# The MERCOSUR and the Creation of the Free Trade Area of the Americas

Vaillant Marcel and Lorenzo Fernando

Departamento de Economía FCS UdelaR

November 2003


Woodrow Wilson Center Reports on the Americas • #14

# MERCOSUR AND THE CREATION OF THE FREE TRADE AREA OF THE AMERICAS

edited by
Fernando Lorenzo
Marcel Vaillant

foreword by
Joseph S. Tulchin
Luis Bitencourt

Woodrow Wilson International Center for Scholars

Latin American Program

# MERCOSUR AND THE CREATION OF THE FREE TRADE AREA OF THE AMERICAS

**Woodrow Wilson Center Report on the Americas #14**

**Coordinators**
Fernando Lorenzo, CINVE
Marcel Vaillant, Universidad de la República

**September, 2003**

**RED MERCOSUR**

**Contributors:**
Julio Berlinski ITDT, Argentina
Andrés López and Gastón Rossi CENIT, Argentina
João Bosco Mesquita Machado and
Galeno Ferraz UFRJ, Brazil
Paulo Fracalanza and Adriana Nunes Ferreira UNICAMP, Brazil
Marcos Fava Neves USP, Brazil
Fernando Masi CADEP, Paraguay
Silvia Laens, Fernando Lorenzo,
and Rosa Osimani CINVE, Uruguay
Alvaro Ons, Inés Terra, and Marcel Vaillant DE/FCS, Uruguay
Carol Wise USC, United States

**Foreword by:**
Joseph S. Tulchin
Luis Bitencourt

**Edited by:**
Fernando Lorenzo
Marcel Vaillant

Woodrow Wilson
International
Center
for Scholars

*Latin American Program*

# MERCOSUR AND THE CREATION OF THE FREE TRADE AREA OF THE AMERICAS

**Foreword by:**
Joseph S. Tulchin
Luis Bitencourt

**Edited by:**
Fernando Lorenzo
Marcel Vaillant

**Contributors:**
Fernando Lorenzo
Marcel Vaillant
Rosa Osimani
Silvia Laens
Inés Terra
Alvaro Ons
Andrés Lopez
Gastón Rossi
Paulo Fracalanza
Adriana Nunes Ferreira
Marcos Fava Neves
Julio Berlinski
Fernando Masi
Carol Wise
João Bosco
Mezquita Machado
Galeno Ferraz

## WOODROW WILSON INTERNATIONAL CENTER FOR SCHOLARS

Lee H. Hamilton, President and Director



## ABOUT THE CENTER

The Center is the living memorial of the United States of America to the nation's twenty-eighth president, Woodrow Wilson. Congress established the Woodrow Wilson Center in 1968 as an international institute for advanced study, "symbolizing and strengthening the fruitful relationship between the world of learning and the world of public affairs." The Center opened in 1970 under its own board of trustees.

In all its activities the Woodrow Wilson Center is a nonprofit, nonpartisan organization, supported financially by annual appropriations from Congress, and by the contributions of foundations, corporations, and individuals. Conclusions or opinions expressed in Center publications and programs are those of the authors and speakers and do not necessarily reflect the views of the Center staff, fellows, trustees, advisory groups, or any individuals or organizations that provide financial support to the Center.

# TABLE OF CONTENTS

# GLOSSARY

The following acronyms are frequently used in the text

**ALADI** Association for Latin American Development and Integration
**ALALC** Latin American Free Trade Area
**CAN** Andean Community of Nations
**CET** Common External Tariff
**CMC** Common Market Council
**CMG** Common Market Group
**ECLAC** Economic Commission for Latin America and the Caribbean
**EU** European Union
**FTAA** Free Trade Area of the Americas
**GATT** General Agreement on Tariffs and Trade
**IDB** Inter-American Development Bank
**IMF** International Monetary Fund
**ISI** Import Substitution Industrialization
**MERCOSUR** Southern Common Market (Spanish)
**MERCOSUL** Southern Common Market (Portuguese)
**NAFTA** North American Free Trade Agreement
**OAS** Organization of American States
**OECD** Organization for Economic Cooperation and Development
**WTO** World Trade Organization

# CHAPTER ONE

## The MERCOSUR and the Creation of the Free Trade Area of the Americas

**Fernando Lorenzo**, ***CINVE***
**Marcel Vaillant**, ***Universidad de la República (DE/FCS)***

### 1. INTRODUCTION

Many studies that have tried to examine the process of the construction of the Free Trade Area of the Americas (FTAA) have been limited by the vast agenda of subjects, countries, and negotiating positions involved. The complexity of the process would seem to require the development of a new perspective. Recent events suggest that focusing on the most important bilateral relations involved is a suitable strategy to use both for the analysis and for the negotiation process itself.

Our central premise is that, considering the asymmetries in market size of the countries involved, the most important bilateral relation on the continent is that between Brazil and the United States. Brazil has formally committed its common trade policy to the MERCOSUR, and past and present Brazilian governments have manifested and put into practice a policy of strengthening the negotiating posture with third markets by having a single voice for the whole MERCOSUR. In this context, the bilateral relation between the United States and the MERCOSUR takes on even more importance.

The population of the United States is 1.3 times larger than that of the MERCOSUR countries and the per-capita product is around 8 times greater, which gives it an economic weight more than 10 times that of MERCOSUR. But clearly it is potentially the United States' most important trade partner on the continent (even more important than Mexico and Canada considered separately).

Although the United States has not ignored MERCOSUR as a valid voice in the FTAA negotiations, it has preferred to orient its efforts toward the continental ambit. There has recently been an indication that bilateralism could become the new element in bringing dynamism to the negotiation process; see, for example, the recent FTA between Chile and the United States and also the acceleration of trade negotiations with the Central American and Caribbean countries in 2003.

The objective of the project that gives rise to the present book is to analyze the economic incentives, on the social and on the private level, of the different alternatives for trade liberalization. That is to say, information is processed to deeply understand the different negotiation scenarios, the bilateral as against the plurilateral alternative, considering aggregated as well as particular national interests in each country/region. The integration process involves many subjects (the harmonization of domestic policies on competition, environmental and labor standards, intellectual property, and so on) and sectors (now including services). Although many of these issues are mentioned and discussed, the focus here is on the changes in market access associated with the proposed liberalization of the trade opening for goods, the area in which MERCOSUR has its clearest interest.

This chapter is organized into two parts that tackle the issue from complementary perspectives. Section 2 deals with the negotiations, the trade patterns, and the global evaluation of the most interesting of the different possible alternatives. The overall organizing criterion has to do with effects on collective welfare, abstracting distributive impacts at the sectoral level, and other considerations that the countries may have in carrying the negotiations forward. These concerns are the focus of Chapters II through IV of this volume. Section 3 is an analysis of the political economy of the bilateral negotiations between the United States and MERCOSUR. Perspectives that are sectoral and also specifically national are developed, particularly with regard to the United States and Brazil, the two central actors in the trade negotiation process. These are the concerns dealt with in Chapters V through X of this book.

