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Mercosur: Evolution and Implications for U.S. Trade Policy

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Mercosur: Evolution and Implications for U.S. Trade Policy

Summary

Mercosur is the Common Market of the South established by Brazil, Argentina, Uruguay, and Paraguay in 1991 to improve political and economic cooperation in the region following a lengthy period of military rule and mutual distrust. On July 2, 2006, Venezuela acceded to the pact as its first new full member, making Mercosur the undisputed economic counterweight to U.S. trade policy in the region, but raising questions about how it may shift regional political and trade dynamics. Collectively, the Mercosur countries have a diversified trade relationship with the world. The United States is the largest trade partner, the European Union (EU) a close second, with each claiming about 25% of total Mercosur trade. By contrast, the four Mercosur countries together account for only 2% of total U.S. trade. Including U.S. imports of Venezuelan oil, the "Mercosur 5" constitute 3.5% of total U.S. trade.

The Mercosur pact calls for an incremental path to a common market, but after 15 years only a limited customs union has been achieved. From the outset, Mercosur struggled to reconcile a basic inconsistency in its goals for partial economic union: how to achieve trade integration, while also ensuring that the benefits would be balanced among members and that each country would retain some control over its trade, production, and consumption structure. This delicate balance faced serious structural and policy asymmetries that became clear when Brazil and Argentina experienced financial crises and deep recessions. These economic setbacks disrupted trade flows among members, causing friction, the adoption of new bilateral safeguards, and a retreat from the commitment to deeper integration.

For now, Mercosur has turned to expanding rather than deepening the agreement. Many South American countries have been added as "associate members" and Mercosur has reached out for other South-South arrangements in Africa and Asia. These are limited agreements and unlikely paths to continental economic integration. Internal conflicts have highlighted Mercosur's institutional weaknesses and slowed the integration process. Uruguay has diversified its trade more toward the United States, and is showing signs of reconsidering the benefits of an "exclusive" Mercosur trade arrangement. Venezuela's accession to the pact adds a decidedly anti-American factor and may complicate both Mercosur's internal balance and regional trade relationships.

It appears Mercosur has opted for political cohesion over deeper economic integration. Mercosur, especially with Venezuela, will likely continue to resist movement toward a Free Trade Area of the Americas (FTAA), with Brazil in particular viewing the World Trade Organization (WTO) as the preferred alternative for achieving its trade policy goals. Given this impasse, it seems that the United States and Mercosur may continue to expand their influence through smaller trade agreements, presenting the possibility of two very different overlapping trading systems emerging in the Western Hemisphere centered around the U.S. and Brazilian economies. Few, if any, view this as an economically and administratively optimal alternative, presenting a formidable challenge to the future direction of U.S. trade policy in Latin America.

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On March 26, 1991, Brazil, Argentina, Uruguay, and Paraguay signed the Treaty of Asunción, establishing the Common Market of the South (Mercado Común del Sur — Mercosur) with the intention of strengthening sub-regional economic and political cooperation. Since then, Mercosur has struggled to achieve deep economic integration, but has made strides toward political cohesion and emerged as an influential voice in regional trade negotiations. In particular, Mercosur has advocated its own expansion as an alternative to completing the proposed Free Trade Area of the Americas (FTAA).[1] On July 2, 2006, Venezuela acceded to the pact as its first new full member, making Mercosur the undisputed economic counterweight to U.S. trade policy in the region, and perhaps diminishing further expectations for a hemispheric-wide trade agreement. In December 2006, Bolivia also requested to become a full member. This report examines the evolution of Mercosur's policy decisions and performance as important elements for understanding the challenges to U.S. trade policy in Latin America. It will be updated periodically.

U.S.-Mercosur Trade Prospects

The Mercosur countries are experiencing a period of strong economic growth in the aftermath of a deep recession caused by financial crises in Brazil (1999) and Argentina (2001). They currently have competitive exchange rates, stable macroeconomic conditions, and improved terms of trade, which have opened the door for significant export growth, spurred also by rising prices and demand for many of their products, particularly primary goods. Strong economic growth at home has also increased demand for imports. Brazil and Argentina are running sizable intra-Mercosur trade surpluses, with the smaller economies, Uruguay and Paraguay, maintaining small trade deficits.[2]

The Mercosur countries have a well-diversified trade relationship with the world, although the United States still accounts for much of Mercosur's rebound in trade. It is Mercosur's largest trade partner, with the European Union a close second, each claiming about 25% of total Mercosur trade, followed by Asia with 10%. It is the largest market for Mercosur exports and a major source of its capital and technology imports. By contrast, in 2005, the four Mercosur countries together

