Global Economic Dynamics

GED Study

A Chain Reaction?

Effects of Mega-Trade Agreements on Latin America

BertelsmannStiftung

GED Study Series

How do Mega-Regional Trade Agreements Affect Emerging Markets

Part 1

A Chain Reaction?

Effects of Mega-Trade Agreements on Latin America

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Executive Summary

Latin America has undergone a series of trade policy vicissitudes in the last century. From periods of protection to bouts of rapid liberalization, the region has at times functioned as a laboratory for experiments in trade as a tool for development. In the last 15 years, a number of South American countries experienced rapid trade expansion stemming from increased commodity prices and commerce with China. Yet, such trends threaten to reinforce longstanding patterns of Latin American commodities traded for final goods from Europe, North America and Asia. More recently however, commodity prices have dipped, and more adverse global conditions reveal the extent of a gap emerging in Latin America between free-trading "Pacific Pumas" such as Chile, Colombia, Mexico and Peru, and more protectionist economies such as Venezuela, Argentina[1] and Bolivia. Brazil, the region's largest country in terms of population, land mass and GDP, remains stuck somewhere between the two camps.

With these historical factors in mind, the Bertelsmann Stiftung and the IFO Institute analyzed the potential effects that a series of mega-trade deals under negotiation could have on Latin America. Specifically, we consider the Trans-Pacific Partnership (TPP),the Transatlantic Trade and Investment Partnership (TTIP), the Free Trade Area of Asia Pacific (FTAAP) and the Regional Comprehensive Economic Partnership (RCEP). In this paper, we present the results of our multi-sector trade model, and offer explanations for the numbers. Ultimately, the text argue that the mega-deals will generally have a limited effect on Latin American countries, with marginally better results for countries participating in the pacts. A key observation from the analysis is that certain "Pacific Puma" countries such as Chile, Colombia and Mexico already have standing agreements with key trading partners that are participating in the mega-deals. As such, they have less to gain from the agreements (their tariffs have already been reduced), and more to lose as they would no longer enjoy privileged access. However, the authors also argue that staying out of mega-deals tends to reinforce dependency on the export of raw materials. In contrast, the model suggests that joining the trade pacts provides an opportunity to add value to commodities as partner-countries remove barriers to exports of processed goods. All told, the data suggests that the mega-deals under negotiation could have a tangible effect on both the composition and direction of Latin American trade flows.

1 The election of pro-business candidate Mauricio Macri for president in Argentina in November 2015 could be indicative of an incipient sea-change

1. Background: Latin America on the Periphery of Global Trade

Historically, Latin America has been a peripheral player in global trade, at least according to dependency theorists who saw the region as relegated to a producer of raw materials for industrial economies. In response to this perceived dependency, many Latin American countries pursued a development strategy based on import-substitution industrialization (ISI), often adopted between the 1930s and 1960s, and promoted by institutions such as the United Nations' Economic Commission for Latin America.[2]

A deliberately protectionist policy, ISI sought to promote domestic industries by shielding local markets from foreign competition. While the strategy successfully generated industrial bases in several Latin American countries (most notably in Argentina, Brazil and Mexico), the closed nature of these economies also resulted in deteriorating competitiveness relative to more export oriented economies in Europe and especially East Asia.

The oil price shocks of the 1970s and the ensuing Latin American debt crises of the 1980s revealed the failure of ISI to create competitive economies, and they also demonstrated the infeasibility of the policy's continuation. Cajoled by multilateral institutions such as the World Bank and International Monetary Fund, the region shifted towards the privatization of domestic industries and increased openness to trade and capital flows; a set of neoliberal policies that became known as the "Washington Consensus".[3]

This strategy reversal had profound effects, especially in Chile where it commenced in the 1970s and eventually led to the creation of several competitive industries, and in Mexico, which, by joining the North American Free Trade Agreement (NAFTA) in 1994, ensured deep-seated economic integration with its northern neighbors.

But if neoliberalism reached an apex in Latin America in the 1990s, the approach rapidly fell out of favor, with a number of countries electing more protectionist leaders in the 2000s. For example, in Argentina, after market-oriented policy makers guided the country into economic crisis at the turn of the century, the electorate consistently rewarded more statist and protectionist candidates until the election of a pro-business candidate, Mauricio Macri, for president in November, 2015.

As a result, 21st century Latin America can increasingly be divided between the "Pacific Pumas"[4] (Mexico, Chile, Colombia and Peru), which have embraced openness and international competition, and the MERCOSUR/Bolivarian block of countries (Argentina, Bolivia, Ecuador, and Venezuela), which employ significant state intervention in the economy as well as real protectionism. Other important countries, most notably Brazil, remain in between, combining a dynamic private sector with significant state intervention and trade protectionism.

The Pacific economies—as well as the smaller countries of Central America and the Caribbean—have entered into a growing number of bilateral free trade agreements, both between each other as well as with their most important global trade partners, such as the US and the EU.

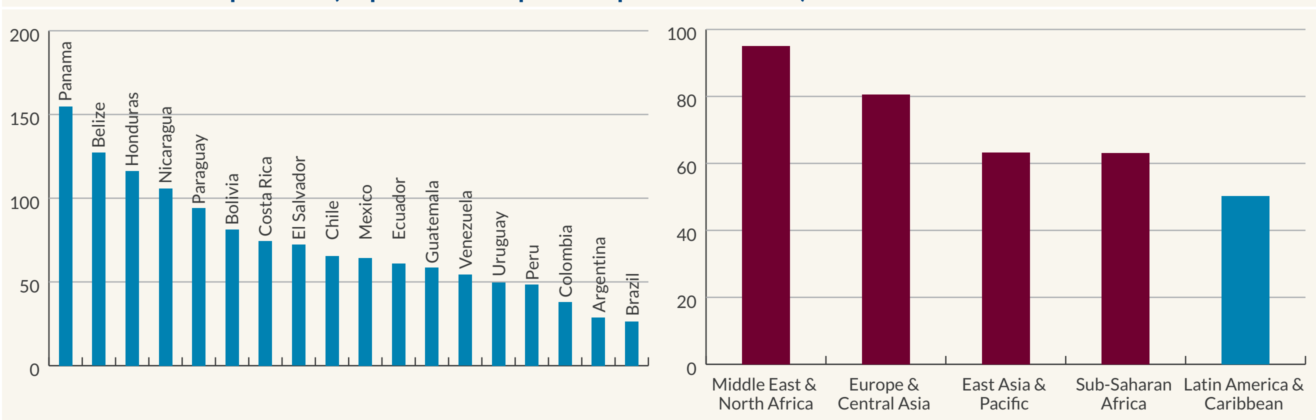
Yet, overall, Latin America remains rather closed to international trade, with openness (measured as exports plus imports relative to GDP) falling below that of other parts of the world. In large part this stems from an absence of cross-border supply chains, the likes of which have

2 Fernando Henrique Cardoso and Enzo Falleto. *Dependency and Development in Latin America.* (Berkeley: University of California Press, 1979).