## 2. TRADE AND WELFARE

### MERCOSUR and the Agenda of International Negotiations

Since its creation in 1991, the MERCOSUR has conceived of regional integration as the fastest way of advancing the process of economic development with equity, in an international context characterized by consolidation into large economic blocs. The process of trade liberalization is a complex phenomenon that includes unilateral opening, multilateral negotiations, and plurilateral preferential agreements.

MERCOSUR's agenda over the next few years will include hemispheric negotiations on the Free Trade Area of the Americas (FTAA), potential separate negotiations with the United States in the "4+1" format (the United States plus the MERCOSUR countries), multilateral negotiations within the framework of the WTO, and ambitious negotiations with the European Union. In South America, MERCOSUR has incorporated Bolivia and Chile as "associated" countries, and has proposed negotiating a free trade area with the countries of the Andean Community of Nations (CAN).

The progress that the MERCOSUR countries made in their own integration process has been a positive contribution to the progress of their external negotiations, since the member countries demonstrated their ability to negotiate, and this increased their credibility. However, in the last few years, these countries have had internal problems that have led to delays in completing their customs union; this has damaged the bloc's credibility and affected its power to negotiate externally.

Although MERCOSUR'S external strategy is the result of compromise among diverse national interests, the bloc as a whole has been able to present a common front in the main negotiations on its agenda (WTO, FTAA, European Union). In particular, it is important to highlight the countries' common position on the question of agricultural protection in the developed countries. As far as the FTAA is concerned, the MERCOSUR countries agree on the importance of gaining access to the US market, and on the premise that the FTAA will be beneficial only if the United States effectively opens its market.

In Chapter II Lorenzo and Osimani analyze the different stages in the process of creating the FTAA. It is currently in the fourth phase, called the end of negotiations, which will run from November 2002 until January 2005, and in it the countries' offers are being negotiated so as to obtain final approval; the presentation of revised and corrected offers will take place on 15 July 2003.

Although the individual MERCOSUR countries have shown different degrees of enthusiasm for negotiations in the FTAA framework, their participation in these talks is inevitable. Staying out is not a feasible strategy because other countries are participating in the negotiations. The MERCOSUR members are aware that the best solution is to work as a bloc, as this strengthens their negotiating power. However, the fact that the FTAA will erode the intraregional preferences that each country has inside the MERCOSUR area cannot be ignored.

For the bloc countries, resolutions on the points of the "old agenda" (market access, agricultural goods, antidumping trade rules, and so on) are of fundamental importance. The question of market access is crucial to them because many of their export products are subject to high tariffs in the markets of many of their potential partners in the FTAA. In fact, these products are even subject to nontariff barriers in the US market. MERCOSUR exports of textiles, clothing, and footwear are in an unfavorable position there compared to exports from Central America and the Caribbean, which enjoy preferences in the US market. In spite of the importance of this question, no substantial progress on it has been made in the FTAA negotiations.

The United States and the MERCOSUR have divergent positions on the subject of agricultural products. The United States maintains a policy of supporting its own agricultural production with direct subsidies to producers and for exports. In 2002, the US Senate approved a Farm Bill that meant a rise in those subsidies. This policy has been particularly prejudicial to MERCOSUR because the bloc has clear competitive advantages in these products. This obstacle worsens the outlook for negotiations in this area. It is true that the United States is disposed to discuss its agricultural policy, but only in a multilateral ambit like the WTO. It considers this subject relevant also to its relations with other developed countries, like those in the European Union and Japan.

The negotiations will probably be beneficial for the MERCOSUR countries if the discriminatory costs that affect them are eliminated. A comparison of access conditions to the US market shows that the MERCOSUR countries are less favored than those in the Latin American Integration Association (LAIA) with respect to trade preferences, and that they are the most affected by nontariff barriers. This discrimination has become a strong incentive to negotiate within the FTAA framework. Another major pending negotiation is about rules of origin. In the creation of a free trade area, it is essential to reach a consensus on this issue, which involves the consent of various actors that have divergent interests.

The negotiation of a "4+1" type of agreement between the MERCOSUR and the United States means similar benefits when it comes to market access, so this kind of negotiation is also on the bloc's external agenda. For this reason, every countries in the bloc, including Brazil, has considered a bilateral agreement with the United States. However, as in the case of the hemispheric agreement, the MERCOSUR countries do not all share the same opinion as to the suitability of such an agreement. In 2001 and 2002 the countries showed considerable interest in establishing better relations with the United States, and this strategy of initiating negotiations in a more reduced sphere confirms the importance of the relationship between MERCOSUR and the United States. The depth and direction of negotiations in this format will be key elements in understanding whether this alternative will be complementary to and compatible with the FTAA process.

## Characteristics of the Trade Pattern

In Chapter III Osimani describes the pattern of bilateral trade between MERCOSUR and the other countries on the continent. In the first ten years of MERCOSUR's existence, there was an important increase in intraregional trade as well as in trade with third countries. Although imports and exports both grew considerably, imports increased more in terms of current dollars. To a large extent, the expansion in the 1990s was related to the fact that the MERCOSUR countries opened their trade to the rest of the world. Another factor, as far as imports are concerned, was the effect of stabilization programs based on the exchange rate used as the nominal anchor.

In the 1980s, total exports grew at a cumulative annual rate of 4.4%, but exports to the MERCOSUR countries grew at a lower rate than those to third countries (the European Union, the United States, and Canada). In the 1990s, exports grew at a cumulative annual rate of 5.6%, but this time they increased among the MERCOSUR countries and in trade with Chile, Bolivia, and the rest of the Americas (excluding the United States). At the same time, the rate of growth of exports to countries of the European Union and to the United States fell.

The growth rates of imports also differ before and after the creation of MERCOSUR. In the 1980s, growth rates were lower because the economies were less open and there were external restrictions. These characteristics changed after MERCOSUR; an improvement in the currency exchange rate and a reduction in tariffs for third countries led to a considerable increase in imports, which grew at a cumulative annual rate of 10% in the 1990s.

The greater share of intra-MERCOSUR exports is in manufactured goods with economies of scale and those based on natural resources. Manufactured goods have also had more weight in exports to other countries involved in the FTAA process, where exports are more diversified and there are also better possibilities of intraindustrial trade. On the other hand, exports to the European Union have followed the more traditional pattern of a high proportion of primary goods.

