THE FREE "TRADE LOVE TRIANGLE": PROSPECTS FOR THE FTAA AND EU-MERCOSUR FTA

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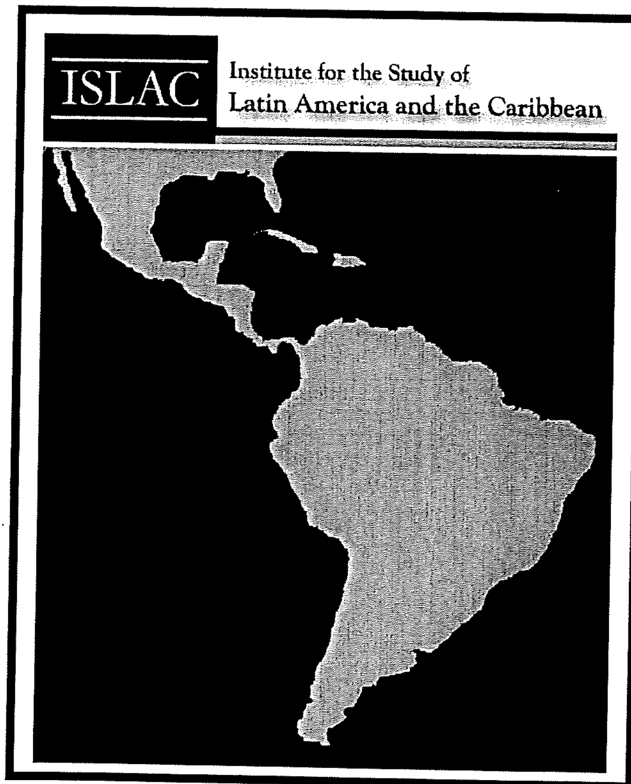

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Foreword

Free Trade Games, Global Strategies, and Regional Trading Regimes: The EU-MERCOSUR-U.S. Triangle

Professor Gaspare Genna's article, "The Free 'Trade Love Triangle': Prospects for the FTAA and EU-MERCOSUR FTA" is a very perceptive attempt to explain and understand the dynamics of trade negotiations and the configuration of trading regimes from the perspective of game theory. It does so using the logic of a rational actor model, where players attempt to maximize outcomes. The specific real life example he uses is the uneasy "love triangle" among MERCOSUR (the South American customs union among Brazil, Argentina, Uruguay and Paraguay, and a number of associated members), the European Union and the United States. One of the features emerging from the analysis of the stalemated nature of the relationship is that the vary pursuit of maximal objectives among large but asymmetrical players leads to a situation of systemic paralysis.

What makes this relationship one fitting the caricature of the love triangle is that the actors are not satisfied with a bilateral liaison and use their partners to establish a more satisfactory bilateral or multilateral association. In a global configuration, and short of paramountcy, promiscuity pays. More than the maximization of actual trade, what is at stake is the desire of all the actors to alter the very rules of the game and acquire meta-power as a way to affect desired results in the longer run. In this context, specific Free Trade Agreements (FTAs), as those of the EU, MERCOSUR and the U.S., are mechanisms in this long-drawn strategic battle for economic and above all political hegemony.

The triangular relationship discussed here has a built-in bias for deadlock and diminishing outcomes for smaller sub-systemic actors. However, the existing playing field is currently being altered by the upsurge of an otherwise extra systemic actor, China, which is increasingly a major player in the global and regional stage. It is the presence of this global player that offers an opportunity for lesser developed, commodity producing states and regional arrangements to improve their position in an otherwise structurally unequal global trading regime.

The Free "Trade Love Triangle":

Prospects for the FTAA and EU-MERCOSUR FTA

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Abstract

Current trade talks between the European Union, Latin American countries, and the United States are at a standstill because of the complexities inherent in a triangular relationship. The EU is attempting to augment its LA trade relations with the creation of the EU-MERCOSUR Free Trade Agreement. The U.S. is doing likewise with the initiative of the Free Trade Area of the Americas (FTAA). All actors are following strategies with the same goal, namely to develop more favorable trade agreements than can be established in the current Doha Round of the World Trade Organization. Brazil hopes to use the negotiations with the EU and the U.S. to receive preferences not currently found in the Doha Round. This research is based upon archival materials on the failed EU-MERCOSUR and FTAA negotiations. The implications of this exploration will be used to focus on the newest actor in the continuing globalization of Latin America, namely the People's Republic of China.

Introduction

The "love triangle" metaphor implies a relationship or game among three individuals that it is unsatisfactory in some way or another to one or more of the individuals involved. In one possible scenario, two of the participants in the game court the third, but the latter is not satisfied with either of the two. It is likely that the third is not satisfied because the other two want the relationship on their own terms, forgetting that the third party has needs and expectations as well. In order to improve the situation, the third can attempt to explain to the other two what needs to change in order for the third to be satisfied. The third player may also try to bring a change of heart on one or both of the other participants. However, the two who have been courting the third independently find that there may be other potential partners and calculate that the third will turn around eventually, once the third recognizes that there is no payoff by not being with the other two. However, what player one and two fail to understand is that the third may feel better to be with others than with uncompromising partners.

While this is an unorthodox way to begin an academic paper on free trade, it does briefly characterize the current state-of-affairs of the transatlantic, western hemispheric and global trade negotiations. In the first half of 2005, observers of trade politics saw years of negotiations failing to reach concrete resolution. On 23 February 2005, Robert B. Zoellick, the U.S. Trade Representative, could not reach an agreement with his Canadian and Latin American counterparts for the establishment of the Free Trade Area of the Americas (FTAA). Negotiations for the FTAA began in 1994 with the idea of establishing a free trade agreement (FTA) that would include all the economies of the western hemisphere, except Cuba (34 in all). The total market size is estimated to be 841.2 million people with a total output of US$12.8 trillion in 2002, of which the U.S. accounts for a little more than 81% (UNDP 2005). The U.S. had already established a trade agreement with Canada and Mexico under the North American Free Trade Agreement (NAFTA) (1994), another with Chile (2004), and the latest one with Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua under the Central American Free Trade Agreement (CAFTA-DR) (2006). Some of the delay in establishing the FTAA can be attributed to the denial of trade promotion authority (TPA) to President William J. Clinton. After the U.S. Congress granted President George W. Bush the TPA, many wrongly believed that the FTAA would be back on track.