3 Eliana Cardoso and Ann Helwege. *Latin America's Economy: Diversity, Trends and Conflicts.* (Massachusetts: MIT Press, 1995).

4 See Samuel George *The Pacific Pumas: An Emerging Model for Emerging Markets.* Bertelsmann Foundation, 2014. Available online at http://www.bfna.org/publication/the-pacific-pumas-an-emerging-pacific-alliance-model-for-emerging-markets.

FIGURE 1 **Trade Openness (Exports and Imports as percent of GDP)**



Source: World Bank WDI

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resulted in exponential trade growth in countries of Europe and Asia.[5] In contrast, Latin America's trade portfolio continues to be dominated by commodity exports and final-product imports. As a result, trade values are subject to commodity prices which ballooned in the 2000s but have fallen significantly in recent years.

The mega-deals currently under consideration provide an opportunity for Latin American countries to challenge this pattern, with three of the Pacific Pumas (Chile, Mexico and Peru) pursuing deeper integration via their participation in the Trans-Pacific Partnership (TPP). Meanwhile, other Latin American countries have been working on their own mega-trade deal: a free trade agreement between the EU and the relatively closed economies of the Common Market of the South (MERCOSUR).

However, negotiations towards this deal have made little progress since talks began over 15 years ago.[6]

This paper evaluates the results of a multi-sector trade model of mega-trade deals for countries in the region, considering both participating countries as well as those remaining on the sidelines.

5 Canuto et al (2015) The Curious Case of Brazil's Closedness to Trade. https://openknowledge.worldbank.org/bitstream/handle/10986/21840/WPS7228.pdf?sequence=2

6 Joe Leahy. "Brazil hails long-awaited EU trade breakthrough." *The Financial Times*, July, 2015. Available online at http://www.ft.com/intl/cms/s/0/9453baea-1d73-11e5-ab0f-6bb9974f25d0.html#axzz3nnBSi4lF

2. The Potential Effect of Mega-Trade Deals on Latin America

Few Latin American countries are active participants in the current mega-treaties under negotiation. Only three countries, Chile, Mexico and Peru, have joined the Pacific-oriented TPP. These three are also members of APEC, implying their participation in a potential Free Trade Area of the Asia-Pacific (FTAAP) that extends beyond TPP by including additional Asian countries, most notably China.[7] The Transatlantic Trade and Investment Partnership (TTIP) and the Regional Comprehensive Economic Partnership (RCEP), a proposed agreement between the member states of the Association of Southeast Asian Nations (ASEAN) and the other Asian and Pacific States (Australia, China, India, Japan, South Korea and New Zealand), do not include any Latin American countries.

However, if implemented, mega-treaties would affect all Latin American countries regardless of participation, as the deals would produce trade diversion as well as increased income, and thus demand, from the participating countries.

a. Trade Creation versus Trade Diversion

Policy makers from participating countries hope that the mega-deals result in trade creation. This occurs when participating countries increase their exports to each other as tariffs and non-tariff barriers are lowered. In this case, free(er) trade facilitates a country's ability to exercise a competitive advantage vis-à-vis trading partners. For participating Latin American countries, this should yield gains on traditionally strong mineral and agricultural sectors, but also in services and manufacturing, where Mexico and Central America have found competitive niches such as call centers and assembly of medical devices. Countries outside of the pacts, on the other hand, will suffer from trade diversion: As the insiders benefit from falling trade costs, outsiders' exports may be displaced by trade between participants.

7 See Bertelsmann Stiftung's companion paper on the effects of mega-deals in Asia.

b. Income Effects

As insiders' income rises, they will increase their demand for final and intermediate inputs from other countries. In particular countries with close trade links to the insiders may benefit from this increased demand for their products. This is particularly relevant for countries that have close links with the US and are expected to harness positive spillover effects from increased growth there.

c. Preference Erosion

Many Latin American countries, especially those participating in mega-deals, already enjoy preferential access to important markets through bilateral free-trade agreements with the US, Canada and/or Japan. A mega-deal such as the TPP could result in the loss of these relative advantages vis-à-vis Asian and Pacific countries. If incoming countries are more cost competitive, they could displace Latin American exports to TPP countries. For example, Latin American manufacturing exports to the US could decrease if Asian participants such as Vietnam demonstrate cost advantages. Moreover, agricultural exports from countries such as Australia and New Zealand could replace certain Latin American exports if they prove to be more competitive in a post-agreement environment.

d. Deepening Supply Chains

Trade deals such as the TPP may ultimately result in the creation of international value chains connecting countries in Latin America with partners in the Asian Pacific. Should such chains emerge, both exports and imports of intermediate goods could markedly increase, with significant efficiency and welfare gains for those involved.

Methodology

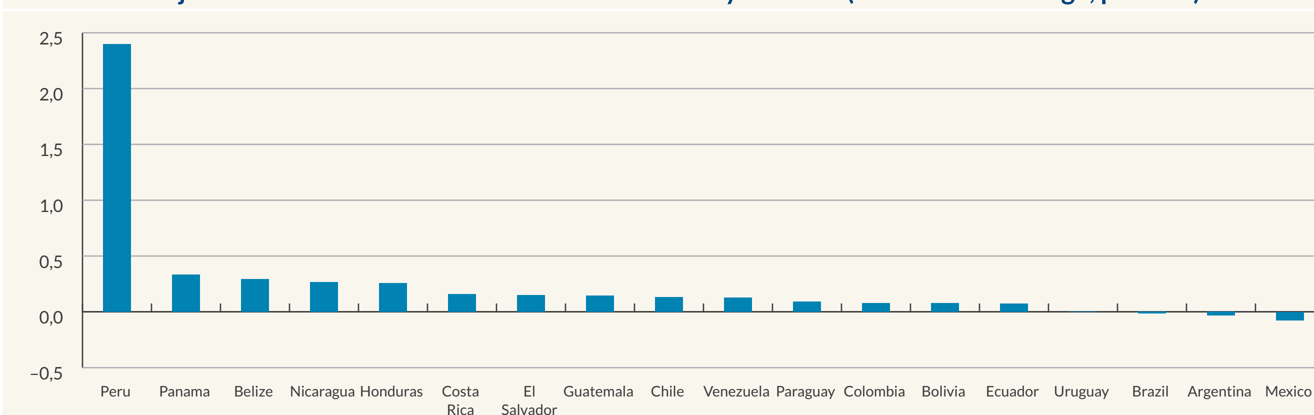
The Ifo trade model, which is described in Aichele et al. (2014) and is an extended version of the Caliendo and Parro model (2015), is a multi-sector trade model that features tariff and non-tariff trade barriers, goods and services trade flows and that carefully accounts for global input-output linkages to capture global value chains. The model (like other modern quantitative trade models introduced in Costinot and Rodríguez-Clare, 2014) can be parameterized based on simple econometric equations that emerge as equilibrium relationships from the model itself. In the Ifo trade model, two types of industry-level parameters matter most: the elasticity at which tariff changes affect trade flows and the effect of preferential trade agreements (PTAs) on those same flows. In the latter, we distinguish between shallow and deep agreements, borrowing a detailed classification from Dür et al. (2014). These trade elasticities and the matrix of trade costs are econometrically estimated sector by sector.