Manufactured goods account for most of MERCOSUR imports (90% in 1997), especially goods with a high technological content and associated diffusion of technical progress. In second place come goods with economies of scale. Primary goods have a larger share in intrabloc imports. In imports from the FTAA, manufactured products have the greatest share; goods connected with the diffusion of technical progress make up 48% of the total, and goods with economies of scale and those based on natural resources account for 25%. Imports from the European Union also have a high content of manufactured goods, with the largest single category of goods with a high technological content. Primary goods have great weight in imports from the rest of the world due to the purchase of energy products.

To analyze the trade between MERCOSUR and the rest of the FTAA countries, the trade intensity index is used. The import intensity index measures the share of imports from the FTAA in total MERCOSUR imports, in relation to exports from the FTAA (net of MERCOSUR) in total world exports. The evolution of this indicator shows that, during the second half of the 1990s, the potential partners in the FTAA sold 1.5 times more to MERCOSUR than they exported to the rest of the world. However, it has to be borne in mind that this intensity shows differences between the various countries considered; it is higher for the CAN countries (especially Chile) and the United States, and lower for Canada and Mexico. The analysis of MERCOSUR imports compared to exports from its potential partners in the FTAA suggests that an agreement that would facilitate access to the MERCO-

SUR for the FTAA countries, in particular those belonging to NAFTA, would be beneficial.

The export intensity index is defined as the share of MERCOSUR exports to the rest of the FTAA countries in relation to the weight of imports from these countries in the world total. This index shows that the share of exports from MERCOSUR to the FTAA is greater than 1 but never exceeds 1.3. Again, the greatest intensity is found for Chile and the CAN countries, while Canada and Mexico have the lowest intensity. The analysis of the data on import intensities suggests that an agreement that facilitates the entry of MERCOSUR exports into new markets, especially those of the NAFTA countries, would be beneficial.

Another important factor used in evaluating the ex-ante impact of the formation of the FTAA is the degree of trade complementarity among the members. This can be analyzed through the so-called complementarity index, which is the result of the differences in trade specialization of two countries. When the composition of one country's exports is specialized in a way similar to the structure of the other country's imports, the bilateral trade between those two countries will be more intense. This is the complementarity effect precisely. Trade intensity is also the result of differences in transaction costs between the partners. Therefore, the intensity index can be expressed as the product between the complementarity index and an index of nonexplained biases.

The pattern of exports to the United States from all the FTAA countries that are members of the LAIA is characterized by a high rating on the complementarity index, but the pattern by subregion is more differentiated. Although Mexico is very connected with the United States as far as exports are concerned, the countries of the Andean Community of Nations (CAN) are less connected, and there is nearly no bias for Chile and the countries of the MERCOSUR. This means that the United States weighs the same in exports from the MERCOSUR and Chile as it does in world trade. The changes that occurred between the 1980s and the 1990s reinforced the structural pattern of the exports from the countries in the region. Mexico moved closer to the United States, the CAN countries did, too, but to a lesser extent, while the MERCOSUR countries and Chile became more distanced. In the 1990s, geography was reinforced by trade agreements; these are tighter and more discriminatory the closer together the countries are geographically.

For MERCOSUR exports to its potential FTAA partners in 1997, the complementarity index and the intensity index were both close to 1. This means that there were no biases related to transaction costs in bilateral trade. When exports to Chile and to the CAN are considered, the greater intensity of the index is explained both by greater complementarity and by lower transaction costs. As for exports from the United States, the intensity index was greater than 1, and when the FTAA (excluding the United States) is considered, the index was 3.65 in 1997. This means that the participation of exports from the United States to the other FTAA countries was nearly four times greater than the participation of these countries in world imports (excluding the United States).

## Impact of the Agreements and Alternative Strategies with Respect to the Agreements

According to the simplest models the effects on welfare of the formation of a free trade area (FTA) are the result of the balance between trade creation and trade diversion. The terms-of-trade effect must also be taken into account. When there are preferential agreements that were in force between countries prior to the FTA, evaluation is more complex because the new agreements can have a positive effect in reducing the costs of trade diversion related to the old agreements, as well as a negative effect in reducing the benefits associated with preferential access.

In this context, two extreme cases can be considered. On the one hand, is a case that can be called an FTA with *reduced protection;* this is when a big partner improves its access to the market of an importing partner, and can satisfy all the demand for imports at the price prevailing in that market. In this case, the net effect of the creation of an FTA is clearly positive for the area as a whole and for the rest of the world. On the other hand, there is the case in which the formation of an FTA means an increase in protection, that is, *enhanced protection.* This occurs when the exporting country is small and the importer is big, so the former's production is not enough to satisfy the latter's demand for imports at the price prevailing in the exporting country. The formation of the FTA allows the small country to reorient production toward the big country at the higher price prevailing in it. In this case, the net effect of the FTA is negative: part of what the importer country loses by trade diversion is compensated for by what the exporter gains from the increase in tariff income and the producers' surplus, but there is a net loss because the FTA reduces imports (at a lower price) from the rest of the world. There is a reallocation of inefficient resources for the FTA, since it discriminates against the rest of the world.

What happens is that the formation of an FTA erodes the prevailing advantages that stem from preferential agreements with other partners. In the case of an FTA with reduced protection, exporters who previously benefited from preferential access lose access to the market, and the costs of trade diversion go down. In the case of an FTA with enhanced protection, the importing country would increase trade diversion while the welfare of the countries which exported under protection would not change.

The simulations carried out in Chapter IV by Laens and Terra allows these arguments to be brought into the discussion of the effects on MERCOSUR of the formation of the FTAA. Simulating a discriminatory unilateral opening on the part of each country of the bloc vis-à-vis the rest of the FTAA, the effects of the creation and diversion of trade on the country which opens, and the effects of the erosion of preferences on the other members of MERCOSUR, can be estimated, added to the income effect derived from the increase in efficiency. The changes in the other members of the FTAA measure the "market access" effect. Access to the market for each member can be measured by simulating a simultaneous opening by all the members of the FTAA while MERCOSUR does not follow suit.

Among the countries that are negotiating the FTAA there is a complex network of bilateral or subregional agreements, including agreements within the framework of the LAIA, the NAFTA, the Central American Common Market (CACM), and the Caribbean Community (CARICOM). Similarly, Canada and the United States concede nonreciprocal preferences to most of the countries in the region in the framework of the Generalized Preference System (GPS). In addition to this, the United States concedes preferential treatment to certain countries, as in the Caribbean Basin Initiative (CBI) and the Andean Trade Preference Act (ATPA). Consequently, the tariffs that are in fact applied to trade in the hemisphere are considerably lower than the Most Favored Nation (MFN) tariffs, which are normally taken as the starting point in FTAA simulations.