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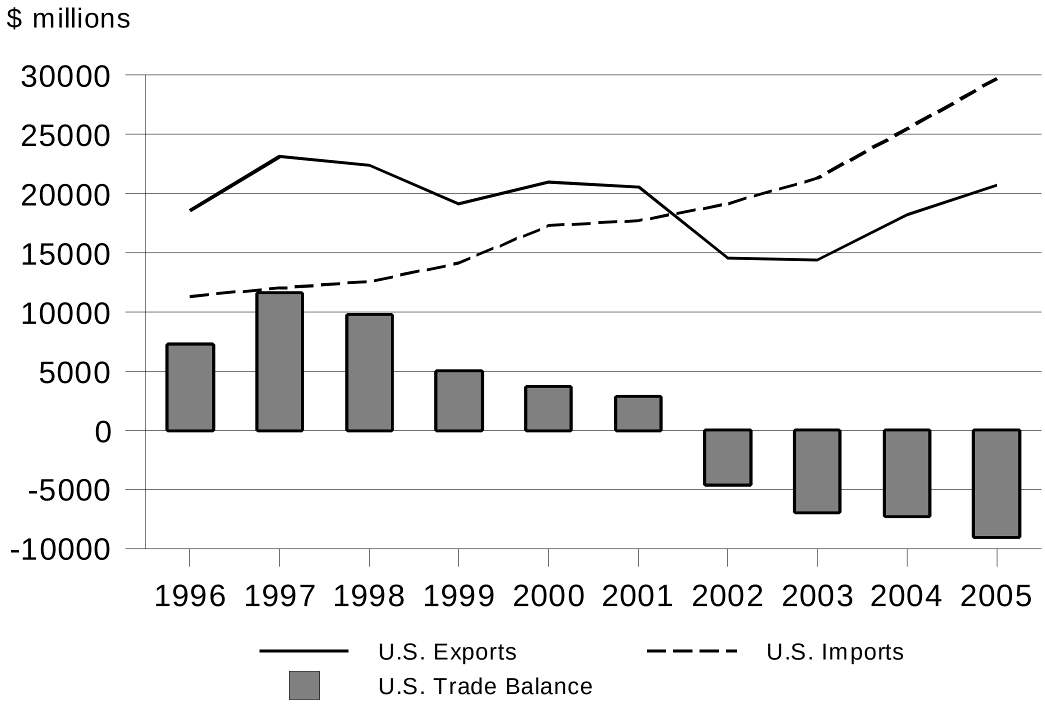
[1] For more on the FTAA, see CRS Report RS20864, *A Free Trade Area of the Americas: Status of Negotiations and Major Issues,* by J. F. Hornbeck.

[2] Inter-American Development Bank. Integration and Regional Programs Department. *MERCOSUR Report: 2004-2005*. No. 10, February 2006. pp. 21-24.

contributed to only 2.0% of total U.S. trade. With the recent addition of Venezuela, the "Mercosur 5" make up 3.5% of total U.S. trade, the increase accounted for almost entirely by U.S. imports of Venezuelan oil. Collectively, the "Mercosur 4" would rank 10^{th} for U.S. exports and 15^{th} for U.S. imports, just ahead of Brazil by itself, the largest economy in South America, representing over three-quarters of total Mercosur trade with the United States.[3]

Figure 1. U.S.-"Mercosur-4" Balance of Trade



Data Source: U.S. Department of Commerce.

Trends in U.S. trade with the original "Mercosur-4" appear in **Figure 1** (individual country data for all five appear in **Appendix 1**). It is important to remember that these trends are highly skewed by Brazil. As may be seen, U.S. imports from Mercosur grew steadily over the past decade, paralleling U.S. economic growth and the concomitant rise in U.S. demand for imports worldwide. Growth in U.S. exports was flat from 1996 to 2001, and then fell precipitously because of deep recessions in Brazil and Argentina. U.S. exports began to rebound in 2003 with Mercosur's economic recovery, but have just returned to levels attained ten years ago. During Mercosur's economic downturn, the U.S. trade balance shifted from a net surplus to deficit. Although macroeconomic trends explain most of these trade patterns, policies deterring trade liberalization remain an important issue for U.S.-Mercosur trade relations given their mutual interest in reducing barriers to trade and resolving, eventually, negotiations for a Free Trade Area of the Americas (FTAA).

The major U.S. exports to Mercosur include mostly capital and high technology goods such as mechanical and electrical machinery (computers), vehicles, aircraft,

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[3] For details on U.S.-Brazil trade relations, see CRS Report RL33258, *Brazilian Trade Policy and the United States*, by J. F. Hornbeck.

medical equipment, and pharmaceuticals. The primary U.S. imports are components for machinery and vehicles, agricultural products, and oil if Venezuela is included. Despite being a relatively small U.S. trading partner, Mercosur contains the largest South American economies, and so prospects for significant trade and investment growth may be driving the ongoing interest in maintaining cordial and cooperative relations, while also exploring avenues toward deeper Western Hemisphere integration, including the FTAA.

Formation and Institutional Development

Mercosur evolved from a series of mid-1980s bilateral agreements between Argentina and Brazil devised to foster new levels of political and economic openness and cooperation following a lengthy period of military rule and mutual distrust. As much as it may be considered a "political project," regional integration was also a response to economic stagnation, the 1980s debt crisis, and expanding regional trade agreements in the European Union (EU) and North America. The Treaty of Asunción called for the creation of a common market between Brazil, Argentina, Uruguay, and Paraguay for the stated purpose of accelerating economic development and social justice. It aims to improve living conditions in all member countries through "balanced and managed growth in trade flows."[4]

The treaty was made under guidelines of the Latin American Integration Association (Asociación Latinoamericana de Integración — ALADI). ALADI is a regional trade organization that provides a common, yet flexible framework for establishing sub-regional trade pacts that encourages inclusiveness and minimizing harm to non-members. This "umbrella" organization oversees integration pacts that are both "regional and partial in scope," in contrast to the U.S. free trade agreement (FTA) model that tends to be more comprehensive. As emphasized by ALADI, Mercosur adopted an approach based on "gradualism, flexibility, and balance," and allows for the negotiated accession of other ALADI member countries.[5]

