

## Trade Triangulation: The Stalemate of the FTAA and EU-MERCOSUR FTA Negotiations

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### Abstract

Why are some free trade agreements (FTAs) in the western hemisphere successfully negotiated and implemented while others seem to stagnate during negotiations? FTAs develop when there is an asymmetrical power relationship and potential partners are satisfied with potential trade patterns. The European Union (EU) and United States have been successful in negotiating agreements with the Caribbean and Central American countries. However, current bilateral and multilateral trade talks between the EU, the Common Market of the South (MERCOSUR), and US are at a standstill. Trade patterns are unsatisfactory for the MERCOSUR members because they are not able to maximize their comparative advantage. Additionally, neither the EU nor US are willing to use their power capabilities to reduce this dissatisfaction. Finally, the growing Chinese economic profile in Latin America further complicates the ability for the three actors to achieve a set of satisfactory trade relations. Evidence to support these arguments comes from archival research of the failed EU-MERCOSUR FTA and Free Trade Agreement of the Americas negotiations.

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## Introduction

The progress in completing free trade agreements (FTAs) in the western hemisphere is a mix of successful and unsuccessful accounts in the opening years of the 21<sup>st</sup> century. I seek to explain this mixed progress by analyzing the power and developmental dynamics of the actors involved. Krasner (1976) correctly predicts some of the events; however his analysis is silent on the behavior of medium-size states. Explaining their behavior is important because western hemisphere negotiations that are currently at a stalemate include these types of states. Why are these negotiations to date unsuccessful? The answer centers on the current transformation underway in the international hierarchy which affects the cost-benefit calculations of a medium-size states in South America, with particular attention to Brazil.

This paper will examine two sets of negotiations, one successful and the other unsuccessful. The latter set is the triangular negotiations between the European Union (EU), Common Market of the South (MERCOSUR),<sup>1</sup> and United States, and is the primary focus of this paper. Specifically, these include the failures in 2005 by US Trade Representative Robert B. Zoellick and EU Trade Commissioner Pascal Lamy to complete negotiations on the Free Trade Area of the Americas (FTAA)<sup>2</sup> agreement and the EU-MERCOSUR FTA,<sup>3</sup> respectively. Explaining these failures rests not only on the details of the negotiations about also the influence of the ascending capabilities of the People's Republic of China. The successful set of negotiations includes

negotiations between Caribbean and Central American states, the EU, and the US. The EU negotiations involve the post-Lomé trade relations while the US negotiations culminated in the Central American and Dominican Republic FTA (CAFTA-DR).

To understanding why the two important and high profile negotiations are in stalemates while others are successfully completed, I test hypotheses developed from power transition theory (PTT) (Organski 1958; Organski and Kugler 1980) with particular attention to its recent extension into the area of regional integration (Efird and Genna 2002). While PTT has many similarities with hegemonic stability theory (HST) (Krasner 1976; Gilpin 1981), it is more capable to explain the behavior of middle-size states especially during the initial rise of a power. In general, FTAs are more likely to form when actors find themselves better off signing than not signing. What constitutes being “better off” depends on the preferences of the larger actor vis-à-vis the other actor(s). Preferences reflect a desired pattern of trade that depends on the actors’ comparative advantage. Developing actors (MERCOSUR members) would prefer a trading relationship where they can ease market entry of their primary goods while hoping to shield infant industries. Developed (EU and US) actors prefer a relationship where they can maximize exports of their capital-intensive goods while protecting their agricultural sectors. Rapidly growing actors (China) need access to inexpensive primary goods to feed their development strategy. These preferences interact with the relative size of the actors: large

economic asymmetries can lead smaller actors to accept less than preferred trade patterns if being locked out of the larger market would make them worse off as stated by both HST and PTT. But a point can be reached when the economic size differential is not large enough to accept trade patterns demanded by the larger actor(s). Furthermore, actors that can switch markets for their exports are less vulnerable to the demands of larger actors. The likelihood of switching export markets increases when a large and rapidly economy is present. PTT predicts this because of its focus on the changing dynamics of the international system. More specifically, both the EU and US are attempting to reorganize the global trade regime along their preferences through the EU-MERCOSUR FTA and FTAA, respectively. However, the members of MERCOSUR see this reorganization to their economic disadvantage. Having the limited access to the EU and US markets does not have enough economic value for MERCOSUR because a rapidly growing China offers an alternative market for MERCOSUR exports. Therefore the developing structural change of the international political economy lowers the likelihood of signing FTAs with the EU and US.

The remainder of this paper will explain the logic behind the western hemisphere's FTA stalemates and successful negotiations by explaining how economic size, actor preferences play, and alternative markets into the decision-makers' perceptions of their countries' benefits. Evidence for the argument will be presented by examining the EU-MERCOSUR FTA and FTAA

negotiations as well as the actions of the EU and US in the Caribbean and Central America and the indirect influence of China. The final section will conclude with policy implications in regards to both trade and security.

#### Explaining the Stalemate: Relative Size and Actors' Preferences

In order to explain the EU-MERCOSUR and FTAA stalemates, a brief overview of the prior research<sup>4</sup> indicates that successful development of regional integration depends on the economic asymmetries and compatible preferences. Power theories stress the distribution of power among states as a central factor influencing the outcomes of international relations. Among such theories, neo-realism argues that the asymmetric gains from exchange tend to hinder international cooperation (Waltz 1979; Grieco 1988). This reasoning is countered by proponents of HST and PTT who argue that the presence of a preponderant state is a necessary condition for liberal international and regional commerce (Krasner 1976; Gilpin 1987; Efind and Genna 2002). Others demonstrate empirically that cooperation can develop under asymmetric conditions if political and military alliances are present (Gowa and Mansfield 1993; Gowa 1994; Mansfield and Bronson 1997; Gilpin 2001). It is logical for allies to cooperate economically because of the intimate relationship physical security has with economic security; reciprocal enhancement of an allies' economic strength will aid in improving military readiness.

Nonetheless the claim that alliance portfolios will always trump other rationales for trade

preferences can be contested. Trade policies can run counter to the ideal suggested by the alliance portfolio literature because of the consequences a potential FTA poses to domestic groups and the related implication it would have on political leadership survival, especially in Latin America (Genna and Hiroi 2004). The preferences of an actor would therefore also need to balance the needs of potential FTA winners and losers in the actor's society with a stronger emphasis on the more powerful and better organized interest groups (Putnam 1988; Milner 1988, 1997; Frieden 1991, 1998; Rogowski 1989; Garrett and Lange 1995; Moravcsik 1997).

In general, power asymmetry and domestically derived preferences, in combination, can offer an accurate picture of when FTA negotiations, and other developments of regional integration, are successful (Efird and Genna 2002; Genna and Hiroi 2004). Open trade develops because the larger member of the asymmetric power relationship provides incentives to small states by leveraging its economic size. Leverage employed can vary from offering economic assistance to discontinuing assistance. It could also include retaliatory actions such as increasing existing trade barriers.

