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# Mercosur and the Automobile Industry — Trade Diversion and Protectionism in the Southern Cone

*Case Study*

COVERING 94% OF THE WORLD GDP AND 83% OF THE WORLD POPULATION

## *Abstract*

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The first agreements that preceded MERCOSUR was the Iguazu Declaration, signed by the Brazilian and Argentinian governments in 1985. It aimed to promote the integration of several areas, such as economic, financial and energy. Already in 1986, the Brazilian-Argentinian Integration Act undertook a program of selective opening of the markets of the two countries. Two years later, a new treaty, called the Integration, Cooperation and Development Treaty, set a goal of full trade liberalisation between the two countries by 2008, with the removal of all tariff and non-tariff barriers.

# Mercosur and the Automobile Industry — Trade Diversion and Protectionism in the Southern Cone

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## I. Introduction

In the 1980s, Brazil and Argentina began several partnerships, signed through bilateral agreements that resulted in MERCOSUR. Three factors can be pointed out as the main determinants of the strengthening of Brazil-Argentina relations: the return of the fullness of the democratic regime to countries, the crisis in the international economic system and the overcoming of geopolitical divergences.

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In July 1990, the Buenos Aires Minutes set the date of 31 December 1994 for the definitive consolidation of the Common Market. In the same year and in the face of increased economic and political relations between the countries, Uruguay and Paraguay were invited to join the agreement. As a result, the Treaty of Assumption for the Constitution of the Southern Common Market (MERCOSUR) was signed by the presidents of the four countries in 1991.

The Treaty of Asunción can be considered the most important in terms of the constitution and regulation of MERCOSUR, although it is complemented with a series of later treaties, such as the Brasilia Protocol and the Ouro Preto protocol, signed later. The Treaty of Asunción dealt with policies of progressive tariff reduction of the members of the bloc, coordination of macroeconomic policies, and the establishment of a Common External Tariff (CET). In addition, it implemented a general regime of origin and a system of dispute settlement. The treaty also established a regional most-favored nation clause with respect to the country-members of the Latin American Integration Association (LAIA); MERCOSUR states parties should extend to other States-Members, in accordance with Article VIII, any advantage, favor, franchise, immunity or privilege granted to a product originating in or destined for third countries not in LAIA.

The institutional structure of MERCOSUR also received treatment, which under a transitional period until 1994, was composed of the Council of the Common Market (the higher entity responsible for conducting policy and meeting objectives) and the Group of the Common Market (executive entity coordinated by the Ministries of Foreign Affairs responsible for implementation of targets, negotiation of agreements before third parties and coordination of macroeconomic policy).

After the end of the transitional period established by the Treaty of Asunción, the signing of the Ouro Preto Protocol in December 1994 marks the definitive institutionalization of MERCOSUR as a customs union, showing that the union provides for the creation of a common market between Member-States. In this period, the legal personality of MERCOSUR was also recorded, which has since started to negotiate international agreements as an economic bloc, taking advantage of the gains of integration. It is worth noting that, although the bloc negotiation is apparently beneficial, it has brought some ties to the expansion of agreements with other blocs and countries over the years.

Among the main points addressed by the Ouro Preto Protocol, these should be highlighted: the maintenance of transitional entities and the creation of new entities, the absence of a supranational institution in favor of decisions taken by consensus, the legal personality of MERCOSUR, and the implementation of a Dispute Settlement mechanism before the established MERCOSUR Trade Commission.

## **II. The Automotive Sector in Mercosur**

From the economic crisis resulting from the Great Depression, Brazil and Argentina especially reoriented their economic policies. The keynote, in an environment with scarcity of international currencies and consumer crisis, was to reorient economic growth to the domestic market. Between 1930 and 1990, interventionist economic policy orientation prevailed, marked by the concept of developmentalism. The internalization of the manufacturing sector in national economies was considered the key to economic development.