Mercosur envisioned an incremental path to a common market, beginning with a transition period (1991-95) in which it operated as an increasingly comprehensive free trade agreement (FTA) based on a schedule of automatic tariff reductions. The formal jump to a common market was made on January 1, 1995, but in reality, Mercosur became (and remains) only a partial customs union.[6] It adopted a common trade policy and a schedule of common external tariffs (CETs) that applied to 85%

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[4] Costa Vaz, Alcides. Trade Strategies in the Context of Economic Regionalism: The Case of MERCOSUR. In: Aggarwal, Vinod K., Ralph Espach, and Joseph S. Tulchin, eds. *The Strategic Dynamics of Latin American Trade*. Washington, DC. Woodrow Wilson Center Press. 2004. pp. 234-35.

[5] Porrata-Doria, Jr., Rafael A. *MERCOSUR: The Common Market of the Southern Cone.* Durham: Carolina Academic Press. 2005. pp. 14-16.

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

of tariff line items, but with some very important exceptions for sensitive sectors such as automobiles, capital goods, computers, and other technology products. The exceptions were to be phased out by 2006, but many have been extended to 2011.[7] The achievement of a full common market remains a distant, if not illusory goal.

The Treaty of Asunción also provided for macroeconomic policy coordination and harmonization of policy legislation at the sectoral level (e.g. energy, agriculture, industry, technology). Some macroeconomic policies, such as exchange rates, have been forced toward complementarity by economic events, but differences remain significant and a designed coordination of policy is not currently feasible. The rationale for sectoral cooperation rests on inter-country factor mobility being pursued gradually, allowing comparative advantage to work, while easing the integration adjustment process. Nonetheless, sectoral issues remain a continuing challenge, especially between Brazil and Argentina.

All parties were required to accept a common set of rights and obligations (Article 2), with little allowance for special and differentiated treatment for smaller economies. There were many follow-on protocols. Among the most important was the December 17, 1994 Protocol of Ouro Preto, which formally established the common market and extended the institutional framework accordingly. Mercosur adopted a democratic commitment clause in 1996, and there were two protocols that clarified and expanded the dispute settlement process, the last being the Olivos Protocol signed on February 18, 2002, and implemented two years later.[8]

Two developments more recently may affect the institutional nature of Mercosur. First is the expansion of its membership. Venezuela was accepted as the first new full member on July 4, 2006 (discussed in detail below). In December 2006, Bolivia also requested to upgrade its status from associate to full member. Second is the announcement on December 14, 2006, of a new Mercosur Parliament to be formed and headquartered in Montevideo. It is to consist of 18 representatives from each full member country and has as its primary goal to work toward harmonization of national laws and policies.[9]

Intra-Mercosur Trade and Internal Dynamics

As Mercosur lowered tariffs, intra-Mercosur trade was expected to grow relative to trade with third-party countries. As seen in **Figure 2**, this was the initial response from 1991 to 1998, with the jump in intra-Mercosur exports also due to its growth from an initially small base, the decade's lengthy global economic expansion, and other economic reforms. There is, however, an equally evident and sudden collapse of this trend, with intra-Mercosur exports falling from 25% of total trade in 1998 to

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[7] IDB, *MERCOSUR Report: 2004-2005,* p. 70.

[8] For details on the legal documents, see Porrata-Doria, *MERCOSUR: The Common Market of the Southern Cone*.

[9] Latin American Weekly Report. *Mercosur Meeting Ends on Sour Note*. December 19, 2006. p. 7.

13% in 2005.[10] This setback reflects intra-Mercosur tariff increases in response to internal Mercosur problems and Argentina's pressure to lower the CET on capital goods, demonstrating a still strong dependence on trade with developed countries.[11]

From the outset, Mercosur struggled to reconcile a basic inconsistency of partial economic union: how to achieve trade integration, while also ensuring that the benefits would be balanced among members and that each country would retain some control over its trade, production, and consumption structure. At the heart of the problem are "natural asymmetries" that exist among four economies with large discrepancies in size, structure, resource endowment, and level of development. In addition to the absolute differences in size, relative differences fluctuate widely over time. For example, the size of Argentina's economy (GDP) tends to be half that of Brazil's, yet this metric has ranged from a high 60% in 1992 to a low of 22% in 2002 because of dramatic shifts in relative economic performance, in this case punctuated by the financial crisis and deep recession in Argentina.[12]

These structural differences can be compounded by "policy asymmetries" that arise from incongruities in fiscal, monetary, industrial, exchange rate, and other policies. Either type of asymmetry can dramatically alter commercial flows, as seen in **Figure 2**, causing large trade imbalances that can threaten the stability of intra-Mercosur relations.[13] When they operate in tandem, the Mercosur policy adjustment framework has proven to be vulnerable, particularly at times when the countries face external economic shocks.

