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**Reflections on Approaching an FTA  
Negotiation with Mercosur:  
A Review of Key Issues**

Simon Roberts

**Trade Reports**

## Post-Script – January 2005

SAIIA Trade Policy Report No. 6

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A Review of Key Issues

Subsequent to the completion of this report, the negotiators from SACU and Mercosur once again gathered in Brazil in December 2004 to sign the SACU-Mercosur trade agreement. They were determined to establish a preferential trade agreement – a distilled version of the FTA originally envisaged some years ago.

Following widespread criticism from both business and labour – not to mention constant delays in the negotiating process – the negotiators from SACU and Mercosur resorted to signing an agreement called a Fixed Tariff Preference (FTP). Such an agreement follows a sector-by-sector approach as opposed to a fully comprehensive FTA. Specific sectors have been selected for inclusion, excluding the more controversial and sensitive products and industries, but for possible inclusion in later negotiations. This, no doubt, helped to fast-track the process, which would otherwise have dragged on for months or even years, while trying to overcome the resistance of opposing industries. This way, the FTP has allowed the negotiators to finally achieve a preferential trade agreement of sorts and use it as a starting point for deeper and wider integration in the future.

In the final analysis, 2000 products were eventually included in the agreement, selected through a relatively complicated process of negotiations along a level of HS 8\* – placing a great deal of emphasis on specific products instead of broader industries. A compromise was reached between the 4000 products submitted by Mercosur and the 1000 products submitted by

SACU, and agreement was reached to extend the list to include additional products in forthcoming negotiations.

*\* A type of trade classification; a product line.*

## **Business Day article**

**Wednesday, 29 December 2004**

*Mercosur, Sacu stay clear of steel tariffs:*

*Duties on about 2000 items set to be reduced by between 25% and 100%*

by Larry Claasen, Industrial Correspondent

TRADE negotiators of the Southern African Customs Union (Sacu) and the South American trading bloc Mercosur gave in to intense pressure from steel producers in SA and Brazil, staying clear of steel tariffs as they moved to reduce duty on 2000 items in their recently concluded trade agreement.

Brazil, a key member of Mercosur, and SA are both major steel producers for export and the move to stay clear of the commodity went some way in facilitating Sacu's first trade agreement as a block. SA's chief trade negotiator, Xavier Carim, said yesterday that while steel products were exempt from the deal, tariffs on some goods were set to drop between 25% and 100%. He said the conclusion of the deal proved that countries in Sacu — SA, Botswana, Namibia, Lesotho and Swaziland — could define a common agenda and act in a common best interest. Carim said that Sacu was also close to concluding a trade agreement with the European Free Trade Association and hoped to restart trade talks with the US in the new year.

The deal between Sacu and Mercosur countries — Argentina,

Brazil, Paraguay and Uruguay — will probably come into effect a year from now as it still needs to be ratified by these countries' parliaments. While SA's exports to Mercosur account for only 1% of total exports, they grew about 19% to R1,65bn this year from the previous year's figures. Carim said besides easing access for local business to Mercosur countries, the deal created a legal framework for resolving trade disputes and facilitated the political objectives of Brazil and SA to do more business with developing countries. Sacu was looking at reaching similar trade agreements with India and China. The exemption of steel products from the deal allayed the fears of the local steel industry which saw a reduction in tariffs as hurting it, as it would open up the domestic market to steel imports from Brazil in particular.

Mike Robertson, executive director of the Steel Tube Export Association of SA, was happy with the decision not to include steel goods in the Mercosur deal. He said the association had been lobbying the South African government not to reduce tariffs on steel products to protect the local industry. Carim said the fear that developing countries could hurt their economies by lowering tariffs on sensitive products saw the World Trade Organisation allowing them to exclude these products when negotiating deals with other developing countries.

**Reflections on Approaching an FTA  
Negotiation with Mercosur:  
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Simon Roberts

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SAIIA Trade Report No. 6

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# Reflections on Approaching an FTA Negotiation with Mercosur: A Review of Key Issues

Simon Roberts<sup>1</sup>

## Introduction

The possibility of a Mercosur-SACU (Southern African Customs Union) free trade agreement (FTA) has moved back to the top of the agenda in the past year following meetings of the presidents of Brazil and South Africa and the leadership role played by each of these countries in international trade forums. There are thus important factors in such a relationship which go beyond simply gains from trade.