The model is brought to the data provided by the Global Trade Analysis Project (GTAP), baseline 2007. It covers 17 merchandise industries and 15 services industries (one of which, “dwellings”, is non-traded) as well as 134 countries and regions. The GTAP data provides the input-output tables for each country or region, which indicate how much any industry (domestic or foreign) supplies inputs to the production of other industries (domestic or foreign) and how much primary factors of production (i.e. labor) are used. The database also contains consistent output data and trade flow information on the bilateral industry level. The effects of mega-deals are simulated in the following thought experiment: in the world as we observe it today, what would sectoral trade flows, industry-level outcomes, and aggregate welfare look like if the respective mega-deal countries had – counterfactually – a deep (TTIP) or shallow (TPP, RCEP, FTAAP) preferential trade agreement of the type observed in the data? Essentially, this means that the TTIP is assumed to have similar effects on trade costs as existing deep agreements; and the TPP, RCEP and FTAAP are assumed to have similar effects on trade costs as existing shallow agreements.

All predicted effects are general equilibrium effects: they take into account the adjustment of incomes in all 134 countries, the reaction of trade flows between those countries in all industries, the changes in value added in all industries and countries, and changes in government revenues that result from a mega-deal. The results can be interpreted as long-run level effect (i.e. they will be realized after 10-12 years).

3. Model Results

FIGURE 2 **Projected Effect of TPP on Latin American Country Welfare (Real income change, percent)**



Source: Ifo Institute and Bertelsmann Stiftung

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a. Trans-Pacific Partnership: A Pacific Puma Springboard?

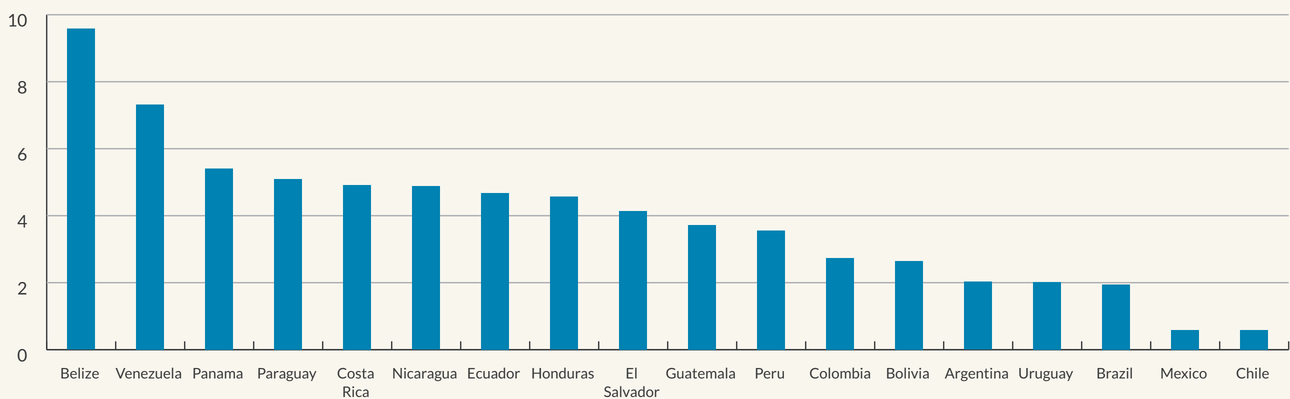
The Trans-Pacific partnership is the most advanced of the mega-deals, with negotiations completed in October 2015. However, the agreement must still be ratified by legislatures in participating countries before it can become active, and approval remains uncertain in several countries.[8] In Latin America, the most obvious effects of the TPP are on the three Pacific Pumas that are part of the agreement: Chile, Mexico and Peru. Surprisingly, the effects of the TPP are small in most cases, with only Peru seeing a significant welfare effect. Chile's welfare gain is rather small, in line with countries outside the agreement, and Mexico is actually seeing a marginal decline in welfare. These findings reflect the fact that Chile and Mexico already enjoy free market access in the major economies participating in the TPP. Peru, on the other hand, benefits from new market openings for its exports to developed countries participating in the TPP. Central American countries also see benefits, as the TPP will strengthen demand for inputs they provide for US exports and which are expected to expand significantly under the TPP.

b. Free Trade Area of Asia-Pacific (FTAAP) – A Rising Tide Lifts All Boats

The Free Trade Area of the Asia-Pacific (FTAAP) includes the same three Latin American countries as the TPP. However, the data suggests the pact would have significant positive effects on all countries in the region, regardless of participation. This is not entirely surprising as the FTAAP is by far the broadest of the agreements considered, including the world's largest economies (the US, China and Japan) and representing about half of global GDP. The FTAAP would therefore result in a boost to global trade, with positive spillovers to all economies in the region. In addition, China has become one of the most important trading partners for many Latin American countries, especially commodity exporters, so an agreement that includes China is bound to have strong effects. The FTAAP data shows

8 Jackie Calmes. "Trans-Pacific Partnership Is Reached, but Faces Scrutiny in Congress." *The New York Times*, October 5, 2015. Available online at http://www.nytimes.com/2015/10/06/business/trans-pacific-partnership-trade-deal-is-reached.html?_r=0

FIGURE 3 **Projected Effect of FTAAP on Latin American Country Welfare, Real Income (Percent)**



Source: Ifo Institute and Bertelsmann Stiftung | BertelsmannStiftung

strong displacement of Chinese chemical and mineral production.[9] Clearly some of this space will be taken up by Latin American countries that already provide significant commodity exports to China, such as Brazil (iron ore) and Venezuela (petroleum).

c. TTIP : How Integration in the North Affects the South

Although Latin American countries are not part of TTIP negotiations between the US and the EU, any agreement between two of the region's largest trading partners is bound to have repercussions for countries in Latin America as well. The estimated results for the region are generally small and quite ambiguous, from a welfare gain of 0.3 percent in Nicaragua to a loss of 0.2 percent in Costa Rica. For the region's largest economies, Brazil, Mexico and Argentina, trade displacement seems to outweigh any positive demand effects from the TTIP partners. These three economies see small losses, as do Chile and Peru. Several smaller economies on the other hand, especially in Central America (Nicaragua, Panama and Belize), benefit.

