a comparative advantage. This clearly implies that smaller countries are not benefiting at all from an improvement in the access to Andean markets.

In contrast with South-South negotiations we observe fruitless South-North negotiations. Examples of the later include the Free Trade Area of the Americas (FTAA), bilateral negotiations with the United States (US), and the long and slow negotiations between the European Unions (EU) and MERCOSUR.

It is clear that in the case of MERCOSUR, the economic incentives of each member are different, with the larger country not having a clear preference for bilateral trade agreements with countries or regions with and equal or higher level of development. **For the leading country, negotiations with third countries are considered as a natural extension of the original regional trade agreements, with these negotiations oriented only to countries of smaller economic size or lesser level of development.** For the smaller countries, incentives work in the opposite direction. For the smaller countries, agreements with North countries diminish the costs of trade diversion produced by the original trade agreement and improve their market access to high income countries. Venables (2005) points out that in South-South agreements, the large country (with intermediate comparative advantages) gains in a static perspective but could suffer dynamic loses in the long-run once we take into account the wrong market signals, and the effects on the patterns of trade specialization.

B) **RECIPROCATED UNILATERALISM: THE POOR LIBERALIZATION OFFER OF THE EU AND THE FAILURE TO ACHIEVE AN AGREEMENT**.

Based on Grossman and Helpman (1994) political economy trade policy model, achieving a causal link between unilateral and reciprocal trade liberalization has been pointed out. Krishna and Mitra (2005) analyze if –without any communication or agreement between the countries involved– unilateral trade liberalization by one country could induce reciprocal liberalization by its partner. The main idea could be summarized as follows. A small economy is trading with a large partner. The small country only has an import-substitution lobby. Assuming that the fixed costs of organizing an export lobby are greater than the net benefit it would generate, exporters do not lobby. Under these assumptions, the endogenous trade policy amounts to to a combination of an import tariff and an export tax. Since unilateral liberalization by the large country increases the world price of the small country´s exportable good, unilateral liberalization by the large country can be shown to generally increase the incentives for the formation of an export lobby in the small country.. The increase in the price of the exportable good makes the export tax more costly for the export lobby; but also means that the import lobby has incentive to ask for an even higher export tax. Therefore, unilateral liberalization by one partner country has a “strategic” effect on the group incentives of other countries such that, with some additional assumptions, free trade by the small country could be the new endogenous trade policy.

The original equilibrium changes because, with the large country protecting its import substitution sector, the export lobby in the small economy is not active, while after the unilateral liberalization by the large country, exporters in the small economy find out that it is profitable to start lobbing. Hence, the endogenous trade policy in the small economy takes a more open oriented direction. Krishna and Mitra (2000) conclude with the following statement: “*We find that such unilateral liberalization induces reciprocal tariff reduction by the partner country. Intuitively, unilateral liberalization by one country has the effect of increasing the incentives for the export lobby in the partner country to form and to lobby effectively against the import competing lobbies there for lower protection. The results stands in contrast to the policy arguments that suggest that closing (or threatening to close) one’s market would help pry open the markets of others as well as some recent results in the literature which* *emphasize institutional reciprocity as an essential means of getting to efficient outcomes*".

The result can also be read in the opposite direction, that is to say a protectionist policy by a large country can increase protectionism in the small country due to changes in the configuration of pressure groups that have an incentive to influence the government trade policy.

The same mechanism could be applied also to a preferential liberalization between North-South countries. Using game theory terminology we can think the North as Stackelberg leader. The North makes a liberalization offer taking into account its effects on the South liberalization offer. The link is given by a political economy mechanism in the South. Exports lobbies in the South will be more active in pro of the agreement the deeper the North liberalization offer. In this scenario, **the non agreement between the EU and MERCOSUR is the consequence of an insufficient offer by EU**.

The resistance of the EU to improve its liberalization offer is linked to domestic political economy problems. This phenomenon results from the fact that MERCOSUR has its comparative advantages on the goods that make the core of the EU´s protectionist policies (this is the agriculture problem but no only that). **The idiosyncratic characteristics of MERCOSUR patterns of trade implies that a preferential liberalization by EU means a reduction in the protection of markets where there is a strong domestic resistance in the EU to such liberalization, so that the offer by the EU is not attractive enough in the South to induce export-lobby groups to become more active.**

C) **EU´s COOPERATION STRATEGY AND ITS CONDITIONALITIES**

Another relevant restriction to achieve a preferential trade agreement between MERCOSUR and the EU is the need of a sufficient level of development in the bloc´s way the of working. In this case, the problem is restricted to the MERCOSUR, which is not mature enough to develop an agreement such as it could be the one with EU. Therefore, another relevant by-product of an agreement with the EU: an improvement in the way MERCOSUR functions as a trade bloc.

Consider for example the Customs Union dimension and the developing of the Common Trade Policy. One of the positive outcomes of the long process of trade negotiations between the EU and MERCOSUR was to promotion of a program to transform MERCOSUR´s intraregional trade rules, with a gradual adoption of free practice rules (see Dec. 54/04 and 37/05). However, MERCOSUR still needs further changes. It is not viable to think in a trade agreement between the two trade blocs with MERCOSUR´s current level of development of common policies and institutions. MERCOSUR is an ambitious trade agreement in the class of the economic integration process similar to the one of the EU. But there is still a strong resistance to share sovereignty over the relevant dimensions that an agreement with the EU would require to work properly. Under the current level of development of MERCOSUR´s common institutions, we can only think in an umbrella agreement with nested bilateral agreements between the EU and each MERCOSUR member. MERCOSUR has applied this technology to other “common” trade agreements in the past.

Moreover, the EU needs to understand that MERCOSUR, which is one of the few trade agreements in the world among developing countries within the class of deep economic integration, offers an excellent opportunity to influence the developing world with a proved successful formula of economic integration. An important tool to achieve this objective is the cooperation dimensions of the agreement.

The cooperation dimensions must be sustained as a strategic view to use cooperation as a tool of transformation, and a way to produce the required conditions to facilitate the trade agreement. For that, cooperation must have strong conditionality with this global orientation, to contribute helping mature MERCOSUR in a way that is compatible with a pontential bloc-bloc agreement.

Perhaps this general idea was originally clear in the Commission but has now weakened. Moreover, in the practical implementation of the cooperation program the problem is even greater because the inter-governmental syndrome of MERCOSUR´s governance is augmented. **The logic the way the cooperation is executed is fundamentally oriented by a nationalistic perspective without a common vision about the future development of the bloc.** In some sense, this is natural because until now the stronger actors in MERCOSUR have been individual governments instead of the bloc´s common institutions. Right now, MERCOSUR countries devote more cooperations resources to the integration process with a nationalistic perspective. The outcome does not necessarily entail further development of the bloc´s common capabilities and the necessary process of institutional maturation.

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