This report seeks to draw together key insights from existing work on Mercosur-SACU, and to point out possible gaps.<sup>2</sup> It also draws from other work related to the competitive positioning of South Africa's industries and the implications of an FTA with Mercosur. Rather than summarising work at an industry level, the main contribution of this report is to explore quite high-level considerations for the FTA from the perspective of South Africa. These include the implications of the possible FTA for South Africa's desired industrial development path, as reflected in government's policy documents, and possibilities for institutional collaboration and learning.

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<sup>2</sup> Much of the work drawn on is internal research conducted by the DTL, which is not separately referenced here.

The report starts by briefly reviewing the way in which economists generally approach assessment of regional trade agreements, and South-South trade agreements in particular. The 'Review on Trade Flows' then examines the overall trade flows between South Africa and Brazil and their implications. The 'Review of Main Product Groupings' draws on a wide range of sector research already undertaken, mostly by the Department of Trade and Industry (DTI), and assesses the implications of a trade agreement for different industries. The last section 'Some conclusions and research requirements' concludes and suggests important areas for further research.

### *A note on regional trade agreements*

There are two main approaches to understanding regional trade agreements. The first is to assess the likely trade creation and trade diversion effects through examining existing trade flows. In this approach trade is based on country differences being the foundation for comparative advantage and best describes trade between countries differing in factor endowments (and generally, of differing levels of development). The second approach is to examine the relationship between trade and economic development in a more dynamic context where countries create and develop comparative advantages based on capabilities in differing industries. It takes into account technology, economies of scale and learning effects and is often employed in examining South-South trade agreements where countries share similar objectives of industrialising and exporting higher value-added products.<sup>3</sup> We briefly discuss the first approach, in the context of the proposed Mercosur-SACU agreement, before

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<sup>3</sup> Sanjaya Lall has been a major exponent of this approach. See for example, Lall S, 'Reinventing industrial strategy: The role of government policy in building industrial competitiveness'. Paper for the Intergovernmental Group on Monetary Affairs and Development (G24), 2003.



highlighting factors important in considering the relationship between trade and economic development.

The trade integration literature generally finds that trade agreements have the greatest economic benefits where the countries would trade with each other in a state of global free trade, where trade flows are determined by countries' comparative advantages without the effects of protection. The liberalisation of protection between the countries in the free trade agreement leads to unambiguous trade creation effects. All countries reap the gains from trade — increased specialisation and exchange.

Increased trade as a result of a free trade agreement can alternatively result from 'trade diversion', where the lower protection between members leads to imports and exports between them instead of from other lower cost sources. For example, lower tariffs on trade with Brazil might lead to a switch to source machinery from Brazil instead of from, for example, Taiwan. South Africa loses the tariff revenue from the imports from Taiwan, and the imports from Brazil may be less competitive meaning that import prices do not necessarily fall.

The implication is that free trade agreements are best concluded between countries that are already significant trading partners, and have commonalities in their patterns of comparative advantage. This rationale supports trade agreements with the European Union, USA and the Far East to which South Africa's major exports of minerals, basic metals, basic chemicals and food products largely go already. It does not suggest significant gains from a free trade agreement between SACU and Mercosur given the very low levels of trade currently.

There are, however, a number of limitations to this framework. The possible gains from the SACU-Mercosur deal, and thus key concerns for the strategy adopted in the negotiations, are based on additional factors in the trade and development relationship.

### *Intra-industry trade*

The orthodox framework understands trade as based on countries' differences and not their similarities. In many respects South Africa's pattern of trade conforms to this. But, trade in industrialised and higher value-added products has increasingly been between similar countries in the same broad types of products.

Intra- as opposed to inter- industry trade reflects two main factors: product differentiation and economies of scale. Product differentiation means gains from specialisation in product characteristics. As firms develop capabilities, they focus on different product niches or particular specifications. Consumers in different countries like variety and choice between a range of specifications that best suit their needs. Two-way trade therefore occurs in the same products between similar countries. This has possible implications for the development of machinery and equipment, for example.

Where this is combined with significant economies of scale, and thus imperfect competition, there are large potential gains from intra-industry trade. This trade allows for firms in each country to reap scale economies through larger volume production and exporting of their specific product and, at the same time, freer trade disciplines the market power of these firms in the domestic market.

In the case of South Africa, these factors are very significant. The local market is characterised by a small number of firms trading in many upstream products linked to processing minerals and raw materials. Mercosur countries have similar industrial capabilities.