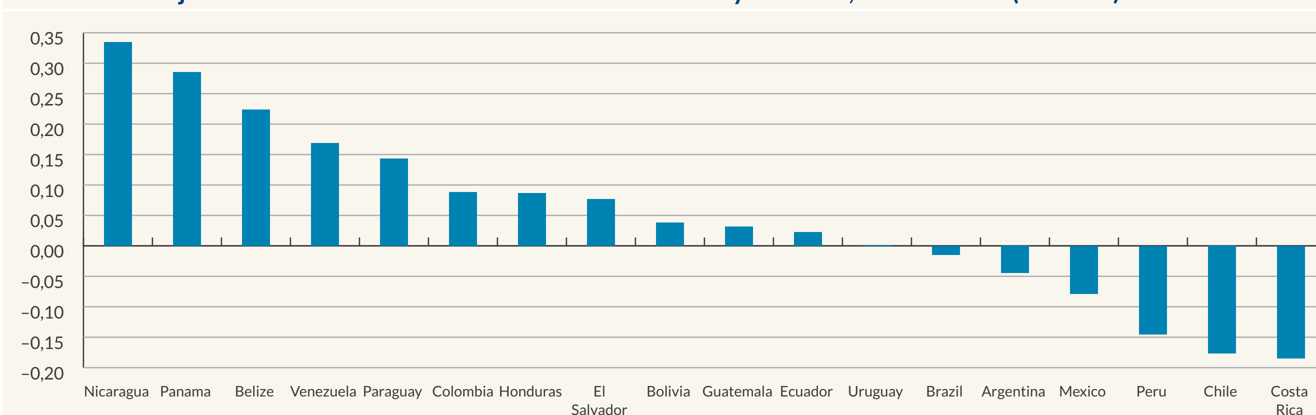
Panama warrants additional attention. Building on the strategic advantage of the canal, Panama has developed a services economy around transport, logistics and finance. It thus stands to benefit from any increase in global trade. Consequently, the country benefits more than just about any other country in the region under any of the mega-deals analyzed.

d. RCEP: No Tsunami Crossing the Pacific

The effects of the RCEP, another mega-deal without Latin American participation, are even more muted. Most countries experience modest welfare gains (0.1 to 0.3 percent). Again, the smaller countries of Central America benefit the most, while the larger economies (Brazil, Mexico, and Argentina) are virtually unaffected. Chile is the only country with a notable negative effect (-0.1 percent), stemming from the displacement of processed metal exports to Asia. In Chile, as well as other countries

9 Fall in chemical output of up to 4.3 percent and in mineral output of up to 66.0 percent (Asia regional paper)

FIGURE 4 **Projected Effect of TTIP on Latin American Country Welfare, Real Income (Percent)**



Source: Ifo Institute and Bertelsmann Stiftung

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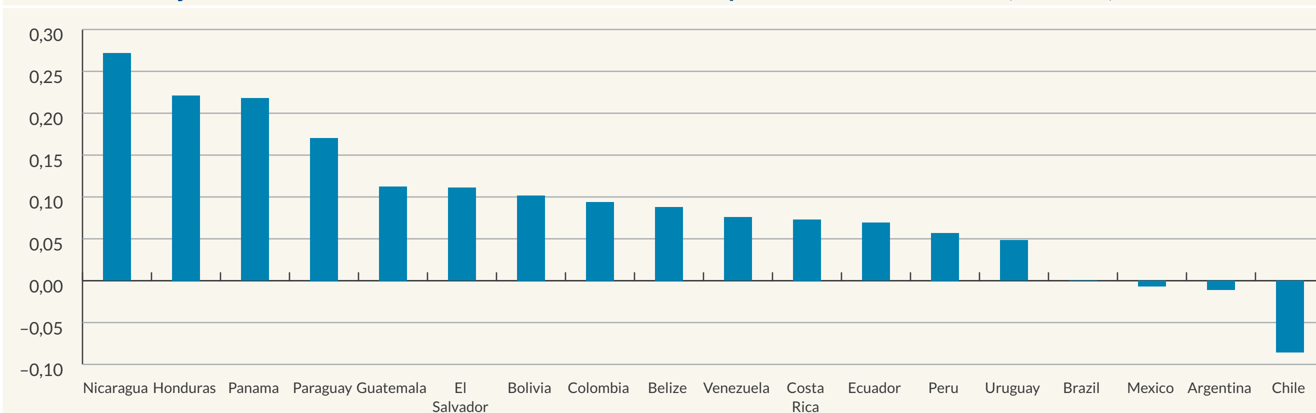
FIGURE 5 **Projected Effect of RCEP on Latin America Country Welfare, Real Income (Percent)**



Source: Ifo Institute and Bertelsmann Stiftung

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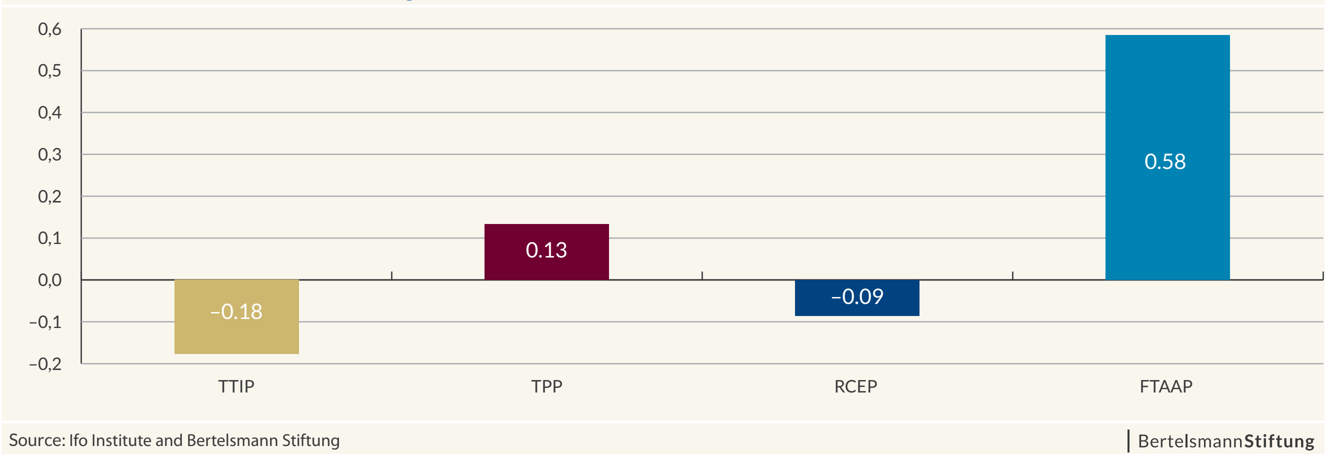
such as Brazil and Peru, the mining sector stands to benefit from increased aggregate demand under the RCEP, however this is offset by falling exports of processed goods. As a consequence, outsider status on this mega-deal tends to reinforce Latin America's dependency on commodity exports.