Such a confluence of events occurred in the late 1990s following a series of external shocks, beginning with the Asian financial crisis in July 1997. It was followed by the Russian default in summer 1998, which directly affected concerns over sovereign financial vulnerability in Brazil, causing prolonged capital flight in the fall of 1998, Brazil's steep currency devaluation in January 1999, and resulting loss of its fixed exchange rate program. With Argentina's strict dollar convertibility regime still in place at the time, the two countries faced a significant "exchange rate policy asymmetry" that altered trade patterns. This was compounded by Argentina's lengthy recession that also began in 1998, leading to its own, far more serious, financial crisis. The Brazilian devaluation further exacerbated Argentina's crisis, which ended with the loss of its fixed exchange rate in December 2001.

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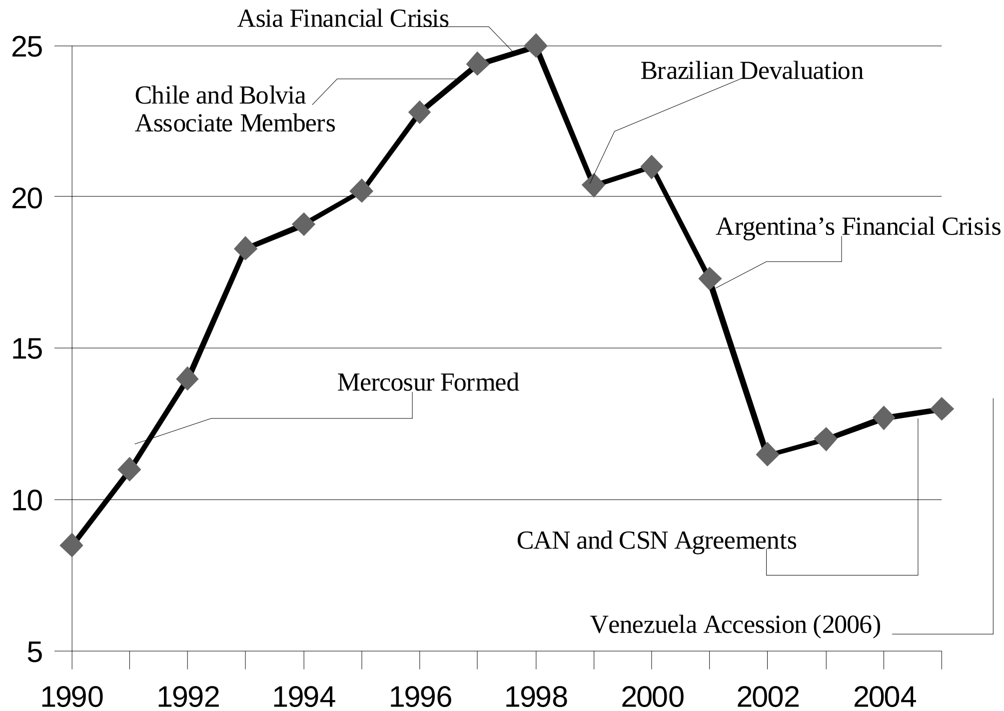
[10] By comparison exports are 60% of intra-EU trade. Intra-Mercosur trade dependence varies by country. In 2005, Mercosur captured 9.8% of Brazil's total trade (exports plus imports) compared to 26.7% for Argentina, 38.8% for Uruguay, and 50.8% for Paraguay.

[11] Phillips, Nicola. *The Southern Cone Model: The Political Economy of Regional Capitalist Development in Latin America*. London: Routledge, Taylor & Francis Group. 2004. p. 94-95.

[12] Heymann, Daniel and Adrián Ramos. *MERCOSUR in Transition: Macroeconomic Perspectives*. United Nations. Economic Commission for Latin America and the Caribbean (ECLAC). Santiago, Chile. December 2005. p. 17.

[13] For details, see IDB, *MERCOSUR Report: 2004-2005,* pp. 39-41.

Figure 2. Intra-Mercosur Exports as Percent of Total, 1990-2005



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

Mercosur's leaders, aware of macroeconomic weaknesses exposed by these crises, proposed a Mercosur Relaunch program in May 2000. It formally reaffirmed a commitment to deeper integration and those policies that had so far proved elusive, but were still necessary to reach the common market goal. The countries agreed to take the first steps toward macroeconomic coordination by harmonizing their statistics and establishing "convergence criteria" on fiscal policies, prices, and public debt. They formally discouraged adoption of measures that would restrict reciprocal trade and reinforced those that would limit recourse to antidumping investigation and would improve dispute settlement. This renewed enthusiasm soon faded, however, as it proved unable to overcome the effects of financial crises, in particular, the fall in trade between Argentina and Brazil, which accounts for 90% of intra-Mercosur commercial exchange.[14] Relations became increasingly strained, with Argentina applying temporary restrictions on Brazilian imports, further reducing trade and diminishing incentives for deeper economic integration.

