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Integration of Mercosur in the global economy

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Integration of Mercosur in the Global Economy

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Integration of Mercosur in the Global Economy^{1 2}

*Andreas Baur, Lisandra Flach, and Feodora Teti**

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Abstract

More than twenty years after the beginning of negotiations, a new window of opportunity seems to have opened for the ratification of a trade agreement between the European Union and Mercosur. For Mercosur, this comes at a crucial juncture in its integration process: the future of the South American trade bloc appears to be more uncertain than ever, with member states holding diverging views on Mercosur's objectives. Thirty years after its foundation, the original goals of Mercosur's integration process have been only partially achieved. While there has been some success in terms of trade liberalization within Mercosur, the goals of forming a customs union and pursuing deeper integration steps remain unfulfilled. High Most Favored Nation (MFN) tariffs and non-tariff trade barriers within the region, coupled with the lack of trade agreements, hinder the integration of Mercosur countries into the global economy. In this report, we take the perspective of Mercosur member states. We describe the evolution of trade flows, highlighting China's growing importance and Europe's declining importance as a trading partner. Next, we analyze trade policy developments within the region and the integration of member states into regional and global value chains. Finally, we emphasize the importance of the EU-Mercosur trade agreement.

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Executive Summary

More than twenty years after the beginning of negotiations, a new window of opportunity seems to have opened for the ratification of a trade agreement between the European Union and Mercosur. For Mercosur, one of Latin America's most ambitious economic and political integration projects, this comes at a crucial juncture: disappointment about the slow progress with respect to economic integration is widespread among member states, and the future of Mercosur seems more unclear than ever.

In the more than thirty years after its foundation, the original objectives of Mercosur's integration process have been only partially achieved: On the one hand, substantial and rapid trade liberalization within Mercosur in the first years after its foundation initially led to an intensification of intra-Mercosur trade and can be regarded as an early success. On the other hand, the ambitious goals set by member states in the beginning have not yet been achieved: the transition from a trade agreement to a customs union remains unfulfilled, and the prospect of achieving deeper integration in other areas appears highly improbable.

China Emerges as Mercosur's Most Important Trade Partner, Whereas the EU Loses Relative Importance in the Region

While Mercosur's exports to China accounted for only around 2% of its total exports in 2000, this share rose rapidly in the following years, reaching 26% in 2021. China is now by far the most important export market for Mercosur's member states, overtaking the European Union, historically the region's most important trading partner. On the import side, a similar picture is emerging: China's share of Mercosur imports has also increased rapidly over the last 20 years and overtook the EU's share in 2019. However, China's rapid rise as the most important trading partner over the past ten years has not led to an overall increase in Mercosur export volumes. Instead, there has been trade diversion away from the European Union toward the Chinese market. Most of Mercosur's exports to China consist of agricultural products (e.g., soybeans) and mineral substances. Although Mercosur exports to the EU are also dominated by this sector, they are markedly more diversified.

Mercosur Countries Have a Low Degree of Integration into Global Value Chains

After 30 years, intra-Mercosur trade has returned to its initial level in the 1990's. Moreover, compared with the Latin American countries of the Pacific Alliance (Chile, Peru, Colombia, and Mexico), the two largest Mercosur members, Argentina and Brazil,

exhibit a lower level of integration into international production networks: only close to 7% of Argentina's and 9% of Brazil's value added is generated via global value chains. This low number stands in stark contrast to the average of 14% for the Pacific Alliance member countries or even the world average. High trade costs due to Most Favored Nation (MFN) tariffs, non-tariff barriers, rules of origin, and hardly any deep trade agreements with third countries have apparently made it difficult for Mercosur member states to integrate into global supply chains.

Tariff and Non-tariff Barriers within Mercosur Hinder Further Integration in the Region

Even though tariffs were eliminated on almost 99% of tariff lines, the four member countries were allowed to exclude sensitive products from tariff reduction. The upshot is a complicated design consisting of a list of tariff exemptions inside Mercosur. Differences in external tariffs among Mercosur members lead to additional trade costs and hinder further integration due to rules of origin. To prevent exporters from third countries from exploiting differences in external tariffs among members, firms exporting within Mercosur must comply with rules of origin to obtain preferential market access. Because rules of origin are costly for firms, they reduce both integration into global value chains and the degree of supplier diversification. Moreover, they may lead to inefficient sourcing decisions.

Non-tariff barriers, in turn, also contribute to the low level of integration within the region. Countries use several protectionist measures that go beyond classic MFN tariffs. Numerous cases of antidumping duties imposed by Argentina on Brazilian textile exports since the 1990's are just one example.

The Role of the EU-Mercosur Trade Agreement

Given Mercosur's hitherto poor integration into global trade and value chains, and the member states' little effort in taking additional steps towards deeper regional integration, the EU-Mercosur trade agreement comes at a propitious moment and could play an important role in fostering Mercosur's integration process. First, the successful ratification of the agreement might remind Mercosur member states again of the advantages of forming a large trade bloc, and might kindle renewed interest in tackling present integration deficits. Second, the agreement can help improve integration into global and regional supply chains in South America, help reduce current dependencies on China as a trade partner, and increase the degree of export diversification.

1 Introduction

In the year 2000, the European Union (EU) and the South American trade bloc Mercosur (Mercado Común del Sur) started negotiations for a trade agreement. Now, more than twenty years later, there seems to be a new chance for a closing of the deal within the coming months. On both sides of the Atlantic, the ratification process has regained strong political momentum, as demonstrated by the president of the European Commission Ursula von der Leyen's visit to Brazil and Argentina in June 2023. For Mercosur, this comes at a crucial juncture in its own integration process: the future of the South American trade bloc appears to be more uncertain than ever as its member states' visions of Mercosur's objectives increasingly diverge.

When the presidents of the four member countries launched Mercosur with the Treaty of Asunción on March 26, 1991, they gave the starting signal for one of the most ambitious integration projects in the recent history of Latin America. The Treaty of Asunción was preceded by the rapprochement between the two regional heavyweights and historical rivals Argentina and Brazil, which had already concluded their first sectoral trade agreements in the late 1980s. Mercosur was supposed to be a great leap forward: the two countries wanted to create a single market based on the model of the EU, i.e., with free movement of goods, services, capital, and workers. Paraguay and Uruguay joined the project of their two large neighbors.

Mercosur is of great importance to South America: 62% of the region's inhabitants live within the bloc, and 67% of South America's GDP is generated there. At the same time, there are enormous disparities in size among Mercosur's member countries, with Brazil alone accounting for nearly three quarters of Mercosur's GDP and about half of both South America's GDP and its population (Figure 1).