FIGURE 6 **Modeled Effects of Mega-deals on Chile, Real Income (Percent)**



Source: Ifo Institute and Bertelsmann Stiftung

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Country Case Studies

e. Chile: A Southern Powerhouse Sees Limited Benefits

Chile is the wealthiest and most developed Latin American economy participating in the TPP. However, the country already has bilateral deals with its most significant trading partners in the pact (China, US, EU and Japan) as well as with its regional partners in the Pacific Alliance (Peru, Colombia, and Mexico). Therefore the additional benefits obtained from trade deals are quite limited.

Chile's mining sector stands to benefit, owing to the country's role as the world's largest producer of copper. The boost to the sector is greatest under the FTAAP, at 6.3 percent. Chile's growing agriculture sector, which focuses on fruit production and fish farming, would also benefit under the FTAAP but not under the other deals. The country benefits in particular from increased exports to Japan (6.8 percent under the TPP and 21.4 percent under the FTAAP).

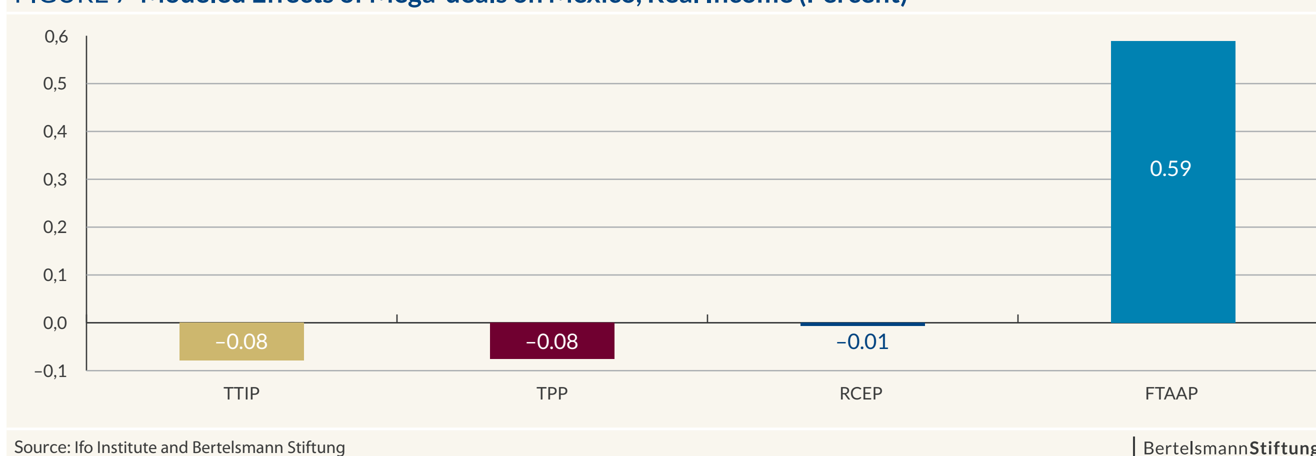
Under the TTIP, Chile sees significant losses in exports to the US and European countries, resulting in an overall welfare loss of 0.2 percent.

Again, the effects on Chile might appear underwhelming. However, it is important to remember that Chile has already reached free trade agreements with its main trading partners, hence the effect of additional liberalization under the mega-deals is marginal. The dominant effects can be expected to come from the rearrangement of global trade flows and increased global demand for the goods as a by-product of expanding world trade, rather than as a result of tariff reduction on their products.

f. Mexico: Latin America's Most Integrated Economy Has Little to Gain

Mexico primarily trades with the US and Canada; such commerce accounts for roughly 80 percent of the country's total trade. Mexico has enjoyed free-market access to these markets since 1994 when the implementation of NAFTA eliminated tariff barriers and resulted in significant supply

FIGURE 7 **Modeled Effects of Mega-deals on Mexico, Real Income (Percent)**



Source: Ifo Institute and Bertelsmann Stiftung

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chain integration across the Rio Grande. It is therefore not surprising that Mexico stands to profit little from the mega-trade agreements.

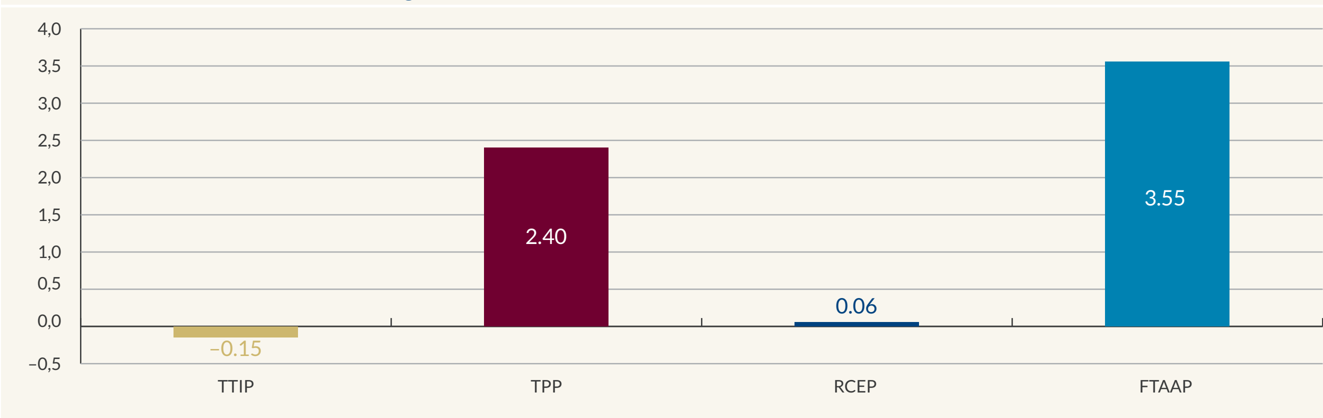
Under the TPP, Mexico's exports to the US and Canada are projected to fall significantly (4.4 percent and 10.2 percent respectively), however the country is able to compensate by exporting more to Europe and South America as global trade flows shift. Mexico's forecasted contraction resulting from the TPP (real income loss of 0.1 percent) may come as a surprise, but it can likely be explained by a loss of relative preference: Mexico will lose the advantages provided by NAFTA for exporting to the US vis-à-vis Asian competitors. This could be particularly significant in light manufacturing and vehicle production, where Mexico has gained important market share in the US, and which are threatened by Asian manufacturers who enjoy cost competitiveness (e.g. Vietnam) or that have an advanced and diversified high-tech manufacturing sector (e.g. Japan). Indeed, the sectors most affected are motor vehicles (-26.5 percent) and leather (-10.8 percent).