It is predictable that, when prior preferential agreements are taken into consideration, the gains from the creation of the FTAA are significantly less, except for the United States and the other NAFTA countries.

Likewise, the losses for the countries that do not participate are lower. The countries that enjoy preferential agreements on access to the large markets in the region are harmed by increasing competition; for Uruguay and Chile the net effect on welfare becomes negative, and the gains of the countries that make up "the rest of the Americas" are seriously eroded. The opposite occurs for the United States; its welfare increases because it benefits from improved access to other regional markets without ceding any significant advantages as regards access to its own market because it has already awarded preferences to its trade partners.

The debate about MERCOSUR's trade insertion ranges from the FTAA, the possibility of creating a South American Free Trade Area (SAFTA) with the formation of a free trade area with the CAN, and the negotiation of agreements with the United States under the "4+1" format. Even though its impact would be small, the FTAA would seem to be the most suitable option for MERCOSUR. According to the simulations, the gain with the FTAA would be 0.26% of total consumption, compared to 0.18% for the SAFTA, and 0.19% for the sum of all the other options. However, these figures include the effects of agreements that have been fully negotiated and whose schedules for trade liberalization are already under way (although the full agreements had not been implemented by 1997). This is the situation of the full completion of MERCOSUR and of total liberalization in the CAN, and the effects of these should be deducted.

An agreement with the United States would have a positive effect for MERCOSUR, but the potential gains would be only slightly greater than those that would flow from a MERCOSUR-CAN agreement. Brazil would be the main winner, there would be a negative impact on Argentina, and Uruguay would hardly be affected at all. The effects of a SAFTA (equivalent to an FTA between MERCOSUR and the CAN) on MERCOSUR's welfare would be clearly positive. For Argentina and Uruguay, this option would be better than a "4+1" agreement with the United States, while for Brazil the welfare effects would be much better with the "4+1" agreement. These results contradict the positions that the countries of the bloc have taken up in the negotiations, and they seem to suggest that besides trade there are other interests in play that are of an economic or political nature. However, it should be borne in mind that this is only a static analysis, and the possibility of significant dynamic effects cannot be discounted.

The MERCOSUR countries have placed a lot of emphasis on defending the liberalization of agricultural trade, and this has brought them into conflict with the United States, which is refusing to negotiate this question within the framework of the FTAA. A comparison of the welfare effects of a total FTA with an FTA that excludes the agricultural sector shows that all three options (the FTAA, the MERCOSUR-CAN agreement, and the MERCOSUR-United States agreement) are positive for MERCOSUR, but it gains much less if the agricultural sector is excluded. Although this is still true for Argentina and Brazil taken individually, surprisingly it is not for Uruguay. This is because Uruguay's preferences in the Brazilian market, one of the main destinations of Uruguayan exports of meat and other agricultural products would be eroded.

Chapter IV allows some conclusions to be drawn with regard to the impact the FTAA could have on the MERCOSUR countries. First, the results of the simulations indicate that the effects of the FTAA on welfare in the MERCOSUR countries are small, and that they have been overestimated in previous studies because they did not take into account existing preferential agreements. Second, the results show that the difference between trade creation and trade diversion is negligible for Argentina and Uruguay, and very small for Brazil, while the "market access" effect assumes greater importance. The erosion of the preferences that Argentina and Uruguay enjoy in the Brazilian market has a strong negative impact.

Third, it can be proved that the consequences of an FTAA have been overestimated (even when the preferences prevailing in 1997 are taken into consideration) because of liberalization schedules that have been negotiated in other subregional agreements that are not attributable to the FTAA. This means that the most important negotiations for the MERCOSUR are those with the United States and the CAN. These results seem to stand in contradiction to the stances that the MERCOSUR countries have adopted in the FTA negotiations (except for Brazil, which has promoted an FTA in South America and seems less enthusiastic about the FTAA negotiations).

Last, the exclusion of the agricultural sector from the FTAA negotiations reduces the potential gains that Argentina and Brazil would enjoy from this agreement. This is not the case for Uruguay because of the importance of its preferential access to Brazilian agricultural markets. However, it ought to be borne in mind that that the simulations here focus exclusively on tariff reduction, and ignore the question of agricultural subsidies.

## 3. THE POLITICAL ECONOMY OF THE NEGOTIATIONS

### Winners and Losers in a Bilateral United States-MERCOSUR Agreement

In Chapter V Vaillant and Ons focus on the characteristics of the political economy of an FTA of this kind. With this objective, they develop a methodology that allows them to study the welfare effects of a bilateral agreement by identifying the sectors that would encounter the most problems and those that would be most favored by a trade agreement. A general typology of the changes under different protection regimes in an eventual free trade area between the United States and MERCOSUR is developed (enhanced protection versus reduced protection and trade diversion versus trade creation). This methodology utilizes data on trade and production, and it allows the typology of goods in each of these categories to be determined empirically. The work is carried out at a high level of disaggregation so as to be able to identify the reciprocal sensitive sectors. The results constitute an objective base for analyzing the lists of exceptions that the trade agreement would entail.

They construct two lists of products (Harmonized System to 6 digits), one expansive and the other defensive, for each of the participants in the FTA agreement. The expansive list includes the trade opportunities (increase in production caused by the expansion of exports), and the defensive list includes the trade perils (contraction in production due to the expansion of imports) that could result from trade liberalization. Governments will try to include in the agreement those products that constitute opportunities and exclude those that are identified as perils.

The authors propose a mercantilist perspective, like the one that is currently being put into practice in trade negotiations. This standpoint supposes that exports are good and imports are bad, although it is well known that, in terms of welfare, the exact opposite is true. But the idea is to identify, and so rationalize in terms of the traditional economic effects of economic integration, the mercantilist focus. The theoretical reference is the model of the political economy of trade policy

(Grossman and Helpman 1994 and 1995, cited by Vaillant and Ons in this volume) applied to the political economy of free trade agreements. From the point of view of the viability of the agreement, the interests to identify are those of producers, who may be against the agreement, defending their domestic market, or in favor of the agreement, seeking to export more to the new trade partner.

In the example, two countries/regions, A and B, that are negotiating an agreement are considered. It is supposed that the area in question is small relative to the rest of the world, so international prices are given. Without loss of generality, a certain product *i* is considered for which A is the more inefficient producer. That is to say, A is an importer, while B is a less inefficient importer or a producer that is as efficient as the rest of the world (it could be an exporter). The effect of including this product in the trade liberalization agreement depends on the extent of the offer from B in relation to the demand for imports in A. The differences between the prices in each country reflect the differences in efficiency.

There are asymmetries in size between the economies that would be integrated, and it is of particular interest to consider these for an FTA between MERCOSUR and the United States. They have been explicitly introduced into the analysis through the identification of three protection regimes: enhanced protection, reduced protection, and the intermediate case.