Similarly, European Union Trade Commissioner, Pascal Lamy, failed to reach a free trade agreement with his counterparts from the Common Market of the South (MERCOSUR), really a customs union on 26 May 2005. The MERCOSUR includes Argentina, Brazil, Paraguay, and Uruguay. The 2002 MERCOSUR market size was 223.4 million people with a total output of US$ 572 million, of which Brazil represents a little less than 80% (UNDP 2005). Negotiations for the EU-MERCOSUR Free Trade Agreement began in earnest in 1999 after years of preliminary talks. It would represent

an estimated market size of 602.5 million people with a total output of US$ 9.2 trillion in 2002, of which the EU would account for approximately 94% (Ibid.). The EU already has a trade association agreement with Chile (2002) and Mexico (2000). MERCOSUR countries also have association agreements with the Andean Community (Bolivia, Colombia, Ecuador, Peru, and Venezuela). México and Chile have free trade treaties with Guyana and Suriname as potential future associate members. In turn all four MERCOSUR members have become associate members of the Andean Community.

The EU-MERCOSUR FTA and the FTAA negotiations were expected to be completed in 2005. Currently, all parties remain optimistic that the EU-MERCOSUR FTA will be completed May 2006, while the FTAA seems to be resting in limbo. Atop of these negotiations lays the latest round of global trade negotiations, the Doha Round of the World Trade Organization (WTO), which has also reached an impasse. However, as indicated above, free trade agreements (FTA) are being signed both in the western hemisphere and the transatlantic. Why is it that some FTAs are negotiated within a brief period of time while others seem to languish in a sea of unmet deadlines? This paper will focus primarily on the triangular negotiations between the EU, MERCOSUR, and the U.S., but will also attempt to understand why each of these actors, while unsuccessfully negotiating agreements among themselves, are successful in completing FTAs with other members of the western hemisphere. The key to understanding this puzzle is an analysis that includes two key interacting variables: the economic size of the three actors and their respective preferences. FTAs are easier to form when actors find themselves better off by joining than by remaining outside. What constitutes "being better off" depends on the preferences of the larger actor and its size vis-à-vis the other actor(s). As the actors' economic sizes approach parity and preferences become incongruent, the likelihood that they will complete an FTA diminishes. More specifically, both the EU and the U.S. are attempting to reorganize the global trade regime along their preferences respectively through the EU-MERCOSUR FTA and FTAA. However, the members of MERCOSUR see this reorganization as an economic disadvantage. In addition, EU and the U.S. preferences are not offset by their economic size relative to the MERCOSUR members. In other words, having access to their large markets does not have enough economic value given the proposed playing field rules.

The remainder of this paper will explain the logic behind FTA stalemate by describing how economic size and actor preferences play into the decision-makers' perceptions that their countries would be better off with an FTA. Evidence for the argument will be presented by examining the record of EU-MERCOSUR FTA and FTAA negotiations. The final part of the empirical section will introduce a fourth actor, the People's Republic of China, for the purpose of exploring future complexity in transatlantic and western hemispheric trade relations. The final section will conclude with possible policy implications.

Explaining Stalemate: Economic Size and Actor Preferences

Explaining the complex nature of the triangle requires an understanding of the conditions of FTA expansion. The conditions involve the rational actions of all three actors in the triangle both bilaterally and multilaterally: the EU, MERCOSUR, and the U.S. These are all large actors. Prior studies suggest that the likelihood of forming or deepening regional integration increases when there is an asymmetric economic condition, combined with and mutual satisfaction with the status quo of bilateral relations (Efird and Genna 2002; Efird, Genna, and Kugler 2003; Genna and Hiroi 2004). This is due to the capability of the larger member of the asymmetric power relationship to leverage its economic size in order to convince smaller members to join an FTA. Leverage employed can vary from offering economic assistance to discontinuing assistance. It could also include retaliatory actions such as increasing existing trade barriers. Therefore, a smaller member would not join an FTA if it would be worse off. If the smaller partner is satisfied with the current relationship and would not wish to harm that relationship, it would join the FTA.

Rational actor theory so far helps us understand the bilateral dynamics but not multilateral ones. Soamiely Andriamananjara (2003) models the conditions of expanding FTAs by examining the assumptions underlying competitive liberalization. The central idea of competitive liberalization is that nonmembers of a FTA will fear a cost of being excluded from FTAs. They see the established FTA as a "gold standard" for trade, in which a cost is incurred when access to a large market for the non-member's products is denied (Hufbauer and Wong 2004). Not wanting to lose, they join the arrangement. Therefore, FTAs expand when a large economy forms the central hub of an FTA wheel and other smaller economies become the spokes. In sum, the non-member decides that it prefers to trade-off the costs of increased competition in its domestic market with the gains of access to the FTA market. This is similar to the regional integration theory previously described: the trade-off is preferable if the FTA market is larger than the nonmembers' market. The final conclusion of competitive liberalism is that a global trading system emerges from the expanding FTA and primarily along the preferences of the hub economy.

The logic of competitive liberalization is problematic on a couple of fronts, and as a result can explain the stalemates in the Doha Round, the FTAA, and the EU-MERCOSUR FTA. First, as Andriamananjara (2003) points out, there is an implicit assumption that members of the FTA cannot block the entry of a non-member. If unanimity is required, then one member can veto the expansion if the potential new member has a comparative advantage in sensitive products. In other words, the new member could threaten an existing member's market share in the FTA region. Under this circumstance, the best outcome would be a series of FTAs where the hub economy

basically dictates the terms of entry into its market. However, we see the same scenario play out when the FTAs are created under the preferences of the dominant economy.

This suggests a second flaw in the competitive liberalization logic, one that is at the center of this study. Knowing that the dominant economy has this leverage, similar sized or middle sized economies would also adopt the same strategy so that they can develop their own trading blocs. The goal would be to develop "competitive leverage" against the dominant player that wishes to play the role of the global hub economy. Therefore, a small group of economies compete to either be that hub economy or to diminish the leveraging power of the dominant economy in its effort to reorganize the global trade regime under its own preferences.

