

**Trade Integration and Latin American Leadership:
Diverging Paths in Mexico and Brazil**

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Regional integration in Latin America has been a long-standing dream marred by many failed projects. However, March 1991 ushered in a new era for the continent; it was the launch of Mercosur, the “Common Market of the South”, a customs union formed by Argentina, Brazil, Paraguay and Uruguay. Two decades later in April 2011, Mexico – together with Colombia, Peru and Chile – constructed the Pacific Alliance (PA) free trade agreement (FTA). As such, a new geo-economic debate emerged across the region. On one side, there is the left-oriented Mercosur, which has lost much of its initial economic momentum and become more of a political organization. On the other side stands the PA – a business-led alliance seeking to move towards free circulation of goods, services, and people, while also strengthening trade with the Asia-Pacific region.

Naturally, one must ask: to what extent can regional integration affect the economic leadership of Brazil or Mexico on the region? Mercosur has been the centerpiece of Brazilian regional trade strategy and had the mission of expanding Brazil’s influence on the world stage. Likewise, Mexico, by joining the PA, has enlarged its network of trade agreements and, more importantly, has challenged Brazil’s dominance in Latin America.

This paper will argue that Mexico’s regional integration with the PA will support the country’s ambition of becoming the economic powerhouse of Latin America. On the other hand, Brazil’s experience with Mercosur has relegated the country to the sidelines of the world economy. The reasons for this discrepancy lie in diverging trade strategies between the two countries and attractiveness as future foreign direct investment (FDI) destination.

Trade Strategies, Comparative Analysis

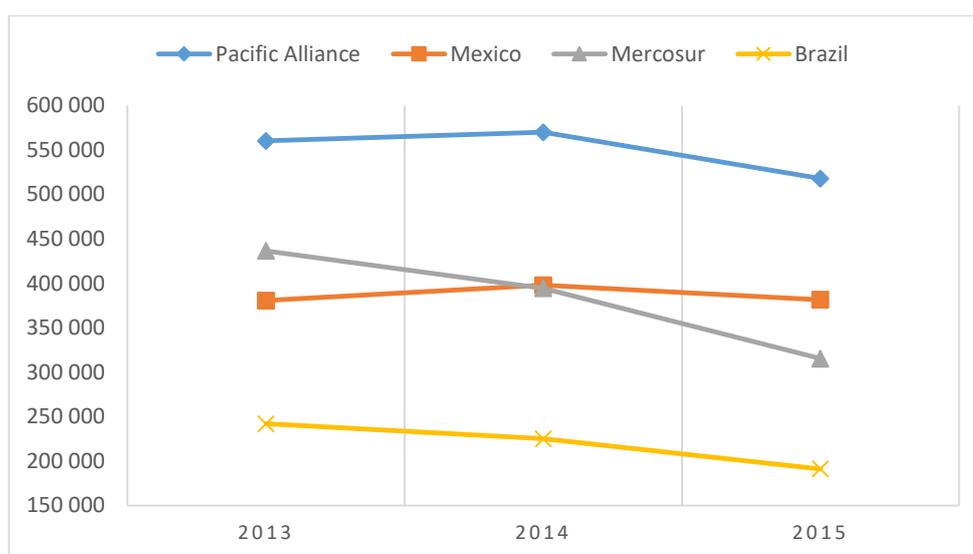
A comparison between the strategies of the PA pro-business trade pact and a more protectionist Mercosur is inevitable. The PA is an innovative platform that goes beyond creating a free trade zone and aspires to form an area of deep integration that boosts further growth among its member states. Three aspects make the PA integration experience unique: the advances made in dismantling trade barriers, the role of the financial market integration initiative and the privileged access to external markets.

On the first point, July 2015 marked the entry into force of the Framework Agreement, which suppresses tariffs for 92 percent of goods traded between bloc members, as well as the gradual elimination of the remaining 8% over the coming years (Organization of American States 2015). The bloc is also addressing non-tariff issues such as sanitary measures, harmonization of

regulations and rules of origin. Secondly, the effort of the private sector in the PA countries has contributed to the integration of the Stock Exchange of Chile, Colombia, Mexico and Peru, leading to the creation of the Latin American Integrated Market (MILA). MILA has already become the region's largest exchange by number of companies and market capitalization, approximately \$900 billion (Mercado Integrado Latinoamericano 2016). Thirdly, the network of FTA allows the access to some of the most important economies of the world, such as the United States and the European Union. In particular, Chile, Mexico and Peru are involved in the Trans Pacific Partnership (TPP), the world's largest free trade zone, accounting for 40% of global GDP (Curry 2016). By the same respect, the economic freedom index (see table 1) average places the PA countries 38th worldwide, while Mercosur members' classification is 118. Thus, the PA market oriented strategy holds key to leverage Mexico's economic position in the region.