Enhanced protection represents the situation when, at the domestic prices prevailing in A before the agreement, the offer from B is not sufficient to satisfy demand. Reduced protection occurs when, at the lower prices which prevail in B, the offer in this market is greater than the demand for imports in country A. Last, the intermediate case occurs when the offer in B is greater than imports into A, at the higher price which prevails in A before the agreement is made, and less at the low price in country B.

Under each protection regime, the economic effects on the interests of producers (which are those that have to be considered when applying a political economy focus) in each country are quite different. Under enhanced protection, the producers in country A will not be affected because the domestic price does not change, so their level of protection remains unchanged. On the other hand, the producers in B are positively affected because now they can export to their trade partner at the higher protected price in the other market. That is to say, an expansion in production is expected, led by an expansion in B's exports. Consumers in A will be worse off due to the trade diversion effect, and consumers in B may be better off if domestic production is substituted by more efficient production from the rest of the world. The FTA as a whole is worse off. However, these products are good candidates to be included in the agreement by virtue of the fact that they have a favorable political economy; there is no lobby against in country A, and there is a lobby in favor in country B.

Under reduced protection, it is the producers in country A who are negatively affected. Country A stops importing from the rest of the world and starts importing everything from the local area, therefore the price in country A falls to the level of prices in B. Producers in country A are negatively affected. With the free trade area they enjoy less protection than they had in the initial situation, and in this sense the agreement does liberalize trade. Consequently, producers in country A will have to reduce production because of an increase in imports from country B. At the same time, the producers in B will not be affected; they are going to trade at the same price after the free trade area is set up as before. Last, the FTA as a whole will be better off as a consequence of trade creation effects (consumers in A may be better off, and consumers in B will be better off if this country is inefficient). This product is a good candidate to be excluded from the agreement insofar as the producers in A are against it, and the producers in B are not applying pressure to be included.

With the creation of a free trade area, governments have to effect a balance between those who find their access to the new partner's market improved (opportunities) and those who lose protection in the domestic market (perils). The methodology used to select these involves three steps: identify products with trade complementarity, identify those that will undergo a significant change in trade preference (sensitive products), and differentiate the protection regimes, and thus the opportunities and the perils, in each country.

In the case of Argentina, the industries in the group with high trade complementarity account for approximately a quarter of exports; around 80% are in the agricultural and fuel sectors. For Brazil, this group makes up about half of the exportable offer, and various manufacturing sectors predominate in it. Only 10% of Paraguay's exports are in this category, and these are mainly agricultural. A quarter of Uruguay's exports have high trade complementarity with the United States, and they are very concentrated in the agricultural sector. Last, the products with high trade complementarity that are exported from the United States to MERCOSUR constitute about half its exports to the bloc, and manufactured goods dominate completely, with around 90% of the total.

When a comparison is made of the total exportable offer of each country, the group of goods with trade complementarity, the group of sensitive products, and the different protection regimes, we find very differentiated levels of access to other markets. In fact, although the overall tariffs that the total exports of each MERCOSUR country face in the United States are lower that those applied to US exports to the MERCOSUR, this relation is drastically inverted when the group of sensitive products is considered. For these products, it emerges that the United States should make much greater tariff concessions, and this is particularly so between Brazil and the United States.

In light of the asymmetry in market size between the two economies, MERCOSUR and the United States, the original conjecture of this study was that exports from the United States would enter MERCOSUR under a reduced protection regime (production in the United States is greater than MERCOSUR's demand for imports at the new prices prevailing in the FTA), but MERCOSUR exports would enter the United States under an enhanced protection regime (imports from the United States are greater than the domestic offer in the MERCOSUR countries).

The central characteristics of the political economy of the agreement based on the above conjecture can be summed up as follows:

- Exporting industries in MERCOSUR will be in favor of the agreement (opportunities) and producers in the United States will be indifferent.

- Import substitution industries in MERCOSUR where the United States is the exporter will be against the FTA (perils for MERCOSUR) and producers in the United States will be indifferent because they will continue to sell at the same price.

- Consumers in the MERCOSUR countries will gain as a consequence of the trade liberalization, and consumers in the United

States will lose as a result of the trade diversion effect associated with an increase in the price of MERCOSUR exports, which means a loss in tariff income that is transferred to the smaller economy.

A first conclusion of the study is that, in the case of US exports to MERCOSUR, the conjecture was confirmed for all products. However, the majority of sensitive exportable products from MERCOSUR to the United States are classified as in a reduced protection regime, and therefore those products constitute perils for the United States. Consequently, it is logical to expect opposition to the agreement from the corresponding group of producers in the United States. On the whole, a possible FTA agreement would be liberalizing in both senses; this does not mean that trade diversion costs would not be incurred in certain exports of manufactures from MERCOSUR to the United States (which would enjoy more protection in the bigger market) or in sectors that would eventually take advantage of the reduction in trade barriers in the other market.

The political economy of an eventual agreement can be summed up as follows:

- Agricultural products in the United States would face a peril if an FTA were formed with MERCOSUR, while agricultural producers in MERCOSUR could have an opportunity, as long as the lowering of barriers in these markets had a big country effect and led to an increase in international prices caused by liberalization and the consequent expansion of demand. The agricultural products that stand out in this situation are frozen concentrated orange juice, sugar, tobacco, and bovine meat.

- There are no evident opportunities for US producers in MERCOSUR because the regional market is small. US producers enter under conditions of reduced protection, and international prices are not expected to be significantly affected by the agreement. On the other hand, MERCOSUR producers in the manufacturing sectors are faced with a clear peril in their domestic markets and in their regional exports. The main manufacturing sectors and products in this situation are machinery and capital goods, as well as some sectors in the automobile industry (engines for vehicles).

- MERCOSUR opportunities, that is to say products that would benefit from protection in the US market, are mainly concentrated in light manufacturing industries, footwear, and clothing.

To sum up, MERCOSUR producers in agricultural sectors in which the region has considerable comparative advantages and in some light manufacturing subsectors would have greater opportunities and would be in favor of the agreement, but there would be resistance from producers in machinery industries, capital goods, and transport materials. In the United States, there would be clear opposition from certain agricultural subsectors.

In general it is expected that consumers on both sides would benefit from an FTA agreement without restrictions because this would liberalize trade to a considerable extent, and a net gain in welfare on both sides can be expected. However, this is not a determinate factor from the perspective of the political economy of the agreement.