Preferences therefore play a key role and interact with the asymmetric nature for the success of regional integration. If the dominant economic power wishes to develop or expand an FTA along its preferences, the likelihood of success diminishes the larger non-member's economic size *and* the less satisfied with the dominant actor's preferences. The relatively mid-sized economic actor sees that not joining the FTA would leave it better off because the dominant economy is not that much bigger than its own and is dissatisfied with the dominant actor's preferences. However, the smaller the non-member's size, the likelihood of a successful FTA increases even if preferences are not ideal because not joining the FTA would leave the smaller economy worse off.

If this theory holds, then stalemate in trade negotiations would occur after the small economies join several hub economies, attempting to reorganize the global trade regime under their preferences. This leaves the mid-sized economies that do not have the incentive to join but do have the incentive to form their own FTAs in order to safeguard their interests in the reorganization of the global trade regime at a disadvantage. Unless the potential global hub economies are willing to yield to the preferences of the mid-sized economies, then stalemate will result. In the context of the EU-MERCOSUR-U.S. negotiations, the next section will empirically develop the following points:

- *Both the EU and the U.S. are developing FTAs with Latin American countries in order to reorganize the global trade regime along their preferences and are attempting to be global hubs under the logic of competitive liberalization.*
- *Brazil as the most dissatisfied and largest economy in Latin America forms its own trade bloc in order to maximize the expression of its own preferences in the global trade regime.*

After establishing the actors' economic leverage and preferences, the remainder of the section will test the following hypothesis:

- *Stalemates will develop in the EU-MERCOSUR FTA and FTAA negotiations due to the economic leverages and preferences of Brazil, the EU, and the U.S.*

The Dynamics and Stasis of the "Love Triangle"

European and U.S. Strategies: The European Union and Washington have different approaches to negotiating FTAs, but are of the same mind in certain key issues that have characterized the talks between these economically developed actors and their developing counterparts. While the U.S. follows an explicit strategy of competitive liberalization, the EU follows an implicit one under its Common Commercial Policy (CCP). Their goal is to reorganize the global trade regime by establishing bilateral or multilateral FTAs outside the WTO negotiations and then use these FTAs as greater leverages inside the Doha Round. Both the EU and the U.S. attempt to become the hub of an FTA wheel and thereby slowly develop a trade regime along their preferences. A brief statement by the leading negotiators can prove the point. Allen F. Johnson, Chief Agriculture Negotiator, stated before a U.S. Senate subcommittee:

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

Echoing this view and providing greater insight is Johnson's supervisor, Robert Zoellick, who stated before a U.S. House of Representatives committee:

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

But Johnson goes deeper into the U.S. strategy:

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

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

The EU strategy is parallel to that of the U.S., but not as manifest. In 1996, the EU developed the Market Access Strategy (MAS). The MAS is a multifaceted policy with one simple goal, to obtain access to external markets. How this is done depends upon resources and legal alternatives involved. While legal remedies (like the WTO dispute settlement procedure) and greater information for EU firms using advanced technologies (such as the Market Access Database) are the highlighted facets of the MAS (WTO 2002), the use of bilateral and multilateral negotiations are important instruments for the elimination of important market access barriers. To this end, the EU negotiates all external trade associations under the CCP. Given the EU's customs union status, Articles 131-135 of the Treaty Establishing the European Community require members of the common external tariff to negotiate with one voice (Dinan 1999). Part of the CCP is the contractual commercial policy which gives the EU Commission the power to initiate and the exclusive right to negotiate trade agreements (Marsh and Mackenstein 2005). Using the terminology of U.S. decision-makers, the EU has a permanent TPA. The Commission can use its supranational stature to negotiate with non-members not only regarding tariffs and quotas but also non-tariff barriers, without the fear that another body will amend the final trade agreement. The EU Council, however, oversees negotiations through observers and the 113 Committee.[1] Final negotiations need to be approved by the Council using qualified majority voting (Articles 133 and 300), but operates more like a legislature that only has an up or down vote (Hix 1999).

Given this single voice, the Commission, through its chief negotiator, can develop specific strategies to achieve the goal of market access. The EU's pattern of behavior regarding FTAs suggests that it is following a "tit-for-tat" strategy vis-à-vis the U.S. As mentioned in the introduction, the EU has trade association agreements with Chile and Mexico. In addition to the current talks with MERCOSUR members, the EU is also in beginning stages of negotiations with the Central American states and the Andean Community for future FTAs. Given this pattern, the EU strategy reflects the competitive liberalization logic, and with it, a potential center of global trade regime reorganization.

More telling of the EU and U.S. parallel strategies is their behavior with the smaller economies of the Caribbean basin. Small, more trade-dependent countries need agreements to remove uncertainty from their trade relations with larger economies. The

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[1] The name "113 Committee" comes from Article 113 using the old numbering system of the Treaty Establishing the European Community. This is the same as Article 133 using the new numbering system (Treaty of Amsterdam), however the name "133 Committee" has not come into vogue.

U.S. provides preferential access for Caribbean countries (including Guatemala and El Salvador but with the exception of Cuba) under the Caribbean Basin Initiative (CBI), but it does so unilaterally. The CBI came into being with the signing into law of the Caribbean Basin Economic Recovery Act, which came into effect 1 January 1984. Other legislation was enacted to expand the types of products and conditions for further preferential trade relationships, namely through the Caribbean Basin Economic Recovery Expansion Act of 1990 and the U.S.-Caribbean Basin Trade Partnership Act of 2000. The CBI provides tariff reductions or exemptions for products from Central America and the Caribbean region countries. CBI benefits are, however, conditional. As stated in Section 202 of the Trade Partnership Act:

> (b) POLICY- It is the policy of the United States-- (1) to offer Caribbean Basin beneficiary countries willing to prepare to become a party to the FTAA or another free trade agreement, tariff treatment essentially equivalent to that accorded to products of NAFTA countries... and (2) to seek the participation of Caribbean Basin beneficiary countries in the FTAA or another free trade agreement at the earliest possible date, with the goal of achieving full participation in such agreement not later than 2005.