The pending ratification of the trade agreement between the EU and Mercosur provides an opportunity to analyze Mercosur's current state of economic integration. What has remained of the "Spirit of Asunción"? How far has the economic integration of the member countries progressed? What areas still exhibit shortcomings?

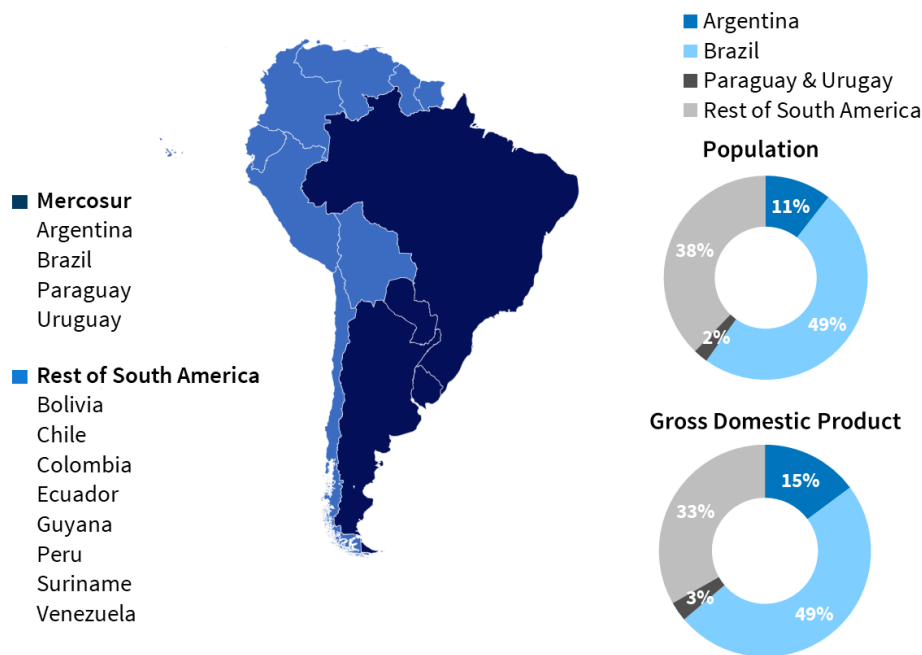
First, we describe the development of trade flows. While today around 10% of all Mercosur exports are traded between its member countries and the EU is losing weight in the region, China has established itself as the main destination market for Mercosur exports. Second, we analyze Mercosur's trade policy and the reasons behind its failure to achieve the original objective of establishing a customs union. The high external

Introduction

tariffs of the Mercosur countries, the large number of non-tariff barriers, as well as the lack of in-depth trade agreements with important partners lead to a significantly lower participation in international trade compared to other trade blocs, such as in the Asia-Pacific region, North America or the EU. Furthermore, Mercosur has a low degree of participation in international production networks. For instance, only 7% of Argentina's value added and 9% of Brazil's are generated through global value chains.

In addition to economic integration, political integration objectives are also firmly anchored in the Treaty of Asunción and have become even more important since the turn of the millennium. An analysis of Mercosur's political, social and cultural dimensions is, however, beyond the scope of this article.³

Figure 1
Mercosur in South America



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Notes: Share of total South America for the year 2021 (%).

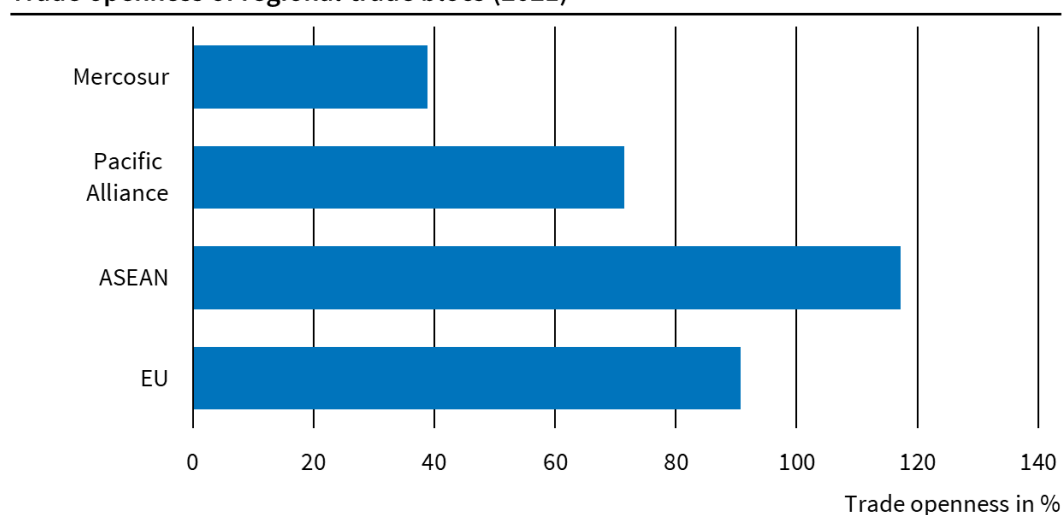
Source: World Bank; Venezuela: IMF estimates; own calculations.

³ Venezuela joined Mercosur in 2012, but its membership has been suspended since December 2016 due to severe human rights violations. We will therefore limit our analysis to the four founding member states of Mercosur.

2 Trade Openness of Mercosur Countries Remains Relatively Low

A first indication of progress in Mercosur countries' trade integration is provided by their respective trade openness. The ratio of trade volume (imports and exports) to gross domestic product provides a measure of an economy's degree of openness. Figure 2 shows the trade openness of several large economic blocs, taking into account both intraregional and extraregional trade flows of goods and services.

Figure 2
Trade openness of regional trade blocs (2021)



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Notes: Trade openness is calculated as the ratio of trade volume (imports and exports) to gross domestic product. When calculating this ratio for the regional economic blocs, both intraregional and extra-regional trade volumes were considered.

Source: World Bank, own calculations.

In relation to Mercosur's economic size, international trade continues to play a minor role for its member countries: although their trade openness increased significantly between 1991 and 2004 (from 17% to 33%), a stagnating trend has been evident thereafter. In 2021, it still amounted to less than 40%. This is extremely low, especially compared to the evolution of other trade blocs. In the EU, trade openness almost doubled between 1991 and 2021, from just under 50% to 91% now. For ASEAN,⁴ the Association of Southeast Asian Nations, the degree of trade openness is as high as 117%. The low level of Mercosur's trade openness becomes particularly clear in comparison with the Pacific Alliance, the second major economic bloc in Latin America. The alliance was founded in 2012 by Chile, Mexico, Peru and Colombia and has a much

⁴ Member countries are Brunei, Indonesia, Cambodia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.

