TRADE AND ECONOMIC GROWTH: A LATIN AMERICAN PERSPECTIVE

by

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ABSTRACT

Although the World Trade Organization has played a significant role in world trade and in the development of world economies it has not been able to evenly distribute the gains from trade across both the developed and developing world. With the effects of the 2008 financial crises still encumbering economic growth for many countries, Mercosur members face serious challenges to accessing world trading markets, attracting foreign direct investment and promoting competition for domestic industries. As such, for Mercosur to recapture the economic growth experienced in the 1990s Mercosur must abandon hopes of achieving success through the special and differential treatment provisions within the WTO and instead pursue a trade liberalization agenda, one which includes negotiating a free trade agreement with the European Union and implementing comparative advantage based structural, social and political reforms.
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INTRODUCTION

Member countries from the South American regional economic organization known as Mercosur have recently turned back to protectionism in an effort to return their countries to economic growth.¹ It is the contention of this dissertation that for Mercosur member countries to return to economic growth this economic bloc must move beyond the World Trade Organization (WTO) and special and differential treatment and instead pursue free trade agreements with large trading blocs, such as the European Union. In addition, to achieve success in a free trade agreement Mercosur must first strengthen the organization’s political, social and economic structure while simultaneously liberalizing the region’s trade policies.

Trade has been a tool for worldwide growth since 1947 when the General Agreement on Tariffs and Trade (GATT) was created. Since the early 1950s there have been eight rounds of trade liberalization resulting in trade increasing more than twenty-seven fold in volume terms.² As a consequence, the share of international trade in world gross domestic product (GDP) increased from 5.5 per cent in 1950 to 20.5 per cent in 2006.³ The integration of the world economy has raised living standards and incomes, produced new technologies and improved social relationships especially for developing nations.⁴

³ Ibid.
⁴ George A. Bermann & Petros C. Mavroidis, WTO Law and Developing Countries (New York: Cambridge University Press, 2007).
Although trade, foreign investment and GDP have on average seen positive growth since the last quarter of 2009 overall worldwide growth has not returned to pre-2008 levels.\(^5\) The world economy continues to be weak while policy options, largely due to public debt levels remain limited. Although many developing countries in Latin America opened up their economies to trade in the first half of the century, the 2008 financial crises caused many countries to revert back to protectionism.\(^6\) In addition to refusing to dismantle trade barriers, many Latin American countries have adopted additional tariff and non-tariff measures in the belief that such policies would prop up domestic industries.\(^7\)

From GATT to the WTO, developing countries have become an increasingly more significant group in world trade, currently accounting for one-third of worldwide trade.\(^8\) Although the WTO has had a strong influence in world trade, it has not, however, been able to evenly distribute the gains from trade across both the developed and developing world.\(^9\) The economic and social benefits many developed countries have received by way of trade, such as better-paying jobs, new markets for products, better technologies and increased savings and investment have generally not been realized by developing countries.\(^10\)

\(^6\) Fredrik Erixon & Sally Razeen, Trade, Globalization and Emerging Protectionism since the Crisis. Working Paper No. 02/2010, European Center for International Political Economy [Crisis].
\(^7\) Commission, supra note 1.
\(^10\) Ibid.
Through the many negotiated WTO agreements the goal of the WTO has been to help producers of goods and services, exporters, and importers from both developing and developed countries conduct their business while allowing governments to meet social and environmental objectives. Moreover, the WTO provides rules that will allow its members to grow and prosper without restricting the development of other members. There are also numerous provisions in the WTO agreements which are meant to assist developing countries achieve similar goals. Developing countries were given special rights and shown leniency from other WTO members through the “special and differential treatment” (S&D) provisions within the WTO agreements. The purpose of S&D is to provide developing countries a greater priority within the WTO system. These provisions have allowed developed countries to treat developing countries more favourably than other WTO members. However, the implementation and enforcement of the S&D provisions have been mostly ineffective and in fact quite troublesome. The main issues with S&D are: the impeding of market access for developing countries in developed countries' markets; the failure to effectively safeguard developing countries' trading interests; persistent barriers applied by developed countries; and the technical difficulties faced by developing countries.

While countries in Latin America have recently come under economic pressure, countries in Asia have progressed and growth has continued at an exceptional rate. South Korea and Singapore for example, have been able to attract large amounts of foreign investment by sticking to a policy

11 World Trade Organization, What is the World Trade Organization, online: WTO <http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact1_e.htm>
12 Crisis, supra note 6.
13 World Trade Organization, Understanding the WTO, online: WTO <http://www.wto.org/english/thewto_e/whatis_e/tif_e/dev1_e.htm> [Understanding].
of trade liberalization and market oriented reforms. Unfortunately Latin America’s history of turning to protectionism has resulted in cycles of prosperity, stagnation and negative growth. Protectionism was not always the method of choice in Latin America. In the early part of the decade Latin American nations, such as Brazil and Argentina moved away from protectionist trade policies and opted for trade liberalization reforms. The pro-trade policies resulted in double digit growth and led to increases in trade and foreign investment resulting in a higher GDP, greater domestic competition and vast improvements in domestic production.

Although many economists see development and growth in Latin America as a fluid process around a secular trend, the reality is that it is best characterized as an intricate interaction of global shifting economic, social and political trends. Currently, Latin America faces serious challenges to accessing world trading markets, attracting foreign direct investment and promoting competition for domestic industries. In Brazil, for example, between 2007 and 2011 GDP growth slowed to 2.7% compared to 9.3% in China and 6.9% in India. To reverse this trend Mercosur members need to agree and implement a number of structural, social and political changes as well as restart trade talks with old trading partners, such as Europe. Policies which are not specific to any particular industry but rather effect larger public initiatives and

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enhance general resource endowments are most in line with the principles of comparative advantage and therefore have the best chance of succeeding.

With many European member countries slipping back into recession the time may be perfect for Mercosur to reengage the European Union (EU) in trade talks. As the European Union searches for solutions to problems within its economic model it is imperative that it finds ways to stimulate economic growth. The deteriorating economic conditions in Europe coupled with the fact that trade was one of the European Union’s founding characteristics; it is likely that the European Commission will be interested in negotiating trade deals with large economic blocs, such as Mercosur. A market the size of Mercosur would provide EU businesses with a large and stable market to sell their goods and services. As over 90% of world demand will be generated outside of the developed economies in the next 10-15 years, Latin America offers the EU an attractive opportunity.20

The dissertation is broken down into the following chapters. Chapter one will discuss the role of trade and the relationship between trade and economic development. Chapter two will review one of the most prominent theories of international trade – comparative advantage, while Chapter three will provide an overview of the general agreement on tariffs and the World Trade Organization. Chapter four will review a number of possible trade reforms in an attempt to better aid developing countries achieve economic growth. Foreign Direct Investment and its relationship to trade and economic growth will be discussed in Chapter five. Chapter six looks at the reasons for the current rush to engage in free trade agreements as well as reviewing the main arguments for and against such agreements. Chapter seven will provide a brief history of

20 European Commission, Agreements, online: <http://ec.europa.eu/trade/policy/countries-and-regions/agreements/>
Mercosur and its role within Latin America which is followed by arguments for why Mercosur and Europe should enter into a free trade agreement in Chapter eight. Chapter nine reviews the past and current trade and economic relationship between Mercosur and Europe and Chapter 10 provides a detailed analysis of some of the significant trade barriers between these two regions. Chapter 11 sets out the main arguments for why Mercosur should pursue a free trade agreement with Europe and why the current economic environment provides Mercosur with the best chance of concluding a balanced agreement. Lastly, Chapter 12 sets out the key comparative advantage inspired structural changes Mercosur should undertake in order to ensure a free trade agreement will be successful and that economic growth returns to Latin America.
CHAPTER 1: THE ROLE OF TRADE

1. Relationship Between Trade and Economic Growth

The relationship between international trade and economic growth and the role of government in influencing this relationship have been long debated issues in economics and economic policy making. Organizations such as the United Nations for Trade and Development, the World Bank, the International Monetary Fund and the World Trade Organizations have consistently argued that trade is a crucial tool for economic development.\(^{21}\) Two significant trends in the post war period changed the political economy with regard to trade relations. First, globalization has connected people from around the world and has led to the flow of money, goods, services and information all around the world.\(^{22}\) Globalization has led to increases in infrastructure and transport networks which have resulted in significant cost reductions and just in time production methods. Globalization managed, as it was in the successful development of much of East Asia, can do a great deal to benefit both the developing and the developed countries of the world. Globalization encompasses many things: the international flow of ideas and knowledge, the sharing of cultures, global civil society, and the global environmental movement. The great hope of globalization is that it will raise living standards throughout the world: give developing countries access to overseas markets so that they can sell their goods, allow in foreign investment that will make new products at cheaper prices, and open borders so that people can travel abroad to be educated and work. Secondly, regionalism has become a policy option for many countries

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and a permanent feature of the international trading environment.\textsuperscript{23} Regionalism has been largely influenced by the setbacks and lack of progress in WTO negotiations. Regional integration can be seen as a process of international restructuring by which new institutions are built, driven and shaped by numerous stakeholders. Of these, governments play a significant role. Since the end of the Cold War, there has been a resurgence of regionalism across the world which has resulted in a growing number of regional trade agreements each year. As Lawrence has argued, “regionalism promotes a deeper integration through coordination or harmonization of policies including competition, product standards, regulatory regimes, investment codes and labour standards”\textsuperscript{24}. Naisbitt has also stated that new forms of regionalism can be seen as building blocks towards the processes of economic globalization.\textsuperscript{25} ‘What is evolving around the world’ writes Naisbitt, ‘is not protectionist trading blocs designed to isolate any given region from the rest of the international players, but economic alliances that promote development within regions, while making all borders more porous.’\textsuperscript{26} These two trends are largely due to the rule based trading system developed in 1947 and the subsequent establishment of the World Trade Organization in 1995.

2. The Establishment of Mercosur and the Impact on Trade

Over the last few decades Latin American countries have experienced the liberalization of their trade and investment policies. The treaty of Asuncion which established a common market among the participating countries Argentina, Brazil, Paraguay and Uruguay (commonly known


\textsuperscript{24} Robert Lawrence (1997), Regionalism, Multilateralism and Deeper Integration, Brookings Institution, Washington.

\textsuperscript{25} John Naisbitt cited in Wil Hout, “Theories of International Relations and the New regionalism”

\textsuperscript{26} \textit{Ibid.}
as Mercosur) essentially continued this liberalizing trend. The treaty called for the elimination of tariffs on intra-Mercosur trade by the end of 1994 but mandated that member countries impose a common external tariff on goods imported from countries outside the union.\textsuperscript{27} In 1991 Mercosur members started lowering tariffs and by 1997 approximately 90\% of intra-Mercosur trade was tariff free.\textsuperscript{28} In 1995 Member countries also adopted the external tariff which ranged from 0 to 20 percent by product type.\textsuperscript{29} Under the Mercosur agreement, however, member countries were permitted to maintain their existing national tariffs on 300 specific products.\textsuperscript{30} The rational for generally higher national tariffs was in order to protect domestic producers and have them better prepared for foreign competition.\textsuperscript{31}

The move to remove tariffs along with general trade liberalization policies in the late 1980 and early 1990’s saw average tariff rates tumble in Latin America from a high of 69\% before 1990 to 13\% in 1995.\textsuperscript{32} These policies resulted in per capital real income growing more than three times faster for those developing counties that lowered trade barriers (5\% per year) than for other developing countries (1.4\% per year).\textsuperscript{33} The lowering of internal trade barriers brought on by the formation of Mercosur led to a significant increase in trade among members.\textsuperscript{34} As a percentage of total trade, intra-Mercosur trade grew from approximately 12\% in 1991 to a high of about

\textsuperscript{27} Jose Maria Fanelli, “Regional Arrangements to support Growth and Macro-Policy Coordination in Mercosur” G-24 Discussion Paper No. 46 (2007).
\textsuperscript{29} Ibid.
\textsuperscript{30} Ibid.
\textsuperscript{31} Ibid.
\textsuperscript{32} Ibid.
\textsuperscript{33} Ibid.
\textsuperscript{34} Mercosur, supra note 23.
19% in 1994.\textsuperscript{35} Further, intra-Mercosur exports showed strong upwards movement rising from 11 percent of total exports in 1991 to 20% in 1996.\textsuperscript{36} Without a doubt Mercosur’s liberalization policies led to lower prices, better information and newer technologies, all of which have played a significant role in in the region’s economic history. The financial crisis experienced in the United States and the rest of the world in 2008, however, had a significant negative effect on trade and foreign investment throughout the world including in Latin America. Although the crisis caused Mercosur members to turn away from liberalization, by returning to a comparative advantage philosophy it is possible for the region to regain its economic growth projections.

\textsuperscript{35} Ibid.
\textsuperscript{36} Ibid.
CHAPTER 2: THE PRINCIPLES OF COMPARATIVE ADVANTAGE

1. A Theory of International Trade

The negative economic effects of the 2008 financial crises are still being felt across Latin America and the rest of the world. Trade policy is a key tool for both developed and developing governments in reviving their respective economies. The ability to affect supply and demand has shown to have direct results on economic activity and foreign direct investment. As a structural policy, trade reforms for both developing and developed nations need to be a part of the overall approach for there to be any hope of reviving economic growth. Before going into the different options for increasing economic performance, it is important to first explore an international trade theory which can help explain not only the relationship between trade and development but also the reasons behind trade and international production and distribution. The following paragraphs will discuss the basic tenants of the theory of Comparative Advantage and the Factor Endowment Theory and the reasons they are most suitable for the study of the relationship between trade and development in Latin America.

1.1. The Ricardian Model – Comparative Advantage

With globalization still driving world economic trends, distinction between national and international trade policies are becoming increasingly blurred. With many national industries still reeling from the economic crises governments are being active in implementing protectionist and discriminate measures to ensure their domestic industries survive. Such measures, however, have
led to distorted markets, decreases in foreign investment and a lack of domestic competition. With regard to Mercosur, in order for the bloc to foster strong domestic market improvements, there must be an effort to first increase the size and skills of the domestic workforce. For this to occur, Mercosur needs to return to drafting and implementing trade policies that are in line with the key features of comparative advantage.

In 1815 David Ricardo introduced the theory of comparative advantage (also known as the Ricardian model), an economic theory which is still considered as one of the main theories for explaining international trade.\(^\text{38}\) The theory posits that it is not the absolute differences in countries’ abilities to produce certain goods and services that determine what countries produce and trade but rather the relative differences.\(^\text{39}\) For example, when comparing the relative price of corn in terms of wheat in country A to the same relative price in country B, country A, with the lower relative price of corn is said to have a comparative advantage in corn while Country B has a comparative advantage in wheat. Therefore, it makes the most sense for Country A to export corn while Country B exports wheat. According to the Ricardian theory, Country A, which may be more efficient in producing corn (absolute advantage) than Country B, may still find it profitable to import corn from Country B and export other goods in which it is relative more productive (comparative advantage). By specializing in only one good, global production of both goods will increase allowing all countries to gain from trade.\(^\text{40}\) The theory emphasizes the relative differences in productivity between countries and argues that such a principle is the

\(^{38}\) OECD (2011), Globalization, Comparative Advantage and the Changing Dynamics of Trade, OECD Publishing. [OECD].

\(^{39}\) Ibid.

engine that drives international trade.\textsuperscript{41} The greater the differences in underlying sources of comparative advantage across countries the larger the gains from trade.

In accordance with the principles of comparative advantage, countries will be able to enhance their individual and joint welfare by specializing through a more efficient use of resources within an economy and throughout the world. From these principles it can be argued that: (a) open economies gain from pure and open exchanges of trade; and (b) that countries can benefit further by concentrating their resources in industries in which they are relatively more efficient and productive.\textsuperscript{42} Within the Ricardian model labour is only one factor of production, and therefore, comparative advantage occurs solely as a result of differences in labour productivity.\textsuperscript{43} Many scholars have argued that the theory’s focus on domestically based resources is no longer relevant in the current globalized world where markets and technology are always changing.\textsuperscript{44} Studies conducted by Kowalski and Bottini, however, have reinforced the theory’s key principles and have demonstrated its relevancy in today’s policy making.\textsuperscript{45} In addition, Liapis’s study which examined the relationship between comparative advantage and growth has shown that a 10\% increase in productivity of processed product exports increased income by .04\%.\textsuperscript{46}

What the Ricardian model does not propose, however, is the implementation of specific sector policies and regulations in an effort to promote existing domestic sectors which already have a

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\textsuperscript{41} OECD, \textit{supra} note 32.  \\
\textsuperscript{42} Ibid.  \\
\textsuperscript{43} Ibid.  \\
\textsuperscript{44} Porter, M.E. (1990), \textit{The Comparative Advantage of nations}, London Free Press, London.  \\
\textsuperscript{45} OECD, \textit{supra} note 32.  \\
\textsuperscript{46} Ibid.
\end{flushright}
Ricardo argued that such actions can actually undermine the positive gains from international trade. The Ricardian model offers two very powerful principles, namely, that labour productivity differences are very important in explaining patterns in trade and, that it is comparative advantage and not absolute advantage that is important for trade.