The automotive industry, because of its back-and-forth chaining effects, has been considered a crucial sector for the industrialization process. Brazil and Argentina protected their domestic markets with tariff increases and created privileged conditions for the installation of foreign car manufacturers in their territories. An automotive park was mainly constituted and at the end of the 1980s, both Argentina and Brazil produced light vehicles (passenger cars and utilities) and heavy vehicles (trucks and tractors). Uruguay, on a smaller scale, since 1962 has also produced some models of different brands by the CKD process (ALVES, 2014).

Although companies were multinationals mainly from the U.S. and Europe, the market in these countries was heavily protected from foreign trade. MERCOSUR's challenge was to drive integration. The automotive sector, although foreseen, is still in the process of adjustment in which intrazone trade is regulated by bilateral agreements between MERCOSUR members. For example, the automotive sectors' agreements between MERCOSUR countries in which Brazil is part are:

- Economic Complementation Agreement No. 14 (Brazil - Argentina - 38 Additional Protocol)
- Economic Complementation Agreement No. 02 (Brazil - Uruguay - 68, 69, 70 Additional Protocols)
- Economic Complementation Agreement No. 74 (Brazil - Paraguay - 1 Additional Protocol)

### **III. Common External Tariff and Trade Diversion**

A regional integration process involves costs and benefits for the countries participating in it. Although some studies question that the benefits of an integration process are greater than costs, some determinants, both positive and negative, should be considered valid in the analysis of an integration process.

The gains and benefits arising from integration can be divided into traditional gains and non-traditional gains. Traditional gains generally refer to efficiency gains provided by reduced tariffs, trade creation, and gains in economy of scale, i.e., gains derived from free trade and related to the free movement of production factors. Non-traditional gains are treated by some authors, such as Fernández (1997), as those related to political and economic aspects that are not directly related to trade itself or the mobility of factors.

One of the main points of an integration process is the analysis "creation versus trade deviation". The creation of trade concerns the efficiency gains in production and consumption resulting from the reduction of tariffs. This means that the creation of trade causes an increase in consumption and a reduction in the domestic production of previously protected goods, i.e. gains in consumption by residents and efficiency gains in the production of one of the countries of the union. On the other hand, the trade deviation is related to the quantum of production and consumption that could be obtained if the union did not adopt any restrictions on the rest of the world, that is, if the domestic price was equal to the world price. In general, an integration process involves benefits for its participants that are not expanded to other countries. Moreover, in a regional trade agreement it is common to establish a common external tariff, as in the case of MERCOSUR, which tends to generate more trade diversion the greater its value.

If the integration process provides more creation than trade diversion, then it tends to be beneficial. On the other hand, if there is more trade diversion than creation, then the process ceases to bring benefits to participants. The creation and deviation of trade depend on the elasticities of supply and demand of the countries of the union. Dornbusch (1986) shows that when countries decide on a regional trade agreement, then there is the possibility of trade diversion when a less costly good from an outside-union country is replaced by a less efficient good produced within the union. This worsens the well-being of society.

A study produced by Yeats (1997) indicated, with some caveats, that MERCOSUR produced more diversion than trade creation, which theoretically worsens the well-being of the bloc's member countries. According to the author, exports of capital-intensive goods increased substantially after the formation of the bloc, although countries do not have comparative advantages revealed in such products. Even if the proportion of factors is considered, the pattern of trade is incompatible, which suggests the trade diversion from the rest of the world in favor of the members of the trade area. Therefore, concludes Yeats (1997), focusing solely on trade creation and trade diversion, MERCOSUR has a negative net result. In one of the most popular textbooks of international economy, Krugman, Obstfeld and Melitz (2018) present MERCOSUR as a current example of trade diversion in the world economy. In the case of the automotive industry, the rates applied are higher than CET. That is, the automotive sector remains protected from international trade outside the bloc, and is one of the major reasons for the occurrence of trade diversion.