## Manufacturing, Agriculture, and Services: Sectors of Interest

An in-depth analysis of various sectors that illustrate different combinations of interests is the focus of Chapters VI and VII. Two types of sectors are chosen for goods, one with regional defensive interests, and the other with offensive exporting interests in the US market. For each sector, and in each region/country, production, domestic demand, trade flows, foreign direct investment, and sectoral employment are studied. Trade specialization indicators are prepared, and trade policy (tariff and nontariff) in the United States and in MERCOSUR is examined. The impact of liberalization (prices, domestic production, consumption, and trade) is analyzed using a partial equilibrium model, and gains and losses of consumers and producers in each case are evaluated.

Lopez and Rossi in Chapter VI identify an industry in which MERCOSUR would have a defensive interest (the region was protected), in which there is intraregional trade, and in which the United States would at the same time have comparative advantages for its exports. With these criteria, the case of the petrochemical industry was selected. This is a sector of the importer-exporter type (intraindustrial specialization and intraregional trade) for MERCOSUR, particularly for Argentina and/or

Brazil. The United States has both an exporting and an importing interest that have to do with the increasing globalization of this sector.

The study of the petrochemical industry has two objectives: to evaluate the potential trade effects of MERCOSUR-NAFTA integration in the petrochemical industry (PCI); and to quantify the welfare effects through a computable partial equilibrium model. The PCI is heavily capital intensive and there are considerable economies of scale, with high intrafirm vertical integration; there is also considerable horizontal integration. Investment is characterized by strong indivisibilities and long gestation periods. Costs and the possibility of access to raw materials (oil, gas) are key factors. The general structure of the market is of the competitive oligopoly type.

The PCI is important in all the NAFTA countries. Raw materials are abundant and cheap, and the United States is the world's largest market in this industry. The plants on the largest scale and with the most modern technology are in Canada and the United States. Protection is low, and in the 1990s there was an increase in the level of intraindustrial trade. In that same period, Mexico's production was stagnant and there was a great increase in imports.

In MERCOSUR, the petrochemical industry is concentrated in Argentina and Brazil. There has been a major change in the organization of this sector. Until the 1980s, it developed with active state participation and a high level of external protection. However, in the last decade, the industry has opened up considerably (although even today MERCOSUR tariffs are somewhat higher than those prevailing in NAFTA), with privatizations, deregulation of the market, and the elimination of subsidies. Argentina has major advantages in availability of raw materials (abundant and cheap natural gas). One of the consequences for MERCOSUR in the PCI has been the growth of intraregional trade, particularly bilateral trade between Argentina and Brazil.

Most petrochemical plants, both in the MERCOSUR countries and in NAFTA, have a scale of production that is greater than or equal to the efficient minimum in the context of the current state of technology in this sector. However, the United States has larger plants; they are up to 7 times larger than Brazil's and 20 times larger than Argentina's. In general, the plants in Brazil are somewhat smaller than those in Canada, and Argentina has plants on a scale similar to those in Mexico.

The effects of the creation of a free trade area in this industry were simulated. The results show that there would be relatively small efficiency gains: for Argentina between 0.14% and 0.37% (with respect to the size of the market) and between 0.04% and 0.12% for Brazil. The estimated reduction in production and local prices in the MERCOSUR countries is also small (less than 5% in most cases). There would be a considerable increase in imports from NAFTA (in some cases more than 100%) that would probably displace intraregional imports. Based on prices and quantities for the year 2000, it was estimated that NAFTA exports to MERCOSUR would increase by $85 million, in contrast to a $2 million increase in exports from MERCOSUR to NAFTA.

Efficiency gains would be small, probably because the current degree of openness is relatively high. Redistributive effects from local producers to local consumers predominate. The NAFTA countries have competitive advantages over the MERCOSUR countries (scale, market size, technology, etc.) and it was estimated that a large increase in the import specialization of the MERCOSUR countries would be generated in this sector. Last, it was shown that it is very important to study dynamic effects in the petrochemical sector, particularly the effects on the destination of new investment and the central role of the entrepreneurial strategies of multinational companies.

In Chapter VII Fracalanza, Nunes Ferreira, and Fava Neves analyze an industry in which MERCOSUR has advantages and the United States is a net importer that protects import substitution producers. For this, the case of frozen concentrated orange juice (FCOJ) was selected. This is an agroindustrial sector in which MERCOSUR production is greater than the import demand of the trade partner. The United States, the importing market, is big in the international economy. It follows that a reduction in impediments to trade would mean an expansion in demand and a rise in the international price. These exports enter the United States under a regime of reduced protection and it is expected that improvement in market access conditions would benefit the exporters because of a better price.

The aim of this study is to examine the allocation of resources and the welfare consequences of reduced trade barriers in the US market for FCOJ imported from MERCOSUR (Brazil). The same methodology is used as for the manufacturing sector mentioned above (a partial equilibrium model with two markets, the domestic product and the imported substitute). Two cases are analyzed, first, without effects on international prices (the small country case), and second, with effects on international prices (the large country case).

Brazil has an outstanding position in international trade in FCOJ; it accounts for more than 80% of world exports. The main destination of these exports is the European Union, which takes more than two-thirds of Brazil's total exports, after which are the NAFTA countries (especially the United States), which receive somewhat more than one-fifth of the total. In the European Union, the tariff applied to FCOJ imports is 35%; in the United States there are specific taxes that are equivalent to an *ad valorem* tax of 56.7%.

The analysis suggests that there is very strong resistance in the United States to trade liberalization for FCOJ. The most realistic case for this market is that of a large country, and it has been found that, within certain parameters, tariff reduction would lead to welfare losses in the US economy due to an increase in international prices. On the other hand, the MERCOSUR exporters (Brazilians) with the best access conditions would enjoy higher prices and would export more. As a consequence, it would be expected that strong resistance would be encountered in the North American market. As is normal in these situations, and anticipating this resistance, Brazilian producers have invested in the North American market, creating orange juice processing capacity in order to become buyers (importers) of FCOJ.

The study carried out by Berlinski in Chapter VIII focuses on services. This sector was chosen because liberalization here is clearly in the interests of the United States, while the MERCOSUR countries tend to maintain a defensive position in negotiating in these sectors. Trade in services is one of the new and important subjects in international negotiations. The same emphasis would apply to domestic deregulation, which is necessary for opening up new opportunities for trade and investment. In these sectors, restrictions on exchange center on asymmetries in domestic regulations.

Basically, trade in services in not restricted by tariffs, which makes the task of liberalizing this area more difficult. The complexity involved in identifying and quantifying trade in services requires the introduction of rules. The analysis of the rules on national treatment (NT) and most favored nation (MFN) help to identify restrictions and determine reciprocal relations. The only way to evade the MFN clause is the Annex on Exemptions, and the Council for Trade in Services examines the persistence of the motives for maintaining these exceptions. The General Agreement on Trade in Services (GATS) introduces the concept of market access (MA), thus access to the market and national treatment are specific commitments applied to the members' positive list, subject to the appropriate qualifications and conditions.