1.2. The Heckscher & Ohlin Model

In addition to technology differences among countries, a nation’s trade policy is also largely shaped by differences in resource endowments. Heckscher and Ohlin are two economists which have emphasized the importance of resources in trade. In the Heckscher and Ohlin theory, trade is determined by the interaction between the relative abundance of factors, such as, capital, labour and land and the relative intensity with which these factors of production are used in the production of goods. The Heckscher and Ohlin model is also known as the factor proportion theory given that comparative advantage is determined by the proportion of factors endowments and the proportion in which these factors are used in the production of goods. As suggested above, a country which has an abundance of labour will have a comparative advantage in the production of relatively labour intensive goods and the nation that has an abundance of capital will have a comparative advantage in the production of capital intensive goods.

47 Ibid.
49 Ibid.
50 Kowalski, supra note 38.
51 Ibid.
52 Ibid.
2. Changing a Country’s Comparative Advantage

It is possible with the appropriate amount of government intervention for a country’s comparative advantage in a product to gradually change over time.\(^{53}\) A country can achieve this as a result of changes in any of the determinants of comparative advantage, including resource endowments, technology, demand patterns, specialization, business practices, and government policies. Many developing countries, such as those from Latin America, suffer from various types of market failures, as their comparative advantage lies in very market sensitive products, such as agricultural commodities and natural resources.\(^{54}\) The heavy reliance on natural resources as a main export may not be ideal as a means to grow an industrial, technology advanced economy. South Korea is a great success story for demonstrating how a country can gradually change its comparative advantage.\(^{55}\) Upon emerging from the Korean War, South Korea had a comparative advantage in rice. The Koreans, however, believed that even if it were successful in increasing the productivity of its rice farmers, it would fail in becoming a developed country with a high standard of living. The South Korean government at the time made the decision to acquire new technology and skills in different sectors in an effort to change its comparative advantage.\(^{56}\) The South Korean’s effectively chose to ignore its current comparative advantage and instead focus on a more desirable long term dynamic comparative advantage.

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55 Ibid.
56 Ibid.
CHAPTER 3: FOUNDATION FOR WORLD TRADE: THE GATT AND THE WTO

1. Formation and Purpose of GATT and the WTO

The World Trade Organization is a system and forum of trade rules and trade discussions. Although the WTO’s main goal is to liberalize trade it also serves as a forum for governments to negotiate trade agreements and settle trade disputes. The WTO agreements cover goods, services, intellectual property and describe the underlying principles of liberalization and the permitted exceptions. Included in these agreements are individual countries’ commitments to lower custom tariffs and other trade barriers and to open and keep open the services markets. WTO members set their own trade policies but are required to notify the WTO about the laws and measures adopted. The WTO has set out numerous oversight committees in order to ensure that these requirements are being followed and properly implemented.

The GATT and the WTO accorded developing countries special rights and privileges which altered the way such countries participated in the multilateral system, known as the special and differential treatment of developing countries. Granting special treatment to developing countries, however, did not come easy. At first the United States was not interested in aiding developing countries and early drafts of the GATT included only minor concessions in the form of infant industry protection – Article XVIII. In the 1954-55 review sessions, however, Article XVIII was revised. The changes allowed developing countries to: (a) maintain flexible tariffs to

59 Ibid.
60 Ibid.
61 Ibid.
promote certain industries; (b) limit imports by quantitative restrictions to address balance of payments problems; and (c) impose tariff and quantitative restrictions to establish a particular industry in order to raise the general standard of living. The revisions to Article XXVII also allowed developing countries to deviate from tariff commitments for industry promotion and to institute certain trade restrictions when encountering balance of payment difficulties. In addition, developing countries were afforded an exemption with regard to export subsidies for manufactured products.

In 1964 during the Kennedy Round, new provisions were introduced giving developing countries the right to seek derogation from GATT rules for development purposes. Other provisions meant to assist developing countries included giving developing countries preferential market access for products of export interest which did not have to be reciprocal. Article XXXVII also included a call for a restraint on duties and non-tariff barriers by developed countries regarding exported products of special interest to developing nations. Lastly, Article XXXVI provided for cooperation by international agreements to improve market access for products of export.

Efforts to further assist developing countries continued between 1966 and 1997 with the generalized system of preferences (GSP) implemented in 1971. Developed countries agreed to

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62 Ibid.
63 Ibid.
64 Ibid.
66 Ibid.
67 Ibid.
grant non-reciprocal trade preferences to developing nations.\textsuperscript{69} Non-reciprocity allowed developing nations to opt out of MFN based liberalization commitments.\textsuperscript{70} Unfortunately, these measures were discretionary and developed countries were not legally required to provide preferential treatment. A developed country, for example, was able to withdraw a preference under GSP if it believed that the developing country was engaged in unacceptable behaviour.\textsuperscript{71} Although preferential treatment was officially implemented in GATT during the Tokyo Round and there was widespread recognition of the assistance developing countries required, the preference provisions did not require any quantifiable action or penalties for non-compliance.\textsuperscript{72} Even though a number of strides were taken to assist developing countries during this time, developing countries continued to be subject to extreme protectionist measures from developed countries.

In 1986, the Uruguay Round was seen as an opportunity for developing countries to re-establish relationships with developed countries and argue for a stricter compliance with the most favoured nation principle under the multilateral trading system. Once the Uruguay Round was concluded, however, member countries decided to adopt the “single undertaking” approach which required both developed and developing countries to adhere to nearly the same set of trade rules.\textsuperscript{73} Given the weakening of special and differential provisions (S&D) in favour of market access, S&D treatment was reoriented to addressing adjustment difficulties in developing nations.

\textsuperscript{69} Ibid.
\textsuperscript{70} Ibid.
\textsuperscript{72} Understanding, supra note 13.
\textsuperscript{73} Peter Kleen & Sheila Page “Special and Differential Treatment of Developing Countries in the World Trade Organization, EGDI Secretariat, Ministry of Foreign Affairs Sweden (2005), online: <http://www.worldfuturecouncil.org/fileadmin/user_upload/papers/40725_Gl_Dev_Stud_2.pdf> [Kleen].
stemming from implementation of the WTO agreements.\textsuperscript{74} Although there are a number of S&D provisions in the WTO agreements that assist developing countries gain market access or financial support, many countries find that the limitations and deficiencies greatly outweigh the benefits. Hoekman agrees with the frustration felt by developing countries and has stated: “Many developing countries regard SDT provisions as being meaningless, while many developed countries regard them as bad economic and outdated.”\textsuperscript{75}

\textsuperscript{74} Ibid.
\textsuperscript{75} Ibid.
CHAPTER 4: THE CHALLENGES WITHIN THE WTO

1. Developing Countries and Current Challenges

1.1. General System of Preferences

Under Article I of GATT, WTO members must grant most-favored-nation (MFN) treatment “immediately and unconditionally” to like products of other members with respect to tariffs and other trade-related measures. In direct contradiction to the MFN principle, however, the general system of preferences (GSP) allows developed countries to grant preferential tariff rates to developing country goods. Generally, the GSP is a preferential tariff system which provides for a formal system of exemption from the more general rules of the World Trade Organization. It is a system which allows countries to be exempt from the most favored nation principle (MFN) that obliges WTO member countries to treat the imports of all other WTO member countries no worse than they treat the imports of their "most favored" trading partner. Although simple in concept, the complexity of GSP rules and its implementation has been consistently criticized as being confusing and counterproductive to the growth of developing countries.

With respect to Latin America, GSP has not lived up to expectations. On one hand, most developed countries have complied with the obligation to generalize their programs by offering benefits to a large swath of beneficiaries, generally including nearly every non-OECD member

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77 Ibid.
78 Kleen, supra note 68.
80 OECD stands for “Organization for Economic Cooperation and Development”. A Group of 30 member countries that discuss and develop economic and social policy.
state. Many developing countries including those from Latin America, however, have not been able to realize the trade increasing benefits due to a number of inherent GSP issues. One such issue is GSP eligible.\textsuperscript{81} Latin American companies, for example, are required to comply with burdensome rules of origin (RoO) which increase costs of administrative procedures and specific technical requirements. Since the various GSP granting countries demand different RoO, the corresponding costs for the exporters can be excessively high. Secondly, because of the continuous multilateral trade liberalization efforts at the WTO, Latin American GSP recipient’s preference margins have eroded over time.\textsuperscript{82} Third, developed countries commonly introduce various side requirements on recipient GSP countries.\textsuperscript{83} These additional restrictions usually relate to human rights and labour conditions and requirements, which are often more restrictive than internationally recognized labour rights. The United States, for example, has excluded countries from GSP coverage for a variety of reasons, including, being communist, being placed on the U.S. State Department’s list of countries that support terrorism, and failing to respect U.S. intellectual property laws.\textsuperscript{84} Sykes is one critic who has argued that by implementing such side requirements donor countries are in fact introducing a substantial element of reciprocity into GSP.\textsuperscript{85} Fourth, based on specified criteria, a country or a specific product can be excluded (ex ante) or graduated (ex post) from GSP coverage, which might be relevant for goods in which GSP receiving countries have a comparative advantage, and are thus sensitive to the donor

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{81} Bernhard Herz & Marco Wagner, The Dark Side of the Generalized System of Preferences, online: http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Arbeitspapiere/The_Dark_Side_of_the_Generalized_System_of_Preferences.pdf [Dark Side].
\item \textsuperscript{82} Grossman, supra note 63.
\item \textsuperscript{83} Ibid.
\item \textsuperscript{84} Ibid.
\item \textsuperscript{85} Ibid.
\end{itemize}
\end{footnotesize}
countries’ import industry. Grossman and Sykes have shown that textiles and apparel as well as certain agricultural goods (key export products for developing countries) are excluded from GSP schemes of the European Union and the US. Moreover, critics have also noted that most GSP programs are not completely generalized with respect to products. That is, GSP has not covered products that are of greatest importance to Latin America or other developing countries. In many developed countries, domestic producers of "simple" manufactured goods, such as textiles, leather goods, ceramics, glass and steel, have long claimed that they cannot compete with large quantities of imports. Thus, such products have been categorically excluded from GSP coverage under many GSP programs.

GSP receiving countries permanently face a considerable degree of uncertainty since GSP schemes can be changed or even terminated ad hoc by altering the requirements of the schemes. Many developing countries have been public about what they see as a biased system given that the provider country has the option, in its sole discretion, to withdraw preferences through its own system of “graduation” or product exclusion. With regard to the arbitrary nature in which graduation gets implemented, Low, has argued that, “by treating developing country status as a binary matter, developing countries have refused to engage in any discussion of graduation and developed countries have largely maintained that any discussion of S&D will

87 Ibid.
89 Keck, supra note 80.
91 Ibid.
be unproductive as long as no differentiation is possible among developing countries at very
different levels of development.”

As discussed above, another factor that has weakened GSP is known as preference erosion. This
occurs when tariff rates are lowered via regional trade arrangements or the reduction of MFN
rates. This devalues the worth of the preference receiving country under GSP. These schemes
can cause trade diversion from non-preference receiving countries to specified beneficiary
countries resulting in certain exports of such developing countries being displaced by others.
These factors have led to a significant decline in the rate of imports that actually receive
preferential treatment.

Overall a negative effect of GSP on the exports of Latin American countries has been found.
Bernard Hertz and Michael Wagner have noted in their studies that there has been an increase in
exports from Latin America by GSP in the short run, but the medium to long run effect was
negative. They conclude that such results demonstrate an opportunistic behaviour on the part of
the industrialized countries in which GSP programs are used to promote their own exports
instead as to foster the exports of developing countries. Ozen, Reighhardt and Panagariya have
also argued for the complete abolishment of non-reciprocal trade preferences. As the medium
to long term effects of GSP resulted in deteriorating exports for developing countries it is not
likely that incremental reforms could improve the situation for developing countries. Hoekman

92 Ibid.
93 Ibid.
94 Bernard Hoekman, Constantine Michalopoulos & L. Alan Winters, “Special and Differential Treatment of
95 Ibid.
96 Ibid.
97 Ibid.
also does not believe that GSP programs have value in assisting developing countries reach their economic potential.  

Hoekman suggests that S&D be limited according to individual nation needs and eligibility criteria.  

Instead of trying to reform GSP non-reciprocal arrangements should be replaced by reciprocal agreements. In general, Mercosur nations have found it difficult to exploit economies of scale and have lacked the necessary investments in their competitive industries to really see growth in their region. As a consequence, these GSP restrictions have caused distortions in the economic structure and in the trading patterns of Mercosur members. Overall, GSP schemes have been found to be an instrument to improve the trade position of industrialized countries rather than a tool to promote growth in developing countries.  

1.2. **Tariff Barriers and its effects on Developing Countries**

Latin American countries also have a number of market access issues when it comes to exporting their products to developed countries. In the United States, 6.6% per cent of imports from developing countries are subject to tariffs over 15%. This is compared to Canada’s 4.8% percent tariff, the EU’s 4.9% and Japan’s 2.8%. As the table below indicates, Mercosur is subject to high tariff rates especially in key domestic products, such as dairy products, cotton and cereals. In addition, tariffs on labour intensive imports from developing countries are 8% and 14% on agricultural commodities. Latin America’s economic problems, however, cannot be attributed...  

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100 Dark Side, *supra* note 75.  
solely to external factors and developed countries. Latin American countries have also played a negative role in their own economic development as many have implemented protectionist trade and investment policies. For example, tariffs on imports from developing countries are often more than three times the average imposed by developed countries.\textsuperscript{102}

\textit{Figure 1- Mercosur tariffs and imports by product.}\textsuperscript{103}

<table>
<thead>
<tr>
<th></th>
<th>Final bound duties</th>
<th>MPN applied duties</th>
<th>Imports</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Duty-free</td>
<td>Max</td>
<td>Binding</td>
</tr>
<tr>
<td>Animal products</td>
<td>35.3</td>
<td>3.4</td>
<td>51.0</td>
</tr>
<tr>
<td>Dairy products</td>
<td>45.4</td>
<td>0.0</td>
<td>50.2</td>
</tr>
<tr>
<td>Fruit, vegetables, plants</td>
<td>34.0</td>
<td>0.9</td>
<td>52.7</td>
</tr>
<tr>
<td>Coffee, tea</td>
<td>34.1</td>
<td>0.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Cereals &amp; preparations</td>
<td>42.3</td>
<td>0.8</td>
<td>54.0</td>
</tr>
<tr>
<td>Oilseeds, fats &amp; oils</td>
<td>34.7</td>
<td>0.4</td>
<td>35.0</td>
</tr>
<tr>
<td>Sugars &amp; confectionary</td>
<td>34.1</td>
<td>0.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Beverages &amp; tobacco</td>
<td>36.2</td>
<td>0.0</td>
<td>45.9</td>
</tr>
<tr>
<td>Cotton</td>
<td>48.6</td>
<td>0.0</td>
<td>48.6</td>
</tr>
<tr>
<td>Other agricultural products</td>
<td>30.1</td>
<td>4.5</td>
<td>46.1</td>
</tr>
<tr>
<td>Fish &amp; fish products</td>
<td>33.8</td>
<td>2.2</td>
<td>35.0</td>
</tr>
<tr>
<td>Minerals &amp; metals</td>
<td>33.1</td>
<td>0.5</td>
<td>35.0</td>
</tr>
<tr>
<td>Petroleum</td>
<td>35.0</td>
<td>0.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Chemicals</td>
<td>21.3</td>
<td>0.3</td>
<td>35.0</td>
</tr>
<tr>
<td>Wood, paper, etc.</td>
<td>30.5</td>
<td>1.5</td>
<td>35.0</td>
</tr>
<tr>
<td>Textiles</td>
<td>34.8</td>
<td>0.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Clothing</td>
<td>35.0</td>
<td>0.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Leather, footwear, etc.</td>
<td>34.6</td>
<td>0.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Non-electrical machinery</td>
<td>33.0</td>
<td>0.3</td>
<td>35.0</td>
</tr>
<tr>
<td>Electrical machinery</td>
<td>32.5</td>
<td>2.1</td>
<td>35.0</td>
</tr>
<tr>
<td>Transport equipment</td>
<td>33.3</td>
<td>0.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Manufactures, n.e.c.</td>
<td>33.2</td>
<td>0.4</td>
<td>35.0</td>
</tr>
</tbody>
</table>

Within Mercosur the common external tariff (CET) is the main instrument of the common trade policy and covers approximately 85% of products.\textsuperscript{104} As shown in the figure above, Mercosur has low tariffs on agricultural products and high tariffs on manufactured products.