Preferences in trade patterns also matter. Compatible preferences are associated with overall trade dependence; the more trade dependent the potential partners, the more likely they will integrate formally. Identifying the preferences of a state could be fine-tuned through an extrapolation of the pattern of trade using the concept of comparative advantage. Specific groups

who own relatively abundant factors that are used intensively in production would favor a FTA while those that do not would oppose (Magee, Brock, and Young 1989; Rogowski 1989).<sup>5</sup> Current trade patterns would reflect the preferences of potential FTA partners. In order for all sides to be satisfied, the negotiations need to favor those economic sectors that have a higher volume of trade than other sectors. For developing countries, these are the primary goods sectors (especially agriculture) while for developed countries this includes the capital-intensive manufacturing, financial, and service sectors. Therefore, a smaller, lesser developed member would not join a FTA if it would be worse off; but if this type of actor is satisfied with the current relationship and would not wish to harm that relationship, it would join the FTA.

[Place figure 1 here]

Explaining successful FTA negotiations under extreme observations of power asymmetries is not new. However little is known about the behavior of medium-size economies. Using the cases of the EU-MERCOSUR FTA and FTAA stalemates, I will pose a set of hypotheses that talk to this gap in the literature. Figure 1 displays the interaction of each actor in this analysis. In figure 1-a, MERCOSUR is tied with the EU in the EU-MERCOSUR FTA negotiations and with the US in the FTAA negotiations. The EU-US linkage refers to their similar strategies. In the background, China is tied to all three. It is important to first look at the logic of the EU and US strategies and then MERCOSUR's counter-strategy. Both the EU and US follow a strategy of

competitive liberalization whose central idea is that nonmembers will fear a cost of being excluded from FTAs (Andriamananjara 2003). Nonmembers perceive that an established FTA is a “gold standard” for trade that incurs a cost for them in the denial of access to a large market for their products (Hufbauer and Wong 2004). Not wanting to lose, they join the arrangement. Therefore, FTAs expand when a large economy forms the hub of a FTA wheel and other smaller economies are the spokes. The nonmember decides that it prefers to trade-off the costs of increased competition in its domestic market with the gains of access to the FTA market. The final conclusion of competitive liberalism is that a global trading system emerges from the expanding FTA, primarily along the preferences of the hub economy.

However, competitive liberalization has two problems because it assumes that its intrinsic power leverage is in a static international structure. Knowing that the dominant economy has this leverage, similar sized or medium-size economies would also adopt the same strategy by developing their own trading blocs. The goal would be to develop a “competitive leverage” against the dominant player that wishes to play the role of the global trade hub. It is possible for a group of economies to compete as a unit to either be that hub economy or more likely, to diminish the leveraging power of the dominant economy in its effort to reorganize the global trade regime under its preferred trading pattern. This alone would not doom the competitive liberalization strategy. Another closely related flaw is that it assumes that no other actor exists in



the international political economy that can frustrate the potential hub actor's efforts. If middle-size actors have an alternative market for their goods and this market is relatively easy to access, then the leverage of the potential hub actor diminishes. In sum, the preponderant power's leverage is countered when a raising power can offer an alternative market to a coalition of states that are dissatisfied by the preponderant power's trade preferences.

PTT has already developed predictions of the increasing challenge China poses for US physical security (Rapkin and Thompson 2003; Lemke 2003), however no study examines the potential challenge China can have on the international trade regime and especially on EU and US trade relations with Latin American states. In figure 1-a we see the ties China has with all three actors. By unwrapping figure 1-a to reveal figure 1-b, we can more clearly see the Chinese ties and the expanded trade negotiating triangles. China's rise influences both set of negotiations because of its alternative markets to MERCOSUR exports. The bottom triangle of 1-b illustrates negative influence China has on both the EU and US negotiating strategies.

Preferences therefore play a key role and interact with the asymmetric conditions in successfully negotiating an FTA. If the dominant economic power wishes to develop or expand a FTA along its preferences, the likelihood of success diminishes the larger the nonmember's economic size *and* the less satisfied with the dominant actor's preferences. The medium-size economic power sees that not joining the FTA would leave it better off because the dominant

economy is not that much bigger than its own and is dissatisfied with the dominant actor's preferences. However, the smaller the nonmember's size, the greater the likelihood of a successful FTA even if preferences are not ideal because not joining the FTA would leave the smaller economy worse off. Finally, the presence of an accessible alternative market further diminishes the likelihood of a FTA negotiated by the large actor that follows the competitive liberalization strategy. Specific to the context of recent western hemispheric trade negotiations, the evidence in the following section will demonstrate support for the following hypotheses:

- *Both the EU and US are developing FTAs with Latin American countries in order to reorganize the global trade regime along their preferences and are attempting to be global hubs under the logic of competitive liberalization.*

However, among the LA countries lies MERCOSUR, and within it, Brazil:

- *Brazil as the dissatisfied and largest economy in Latin America forms its own trade bloc in order to maximize the expression of its own preferences in the global trade regime.*
- *Trade negotiations between the Caribbean and Central American states and the EU and US are successful due to large size asymmetries and satisfaction with current trade patterns with the EU and US.*

This analysis will also focus on the impact China will have on the EU-MERCOSUR FTA and

FTAA negotiations as an outside player:

- *Stalemates develop in the EU-MERCOSUR FTA and FTAA negotiations due to the lack of economic leverages (accessibility to China's market) and trade pattern preferences of Brazil, the EU, and the US.*

### Trade Triangulation

EU and US Strategies. The EU and US are of the same mind in certain key issues that have characterized the talks between these economically developed actors and their developing counterparts. While the US follows an explicit strategy of competitive liberalization, the EU follows an implicit one under its Common Commercial Policy (CCP). Their goal is to reorganize the global trade regime by establishing bilateral or multilateral FTAs outside the WTO negotiations. Each actor attempts to become the hub of a FTA wheel and thereby slowly developing a trade regime along their trade preferences.

Demonstrating the US strategy is straightforward; a brief overview of the statements of the leading negotiators can suffice. Allen F. Johnson, Chief Agriculture Negotiator, made the following statement before a US Senate subcommittee:

Our strategy is to incite competitive liberalization by negotiating regional and bilateral trade agreements to complement our global strategy in the WTO. If others are ready to open their markets, America will be their partner. If some are not ready, or want to complain but not lower their own barriers, the United States will proceed with countries that are ready (US Senate 20 May 2003).

Echoing this view and providing greater insight is Johnson's supervisor, Robert Zoellick before a

US House of Representatives committee:

We would like to pursue FTAs with the largest markets around the world, including the European Union and Japan among others. But right now, those countries are unwilling to move forward. As a result, we are pushing for the liberalization of their markets through the WTO. At the same time, as another facet of competitive liberalization, we hope our progress on other FTAs will encourage these important markets to reconsider their stance (US House of Representatives 28 April 2004).

But Johnson goes deeper into the US strategy in another quote from his US Senate subcommittee

testimony:

This competition in liberalization strengthens the United States' already considerable leverage, including in the WTO...Our bilateral and regional FTAs in the hemisphere – the U.S.-Chile FTA, the CAFTA, and the FTAA – also complement our trade objectives in the WTO. They set high standards for trade agreements and spur competitive liberalization. They provide a counterweight to the FTAs our Western Hemisphere partners have signed with other countries, including Canada, Chile, and the EU. Finally, U.S. trade pacts in the Western Hemisphere deepen our ties with individual and small groups of trading partners – alliances that could help us in the WTO (US Senate 20 May 2003).