The FTAAP is still projected to have a positive, though fairly small effect (+0.6 percent). Under the FTAAP, the effect on Mexican exports to the US is small and positive, while those to Canada shrink. The main positive effect of the FTAAP would be a dramatic increase of exports to China. This observation is most likely driven by the boost the FTAAP for Mexico would have on global trade and incomes. Notably, Mexico's gains under the FTAAP are smaller than those of other countries in the region, and much smaller than those of the US, its major trade partner.[10] According to the model, any gains from trade creation are mostly negated by diversion or displacement effects in Mexico's key export markets. An obvious candidate for reduction are Mexican exports to the US and Canada, where Mexico would enter into even tougher competition with Asian countries.

The TTIP, an agreement Mexico is not a party to, is projected to have a small negative effect on Mexico's welfare—one almost identical to the effect of the TPP. However, TTIP does imply changes to Mexico's trade patterns. Exports to the US and Canada are expected to decline significantly

10 The US is projected to see a welfare gain of 2.8 percent under the FTAAP and 2.0 percent under the TPP.

FIGURE 8 **Modeled Effects of Mega-deals on Peru, Real Income (Percent)**



Source: Ifo Institute and Bertelsmann Stiftung

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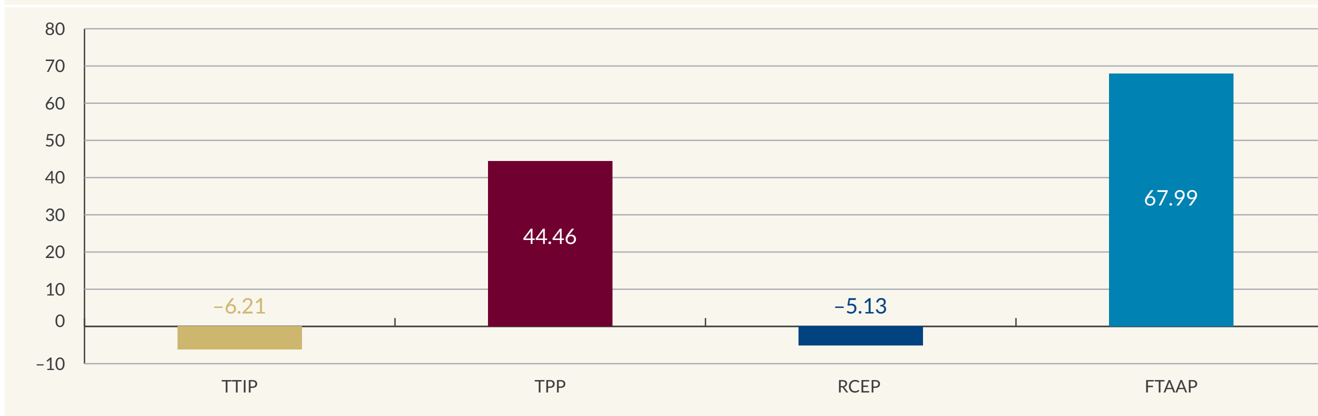
under the TTIP (5.7 percent and 4.4 percent), as European competition displaces Mexican products in key export markets. However, Mexico increases its exports to many other trading partners, especially in Latin America. As a result, the loss of exports to the US under the TTIP would come with a somewhat reduced dependency on its neighbor to the north.

g. Peru: The Least Developed of the Three "Insiders" Sees the Largest Gains

Peru is projected to benefit significantly from the deals to which it is a party (the TPP and FTAAP), in part based on a boost from exports to developed countries, especially the US, Japan and Canada. However, some of this increase relative to the 2007 baseline could materialize even in the absence of the mega-deals, as the country signed bilateral free trade agreements with the US and Canada in 2009.

The metals sector benefits most from the deals (value added gains of 44.5 percent under the TPP and 68 percent under the FTAAP). The traditionally strong mining sector, on the other hand, is expected to remain comparatively stable. This could be a demonstration of how trade agreements allow for growth in value -added through the domestic upgrading of raw materials. When subject to tariff escalation (higher tariffs on processed goods compared to raw materials), commodity producers often export raw products even when domestic processing is economically efficient. Removing tariffs from processed goods changes this calculus: now raw metals can be refined in Peru and exported as intermediated goods, adding significant value. Notably, the metals sector only sees positive effects under the deals to which Peru is a party (the TPP and FTAAP) but negative results under deals where Peru does not achieve tariff reductions for its products in destination markets (TTIP and RCEP).

FIGURE 9 **Value added Gains (and Losses) for Peru's Metals Sector (Percent)**



Source: Ifo Institute and Bertelsmann Stiftung

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4. Effects on Outsiders

A number of major economies in Latin America are not participating in the mega-deals. However, since the proposed agreements include many of their key trading partners, outsiders will still be effected. This section considers the effects on non-participating economies and assesses their effects on the region's largest economy, Brazil.

Trade Diversion

One consequence of the mega-deals could be that efficient Latin American producers outside of the pacts will be replaced by countries inside which, following an agreement, would enjoy preferential access. An example would be agricultural exports from South America to the EU that could be replaced by US products under the TTIP.

Loss of Preference

Many Latin American countries, especially poorer countries in Central America and the Caribbean, already have preferential access to large markets, in particular the US and EU (through DR-CAFTA, Caribbean basin, EU Cotonou Agreement, and GSP). The economies of MERCOSUR would enjoy market access under a proposed MERCOSUR-EU agreement. If other producers realized similar access, less competitive Latin American producers could be replaced.