\textsuperscript{102} Ibid.
\textsuperscript{103} Ibid.
Another key trade obstacle has been double duties. EU exporters are required to pay tariffs both when they export their products to a Mercosur member country and pay a second duty when they re-export the product to a second Mercosur member. There is also an issue in the manner tariffs get applied to processed items. Known as “tariff escalation”, tariffs on fully processed foods are 42% in Canada, 65% in Japan and 24% in the EU.\textsuperscript{105} There is also a disproportionate application of tariffs when you compare these amounts to the 3% (Canada), 35% (Japan) and 15% (EU) for the least processed product.\textsuperscript{106} Consequently, this has deterred many companies from Latin America and developing countries generally from processing raw materials resulting in a poor diversification of exports.\textsuperscript{107}

As discussed above, during the economic crisis, Latin American countries experienced falls in output and increases in unemployment. Trade restrictions increased steadily during this time contributing to the contraction of trade. After a six year period of economic expansion Latin America saw its trade flows decrease by more than 20% in 2009.\textsuperscript{108} A study that looked at imports and exports in Latin American from 2003 to 2008 showed that Latin American exports grew 16.8% but then decreased 22.5% in 2009.\textsuperscript{109} For the same periods, imports contracted 24.7% after increasing at annual rate of 17.4% during the preceding six years.\textsuperscript{110} Although the fall varied, all the Latin American economies faced contractions of trade flows.\textsuperscript{111} The study also

\begin{footnotesize}
\begin{enumerate}
\item T.N. Srinivasan, “Developing Countries and the Multilateral Trading System After Doha Center” (2002) Discussion paper No. 842, online: Yale University <http://www.econ.yale.edu/growth_pdf/cdp842.pdf>\textsuperscript{105}
\item Ibid.\textsuperscript{106}
\item Ibid.\textsuperscript{107}
\item Ibid.\textsuperscript{108}
\item Ibid.\textsuperscript{110}
\item Ibid.\textsuperscript{111}
\end{enumerate}
\end{footnotesize}
revealed that Latin American countries were harmed by measures implemented by their partners and at least 11 of 17 selected economies from the study also enacted restrictive measures against foreign interests.\textsuperscript{112}

In general, larger exporters in Latin America with a more diversified production structure faced more restrictions and were affected in more sectors than smaller countries. The economies most affected by restrictive measures were Brazil, Mexico, Argentina, Chile, Uruguay, Colombia and Peru.\textsuperscript{113} The activities which faced barriers most frequently are the ones related to agriculture and some manufacturing industries, such as textile and apparel, machinery, furniture, the most important industries for Latin America.\textsuperscript{114} Most of the restrictions harming the region were bail out/state aid measures and tariff barriers. Argentina and Brazil are two Mercosur members where the implementation of restrictive measures exceeded those confronted (52.3\% and 16.1\%, respectively)\textsuperscript{115} As in many other developing countries, trade defence measures and tariff barriers are the most frequent restrictions. Unfortunately, with growth still stunted, there is a risk many Latin American countries could continue to implement protectionist policies and regulations instead of liberalizing their trade policies. As will be discussed below, however, an EU, Mercosur FTA that reduces and eventually eliminates Mercosur tariffs on manufactured products and EU tariffs on agricultural products would stimulate growth for both regions by increasing exports of those products which each region has a comparative advantage.

\textsuperscript{112}Ibid.
\textsuperscript{113}Ibid.
\textsuperscript{114}Ibid.
\textsuperscript{115}Ibid.
1.3. *Best Endeavours*

At the heart of most special and differential treatment provisions is the phrase “best –endeavour”. This phrase has limited the effects of the S&D provisions as countries are under no obligation to grant preferences since they are non-binding, are voluntary and unenforceable. The S&D provisions were developed with the intent of assisting governments build institutional capacity in order to implement WTO agreements with the ultimate goal of increasing participation in the multilateral trading system. For example, Article 12.3 – the technical assistance provision states that members shall: “take account of the special development, financial and trade needs of developing country members with a view to ensuring that such regulations do not create unnecessary obstacles to exports from developing country members.”\(^{116}\)

Similarly, Article 10(1) states that member countries should, “take account of the special needs of developing country members”\(^{117}\). These provisions, as well as many others, impose a duty to consider the impact of such measures on developing countries but there is no requirement. Also, there is no requirement embedded in these provisions stating that developed countries are to refrain from implementing harmful policies.

1.4. *Infant Industry Protection Challenges.*

Those against free trade argue that infant industries in developing countries cannot compete with foreign firms unless they are afforded protection by way of tariffs and non-tariff barriers.\(^{118}\)

Such policies allow “infant industries” the opportunity to prepare for freer trade by becoming

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\(^{117}\) *Ibid.*

more productive through “learning by doing,” facilitating local supplier networks, investing in physical capital, and undertaking research and development. These infant protection barriers should only be in place long enough for such firms operating in a protected industry to gain the skills and knowledge needed to compete globally.\textsuperscript{119}

When checked against empirical evidence, however, infant industry protection policies have failed Latin America and developing countries for three reasons.\textsuperscript{120} First, firms have not achieved the best-practice productivity that protection was intended to afford.\textsuperscript{121} Learning-by-doing for a largely domestic market has been insufficient, capital investments were often misdirected and research and development has been unproductive.\textsuperscript{122} With infant industry protection, domestic firms do not get exposed to global best practices, the newest advances in technology or access to foreign capital. Secondly, for those companies that have been protected and have shown to be efficient, political-economy incentives has compelled such companies and other beneficiaries to seek additional protection for longer periods than might be warranted.\textsuperscript{123} Lastly, with respect to comparative advantage, certain industries within Latin America have often incurred opportunity costs of foregone comparative advantage. For example, when an infant protected industry sector expands, the aggregate national welfare can still be lowered as the resources used in expansion might have been more productively used by other firms in other sectors.

1.5. Agricultural

Urbanization, growing populations and incomes will result in an increase in consumption of the

\textsuperscript{119} Ibid.
\textsuperscript{120} Ibid.
\textsuperscript{121} Ibid.
\textsuperscript{122} Ibid.
\textsuperscript{123} Ibid.
main agricultural commodities. Global production of agricultural products from developing countries is expected to increase as domestic and international investments flood to developing regions. Over the next 10 years it is estimated that developing countries will account for 80 percent of the growth in global meat production and capture a majority of world exports of coarse grains, rice, oilseeds, vegetable oil, sugar, beef, poultry and fish by 2022. In order to ensure the economic benefits of the rise in global production of agricultural products governments from developed and developing countries will need to invest in agricultural sectors to encourage innovation, increase productivity and improve integration in global value chains. Unfortunately, the agriculture sector has been a significant hurdle in many free trade discussions, especially those involving Latin America.

Although the level of government support for the agricultural sector has declined since 1997, the value of support is still extraordinary high. In 2011, for example, support to producers from OECD countries hit $252 billion, more than twice the value of development aid provided in the year. The sector has been described as “the greatest of all scandals” for the enormous amounts of subsidies farmers from developed countries receive. Farm subsidies in OECD countries have led to the suppression of world prices for agricultural goods’ resulting in devastating outcomes for poorer farmers. Agricultural policies need to address the inherent volatility of commodity markets with improved tools for risk management while ensuring the sustainable use

of land and water resources and reducing food loss and waste.

In previous Mercosur free trade discussions the EU has argued that it requires agricultural restrictions in order to support its farmers for social, cultural and environmental reasons. Although the EU may prove to be the best option for Mercosur to strike a trade deal, the EU’s trade restrictions in the agricultural sector has been one of the most contentious issues at the WTO and in regional and bilateral trade discussions.\(^{129}\) Unfortunately, the agricultural trade structure is a complex non transparent system that evolved from the WTO agreement on agricultural. The agricultural agreement was meant to transform quantitative restrictions into a more transparent and open tariff based system, however, the rules within the agreement still allow countries to effectively protect their domestic agricultural producers.\(^{130}\) Therefore, in addition to the high tariffs and non-transparency of the agricultural sector, Latin America and other developing countries have to compete with the large amount of subsidies (direct income support or export subsidies) the EU offers to European producers.

Agricultural trade is very important for Latin American development. In many Latin American countries, agricultural trade makes up approximately 34\% of all exports.\(^{131}\) Currently, Latin America exports less than 2 dollars for every dollar it imports compared to 7 dollars for every dollar of imports in the 1960s.\(^{132}\) The structure of agricultural exports has also changed over time. Where cocoa, coffee and sugar represented over 60\% of all agricultural exports for the


region in the 1950’s and 1960’s, oilseeds, fruits and vegetables currently make up the majority of Latin American exports today.\textsuperscript{133} In general, the evolution of trade flows will depend on trade and agricultural policies in the Americas and Europe, which will all be influenced by different multilateral, regional and bilateral agreements. As noted above, the issues facing Latin America and the developing world are significant and the options for growth and change within the WTO remain limited. The following pages will look at a number of options that have been put forth as possible alternatives for improving economic growth within Latin America.

\textsuperscript{133} Ibid.
CHAPTER 5: PROPOSALS FOR REFORM

1. Multilateral Liberalization and Strengthening MFN Obligations

1.1. Reforms within the WTO

Many proponents of free trade argue that multilateral liberalization offers the best alternative to the S&D system for developing nations and their quest for sustainable economic growth.\(^{134}\) Robert Hudec, for example, argued that only through most favoured nation (MFN) obligations would developing countries gain market access.\(^{135}\) The graduation approach, whereby, preferences are given to developing countries based on their varying levels of development would be used by developed countries to allow for minor non-reciprocal benefits to developing countries.\(^{136}\) Although the arguments in favour of strengthening MFN obligations have been consistently made throughout the years, there has not been any significant development. Hoekman has also expressed his belief that MFN based market access would have the most significant effect on the economic development of developing nations.\(^{137}\)

There are, however, a number of concerns with the multilateral liberalization proposal. The most common argument against this approach is that further liberalization may not be appropriate for all developing nations as there are a number of country specific factors that will impact the implementation and effectiveness of liberalization tools and ultimately the success of such liberalization efforts.\(^{138}\) Rodrik, for example, makes a compelling argument against having a

\(^{135}\) Ibid.
\(^{136}\) Ibid.
\(^{137}\) Ibid.
“one size fits all” approach to trade.\textsuperscript{139} He has argued that developing countries should not be forced to liberalize their trade policies at speeds that deprive them of setting their own course for economic development.\textsuperscript{140} Given that developed countries had several decades to devise a path out of poor economic performance, it is logical to assume that developing countries would need the same time and flexibility to devise their own plan. The best route for development, Rodrik argues, is to change from a framework of “market access” to a development mentality, whereby developing countries would not articulate their needs in terms of market access, but in terms of the policy autonomy.\textsuperscript{141} He believes this would allow developing economies to exercise institutional innovations that depart from prevailing orthodoxies.

To support his arguments Rodrink compares the economic development histories of Latin America and Asia. Where Latin America followed a western style laissez faire path, Asian countries, such as Singapore, Taiwan and South Korea implemented and followed unique nation specific policies that allowed them to exceed the growth rates of Latin American countries.\textsuperscript{142} Further, Rodrik has stated that in order for developing countries to be successful in sustaining economic growth each country has to be successful in developing unique, strong and efficient country specific trade tools and institutions as well as be able to gradually implement a plan to lower trade barriers and to attract foreign direct investment.\textsuperscript{143}

\begin{itemize}
  \item \textsuperscript{139} \textit{Ibid.}
  \item \textsuperscript{140} \textit{Ibid.}
  \item \textsuperscript{141} Dani Rodrik, \textit{The Global Governance of Trade as if Development really mattered}, online: Harvard University John F. Kennedy School of Government 2001 \textless \texttt{http://www.giszpenc.com/globalciv/rodrik1.pdf}\textgreater
  \item \textsuperscript{142} Dani Rodrik, \textit{Developments Strategies for the Next Century}, online: Harvard University \textless \texttt{https://www.sss.ias.edu/files/pdfs/Rodrik/Research/development-strategies.PDF}\textgreater
  \item \textsuperscript{143} \textit{Ibid.}
\end{itemize}
1.2. Unilateral Liberalization

Another proposal for the economic development of developing countries is the unilateral liberalization approach, whereby, a country unilaterally eliminates trade barriers without any agreement, promise or guarantee that they will receive reciprocal treatment from other nations. Unlike in the multilateral liberalization option whereby tariffs for WTO countries are the same across the board, countries that decide to liberalize unilaterally can discriminate in their tariff setting depending on the other country. Supporters of the unilateral liberalization approach often use China and India as two successful examples. Sally Razeen, adjunct scholar at the Cato Institute and co-Director of the European Centre for International Political Economy (ECIPE), believes that there are too many issues with the multilateral liberalization approach for it to be successful. In writing about trade liberalization through the WTO, Razeen has argued that the WTO is too large “with an unwieldy agenda that has a chaotic framework of decision-making.” He states:

“Compelling political and economic arguments favour unilateral liberalization, with governments freeing up international trade flows of capital and labour independently, not in the first stances via international negotiations. As any student of trade economic knows, welfare gains result directly from import liberalization, which replaces comparatively costly domestic production and reallocates resources more efficiently. It also spurs capital accumulation and economies of scale, as well as longer run dynamic gains such as the transfer of technology and skills. Among its many benefits, import liberalization provides cheaper inputs and reallocates resources to promising export sectors.”

144 Jagdish Bhagwati, Going Alone The Case for relaxed Reciprocity in Freeing Trade, (MIT Press: Cambridge, 2002), [Bhagwati].
146 Ibid.
147 Ibid.
Critics of the unilateral approach are quick to point out, however, that a government pursuing such an approach would find it difficult to conjure up domestic support for a scheme that would have no reciprocal benefits.\textsuperscript{148}

Given the current political and social instability in many Latin American countries, any unilateral decision that could negatively affect the nation’s producers and manufactures could cause significant unrest. Many Latin American countries also currently suffer from a lack of investor confidence. Unlike multilateral liberalization where tariffs are set at the same rate for all WTO members, a Latin American country which chooses to pursue an investor friendly unilateral liberalization strategy can just as easily choose to unilaterally raise tariffs in a discriminatory fashion. This will undoubtedly lead to market uncertainty further discouraging foreign investment. If governments, however, were successful in describing their unilateral liberalization efforts as a precursor to multilateral liberalization, than they may be able to gain domestic and international support.

\textit{1.3. Policy Options for Special and Differential Treatment}

Special and differential treatment for developing countries continues to be a defining feature of the multilateral trading system. The three main objectives of Special and Differential Treatment provisions have been: preferential access for developing countries to developed countries’ markets; promises by developed countries to provide technical assistance to lower income economies to help implement multilateral rules; and exemptions from certain WTO rules.\textsuperscript{149} In 2001, WTO members launched a new round of trade negotiations called the Doha Development

\textsuperscript{148} \textit{Ibid.}

\textsuperscript{149} Stigliz, \textit{supra} note 53.
Agenda (DDA). The reason for the DDA was to address concerns, issues and obstacles regarding development within the multilateral system. Under certain GATT provisions countries had a lot of flexibility to retain protectionist policies which became the central elements of what are now referred to as the Special and Differential Treatment provisions. The Doha Ministerial Declaration reaffirmed the importance of S&D by stating that “provisions for special and differential treatment are an integral part of the WTO agreements.”\textsuperscript{150} The Doha also called for a review of the S&D provisions with the plan of “strengthening them and making them more precise, effective and operational.”\textsuperscript{151} Unfortunately, such goals were never achieved and great divisions between WTO members on how to improve S&D became apparent.

As was discussed above, one of the main goals of the S&D provisions was to enable infant industry development. Proponents argued that since new domestic industries did not have the economies of scale that their old competitors had they needed to be protected until they were able attain similar economies of scale. Infant industry protection has and continues to cause controversy as a policy recommendation. For starters, special treatment for such industries clash with two main GATT/WTO trade principles, reciprocity and non-discrimination (MFN). There have also been issues with the implementation of S&D as there has never been an ideal way of knowing which countries should be eligible and what the duration and process of graduation of such preferences should be.

The main principles of S&D are: (1) S&D is an acquired right; (2) developing countries should enjoy privileged access to the markets of their trading partners; (3) developing countries should

\textsuperscript{150} World Trade Organization, Doha Work Programme (2005), online: WTO <http://www.wto.org/english/thewto_e/minist_e/min05_e/final_text_e.htm>

\textsuperscript{151} Ibid.
have the right to restrict imports to a greater degree than developed countries; (6) developing countries should be allowed additional freedom to subsidize exports; and (7) developing countries should be allowed flexibility in respect of the application of certain WTO rules.\textsuperscript{152}

What is needed for growth is for developing countries to foster industrial capacity in non-traditional manufactures both to reduce import dependence and to diversify away from traditional commodities.\textsuperscript{153}

A number of new approaches to S&D have been suggested, such as differentiating among developing countries. Similar to the principle of ‘common but differentiated responsibility’ (CBDR), the responsibility of each state to address global environmental problems can differ due to different social, economic and ecological circumstances. This would allow every country to have different extents of responsibility. This would mean not only differentiation between developed and developing countries but also differentiation between developing countries. This would require that each developed country take the specific needs and interests of each developing country into account. Secondly, development assistance can help in building the institutional and trade capacity needed to benefit from increased trade and better access to markets. Firms in many developing countries find it difficult to understand regulatory requirements that apply in export markets. Such assistance can go beyond implementation of WTO rules and assist with supply capacity more generally along with assisting with adjustment costs resulting from reforms. There has also been an overuse of the nonreciprocal clause. This has only excluded developing countries from the major source of gain from trade


\textsuperscript{153} Hudec, \textit{supra} note 131.
liberalization.\textsuperscript{154} Latin American governments that have relied on non-reciprocity have lost out on a mechanism that could have been used to support the pursuit of beneficial trade policy reforms and on an instrument that could have created better access to export markets. Any attempt to fix S&\textsuperscript{D} must start with developing countries recognizing that a one size does not fit all when it comes to economic policies.

