98-432 F
May 6, 1998

# CRS Report for Congress



## Mercosur: Formation, Status, Trade Effects, Policy Challenges, and U.S. Interests

(name redacted)
Specialist in Trade Relations
Foreign Affairs and National Defense Division

### Summary

Mercosur, consisting of Argentina, Brazil, Paraguay, and Uruguay, is the third largest preferential trading group in the world. Since its inception in 1991, Mercosur has made considerable progress in integrating the economies of its members. The integration --- an almost complete free trade area and a partial customs union-- has been accompanied by a significant increase in U.S. exports and investment to the region. In general, the United States has viewed the evolution of Mercosur as being supportive of its political interests as well, although Mercosur is seen as favoring a slower approach to hemispheric economic integration. In the future, Mercosur faces challenges affecting the size of its membership, the depth of its integration, and the strength of its institutions.

### Formation

Mercosur, the Spanish acronym for the Common Market of the South, was created in 1991 by the Treaty of Asuncion. Consisting of Argentina, Brazil, Paraguay, and Uruguay, Mercosur has a combined GDP of $1.2 billion and a population of 208 million in 1997. It is the third largest preferential trade grouping in the world (after the European Union and NAFTA).[1] Brazil and Argentina are the dominant members of Mercosur. Together these two countries account for 97% of Mercosur's gross domestic product. Cooperation between these two historic rivals remains crucial to the continued viability of the trade grouping.

The 1991 Treaty of Asuncion and its amendments, embodied in the 1994 Protocal of Ouro Preto, commits the members of Mercosur eventually to form a common market. In a common market, goods, services, capital, and labor are provided free movement among its members. A sequential process to establish a common market was envisioned, with a

[1] Chile and Bolivia became associate members in 1996, adding another 21 million inhabitants and $84 billion (World Bank parity prices) to Mercosur's total.

free trade area and a customs union to be achieved first.[2] To lay the foundation for the creation of a common market, the Treaty called for the coordination of labor, monetary, tax, research and development, and industrial policies.

While Mercosur was created primarily for economic reasons, it clearly has a wider geo-political rationale as well. In drawing up their proposals for economic integration, Mercosur's charter members underlined the importance of political stability and commitment to democratic principles. Subsequently, they all proceeded to sign a "democracy clause," which ensures that only those governments that are democratically elected will be welcomed as members.[3] Mercosur was also envisioned as a mechanism to provide its members with more influence in the global trading system. In terms of trade relations, Mercosur negotiates in a united way as one single trading bloc.

## Status

For the most part, Mercosur is a fully functioning free trade area. The vast majority of goods traded among its four members receive duty-free treatment. Mercosur is also close to becoming a full-fledged customs union, but the establishment of a common market remains a fairly distant aspiration.

Mercosur has made steady progress toward becoming a free trade area. By January 1, 1995, tariffs among the four countries were eliminated on 85% or approximately 9,000 dutiable items. The remaining 15% included exceptions for sensitive products such as textiles, steel, and paper products. Special arrangements are also scheduled to remain in effect until the year 2000 for two protected sectors — automobiles and sugar.

In moving towards a full-fledged customs union, Mercosur members began implementing a common external tariff (CET) on January 1, 1995. The CET, which is imposed on imports from nonmember countries, applies to 85% of all tariff items. The maximum tariff imposed is 20% ad valorem with various rates between 2% and 18% also in effect depending on the product. The average tariff rate is about 14% ad valorem.

Computers, automobiles, and capital goods, which comprise 15% of the tariff items but a higher percentage of trade, will continue to be subject to national tariffs until the turn of the century. Capital goods will have a maximum CET of 14% effective from the year 2001 for Brazil and Argentina, and computer equipment and telecommunications goods will have a maximum CET of 16% from 2006. In addition to these general exceptions, each country has at least 300 products on which the CET will not apply until the year 2001 or 2006.[4]

---

[2]A free trade area, such as NAFTA, eliminates tariffs on intra-group trade. A customs union entails free trade among its members and a common trade and tariff policy towards the rest of the world, but it does not involve the free movement of labor among member countries.

[3]Mercosur was widely credited with keeping Paraguay on a democratic path in 1996. When a rebellious general moved against President Juan Carlos Wasmosy, Mercosur foreign ministers traveled to Asuncion and made clear he would face diplomatic and economic isolation.

[4]The temporary exemption of products and sectors from the CET implies that major (continued...)

In late 1997, in response to generalized concerns over growing balance of payments deficits, Brazil and Argentina agreed to raise the CET by 3%. Paraguay and Uruguay, both more dependent on imports than Brazil and Argentina, agreed to the increase under the condition that they be allowed to exempt up to 600 items. The 3% increase, to be in effect for 3 years, moves the average external tariff to 17% and the upper limit to 23%.[5]

Although the 1991 Treaty of Asuncion established 1995 as the date for completing the common market, the goal has not been reached, and it remains a long-term objective lacking a concrete deadline or strategy. Key issues, such as free movement of labor, have not been addressed and only minimal efforts have been made to coordinate policies among Mercosur members with respect to macroeconomic and exchange rate policies.