Positive Effects

As the TPP redirects trade flows from Asia towards North America, some countries, especially in Central America, could gain market shares in Europe, particularly in light manufacturing such as textiles or electronics. Positive neighborhood effects as a result of increased demand from participating countries could also provide increased demand for inputs and final goods provided by non-participating countries. This seems to be particularly relevant for countries in Central America and the Caribbean, which have strong trade relations with Mexico and the US.

a. Case Study Brazil: The Opportunity Cost of Opportunities Lost

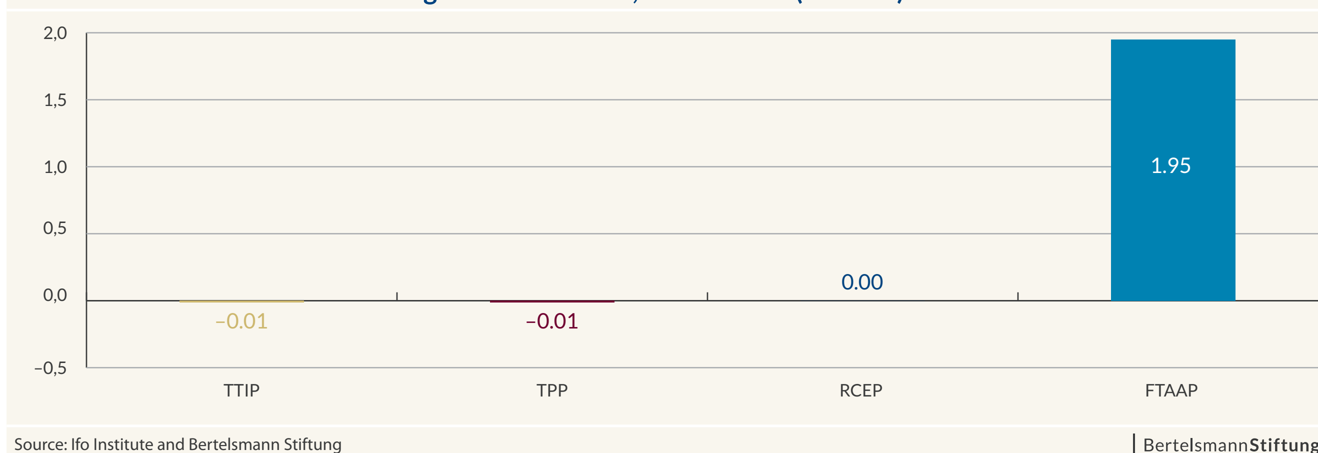
In the 1990s, Brazil entered a period of trade liberalization. However, at the time, it tied itself to MERCOSUR, whose charter does not permit bilateral agreements between member states and nonmember countries.[11] Consequently, Brazil is not a member in any of the mega-deals and has not concluded any significant free trade agreements in the last 20 years. The economy thus remains comparatively closed, with increased commodity exports when market conditions are favorable, and rendering the non-commodity sector ever more dependent on a protected market at home and within MERCOSUR.

MERCOSUR continues to dominate Brazilian trade policy as it provides the basis of the bilateral relationship with Argentina, an important political partner and the largest market for Brazil's manufacturing exports. However, Argentina's protectionist leanings in recent years have prevented integration efforts between MERCOSUR and others.

Brazil itself has a conflicted attitude to trade, maintaining relatively high tariffs and high non-tariff barriers such as local content requirements in key industries. However, most recently, signs are emerging that the government is becoming more open to integration. A growth slowdown since 2011 and the current deep recession have once again exposed the competitiveness problems of Brazilian manufacturing and increased exposure to volatile

11 See MERCOSUR Council Decision 32/2000

FIGURE 10 **Modeled Effects of Mega-deals on Brazil, Real Income (Percent)**



Source: Ifo Institute and Bertelsmann Stiftung | BertelsmannStiftung

commodity prices. The government is moving towards trade facilitation and is pushing for the completion of the MERCOSUR-EU agreement. Brazil recently supported Uruguay in a push to allow more flexibility for MERCOSUR members to pursue agreements with outside countries.[12] This would be a way to circumvent the restrictions of MERCOSUR, rather than waiting for reluctant members to engage in MERCOSUR-wide agreements.

The overall estimated effects of the mega-deals on Brazil's welfare are rather small. This is mostly due to the closed nature of the Brazilian economy, where total trade (exports plus imports) represents less than 30 percent of GDP.[13] Nevertheless, the structure of Brazil's trade would be significantly affected by trade deals in which it does not participate. Overall, the mega-deals, with the exception of the FTAAP, would leave Brazil even more isolated in global trade, and ever more reduced to an exporter of commodities. In the case of the FTAAP, Brazil would benefit positively from the overall increase in world trade and GDP and in particular from the involvement of China. In recent years (2003-2011), trade between Brazil and China has grown exponentially, turning the Asian giant into Brazil's top export destination.[14] Under the FTAAP, Brazil's exports to China are expected to grow by an additional 84 percent relative to the 2007 baseline.

Brazil's exports to China are also expected to grow moderately under the TPP (4.4 percent), supporting the notion that mega-deals strengthen ties between two large outsiders.[15] This stems from a redirection of trade flows in many sectors. For example, the trade liberalization and

12 "Uruguay convinced Mercosur will be more flexible regarding trade accords with third parties." *Mercosur*, May 15, 2015. Available online at http://en.mercopress.com/2015/05/15/uruguay-convinced-mercosur-will-be-more-flexible-regarding-trade-accords-with-third-parties

13 Otaviano Canuto, Cornelius Fleischhaker, and Philip Schellekens. *The Curious Case of Brazil's Closedness to Trade.* The World Bank Policy Research Working Paper 7228, April 2015. Available online at https://openknowledge.worldbank.org/bitstream/handle/10986/21840/WPS7228.pdf?sequence=2

14 *Implications of a Changing China for Brazil: A New Window of Opportunity.* The World Bank, 2014. Available online at http://ww-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2014/07/14/000020439_20140714120028/Rendered/PDF/894500WP0P148300Bank02014000English.pdf

15 Otaviano Canuto. "Are Mega-Trade Agreements a Threat to Brazil?" *The Huffington Post*, February 26, 2015. Available online at http://www.huffingtonpost.com/otaviano-canuto/are-mega-trade-agreements_b_6763692.html.

regulatory convergence of the 12 member countries in the agricultural segment of the Trans-Pacific Partnership (TPP) will cause a strong deviation from Brazil's trade flows to Asia in favor of competitors from the US, Canada and Australia.[16]

However, any gains in exports to China under a TPP scenario are outweighed by significant losses in exports to TPP participants, especially to the US (-6.6 percent) and Mexico (-10 percent).

The results are somewhat different under the TTIP. Here, Brazil is expected to see increased exports to most major European economies (France, Germany, and Italy). Since these countries' exports of manufacturing goods (machinery, motor vehicles) incorporate Brazilian inputs (especially minerals), an expansion of European production under the TTIP would generate increased demand for Brazilian goods.[17] However, this comes at a cost to exports in other key markets, including to China and the US, with the result that overall trade and welfare effects remain negative.