\textsuperscript{154} \textit{Ibid.}
CHAPTER 6: FOREIGN DIRECT INVESTMENT AND TRADE

1. Foreign Direct Investment, Trade and Economic Growth

Trade liberation through the WTO has brought about significant changes in the world economy. Foreign investment into Latin America has not only helped Latin America develop into an emerging region but has substantially changed the fundamentals of its trade relationships with both developing and developed countries.\(^{155}\) Although Mercosur has consistently been a top destination of global inflows of investment, Asia and China in particular, have gradually been receiving a greater percentage of investment from developing countries.\(^{156}\) The emergence of Asia as a destination of Foreign Direct Investment (FDI) is and will continue to be of great concern for Mercosur.\(^{157}\)

2. Multinational Firms and Foreign Direct Investment

A high and rising share of world trade is mediated on at least one side by a multinational firm. The WTO estimates that intra firm trade conducted by multinational corporations’ accounts for approximately one third of annual world trade while exports by multinational corporations to non-affiliates account for another third of world trade.\(^{158}\) In order to have an international production or distribution network a firm must establish one or more plants in the foreign jurisdiction. This process will undoubtedly involve FDI as a prerequisite. On many dimensions multinational firms operate differently and in some cases more efficient than their purely


\(^{158}\) *Ibid.*
domestic counterparts. It is therefore imperative for Latin American policy makers to start treating trade and FDI policy as interrelated and not as separate and distinct issues. This also leads to the realization that infant-industry protection as discussed above involves multinational capital as well as cross-border flows of goods and services. Openness to trade and investment may be necessary to stimulate industrial development in developing countries, but it is not likely to be sufficient. Government policies can influence the success of global engagement. Some policies can be implemented and yield results quickly, such as adjusting the national tax code to be transparent and to offer at least neutral treatment to foreign firms.

3. Tariffs and Non-tariff Measures

In addition, trade liberalization through tariff reduction and non-tariff barrier reduction will greatly reduce transaction costs and improve trade related regulatory efficiency. There is a significant link between FDI related transactions and FDI flow and international trade.\textsuperscript{159} The positive link between trade liberalization and FDI suggest that trade barriers adversely affect FDI growth.\textsuperscript{160} The WTO has reinforced this notion and stated that beside overall economic growth capital flows and trade policy are the major determinants of international trade flows.\textsuperscript{161} Unfortunately, many Latin American countries fail to recognize that there is a strong relationship between trade and FDI which consequently has resulted in imperfect trade policy development. The implementation of polices that promote FDI by Mercosur members can reverse this trend and result in foreign technology and resources being brought into Latin America ultimately resulting in a more competitive domestic market.

\textsuperscript{159} U.N., supra note 142.
\textsuperscript{160} Ibid.
\textsuperscript{161} Ibid.
CHAPTER 7: FREE TRADE AGREEMENTS

1. The Momentum Towards Free Trade Agreements

1.1. Free Trade Agreements Defined

Free trade agreements (FTAs) and regional trade agreements (RTAs) are wide ranging tax, tariff and trade treaties aimed at reducing tariffs, quotas and other trade restriction among a group of countries. Article XXIV provides for more beneficial treatment between members to a FTA than that afforded by the schedule of concessions negotiated under the WTO. For an FTA to be acceptable under Article XXIV, duties and other restrictive regulations imposed on non-free trade area members may not be higher than those that were in existence before integration. Also, within the free trade zone, duties and restrictive barriers must be eliminated on substantially all trade. Free trade agreements also represent an important exception to the non-discrimination principle included in the WTO. Under the WTO rules governing FTAs countries can trade using preferential tariffs and ease market access conditions for those FTA member countries compared to other WTO member countries.

Over the last two decades there has been a surge in regional and free trade agreements worldwide. In 2003, over 250 FTAs were presented to the WTO compared to just 50 in

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164 Ibid.
165 Ibid.
Currently more than 50% of global trade takes place through free trade agreements with 145 WTO countries out of 146 currently participating in some sort of free trade agreement. There are five categories of trade agreements, preferential trade agreements, free trade agreements, custom unions, common markets and economic unions. At a basic level, preferential trading agreements (PTA) impose lower trade barriers on goods created within the union for member nations. An FTA is a special form of PTA whereby member countries agree to eliminate substantially all trade barriers for goods originating between the parties subject to the FTA. A third type of FTA is known as a Custom Union and it provides for deeper integration than an FTA as it requires member countries to also apply a common external tariff on a goods imported from outside countries. Common market agreements allow for countries to harmonize some institutional arrangements and commercial and financial laws and regulations. Lastly, in an Economic Union, member countries work towards implementing common economic policies and regulations and adopt a single currency. As will be discussed below, entering into free trade agreements with important economic blocs as the EU is most likely to yield positive results for Mercosur. There are, however, a number of criticisms associated with free trade agreements and the following paragraphs will briefly discuss the most common ones.

As noted above, Article XXIV is an exception to the MFN principle as set out in Article 1 GATT. The exception states “…the provisions of this agreement…shall not prevent the

167 World Trade Organization, How many regional trade agreements have been notified to the WTO? oneline: <http://www.wto.org/english/tratop_e/region_e/regfac_e.htm>
168 Ibid.
169 World Trade Organization, Regional trade agreements and preferential trade, online: <http://www.wto.org/english/tratop_e/region_e/rtagreement.htm>
170 Ibid.
171 Ibid.
formation of a CU/FTA”. Deviating from the MFN provision, however, is conditional as it only applies to entities meeting certain requirements. In order to be able to form a CU or an FTA the requirements in paragraph five and eight of Article XXIV have to be met. Paragraph eight known as the internal requirement provision specifies that customs unions, free trade areas and interim agreements leading to a customs union or a free trade area are exempt from the MFN requirements

There are a number of sound economic reasons for why countries pursue FTAs. For instance, it may be easier for a small group of either neighboring countries or countries with similar concerns and cultures to agree on opening their markets in a particular area or sector than to reach an agreement in a wider forum such as the WTO. Free trade agreements also offer new approaches to rule-making. They can act as stepping stones on the way to a multilateral level agreement. An additional benefit of concluding an FTA can also include the lowering of consumer prices by adhering to the key principles of comparative advantage with resources flowing to their most productive uses. Whether countries embrace regionalism or not, regionalism has gained a renewed dynamism and free trade agreements have become a defining feature of the modern world and a powerful tool for international cooperation and development. Countries which choose to ignore this trend and continue or follow a protectionist agenda will eventually find themselves in greater economic turmoil.


173 Ibid.

174 Ibid.

175 Ibid.
1.2. Depth Of Free Trade Agreements

The depth of FTAs has also changed with measures often going further than WTO measures. In addition to the traditional aspect of FTAs, such as, removing trade barriers, many free trade agreements are moving to include liberalization and facilitation of services trade and foreign investment policies. In the area of services, unlike in GATT, FTAs adopt a “top down” or negative list approach whereby all sectors and non-conforming measures are to be liberalized unless otherwise specified. With regard to labour mobility, several FTAs include provisions that go beyond provisions of the GATT/WTO by providing for full national treatment and market access for service suppliers or special market access or facilitated access for certain groups.

Other key negotiated areas that FTAs often cover are investment and competition. In both instances FTAs commonly go beyond the provisions of the WTO. With investment provisions, FTAs can include a right of establishment and build on treatment and protection principles of bilateral investment treaties. In the area of competition, FTAs usually contain general obligations to take action against anti-competitive business conduct or by calling for coordination of specific competition standards. FTAs also go beyond the WTO provisions in areas such as government procurement, intellectual property rights and the environment, important issues for many developed countries.

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176 Ibid.
178 Ibid.
179 Ibid.
180 Sally, supra note 143.
181 Ibid.
Another key reason for the growth in FTAs has been the fact that such agreements are not necessarily being entered into by countries in close proximity. At one time, it was common for FTAs to be entered into between countries geographically close to each other. The trend over the last number of years has been for countries that are geographically distant to be entering into free trade agreements, such as the US and Japan agreement and Singapore and New Zealand agreement. Latin American countries have been active participants in the regionalism movement and developed countries such as the EU see regional cooperation through trade agreements as an essential step towards reigniting the union’s economic growth. In Latin America, 33 of the 39 countries belong to at least one FTA. Driving this move to FTAs in Latin America has been the United States. The US has completed agreements with Chile, Columbia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama and Peru.

FTAs also enable flexibility with regard to different arrangements that are not otherwise possible within the multilateral context. Canada and Chile, for example, agreed to not impose anti-dumping duties on products originating in either country, thereby allowing for greater market access. In addition, under the North American Free Trade Agreement (NAFTA), private investors are allowed to submit complaints of investor violations within the FTA and participate

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182 Perdikis, supra note 172.
183 Gallagher, Kevin, Trading Away Stability and Growth: United States Trade Agreements in Latin America, (2011) working paper 266, Political Economy Research Institute, University of Massachusetts Amherst.
184 Ibid.
in binding arbitration.\textsuperscript{186} This is in stark contrast to the WTO whereby governments alone are allowed to participate in disputes.

\textit{1.3. Trade Creation and Trade Diversion}

Most important to the pro free trade argument, however, is the fact that free trade agreements create additional trade for the participants.\textsuperscript{187} By eliminating tariffs between member countries the price of a certain good will become more affordable. With a new free trade partnership member countries will likely increase their imports from other member countries leading to greater social and economic benefits, a higher standard of living, more product and service choices and new technology.

There are however, a number of negative effects of FTAs. In 1950 Viner argued that an FTA does not necessarily improve a members’ welfare.\textsuperscript{188} He noted that an FTA will only lead to trade creation if due to the formation of the regional agreement participants’ switch from inefficient domestic producers and import more from efficient producers from other members of the FTA.\textsuperscript{189} He believes that there is a greater likelihood of trade diversion taking place as members switch imports from low cost production in the rest of the world and import more from higher cost producers in the member countries.\textsuperscript{190} Viner argued that trade diversion creates inefficiency in world production which is most detrimental to countries not members of the FTA.

\textsuperscript{186} Foreign Affairs, Trade and Development Canada, online: <http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/nafta-ala/en/s/nafta-settle.aspx>

\textsuperscript{187} Steven M. Suranovic, “Trade Diversion and Trade Creation” online: The International Economics Study Center <http://internationalecon.com/Trade/Tch110/T110-2A.php>

\textsuperscript{188} Jacob Viner, The Customs Union Issue, (New York: Carnegie Endowment for International Peace, 1950) [Viner].


\textsuperscript{190} Viner, supra note 173.
He stated: “...where the trade diverting effect is predominate, one at least of the member countries is bound to be injured, the two combined will suffer a net injury, and there will be injury to the outside world and to the world at large”\textsuperscript{191}

2. Free Trade Agreements and Rules of Origin

The most common complaint of FTAs is the necessary creation of rules of origin (RoO) which are required to prevent non FTA members from enjoying intra-FTA preferences.\textsuperscript{192} The intricate web of rules of origin has been declared a significant barrier to trade and often result in higher increase transaction costs further deterring trade.\textsuperscript{193} Economist Jagdish Bhagwati coined the expression “The Spaghetti Bowl” (as depicted in the following image) to describe the overlapping web of FTAs and the complicated rules of origin.\textsuperscript{194} The Spaghetti Bowl clearly demonstrates the complexity and added costs of ensuing compliance with the many overlapping rules. Such rules are required to ensure that products that receive preferential treatment originate in the counterparts country. For example, if the value added of a product is below 50\% of the total value the product would not qualify as having been produced within the preferential area. Determining the share of value added to a certain product in the FTA member state can become extremely difficult especially when one nation is, for example, a member of 8 different FTAs with all different RoO. A country with multiple FTAs and RoOs can see a variety of disadvantages, such as inefficient border controls and delay in transports.

\begin{itemize}
\item [\textsuperscript{191}] \textit{Ibid.} \\
\item [\textsuperscript{192}] Patricia Augier, Michael Gasiorek & Charles Lai-Tong, “Multilateralising Regionalism: Relaxing Rules of Origin or Can those PECs be flexed?” (2007) CARIS Working Papers No. 3, Centre for the Analysis of Regional Integration at Sussex, University of Sussex, Sussex, UK. \\
\item [\textsuperscript{193}] \textit{Ibid.} \\
\end{itemize}
Export producers have also raised concerns with the growing number of FTAs as they are under increasing pressure to tailor products for a variety of different markets in order to be able to benefit from low or no tariffs.\textsuperscript{195} It has been well documented that the tailoring process has resulted in higher production costs, often higher than the value of the preferential tariffs.\textsuperscript{196} Consequently, many producers have chosen to pay the higher WTO tariff as they do not find it profitable to adapt to the rules of origin.\textsuperscript{197} The question for producers then becomes, what is the price of complying with RoO? An FTA with an established tariff of zero will also have a set of RoO. In a FTA RoO replaces MFN, meaning that the opposite of what MFN was meant to establish actually takes place.

\textsuperscript{196} Ibid.
\textsuperscript{197} Ibid.
The associated costs for the administration and adaptation of products in order to meet RoO guidelines will need to be added to the total shipment value. Therefore, an exporter wishing to export to a WTO country which is also a FTA partner has to engage in one of the following calculations. The exporter can choose to pay the MFN tariff or he can choose to meet the RoO in order to avoid duties entirely. Medvedev has completed research in this area and has come to the conclusion that the cost for RoO compliance is equal to a MFN tariff of between 3% and 6% of shipment value. Based on this value he estimates that total share of preferential RTA trade is 15.4% - 11.4% of world trade. This extremely low number when compared to total FTA participation demonstrates that many FTAs are not fully utilized. The main reason for all of this is the low MFN tariffs which render FTA tariffs useless when adding RoO costs for compliance. As a single set of trade rules are easier to comply with than 10 different sets of rules, Bhagwati argued that free trade agreements are actually hindering free trade. In addition to the added costs of complying with multiple sets of RoO they also result in inefficient border controls and delay transports, consequently leading to greater economic injury. Bhagwati has stated that given the state of comparative advantage, any preference on tariff rates can also result in trade diversion. Even though current trade preferences may not lead to trade diversion, preferences may cause countries to lose their comparative advantage to rivals. Take for example a rule of origin for cars that specifies that the domestic content of the car must be a certain proportion of

199 Ibid.
200 System, supra note 180.
201 Ibid.
202 Ibid.
the value of the car. This causes an endless cycle of looking into the development chain of the car to determine where each component originated from.

There are numerous trade and investment policies both domestic and internationally currently thwarting economic growth in Latin America. Although a number of options to increase economic growth were discussed above, there is no clear guaranteed solution that will see growth return to Latin America. Entering into an FTA, however, has been consistently shown to be an effective growth tool. The North American Free Trade Agreement is one example of a successful free trade agreement that has benefited all members. A Mercosur FTA with a large economic bloc, such as the European Union, would provide Mercosur members the large, stable market its producers and manufactures desire and it is likely the best option available to kick start the regions’ economic growth. As noted above, countries and trading blocs from around the world are pursuing free trade agreements in the hope of revitalizing their country’s economic growth. With many countries increasing their trading partners, Mercosur risks being left out of the trade and FTA movement. The European Union for example, has already negotiated an FTA with Canada and is currently discussing a similar agreement with the United States. To best understand why Mercosur should pursue an FTA with a large economic bloc such as the EU, it is important to first set out the past and current trade history of these two regions.
CHAPTER 8: MERCOSUR AND LATIN AMERICA

1. Mercosur and Latin American Review

1.1. Economic History of Latin America

After years of strong GDP growth Mercosur is currently struggling to achieve sustained economic growth. The decision to either introduce additional protectionist policies or seek an FTA with the EU will determine Mercosur’s future economic performance. In 2010, Mercosur’s population reached approximately 250 million people with a GDP per capita of only 6,800 Euros. With the exception of the economic crises in Brazil in 2003, Mercosur has seen high growth with an annual rate of 4.6%. The following table provides the key economic indicators for Mercosur between the 2002 and 2010 and clearly shows the growth in Mercosur GDP during this period.