In sum, the US strategy, under the logic of comparative liberalization, is to gather steam in the WTO by establishing FTAs with willing partners. These FTAs would begin a process of making its preferences resonate in the global trade regime by countering other FTAs and establishing greater leverage against the biggest economies, namely those of the EU and Japan.

The EU strategy is parallel to that of the US, but not as explicit. In 1996, the EU developed the Market Access Strategy (MAS). The MAS is a multifaceted policy with one simple goal, to

obtain access to external markets. How this is done depends upon resources and legal alternatives involved. While legal remedies (like the WTO dispute settlement procedure) and greater information for EU firms using advanced technologies (such as the Market Access Database) are the highlighted facets of the MAS (WTO 2002), the use of bilateral and multilateral negotiations are important instruments for the elimination of important market barriers. To this end, the EU negotiates all external trade associations under the CCP. Given the EU's customs union status, Articles 131-135 of the Treaty Establishing the European Community require members of the common external tariff to negotiate with one voice (Dinan 1999). Part of the CCP is the contractual commercial policy that gives the EU Commission the power to initiate and the exclusive right to negotiate trade agreements (Marsh and Mackenstein 2005). The Commission can use its supranational stature to negotiate with nonmembers not only regarding tariffs and quotas but also non-tariff barriers, without the fear that another body will amend the final trade agreement. The EU Council, however, oversees negotiations through observers and the 113 Committee.<sup>6</sup> Final negotiations need to be approved by the Council using qualified majority voting (Articles 133 and 300), operating like a legislature that only has an up or down vote (Hix 1999).

Given this single voice, the Commission, through its chief negotiator, can develop specific strategies to achieve the goal of market access. The EU's pattern of FTA behavior suggests that it

is following a parallel strategy vis-à-vis the US. For example, the EU has trade association agreements with Chile and Mexico. In addition to the current talks with MERCOSUR members, the EU is also in the beginning stages of negotiations with the Central American states and Andean Community for future FTAs. Given this pattern, the EU strategy reflects the competitive liberalization logic, and with it, a potential center of global trade regime reorganization.

More telling of the EU and US parallel strategies is their behavior with the smaller economies of the Caribbean basin. Small, more trade-dependent countries need agreements to remove uncertainty from their trade relations with larger economies. The US provides preferential access for Caribbean countries (including Guatemala and El Salvador but not Cuba) under the Caribbean Basin Initiative (CBI), but it does so unilaterally. The CBI came into being with the signing into law of the Caribbean Basin Economic Recovery Act, which came into effect 1 January 1984. Other legislation was enacted to expand the types of products and conditions for further preferential trade relationships, namely through the Caribbean Basin Economic Recovery Expansion Act of 1990 and the US-Caribbean Basin Trade Partnership Act of 2000. The CBI provides tariff reductions or exemptions for products from Central American and Caribbean countries. CBI benefits are, however, conditional. As stated in Section 202 of the Trade Partnership Act:

(b) POLICY- It is the policy of the United States--

(1) to offer Caribbean Basin beneficiary countries willing to prepare to become a party to

the FTAA or another free trade agreement, tariff treatment essentially equivalent to that accorded to products of NAFTA countries... and

(2) to seek the participation of Caribbean Basin beneficiary countries in the FTAA or another free trade agreement at the earliest possible date, with the goal of achieving full participation in such agreement not later than 2005.

This section sets up the precondition of signing on to the FTAA or other FTAs on terms that were yet to be specified, but giving the CBI countries benefits immediately. The US established a status quo that would cause these countries to be worse off by not signing on to a FTA because not doing so could lead to losing access to the US market. Signing the FTA will lock in the trade arrangements of the CBI. The result was the enactment of the Central American-Dominican Republic FTA and the current negotiations with the other Caribbean countries.

The EU also practices a similar relationship with Caribbean countries that were former colonies of the member states. First initiated under the Lomé Convention,<sup>7</sup> the EU has a preferential trading relationship with a group of countries referred to as the African, Caribbean, Pacific group (ACP). Lomé provided a development assistance package that included free access to the European market for products that originated in the ACP countries as well as aid and technical assistance (Dinan 1999). The EU-ACP relationship is currently evolving as a result of the Cotonou Partnership Agreement (2000). A central pillar of the agreement is the movement away from the non-reciprocal trade arrangement under Lomé to a series of negotiated economic partnership agreements (EPAs) (Articles 36 and 37 of the Cotonou Partnership Agreement). The

rationale is to make the ACP economies more competitive in the global economy. However the choice for each trade-dependent state, like the case of the CBI, is to either lose access to the larger market or sign EPAs and lock-in access through a WTO recognized agreement. Again, the smaller states would opt for the free trade arrangement and diminish the uncertainty that may result from not signing.

Brazilian Strategy. During an interview with an Argentine journalist, Brazil's Foreign Affairs Minister Celso Amorim said,

Even though Brazil is the largest economy in South America, it needs the company of other countries, and above all, it needs MERCOSUR. To have a true multipolar system, there must be some minimal correlation of power. (Niebieskikwiat 5 February 2003).

These two sentences were given in the context of the EU-MERCOSUR FTA and FTAA negotiations, and provide the key component of the Brazilian strategy vis-à-vis the EU and US. By developing its own trading bloc, Brazil can credibly attempt to maximize the expression of its preferences in the global trade regime. While the size of the MERCOSUR five economies is small when compared to the EU or US, the strategy has been endorsed by the Inter-American Development Bank (IDB 2002). By combining the economic weight of several Latin American countries, Brazil has the ability to reduce the economic leverage of the economic heavyweights. Neither the EU nor US has the economic capacity to offer countries like Brazil and Argentina the same preferential trade agreements they have for the Caribbean Basin states. Therefore Brazil's



calculation for forming a FTA differs: it could be worse off by signing a FTA if the trade preferences of the larger states are very distant from its own. If it can convince other states to form a bloc with aligned trade preferences, then it is not stuck in the competitive liberalization trap because it will not be left out of a market that others access. In this reworking of the conditions, its cost of not joining is low.

However, Brazil must do what the other larger actors do, namely provide incentives for regional partners to form a trading bloc. Although Brazil does not have as large a capacity as the EU or US, it has demonstrated the ability to keep the block together even in the worst of times (Genna and Hiroi 2005). Brazil has provided benefits to other members during key episodes of MERCOSUR's development. For example, Brazil accepted Argentina's trade needs during the 2002 economic crisis even when those measures were costly in the short run. This and other episodes demonstrate the importance Brazil places on regional integration. This leadership continued in December 2004 when a FTA was finalized between MERCOSUR and the Andean Community bringing about the South American Community (SAC). In a practical sense, a free trade area of the Americas has already formed with the SAC given Mexico's upcoming associate status with MERCOSUR. It is one, however, where Brazil is potentially more of the hub economy than the US.