More intrusive economic ties entailed in a common market would require closer political relations between Brazil and Argentina. On the one hand, historic rivalries and disparities in per capita incomes, population, and educational levels could impede movement in this direction. On the other hand, Mercosur is broadly credited with bringing a number of political developments that would not have been imagined possible a decade ago. These include the movement by Brazil and Argentina to renounce their incipient nuclear programs and the decision to conduct joint military exercises.

## Trade Effects

The economic integration achieved to date — an almost complete free trade area and a partial customs union — has boosted trade among the four members of Mercosur since its inception. U.S. economic interaction with these four countries has also accelerated.

Following the establishment of Mercosur, trade among its members (intra-regional trade) has grown from about $4 billion to over $20 billion in 1997. The rate of increase since 1995 have been over 20 % per year, more than double the rate of trade growth with the rest of the world.[6]

Despite the rapid growth in trade, Mercosur countries remain relatively closed by international standards. Total trade/GDP ratios (imports plus exports as a percentage of GDP) for Mercosur averaged only 15% in 1995. Compared to the ratio of around 24% for the United States, the economies of the Mercosur countries appear to have the potential for much higher levels of trade.[7]

While many other factors are involved, Mercosur integration has not had an unfavorable impact on U.S. trade and investment flows. U.S. exports to the region have increased by over 300%, rising from $5.6 billion in 1990 to $23.1 billion in 1997. Lower

---

[4](...continued)
adjustments in the industrial structure of member countries will have to be made in the future.

[5]The Office of the U.S. Trade Representative expressed concern about this tariff increase in bilateral meetings and at the World Trade Organization.

[6]Data compiled by the Inter-American Development Bank.

[7]Leipziger, Danny M., Claudio Frischtak, Homi J. Kharas, and John F. Normand, "Mercosur: Integration and Industrial Policy," *World Economy*, v. 20, August 1997, p. 594.

trade barriers and rapid economic growth of the Mercosur economies in the aggregate (an average growth of 4.4% in 1993, 6.8% in 1994, 2.0% in 1995, 3.4% in 1996, and 4.5% in 1997) have been the primary forces driving the rapid expansion of U.S. exports.[8]

During this same period, U.S. imports from Mercosur countries have increased by only 23%, rising from $9.6 billion in 1990 to $12.1 billion in 1997. As a result of a very rapid increase in exports and stagnating imports, the U.S. trade balance with Mercosur has improved from a deficit of $3.9 billion in 1990 to a surplus of $11.1 billion in 1997, with $6.3 billion accounted for by Brazil and $3.6 billion by Argentina.

The European Union (EU) remains Mercosur's largest trading partner. EU-Mercosur trade totaled $42.7 billion in 1996, compared to $31 billion for U.S.-Mercosur trade. The EU supplied 29% of Mercosur's imports and purchased 23% of Mercosur's exports. The comparable percentages for the U.S. were 23% and 15% respectively. Since 1990, the EU and the United States both have improved their share of Mercosur's import trade (up 5.6 percentage points for the EU and up 3.7 percentage points for the U.S.), but have lost importance as a destination of Mercosur exports (down 8.5 percentage points for the EU and down 8.1 percentage points for the U.S.).[9]

Regarding foreign direct investment, the United States is by far the largest investor in Mercosur, with a stock of foreign investment totaling about $34 billion in 1996. U.S. foreign direct investment flows were almost three times greater than EU flows between 1990-1995. During this period, U.S. foreign direct investment flows totaled $21 billion compared to $8 billion for the EU. Over time, the substantially larger presence of U.S. multinational companies operating in Mercosur, mostly in Argentina and Brazil, could help the United States gain a larger share of Mercosur's import market as those companies increasingly source inputs and machinery from affiliates located in the United States.[10]

## Policy Challenges

While the four Mercosur countries have made considerable progress in integrating their economies more closely, there are a number of challenges they must address to ensure continued future progress. Among these challenges are the issues of expansion, deepening, and organization.[11]

Since the December 1994 Summit of the Americas, most countries in the Western Hemisphere, with the exception of the United States, have been actively involved in expanding sub-regional trade groupings. Mercosur has been the most active. During 1996, Mercosur reached free trade agreements with Bolivia and Chile that are designed to serve as stepping stones for full membership into Mercosur. Preliminary talks with the Andean Community gave rise to much speculation that Mercosur would be able to expand its membership to all of South America, thereby creating a Brazil-led South American Free

---

[8]U.S. trade data compiled by the Latin American Integration Association (ALADI).

[9]International Monetary Fund, *Directions of Trade*, various editions.

[10]U.S. Department of Commerce data.

[11]For a fuller discussion, see Raman, Sujit. "Slow But Sure: The Continuing Growth of Mercosur," *Harvard International Review*, Spring 1997, pp. 52-53, 73.

Trade Area (SAFTA). This view of Mercosur's rapid expansion was also buttressed by free trade talks Mercosur was undertaking with the EU, Mexico, and Canada.