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

The European Union also practices a similar relationship with Caribbean countries that were former colonies of the member states. First initiated under the Lomé Convention, the EU has a preferential trading relationship with a group of countries referred to as the African, Caribbean, Pacific group (ACP). Lomé[2] provided a development assistance package that included free access to the European market for products that originated in the ACP countries as well as aid and technical assistance (Dinan 1999). The EU-ACP relationship is currently evolving as a result of the Cotonou Partnership Agreement (2000). A central pillar of the agreement is the movement away from non-reciprocal trade arrangement under Lomé to a series of negotiated economic partnership agreements (EPAs) (Articles 36 and 37 of the Cotonou Partnership Agreement). The rationale is to make the ACP economies more competitive in the global economy. However, the choice for each trade-dependent state, like in the case of the CBI, is to either lose access to the larger market or sign EPAs and lock-in access through a

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[2] The Lomé Convention was actually a series of five agreements: Lomé I-IV and an amended IV.

WTO recognized agreement. Again, the smaller states would opt for the free trade arrangement and diminish the uncertainty that may result from not signing.

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

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

These two sentences were given in the context of the FTAA and EU-MERCOSUR FTA negotiations, and provide the key component of the Brazilian strategy vis-à-vis the EU and the U.S. By developing its own trading bloc, Brazil can credibly attempt to maximize the expression of its preferences in the global trade regime. While the size of the MERCOSUR's four economies is relatively small when compared to the EU or the U.S. (see Table 1), the strategy has been endorsed by the Inter-American Development Bank (IDB 2002). By combining the economic weight of several Latin American countries, Brazil has the ability to reduce the economic leverage of the economic heavyweights. Neither the EU nor U.S. has the economic capacity to offer countries like Brazil and Argentina the same preferential trade agreements (PTAs) they have for the Caribbean Basin states. Therefore Brazil's calculation for forming an FTA differs: it could be worse off by signing an FTA if the preferences of the larger states are very distant from its own. If it can convince other states to form a bloc with aligned preferences, then it is not stuck in the competitive liberalization trap because it will not be left out of a market that others access. In this reworking of the conditions, its cost of not joining is low.

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

The previous two sections laid out the trade strategies of Brazil, the EU and the U.S. These strategies include the desire of the larger actors to reorganize the global trade regime under their preferences and Brazil's desire to modify that reorganization. However, the central argument rests on two key variables, with size being only one. The other is the degree of satisfaction actors have with the reorganization of the global trade regime. This satisfaction comes out of specific preferences associated with the EU-MERCOSUR FTA and FTAA negotiations. The next two sections explain the stalemates in the EU-MERCOSUR FTA and FTAA negotiations, which ensued due to both preferences and the relative size of the actors.

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

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

A closer examination of trade statistics further confirms this pattern. Figure 1 shows the changing trade relationship the EU has with the MERCOSUR states. MERCOSUR's share of total EU trade declined slightly from 2.3 to 2.7 percent during 2000-2004. This was due to the steady decline from 2.8 in 2000 to 1.9 percent in 2004 in exports to MERCOSUR. This decline was likely due to the economic crises experienced among the members. Exports to the EU increased slightly during the timeframe from 2.5 to 2.8 percent. Although we see a slight decline in trade, the degree of overall trade dependency the EU has with MERCOSUR is very small. The same can be said for EU exports. The largest category of products sold in the MERCOSUR market is machinery and transport equipment. In 2004, this accounted for 50.1 percent of exports, but only 2.1 percent of total EU exports (Eurostat 2005). The next largest category is chemicals and related products which account for 22.5 percent of MERCOSUR trade, but only a 2.7 percent in the share of total exports (Eurostat 2005).

However, when we examine specific categories of products imported by the EU from MERCOSUR in 2004, a slightly different picture develops. The largest category of

products is food and live animals, which accounts for 37.2 percent of imports from MERCOSUR members and 20.2 percent of total EU imports (Eurostat 2005). The next category is raw goods, (except fuels) which accounts for 25.7 percent of MERCOSUR imports and 17.1 percent of all imports (Eurostat 2005). In total, these primary materials account for 37.3 percent of all EU imports. Therefore we do see some EU dependency, but only in the two categories of primary goods from MERCOSUR.

Figure 2 displays MERCOSUR's world trade[3] share of EU. From 1999 to 2004, the EU percent share of overall trade ranges from 23.2 to 26.8 percent with an average of 24.3 percent (Eurostat 2005). This is reflected in both exports and imports, which averages 22.8 and 25.9 percent respectively. When examining the specific products we see that MERCOSUR's export dependence with the EU is not as high as the EU dependence on MERCOSUR. While 25.7 percent of the EU's imports of food and live animals is from MERCOSUR, this only accounts for 9.9 percent of total MERCOSUR exports, but 37.2 percent of exports to the EU in 2004 (Eurostat 2005). While 6.8 percent of total MERCOSUR exports of raw materials (excluding fuels) go to the EU, this accounts for 25.7 percent of all exports, to the EU. The two items together account for 16.8 percent of all MERCOSUR exports but they constitute 62.9 percent of exports to the EU. In sum, MERCOSUR's main export to the EU and the EU's main dependence is in the category of primary goods.

In the case of EU exports to MERCOSUR, we again see a small amount of value, but a large share of a specific product, namely manufactured goods. The top categories of MERCOSUR imports from the EU are machinery and transportation equipment, chemicals, and other manufactured goods. Together they account for 22.4 percent of world imports into MERCOSUR, but make 89.6 percent of EU imports (Eurostat 2005). However, this only accounts for 1.7 percent of global EU exports. Again, MERCOSUR does not represent a large value of trade for EU exports, but manufactured products dominate the value of trade into MERCOSUR.