### *South-South trade: Dynamic gains from trade, and links with industrial development*

The orthodox trade theory framework is entirely static. Comparative advantage is based on today's production costs and capabilities. This means that greater trade serves to reinforce the existing industrial

structure and pattern of capabilities. For South Africa this suggests that trade will reinforce the minerals-oriented nature of its industry which will not contribute to meeting the employment creation objectives of government.

Changing a country's economic and industrial structure is a key consideration underpinning the increase in South-South regional trade agreements. Such agreements allow countries which may be similar in many regards to realise opportunities for reaching scale economies, overcoming the obstacles posed by small domestic markets and increase specialisation.<sup>4</sup> South-South regional trade agreements have also been motivated by the barriers to exports to northern markets, and more generally as a way to strengthen the capacities of developing countries in dealing with the challenges of globalisation and liberalisation. Moreover, the major changes achieved by some developing countries in altering their industrial structure and attaining high rates of growth (notably Asian countries such as South Korea, Taiwan and Malaysia) provide added impetus as their demand grows for goods and services from other developing countries. Most of the increased trade between developing countries in trade agreements has been intra-regional, however, there are increasing moves to agreements between countries in different continents.

The South African DTI's Integrated Manufacturing Strategy (IMS) explicitly states that the goal of government's industrial policy is to move to higher value-added and more knowledge-intensive products. It is thus necessary to understand how increased trade will conflict with or support these goals. Trade, and increased exposure to the international economy more broadly, provides the basis for companies in late industrialising countries to 'catch-up' through adopting and adapting international technologies. As countries develop improved production capabilities they may be in an

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<sup>4</sup> See, for example, UNCTAD, 'Regionalism and South-South co-operation: The case of Mercosur and India'. Note by the UNCTAD secretariat, 2 June 2004.

intermediate position, having a comparative advantage relative to less industrialised countries and a disadvantage relative to industrialised countries, in a 'ladder' of comparative advantage. Moving up the ladder to higher value-added products means understanding where a country is currently and whether existing production capabilities are sufficient for it to exploit export opportunities.

A key challenge for the DTI's policy is to ensure that competitive advantages and low production costs in the manufacture of upstream intermediate products such as steel, aluminium and basic chemicals are passed on in the form of competitively priced products. At present, import parity pricing and the absence of local competition means that cheap production costs for basic metals and basic chemicals (and very large trade surpluses in many of these products) are not passed on in the form of relatively cheap steel, aluminium or polymer chemicals. The downstream and relatively labour-intensive activities such as metal products, plastics and even machinery are relatively under-developed, and many record net trade deficits.

### *Transnational corporations*

The significance of transnational corporations (TNCs) in many industries means that a country's trade flows are determined by TNC decisions over the location of production. In addition, licenses for the use of foreign technology often come with restrictions as to where the manufacturer can sell. This means that although a free trade agreement may open up opportunities for increased exports and growth of an industry more broadly, the TNC relationships prevent this from occurring.

In sectors such as automotive, and electrical and electronic goods, a country's production generally depends on how the policy framework, including trade, affects the TNC's incentives.

*Industrial policy and institutional development:  
Learning from international experience*

A related issue is the opportunity to learn from the experiences of countries at a similar level of development. This includes examining the policy tools and institutions utilised, including development finance institutions, competition authorities and mechanisms to support small business. Industrialised country models are not necessarily the most appropriate. A free trade agreement with Mercosur could provide a framework within which greater interaction and co-operation occurs (although such links clearly do not require a trade agreement).

*Political economy*

An important motivation for the proposed SACU–Mercosur agreement is evidently the common positions being taken by Brazil and South Africa in international trade forums as part of the G20+ and the development of India-Brazil-South Africa links (IBSA). Again though, this does not necessarily require a free trade agreement.

*Background on Mercosur*

Mercosur has developed as a free trading area with four core members (Brazil, Argentina, Paraguay and Uruguay) and two associated countries (Chile and Bolivia). Mercosur was initiated in 1991 with most internal tariffs being removed by 1994. Remaining tariffs were eliminated by 2000, except for in motor vehicles and sugar. Mercosur has a common external tariff, with exceptions in products such as capital goods and telecommunications. There is also a specific arrangement in the auto sector (discussed in more detail below). While there have been periods of uncertainty about its durability, particularly due to the effects of large currency movements, it is increasingly well-established.