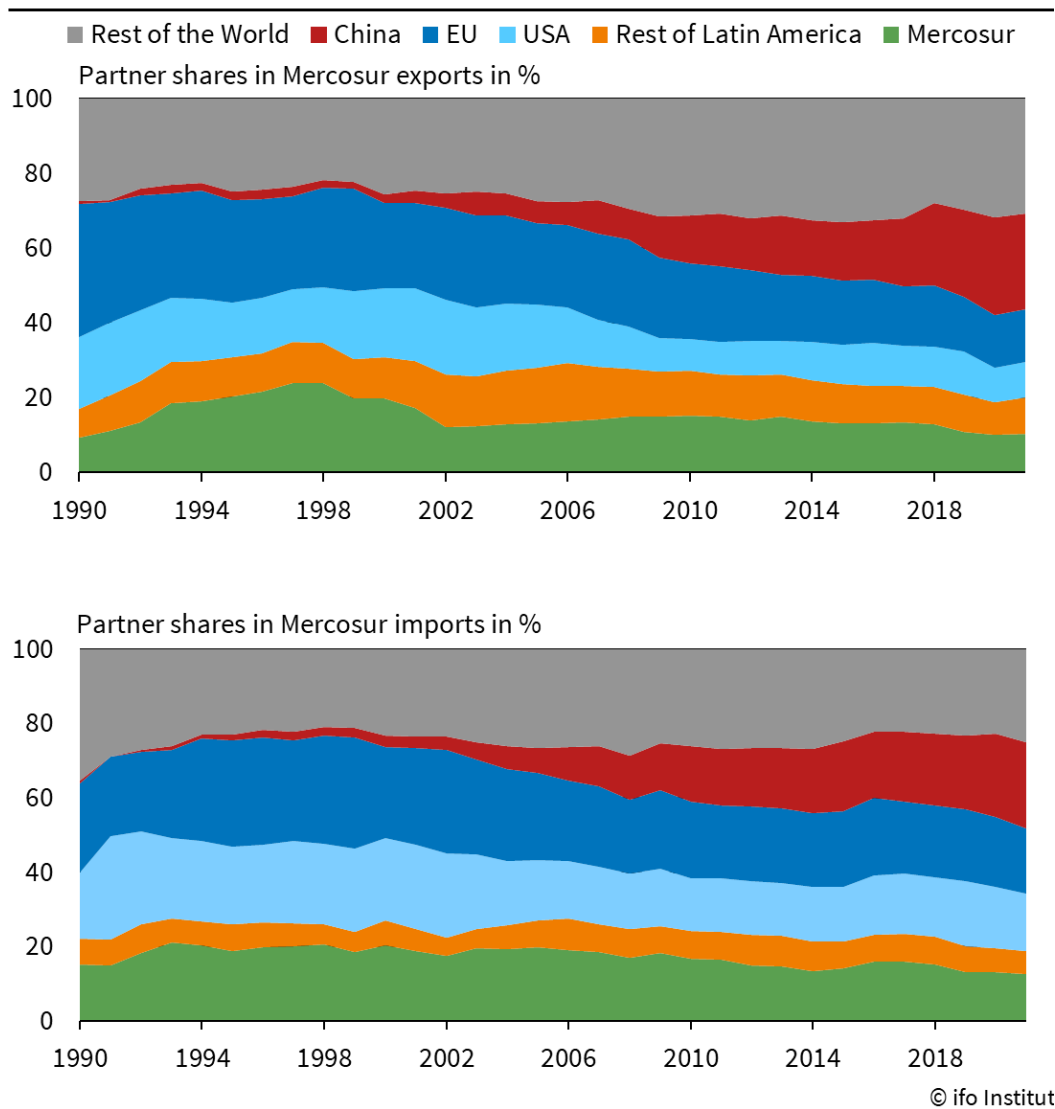
greater degree of openness than Mercosur, additionally exhibiting a sustained upward trend.

3 Mercosur's Trading Partners: Little Intra-Bloc Trade, China on the Rise

The evolution of trade flows over the past thirty years (Figure 3) gives a first impression of how far trade integration has progressed within Mercosur. When the Treaty of Asunción was concluded in 1991, exports among Mercosur countries represented 11% of their total exports. More than thirty years later, this ratio stands even slightly lower, at only 10%. While intra-Mercosur trade gained significant momentum, especially in the early years, rising to 24% of the total in 1998, there has been an almost continuous decline back to the initial level of the founding year. This is also reflected in the value of intra-Mercosur exports, which in U.S. dollar terms has never again reached its all-time high of 2011. However, it should be noted here that currency effects (depreciation of domestic currencies against the U.S. dollar) also play a role to some extent.

Figure 3 also shows Mercosur's most important trading partners since 1990. Here, the remarkable rise of China stands out for both exports and imports: while Mercosur's exports to China accounted for only about 2% of its total exports in 2000, the ratio rose rapidly in the following years, to 26% in 2021. China is now, by far, the most important destination market for Mercosur exports, having overtaken the EU, historically the region's most important trading partner. On the import side, a similar picture is emerging. China's share of Mercosur imports has also increased rapidly over the past twenty years, and overtook the EU's share in 2019.

Figure 3
Mercosur trade flows by trading partner (1990-2021)



Source: Comtrade; Gaulier and Zignago (2010); own calculations.

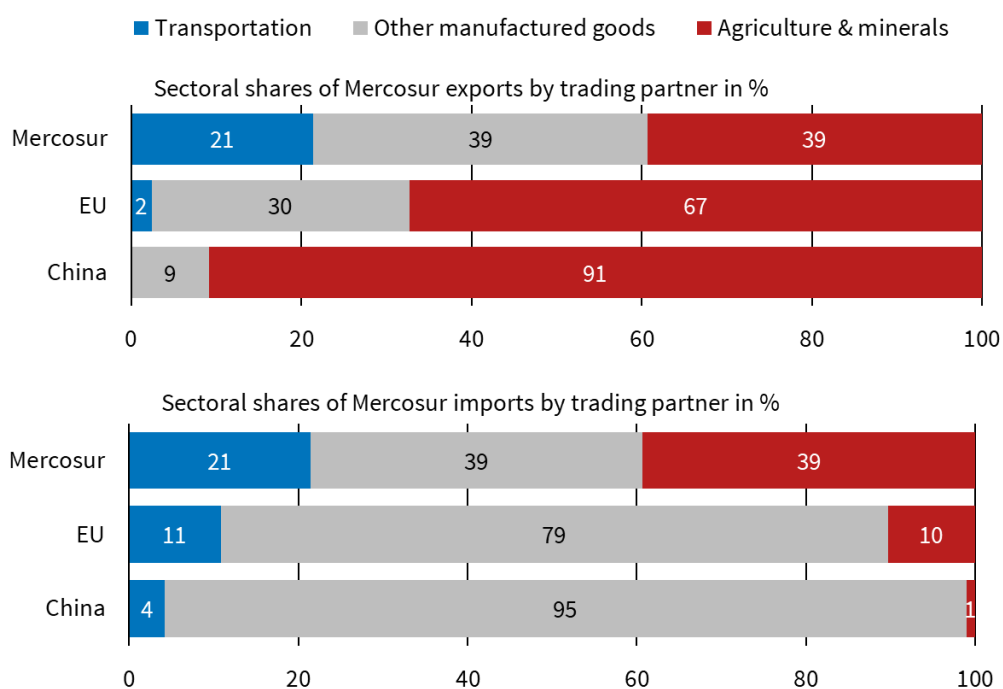
China's rapid emergence as the most important market over the past decade has not led to an overall increase in Mercosur's export volume. What happened instead was a shift in trade away from Europe to the Chinese market. Mercosur's exports to Europe have been trending downward, falling by more than 25% between 2011 and 2021.⁵ While in 1991 almost one third of all export goods left the South American member countries for Europe, in 2021 it was only 14%. Mercosur's share of imports from the EU, which consist primarily of manufactured goods, is also trending downward.