The areas of negotiation among the three mega-players are centered on primary products and manufactured goods. Both sides wish to maximize the amount of trade in their favored area of comparative advantage while attempting to minimize competition for domestic firms. In March 2003, MERCOSUR offered to eliminate tariffs on 83-85 percent of the average value of EU goods over ten years with the remaining 15 percent eliminated over a period greater than ten years (BBC MIR 5 March 2003). The EU, however, wanted to see 90 instead of 85 percent. The EU's counteroffer was an exclusion from tariffs for 10 percent of MERCOSUR imports, which were primarily agricultural goods (BBC MIR 5 March 2003). The increase by MERCOSUR to 85 percent was not

[3] 2004 MERCOSUR trade figures are estimated based on the first nine month figures and 2003 annual figures.

for 10 percent of the imports to be excluded, but an attempt to get the EU to discuss agricultural subsidies, which the EU refuses to discuss bilaterally but wishes instead to hold such discussions at the Doha Round (BBC MIR 5 March 2003). In November 2003, the EU attempted to gain greater access for their products through the liberalization of MERCOSUR members' government procurement and services sector (Osava 3 November 2003). The EU offered to increase the import quotas for agricultural goods, but this was not satisfactory for MERCOSUR, whose representatives still insisted on discussing agricultural subsides (Osava 3 November 2003). The EU offered to further increase the agricultural import quota if MERCOSUR did not request a reform of the EU agricultural subsides in December 2003 (Osava 3 November 2003). The new negotiations at the beginning of 2004 began with deep frustration on the EU side. At the commencement of the March 2004 talks, EU trade representative Karl Falkenberg questioned the integration of the MERCOSUR members when he stated that it was "more a vision than reality" and went on to question the degree of trust among the four members (MercoPress 11 March 2004). This lead to a defense of MERCOSUR's integration practices by the Argentine trade representative, Martín Redrado (MercoPress 11 March 2004). The talks also failed for other reasons: the refusal by MERCOSUR to open government procurement contracts in the service sector; they failed also because the EU said no to unrestricted access for beef, cereals, poultry and other agricultural products (MercoPress 30 March 2005). In April 2004, the same requests where made again, but both sides refused to acquiesce (Benson 21 April 2004). MERCOSUR negotiators did budge in June 2004 and agreed to increase the percentage of manufactured goods coming in at a reduced tariff to 90%, without a favorable reply from the EU side (Latin News Daily 14 June 2004; O Estado de São Paulo 14 June 2004). In an interesting escalation of negotiations, MERCOSUR negotiators walked out of the July Brussels discussions after the EU negotiators reduced the quota amounts on agricultural goods by half the amount they previously promised (Mancini 22 July 2004). The EU delegation returned the favor by walking out of the August Brasília negotiations over the issue of agricultural products (Teixeira 13 August 2004). At the beginning of September 2004, Pascal Lamy stated that the problem with the EU-MERCOSUR negotiations is with the MERCOSUR members, because they were unwilling to match the agricultural concessions the EU made with greater access to investment markets, telecommunications, maritime transport, and banking services (MercoPress 1 September 2004). However, MERCOSUR negotiators (after agreeing not to talk about EU agricultural subsidies) felt that the concessions were not enough and wanted larger agricultural quotas, especially for wheat and beef, and for these quotas not to have a ten year limit (MercoPress 1 September 2004).

On 26 May 2005, the representatives of the EU and MERCOSUR put forth a joint communiqué reiterating their commitment to finalizing an FTA in conformity with the 1995 Declaration on Political Dialogue that began the negotiation process. The publication of the communiqué signaled that the FTA would not be finalized soon. The transatlantic stalemate occurred because MERCOSUR members understood that they had nothing to lose from not signing the FTA. The EU already depends on their exports of

primary goods, and short of switching to another set of providers, it would continue to import. The large share of EU manufactured goods entering into the MERCOSUR market would threaten domestic producers, leaving MERCOSUR economies worse off. Unless the EU liberalizes their agricultural sector, it would not be in the interest of MERCOSUR members to sign the FTA.

FTAA. The conditions of negotiation were no different with regard to the FTAA. While the U.S. was able to develop willing partners among the small trade-dependent states of the Caribbean and its NAFTA partners, it could not develop such relations with the MERCOSUR members. The MERCOSUR-U.S. asymmetric trade relationship disguises as well a mutual trade dependency for both actors.

Like the EU-MERCOSUR trade relationship, MERCOSUR is more trade-dependent on the U.S. than vice versa. Figure 3 illustrates the overall trade dependency the US has with MERCOSUR. As with the EU, the overall percent value of trade is not high. Total trade has remained somewhat level during the 1997-2001 timeframe: 2.3 to 1.9 percent with an average value of 2.1 percent (FTAA 2005). The percent value of imports to MERCOSUR also has remained level ranging from 1.6 to 1.4 percent, with an average value of 1.4 percent (FTAA 2005). Also, as in the EU case, U.S. exports have declined from 3.4 to 2.7 percent (FTAA 2005). The case of MERCOSUR's overall trade dependency on the U.S. resembles that of the EU (Figure 4). Overall, the percent share of global MERCOSUR trade ranges from 17.0 to 20.7 percent with an average of 19.3 percent during 1997 – 2001 (FTAA 2005). U.S. imports account for 21.0 to 22.7 percent, with an average of 21.6 percent (FTAA 2005). Exports to the U.S. account for 11.3 to 19.4 percent, with an average of 16.6 percent (FTAA 2005).

When we look deeper, we see the same pattern of trade between MERCOSUR and the U.S. as we saw with the EU-MERCOSUR case. While 28.3 percent of the U.S. imports from MERCOSUR are in the category of primary goods, this only accounts for 5.8 percent of total MERCOSUR exports (FTAA 2005). Also, 83.3 percent of MERCOSUR imports from the U.S. are in the category of manufactured goods, accounting for 17.4 percent of total U.S. exports. Therefore, primary goods sent to the U.S. are a small portion of MERCOSUR exports, but manufactured goods represent a larger share of U.S. imports to MERCOSUR. In sum, while MERCOSUR is more dependent on trade with the U.S., the U.S. is dependent on MERCOSUR for sales of manufactured goods and acquisitions of primary products.