At a time when the PA is managing to enlarge its influence in the world, Mercosur faces a prolonged crisis that has undermined the development of regional integration. The bloc has achieved modest commercial results, but was unable to negotiate FTA with large economies and remains excessively dominated by Brazil (Abreu e Florêncio 2015). Since 2013, Mercosur's exports have collapsed, falling from approximately \$436 billion to nearly \$315 billion in 2015 (see figure 1). Macroeconomic instability, lower growth rates, higher inflation levels and rising unemployment, especially in Brazil, explain the recent economic performance of the organization. Furthermore, Mercosur is often classified as an "incomplete customs union" due to numerous exceptions to the common external tariff, lack of enforcement of the customs code and its failure to evolve into a unified single market (Bouzas 2003). Over its lifespan, Mercosur has only signed four free trade deals with Egypt, Peru, Israel and Palestine. These results illustrate the degree of economic isolation and protectionism of the partnership. With a share of approximately 74% of Mercosur's GDP, Brazil has an overwhelming economic and political weight. Therefore, the country has not hesitated to take unilateral decisions in times of crisis, which has harmed the interests of other members. This asymmetry, not constrained by a supranational institution, has proved to be a permanent weakness of the integration process (Carson 2011, 98). The shortcomings of the Mercosur construction and its inward focus contributed to decelerate the process of regional integration.

Figure 1: Evolution of Total Exports in Latin America, 2013-2015



Source: (ECLAC 2015)

The PA's outward-oriented focus is in line with Mexico's export promotion strategy. Since NAFTA, Mexico's dependence on the US market has increased significantly. Today, the North American country represents approximately 80% of Mexican's exports and almost 50% of its imports (WTO 2015). In order to overcome this dependence Mexico has recently established commercial alliances with numerous countries, and the PA is becoming the perfect platform to develop this strategy. Clearly, there are two targets of this diversification plan: Latin America and Asia. Latin America still has tremendous potential for export growth, since the continent's weight in Mexican's exports is less than 7% and Asia the fastest growing region is responsible for barely 4.5% of total exports (World Integrated Trade Solution 2014). The range of economic opportunities provided by these two regions is already factored into growth forecasts. According to the OECD, Mexico's real GDP growth rate is expected to reach 3.05% in 2016 and 3.3% in 2017, while Brazil contracts by -1.2% in 2016 and grows by only 1.81% in 2017 (OECD 2016). Indeed, the PA reinforces Mexico's position as a global trade hub, where international companies can take advantage of preferential access to an impressive number of markets.

By contrast, Brazil remains highly protectionist and its participation in Mercosur has lacked global integration. The interests of the importing-competing sectors have predominated over the export-oriented ones in defining industrial and trade policy (da Motta Veiga 1999). As a result, 39% of all Brazilian exports are agricultural products, 24.4% fuel and mining products and only 33% manufactures (WTO 2015). This trade profile differs completely from the Mexican one, where manufactures are the engine of the economy, representing 77.8% of total exports

(WTO 2015). Moreover, Brazil's tariff structure continues to target the non-commodities sectors, such as manufactures (see annex), not allowing them to benefit from international competition. In recent years, both commodity prices and China's demand for primary goods have dropped, revealing the limitations of the Brazilian economy. GDP shrank by 3.8% in 2015, the share of exports over GDP fell to 11.5% in 2014 and the average unemployment rate grew to 8.5% in 2015 (Villas Boas e Pamplona 2016). In sum, the involvement of Brazil in Mercosur was unable to contest the chronic protectionism shaping its economy.

Foreign Direct Investment prospects

Foreign direct investment has been one of the main drivers of global integration in Latin America. The benefits of it vary from country to country, but it is widely accepted that FDI allows for technology transfer, contributes to the spread of best practices in corporate governance and expands the productive capacity of the country.