⁵ This also holds true for the period between 2011 and 2019 (excluding the Covid-19 pandemic).

Intraregional Trade below Average Compared to Other Trade Blocs

Figure 4 illustrates how poorly diversified the trade relationship between South American countries and China is: while China supplies mainly industrial products to Mercosur countries, 91% of Mercosur's exports consist of agricultural products (such as soybeans) and minerals. Although Mercosur's exports to Europe are also clearly dominated by this sector, with a value of 67%, they nonetheless show a higher degree of diversification. Compared to the exchange of goods with external trading partners, the sectoral composition of intra-Mercosur trade is striking: although agricultural products and minerals also play a significant role, with a share of 39%, trade in manufactured goods and products from the automotive sector currently dominates trade within Mercosur, with a share of around 60%.

Figure 4
Sectoral composition of Mercosur trade flows (2021)



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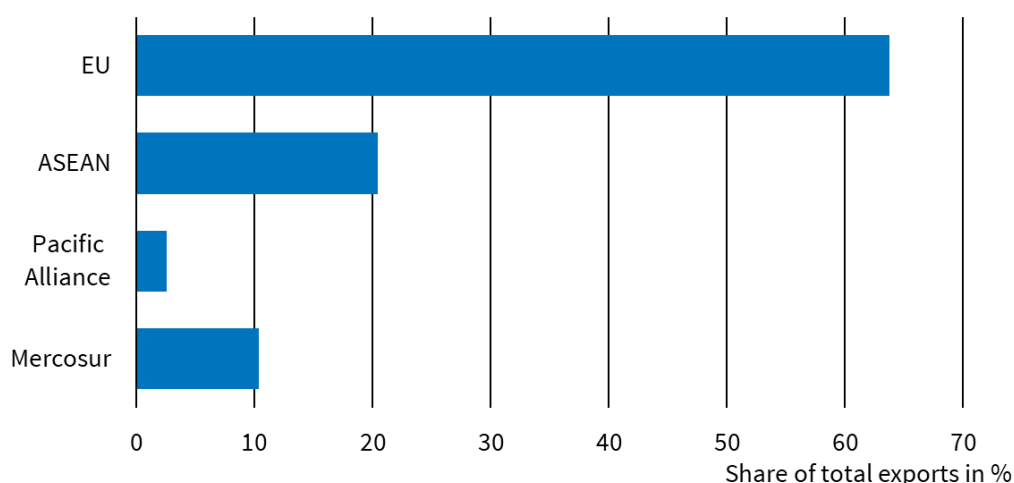
Sources: Comtrade; Gaulier and Zignago (2010); own calculations.

4 Intraregional Trade below Average Compared to Other Trade Blocs

In comparison with other regional economic blocs, it is striking that intra-Mercosur trade, with a share of just 10% of total exports, is relatively low (see Figure 5). Well over half of all EU goods exports, for instance, are destined for other EU member states

(64%), while for ASEAN countries one fifth of all exports remain within the trade alliance. The fact that intra-Mercosur exports account for only 10% of total exports can be seen as an indication of a significantly lower level of economic integration among the Mercosur countries. However, one should not take these figures as a strict ranking, because some caution is warranted when comparing these ratios. First, economic integration between Latin American countries has been historically relatively weak. This is also evident from the share of exports within the Pacific Alliance relative to their total export volume. Secondly, the relative size of the member countries within the respective economies must always be taken into account. Brazil's GDP alone represents almost three-quarters of Mercosur's GDP. While Brazil is the most important export market for Argentina and Paraguay and the second most important export market for Uruguay, only Argentina is among the top five largest markets for Brazil's exports.

Figure 5: Trade within regional trade blocs (2021)
Trade within regional trade blocs (2021)



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Source: Comtrade; Gaulier and Zignago (2010); own calculations.

5 Trade Policy of Mercosur

From the point of view of trade policy, Mercosur was intended to create a single market. The four member states committed themselves to the free movement of goods, services, and production factors — workers and capital — between their countries. The formation of a customs union represents the first step in the direction of deep economic integration, following the example of the EU single market.

Similar to a trade agreement, which under Article XXIV of the General Agreement on Tariffs and Trade (GATT) may be concluded only if trade barriers are eliminated in at least 90% of trade, a customs union completely eliminates tariffs between member countries. While the participating countries retain autonomy over their external tariffs when concluding a trade agreement, the members of a customs union agree on a common external tariff and commit themselves to negotiating trade agreements with third countries only jointly.

The planned integration process of Mercosur can be divided into two phases. First, the transition between 1991 and 1994, in which all tariffs within Mercosur were to be abolished by means of a trade agreement. Second, although Mercosur was *de jure* transformed into a customs union on January 1, 1995, full external tariff harmonization was not planned until 2001. In the following, we analyze first the liberalization process among the Mercosur countries, then the adjustment of the common external tariff, and finally the implications of these developments.

5.1 What Trade Barriers Still Exist within Mercosur?

The Treaty of Asunción provided for the complete elimination of Most Favored Nation (MFN)⁶ tariffs by January 1, 1995. To achieve this goal, it was agreed that tariffs would be reduced gradually, linearly, and automatically: 54% of all tariffs were to be eliminated by the end of 1991, 68% by the end of 1992, 82% by the end of 1993, and 100% by the end of 1994 (see Azevedo 2004 for a detailed description).