When examining the negotiations for the FTAA, the first item that becomes apparent is the emphasis on manufactured goods at the expense of primary goods. The nine official areas of the negotiations are: 1) Market Access 2) Agriculture 3) Government Procurement 4) Investment 5) Competition Policy 6) Intellectual Property Rights 7) Services 8) Dispute Settlement 9) Subsides, Anti-dumping, and Countervailing Duties. Only a small fraction of the areas lend themselves to opening up commodity markets, but

many do talk about the liberalization of sectors that will increase trade in manufactured goods. Like the EU, the U.S. has been and continues to be opposed to discussing agricultural subsides at the FTAA table, insisting that it be discussed at the Doha Round. With this off the FTAA table, the vast majority of the discussions involve manufactured goods.

The discussions of the meetings divided the participants in the predicted manner. Sides were drawn between the U.S., Canada, Mexico, and Central American countries favoring a comprehensive agreement, while MERCOSUR members wished to remove subjects such as government procurement, services rules and intellectual property rights from discussions (Sevilla 2004). Given the ties that Canada, Mexico, and the Central American countries already had with the U.S., they favored the U.S. position that included negotiation topics that would liberalize sectors and be receptive for its products. However, MERCOSUR, given the current trade pattern, would be at a disadvantage by signing an agreement that did not liberalize market sectors that would favor their products.

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

The talks became more heated after the failure of the September 2003 WTO Cancún talks. The EU and U.S. requested that MERCOSUR members forgo discussing agricultural subsidies until the Doha Round resumed. Brazil along with other members of the G-20[4] held the EU and U.S. (as well as Japan) to their words, but without a satisfactory outcome. At the resumption of the FTAA negotiations, the MERCOSUR members reintroduced the topic of agricultural subsidies, which the U.S. refused to discuss but pointed to the need for the liberalization of services, which the MERCOSUR

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

members stated would be better discussed at the Doha Round (Valente 24 October 2003). This response prompted U.S. Deputy Trade Representative Peter Allgeier to state that an FTAA can be created without Brazil (Valente 24 October 2003). This was not the only time a US trade representative mentioned that Brazil could be left out of the competitive liberalization formula. In 2002, Zoellick stated that Brazil could trade in "another direction...Antarctica" if it did not want to trade with the U.S. (Hay 29 December 2004). In reaction, the MERCOSUR members formalized their unity by signing the "Buenos Aires Consensus" outlining a common position regarding agricultural subsidies (Valente 24 October 2003).

In the hope of moving the negotiations forward, a new negotiation framework was decided ahead of the ministerial meetings in Miami in November 2003. "FTAA lite," as it was called, would allow each country to negotiate in certain areas and not in others (Osava 20 November 2003). However, this did not stop the MERCOSUR members from continuing their common strategy, which further developed ahead of the February 2004 meetings (Invertia 16 January 2004). Most of 2004 resulted in the same stalemate between MERCOSUR and the U.S. regarding agricultural subsidies and liberalization of services. In the most recent attempt, Brazil and U.S. representatives met in Washington, D.C. from 22-23 February 2005. The result was an insipid joint communiqué stating that both sides are committed to an FTAA in the future but without stating how this would occur.

Like the EU-MERCOSUR stalemate, the Western hemispheric one occurred because MERCOSUR members understood that signing the FTAA would place them in a worse position. The U.S. exports a large percentage of manufactured goods to and imports a fair percentage of primary goods from MERCOSUR members. As in the case of the EU, an increase of manufactured goods entering into the MERCOSUR market would threaten domestic producers, leaving MERCOSUR economies worse off.

An Alternative to the Triangle

An added complication to the EU-MERCOSUR-U.S. triangle is China's growing economy. With average annual growth rates of 8 percent, the Chinese economy is becoming increasingly hungry for food, raw materials, and energy. For example, China has been the world's largest consumer of oil since 2003. They continually need reliable sources of raw goods with a portion of them already arriving from Latin America. In 2003, Brazilian exports to China grew 79.8 percent and MERCOSUR exports increased by 96.5 percent from 2000 to 2003 (Osava 18 May 2004). Overall trade with Latin America increased 50.4 percent from 2002 to 2003 (Business Daily Update 3 December 2004). China is also becoming an active business partner, accounting for 36.5 percent of total foreign direct investment in Latin America in 2003 (MercoPress 11 November 2004). Although trade with Latin America only accounted for 3.4 percent of total Chinese trade

volume in 2003 and with a growing trade deficit with Latin America, Chinese state analysts say trade is worth it if they are able to secure raw materials for their fast growing economy (Business Daily Update 3 December 2004). If China is willing to buy more and more Latin American goods along favorable trade arrangements, then Brazil and its MERCOSUR partners would be able to expand the market for their products even despite the EU and U.S. stalemates. In addition, pressure would be off of these countries to sign unfavorable FTAs.

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

China has wider economic plans for Latin America. After his Brazilian visit, Hu's next stop was Argentina, where he and Argentine President Nestor Kirchner announced a US$19.7 billion investment package for infrastructure improvement, and hydrocarbon exploration and production over five years (MercoPress 17 November 2004). Also as a result of Hu's visit, Chinese sanitary authorities later certified several Argentine beef and poultry processing plants, thereby expanding trade of these products for the Chinese market (MercoPress 13 July 2005). In addition, Chile and China began negotiations for an FTA in November 2004, with plans to complete the agreement by March 2006 (China Daily 26 January 2005). Finally, China wishes to join the Inter-American Development Bank and has garnered MERCOSUR's support but faces opposition from the U.S., the Central American states, and Japan (MercoPress 11 April 2005).

Conclusions

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

favorably on accessing larger markets, but fear domestic market competition. If their domestic market is vulnerable, then they would be better off signing an FTA if preferential trade would be cut off by the larger economy. If no preferential arrangement is present, then they would be worse off signing the FTA.