In this study, a comparison is made between multilateral concession in the GATS of the MERCOSUR countries and the NAFTA countries (particularly the United States). In each case there is a comparison with the starting point, corresponding to what was negotiated in the Uruguay Round both in MA and NT, and later, when the additional effect of Protocols 4 (telecommunications), 2, and 5 (financial services and insurance) were introduced. The overall orientation of the negotiation in services in the framework of the FTAA is also reviewed.

The GATS includes four modes of offer among members: from the territory of one to the territory of another (cross-border supply); in the territory of one to a consumer in another (consumption abroad); the commercial presence of a provider in the territory of another member (commercial presence); and the physical presence of persons from one member in the territory of another (presence of natural persons).

The FTAA agreement is of the so-called second generation type, since apart from the subjects of trade it includes domestic regulations, rules of recognition of evaluation procedures, and conformity with sanitary and phytosanitary rules. There are marked asymmetries among the MERCOSUR countries, and this makes it difficult for them to negotiate as a bloc with third parties without first going through a process of regional harmonization. However, following Brazil's lead, they are tending toward greater liberalization of the commercial presence mode in relation to the cross-border supply of trade in services. The United States has the opposite emphasis.

Since the regulations that are being debated involve domestic aspects, it can happen that, in federal states, national regulations negotiated with other countries may contradict regulations established by local governments. This problem makes it necessary to complement the negotiating process with an institutional juridical analysis that would accompany the process of liberalization in this services sector.

An important question is the maintenance of preferences that were conceded previously. Depending on the orientation of the negotiations, individual countries or groups of countries could welcome the formation of blocs with common commitments and interests. Commitments in the FTAA could coexist with other commitments that involve deeper integration. Besides this, the difference in income levels in the economies involved has to be considered. This could mean taking into account differences in the negotiations with respect to the sizes of the economies, or the possibility of nonreciprocity in agreements with countries that have high income levels.

## The Vision of the Main Actors: The United States and Brazil

In order to determine whether greater trade liberalization in the hemisphere is viable, it is necessary to characterize the positions of the main actors in this process—the United States and Brazil. The central elements of the new context in which the countries are positioning themselves are the increasingly strong link between security and trade (especially since 11 September), the economic recession in the United States, the increase in protectionism in the United States, the economic crises in the MERCOSUR countries, and the slowing down of the economic reform processes in Latin America.

In Chapter IX, Masi and Wise analyze the posture of and describe the main objectives that the United States is pursuing in the FTAA compared to its strategies and objectives in the context of NAFTA. The authors are particularly interested in determining why MERCOSUR is important for the United States in the context of the creation of a hemispheric free trade area. A group of related questions are answered in this study: Is MERCOSUR, in its format as a customs union, compatible with the trade interests of the United States in the region? Why is the Brazil-United States axis important for negotiating perspectives in the FTAA? What place do relations with Argentina and the smaller MERCOSUR countries have in the situation? What are the main points of convergence and divergence between MERCOSUR and the United States in the context of the creation of a hemispheric free trade area? In particular, the positions of the governments at the negotiation table are examined. This includes a study of the stance of the United States on the different subjects under negotiation vis-à-vis the posture of Brazil and the rest of the MERCOSUR countries.

The authors maintain that there are at least three ways to locate and justify the United States' strategy in the FTAA. First there is the idea that more trade is the answer to the needs of the countries in the region for development, for help, and for cooperation. Second is the issue of increasing opportunities to expand trade and direct foreign investment in the countries in the region, thus reducing the discrimination that prevails under subregional agreements and weakening the intensity of those countries' economic and trade relations with the European Union (the new Monroe doctrine, and the idea of a new "manifest destiny"). Third, regionalism in the hemisphere is a response to the slow progress of multilateral negotiations in the WTO. At the same time, it is understood that North America's international interests are best defined in relation to Japan and the European Union based on the framework of hemispheric integration, which is the only regionalism that would allow the economies of the region to join in the process of international economic globalization.

The benefits for the United States of the FTAA in general, and with MERCOSUR in particular, are an increase in trade, fostered by tariff reduction for competitive goods (capital and high technology goods); the opening of markets for services and government procurement issues; and a greater regional commitment on subjects that are a priority for the United States, such as the defense of intellectual property rights.

The costs for the United States, and the conflictive situations involved, occur both on the sectoral level and in general terms that cover all sectors. At the sectoral level it is clear that the United States has a group of productive activities that are much protected (particularly in some agricultural sectors and in traditional manufactures) that coincide with sectors in which the MERCOSUR countries have advantages. These sectors have put a brake on any rapid progress towards a reciprocal trade liberalization agreement.

As far as general matters are concerned, there is the traditional presence of groups that distrust this kind of trade agreement and warn of the dangers involved because they consider that such agreements erode environmental and labor rights. This position can be summed up as what has come to be called environmental dumping and social dumping. It is known that the developing countries in the region have less stringent and less committed institutional regulations than the industrialized countries on environmental and labor matters. To intensify trade with the region would mean importing goods that are "artificially cheaper" because neither environmental costs nor the adequate attention to labor rights are included. Therefore, this intensification of trade could erode domestic dispositions in these areas, resulting in a kind of "back to the bottom" leveling process. Although this argument has merit, it necessarily involves a position that is strongly protectionist and against trade liberalization. These are powerful interest groups in the United States, and they must be taken into account when it comes to identifying the points of conflict.

Another posture in the negotiations is based on the conviction that the benefits are greater than the costs. The discussion about the Trade Policy Authority (TPA) in July 1992 showed that the coalition in favor of the FTAA is made up of a heterogeneous group of sectors (agricultural, electronics manufacturing, and high technology manufacturing) that see major opportunities for expanding trade and investment in the MERCOSUR region.

Masi and Wise consider that the future of the FTAA in 2005 basically depends on four points:

- an agreement between the United States and Brazil on trade liberalization strategy;

- the kind of support the United States will give to the economic recovery of Argentina and Brazil;

- the weight and the speed of the US bilateral and multilateral negotiations, and in particular how negotiations about agriculture progress in the WTO;

- what strategy, with respect to the MERCOSUR, do Argentina and Brazil want to pursue.

The study concludes with a description of three alternative scenarios: the construction of the FTAA on a foundation of bilateral agreements; expansion and deepening of MERCOSUR and FTAA only to include Central America and the Caribbean; and a complete union of North and South in the FTAA.