This goal was narrowly missed. Although tariffs were completely eliminated on almost 99% of tariff lines, the four member countries were allowed to exclude sensitive products from tariff reduction. Each country then created a list of exemptions. The MFN tariffs, which therefore remained in force, were initially to be completely eliminated by January 1, 1999. This deadline was repeatedly postponed – to this day, MFN duties are still levied on 1.2% of the tariff lines.

The exemptions have a strong sectoral component. In 2018, 212 exempted tariff lines spread across only six groups of goods. 64% of all exemptions from zero duty are in the goods group of tractors, motor vehicles, motorcycles, and bicycles. In addition, 16% and 15% of the exemptions from zero duty can be attributed to the goods group of telephones and machinery, respectively. The remaining exemptions are distributed among sugar and confectionery, (4%), cigarettes, and razors (0.5% each).

⁶ The Most Favored Nation (MFN) tariff is the tariff that WTO members impose on all other WTO member countries. This means that Brazilian imports are initially subject to the MFN tariff regardless of the country of origin, whether the goods come from the EU or the US. After a trade agreement is concluded, the lower preferential tariff applies, usually zero.

This strong and, above all, over decades persistent concentration on a few groups of goods shows that certain sectors enjoy special protection. The exempted tariff lines are not chosen at random. Instead, the sectors most affected are those in which particularly strong negative adjustment effects are expected from a complete liberalization.

Overall, it can be said that almost all tariffs have been successfully eliminated within Mercosur. Nevertheless, the goal of completely free trade in goods within Mercosur, modeled on the EU, has not been achieved. Since the exceptions are still an integral part of the member states' trade policies today, more than thirty years after they were signed, a complete elimination of tariffs within Mercosur seems to be rather unlikely in the foreseeable future.

Table 1 Exemptions from Zero Duty (2018)

Product Group	Share of Exemptions (in %)
Tractors, motor vehicles, motorcycles, bicycles	64
Telephones and accessories	16
Machines and mechanical devices	15
Sugar and confectionery	4
Cigarettes	0.5
Razors and blades	0.5

Source: ITC, own calculations

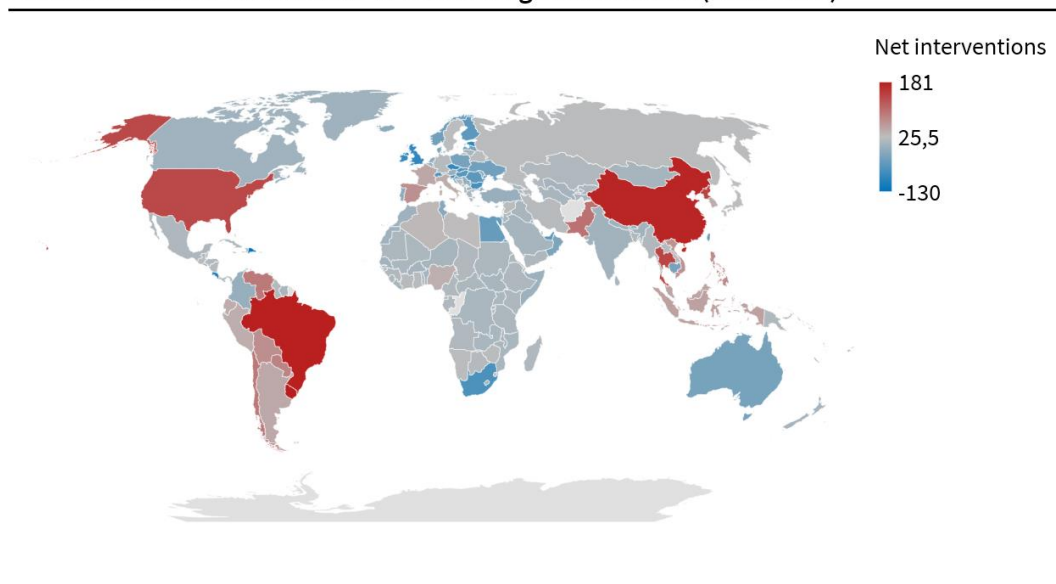
In addition to tariffs, trade remedies and non-tariff barriers also help to explain the low level of integration within the region. Countries use protectionist measures that go beyond traditional MFN tariffs. One example are antidumping duties, which torpedo trade despite promises to eliminate all trade barriers within Mercosur. For example, Argentina has imposed quite a few antidumping measures on Brazilian textile exports since 1990, to which Brazil often responded with similar measures (Bown and Tovar 2016).

To analyze non-tariff barriers in more detail, we next look at the extent of non-tariff protectionism inside and outside Mercosur. We use data from Global Trade Alert (2023), which collects all trade policy measures beyond MFN tariffs. These measures can be liberalizing or protectionist, as well as applied to individual countries or all trading partners.

Figure 6 shows the number of newly imposed protectionist measures minus the number of liberalizing measures imposed by the four Mercosur countries on other countries. The redder the coloring, the higher the net number of protectionist measures. It is particularly noticeable that the other Mercosur countries impose a large number of protectionist measures against Brazil, Paraguay and Uruguay. In Argentina, the number of protectionist policies net of liberalizing policies is relatively low, but Argentina's

absolute number of protectionist measures against Mercosur countries is comparably high. Outside Mercosur, protectionist measures are mainly applied against exports from China.

Figure 6
Protectionist interventions net of liberalizing interventions (2009-2022)



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Notes: The world map shows the number of protectionist policy interventions directed by Mercosur countries against other countries minus liberalizing measures.

Source: Global Trade Alert (2023), own calculations

Thus, the almost complete elimination of MFN tariffs in the early 1990s seems to suggest a greater liberalization success of intra-Mercosur trade than has actually occurred: the widespread use of non-tariff barriers within Mercosur is at odds with Mercosur’s original objective of allowing the free exchange of goods. A redefinition of the scope of non-tariff barriers, such as a restriction of anti-dumping measures against other Mercosur countries, represents an important opportunity for further trade liberalization.

5.2 Strong Tariff Reductions in the Initial Phase Go Hand in Hand with an Intensification of Trade

Despite exemptions, most tariffs within the Mercosur bloc have been eliminated. To get a sense of how big these tariff reductions were, we check next the MFN levels in 1991, i.e., the year when the liberalizing process began. As most tariff lines had no tariffs after the integration was finalized, the level of the MFN tariffs is a good proxy for the change in tariffs. Column (1) of Table 2 shows the average MFN tariffs as well as the tariff peaks of the four countries at the beginning of liberalization in 1991. On average, the MFN tariff was 15%. For the Brazilian market in particular (average MFN tariff: 23%), the

elimination of tariffs meant a rapid opening – at least to South American partners. In addition, Table 2 shows the development of the MFN tariffs over time. First, it becomes apparent that for Brazil and Paraguay, joining Mercosur meant that they lowered their MFN tariffs vis-à-vis the rest of the world. Second, not much has happened since 1996, as the stagnant levels of MFN tariffs indicate. Third, tariffs against the rest of the world were still at a very high level in 2017.