Figure 3 – Mercosur Economic Indicators

<table>
<thead>
<tr>
<th>Item</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
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<tr>
<td>Population, millions of persons</td>
<td>223</td>
<td>226</td>
<td>229</td>
<td>232</td>
<td>234*</td>
<td>236*</td>
<td>239*</td>
<td>241*</td>
<td>244*</td>
</tr>
<tr>
<td>Gross domestic product, current prices, billions of €</td>
<td>663</td>
<td>618</td>
<td>673</td>
<td>876</td>
<td>1,061</td>
<td>1,295</td>
<td>1,368</td>
<td>1,384*</td>
<td>1,658*</td>
</tr>
<tr>
<td>Gross domestic product per capita, current prices, thousands of €</td>
<td>3,0</td>
<td>2,7</td>
<td>2,9</td>
<td>3,8</td>
<td>4,5*</td>
<td>5,3*</td>
<td>5,7*</td>
<td>5,7*</td>
<td>6,6*</td>
</tr>
<tr>
<td>Gross domestic product, constant prices, annual percent change</td>
<td>-0.2%</td>
<td>2.6%</td>
<td>6.3%</td>
<td>4.2%</td>
<td>4.7%</td>
<td>6.9%</td>
<td>5.5%</td>
<td>0.0%*</td>
<td>5.2%*</td>
</tr>
<tr>
<td>Inflation, average consumer prices, annual percent change</td>
<td>11.1%</td>
<td>14.6%</td>
<td>6.2%</td>
<td>7.3%</td>
<td>5.3%</td>
<td>4.5%</td>
<td>6.2%</td>
<td>5.1%</td>
<td>5.9%*</td>
</tr>
<tr>
<td>Current account balance, percent of gross domestic product</td>
<td>0.3%</td>
<td>1.8%</td>
<td>1.7%</td>
<td>1.7%</td>
<td>1.5%</td>
<td>0.4%</td>
<td>-1.2%</td>
<td>-0.8%*</td>
<td>-2.0%*</td>
</tr>
<tr>
<td>Current account balance, billions of €</td>
<td>2</td>
<td>11</td>
<td>12</td>
<td>15</td>
<td>16</td>
<td>5</td>
<td>-17</td>
<td>-11*</td>
<td>-34*</td>
</tr>
</tbody>
</table>

The European Union has a total population twice as large as Mercosur, their development is much higher with GDP per capita around 23,000 euros and they also have a smaller current

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203 Barriers, supra note 108.
204 Ibid.
205 Ibid.
account deficit.\footnote{Ibid.} The following table includes the key European economic indicators and clearly shows a slower GDP growth rate than that of Mercosur.\footnote{Ibid.}

\textit{Figure 4 - European Economic Indicators.}\footnote{Ibid.}

<table>
<thead>
<tr>
<th>Item</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population, millions of persons</td>
<td>485</td>
<td>487</td>
<td>489</td>
<td>491</td>
<td>493</td>
<td>495</td>
<td>498</td>
<td>500</td>
<td>501</td>
</tr>
<tr>
<td>Gross domestic product, current prices, billions of €</td>
<td>9,950</td>
<td>10,118</td>
<td>10,617</td>
<td>11,072</td>
<td>11,599</td>
<td>12,396</td>
<td>12,493</td>
<td>11,787</td>
<td>12,120</td>
</tr>
<tr>
<td>Gross domestic product per capita, current prices, thousands of €</td>
<td>20,5</td>
<td>20,8</td>
<td>21,7</td>
<td>22,5</td>
<td>23,7</td>
<td>25,0</td>
<td>25,1</td>
<td>23,6</td>
<td>24,2</td>
</tr>
<tr>
<td>Gross domestic product, constant prices, annual percent change</td>
<td>1.2%</td>
<td>1.3%</td>
<td>2.5%</td>
<td>2.0%</td>
<td>3.2%</td>
<td>3.0%</td>
<td>0.5%</td>
<td>-4.2%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Inflation, average consumer prices, annual percent change</td>
<td>2.5%</td>
<td>0.3%</td>
<td>2.4%</td>
<td>2.3%</td>
<td>2.4%</td>
<td>2.9%</td>
<td>0.3%</td>
<td>-1.5%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Current account balance, percent of gross domestic product</td>
<td>0.2%</td>
<td>0.1%</td>
<td>0.5%</td>
<td>-0.1%</td>
<td>-0.3%</td>
<td>-0.4%</td>
<td>-1.0%</td>
<td>-0.3%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Current account balance, billions of €</td>
<td>17</td>
<td>13</td>
<td>52</td>
<td>-8</td>
<td>-36</td>
<td>-49</td>
<td>-129</td>
<td>-35*</td>
<td>-8*</td>
</tr>
</tbody>
</table>

1.2. Trade And Investment Barriers

Mercosur trade and investment barriers and challenges remain central to Latin America’s growth prospects. Latin America has a long history on having trade barriers in place in order to protect domestic industries. In the days before an international trading system countries managed their trade largely ad hoc. From 1870 to 1913, Latin American countries had an average tariff of 27
percent, extremely high when compared to the 7 percent tariff in Asia.\footnote{Harold L. Cole, “Latin America in the Rear-view Mirror” online: Federal Reserve Bank of Minneapolis, Report 351 November 2004 <https://www.minneapolisfed.org/research/sr/SR351.pdf>}

Unfortunately it got worse in Latin America before it got better. Before and especially after World War II, depending on the category of good, nominal rates of tariffs ranged from 22 percent to 172 percent.\footnote{Ibid.}

Consequently, this had a substantial effect on economic growth and poverty especially when compared to the European countries which averaged tariff measures of 11 percent.\footnote{Ibid.}

Moreover, Latin American countries had some of the most restrictive quota measures. In 1956, 28 percent of products were subject to quotas and this rose to 74 percent by 1974.\footnote{Ibid.}

Latin American countries employed protectionist measures up until the early 1990s.\footnote{Ibid.}

During this period growth was stagnant, poverty increased, competition was non-existent and governments fell. In addition, Latin America had some of the highest barriers to competition, such as, high entry costs, excessive government intervention in industries and high costs of building workforces and infrastructure.\footnote{Ibid.}

Data was collected in 1997 on the costs of starting a business in Latin America compared to the United States, Asia and Europe. The study revealed that the total estimated cost of starting a business in Latin America was 80\% of per capita GDP, compared to less than 2\% in the United States, 24\% in Asia and 36\% in Europe.\footnote{Barriers, supra note 108.}

Moreover, as the following chart demonstrates, the added time and procedures required to start a business was significantly higher for Mercosur based companies than it was for other developing countries, consequently leading to an increase in cost.
Spurred by the success of the European Common, regional integration began in Latin America with the establishment of the Latin American Free Market Association based in Montevideo in 1960 ("LAFMA") and then the Andean Pact based in Lima in 1969. Social and political unrest followed by military coups stopped any momentum for such initiatives and in 1976 Chile’s military regime quit the Andean Pact. Only after a complex transition to democracy would regional integration again come to the forefront. Since the 1980’s Latin America has pursued a very aggressive trade liberalization policy. Specifically, preferential liberalization had become a center piece of trade policy in Latin America.

216 Ibid.
2. Old and New Regionalism

Latin American regionalism and trade policy can be characterized in two stages “Old Regionalism” and “New Regionalism”. These two processes vary as to the objectives they were meant to achieve. Old Regionalism had its roots in Latin America at a time when countries in the region where pursuing Import Substitution Industrialization (ISI), a development strategy that focused on developing a domestic industry in order to break free from the reliance on exports. In an ISI strategy it was common for countries to implement multiple exchange rates, tariffs, import licenses quotas and export taxes. Industrialization was also a fundamental objective for many Latin American countries as it contributed to sustained economic development, increased employment opportunities and led to diversification and modernization of economies. Trade policies have had a significant impact on the pace and pattern of industrialization in Latin America.

The EP industrialized strategy on the other hand is associated with trade related policies that are directed at ensuring that the incentives to export balance with the incentives to produce for import substitution. This is usually achieved by either an open trade regime or one that compensates for any import protection by offering incentives for export. Therefore the main reason behind EP is to have a neutral trade regime and have the economy find its own comparative advantages and facilitate structural change towards efficiency. On the opposite

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221 Valvis, supra note 216.
222 Ibid.
223 Ibid.
224 Ibid.
end, the ISI model emphasizes the importance of protectionism as a way to compete and separate from the developed countries.\textsuperscript{225} The ISI approach argues for diversification in production in order to access a broad range of goods, consequently, the opposite of embracing comparative advantage.\textsuperscript{226}

Economic results have strongly favoured the EP model and Asia countries that have dropped the ISI approach in favour of the EP model have done significantly better than those that have stayed with the ISI model.\textsuperscript{227} The Japanese government, for example, played a key policy role in the 1950’s in driving its economy to growth.\textsuperscript{228} The government introduced “complementary policies” such as investments in education, training and infrastructure.\textsuperscript{229} As a labour intensive economy in the 1950’s, Japan’s exports were mainly labour intensive products.\textsuperscript{230} As Japan’s economic structure changed and capital began being accumulated its exports started becoming varied. This approach ensured that the Japanese engaged all of its work force and achieved economic efficiency. The Japanese approach is in stark contrast to Brazil’s ISI approach during the 1960’s and 1970’s. During this period Brazil embraced ISI which led to very slow growth.\textsuperscript{231} The inefficiencies created by the ISI model proved to be counterproductive. As Brazil tried to protect its capital intensive sectors in its labour abundant country, effectively going against comparative advantage principles, it chose capital over labour and manufactures over agriculture which resulted in a number of inefficiencies, employment issues and a significant large income

\textsuperscript{225} Ibid.
\textsuperscript{226} Ibid.
\textsuperscript{227} Ibid.
\textsuperscript{228} Ibid.
\textsuperscript{229} OECD, supra note 32.
\textsuperscript{230} Ibid.
\textsuperscript{231} Ibid.
distribution problem.\textsuperscript{232} The debt crises in the 1980s brought an end to the import substitution period in Latin America and Brazil ended up adopting the EP model.\textsuperscript{233} Fortunately, what followed the debt crises was a period of economic and regional restructuring that was accompanied by a reduction of state involvement in the economic affairs of the country. Brazil’s economy showed great strength and agility in adapting to changing domestic demands.

Central to “New Regionalism” was the unilateral reduction of tariffs. Where the “old regionalism” was seen to be inward focuses, the new wave of regional integration was conceptualized as part of an overall outward looking philosophy.\textsuperscript{234} New regionalism has been an integral part of the structural reform process which was designed to make economies more open, market friendly, socially equitable, more democratic and internationally competitive. The two main examples of “new” regionalism are the North American Free Trade Agreement and Mercosur. These two achievements were aimed at opening domestic markets to the world and promoting the role of the private sector while withdrawing the state from direct economic interference. NAFTA and Mercosur also set to increase the amount of foreign direct investment and to booster intra region trade to grow their market size.\textsuperscript{235} Moreover, NAFTA and Mercosur also aimed at developing closer ties among member countries, fostering political cooperation in international forums and strengthening a members bargaining position in ongoing multilateral trade negotiations.

\textsuperscript{232} Ibid.
\textsuperscript{233} Ibid.
\textsuperscript{234} Regionalism, supra note 219,
\textsuperscript{235} Ibid.
In 1991 an economic and political agreement was reached in Latin America with the goal of promoting free trade and fluid movement of goods, people and currently.\textsuperscript{236} Mercosur now includes Argentina, Brazil, Paraguay, Uruguay and Venezuela and Bolivia. The economic bloc’s purpose is to allow for free trade between member states with the ultimate goal of full South American economic integration.\textsuperscript{237} During the 1990s, tariff and non-tariff barriers declined significantly and there was very little reverting back to the protectionist policies of the past even during the macroeconomic shocks of the 1990’s.\textsuperscript{238} The trade liberalization policies resulted in a strong surge in trade flows which increased the pressure of local producers to compete with worldwide imports. Intra-Mercosur merchandise trade grew from US$10 billion at the time of inception of the trade bloc to over US$85 billion in 2010.

After the initial transition period of 1991 - 1994 a relative ineffectiveness and inefficiency characterized the evolution of the economic integration process. On the national and international level Mercosur witnessed a deterioration of its credibility.\textsuperscript{239} The period between 1998 and 1999 saw Mercosur’s reputation decline to new levels with the Brazilian devaluation of the Real and then again with Argentina’s own economic and political crises in 2002 and 2003.\textsuperscript{240} Mercosur members have also shown division over whether the organization should remain focused on regional trade or whether it should add political affairs to its mandate.

\begin{thebibliography}{99}
\bibitem{236} Regionalism, \textit{supra} note 219.
\bibitem{237} \textit{Ibid.}
\bibitem{238} \textit{Ibid.}
\bibitem{239} \textit{The Path to Regional Integration}, online: Woodrow Wilson International Center for Scholars <http://www.wilsoncenter.org/sites/default/files/Mercosur\%20Rpt\%20on\%20Amer\%205.pdf>
\end{thebibliography}
Mercosur now constitutes an international subsystem that results in international interactions at the political, economic and cultural levels. At its core, Mercosur aims at developing a stable political and democratic framework within the region by focusing on economic preferences and common policies. Mercosur members are working towards making the block a first rate world actor allowing them to compete with other large trading nations such as, Russia, China and India. The key win-win objectives for Mercosur were to enlarge the national markets in order to allow firms to invest and transform them in becoming more competitive at the regional and global level. As Mercosur provided common principles, criteria and rules of the game, citizens, investors and countries outside of Mercosur viewed such signals as long term goals of stability.

3. Current Economic Circumstances in Latin America

Despite Latin America’s history of economic and financial issues, Mercosur has become the fourth largest economic group in the world with a GDP of approximately US $1002 billion. Mercosur has been recovering from the economic and financial crises suffered by Argentina, Uruguay Paraguay and Brazil since 2003. Argentina for example, has seen a growth rate of 9.2 percent together with the restoration of currency and price stability and a gradual return of depositors. Thanks to prudent economic policies Brazil has also seen similar improvements. The Brazilian Real has appreciated from its low in 2002 and yield spreads on international bonds have declined significantly.

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242 Ibid.
243 Ibid.
244 Ibid.
Despite these economic improvements, the region remains vulnerable and Mercosur has stalled as a formal economic integration process. Disputes between Mercosur members have increased in recent years and there is fear that the economic momentum in the region has slowed. Although Argentina had nearly matched China for growth in 2012 and Brazil was teaching the developing world some lessons on how to run a successful modernizing economy, such success have been short lived. Most recently, Brazil and Argentina have begun worrying about competitors from Asia. China has grown as a competitor and is taking market share away from Argentina’s and Brazil’s local manufacturing. Out of fear of deindustrialization, Brazil and Argentina have resorted to protectionist policies. Argentina recently instituted a requirement on some importers to match their orders with exports and has blocked and delayed imports from other member nations in order to protect its surplus. Brazil has retaliated to such measures by imposing barriers on imports from Argentina. Other Mercosur members have also started to revert back to protectionism. In May 2012, member countries agreed to raise the maximum external tariff on imports to 35 percent.

As the largest economy in Latin America and now the sixth largest in the world, Brazil needs to be leading the push to tear down barriers within Latin America. Brazil’s agreement with Mexico for example has benefited the car industry in both countries. By offering a larger market and more economies of scale, it has encouraged specialization. Brazil and Argentina should also look

247 Ibid.
248 Ibid.
249 Ibid.
250 Ibid.
at Mexico’s history when it comes to free trade. After years of seeing many of its manufacturing jobs leave for China, Mexico has reversed this trend and has been seeing positive growth for years.\textsuperscript{251} This is mostly due to its wide range of trade agreements, including NAFTA.

\textsuperscript{251}Ibid.
CHAPTER 9: MERCOSUR - EUROPEAN UNION FREE TRADE AGREEMENT

1. Economic, Social and Political Reasons for Pursuing an FTA with the EU

There are a number of external and internal factors as well as economic, political, social and security related reasons for why Mercosur should pursue a FTA with the EU. Generally, the driving force behind countries engaging in FTAs is the belief that positive economic benefits will arise for both parties. Countries believe there will be a win-win situation whereby each country to the FTA will have increased market access, access to new technology and better products and services.

1.1. New Markets for Exports

For Mercosur, an FTA with Europe would mean securing additional markets and providing export opportunities for domestic companies by dismantling the trade barriers between these two regions. The expansion of production that would result from the increased export opportunities would enable Mercosur companies to reap the benefits of economies of scale which in turn lead to more efficient production. Given the number of FTAs being negotiated and finalized, such as the Canada EU Comprehensive Economic and Trade Agreement (CETA) and the US, EU free agreement, Mercosur would see a potential loss of market opportunity as a result of being excluded from a free trade agreement with the EU. Mercosur members would also see a number of internal benefits from joining a Mercosur European Union FTA, the greatest being economic growth from the increased efficiency that would result from greater competition.\(^\text{252}\) Mercosur has already seen the economic benefits that come with the liberalization of foreign trade and

investment, with deregulation and the removal of domestic regulations. Through this process a number of inefficient Latin American companies will be pushed out of the market while at the same time creating other opportunities for those companies with latent competitive strengths.