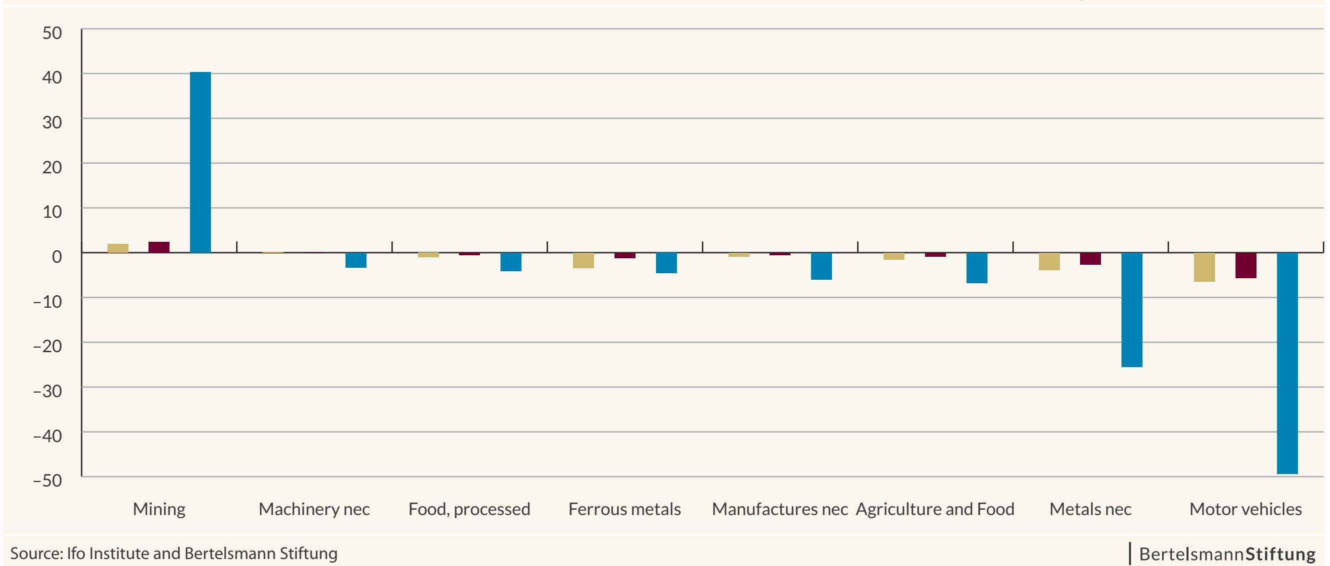
The only sector of the Brazilian economy seeing significant value-added gains under any of the mega-deals is the mining sector (ranging from 2 percent under the TTIP to 40.3 percent under the FTAAP). Other commodity-intensive sectors such as metals and agriculture would not benefit. Brazil's clear advantages in these sectors demonstrates the opportunity cost of remaining outside of trade agreements. The fact that other agricultural powers such as Canada or Australia would gain preferential access to important markets such as the EU and Japan would lead to the displacement of Brazilian exports, which would continue to be subject to tariff barriers.

The de-industrialization of the Brazilian economy, ongoing since the beginning of the commodity boom in the 2000s, would accelerate with the mega-trade deals. The Brazilian manufacturing sector, which still accounts for almost half of the country's exports, is expected to shrink in all scenarios, led by the automobile industry. Even upgraded commodities and semi-manufactured products such as processed food and metals see significant losses. Again, this can be seen as a direct cost of remaining outside of trade deals and value chains, as Brazilian producers should be competitive in these areas if put on an equal footing. The weakening of the manufacturing sector is mirrored by weakening trade with MERCOSUR partners. Exports to Argentina, by far Brazil's most important export destination in MERCOSUR and the largest market for Brazilian manufacturers, are projected to decline by up to 25.1 percent (under the FTAAP).

16 "TTP to increase competition of Brazilian exports" *Valor International*, October 6, 2015. Available online at http://www.valor.com.br/international/news/4256966/tpp-increase-competition-brazilian-exports.

17 Gabriel Feybermayr. *Transatlantic Trade and Investment Partnership (TTIP) Who benefits from a free trade deal?* Bertelsmann Stiftung, 2013. Available online at http://www.bfna.org/sites/default/files/TTIP-GED%20study%2017June%202013.pdf.

FIGURE 11 **Value Added Effect of Trade Deals on Selected Sectors of the Brazilian Economy (Percent)**



Source: Ifo Institute and Bertelsmann Stiftung

BertelsmannStiftung

5. Dealing with Mega-Deals: Opportunities and Challenges

The regional mega-deals currently under negotiation provide an opportunity for countries to enhance their integration in global value chains. This is particularly relevant in Latin America, where cross-border value chains have been largely absent due to the long shadow of import-substitution industrialization policies.

What has been achieved in value-chain integration has been largely due to existing regional deals. The most important example is Mexican manufacturing integrating into value chains with the US. However MERCOSUR also achieved some level of integration, for example between the automobile industries of Brazil and Argentina, even though this sector has run on fumes in recent years.[18]

In many cases, remaining outside of transnational value chains resulted in loss of competitiveness of domestic industries, which lack access to low-cost inputs and the latest technology. Too often the response has been to increase trade barriers, further separating the domestic market from global integration. Consequently, the cost of being left out increases. However, this also implies that any change in direction would result in a fairly severe adjustment.

The new mega-deals come at a time when Latin American countries, especially the large economies, which have avoided integration, are in crisis. Brazil's economy appears to have contracted by more than three percent in 2015 and is expected to contract a further two percent in 2016, while Argentina's is expected to remain stagnant. Mexico and Central America, on the other hand, are projected to grow, riding on the coattails of a rebounding US economy with which these countries have become increasingly integrated.

Domestic economic malaise combined with the example of countries in the region benefiting from trade and integration might eventually change the political calculus in Brasilia and Buenos Aires. A paradigm shift away from protectionism and domestic vertical integration through national content requirements and towards embracing cross-border supply chains might also be supported by the decline of commodity prices, which have long supported trade balances in Latin America.

The fall in commodity prices and a bleak economic outlook have also resulted in a significant weakening of exchange rates in many countries, especially in Brazil, where the currency lost about half of its value in 2014 and 2015. This depreciation could provide an opportune moment for opening to trade, as it provides at least a temporary boost to the competitiveness of domestic industries, which could facilitate the adjustment.

18 Rogerio Jelmayer. "Brazil Auto Sales, Production and Exports Dropped in 2014." *The Wall Street Journal*, January 8, 2015. Available online at http://www.wsj.com/articles/brazil-auto-sales-production-and-exports-dropped-in-2014-1420730602.

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