Finally, in Chapter X Mezquita Machado and Ferraz discuss the challenges and risks involved for Brazilian society in the creation of the FTAA, in the model currently defined in the negotiating process. They examine the role of the government, the level of commitment, and the negotiating strategy in both the ambit of the FTAA and in a "4+1" type of agreement with the United States. They also examine some Brazilian productive sectors that are under threat (capital goods, petrochemicals, transportation equipment) in relation to others that have opportunities (paper and cellulose, steel, fruit juice, textiles).

Whether or not Brazil supports the FTAA depends to a large extent on far-reaching changes in the structure of protection in the United States. Major concessions ought to be made in areas like agricultural subsidies, legislation on and the implementation of antidumping practices, and the levels of protection for products that are defined as sensitive (Paiva Abreu, 2002, cited by Mezquita Machado and Ferraz in Chapter X). On the other hand, Brazil is wary about whether major and reciprocal tariff reduction would be the correct strategy for generating symmetrical conditions for constructing a level playing field in market access. This is because tariffs are so important in both countries for providing protection.

Skepticism about the negotiations generates fear that an FTAA could come into being without Brazil. This leads to a defensive strategy that is made up of a number of components: intensification of the subregional integration process; taking an active leadership role in MERCOSUR again after letting this weaken (in order that an agreement excluding Brazil would be equivalent to excluding MERCOSUR); and the search for extraregional agreements with other countries or regions that would also be ultimately threatened by the consolidation of the FTAA. This strategic motive explains Brazil's interest in a relationship with Europe, but that is not the only case; Brazil has undertaken many initiatives that fit in with this defensive scenario, the most significant of which are new relationships with Russia, India, and South Africa.

With respect to the impact that the FTAA agreement would have, and based on a series of previous studies, the authors group the industries into four categories. The first are those industries that would have greater opportunities if an FTAA were established, namely coffee, fruit and citrus juice, leather and clothing, steel, and part of the textile sector. The second group is formed of sectors that would be seriously threatened by the North American countries in the domestic Brazilian market and in the region; it includes capital goods, the petrochemical industry, and processed plastics. The third group comprises industries with a combination of opportunities and perils: ceramics, wooden furniture, and cosmetics. The fourth group includes industries with the dominant participation of multinational companies and in which intrafirm trade is of paramount importance, which is the case of the automobile industry, pharmaceuticals, telecommunications equipment, and consumer electronic appliances. Trends in trade flows in this group are very dependent on the strategies of multinational companies regarding the postintegration role of their Brazilian subsidiaries.

There is a general feeling that it is necessary to tread carefully in the FTAA negotiations because of the serious risk that major contractions could follow from a large-scale penetration of the Brazilian market by imports from the NAFTA countries, or of the displacement of Brazilian exports to the other countries in the region (MERCOSUR). The capital goods and petrochemical industries are two cases in point. It is feared that Brazil might become less important in the strategies of multinational companies, and that the domestic market would be supplied through NAFTA exports substituting the production of Brazilian subsidiaries, especially in pharmaceuticals, telecommunications equipment, and the automobile industry.

On the opportunities side, their study shows that an increase in exports from groups of sectors that have advantages depends on considerable concessions being made both in tariffs and in nontariff barriers, and, furthermore, that these preferences should not be extended to other competitive countries outside the continent. It is understood that the dispute in agribusiness could be resolved more satisfactorily in a multilateral sphere rather than in the specific ambit of the FTAA. As to the multinationals, there is a feeling in Brazil that this question can be resolved by negotiating with these companies on the role their Brazilian subsidiaries would have under the new FTAA rules. The potential gains from economies of scale that the FTAA would make possible are great, but it is believed that these will not be attainable in the short term.

## 4. CONCLUSION

In all the scenarios, the consolidation of MERCOSUR seems to be a necessary prerequisite to progress in the process of continental trade liberalization. The establishment of the FTAA is not seen as a substitute for the process of subregional integration. The road to follow, in a way that is realistic from a political point of view, is to understand these two processes as complementary modes for bringing about the greater integration of the MERCOSUR economies into the international economy.

The simulations confirm the theory in that they show it is universal agreements between all countries and including all sectors, rather than agreements between particular countries and only certain sectors that make the greatest aggregate gains possible. However, paths to liberalization that are based on choosing less domestic adjustment and consequently a lower political cost among the groups that are negatively affected are not necessarily the best. The domination of criteria that are exclusively mercantilist and political leads to the worst agreements, in spite of the fact that, for certain countries in certain situations, these agreements may appear to be the most attractive under the circumstances. The particular balance between the costs of trade diversion, gains in trade, and the effect of improved access to another market produces a very idiosyncratic fabric of effects on sectors and countries. Orientation toward a universal agreement is a suitable goal, but the gravitational pull of the most important bilateralism on the continent, between the United States and the MERCOSUR, cannot be ignored. An in-depth understanding of the nature of this bilateralism has been one of the aims of this project.

Negotiations between MERCOSUR and the United States are clearly complex because, in mercantilist terms, there is much to be gained and much to be lost in them. The position of the United States is characterized by the demand for greater access in certain agricultural and manufacturing sectors (chemicals, electronics, high technology, capital goods), and liberalization in services and government purchases, and by the desire to limit the extent of negotiations on access to its own market in sensitive and protected goods (steel, paper and cellulose, softwood lumber, textiles, concentrated orange juice, sugar, tobacco). MERCOSUR/'s position, which is clearly represented by Brazil, is the exact opposite.

The two industrial studies, one in each group, give a result that is in accordance with the political economy vision, but the quantification involved permits greater precision in the definition of each case. For example, the study of the MERCOSUR PCI does not expect any large contraction in that industry, and furthermore it is understood that the consolidation of the regional process itself is more important than the construction of the FTAA. On the other hand, the liberalization of

FCOJ in the United States would have serious negative consequences for that sector. This is only one example, and certainly in other cases the seriousness of the adjustments would be inverted (capital goods and paper pulp, for example).

To sum up, the possibility of the liberalizing position gaining strength depends on the favored groups (exporters and entrepreneurs disposed to invest in the other market). The extent of their power to put pressure on their own government depends critically on the options for improving access to the other partner's market. In other words, the United States has the option of going forward with an active policy of obtaining liberalization in the MERCOSUR market in the sectors and areas it is interested in, and making large concessions in its own market in sectors in which MERCOSUR has a clear interest. This would strengthen the coalition of exporters who are in favor of an agreement with the MERCOSUR and promote the liberalization and opening of the United States' own market. It will be difficult for the United States to obtain improved access in the electronic manufactures, high technology, or capital goods markets if it is not disposed to making considerable concessions in the core of its protectionist structure in agriculture and traditional manufactures that would alter the equation in favor of the other partner. What is true for the bigger partner (the United States) is also true for MERCOSUR, and this underlines the fact that international negotiations ultimately center on domestic matters.