1.2. Efficiencies

There are many motivations for countries choosing to access overseas markets through domestic trade reforms as opposed to pursuing similar outcomes through multilateral trade negotiations at the WTO. For Mercosur, being able to conclude an FTA with the EU will almost certainly involve less time than negotiating benefits for Latin America at the WTO. The Uruguay Round for example, was initially scheduled to be completed in four years. In the end it took approximately eight years to conclude. It took nearly double the initial time because of the sheer number of items that had to be negotiated as well as the expansion in the number of participating nations.

As can be seen from the chart below, WTO negotiations with an increasing member count can take a long time to conclude.

<table>
<thead>
<tr>
<th>Round</th>
<th>Duration</th>
<th>Year Range</th>
<th>Members</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dillon Round</td>
<td>2 years</td>
<td>1961-1962</td>
<td>App. 40 Countries</td>
</tr>
<tr>
<td>Kennedy Round</td>
<td>3 years</td>
<td>1964-76</td>
<td>App. 60 Countries</td>
</tr>
<tr>
<td>Tokyo Round</td>
<td>6 years</td>
<td>1973-79</td>
<td>App. 80 Countries</td>
</tr>
<tr>
<td>Uruguay Round</td>
<td>8 years</td>
<td>1986-94</td>
<td>App. 100 Countries</td>
</tr>
<tr>
<td>Doha Round</td>
<td></td>
<td>2001 -</td>
<td>App. 150 Countries</td>
</tr>
</tbody>
</table>
A key benefit of concluding an FTA with a large economic bloc is that it ultimately assists the region in other multilateral negotiations.\textsuperscript{253} For example, an FTA with the EU cuts down the number of WTO negotiators from 27 to 1.\textsuperscript{254}

\textit{1.3. Global Influence and Respect}

Moreover, completing an FTA with the EU would strengthen Mercosur’s political and economic influence with other international players in North America and Asia. The Association of Southeast Asian Nation (ASEAN), for example was created as a political and security forum with an FTA being completed in 1992 as a means to combat the rise of China.\textsuperscript{255} At the time China was attracting large amounts of FDI by companies wanting to gain access to the large Chinese market and its cheap labour. The ASEAN members realized that FDI was crucial to their own region’s economic growth and therefore decided to establish an FTA which created a large and competitive market. Similarly, Mercosur is currently facing strong competition from Asia in attracting US and EU foreign investment as an increasing larger number of US and EU companies are choosing Asia as their investment region. As figure 6 below depicts, Mercosur is losing large amounts of EU investment to China, India and Russia.\textsuperscript{256}

\begin{footnotesize}
\begin{enumerate}
\item Ibid.
\item Ignatius Ismanto & Indra Krishnamurti, The Political Economy of ASEAN-China Free Trade Agreement: An Indonesian Perspective, online: http://www.wti.org/fileadmin/user_upload/wti.org/7_SECO_WTI_Project/Publications/Final_Report_ACFTA__2014_.pdf
\item Barriers, \textit{supra} note 108.
\end{enumerate}
\end{footnotesize}
More importantly, an FTA with Europe would provide foreign investors looking at Latin American as a possible investment destination with peace of mind. The trade, investment and political stability required for negotiations and implementation of an FTA ensures a certain level of commitment and leadership from government. Investors will recognize that the investor protections that accompany an internationally recognized agreement become much more difficult to reverse than those reforms that are done on a solely internal basis.

Mercosur and the EU share a similar view of regional integration and its place in the international geopolitical order. Contrary to other integration processes, the EU and Mercosur have envisioned the construction of a common market, the deepening of political cooperation and the achievement of a prominent international role through regional integration policies. For Mercosur an agreement with the EU can also provide much needed incentives to consolidate its own organization’s integration process and would lead to an increase in internal legitimacy and external credibility.

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257 Ibid.
258 Barriers, supra note 108.
The economic benefits that can be achieved by a European Union Mercosur agreement can be seen through the last decade’s trade and investment flows. The EU is already Mercosur’s primary trading partner accounting for more than 30% of total external trade and Mercosur is the most important partner of the EU in Latin America and the Caribbean accounting for approximately 50% of all EU-LAC trade.\textsuperscript{259} Mercosur has come out of the economic crises relatively unscathed compared to many of EU member countries and with pressure mounting on the European Union to find new markets for their member’s multinational corporations, Mercosur is in a prime position to negotiate a favorable agreement.

Proponents of FTAs have also argued that such agreements are more successful in tackling significant global issues, such as, labour standards and environmental issues, all of which are difficult to form a consensus on at the multilateral stage.\textsuperscript{260} Research has also shown that countries enter into free trade agreements to increase their bargaining power with third countries.\textsuperscript{261} Successful negotiations and implementation of an FTA with the EU will also serve as a precedent and assist Mercosur in its negotiations with the United States and Canada should both countries decide to restart discussions on a free trade area of the Americas. The European Economic Community, for example, was formed with the idea of being a counterbalance to the United States.\textsuperscript{262}

\textsuperscript{259} Ibid.


\textsuperscript{262} Ibid.
Similar to how NAFTA allowed Canadian producers achieve some degree of exemption from the use of anti-dumping and countervailing duties by US producers; the same types of benefits can be had by Latin American producers through an FTA with the EU.\textsuperscript{263} The economic importance of securing markets as a reason for pursuing FTAs has become more essential as regionalism has expanded. In order to avoid having their market access erode, from a defensive standpoint, an FTA with the EU is essential.\textsuperscript{264} Before going into a comprehensive discussion on the benefits a free trade agreement with the EU would bring Mercosur, it is necessary to first lay out the historical and current trade practices of these two regions and the trade barriers currently hampering a more robust economic relationship.

\textsuperscript{263} Ibid.
\textsuperscript{264} Bridging, supra note 239.
CHAPTER 10: RELATIONSHIP BETWEEN LATIN AMERICA AND THE EUROPEAN UNION

1. Historical Economic Relationship

Since the 1960’s the EU has supported an increasing series of political and trade relations as well as other co-operative and investment agreements with Latin America.\textsuperscript{265} This process of cooperation allowed the two regions to strike a strategic partnership in the 1999 Rio De Janeiro Summit.\textsuperscript{266} The Summit was the first time that an action plan was agreed upon by the 48 EU and Latin America countries in attendance in order to increase cooperation in the political economic and cultural fields. The EU has been a strong supporter of regional integration and was an early supporter of Mercosur from its inception in 1991.

Although Mercosur has a relatively low average GDP per capita the region has historically been an attractive market for European exporters and investors.\textsuperscript{267} The EU is the world's biggest exporter of manufactured goods and services and it is the biggest import market for over 100 countries making it the world’s largest single market area.\textsuperscript{268} Both European and international consumers and investors enjoy the benefits of a simplified EU system – an area where people, goods, services and money can move freely.


\textsuperscript{266} Ibid.

\textsuperscript{267} Barriers, supra note 108.

\textsuperscript{268} Ibid.
The EU negotiates agreements through its world-wide network of trade relations. It engages with a large range of partners mostly through free trade agreements. These partnerships seek to create growth and jobs for Europeans by opening new markets with the rest of the world. Transatlantic markets, for example, represent transactions worth around 2 billion euros every day.\textsuperscript{269} For the world’s poorest countries, EU trade policy looks to combine trade and development.\textsuperscript{270} Allowing lower duties, supporting small export businesses, and advising on improvements to governance are just some of the ways trade and development can work hand in hand to ensure the neediest benefit from trade-led growth. The chart below highlights that Mercosur has room to grow in terms of receiving EU products and services. Two other developing countries China and Russia have consistently out ranked Mercosur in attracting EU exports.\textsuperscript{271}

\textit{Figure 7 - The EU’s Main Export Destinations}\textsuperscript{272}

While trade and investment is once again picking up between Mercosur and Europe, trade and investments are still below potential levels.\textsuperscript{273} Prior to the economic crises exports to Mercosur

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|c|c|c|}
\hline
\hline
2 & Japan & China & China & Russia & Russia & Russia & Russia & China \\
3 & China & Japan & Russia & China & China & China & China & Russia \\
4 & Russia & Russia & Japan & Turkey & Turkey & Turkey & Turkey & Turkey \\
5 & Turkey & Turkey & Turkey & Japan & Japan & Japan & Japan & Japan \\
6 & Canada & Canada & Canada & UAE & Canada & India & Mercosur & India \\
7 & Hong Kong & Hong Kong & Australia & Canada & UAE & Mercosur & UAE & Mercosur \\
8 & Mercosur & Australia & Hong Kong & India & India & UAE & India & UAE \\
9 & South Korea & UAE & UAE & Mercosur & Mercosur & Canada & Canada & Canada \\
10 & Australia & South Korea & Mercosur & Australia & Hong Kong & South Korea & South Korea & Australia \\
\hline
\end{tabular}
\end{table}

\textsuperscript{269} Strategy, supra note 219.
\textsuperscript{270} Ibid.
\textsuperscript{271} Barriers, supra note 108.
\textsuperscript{272} Ibid.
amounted to 52 billion Euros, while imports into Europe from Mercosur amounted to $61 billion. Foreign direct investment has also not reached pre-crisis levels. Between the years of 2004 and 2009, EU investments in Mercosur increased from 103 billion to 182 billion.

Brazil is the EU’s 10 largest trading partner with exports in goods from the EU totaling over 21 billion euros and the EU is Brazil’s largest trading partner with agricultural imports accounting for one in eight of total EU agricultural imports. Argentina is also a key trading partner for the EU with the EU being the largest foreign investor in Argentina. Food, live animals and other crude materials make up the majority (65%) of the EU’s imports from Mercosur. With regard to the EU’s exports to Mercosur, the majority of items consist of machinery and transport equipment which account for over 70% of EU exports. Between 2007 and 2009 the EU had an average trade deficit in agriculture and manufactured products worth 12.7 billion and a trade surplus in services. With regard to services, in 2008 the EU exported 18.4 billion in services to Mercosur while imports accounted to 12.7 billion. As shown in the following graph, EU exports to Mercosur had a significant drop in 2003.

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273 Ibid.
274 Ibid.
275 Ibid.
276 Ibid.
278 Ibid. supra note 108.
279 Ibid.
280 Ibid.
281 Ibid.
282 Ibid.
Moreover, as the following graph will show, the EU and Mercosur have historically enjoyed a close economic relationship when it comes to bilateral investments. Between 2004 and 2009 foreign direct investment into Europe from Mercosur went from an insignificant amount to 60 billion.\textsuperscript{283} During the same period EU investments into Mercosur went from 103 billion to 182 billion accounting for more than half of the total stock of inward FDI in Mercosur.\textsuperscript{284} The EU’s investment into Mercosur compared to Russia, India and China, (other BRIC countries) is a significant accomplishment for Mercosur. As will be discussed below, however, the BRIC countries (other than Brazil) have been clawing away at Mercosur’s share of EU investment and are increasing their efforts to attract additional EU investment most likely at the expense of Brazil.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure8}
\caption{Trade in goods between the EU and Mercosur 2002-2009}
\end{figure}

\textsuperscript{283} Ibid.
\textsuperscript{284} Ibid.
With regard to trade in services, the EU also exports a higher dollar value in services to Mercosur than Mercosur exports to the EU.\textsuperscript{285} As per figure 10 below, in 2008 the EU exported approximately 18.4 billion euros in services to Mercosur while Mercosur exported 12.7 billion during the same period.\textsuperscript{286} The EU’s surplus in services shown in the last column is largely due to transportation and construction services. During this period the EU ran a trade deficit in relation to government services, personal, cultural and recreational services.

\textsuperscript{285} Ibid.
\textsuperscript{286} Ibid.
Over the years Mercosur has been trying to gain additional traction in Europe for their producers and manufactures but has seen their efforts stymied by other countries, such as India, Russia, US and Japan. As seen from figure 11, the EU’s share of imports from Mercosur has remained consistent at approximately 3% of total imports with exports hitting a peak of 2.5% of the union’s total exports in 2009.\textsuperscript{288}

\textit{Figure 10 – Trade in Services}\textsuperscript{287}

\textit{Figure 11 – Mercosur Share of Total EU Trade}

\begin{tabular}{|l|c|c|c|c|c|c|c|}
\hline
 & EU exports &  & EU Imports &  & EU trade balance &  \\
\hline
Total Mercosur & 9,814 & 13,643 & 18,422 & 8,345 & 9,504 & 12,743 & 1,469 & 3,539 & 5,679 \\
\hline
of which: & & & & & & & & & \\
Transportation & 3,789 & 4,497 & 5,273 & 2,552 & 2,889 & 3,345 & 1,237 & 1,608 & 1,828 \\
Travel & 2,191 & 2,680 & 3,468 & 2,617 & 2,810 & 3,022 & -426 & -130 & 385 \\
Other services & 3,729 & 5,698 & 9,576 & 3,093 & 3,691 & 5,177 & 630 & 2,007 & 2,399 \\
\hline
of which: & & & & & & & & & \\
Communication services & 185 & 265 & 341 & 142 & 183 & 215 & 43 & 82 & 126 \\
Construction services & 517 & 702 & 1,117 & 160 & 218 & 261 & 358 & 484 & 855 \\
Insurance services & 246 & 242 & 378 & 87 & 85 & 120 & 150 & 157 & 258 \\
Financial services & 327 & 524 & 473 & 167 & 256 & 269 & 161 & 268 & 205 \\
ICT services & 377 & 490 & 627 & 121 & 141 & 202 & 256 & 349 & 426 \\
Royalties and license fees & 49 & 68 & 98 & 37 & 73 & 111 & 462 & 524 & 824 \\
Other business services & 1,382 & 2,034 & 3,448 & 2,050 & 2,332 & 4,565 & -666 & 202 & 882 \\
Personal, cultural and recreational services & 115 & 141 & 133 & 117 & 152 & 163 & -2 & -11 & -44 \\
Government services & 81 & 103 & 118 & 220 & 252 & 251 & -139 & -149 & -133 \\
Total extra-EU27 & 566,128 & 586,514 & 769,441 & 476,310 & 569,360 & 648,528 & 114,418 & 118,955 & 114,513 \\
Mercosur/extra-EU27 & 1.73\% & 1.89\% & 2.41\% & 1.75\% & 1.67\% & 1.96\% & & & \\
\hline
\end{tabular}

\textsuperscript{287} \textit{Ibid.}
\textsuperscript{288} \textit{Ibid.}
The same pattern was also played out in the EU’s investment into Mercosur. As figure 12 below indicates, total FDI into the EU from Mercosur and into Mercosur from the EU has consistently increased with the EU currently accounting for more than half of total Mercosur stock of inward foreign direct investments.\(^{289}\) The EU’s direct investment in other countries such as China, India and Russia, however, has increased at a faster rate than the EU’s investment in Mercosur.\(^{290}\)

\textit{Figure 12 – Bilateral FDI Stock by the EU and Mercosur}

The importance of a stronger economic, social and political relationship between Mercosur and the EU for Mercosur’s future growth cannot be overstated. Unfortunately, however, there are a number of trade and investment obstacles and barriers that are unnecessarily hindering the establishment of a more robust trading relationship between these two regions. Chapter eleven will outline the most onerous trade and investment barriers currently hampering trade between these two regions.

\(^{289}\) \textit{Ibid.}\(^{290}\) \textit{Ibid.}
CHAPTER 11: TRADE BARRIERS BETWEEN MERCOSUR AND EUROPE

1. Trade Barriers

1.1. Tariffs and Non-Tariff Measures

Tariffs and non-tariff barriers are significantly reducing the amount of trade and investments in Latin America and depriving consumers and exporters of considerable economic benefits.\textsuperscript{291} There are high tariffs on Latin American products mainly on agricultural products at the European borders denying Mercosur producers from supplying Europe at competitive prices.\textsuperscript{292} In the services sector, regulatory barriers are holding back cross-border trade and the establishment of foreign affiliates.\textsuperscript{293} Barriers to exports and investments commonly fall into two categories, tariffs and non-tariff measures. Moreover, the ever changing regulatory regime in Latin American also creates uncertainty for investors and exporters from Europe and around the world.

1.2. Tariffs

The common trade policy found in Mercosur is the Common External Tariff (CET) which accounts for 85% percent of products.\textsuperscript{294} The common external tariff is unnecessarily high and un-harmonized with very few imports entering Mercosur duty free.\textsuperscript{295} There are extremely high tariffs for agricultural products such as dairy, sugars, confectionary, beverages and tobacco, in

\textsuperscript{291} Barriers, supra note 108.
\textsuperscript{292} Ibid.
\textsuperscript{293} Ibid.
\textsuperscript{294} Ricardo Gazel, Mercosur: past, present, and future, online: Inter-American Development Bank: \texttt{<http://www.face.ufmg.br/novaeconomia/sumarios/v13n2/Paiva.pdf>}
\textsuperscript{295} Barriers, supra note 108.
the range of 35-45% and average applied MFN tariffs of 15-17%. With regard to transport equipment, footwear and textiles, tariffs are approximately 35%. Added to this is the added burden of double duties where exporters often end up paying tariffs both when they export their products to a Mercosur nation and then again when they have to re-export that same product to another Mercosur country.