The previous two sections laid out the trade strategies of Brazil, the EU and the US. These

strategies include the desire of the larger actors to reorganize the global trade regime under their preferences, the execution of those strategies with the Caribbean and Central American states, and Brazil's desire to modify that reorganization. However, the central argument rests on two key variables, with relative size being only one. The other is the degree of satisfaction actors have with the reorganization of the global trade regime. This satisfaction comes out of specific preferences associated with the EU-MERCOSUR FTA and FTAA negotiations. Each of the actors wishes to maximize market access for those sectors where they have a comparative advantage while attempting to limit competition in their respective markets. The next two sections explain the stalemates in the EU-MERCOSUR FTA and FTAA negotiations, which ensued due to divergent preferences and the relative size of the actors.

EU-MERCOSUR FTA. This section outlines the preferences of the EU and MERCOSUR derived from the pattern of trade. Overall, the trade relationship is asymmetric with MERCOSUR having the greater dependence on the EU market. However, the EU-MERCOSUR trade patterns illustrate a high percentage of primary goods exports from MERCOSUR and a larger proportion of manufactures exports from the EU. This characteristic of the current trade pattern leads Brazil (and MERCOSUR in general) to demand greater openness for agricultural products. The stalemate came about when the EU refused to open up their agricultural market, but made greater demands on MERCOSUR to open up those sectors that would consume

manufactured products.

First, MERCOSUR is dependent on the EU for their trade. In 2004 Brazil was the EU's 11<sup>th</sup> major trading partner but accounted for only 1.8% of overall EU trade (Eurostat 2005). The remaining four MERCOSUR members scored in the bottom of the rankings. However, the EU ranks as the number one trading partner for MERCOSUR, accounting for 22.9% of its total trade (Eurostat 2005).

[Place figure 2 here]

This story is repeated in a closer examination of the trade statistics. Figure 2 illustrates the EU-MERCOSUR trade patterns (1999-2004). The first three bars illustrate the trade dependence the EU has with MERCOSUR. MERCOSUR's share of total EU trade averaged 2.46% (s.d. 0.18%). Its percent share of EU imports and exports averaged 2.65% (s.d. 0.12%) and 2.26% (s.d. 0.49%), respectively. Overall, the degree of the EU's overall trade dependence on MERCOSUR is very small. The largest category of products sold in the MERCOSUR market is machinery and transport equipment. In 2004, this accounted for 50.1% of exports, but only 2.1% of total EU exports (Eurostat 2005). The next largest category is chemicals and related products, which account for 22.5% of MERCOSUR trade, but only a 2.7% share of total exports (Eurostat 2005).

However, when we examine specific categories of products imported into the EU in 2004, a slightly different picture develops. The largest category is food and live animals, accounting for

37.2% of imports from MERCOSUR and 20.2% of total EU imports (Eurostat 2005). The next category is raw goods (except fuels), accounting for 25.7% of MERCOSUR imports and 17.1% of all imports (Eurostat 2005). In total, these primary materials comprise 37.3% of all EU imports. Therefore, there is some EU trade dependence on MERCOSUR, but only in primary goods.

The last three bars display the EU share of MERCOSUR world trade.<sup>8</sup> From 1999 to 2004, the EU's percent share of overall trade averaged 24.3% (s.d. 1.65%). This is reflected in both exports and imports, which averaged 22.8% (s.d. 2.14%) and 25.9% (s.d. 1.77%) respectively. However, MERCOSUR's export dependence with the EU is not as high as the EU dependence on MERCOSUR. While 25.7% of the EU's imports of food and live animals are from MERCOSUR, this is only 9.9% of total MERCOSUR exports but 37.2% of exports to the EU in 2004 (Eurostat 2005). In addition, 6.8% of total MERCOSUR exports of raw materials (excluding fuels) go to the EU, accounting for 25.7% of all exports to the EU. The two items together account for 16.8% of all MERCOSUR exports but 62.9% of exports to the EU. In sum, MERCOSUR's main export to the EU and the EU's main dependence is in the category of primary goods.

In the case of EU exports to MERCOSUR, we again see a small amount of value, but a large share of a specific product, namely manufactured goods. The top categories of MERCOSUR

imports from the EU are machinery and transportation equipment, chemicals, and other manufactured goods. Together they are 22.4% of world imports into MERCOSUR, but 89.6% of EU imports (Eurostat 2005). However this is only 1.7% of global EU exports. Again, MERCOSUR does not represent a large value of trade for EU exports, but manufactured products do overwhelm the value of trade into MERCOSUR.

The areas of negotiation are centered on the primary products and manufactured goods. Both sides wish to maximize the amount of trade in their favored area of comparative advantage while attempting to minimize competition for domestic firms. In March 2003, MERCOSUR offered to eliminate tariffs on 83-85% of the average value of EU goods over ten years with the remaining 15% eliminated over a period greater than ten years (BBC MIR 5 March 2003). The EU, however, wanted to see 90% instead of 85%. The EU's counteroffer was an exclusion from tariffs for 10% of MERCOSUR imports, which were primarily agricultural goods (BBC MIR 5 March 2003). The increase by MERCOSUR to 85% was an attempt to get the EU to discuss agricultural subsidies, which the EU refuses to do bilaterally but wanted instead to hold such discussions at the WTO talks (BBC MIR 5 March 2003). In November 2003, the EU attempted to gain greater access for their products through the liberalization of MERCOSUR members' government procurement and services sector (Osava 3 November 2003). The EU offered to increase the import quotas for agricultural goods, but this was not satisfactory for MERCOSUR

who insisted on discussing agricultural subsidies (Osava 3 November 2003). The EU offered to further increase the agricultural import quota if MERCOSUR did not request a reform of the EU agricultural subsidies in December 2003 (Osava 3 November 2003). The new negotiations at the beginning of 2004 began with deep frustration on the EU side. At the commencement of the March 2004 talks, EU trade representative Karl Falkenberg questioned the integration of the MERCOSUR members when he stated that it was “more a vision than reality” and went on to question the degree of trust among the four members (MercoPress 11 March 2004). This led to a defense of MERCOSUR’s integration practices by the Argentine trade representative, Martín Redrado (MercoPress 11 March 2004). The talks also failed due to the MERCOSUR refusal to open government procurement contracts and the services sector because the EU would not allow unrestricted access for beef, cereals, poultry and other agricultural products (MercoPress 30 March 2005). In April 2004, the same requests were made again, but both sides refused to acquiesce (Benson 21 April 2004). MERCOSUR negotiators did budge in June 2004 and agreed to increase the percentage of manufactured goods coming in at a reduced tariff to 90%, without a favorable reply from the EU side (Latin News Daily 14 June 2004; O Estado de São Paulo 14 June 2004). In an interesting escalation of negotiations, MERCOSUR negotiators walked out of the July Brussels discussions after the EU negotiators reduced the quota amounts on agricultural goods by half the amount they previously promised (Mancini 22 July 2004). The EU delegation

returned the favor by walking out of the August Brasília negotiations over the issue of agricultural products (Teixeira 13 August 2004). At the beginning of September 2004, Pascal Lamy stated that the problem with the EU-MERCOSUR negotiations is with the MERCOSUR members because they were unwilling to match the agricultural concessions the EU made with greater access to investment markets, telecommunications, maritime transport, and banking services (MercoPress 1 September 2004). However, the MERCOSUR negotiators (after agreeing not to talk about EU agricultural subsidies) felt that the concessions were not enough and wanted larger agricultural quotas, especially for wheat and beef, and for these quotas not to have a ten year limit (MercoPress 1 September 2004).