Together Mercosur and the PA are responsible for more than 90% of Latin American FDI flows, both with similar weights, but have differing environments and future prospects. Mercosur's capacity to attract FDI relies on Brazil's performance that normally concentrates more than 80% of FDI inflows of the trading block. While Brazil is still the largest recipient of FDI in the region, its FDI-to-GDP is one of the lowest (1.5%), comparing to 2% in Mexico. Additionally, FDI in medium-high and high technology sectors represents approximately 60% of total inflows in the region and Mexico already collects the highest share of such FDI (ECLAC 2015). Considering the Competitiveness Index, PA members' rank 56th worldwide on average, while Mercosur countries rank 101st. Even more impressive are the results of the Doing Business Index, where the PA ranks 48th while Mercosur averages 123rd. Behind these outcomes are reforms taken over the last decade by the PA members to facilitate investment, that have contributed to dynamic FDI inflows. On the other hand, the outlook for the Portuguese speaking country does not show signs of improvement. In 2016, political instability associated with the possible impeachment of President Dilma Rousseff is generating uncertainty among investors and dissuading future FDI inflows. The PA members can position themselves has credible alternatives for those who do not consider anymore Brazil as a promising destination for investment.

Table 1: Competitiveness indicators

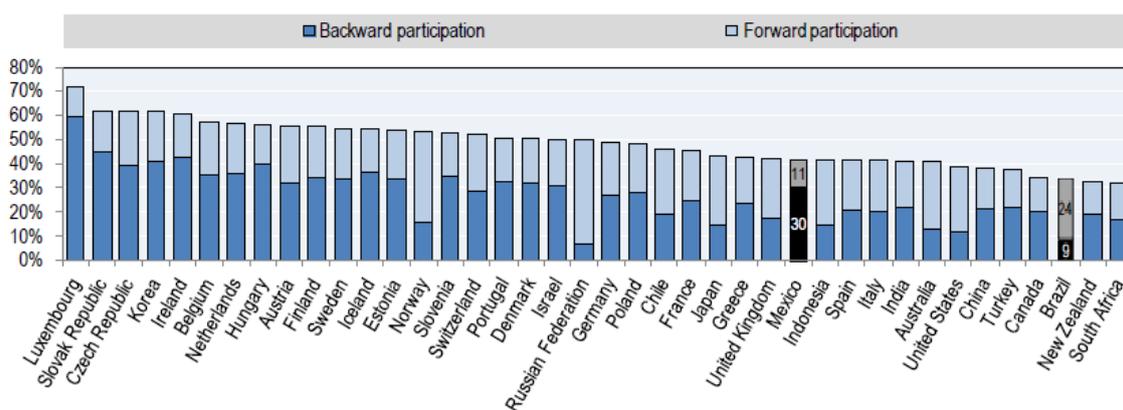
Country	Organization	Doing Business 2016	Competitiveness index 2015-2016	Index of Economic Freedom 2016
Mexico	Pacific Alliance	38	57	62
Chile	Pacific Alliance	48	35	7
Peru	Pacific Alliance	50	69	49
Colombia	Pacific Alliance	54	61	33
	Average	48	56	38
Uruguay	Mercosur	92	73	41
Paraguay	Mercosur	100	118	83
Brazil	Mercosur	116	75	122
Argentina	Mercosur	121	106	169
Venezuela	Mercosur	186	132	176
	Average	123	101	118

Source: Doing Business 2016 (World Bank), Competitiveness index 2015-2016 (World Economic Forum), Index of Economic Freedom (The Heritage Foundation)

A more integrated economic space within the PA will encourage FDI and leverage Mexico's participation in global value chains (GVC). In particular, the differing economic structures of the PA members promote potential production complementarities. Intra-regional trade patterns indicate that Peru, Chile and Colombia have surpluses in raw materials and deficits in manufactures, while Mexico is the opposite case (World Economic Forum 2014). Thus, Mexico tends to be located in the final stages of the supply chains, where its comparative advantage lies. According to the OECD, the percentage of a country's exports that are part of GVCs measures a country's degree of participation. Mexico degree of participation is 41%, mainly driven by the use of foreign intermediate goods in assembly activities. (OECD 2013) Based on the same sources, Mexico produces 76% of its value-added domestically and hosts regional high-technology clusters, such as the automotive or aerospace.

By way of contrast, Mercosur has had limited influence in the participation of Brazil in GVC. The country's exports are determined by commodities such as agricultural goods used as intermediate goods by other countries in their exports, in other words, a predominantly forward participation in GVC. Contrary to Mexico, Brazil has a percentage of exports part of GVC of only 31% and produces nearly 90% of its value-added domestically (OECD 2013). This pattern indicates an inefficient allocation of resources, where there is an emphasis in domestic activities to supply the home market.