The CET does not apply to all items imported into Mercosur and differences between tariffs within Mercosur remain. In cases where the external tariff is not fully harmonized across geographies Mercosur’s rules of origin prevent non-member countries from exploiting import differences between Mercosur members. To benefit from tariff-free trading a certain percentage of the product has to be manufactured within Mercosur. EU exporters, for example, will be able to receive the preferential tariff rate and gain access to the whole Mercosur market by establishing themselves in one Mercosur country and receiving a signed certificate of origin which will be valid for 180 days. Unfortunately many EU companies have reported delays in obtaining an import license causing them to exceed the 180 days validity period.

1.3. Mercosur Customs Procedures

As Mercosur is not a customs union there are many differences among national trade regimes and intraregional customs which have added to the difficulties and costs of exporting goods to Mercosur. For example, due to port costs, strikes, corruption and bureaucratic barriers,

296 Ibid.
297 Ibid.
299 Trade, supra note 256.
it costs approximately $1,520 to import a container to Mercosur.\textsuperscript{300} The following table shows that similar costs are much lower for India and China.\textsuperscript{301}

\begin{center}
\textit{Figure 13 – Efficiency of import-export procedures}
\end{center}

<table>
<thead>
<tr>
<th>Country</th>
<th>Cost to import, US$ per container</th>
<th>Documents to import, number</th>
<th>Time to import, days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mercosur</td>
<td>1,520</td>
<td>7</td>
<td>16</td>
</tr>
<tr>
<td>Argentina</td>
<td>1,810</td>
<td>7</td>
<td>16</td>
</tr>
<tr>
<td>Brazil</td>
<td>1,440</td>
<td>7</td>
<td>16</td>
</tr>
<tr>
<td>Paraguay</td>
<td>1,750</td>
<td>10</td>
<td>33</td>
</tr>
<tr>
<td>Uruguay</td>
<td>1,350</td>
<td>10</td>
<td>22</td>
</tr>
<tr>
<td>Russia</td>
<td>1,850</td>
<td>13</td>
<td>36</td>
</tr>
<tr>
<td>India</td>
<td>960</td>
<td>9</td>
<td>20</td>
</tr>
<tr>
<td>China</td>
<td>545</td>
<td>5</td>
<td>24</td>
</tr>
</tbody>
</table>

In addition, as the following Custom Procedures graph will show, many Mercosur countries have cumbersome, unpredictable and slow custom procedures.\textsuperscript{302} The bureaucratic process in obtaining an import license in Mercosur is one of the most cumbersome in the world with no less than seven documents required to be able to import from China.\textsuperscript{303} Under WTO regulations, such import licenses should be released within 60 days of filing an application.\textsuperscript{304} This process usually takes much longer in Latin America, with Argentina taking up to 100 days for approval.\textsuperscript{305} Mercosur also requires registration of importers and coordination with many different government agencies, all of which become problematic in cases of urgent shipments.\textsuperscript{306}

\textsuperscript{300} Barriers, \textit{supra} note 96
\textsuperscript{301} Ibid.
\textsuperscript{302} Ibid.
\textsuperscript{303} Ibid.
\textsuperscript{304} Ibid.
\textsuperscript{305} Ibid.
\textsuperscript{306} Ibid.
These cumbersome barriers to import has resulted in Mercosur being ranked 114 on the burden of custom procedures, compared to number 38 for China, 68 for India and 122 for Russia.³⁰⁷

Mercosur members have also been hurting themselves with the implemented protectionist policies. One example is Argentina’s 2009 decision to introduce reference prices and implementation of non-automatic import licensing requirements on steel, metallurgical, and textile products.³⁰⁸ This created a large bureaucratic burden on European importers resulting in a considerable slowing of imports into Argentina. Not only have these policies frustrated EU exporters but have caused considerable tension between Mercosur member nations. As seen from figure 14, when compared to other BRIC countries, Mercosur’s custom procedures rank as the second worst only behind Russia.³⁰⁹

Figure 14 – Custom procedures

³⁰⁷ Ibid.
³⁰⁹ Barriers, supra note 108.
Unless rectified through FTA negotiations such procedures will continue to pose a risk to Mercosur’s trade balance and economic growth.

**1.4. Compulsory Registration Barriers**

A foreign corporation wishing to enter or expand its business with a Mercosur member country will have to also deal with a very slow, burdensome and complex bureaucracy. Registration barriers such as, construction permits and property registration have resulted in agency backlogs and long delays.\(^{310}\) In Brazil, regulatory backlogs have caused the introduction of new goods and services to be delayed from entering the market for months and even years.\(^{311}\) Many EU exporters have found it easier to partner with local businesses rather than setting up a new entity in a Mercosur member country.\(^{312}\)

Another example of a protectionist policy is Argentina’s 2010 decision to introduce a set of restrictions with regard to food imports. The restriction does not allow certain foods from entering the market if a similar food product is able to be produced in Argentina.\(^{313}\) Recently, the Instituto Nacional de Alimentos began delaying the issuance of certificates of free circulation for food imports which are necessary for EU corporations to release products in the Argentinian market.\(^{314}\) Although this was just a formality prior to 2010 the current practice of sending such requests for a certificate to the Secretary of State for Internal Trade has caused significant delays

\(^{310}\) Ibid.

\(^{311}\) Ibid.


\(^{313}\) Ibid.

and has resulted in negative trade effects on EU exports.\(^{315}\) This has also caused EU exports, such as canned peaches, cheese, premium good products, pasta, olive oil and vinegar from being stopped at the gate in Argentina with importers refusing to place new orders. As noted above, the compulsory registration system within Mercosur has made it difficult for EU companies to start or expand their brand in the region. Such policies have resulted in the Global Competitiveness Index ranking Mercosur 130 out of 139 on an assessment of the number of procedures required to start a business.\(^{316}\)

Mercosur is not currently known as an overtly open and friendly place for multinational corporations and foreign investment. The Trade Enabling Index provides an assessment of a country’s obstacles to trade. As noted in the following chart, out of 125 countries ranking the most open country first, Mercosur was on average ranked 88 in 2010.\(^{317}\) In addition, as highlighted in the chart below, when it comes to openness to trade and investment and overall competitiveness, Mercosur along with Russia and India are considered poor performers.\(^{318}\)

\(^{315}\) *Ibid.*

\(^{316}\) *Barriers, supra note 108.*

\(^{317}\) *Ibid.*

Moreover, Brazil and Argentina have recently introduced restrictions in maritime transportation and are also placing restrictions on the export of raw materials. Export taxes in Argentina for products such as soya beans, for example, are as high as 35%. Finally, in response to the financial crises, Argentina has extended its system of non-automatic license to a wide range of products. Originally this license system focused on textiles, footwear and toys but has now been expanded to include tires, iron pipes, machinery and mechanical appliances, base metal and articles of base metal and auto parts. The Argentinean government has also taken steps to restrict imports of certain foods by informally encouraging supermarkets not to sell such products and by delaying the issuances of “certificates of free circulation” for such products to be sold.

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319 Barriers, supra note 108.
320 Trade, supra note 256.
322 Brief, supra note 288.
323 Ibid.
In a recent study, Philippidis and Sanjuan calculated the trade cost equivalents (TCEs) of Mercosur’s non-tariff measures - the express cost impact on cross border trade of the identified non-tariff measure.\textsuperscript{324} Figure 16 provides some insight into which products carry the highest TCEs. The study concluded that non-tariff measures should be of particular concern for European exporters, specifically, with regard to tobacco and beverages.\textsuperscript{325} The study reported that non-tariff measures for the aforementioned sectors are the same as having a tariff of 160% of the value of the product.\textsuperscript{326} Similar conclusions were made for Mercosur imports of livestock, vegetables, fruit and nuts from the EU.\textsuperscript{327} With regard to agriculture, Mercosur has low tariffs and high NTMs whereas with manufacturing products the opposite is true.\textsuperscript{328}

\textit{Figure 16 – Trade Cost Equivalents of Mercosur}

As seen in the graph below, it is evident that traditional non-tariff measures, such as, price controls, licensing and quantity controls are high in Mercosur and pose cumbersome challenges

\textsuperscript{324} Barriers, \textit{supra} note 108.
\textsuperscript{325} \textit{Ibid}.
\textsuperscript{326} \textit{Ibid}.
\textsuperscript{327} \textit{Ibid}.
\textsuperscript{328} \textit{Ibid}.
to EU exporters. Out of 125 countries Mercosur ranks 80, slightly ahead of Russia but behind China and India.

*Figure 17 - Nontariff Measures*

The above barriers are just a few of the most cumbersome trade restrictive policies currently in place. It is reasonable to conclude that a free trade agreement that includes provisions for the reduction of tariffs and non-tariff measures as well as a commitment to reduce the regulatory and administrative obstacles to trade would have a substantial impact on Mercosur economic growth. The following pages will set out the key economic, political and social arguments for why Mercosur should complete a FTA with the EU and why the current economic environment in Europe provides Mercosur with the best opportunity in striking a balanced agreement.

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CHAPTER 12: TIMING IS EVERYTHING

1. Pursuing an FTA with the Europe

   1.1. Economic Benefits and Current Environment

   Trade discussions at the multilateral level have produced few significant results. Developed and developing countries continue to argue over a number of trade issues, from agricultural subsidies and anti-dumping measures to technical barriers. The 2008 Financial crises highlighted the need for all countries to diversity their exports beyond their boarders. Europe and Latin American have a cooperative history that stretches back to the 1960’s when a number of co-operation agreements came into existence.\footnote{Anastasios I. Valvis, \textit{Regional Integration in Latin America, Institute of International Economic Relations}, online: <http://idec.gr/iier/new/Valvis-Latin_America_regionalism.pdf>}

   A Mercosur inspired FTA with the EU has the potential to not only significantly increase the standard of living for Latin Americans and bring new products, technologies and services but can bring Mercosur international recognition as a formidable economic bloc in subsequent trade discussions. Although Europe would be the dominant member in any trade negotiation with Mercosur, countries such as Brazil and Argentina have the potential to propel Mercosur into a more dominate position given the EU’s current economic woes.

2. Economic Impact of an FTA

   In an Economic Impact Assessment conducted in May 2011 which looked at the pros and cons of a Mercosur EU free trade agreement it was estimated that an agreement which removed tariffs and reduced non-tariff barriers would enhance Mercosur GDP by 2-3 billion while increasing the

\footnote{Anastasios I. Valvis, \textit{Regional Integration in Latin America, Institute of International Economic Relations}, online: <http://idec.gr/iier/new/Valvis-Latin_America_regionalism.pdf>
EU’s GDP by 15 to 21 billion. The benefits of an FTA with the EU greatly outweigh the
negatives. Latin Americans would have access to a vastly larger product supply as a free trade
agreement would double the amount of EU exports to Mercosur in dollar terms from 52 billion
(2008) to approximately 104 billion. Companies from all industries within Latin America
would also be given access to one of the largest markets in the world. A trade agreement with the
EU would be an opportunity to secure market access in its major export market and help balance
the trade deficit through the increase of agricultural exports and the diversification of manufactured exports.

A free trade agreement with the EU would also provide Mercosur with incentives to consolidate
their own integration process and to increase internal legitimacy and achieve greater external
credibility. Moreover, a deeper relationship with the EU will provide Mercosur with valuable
integration technologies, compensation mechanisms and an understanding of which regulatory reforms are needed for deeper integration of macroeconomic coordination and monetary unification. The key for Mercosur in achieving success, however, is to have a better degree of intergovernmental coordination in order to present a united front when negotiating with the EU.

3. Continued Economic Woes in Europe

Europe may never be more motivated to enter into a free trade agreement with Mercosur than the present time. Given the sluggish state of the European economy an FTA can be the tool that

331 Barriers, supra note 108.
332 Ibid.
333 The Inter-American Development Bank, The External Dimension of Mercosur. Prospects for North South Integration with the European Union, online:
allows European members to export their way back to growth. The EU is also acutely aware that continued failure to expand their market would leave Europeans overpaying for food and other products and services. The EU is also aware that an agreement with Mercosur will allow European member countries to consolidate cultural and historical bilateral relations, such as those of Spain, Portugal and Italy; three EU economies that were hardest hit by the economic crises.\footnote{Ibid.} Most importantly, an agreement with Mercosur would allow the EU to consolidate the regions commercial presence in the most dynamic emerging external market and allow EU investors access to a stable regulatory framework for direct investment, intellectual property protection and dispute settlement. An agreement with Mercosur can also be used by the EU as a model for relations with other developing countries.

Europe sees a new market for its manufacturers in the emerging middle classes of Brazil, Argentina and other Latin American nations. The post 2008 austerity policies has made EU farm subsidies ever more unaffordable and cheaper food for Europeans will only assist politicians in selling such an agreement to their people.\footnote{The Economist: Strategic Patience Runs Out; 4 December 2013 (http://www.economist.com/news/americas/21591629-last-brazil-keen-trade-deal-strategic-patience-runs-out)} Given Mercosur’s $3.47 trillion annual income and 250 million people, many European nations see Latin America as a lucrative market and a remedy to its numerous economic ills.\footnote{Integration, supra note 313.}

From a political perspective, Latin America, and Brazil in particular, is one of the few important emerging economic blocs with which the EU has shown a willingness to negotiate. Brazil has made important strides in establishing itself as a protector of emerging and developing economies in the trade and economic debates at the WTO. The EU was very satisfied with
Brazil’s position at the Doha Round with Brazil being vocal and supportive in suggesting concessions from emerging nations, a similar role the EU was taking with developed nations. Additionally, as countries from all over the globe are still struggling from the ramifications of the 2008 crises, from reducing unemployment to kick starting growth, the EU needs to open its market to regions that are large, well regulated and well connected with the rest of the world. Mercosur is a stable region that has the necessary scale and scope of economies to have an impact on EU relative prices. As economic analyses have shown, relative prices are what determine the comparative advantages of trading partners, and thus the gains from trade.\footnote{OECD (2011), Globalization, Comparative Advantage and the Changing Dynamics of Trade, Publishing. [Comparative].}

Brazil alone is large enough to be a major international actor in some key industries of vital importance to the EU, such as agriculture, raw materials and industrial sectors such as aerospace. Lastly, the EU should be wary of the increasing role China is playing in Latin America.

4. Emergence of China in Latin America

Trade data has shown that during the last decade China has significantly increased its trade relation with Latin America by fostering stronger relationships with Mexico, Brazil, and Costa Rica.\footnote{Rhys Jenkins, Enrique Peters & Mauricio Moreira, “The Impact of China on Latin America and the Caribbean” (2008) 36: 2 World Development.}

As the table below indicates this has resulted in countries like Brazil to increase their exports to Asia.\footnote{Ibid.} It is clear from the dollar amount and percentages in the table that Brazil exports the greatest value in goods to China. This expansion of Chinese influence is worrying and frustrating

\footnotetext[337]{OECD (2011), Globalization, Comparative Advantage and the Changing Dynamics of Trade, Publishing. [Comparative].}
\footnotetext[339]{Ibid.}
the EU as China’s influence is only projected to grow leading to a further deterioration of Mercosur’s trading relationship with its traditional partners, the US and the EU.