On 26 May 2005, EU and MERCOSUR representatives put forth a joint communiqué reiterating their comment to finalizing a FTA in conformity with the 1995 Declaration on Political Dialogue that began the negotiation process. The publication of the communiqué signaled that the FTA would not be finalized soon. The transatlantic stalemate occurred because MERCOSUR members understood that they had nothing to lose from not signing the FTA. The EU already depends on their exports of primary goods and would continue to import. The large share of EU manufactured goods entering into the MERCOSUR market would threaten domestic producers leaving MERCOSUR economies worse off. Unless the EU liberalized their agricultural sector, it would not be in the interest of MERCOSUR members to sign the FTA.

FTAA. The conditions of negotiations were not different with regard to the FTAA. While the US was able to develop willing partners among the small trade dependent states of Central America, the Caribbean, and its NAFTA partners, it could not develop such relations with the MERCOSUR members.

[Place figure 3 here]

Like the EU-MERCOSUR trade relationship, MERCOSUR is more trade dependent on the US than vice versa. Figure 3 illustrates the US-MERCOSUR trade patterns. The first three bars illustrate the trade dependence the US has with MERCOSUR. As with the EU, the overall percent value of trade is not high. Total trade has remained somewhat level during the 1997-2001 timeframe an average value of 2.09% (s.d. 0.17%). The percent value of imports to MERCOSUR also has remained level averaging at 1.43% (s.d. 0.07%). Furthermore, US exports averaged 3.02% (s.d. 0.33%). MERCOSUR's overall trade dependence on the US resembles the EU (last three bars of figure 3). Overall, the percent share of global MERCOSUR trade averaged 19.3% (s.d. 1.48%). Imports from the US account averaged 21.6% (s.d. 0.70%). Exports to the US averaged 16.6% (s.d. 3.43%).

A deeper look exposes the same pattern of trade between MERCOSUR and the US as in the EU-MERCOSUR case. While 28.3% of the US imports from MERCOSUR is in the category of primary goods, this only accounts for 5.8% of total MERCOSUR exports (FTAA 2005). Also,



83.3% of the MERCOSUR imports from the US are in the category of manufactured goods, accounting for 17.4% of total US exports. Therefore, primary goods sent to the US is a small portion of MERCOSUR exports but manufactured goods represent a larger share of US exports to MERCOSUR. In sum, while MERCOSUR is more dependent on trade with the US, the US also is dependent on MERCOSUR for sales of manufactured goods and acquisitions of primary products.

When examining the negotiations for the FTAA, the first item that becomes apparent is the emphasis on manufactured goods at the expense of primary goods. The nine official areas of the negotiations are: 1) market access, 2) agriculture, 3) government procurement, 4) Investment, 5) competition policy, 6) intellectual property rights, 7) services, 8) trade dispute settlement, and 9) subsidies, antidumping, and countervailing duties. Only a small fraction of the areas lend themselves to liberalizing primary commodity markets but many do talk about the liberalization of sectors that will increase trade in manufactured goods. Like the EU, the US has been and continues to be opposed to discussing agricultural subsidies at the FTAA table, insisting that it be discussed at the WTO level. With this off the FTAA table, the vast majority of discussions involve manufactured goods.

The discussions of the meetings divided the participants in the predicted manner. Sides were drawn between the US, Canada, Mexico, and Central American countries favoring a

comprehensive agreement while MERCOSUR members wished to remove subjects such as government procurement, services rules and intellectual property rights from discussions (Sevilla 2004). Given the ties that Canada, Mexico, and Central American countries already had with the US, they favored the US position that included negotiation topics that would liberalize sectors and be receptive for its products. However, MERCOSUR, given the current trade pattern, would be at a disadvantage by signing an agreement that did not liberalize market sectors that would favor their products (i.e. agricultural products).

To end this impasse, Brazil suggested in May 2003 a “4+1” set of negotiations. This would produce two versions of the FTAA. One version is that the members of MERCOSUR negotiate with the US directly. The other is a parallel set of negotiations that would include the US and the remaining states (Osava 28 May 2003). The proposed arrangement would permit the process to continue at two speeds and allow Brazil to focus on issues that the US and its coalition wanted to ignore. Robert Zoellick rejected Brazil’s suggestion knowing that it would be possible to get a wider FTAA by keeping the US coalition together in order to thwart Brazil’s preferences. This would allow no discussions of agricultural subsidy cuts and anti-dumping rules, both of which the US wanted to defer to the Doha Round. In addition, by keeping the coalition together, it would be more likely to get the service sector liberalized and reward the Caribbean and Central American countries with extra trade preferences (Osava 28 May 2003).

The talks became more heated after the failure of the September 2003 WTO Cancún talks. Recall that the EU and US requested that the MERCOSUR members forgo discussing agricultural subsidies until the Doha Round resumed. Brazil along with other members of the G-20<sup>9</sup> held the EU and US (as well as Japan) to their words, but without a satisfactory outcome. At the resumption of the FTAA negotiations, the MERCOSUR members reintroduced the topic of agricultural subsidies, which the US refused to discuss but pointed to the need for the liberalization of services, which the MERCOSUR members stated would be better discussed at the Doha Round (Valente 24 October 2003). This response prompted US Deputy Trade Representative Peter Allgeier to state that an FTAA can be created without Brazil (Valente 24 October 2003). This was not the only time a US trade representative mentioned that Brazil could be left out of the competitive liberalization formula. In 2002, Zoellick stated that Brazil could trade in “another direction...Antarctica” if it did not want to trade with the US (Hay 29 December 2004). In reaction, the MERCOSUR members formalized their unity by signing the “Buenos Aires Consensus” outlining a common position regarding agricultural subsidies (Valente 24 October 2003).

In the hope of moving the negotiations forward, a new negotiation framework was decided ahead of the ministerial meetings in Miami in November 2003. “FTAA lite,” as it was called, would allow each country to negotiate in certain areas and not in others (Osava 20 November

2003). However this did not stop the MERCOSUR members from continuing their common strategy, which was further developed ahead of the February 2004 meetings (Invertia 16 January 2004). Most of 2004 resulted in the same stalemate between MERCOSUR and the US regarding agricultural subsidies and liberalization of services. In the most recent attempt, Brazil and US representatives met in Washington, DC from 22-23 February 2005. The result was an insipid joint communiqué stating that both sides are committed to a FTAA in the future but without stating how this would occur.

Like the EU-MERCOSUR stalemate, the FTAA stalemate occurred because MERCOSUR members understood that signing the FTAA would place them in a worse position. The US exports a large percentage of manufactured goods to and imports a fair percentage of primary goods from MERCOSUR members. As in the case of the EU, an increase of manufactured goods entering into the MERCOSUR market would threaten domestic producers leaving MERCOSUR economies worse off. However the final factor that gave the MERCOSUR members more incentives to reject both the EU and US proposals was the indirect impact of China's economic relations with Latin America.