Since 2002, intra-Mercosur trade has rebounded slightly with economic growth and stability, but this did not alleviate problems with intra-Mercosur trade imbalances. Argentina's prolonged recession reduced demand for imports, and so it was able to maintain a small trade surplus with Brazil even after the Brazilian devaluation. With Argentina's economic recovery in 2003, however, it began to run large trade deficits with Brazil, mostly in industrial goods. Argentine exports fell from 13% of Brazilian imports in 1998 to 8% in 2004. Brazilian exports, in contrast,

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[14] Bouzas, Roberto. Mercosur After Ten Years. In: Tulchin, Joseph S. And Ralph H. Espach, eds. *Paths to Regional Integration: The Case of Mercosur*. Woodrow Wilson International Center for Scholars. Washington, DC. 2002. p. 120.

rose from 22% to 34% of Argentine imports. The growing imbalance resulted from numerous factors: 1) new exchange rate equilibriums that favored Brazilian goods in the Argentine market over U.S. and European products; 2) a post-recession jump in Argentine aggregate demand; and 3) Brazil's export promotion policy emphasizing greater use of domestic inputs.[15]

Mercosur was meant to achieve balanced gains for its members, but there was no enforceable mechanism to guard against sudden large trade imbalances. In 2003, Argentina once again called for a managed solution to the growing and, what some feared may be a structural bilateral trade imbalance with Brazil. By June 2004, Argentina had raised trade barriers on Brazilian appliances to protect its domestic production against what it considered to be its neighbor's unfair industrial development strategy. This was done in the context of Argentina's decision to "re-industrialize" its own economy, a policy that was threatened by the sharp rise in Brazilian exports.[16]

By February 2006, over the objections of Brazilian industry, Brazil and Argentina agreed to a Competitive Adaptation Mechanism (CAM). It allows for the application of tariffs and quotas in cases where sudden increases in imports of one country are deemed to hurt an industry of the other (safeguards). The CAM is a major policy shift for Mercosur and raises multiple issues. First, it is a bilateral arrangement between Brazil and Argentina established under the ALADI system and not governed by Mercosur. Second, import restrictions represent a retreat from the stated free trade philosophy of Mercosur, increasing doubts about its ability to proceed toward a common market. Third, the CAM has no enforcement mechanism under ALADI. In short, it presents serious institutional problems and may eventually undermine the Mercosur agreement even as it attempts to restore balance to the largest bilateral relationship within it.[17]

Expanding Mercosur

As Mercosur's relaunch effort dwindled, it shifted emphasis to expanding membership. To date, Mercosur has entered into "economic complementarity agreements" with most of South America, under ALADI guidelines. Also referred to as "associate membership," this arrangement is limited largely to the long-term pursuit of a free trade agreement, supported by sectoral cooperation. It does not convey membership status per se, and while members may attend meetings, they have no voting rights, do not participate in the internal functions of Mercosur, and are not required to adopt the CET. In 1996, Chile and Bolivia, following lengthy

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[15] Inter-American Development Bank, *MERCOSUR Report: 2004-2005,* pp. 30-32. Heymann and Ramos, *MERCOSUR in Transition*, p. 20.

[16] IDB, *MERCOSUR Report: 2004-05*, p. 47.

[17] Haskel, David. Bilateral Agreements: Argentina, Brazil Start Safeguard System To Shield Industries from Mutual Imports. *International Trade Reporter*. February 7, 2006. p. 247, and Inter-American Development Bank. *Southern Common Market: New Integration and Co-operation Agreements Between Argentina and Brazil*. [http://www.iadb.org/intal]

negotiations, became the first additions as associate members.[18] Peru followed in 2003 (not implemented) and Venezuela in 2004. Mexico has observer status.

In October 2004, after years of talks, Mercosur and the Andean Community of Nations (Comunidad Andina de Naciones — CAN) signed a trade pact, giving all Andean countries the equivalent of associate membership. This breakthrough led directly to creation of the South American Community of Nations (Comunidad Sudamericana de Naciones — CSN) two months later in a pact that included 12 countries (those in Mercosur, CAN, along with Chile, Guyana, and Suriname). The CAN and CSN are limited trade arrangements and in many ways not true regional agreements. Although they have common rules adopted by Mercosur and the CAN, details on market access and other specific provisions are bilateral arrangements between each Mercosur country and the CAN. Brazil also granted numerous unilateral concessions to ensure the agreement would be completed.[19] These constraints limit prospects for deep continental integration. Nonetheless, sectoral initiatives, such as the proposed South American gas pipeline, already reflect a growing attitude of cooperation and collective self-determination that is taking hold in the region, and which now has an institutional presence in the CSN.

Mercosur's other negotiations have had mixed success. Trade talks with the European Union and the Western Hemisphere countries for a proposed Free Trade Area of the Americas (FTAA) have both come to an impasse over the inability to reach an agricultural agreement acceptable to Brazil. Brazil has also declined U.S. and EU overtures on market access for industrial goods, services trade, enforceable intellectual property rights, and investment provisions. Speculation has also turned to dwindling interest by the EU given the stalemated FTAA, the growing EU perception of Mercosur as less than a credible collective negotiating authority, and the desire by all parties for a "successful" conclusion to the Doha Round, although this appears to be increasingly in doubt. South-South trade talks have advanced only in limited form. Mercosur has begun preliminary discussions with a host of countries that include China, India, SACU, Canada, the Russian Federation, Korea, Egypt, Morocco, and Pakistan. None has moved beyond a simple framework agreement.[20]

Venezuelan Accession

On July 4, 2006, Mercosur agreed to accept Venezuela as the first additional full member of the pact, although the accession has not been ratified by all member legislatures. The accession protocol was accelerated in mid-2006 at the behest of President Hugo Chávez, who saw it as being consistent with his effort to unify South America and advance his "Bolivarian agenda" that generally stands in opposition to U.S. influence in the region.

The expedited accession approval process was unhindered by any need for consultation with legislative or businesses interests, but was initially expected to be

[18] Porrata-Doria, *MERCOSUR: The Common Market of the Southern Cone,* pp. 123-124.