In recent months, momentum for Mercosur's expansion has appeared to falter. Bolivia's full entry into Mercosur is not scheduled to take place for 10 years. A more rapid entry by Chile has been halted by Mercosur's tariff hike of 3%. Mercosur's negotiations with the Andean countries, Mexico, and Canada have made little progress -- and these countries all have much stronger trading relationships with the United States than with Mercosur. And a decision to commence any kind of formal negotiations with the EU is not expected to be made until 1999.[12]

The political allure of expansion, however, is unlikely to fade away. The creation of a SAFTA could position Mercosur to play a much more important role in regional and world affairs. And the prospect of negotiating with the United States and the EU simultaneously over the terms of potentially rival free trade agreements would provide an enlarged Mercosur with considerable negotiating leverage.

Mercosur currently appears to be paying increased attention to internal challenges associated with the deepening of the integration scheme. In September 1997, Argentina and Brazil attempted to address the problem of bringing automobiles and sugar within the rules of the Mercosur free trade area. At a Presidential summit in December 1997, other efforts at deepening trade integration were made. These included a decision to begin talks at freeing trade in services over a 10-year period, as well as to begin a study on government procurement rules. The Presidents of the member countries also announced efforts to improve border crossings.[13]

A final challenge relates to the organization of Mercosur. Since its inception, Mercosur has been characterized by a top-down organizational strategy heavily dependent on presidential initiatives. Although the respective national parliaments approved the Treaty of Asuncion overwhelmingly, they have played a relatively small role in the development of Mercosur to date. Currently, each individual problem and dispute must be resolved directly by members' heads of state or foreign ministry officials. This is not only time consuming, but makes Mercosur vulnerable to domestic political agendas that may change from administration to administration. A decision made by the Presidents last December to inaugurate a formal Mercosur headquarters in Montevideo could be seen as a modest step towards addressing this problem.

## U.S. Interests

In general, the United States has viewed the establishment of Mercosur as being supportive of U.S. economic and political interests. Mercosur-inspired trade and economic reforms have contributed to the strong economic performance of member countries and helped facilitate large-scale increases in U.S. exports and direct investments in the region. Mercosur's existence, by most accounts, has also contributed to political stability and a commitment to democratic principles in the member countries.

---

[12] Hall, Kevin G. "Economic Woes Drive Mercosur to Clean Up Its Own House," *Journal of Commerce*, March 12, 1998, p. 1A.

[13] *The Economist*, "Mercosur: Back and Forth," December 20, 1997, p. 32.

U.S.-Mercosur relations, however, have been somewhat strained by differences over the tone and pace of discussions aimed at creating a Free Trade Area of the Americas (FTAA) by 2005. Most generally, Mercosur, led by Brazil, has backed slow and staggered talks in support of the hemispheric free trade goal, while the United States has supported a more comprehensive and swift negotiating approach.

A go-slow approach would provide Brazil with the opportunity to expand Mercosur into a larger South American free trade bloc. Buttressed by the diplomatic support provided by a larger Mercosur, Brazil could be better positioned to negotiate with the United States from a position of strength. This is important because Brazil and Argentina both wish to extract from the United States concessions limiting Washington's use of unfair trade practice remedies (e.g. antidumping and countervailing duties) and to improve access to the U.S. market for agricultural products.[14] In addition, because Mercosur currently protects a number of sectors (such as financial services, telecommunications, and government procurement), a longer period of time would provide these sectors with more leeway and capacity to adjust to increased import competition.

Lacking fast-track trade negotiating authority, the Clinton Administration's leverage to dominate the setting of the structure and scope of the FTAA negotiations has been arguably constrained. Most recently, at a March 1998 meeting of the trade ministers from 34 countries of the Americas held in San Jose, Costa Rica, the United States accommodated a number of Mercosur interests and demands. Argentina, for example, was named as the chair of a negotiating committee on agriculture— the creation of which was a top Brazilian priority. Significantly, Brazil was also named co-chair with the United States for the final 3 years of the FTAA negotiations. This position could provide Brazil with the power to veto any unfavorable positions or to prolong the negotiations beyond 2005. These decisions were ratified by the 34 leaders of the hemisphere at Second Summit of the Americas held April 18-19, 1998 in Santiago, Chile.[15]

The United States also gained a number of its objectives at the Costa Rican meeting. Among these were the establishment of study groups on labor and the environment, and the designation of Miami as the official site of the negotiations until 2001. But the trade-offs and compromises accepted left little doubt that Mercosur has become a strong regional grouping that is able to assert its economic interests forcefully, as well as to play a skilled diplomatic game.

Mercosur's relationship to the proposed FTAA will remain an outstanding concern. At the San Jose ministerial last March, agreement was reached that sub-regional agreements such as Mercosur and NAFTA can coexist with the FTAA only to the extent that the rights and obligations under those agreements are not covered beyond those of the FTAA. This agreement appears to fly in the face of the notion, particularly popular in Brazil, that Mercosur is an end in itself -- not a stage toward a FTAA.

---

[14]U.S. agricultural exports to Mercosur are likely to remain small compared to exports to Asia or Canada as Mercosur continues to be a net agricultural exporter.

[15]For fuller discussion, see Ahearn, Raymond J. "Trade and the Americas," *Congressional Research Service*, Issue Brief 95017 [continuously updated].