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

While some states are game, others have deep reservations. The EU and the U.S. have developed FTAs in the Western Hemisphere, but with the smaller more dependent states. The Caribbean states benefited from favorable trade relations established by the EU and the U.S. through their respective unilateral policies. Therefore, not signing an FTA for these countries could threaten their trade dependence with the larger actors. The Andean Community will more than likely follow suit given the amount of military and other aid given to fight their domestic drug/insurgency problems (Venezuela being the exception). The MERCOSUR members, on the other hand, do not have such incentives. They primarily sell raw goods to the EU and the U.S. who shield their domestic producers with tariffs and subsidies. The larger economies wish to increase sales of manufactured goods to MERCOSUR without exposing domestic agricultural producers to competition. Although they wish to address these issues at the WTO talks, the Cancún negotiations proved otherwise. Since no incentive is present, an FTAA with MERCOSUR is not very likely given the current preferences of the U.S.

China has to be added to the calculation, given its global paramountcy and the size of its expanding economy. Its needs huge amounts of raw materials and an improved status in the WTO, both of which the MERCOSUR connection can provide. In return, China can provide incentives for MERCOSUR cooperation. The current trajectory implies greater trade interactions between the larger economies of the developing world and the need to tackle some endemic problems present in north-south trade. To improve global trade cooperation, greater incentives are needed from the EU and the US. The liberalization of the agricultural sectors is an important first step towards this. Another is a slow opening for services and government procurement so as to improve the integration of these sectors in the international market. This could elevate the likelihood of increasing domestic stability in the smaller, poorer countries. In addition, it can offer these economies an opportunity to develop so that they are not exclusively the providers of raw materials in an otherwise skewed international division of labor.

Table 1. Market Size Comparison (2002)

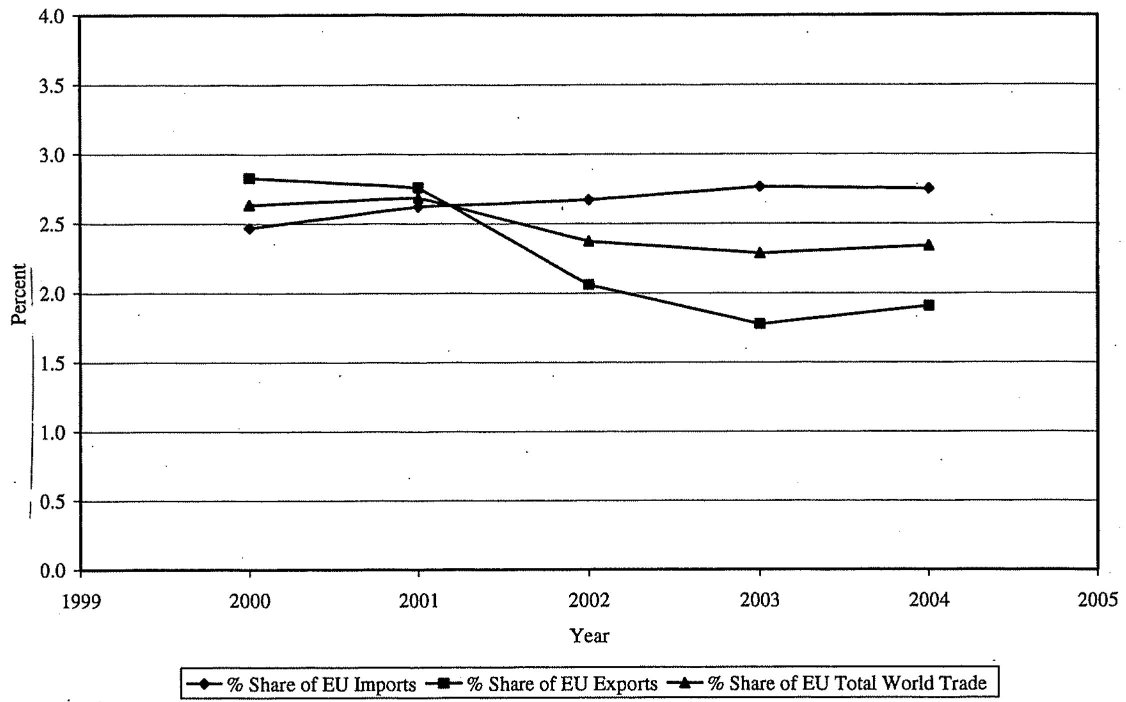
	GDP (trillions US$)	*Population (millions)*	*GDP per capita (US$)*
European Union (15)[a]	8.6	379.1	22,759
MERCOSUR[b]	0.6	223.4	2,560
United States	10.4	291.0	35,681

Source: United Nations Development Programme 2005

[a]EU 15 includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

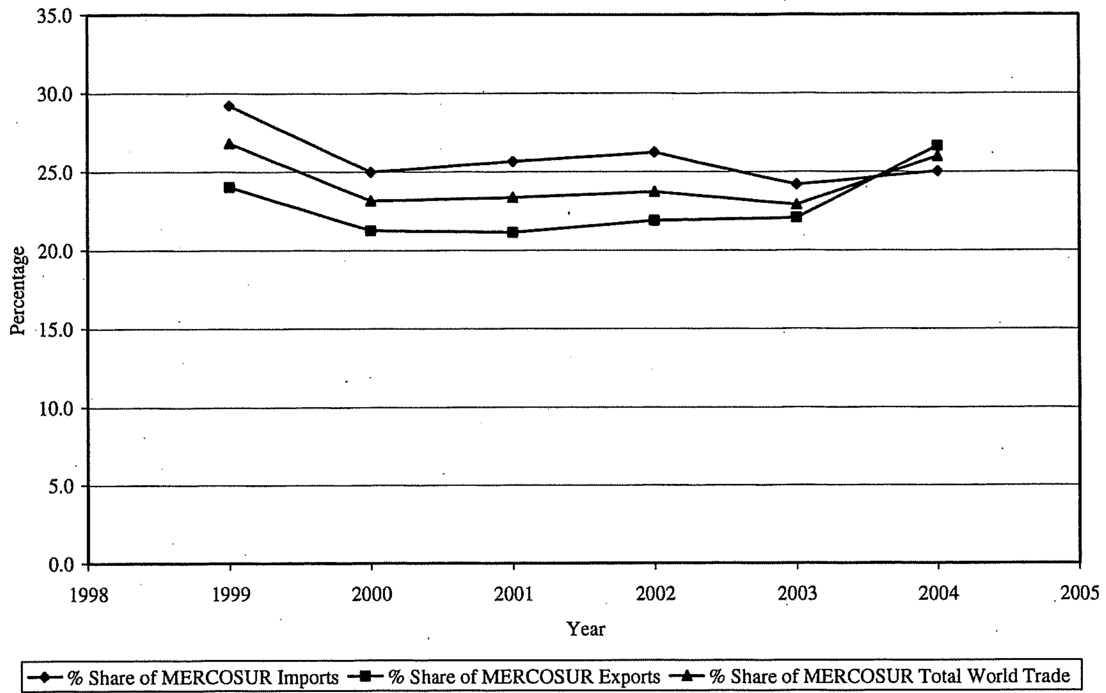
[b]MERCOSUR includes Argentina, Brazil, Paraguay, and Uruguay.