On the other hand, analyzing NAFTA, which began in 1994 and overlapped with a bilateral agreements that had already been signed between Canada and the United States, including Mexico, Krueger (1999) shows that the union promoted more creation than trade diversion. In addition to the expansion of trade in the three members of the union, the data revealed, according to Krueger (1999), that the increase in trade was accompanied by the creation of trade and changes in the allocation of production according to the comparative advantages of each country.

## **IV. Joint Negotiation Difficulties**

The process of regional integration depends substantially on the similarity between the countries of the region, or even a reduction in disparities so that the functioning of the trade agreement can occur in a beneficial way for its members. One issue worth mentioning is symmetry of the shocks that the region will face, as well as treatment given to possible asymmetric shocks. The asymmetry of shocks represents the possibility of an external or internal fact affecting relatively different countries of an integrated region, because in this case, there is a risk that the automatic adjustment mechanism given by work mobility will not work as visualized by Mundell (1961).

In 1999, when Brazil changed the exchange rate regime, there was a reversal of Brazil's price relationship with the other MERCOSUR countries. In part, Brazilian products became "cheap" for other member countries, while the members' products became costly for Brazilians. This illustrates possible effects of shocks in a region. Thus, integration assumes the need for a process of microeconomic and macroeconomic convergence so that shocks are not asymmetric and that labor mobility can balance levels of production and employment equitably, promoting the gains of integration. Since the end of the 1990s, sharp currency devaluations in one of the members, especially Brazil or Argentina, have been causing relative price changes and tensions between sectors of countries that lose the market suddenly.

The disparity in economic performance and uncoordinated macroeconomic policies create an environment that favors divergences among the members of the bloc. Moreover, the different political and ideological interests in the management of countries make it even more difficult to build consensus. This makes the bloc negotiating clause an obstacle to the establishment of bilateral trade agreements between other MERCOSUR nations and member countries, and it eventually becomes a barrier to free trade.

An example of the undesired impact of MERCOSUR's mandatory bloc negotiation is the MERCOSUR-European Union agreement, which, aiming to stimulate and increase trade between these markets, would have its decisions defined from consensus among the countries participating in their respective blocs. This has prevented the establishment of an important trade agreement to date. The MERCOSUR-European Union agreement began negotiation in 1999 and was announced concluded two decades later (in 2019). If the agribusiness sector is a sensitive point for the European Union, the manufacturing sector, especially the automotive, is a sensitive point for MERCOSUR.

## V. **The Future of Mercosur**

At the beginning of its operation, MERCOSUR promoted an expansion of trade between member countries. However, a few years later, the need for bloc negotiations with other countries and other blocs became a tie to the process of advancing trade agreements. This was due to numerous divergences between member countries, highlighting the macroeconomic differences and economic policy objectives of each member.

Despite being announced, the MERCOSUR-EU agreement has not been ratified and there is no time frame for this to happen, as it effectively depends on the approval of the respective Congresses of the MERCOSUR countries and the European Parliament. Although it has been announced as a success, from the political point of view there is a long way to go. There remains resistance by specific sectors of several countries in "accepting" the tariff reduction and other aspects imposed by the agreement, which involve economic, political and environmental issues.

Due to restrictions on the individual interests of member countries and for creating difficulties in foreign trade, in December 2020 Uruguay presented a proposal for flexibility of MERCOSUR trade agreements. According to the proposal presented at the MERCOSUR summit, the partners could negotiate trade agreements at different speeds with other countries and groups of countries. Thus, MERCOSUR is gradually changing its original configuration.

In the case of the automotive sector, in January 2021, despite all protection, Ford Motor Co. announced the closure of all its production units in Brazil (trucks, automobiles, SUVs and engines). Only the Argentinian plant, responsible to produce utility vehicles (such as pick-up trucks), is still in operation. This is not domestic market protection that guarantees, in the long term, the permanence of companies and desired economic development.

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