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

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

longer and more involved because of two significant hurdles: Venezuela's membership in the CAN, which would not have been allowed under Mercosur protocols; and the requirement to adopt the Mercosur CET. Venezuela dealt with the first issue by defiantly withdrawing from the Andean trade pact in April 2006. Citing Peru and Colombia's negotiations for FTAs with the United States as contrary to CAN's and Latin America's best interests, Chávez left the pact specifically to join Mercosur. To address the second issue, Mercosur, under Brazil's leadership, negotiated to give Venezuela four years to comply with the CET, with other obligations of the pact not completely phased in until 2014.[21]

Mercosur may have many incentives to bring Venezuela into the fold. The addition of a fifth member adds to the economic strength of the bloc, which now represents three-quarters of South American GDP. Venezuela also promised immediate selective duty-free treatment to Paraguay and Uruguay, with no requirement for reciprocal treatment until 2013. Venezuela may increase the potential for intra-Mercosur trade as a relatively large Latin American market that also offers sectoral complementarity and energy security with its vast oil reserves and plans for a regional pipeline. Interestingly, this anticipated trade growth would likely result in part from trade diversion, or an expected offsetting decline in trade from non-Mercosur members who will face higher Venezuelan tariffs if and when the Mercosur CET is adopted.[22]

The political motivations for Venezuela's accession may be even more compelling. Until the accession is ratified by all Mercosur members, Venezuela remains a non-voting member. Venezuela does, however, have a voice in Mercosur affairs, increasing its influence on intra-pact and external trade negotiations, likely to the detriment of U.S. interests. The marginal effect may be to strengthen resolve in some countries to challenge U.S. influence in South America, although Brazil and others may prove to be moderating influences. Uruguay and Paraguay may also view Venezuela as having a diluting force on Brazil's political dominance in the pact.

Venezuela's accession, however, may have unintended regional consequences should countries outside Mercosur be put in a position of having to choose between a U.S. or Mercosur trade agreement. Peru has even suggested forming a new trade bloc, the Community of the Pacific, which would include countries with complementary trade arrangements: the United States, Canada, Mexico, the Central American countries, Panama, Colombia, Peru, and Chile.[23] This prospect may be further reinforced by Bolivia's recent request to become a full member of Mercosur.

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[21] Mercosur. Protocolo de Adhesión de la República Bolivariana de Venezuela al Mercosur. Articulo 4. July 4, 2006. Haskel, David. Mercosur, Venezuela Agree on Protocol for Caracas Accession to Trading Bloc. *International Trade Reporter*. BNA, Inc. June 1, 2006. p. 837.

[22] Ibid and Haskel, David. Venezuela's Full Membership in Mercosur Seen as Boon to Exports by Other Members. *International Trade Reporter*. BNA, Inc. August 24, 2006. p. 1262. Higher tariffs in Venezuela could also have an inflationary impact.

[23] Chauvin, Lucien O. Peru Proposes New Trade Bloc of Hemisphere Nations on Pacific Coast. *International Trade Reporter*. BNA, Inc. August 3, 2006. p. 1172.

Mercosur Internal Challenges

Two important internal disagreements currently challenge Mercosur's organizational cohesiveness. The first is Argentina's ongoing dispute with Uruguay over the planned construction of a pulp plant on the Uruguay River by a Finnish firm.[24] Argentina alleges that it is in violation of a bilateral environmental protocol the two countries signed in 1975. Although a World Bank review concluded that the plant poses no serious environmental problems and has provided $100 million in financing for the project, the issue continues to spawn protests and diplomatic flare-ups. In particular, Argentine protesters have blocked bridges over the Uruguay River, disrupting trade and tourist traffic between the two countries. Uruguay turned to the Mercosur system for dispute settlement, and a ruling by the Mercosur Ad-Hoc Arbitration Tribunal on September 6, 2006, found that Argentina had failed to live up to its commitment to ensure the free movement of people, goods, and services under the pact. The tribunal, however, did not make any awards in the case.[25]

Argentina has also filed a petition with the International Court of Justice (ICJ) at The Hague for arbitration. The ICJ denied Argentina's request for an injunction to terminate construction and set January 15, 2007, as the final date for Argentina to submit its case. Uruguay subsequently filed a counter claim, arguing that Argentina has failed to take action against the protesters. In the meantime, both Brazil and Venezuela have declined to help mediate a solution and the dispute remains a serious point of contention, raising a question regarding the institutional capacity of Mercosur to arbitrate disputes within the bloc.[26]

A second recurring challenge to Mercosur concerns perceived asymmetries in trade benefits and in the exercise of power. Both Paraguay and Uruguay have complained that Mercosur disproportionally benefits the larger countries, to the detriment of export growth in the smaller countries. In part, this is a structural element of the Mercosur agreement that promises "balanced" benefits, but which gives little in the way of special and differential treatment to the smaller economies and allows Mercosur diplomacy to occur bilaterally through presidential summitry rather than the formal Mercosur system.[27] The safeguards mechanism adopted by Brazil and Argentina is another example, pointing to asymmetrical arrangements

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[24] Originally, the dispute involved a second plant to be built by a Spanish firm. This plant has been relocated, defusing it as an issue.