The combination of the sharp tariff reductions and continued high MFN tariffs vis-à-vis the rest of the world contributes significantly to the increase in intra-Mercosur trade up to the turn of the millennium (Figure 3). At the same time, Mercosur's constant MFN tariffs against third countries, which is quite high compared to other South American countries,⁷ provides one explanation for the sluggish development of trade with countries outside Mercosur.

Table 2 MFN Tariffs over Time, in Percentage Points

	1991		1996		2001		2017	
	MFN	MFN	$\Delta 96-91$	MFN	$\Delta 01-96$	MFN	$\Delta 17-01$	
Mercosur	15	12	-3	13	+1	12	-1	
[min, max]	[0; 85]	[0; 70]		[0; 55]		[0; 74]		
Argentina	13	13	0	13	0	14	+1	
[min, max]	[0; 35]	[0; 30]		[0; 37]		[0; 74]		
Brazil	26	13	-12	14	+1	14	0	
[min, max]	[0; 85]	[0; 70]		[0; 55]		[0; 35]		
Paraguay	16	11	-5	13	+2	10	-3	
[min, max]	[0; 72]	[0; 30]		[0; 32]		[0; 35]		
Uruguay	6	11	+5	14	+3	11	-3	

Note: The table shows for Mercosur countries the (unweighted) average MFN tariffs, their absolute change, and minimum or maximum over time.

Source: Teti (2020); own calculations.

5.3 The Common External Tariff: The Heart of the Customs Union

For a successful transformation of the trade agreement that existed until 1995 into a customs union, the country-specific MFN tariffs must be adjusted to a uniform tariff level. Table 2 shows the change in MFN tariffs over time. Although, on average, MFN tariffs were aligned by 2001, as agreed, the very different tariff peaks across member countries show that there were still some tariff lines where no common external tariff

⁷ For example, for 2017, Chile has an average MFN duty of 6%, Colombia 9%, Peru 3%, and Mexico 7%.

applied even after the deadline that was set for aligning the external tariffs. The reason is similar to the liberalization of intra-Mercosur trade, with each member country being allowed to compile a list of exemptions from the external tariffs for which the country-specific MFN tariff applies. Since the exempted tariff lines are not perfectly congruent for the four member countries, there are quite large differences in external tariffs. These differences persist to this day. Moreover, a divergence occurred since 2001: although the external tariffs are very similar between Argentina and Brazil and the two smaller countries Paraguay and Uruguay, the tariff levels between the two groups differ significantly.

To better understand the external tariff divergence, we next look at disaggregated data. For this purpose, we first calculated how often a deviation from the external tariff was observed for 2018 at the tariff line level (Table 3). Of the 10,230 tariff lines in total, the external tariff is identical for only 67% for all four members. Argentina and Brazil have the same external tariff for 94% of all tariff lines; Paraguay, and Uruguay for 84%.

The table also shows the deviations from the common external tariff for the different sectors. The sectors are ranked in descending order by the largest percentage deviation. For textiles and apparel, Argentina and Brazil do have an identical external tariff. However, since the two large countries have much higher tariff levels than the two smaller ones (Brazil and Argentina: 25%, Paraguay and Uruguay: 17%), there are significant tariff differences for Mercosur as a whole. Transportation is the sector with the second highest number of exemptions from the common external tariff. This is mainly due to the motor vehicle sector, where Brazil and Argentina in particular want to protect their domestic production.

Table 3 Deviations from the Common External Tariff (2018)

Sectors	Quantity Tariff lines	Deviation (in %)		
		All	AR&BR	PY&UY
Total	10 230	33	6	16
Textiles & apparel	1 055	87	0	13
Means of transportation	230	74	33	57
Mechanical devices & electrotechnical goods	1 766	70	18	34
Shoes	70	54	1	50
Optical instruments	450	47	12	17
Miscellaneous goods	168	37	8	28
Plastics	424	25	4	19
Fats & oils	74	20	11	12
Base metals	740	19	4	16
Stones & glass	217	16	1	14
Food, beverages & tobacco	311	14	5	12
Paper & cardboard	222	13	0	10
Chemical industry	3 021	9	2	8
Wood	157	8	2	7
Leather	113	6	0	5
Plant products, roots	404	4	1	3
Jewelry	64	3	2	3
Live animals	515	2	0	2
Art objects & antiques	7	0	0	0
Mineral materials	207	0	0	0
Weapons & ammunition	18	0	0	0

Note: The table shows the unweighted average MFN tariffs, the mode (the most frequently chosen MFN tariff), and the share of tariff lines that deviate from the common external tariff. A distinction is made here between a common external tariff for all four members (“all”) and a common external tariff for Argentina and Brazil (“AR&BR”) or Paraguay and Uruguay (“PY&UY”).

Source: ITC; own calculations.

5.4 Differences in External Tariffs Lead to Further Trade Barriers

The differences in external tariffs lead to further costs in intra-Mercosur trade due to rules of origin. In order to prevent exporters from third countries from exploiting differences in external tariffs in their favor by first exporting to the country with the lowest external tariff and then being able to trade the goods duty-free within Mercosur, Mercosur countries must introduce customs formalities within the bloc.

An example illustrates this possibility for arbitrage: suppose a Chinese company exports a good to Brazil and must pay an import duty of 20% on that good. If Uruguay imposes only a 5% tariff on the same good, the exporter from China would have an incentive to

enter Mercosur via Uruguay and then transport the good to Brazil duty-free, as this would allow the good to be offered more cheaply due to the lower tariffs.

Rules of origin, which any exporter exporting within Mercosur must comply with to obtain preferential market access, prevent this exploitation of tariff differentials. Exporters must provide proof of origin that demonstrates “domestic production”. This is understood to mean that the goods were produced largely within Mercosur. For example, Uruguayan exporters must prove that at least 60% of the production took place either in Uruguay or one of the other Mercosur countries; if this proof is not provided, the MFN duty will apply. For the exporter from China from the above example, it is now no longer possible to take advantage of tariff differentials unless a large proportion of the value added takes place within Mercosur.

In the case of customs unions that have a common external tariff, as in the case in the EU, the proof of origin is not required. The reason is simple: with an identical external tariff, exporters from non-EU countries no longer have the possibility of tariff arbitrage and the resultant shift in trade flows.