Table 1: Macroeconomic data on SACU and Mercosur, 2001

	GDP (\$mn)	Pop. mn	GDP pc, \$	GDP % gr 1990- 2001	Industry, % of GDP	% Merch X:GDP	Manuf X, as % of merch X	High tech X, as % of man X
Brazil	502,509	172.6	2,911	2.8	36	12	59	19
Argentina	268,773	37.5	7,167	3.7	28	10	32	9
Uruguay	18,429	3.4	5,420	2.9	27	11	42	2
Paraguay	6,926	5.6	1,237	2.0	27	14	19	3
Total Mercosur	796,637	219.1	3,636			11		
South Africa	113,274	43.2	2,622	2.1	31	26	-	-
Botswana	5,142	1.6	3,214	5.2	44	45	-	-
Lesotho	789	2.1	376	3.9	46	33	-	-
Namibia	3,168	1.8	1,262	4.1	28	51	-	-
Swaziland <sup>1</sup>	1,388	1.1	1,262	-	-	-	-	-
SACU	123,761	49.8	2,485				54	1

- Notes:
1. Swaziland is gross national income, not GDP.
  2. Industry includes mining.
  3. Breakdown of trade only available for SACU as a whole.
  4. Trade data breakdown are for 2000.
  5. High technology defined as products with high R&D intensity, and include aerospace, computers, pharmaceuticals, scientific equipment and electrical machinery.
  6. Note that the relative size of Argentina's economy has shrunk significantly following the sharp depreciation of its currency.

Source: World Bank, *World Development Report 2003*.

The most striking issue is perhaps the size of Mercosur. SACU countries will be entering into a trade integration arrangement with an economy more than six times as large (Table 1). The Brazilian economy alone is more than four times the size of the South African economy. One result of their size is that international trade flows are much less important, but this also reflects historically high levels of protection (and it holds for the two smaller countries of Paraguay and Uruguay). Brazil has a similar level of GDP per capita to South Africa and Botswana, while Argentina and Uruguay are relatively more advanced. Brazil also has similar levels of inequality to South

Africa, and faces similar development challenges. For example, the industry share of GDP masks the importance of mining to both the South African and Brazilian economies.

A key difference is that Brazil has been successful in increasing the technological component of its manufacturing exports, reflecting successful development of its capabilities across areas such as aerospace, pharmaceuticals and machinery. By comparison, South Africa's manufactured exports remain dominated by basic metals and basic chemicals, reflecting capabilities which are closely related to mining and energy. Agricultural exports are also important for Mercosur countries, Argentina, in particular.

## **Review of trade flows**

We briefly review the overall trade data drawing from Van Seventer on Brazil-South Africa trade flows, and discuss its implications in terms of the likely static and dynamic effects of moving to free trade with Mercosur.<sup>5</sup>

South Africa might be expected to gain from the opportunities offered by the large markets in Mercosur. In addition, Brazil, like South Africa, has been through a major trade liberalisation in the 1990s. As in South Africa, the sectors that initially increased exports under the liberalisation in Brazil were capital-intensive, although Brazil's comparative advantage is broadly in natural resource and labour intensive sectors.<sup>6</sup> It is also interesting that Brazil is a net importer of manufactured products such as chemicals, pharmaceuticals, textiles and machinery from India.<sup>7</sup>

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<sup>5</sup> Van Seventer D, 'A quantitative analysis of aspects of trade between South Africa and Brazil'. Paper presented at SAIIA-IPEA seminar, Rio de Janeiro, February 2003.

<sup>6</sup> Pinheiro AC & MM Moreira, 'The profile of Brazil's manufacturing exporters in the nineties: what are the main policy issues', BNDES discussion paper No. 80, 2000.

<sup>7</sup> UNCTAD, *op. cit.*

### *Overall trade flows*

Trade flows between Brazil and South Africa are small, although growing rapidly in the past decade, with the balance developing in favour of Brazil. South Africa's exports to Brazil are broadly in line with overall exports, with approximately three quarters accounted for by mineral products (coal), chemicals and basic metals. The main imports from Brazil are machinery, vehicles, vehicle components and chemicals. South Africa thus exports lower value-added primary products and imports higher value-added products.

When one looks at the share of trade flows with Brazil as a proportion of total trade by product grouping, a similar bias to primary products emerges. In other words, trade with Brazil has not contributed to South Africa moving up the comparative advantage ladder (unlike South Africa's trade with other African countries). The exceptions are South African exports of aircraft and parts thereof (in which there are, however, much larger imports), and paper & paper board.

Intra-industry trade flows are low, reflecting the trade patterns outlined above. The exceptions here are aluminium, ferro-alloys, motor vehicles, and wood packaging products. In motor vehicles, in particular, this highlights the need to understand trade flows and the response to an FTA in terms of intra-industry specialisation and firms decisions within the transnational organisation of production.