[25] Inter-American Development Bank. Institute for the Integration of Latin America and the Caribbean. Dispute Between Argentina and Uruguay: Arbitration Tribunal Award. *INTAL Monthly Letter*. September 2006. This episode points to Mercosur's observed highly politicized dispute settlement and decision-making processes, which can allow for resolutions based on "political whim, unilateral action, and non-observance of agreed policy commitments." Phillips, op. cit., p. 99.

[26] One Year On, Small Dispute Threatens to Fracture Mercosur. *Latin American Regional Report. Brazil and Southern Cone*. April 2006. p. 1, Puentes, Alberto. Uruguay. *Emerging Markets Economics Daily*. July 14, 2006. p. 4, and Haskel, David. Uruguayan, Paraguayan Auto Parts Makers Ask for Bigger Share of Mercosur's Market. *International Trade Reporter*. BNA., Inc. August 24, 2006. p. 1261.

[27] Phillips, op. cit., p. 99.

despite the Mercosur principle of reciprocity in rights and obligations. The "asymmetries" issue became even more inflammatory when Argentina and Brazil decided to exclude it from the January 18-19, 2007 Mercosur summit. This decision rankled Uruguay's President Vázquez, who has decided not to attend the summit.

Uruguay has further expressed its dissatisfaction with Mercosur by threatening to expand its trade affiliations outside the pact. On November 4, 2006, following U.S. Senate approval, a Bilateral Investment Treaty (BIT) between the United States and Uruguay went into force. Uruguay also sought and received permission from Brazil to explore an FTA with the United States. It subsequently decided to pursue a Trade and Investment Framework Agreement (TIFA) with the United States when faced with serious domestic political division over the FTA option. A Joint Commission on Trade and Investment will provide the means for ongoing U.S.-Uruguay discussions regarding opportunities for specific trade deals.

The TIFA approach provides a way for Uruguay to explore expanding its exports to the United States, without diminishing its commitment to Mercosur. In the past TIFAs have also served as precursors to FTA negotiations (e.g. Chile). Uruguay has directly linked its desire to develop closer U.S. trade ties with its concern over increasing "bilateralism" that it sees developing between Argentina and Brazil. In December 2006, Argentina again criticized Uruguay for attempting to circumvent Mercosur in its quest to diversify its trade relations, likely reflecting deepening tensions between the two countries.[28]

In January 2007, Argentina also filed a complaint in the WTO against Brazilian antidumping practices related to Argentine PET resin imports, without notifying Brazil or appealing to the Mercosur consultation or dispute resolution process. This tactic again points to a lack of confidence in the institutional capacity of Mercosur to adjudicate its own internal disagreements.[29]

Implications for U.S. Trade Policy

Historically, the United States has supported Mercosur as a potential complementary path to meeting its own goal of Western Hemisphere economic integration. By reemphasizing its political goals rooted in sub-regional stability and cooperation, Mercosur, however, is evolving in ways that do not bode well for the U.S.-driven FTAA. In fact, Mercosur has taken a step backward in the commitment to its own common market by adopting a bilateral safeguards agreement between Brazil and Argentina, failing to resolve its internal bilateral economic disputes, and ceasing any pretense that deeper integration is feasible in the near future.

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[28] Haskel, David. Uruguayan President Turns Down Offer to Negotiate Free Trade Agreement with U.S. *International Trade Reporter*. BNA, Inc. October 5, 2006. p. 1440 and Argentina Blasts Uruguay's Pursuit of Free Trade with Non-Mercosur Nations. *International Trade Reporter*. BNA. Inc. January 4, 2007. p. 22.

[29] Marin. Denise Chrispim. Argentina Denuncia Brasil e Ameaca Cúpula do Mercosul. *O Estado de Sao Paulo*. Brasil. January 5, 2007.

Mercosur's recent addition of Venezuela reinforces the political focus of the pact, particularly in light of the small amount of trade between Venezuela and the Mercosur-4. Venezuela has also been allowed four years to adopt the CET, which further weakens Mercosur's claim to being a functioning customs union with all members adhering to a common set of rights and obligations. The Venezuelan accession may also rebalance the internal Mercosur power structure in unpredictable ways, raising questions over the possible effect on trade relations in the region given Chávez's open anti-Americanism and determination to create a united South America in opposition to what he terms U.S. economic and political "imperialism."[30]

Internal challenges may further continue to hinder Mercosur's ability to advance economic complementarity. Mercosur faces ongoing complaints from the smaller partners, whose rising expectations for export growth may not be easily satisfied, and who may be exhibiting lingering doubts about deeper economic integration in the aftermath of their own deep recessions caused by financial crises in the two larger countries. Uruguay's dispute with Argentina and export diversification away from Mercosur toward the U.S. market, not to mention its interest in developing closer economic ties with the United States, presents another challenge to Mercosur cohesiveness. Mercosur's new alignment with Venezuela may also point to a not-so-subtle shift in regional trade dynamics. Although Mercosur has resisted the FTAA as envisioned by the United States, Venezuela is the only country in Latin America to reject the idea unequivocally. With Venezuela's new-found status as a negotiating member of Mercosur, the United States may find it more difficult to isolate Chávez's unabashedly negative influence on the FTAA negotiations.