[Place figure 4 here]

The Impact of China. With average annual growth rates of 8%, the Chinese economy is becoming increasingly in need of food, raw materials, and energy. For example, China has been

the world's largest oil consumer since 2003. They continually need reliable sources of raw materials with a portion of them already arriving from Latin America. Volume of exports from the Caribbean, Central America, and South America to China has dramatically increased over the last 10 years (see figure 4). From 1994 to 2005, the proportion of total exports leaving these countries to China increased from 1.63% to 6.47%. The overall growth of MERCOSUR members' exports was 73.3% and now accounts for approximately 8.5% of total exports. The growth was larger among the Caribbean and Central American countries (98.2%) but exports are still a small percentage of the total (approximately 2.50%). Other South American countries saw an increase of approximately 77%, with approximately 5.6% of total exports heading to China in 2005. Therefore, the MERCOSUR countries are taking a greater advantage of China's market than the smaller Caribbean and Central American countries.

China is also becoming an active business partner, accounting for 36.5% of total foreign direct investment in Latin America in 2003 (MercoPress 11 November 2004). Although trade with Latin America only accounted for 3.4% of total Chinese trade volume in 2003, and with a growing trade deficit with Latin America, Chinese state analysts say trade is valuable if they are able to secure raw materials for their fast growing economy (Business Daily Update 3 December 2004). If China is willing to buy more and more Latin American goods along favorable trade arrangements, then Brazil and its MERCOSUR partners would be able to expand the market for

their products even with the EU and US stalemates. In addition, pressure would be off of these countries to sign unfavorable FTAs.

Latin American leaders welcome and actively seek out China's economic partnership. In May 2004 Brazilian President Luiz Inácio "Lula" da Silva visited China with a large entourage of business representatives in order to begin the process of extending commercial ties for exports such as food products, chemicals, and machinery, among others (Osava 18 May 2004). In return for officially recognizing China as a market economy within the rules of the WTO during President Hu Jintao's visit in November 2004, China signed numerous commercial agreements with Brazil (Deutsche Presse-Agentur 12 November 2004). One such agreement partnered Brazilian and Chinese state-owned oil firms (Petrobras and China Petroleum and Chemical Corporation) and China's Export and Import Bank for a US\$1 billion Brazilian north-south natural gas pipeline construction project (MercoPress 13 November 2004). Another was a US\$2 billion investment in Brazilian rail so as to improve freight transportation and lower commodity prices (MercoPress 13 November 2004). Overall, Hu pledged US\$10 billion for multiyear investments in Brazil during his visit (Business Daily Update 3 December 2004).

China has wider economic plans in Latin America. China and Argentina signed a US\$19.7 billion investment package for infrastructure improvement and hydrocarbon exploration and production over 10 years (MercoPress 17 November 2004). At the time of signing this agreement,

Chinese sanitary authorities later certified several Argentine beef and poultry processing plants, thereby expanding trade of these products for the Chinese market and Argentina granted China WTO market economy status (MercoPress 13 July 2005). Finally, China represents Argentina's top market for soybeans (MercoPress 26 August 2006). Chile and China began negotiations for a FTA in November 2004 (China Daily 26 January 2005) with its enactment in August 2006 (Financial Times 23 August 2006). This FTA represents the first one for China in Latin America. Its presence in the political sphere is also growing with its acceptance as a formal observer in the Organization of American States (MercoPress 26 August 2006) and its wish to join the Inter-American Development Bank (MercoPress 11 April 2005). The latter move has garnered MERCOSUR's support, with opposition coming from the US and the Central American states (MercoPress 11 April 2005).

### Conclusions

The EU-MERCOSUR and MERCOSUR-US stalemates resulted from a combination of disjointed preferences, relative market size, and the growing advantages of trade with China. When entering into a FTA, all potential partners prefer to sign an agreement so long as they are better off than not signing it. For a large economy the goal of signing FTAs with smaller economies does have a marginal economic advantage, but the primary goal is an evolution toward a global trade regime more favorable to its preferences. Smaller economies do look

favorably on accessing larger markets, but they fear domestic market competition. If their domestic market is vulnerable, then they would be better off signing an FTA if current trade could be cut off by the larger economy. Medium sized economies are less likely to sign when they cannot exploit comparative advantages. Alternative markets in rapidly growing economies also lower the incentives to sign.

The EU and the US have similar goals. The idea of establishing FTAs allows for a reorganization of the global trade regime along their preferences. The idea is to expand markets for their exports while protecting their more vulnerable products. If they convince states to sign FTAs along these preferences, then they have a de facto global trade regime without the WTO negotiations. As such they consolidate their status as hub economies and continue to compete with each other over a greater share of the global market.

While some states are willing to sign FTAs, others have deep reservations. The EU and US have developed FTAs in the Western Hemisphere, but with the smaller more dependent states. The Caribbean and Central American states benefited from favorable trade relations established by the EU and US through their respective unilateral policies. Therefore not signing an FTA for these countries could threaten their trade dependence with the larger actors. The MERCOSUR members, on the other hand, do not have such incentives. They primarily sell raw goods to the EU and US who shield their domestic producers with tariffs and subsidies. The larger economies



wish to increase sales of manufactured goods to MERCOSUR without exposing domestic agricultural producers to competition. In addition, China's growing economy is in need of raw materials and an improved status in the WTO, both of which MERCOSUR is willing to provide. In return, China does provide incentives for MERCOSUR cooperation. The current trajectory implies greater trade relations between the larger economies of the developing world and problems for the north-south variety of trade. Since little incentive is present, a successful end to the FTAA and EU-MERCOSUR FTA negotiations is not very likely under the current preferences of the EU and US.

One implication is the possible spillover into the security realm as potential alliances develop among burgeoning economic partners. The growth of China in conjunction with western hemispheric dissatisfaction can produce unnecessary and unwanted consequences. The growth of Chinese importation of Latin American primary products and investment in the region can produce possible security issues for both the EU and the US. Scholars have already recognized the future power transition between China and US and its implication for potential conflict (Efird, Genna, and Kugler 2003). When China and US achieve parity in economic and military power, and should this parity come with Chinese dissatisfaction with the US management of the global status quo, there is a good likelihood of armed conflict. This conflict will not likely see the EU on the sidelines. Should the EU and the US decide to open up the markets for agricultural goods,

resources can possibly shift away from China to toward EU and US markets given their higher per capita income. Opening up the EU and US markets could mean an increase in primary commodity prices as demand for Latin American goods increase. This will benefit EU and US growers since high price guarantees are at the root of subsidies. It could also slow the growth of China's economy and therefore extending the timeframe of the next power transition. In addition, it will lessen the possible military alliances that may become associated with the stronger investment and trade between China and Latin America.

To improve the degree of global trade cooperation, greater incentives are needed from the EU and US. The liberalization of the agricultural sectors is an important first step towards this. Another policy suggestion is a slow opening for services and government procurement in the MERCOSUR members so as to improve the integration of these sectors in the international market. The final policy implication is the strengthening of the Asia-Pacific Economic Cooperation (APEC) with the added membership of the MERCOSUR countries. A FTA that spans the Pacific Rim can further not only economic growth but also security. To improve APEC members' integration, the US, as the preponderant power, will need to modify its trade preferences so as to reach a common ground with MERCOSUR.