Proof of origin is costly. On the one hand, it reduces integration into global value chains and the degree of supplier diversification, making it difficult to comply with the domestic production criterion. Moreover, compliance with rules of origin may lead to inefficient choices in favor of suppliers within Mercosur: instead of the lower-cost supplier from a third country, the more expensive alternative from one of the Mercosur countries is chosen. Conconi et al. (2018) show this relationship for NAFTA, the trade agreement between Canada, Mexico, and the United States. Exporters may also decide not to provide proof of origin and choose suppliers from lower-cost third countries. In this case, the MFN tariff, which is often quite high, is incurred. Since Mercosur does not have a common external tariff, proof of origin must be provided for each export, a transaction cost that could otherwise be avoided.

The differences in external tariffs also mean that when negotiating trade agreements with third countries, each Mercosur country negotiates its own tariff reductions. This contradicts the principle of a common trade policy that would have to apply if the trade agreement were successfully transformed into a customs union – another criterion that is not being met. In addition, Mercosur countries lose an important lever in bilateral negotiations: since negotiations are country-specific, Mercosur cannot use the entire market size as a bargaining chip. Therefore, worse negotiation results are to be expected with this small-scale solution.

6 Mercosur Countries Have a Low Level of Integration into Global Value Chains

The creation of Mercosur coincided with the beginning of a tremendous period of growth in global trade in the 1990s and early 2000s. Driven by advances in information and communications technology, more and more companies began to offshore individual stages of production abroad. This led to a huge increase in the trade of intermediate goods and a sharp rise in the importance of international production networks (Baldwin 2016).

To what extent have the Mercosur countries managed to participate in this development? The analysis of value-added flows with the help of input-output tables⁸ makes it possible to answer this question. With this data, it is possible to map direct and indirect trade linkages and thus the economic interdependencies between countries.

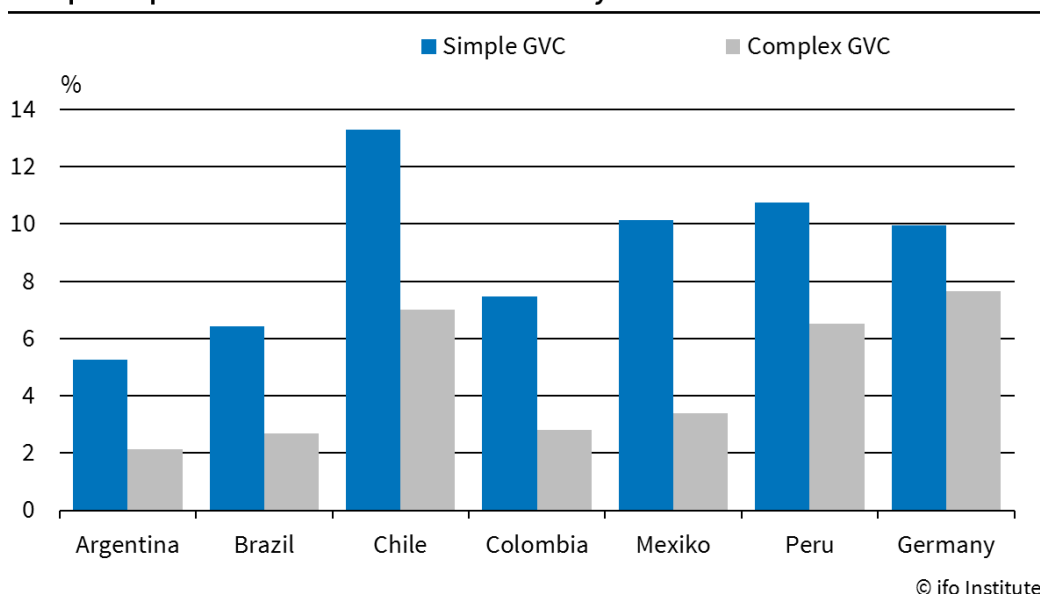
Figure 7 graphically depicts the share of simple and complex value chains in the total value added of the Mercosur countries Brazil and Argentina. Simple value chain linkages occur when intermediate goods are exported as part of a production process and are then further processed in the partner country for local consumption. If intermediate goods cross a national border several times, the term complex value chain is used (see Wang et al. 2017).

Especially in comparison to the Latin American member states of the Pacific Alliance (Chile, Peru, Colombia, and Mexico), the two largest Mercosur member countries, Argentina and Brazil, exhibit a relatively low participation in global value chains:⁹ only 7% of Argentina's and 9% of Brazil's value added is generated through simple and complex supply chains, respectively. By contrast, the level is much higher on average for the Pacific Alliance member countries shown in the figure. In particular, Chile shows strong participation in both simple and complex global value chains. The difference between the Mercosur countries and Germany is also significant: about 18% of German value added is generated via simple and complex global value chains.

⁸ Input-output tables show the origin of production, i.e., the use of intermediate inputs and factors of production, and the use of the goods produced for all sectors of the economy.

⁹ Unfortunately, no data is available for the two smaller Mercosur economies, Paraguay and Uruguay.

Figure 7
GVC-participation for selected countries in the year 2018

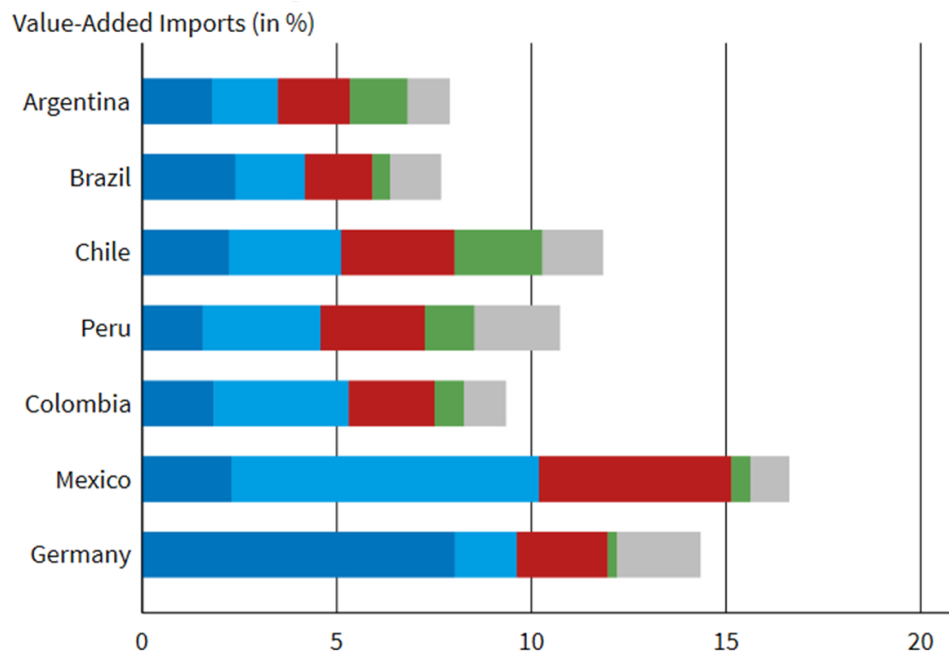


Notes: This figure shows the share of simple and complex GVS in total value-added for the year 2018.
 Source: OECD ICIO 2021, own calculations