Figure 1. MERCOSUR Percent Share of EU World Trade



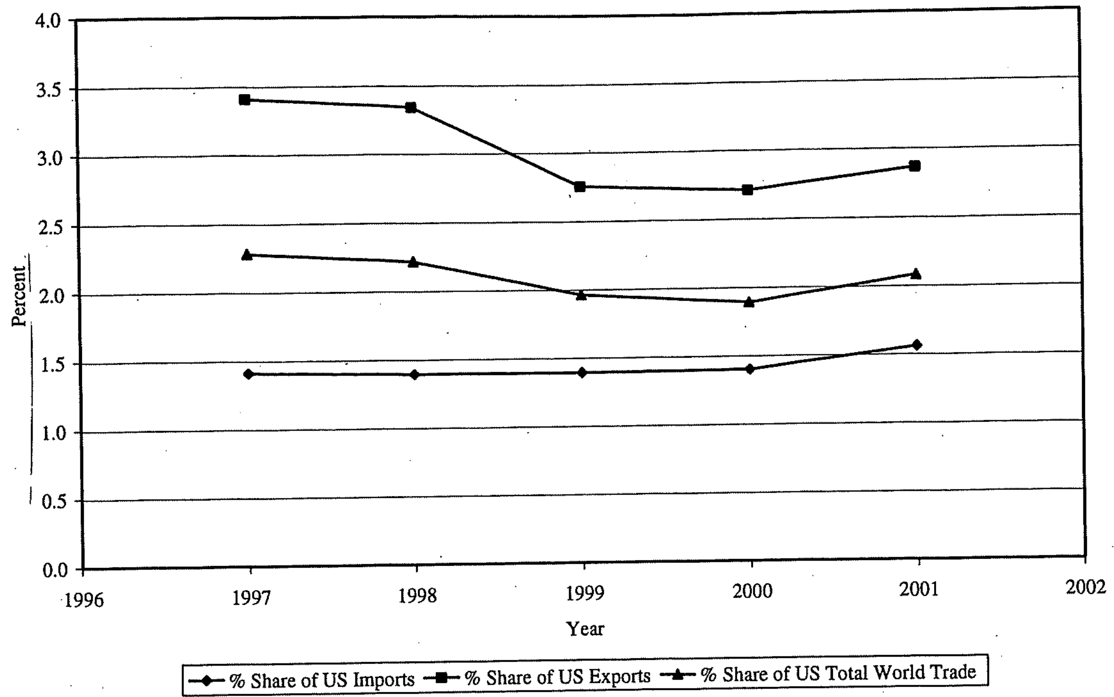
Source: Eurostat 2005

Figure 2. EU Percent Share of MERCOSUR World Trade



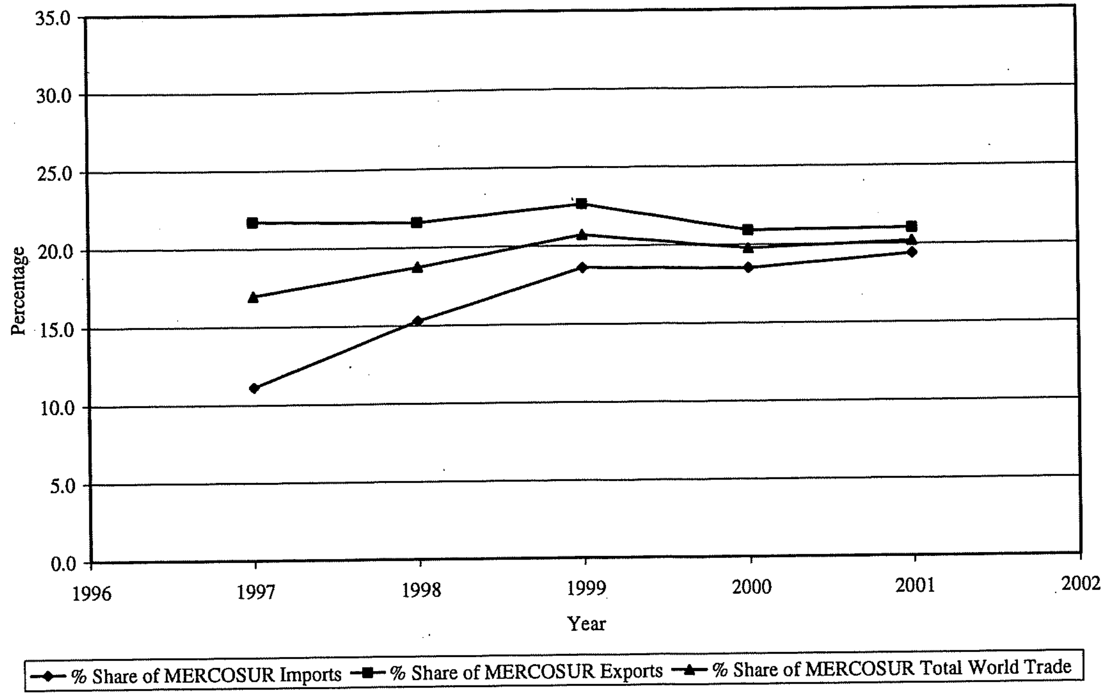
Source: Eurostat 2005

Figure 3. MERCOSUR Percent Share of US World Trade



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

Figure 4. US Percent Share of MERCOSUR World Trade



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

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