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Figure 1. Trade Negotiation Triangulations

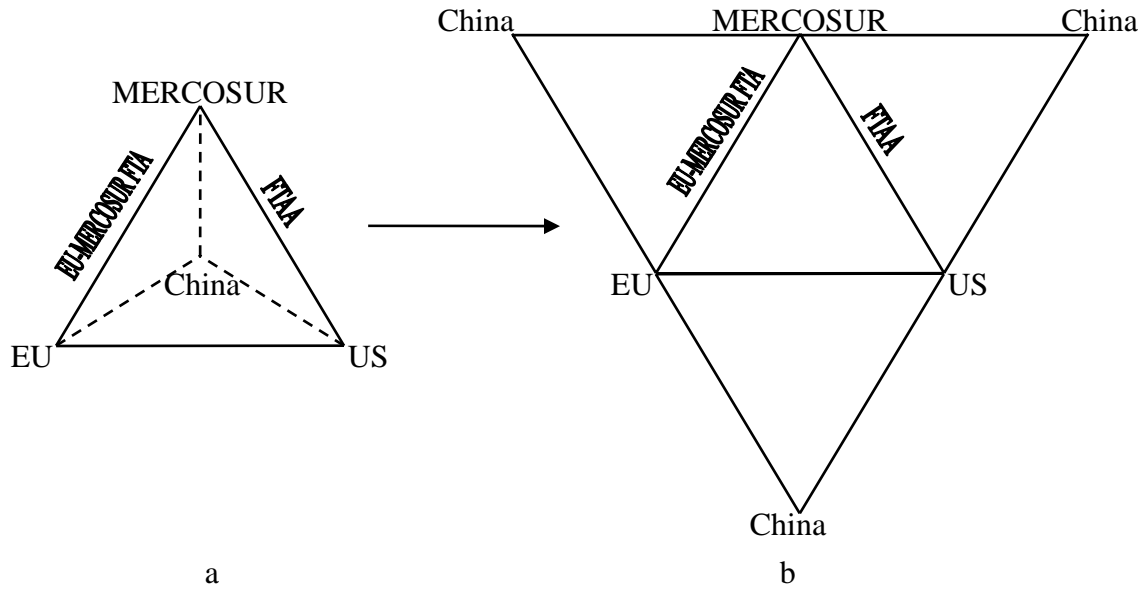
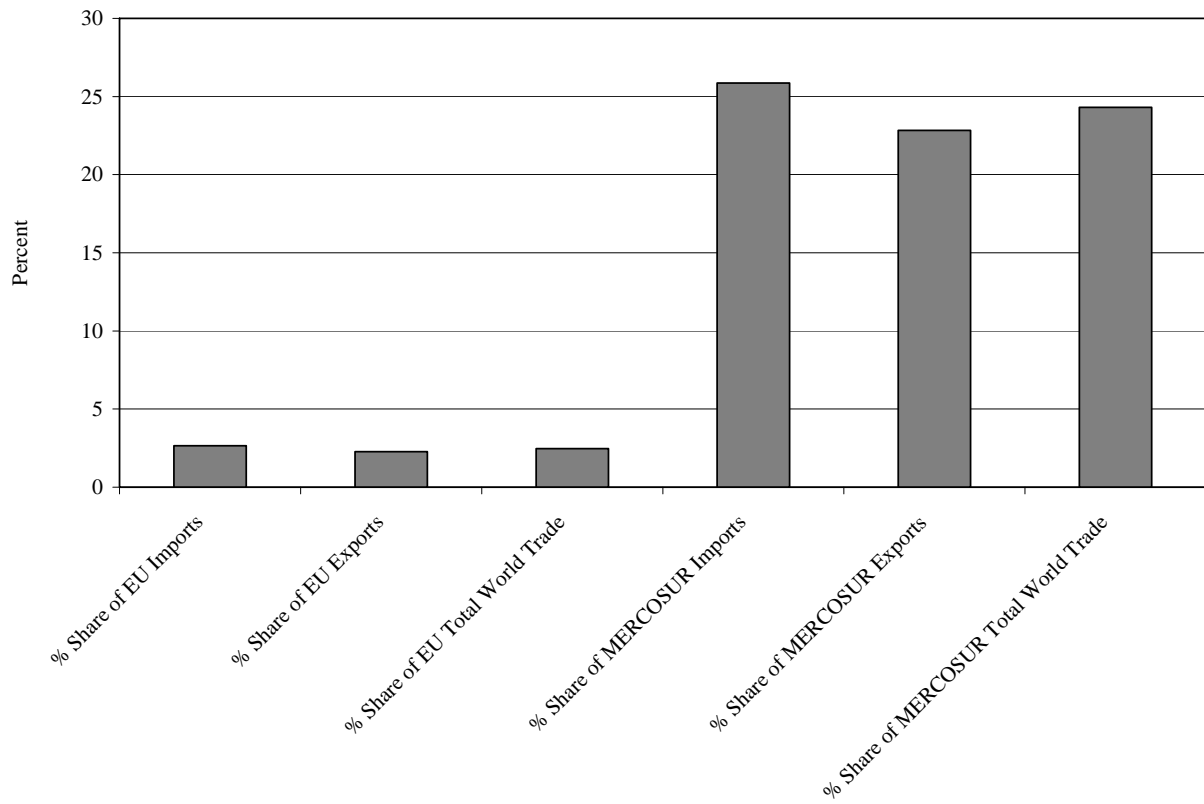
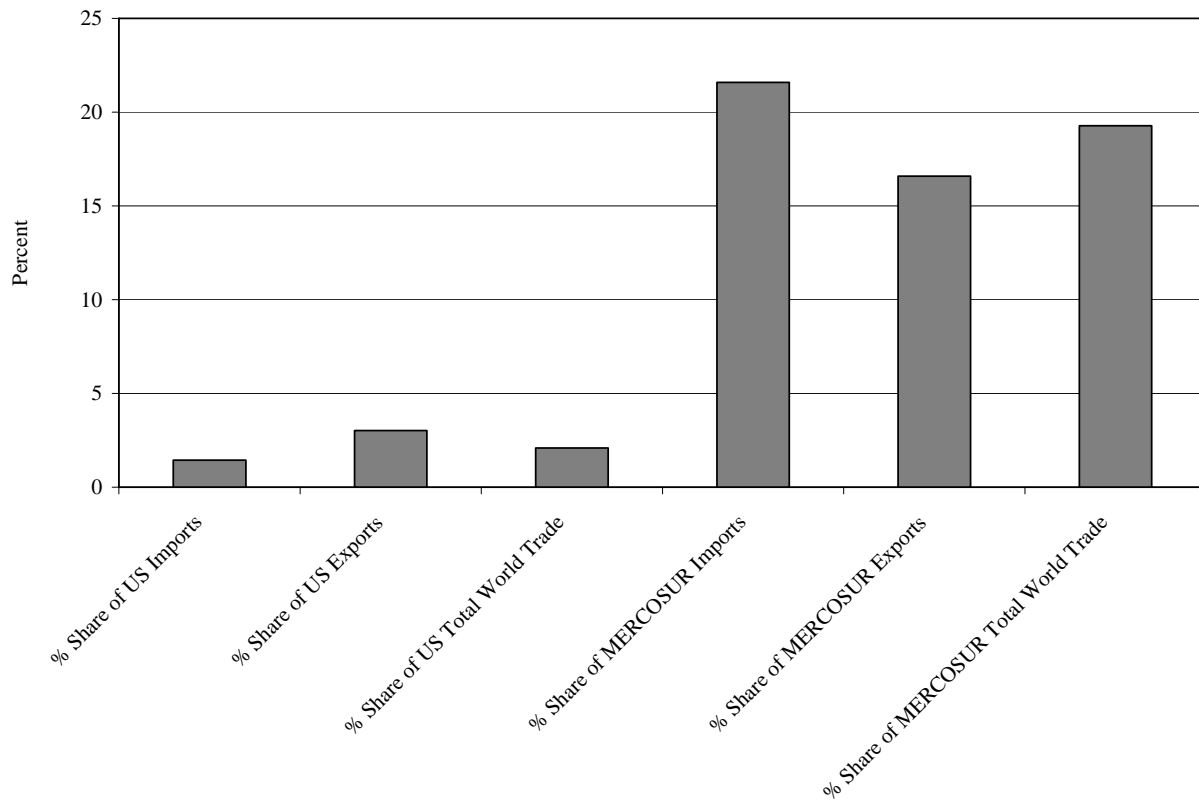