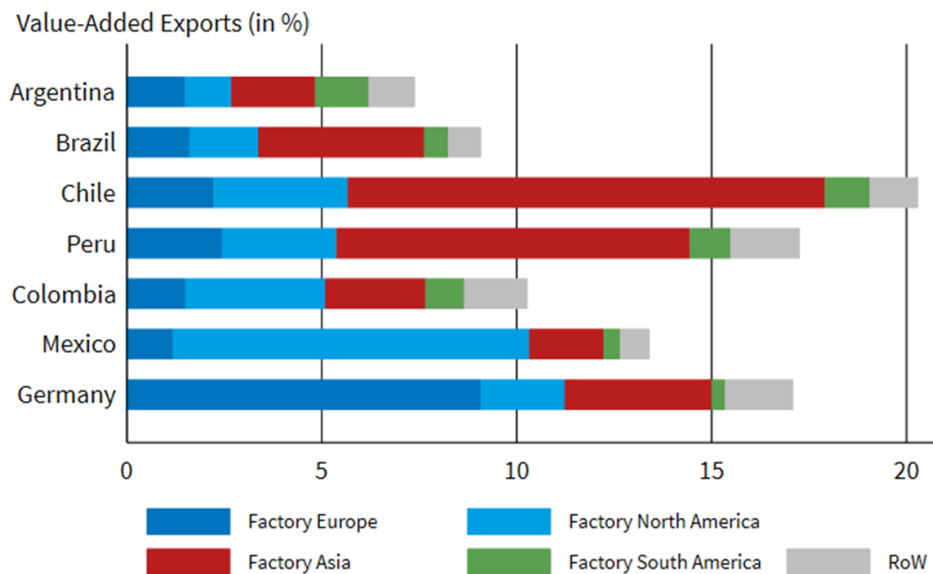
When analyzing value chain linkages, it is also possible to take the view of the upstream or downstream industries or countries. These are referred to as forward and backward linkages. When analyzing forward linkages, one examines how the value added of an industry/country reaches the consumer. This gives a measure of dependence on downstream production in other countries. Backward linkages, on the other hand, look at the supply chains for the production of final goods, i.e., the direct and indirect supply structure with value added from upstream industries/countries. This shows how dependent a country is on value added from abroad for domestic production.

Figure 8 provides information on the regional structure of value chain linkages, distinguishing between forward and backward linkages. For both types of value chain linkages, it can be seen that cross-border value chains in South America are more global than regional. The shares of value added which can be attributed to the production networks of Asia, Europe, and North America dominate both in Mercosur and the Pacific Alliance. In contrast, the production network within South America accounts for only a small share of both trading blocs. This is in stark contrast to Europe, North America, or Asian countries, which have strong linkages within the region, as described by Aichele et al. (2020) and Flach et al. (2021).

Figure 8
GVC Backward Linkages



GVC Forward Linkages



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Note: The dependence of various countries on backward and forward linkages is shown for 2018. In the case of backward linkages, the view is taken of a country that processes the value added into final goods and thus stands at the end of the value chain. The share of value added from different supplier countries in the total processed value added of this country is shown. In the case of forward linkages, the perspective of the country that sends value added to other countries for further processing is taken, and thus stands at an upstream stage of the value chain. The share of value added that is sent directly or indirectly to the partner country for further processing is shown, measured against the total value added of this country. Factory Asia includes the ASEAN countries, China, India, Japan, Korea, and Taiwan; Factory North America comprises Canada, Mexico and the United States; Factory Europe includes the EU, Turkey, Norway, Iceland

Conclusion and Outlook

and Switzerland; Factory South America encompasses Argentina, Brazil, Chile, Colombia and Peru. Domestic linkages are excluded for each Factory.

Source: OECD ICIO 2021, own calculations.

Since global value chains cross national borders several times, low trade barriers play an important role; otherwise, high costs accumulate and this type of production would be unprofitable. Mercosur's protectionist trade policies, characterized by a high MFN tariff and numerous non-tariff trade barriers, make it thus difficult to participate in global value chains. In addition, Mercosur countries have not yet succeeded in concluding a modern and comprehensive trade agreement with key trading partners. Such an agreement could contribute to the intensification of global or regional value chains in the South American region. The rules of origin, which prevent a large foreign share of production, further complicate integration.

7 Conclusion and Outlook

More than thirty years after its founding treaty entered into force, the results of Mercosur's economic integration progress present a mixed picture. On the one hand, the initial trade liberalization within Mercosur can be regarded as a success, which is also reflected in an intensification of intra-Mercosur trade in the first few years. On the other hand, the ambitious goals of the Treaty of Asunción have yet to be achieved: the transition from a trade agreement towards a customs union has not been completed, and deeper integration steps in other economic areas hardly seem feasible.

The share of intra-Mercosur trade in the total trade of the member states is currently back at the level of the founding year. Moreover, integration into international production networks has succeeded only to a limited extent. Mercosur's protectionist trade policy, high MFN tariffs, and non-tariff trade barriers, as well as hardly any trade agreements, are possible reasons for the Mercosur countries' low level of integration into the global economy. An unfavorable balance has been struck in the common trade policy: despite the seeming impossibility of introducing a common external tariff for the four member countries, the countries are not allowed to enter into individual trade agreements. Uruguay, for example, expresses interest in a trade agreement with China, but its efforts face opposition from Argentina and Brazil.

The member states of Mercosur must now consider the path they wish to follow for the ongoing integration process they initiated over three decades ago. At the current stage, it appears to be rather unlikely that Mercosur will ever become a single market along the lines of the EU. The will to take the final steps toward successful economic integration is difficult to discern, as shown by the numerous postponements of

deadlines over the past 32 years for the still pending alignment of external tariffs and the elimination of remaining tariffs between Mercosur countries.

In this context, the ratification of the EU-Mercosur trade agreement could assume greater importance. A successful ratification of the agreement would once again serve as a clear demonstration to the member states that Mercosur can be an effective platform for finalizing trade agreements that provides added value to its members, particularly in negotiations with large economies. In addition, the agreement can contribute to the the South American region's integration into global and regional value chains, as well as reduce the current reliance on the Chinese market.

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