Both the United States and Mercosur have reacted to the impasse in the FTAA talks by expanding their influence through smaller trade arrangements. This development points to the possibility of two overlapping, if not competing trading systems emerging in the Western Hemisphere centered on the U.S. and Brazilian economies. In fact, Peru's proposed Community of the Pacific points to just such a bifurcated trading system, with one group linked by U.S.-style FTAs (Canada, Mexico, Chile, Central America, the Caribbean, Panama, Peru, and Colombia), juxtaposed with a Mercosur customs union-based pact (Brazil, Argentina, Paraguay, Uruguay, Venezuela, and possibly Bolivia and Ecuador).

Any type of dual or competing regional trading system would have awkward implications for businesses trying to operate under decidedly different commercial rules and for countries with multiple political and economic affiliations. For example, Chile has an open trade policy and announced in August 2006 that it would accept formal associate membership in the CAN, while also continuing to encourage commercial relations with both Mercosur and the United States. Talk of an Uruguay-U.S. FTA (currently focused on a TIFA) may suggest that allegiances could shift. Ecuador and Bolivia have resisted an FTA with the United States, and trade legislation passed at the close of the 109th Congress made clear that preferential treatment given to their imports under the Andean Trade Preference Act, as amended, would not be extended beyond June 30, 2007, unless they enter into an FTA with the

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[30] Obiko Pearson, Natalie. Chávez Hosts 6-Nation Trade Summit. *Associated Press*. July 5, 2006.

United States.[31] This congressional response could either convince them to rethink their position on an FTA with the United States, or push them closer to the Mercosur camp, as appears to be the case with Bolivia. Given President Lula's preference for enlarging Mercosur over pursuit of the FTAA, he would likely welcome such an opportunity.

Finally, an important question for Mercosur's future is whether Venezuela will come to be a reliable and cooperative partner within the Mercosur system, or a destabilizing influence on the intricate, yet enduring, political and economic balances that have been the main reason for Mercosur's existence. The problem with over-politicizing a trade agreement is that political issues can be narrowly focused and eventually run head on into economic realities. For U.S.-Mercosur trade relations, the issue may have to be recast from basic premises. Perhaps the decision to continue pursuing a hemispheric trade agreement may not come down to whether Mercosur or the United States need each other, but whether the two can agree anew that closer commercial and economic ties are happening with or without a formal agreement and that an FTAA might still be pursued as matter of policy for its promise of long-term mutual benefit.

[31] P.L. 109-432.

Appendix 1. U.S. Merchandise Trade with Mercosur

($ millions)

Country	2001	2002	2003	2004	2005	% Change 2004-05	% Change 2001-05
U.S. Exports							
Brazil	15,879	12,376	11,211	13,897	15,372	10.6%	-3.2%
Argentina	3,920	1,586	2,437	3,388	4,122	21.7%	5.2%
Uruguay	406	209	327	326	357	9.5%	-12.1%
Paraguay	389	433	484	623	896	43.8%	130.3%
Mercosur 4	20,594	14,604	14,459	18,234	20,747	13.8%	0.7%
Venezuela	5,642	4,430	2,831	4,767	6,421	34.7%	13.8%
Mercosur 5	26,236	19,034	17,290	23,001	27,168	18.1%	3.6%
Mexico	101,296	97,470	97,412	110,834	120,365	8.6%	18.8%
LAC*	58,157	51,551	51,946	61,465	72,407	17.8%	24.5%
Latin America	159,453	149,021	149,358	172,299	192,772	11.9%	20.9%
World	729,100	693,103	724,771	818,775	905,978	10.7%	24.3%
U.S. Imports							
Brazil	14,466	14,781	17,910	21,160	24,436	15.5%	68.9%
Argentina	3,013	3,187	3,170	3,745	4,584	22.4%	52.1%
Uruguay	228	193	256	580	732	26.2%	221.1%
Paraguay	33	44	53	59	52	-11.9%	57.6%
Mercosur 4	17,740	18,205	21,389	25,544	29,804	16.7%	68.0%
Venezuela	15,250	15,094	17,136	24,921	33,978	36.3%	122.8%
Mercosur 5	32,990	33,299	38,525	50,465	63,782	26.4%	93.3%
Mexico	131,338	134,616	138,060	155,902	170,109	9.1%	29.5%
LAC*	67,370	69,503	78,829	98,647	122,873	24.6%	82.4%
Latin America	198,708	204,119	216,889	254,549	292,982	15.1%	47.4%
World	1,140,999	1,161,366	1,257,121	1,469,704	1,673,455	13.9%	46.7%
U.S. Balance of Trade							
Brazil	1,413	-2,405	-6,699	-7,263	-9,064		
Argentina	907	-1,601	-733	-357	-462		
Uruguay	178	16	71	-254	-375		
Paraguay	356	389	431	564	844		
Mercosur 4	2,854	-3,601	-6,930	-7,310	-9,057		
Venezuela	-9,608	-10,664	-14,305	-20,154	-27,557		
Mercosur 5	-6,754	-14,265	-21,235	-27,464	-36,614		
Mexico	-30,042	-37,146	-40,648	-45,068	-49,744		
LAC*	-9,213	-17,952	-26,883	-37,182	-50,466		
Latin America	-39,256	-55,098	-67,531	-82,250	-100,210		
World	-411,899	-468,263	-532,350	-650,929	-767,477		

Source: Table created by CRS from U.S. Department of Commerce data.

* Latin America and the Caribbean, except Mexico.