Figure 2: GVC participation across countries, 2009



Source: (OECD 2013)

Conclusion:

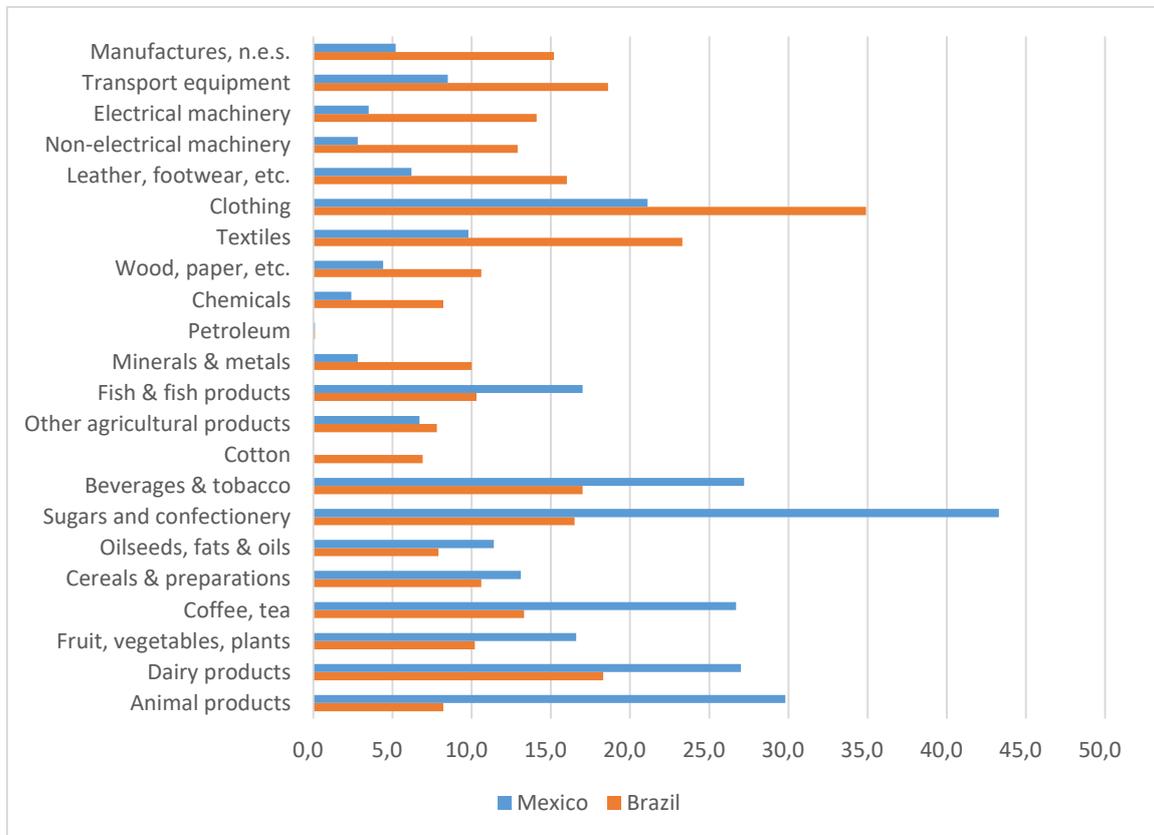
This paper explored how the PA trade strategy can sustain the ascension of Mexico as future leader of Latin America. It acknowledges that the integration experience with the PA will boost Mexico’s participation in GVC. It also underlined the shortcomings of Mercosur integration process and how it has failed to improve Brazil’s competitiveness in the world stage.

The current success of the PA lies in its commitment to genuine free trade policies and economic integration with the global economy. Particularly, the alliance has a great potential in attracting FDI from Asia. The TPP will also work as a complementary agreement to the PA and intensify trade relations between the Mexico and the Asia-Pacific region. For this reason, Brazilian exports will likely lose market share. If the PA succeeds, it could further pressure Mercosur countries to adopt an outward approach to international trade.

The economic strategy followed by Mercosur relied on an ideological left wing and protectionist alliance. This orientation has started to be questioned by the rise to power of Mauricio Macri in Argentina, who is willing to realign the country with a more business-oriented model. Voices of disfavor come from Brazil as well. Jose Augusto de Castro, President of Brazil’s Foreign Trade Association, has called for downgrading Mercosur from a custom union to a FTA due to its incapability to establish a single trade deal with major economies (Abreu e Florêncio 2015). This is a consequence of Mercosur’s protectionist policies that have undermined the integration of Brazilian companies in the global economy. If Brazil continues on this trajectory, it will undoubtedly observe Mexico rise as Latin America’s number one economy.

Annex:

Figure 3: Tariffs in imports by product groups in Mexico and Brazil (Most Favored Nation applied duties, Average 2014)



Source: (WTO 2014)

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