Figure 2. EU-MERCOSUR Trade Patterns (1999-2004 Averages)



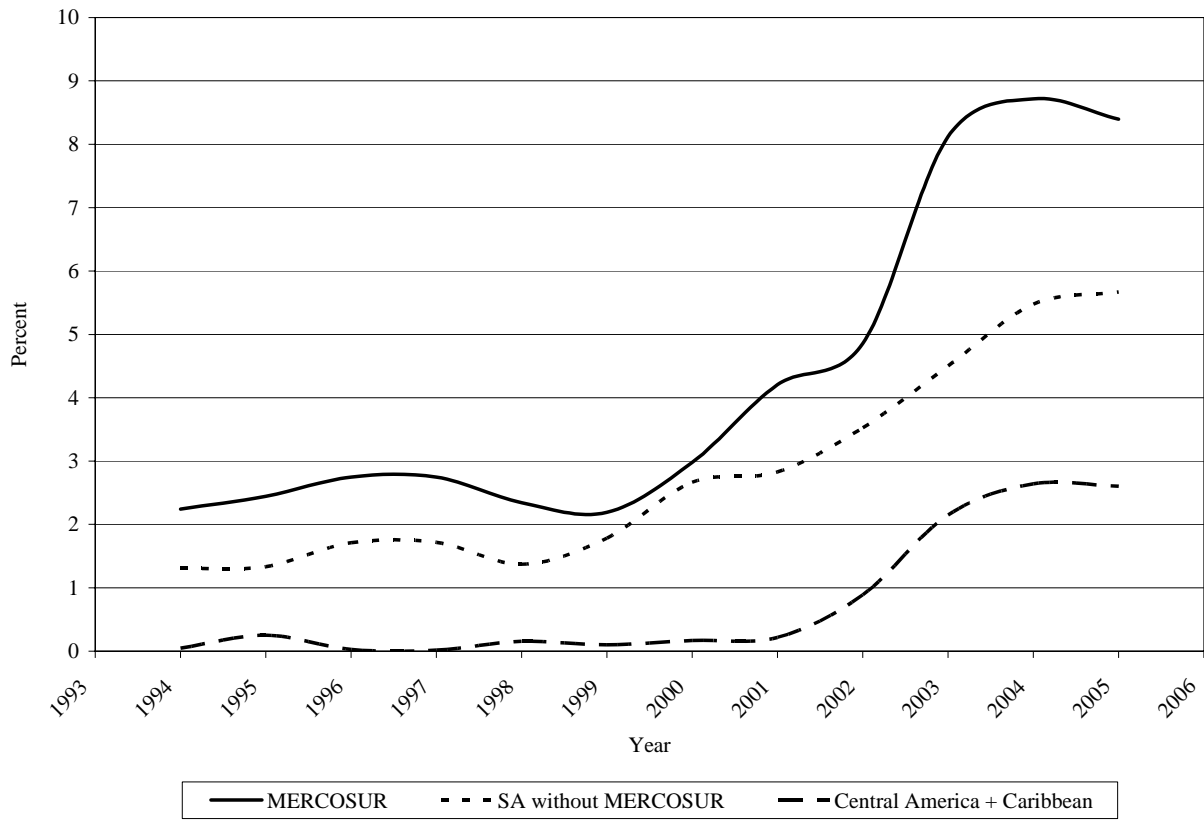
Source: Eurostat 2005

Figure 3. US-MERCOSUR Trade Patterns (1997-2002 Averages)



Source: Free Trade Area of the Americas: Hemispheric Trade and Tariff Database 2005

Figure 4. Percentage of Exports to China (1994-2005)



Source: International Monetary Fund

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<sup>1</sup> The MERCOSUR customs union includes Argentina, Brazil, Paraguay, Uruguay, and Venezuela with Chile, Bolivia, and Peru as associate members. In 2002, MERCOSUR market size was 223.4 million people with a total output of US\$572 billion, of which Brazil represents a little less than 80% (UN Development Programme 2005).

<sup>2</sup> Negotiations for the FTAA began in 1994 with the idea of establishing a FTA that would include all the economies of the western hemisphere, except Cuba (34 economies in all). The total market size is estimated to be 841.2 million people with a total output of US\$12.8 trillion in 2002, of which the US would account for a little more than 81% (UN Development Programme 2005).

<sup>3</sup> Negotiations for the EU-MERCOSUR FTA began in earnest in 1999 after years of preliminary talks. It would represent an estimated market size of 602.5 million people with a total output of US\$9.2 trillion in 2002, of which the EU would account for approximately 94% (UN Development Programme 2005).

<sup>4</sup> See Feng and Genna 2003 and Genna and Hiroi 2004 for a complete assessment of regional integration theory.

<sup>5</sup> See also the Heckscher-Ohlin and Stolper-Samuelson theorems (Krugman and Obstfeld 2002).

<sup>6</sup> The name “113 Committee” comes from Article 113 using the old numbering system of the Treaty Establishing the European Community. This is the same as Article 133 using the new numbering system (Treaty of Amsterdam); however the name “133 Committee” has not come into vogue.

<sup>7</sup> The Lomé Convention was actually a series of five agreements: Lomé I-IV and an amended IV.

<sup>8</sup> 2004 MERCOSUR trade figures are estimated based on the first nine month figures and 2003 annual figures.

<sup>9</sup> Brazil’s international strategy included commercial ties with other developing nations other than MERCOSUR. To this end it helped form a negotiating alliance first with India and South Africa, call the BIAS Group, that later transformed into the G-20, which also includes China (Brazil Report 23 November 2004).