Figure 18 –Brazilian Exports by Principle Regions and Countries of Destination

<table>
<thead>
<tr>
<th></th>
<th>Values in US$ Million</th>
<th>% Changes</th>
<th>% Participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>56273</td>
<td>40239</td>
<td>39.3</td>
</tr>
<tr>
<td>China</td>
<td>30786</td>
<td>21004</td>
<td>46</td>
</tr>
<tr>
<td>LAC</td>
<td>48005</td>
<td>35655</td>
<td>34.1</td>
</tr>
<tr>
<td>MERCOSUR</td>
<td>22597</td>
<td>15829</td>
<td>42.2</td>
</tr>
<tr>
<td>Other LAC countries</td>
<td>254,8</td>
<td>19826</td>
<td>27.6</td>
</tr>
<tr>
<td>EU</td>
<td>43130</td>
<td>34037</td>
<td>26.2</td>
</tr>
<tr>
<td>USA</td>
<td>19463</td>
<td>15740</td>
<td>23.2</td>
</tr>
<tr>
<td>Middle East</td>
<td>10525</td>
<td>7552</td>
<td>38.8</td>
</tr>
<tr>
<td>Africa</td>
<td>9262</td>
<td>8692</td>
<td>6.1</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>4788</td>
<td>3383</td>
<td>41</td>
</tr>
<tr>
<td>Rest of the World</td>
<td>10470</td>
<td>7697</td>
<td>35.5</td>
</tr>
</tbody>
</table>

China is the single largest destination of Brazilian exports and Brazil’s largest trading partner. South Korea and Japan are also playing a larger more significant role in Latin America than a decade ago. It is only a matter of time before China surpasses the EU in terms of total bilateral trade volume, second only to the United States. With respect to imports, figure 19 shows that despite a recovery in imports from the EU the percentage variation was significantly lower compared to China. It is clear that while the EU was focusing on recovering from the 2008

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340 Ibid.
342 Ibid.
343 Luiza, supra note 154.
344 Ibid.
financial crises China was strongly engaging Mercosur members and increasing their investment in Latin America. China’s determination has been paying off as total Mercosur exports to China have gone from $3.9 billion in 2000 to $86 billion in 2011.\textsuperscript{345} In addition, China has already surpassed the EU in exports to Latin America and in some Latin American countries China has become the top trading partner overtaking the US.\textsuperscript{346}

\textit{Figure 19 - Brazilian Imports by Principle Countries and Regions.\textsuperscript{347}}

<table>
<thead>
<tr>
<th></th>
<th>Values in US$ Million</th>
<th>% Changes</th>
<th>% Participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>56141</td>
<td>36141</td>
<td>55</td>
</tr>
<tr>
<td>China</td>
<td>25591</td>
<td>15911</td>
<td>60</td>
</tr>
<tr>
<td>LAC</td>
<td>30933</td>
<td>22746</td>
<td>36</td>
</tr>
<tr>
<td>MERCOSUR</td>
<td>16612</td>
<td>13107</td>
<td>26</td>
</tr>
<tr>
<td>Other LAC countries</td>
<td>14321</td>
<td>9639</td>
<td>48</td>
</tr>
<tr>
<td>EU</td>
<td>39117</td>
<td>29224</td>
<td>33</td>
</tr>
<tr>
<td>USA</td>
<td>27248</td>
<td>20187</td>
<td>34</td>
</tr>
<tr>
<td>Middle East</td>
<td>4680</td>
<td>3142</td>
<td>48</td>
</tr>
<tr>
<td>Africa</td>
<td>11302</td>
<td>8466</td>
<td>33</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>3024</td>
<td>2105</td>
<td>43</td>
</tr>
<tr>
<td>Rest of the World</td>
<td>9193</td>
<td>57,9</td>
<td>60</td>
</tr>
</tbody>
</table>

Accessing one of the largest markets in the world tariff free would be a tremendous accomplishment for Mercosur. It would substantially change the economic outlook for millions of manufactures, producers and service providers. It is clear that the time and environment for Mercosur to engage the EU in trade discussions is now. The EU’s high unemployment, slow to no economic growth, the rising government debt means that Mercosur would have more flexibility and leverage in trade negotiations then would otherwise be possible. To conclude, the


\textsuperscript{346} \textit{Ibid.}

\textsuperscript{347} Barriers, supra note 108.
following paragraphs will review the interesting question of what comparative advantage based structural changes Mercosur can make in order to ensure that a free trade agreement with the EU would be successful.
CHAPTER 13: STRUCTURAL CHANGE AND DEVELOPMENT

1. Comparative Advantage and Structural Change to Kick Start Growth

1.1. Policy Options

Understanding the relationship between trade policy and complementary policies is a challenging task, one which has become more difficult as the variables involved in international commerce and trade have increased and become more complex. As will be discussed below, there are a number of structural, institutional and policy options available for Mercosur while staying true to the principles of comparative advantage that can lead to higher standard of living for Latin Americans and sustained economic growth.

Since the end of World War II comparative advantage principles have been used to explain the relationship between international trade and higher incomes.\(^{348}\) Sound economic policies implemented based on comparative advantage principles have already resulted in trade liberalization and regional integration in Latin America.\(^{349}\) Trade barriers came down and governments introduced trade related structural adjustment in order to benefit from comparative advantage driven trade. Regardless of whether developed countries look to maintain a competitive advantage or developing countries seek to gain competitiveness in a certain sector, both groups require drawing on best practices and developing effective broad policies that can facilitate gaining and maintaining a competitive edge. Research has shown that it is the difference between countries, including the differences in policy settings and policy performance that create relative differences in productivity and give rise to trade and gains from trade.\(^{350}\) The

\(^{348}\) OECD, supra note 32.
\(^{349}\) Ibid.
\(^{350}\) Ibid.
difference in trade policy between nations is often a result of the different stages of economic development but can also be due to different policy decisions. Developing countries that hope to gain ground on developed nations need to realize the benefits of comparative advantage based trade yields even at early stages of development. What this implies is that trade openness and comparative advantage driven specialization is not a constraint to the economic development process but rather its catalysis.\textsuperscript{351} Any interference with the principles of comparative advantage, however, even in the form of government support to sectors which already have a natural comparative advantage can result in a reduction of gains from trade or even render them negative.\textsuperscript{352} The key question then becomes, can governments influence comparative advantage in a way that is sustainable and beneficial for the country?

As Riccardo has argued the theory of comparative advantage indicates that specialization according to the main principles of the theory is a precondition for realizing on the benefits of trade.\textsuperscript{353} Mercosur must be careful therefore to not undertake any substantive policy changes that could unintentionally interfere with the natural process of comparative advantage. To reap the full benefits of trade based on comparative advantage principles Mercosur needs to develop policies that are not specific to any particular industry but rather implement policies that assist larger public initiatives and enhances general resource endowments.

In the Hecksher-Ohlin Samuelson model of comparative advantage differences in relative factor endowments have been proposed as a source of comparative advantage.\textsuperscript{354} Numerous empirical

\begin{thebibliography}{9}
\bibitem{351}
Ibid.
\bibitem{352}
\bibitem{353}
\bibitem{354}
\end{thebibliography}
studies have shown that countries commonly export products whose production requires a relatively intensive use of the factor of production in which they are relatively endowed. Therefore, a country that has an abundance of capital would tend to export capital intensive products and import labour intensive products. Moreover, economists have also studied the importance of human capital accumulation in relation to economic performance. Lucas has argued that human capital accumulation is the “engine of growth” while Romer and Barro found support for the positive relationship between human capital accumulation and economic growth.

Another policy area Mercosur needs to focus on is financial markets. A comprehensive policy aimed at developing efficient and well regulated financial markets will encourage capital accumulation without being seen as principally designed to favour any specific industry. In a paper by Rajan and Zinbales it was shown that industrial sectors that require external financial assistance develop quicker in countries with well-developed financial markets. In addition, it was also shown that financial market development translates into a comparative advantage in industries that use more external finance. Similarly, a well-functioning education system and trade based schooling can boast the endowment of human capital in Latin America without such policies directly favouring any one line of production or service.

Furthermore, Mercosur has an abundance of energy inputs and thus an important source of comparative advantage. Policy decisions should be aimed at increasing the energy supply in

355 Ibid.
356 OECD, supra note 36.
357 Ibid.
358 Ibid.
359 Ibid.
order to increase exports in energy intensive sectors. The availability and affordability of energy especially in Brazil can be an important factor for the regions export performance and a key tool in free trade discussions with the EU. Lastly, the business climate in Latin American, especially the availability of efficient institutions can be a source of comparative advantage. Recent studies have shown that the business climate has a substantial impact on economic growth and development. In one study Costinot found that in complex industries good institutions are a complementary source of comparative advantage. Moreover, Nunn found that consistent export contract enforcement had a significant impact on trade patterns.

Structural policy adjustments to the liberalization of international trade and investment together with the implementation of policies that encourage structural adjustments to labor and capital markets should be main goals for Mercosur. These changes will allow resources and capital to move efficiently to new areas of economic activity. Mercosur can no longer ignore the important role policy plays in foreign investment and ultimately in economic development.

Other issues that have fettered development in Mercosur and which require structural change is the region’s lack of domestic competition. As seen from figure 20 below, the Global Enabling Trade Indictors on Competition has noted that competition within Mercosur is substantially less than other developing nations such as India and China. Moreover, the Ease of Doing Business Index reflects whether the regulatory environment in a country is conducive to starting and operating a local firm. Out of 183 countries raking the most business friendly country first, 

\[\text{Ibid.}\]  
\[\text{Ibid.}\]  
\[\text{Ibid.}\]  
\[\text{Ibid.}\]  
\[\text{Barriers, supra note 108.}\]  
\[\text{Ibid.}\]
Mercosur was on average ranked 124 in 2010.\textsuperscript{365} Mercosur also ranked 65 out of 139 on the Global Competitiveness Index which summarizes a set of institutions, policies and factors that determine the level of productivity of a country and the return of investment.\textsuperscript{366}

*Figure 20 – Competition Indicators*\textsuperscript{367}

<table>
<thead>
<tr>
<th>Country</th>
<th>Intensity of local competition</th>
<th>Extent of market dominance</th>
<th>Effectiveness of anti-monopoly policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mercosur</td>
<td>64</td>
<td>59</td>
<td>58</td>
</tr>
<tr>
<td>Argentina</td>
<td>107</td>
<td>104</td>
<td>118</td>
</tr>
<tr>
<td>Brazil</td>
<td>50</td>
<td>46</td>
<td>39</td>
</tr>
<tr>
<td>Paraguay</td>
<td>117</td>
<td>110</td>
<td>132</td>
</tr>
<tr>
<td>Uruguay</td>
<td>105</td>
<td>56</td>
<td>104</td>
</tr>
<tr>
<td>Russia</td>
<td>115</td>
<td>88</td>
<td>108</td>
</tr>
<tr>
<td>India</td>
<td>30</td>
<td>26</td>
<td>29</td>
</tr>
<tr>
<td>China</td>
<td>19</td>
<td>23</td>
<td>50</td>
</tr>
</tbody>
</table>

\textsuperscript{365} Ibid.
\textsuperscript{366} Ibid.
\textsuperscript{367} Ibid.
CONCLUSION

From the ancient Greeks to current government officials and economists, all have pondered the determinants of trade between countries and have studied the results of trade in an attempt to determine whether trade produces positive or negative outcomes for those involved. As has been discussed, international trade promotes growth, production efficiency and encourages the sharing of technological advances.\(^{368}\) From the time countries started trading with each other developed and developing countries have been able to provide their respective citizens with a greater variety and less expensive products and services. Without a doubt openness to trade has helped developing countries grow their domestic industries, compete internationally and adapt to changing economic and social needs.\(^{369}\) In the early part of the century developing countries were able to grow by accepting structural change as a consequence of the forces of comparative advantage. Today, comparative advantage based trade is being driven by traditional factors such as production, finance, supply and policy directives. A country’s structural adjustments to its domestic and international policies that are geared to changes towards the country’s competitive advantage have the best chances of success.

As the primary international body tasked with promoting trade, the WTO focuses on reducing trade barriers between all members while also promoting economic growth of developing countries through the special and differential treatment provisions.\(^{370}\) The WTO however has been labelled a two-tier organization as far greater liberalization obligations have been

\(^{368}\) Stigliz, supra note 53.

\(^{369}\) Ibid.

\(^{370}\) World Trade Organization, What is the World Trade Organization?, online:<http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact1_e.htm>
undertaken by developed countries compared to developing country members.\footnote{Arvind Subramanian & Shang-Jin Wei, “The WTO Promotes Trade, Strongly but Unevenly” (2003), International Monetary Fund Working Paper WP/03/185. [Arvind].} Since the early days of the GATT developing countries have had far fewer obligations to liberalize which has resulted in less economic benefits. This reluctance of developing countries to take on obligations to liberalize under the WTO was codified under the principle of special and differential treatment which has defined the terms of developing country participation.\footnote{Ibid.} As developing countries were not as actively engaged in reciprocal liberalization, developed countries brought down many trade barriers on products produced and exported by other developed countries and exempted a number of developing important sectors and products, such as agriculture, textiles and clothing.\footnote{Ibid.} Therefore, although trade has increased as a result of the WTO, such growth has been uneven with the majority of gains only being recognized by developed countries.

A number of options to increase trade and promote economic growth within Latin America were discussed: strengthening MFN obligations, unilateral trade liberalization, strengthening special and differential treatment provisions and engaging in free trade agreements. Although all of the above options have a number of advantages and disadvantages it was argued that a free trade agreement with Europe offers Mercosur and Latin America the best option for sustained economic growth. Latin America’s impact on the international stage has been and will continue to be significant. With Brazil being the world’s sixth largest economy and Mercosur the third largest trading block in the world it is clear that increasing its trading relationships will be the region’s best avenue for economic growth. Mercosur members are still considered developing countries and continue to receive special treatment under the WTO. Although growth in many
Latin American markets was originally achieved by protecting domestic industries from foreign competition, these protectionist policies proved to be detrimental to the country’s economic growth as new technologies were never realized and new markets never pursued.

It was argued that Mercosur should pursue an FTA with Europe and move beyond the special and differential treatment provisions in hope of achieving sustained economic growth. The EU and Latin America have a long history of cooperation and by further deepening the economic, social and political ties the benefits for both regions can greatly outweigh concerns of trade diversion. For Mercosur, a trade agreement with the EU is an opportunity to secure market access in its major export destination and through an increase in agricultural products and a diversification of manufactures balance its trade deficit. More importantly for Mercosur, however, may be the fact that existing EU trade preferences have expired. In January 2014, all Mercosur countries except Paraguay lost the preferential access the EU grants to developing countries as they are now deemed too rich to need it.  

With record unemployment and debt levels, the current economic environment in Europe makes it more likely that the EU will listen to a Mercosur proposed trade agreement and be willing to settle on a balanced agreement. Completing an FTA with Mercosur would mean consolidating the EU’s commercial presence in their most dynamic emerging external market as well as ensuring a stable and foreseeable regulatory framework for direct investment, intellectual property protection and dispute settlement. With many developed economies struggling to return their economies to growth, the next phase of world growth will undoubtedly come from the


developing world. Success in completing a comprehensive free trade agreement would help stagnant Europe export its way back to growth and open new markets for Mercosur’s efficient farmers and energy producers.\(^\text{376}\) Failure would leave Europeans overpaying for food and South America’s biggest economy, Brazil, languishing on the sidelines of globalization.

Free trade agreements have been shown to create additional trade and improve economic growth.\(^\text{377}\) With a free trade partnership that reduces tariffs and non-tariff barriers, the EU and Mercosur will be able to achieve greater social and economic benefits, a higher standard of living, more product and service choice and new and efficient technologies. A positive shift in attitude is also occurring in Brazil. Brazilian businesses once thought that they would be able to profit from the country’s large domestic market. Cheap imports from China however, have shown that even harsh tariffs cannot keep out competition. Before being able to engage the EU in an FTA, Mercosur faces a number of significant hurdles along the path of a deeper relationship with the EU. Internally, Mercosur still suffers from a lack cohesiveness in political and economic vision.\(^\text{378}\) Although countries in Latin America have been embarking upon co-operation initiatives for many years, they have failed to implement effective region wide policies and have not always been able to speak as one voice in international affairs. In relation to increasing the bloc’s cohesiveness, Latin American needs to become more business friendly. By reducing the costs and administrative burdens for Multinational Corporations to conduct business within Latin America foreign investment will certainly start flowing into the region. Mercosur needs to start

\(^{376}\) Ibid.

\(^{377}\) Sally, supra note 133.

\(^{378}\) Strategy, supra note 220.
implementing trade policies that are in line with investment principles as increasing FDI has been shown to result in an increase in economic growth.379

In addition, such domestic policies need to focus on reducing the number of inefficient industries along with the promotion of sectors showing a comparative advantage. Even though international norms and domestic policies and principles have changed over time, comparative advantage remains an important determinant of trade. Since 1898, comparative advantage principles have shown that high physical and human capital increase trade underscoring the benefits of implementing policies that influence the pace and quality of physical and human capital accumulation. Moreover, credit availability and energy supply are key factors in boosting exports which requires appropriate policies to ensure such sectors function efficiently.380 As all countries have a comparative advantage in one form or another, whether it is human capital, industrial, natural or financial assets, all have the capacity to produce goods and services for their domestic market and to compete globally.381 Economic theory posits that such countries can benefit when these goods and services are traded. The principle of comparative advantage argues that countries prosper first by taking advantage of their assets in order to concentrate on what they can produce best and then by trading these products for products that other countries produce best.382

A Latin American approach that redesigns economic, labour market, education and social policies have the best chance of achieving success and opening new avenues to trade for both

380 OECD, supra note 36.
381 Ibid.
382 Kowalski, supra note 38.
regions. Implementing the aforementioned policies will take time and European and Latin American governments need to play an active role in facilitating this process. Although trade talks between the EU and Mercosur have commonly stalled due to the EU’s reluctance to subject their farmers to competition from Latin America and Latin America strongly wanting to protect their domestic industries from high quality imports, the changing world economic dynamics are bringing both sides back to the table.\textsuperscript{383}

As David Ricardo argued, it is the differences between countries, including the differences in broad policy settings and policy performance that create relative differences in productivity and give rise to trade and gains from trade.\textsuperscript{384} For Mercosur to successfully achieve sustained economic growth it must therefore establish a comprehensive economic model, a model that achieves consistency between trade and other domestic and regional objectives.

\textsuperscript{383} Patience, \textit{supra} note 375.
\textsuperscript{384} OECD, \textit{supra} note 36.
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