In terms of opportunities, based on comparison of South Africa's exports to the rest of the world and the exports to Brazil, the main product areas are aluminium and articles thereof; aircraft; various chemical products and synthetic yarns; iron and steel; furniture; and fruit and vegetables. It is also possible to assess products that appear to be 'under-traded' given the existing trade barriers. This is done by assessing the importance of Brazil's imports from South Africa relative to Brazil's imports from the Rest of the World. This suggests that currently under-traded products are motor vehicles and components, synthetic fibres and various machinery products. The



fact that Brazil imports these products indicates that there is a potential opportunity to be exploited, but does not indicate the competitiveness of South African firms in this regard.

The primary product nature of much of South Africa's exports is reflected in the bulk of South Africa's exports being subject to tariffs below 10%. Brazil has tariff peaks in motor vehicles (35%), and consumer electronics (28%). Tariffs on other important exports from South Africa are chemicals (16%), electrical machinery (10–20%) and pharmaceuticals (10%).

### *Implications for static and dynamic effects of an FTA*

Key possible gains from an FTA derive from exploiting niches in which South Africa has an existing advantage, from integrating South African producers into sectors already strong in the Mercosur economies such as aircraft manufacture, and from intra-industry specialisation in sectors such as motor vehicle manufacture. The static gains are therefore small, and do not generally relate to sectors which are going to be employment generating as part of South Africa's strategy of moving up the value chain. The key possible gains relate to the dynamic possibilities.

Given the importance of non-tariff barriers in Mercosur, and the complexity of regulations on trade and business in general, an important negotiating concern on the part of South Africa for an FTA is transparency on the impediments to imports into Mercosur.

A second group of issues is not specifically related to trade between Mercosur and South Africa, although they have been important in motivating the negotiations. These are the political economy considerations, and also the possibilities for co-operation on policy initiatives and between institutions such as dealing with small business development, development finance, and competition.

To the extent that these deal with improving competitiveness of firms and industries, there is a direct relationship with trade

performance, but not specifically an FTA. Industries for collaboration on technical capabilities could include machinery and equipment, aircraft and motor vehicles.

### **A review of main product groupings**

Much of the work done in 2000 and 2001 on SACU–Mercosur related to particular industrial groupings and likely offensive and defensive concerns.<sup>8</sup> The analysis was mainly of industries in Brazil, although some information has also been collected on Argentina.

One issue with the sector work is that there has been a tendency to focus on sectors in terms of their absolute size of production and trade, without reference to their significance in terms of employment or future development. This is apparently often due to the presence of very large companies who are relatively well able to organise information to support analysis. This does mean that the agenda is set in such a way as to make it difficult to assess employment implications despite these evidently being critical. Good examples of this are in metals and chemicals. The South African Iron and Steel Institute (SAISI) represents the primary steel producers and put together a careful list of how primary steel products may be affected. Of much greater interest for employment is, however, the effects on downstream metal fabricating companies. There are many firms engaged in these activities and they are much less well-organised, meaning that their interests are not well represented.

A similar case exists in chemicals where the focus is on the upstream and very capital-intensive activities dominated by a small number of firms, while downstream activities such as plastic products and consumer chemicals are far more important in terms of employment. Some reference is made to the smaller trade flows in plastic products compared to primary plastics, but this essentially misses the point. Smaller trade flows do not mean the activities are

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<sup>8</sup> This relates to the internal DTI research.

unaffected, and many more jobs are in fact at stake (both in terms of possible gains and losses).

The treatment of the industries here cannot do more than place them within a broader framework of strategic concerns.

### *Metals*

It is important to distinguish between upstream manufacture of basic metals such as iron and steel and aluminium, and the downstream fabrication of metal products. We start by considering upstream production before commenting briefly on downstream activities, although the research conducted to date appears to focus on upstream production and to draw heavily and uncritically from the relevant industry organisations.

An initial appraisal suggest few gains for South Africa from an FTA. Brazil, in particular, has a very large and well-developed steel industry with abundant iron ore of which it is a large net exporter. There are opportunities in the export of aluminium and of some ferrous alloys. The South African steel industry also suggests that there are potential gains in the thinner steel products (especially the ultra-thin hot-rolled coil produced at Saldanha) in which the South African industry has relatively better capabilities. They are, however, more cautious in thicker steel sheet and in long steel products in which Brazil is more competitive. South African tariffs of 5% on steel are already relatively low.

Of greater interest, however, should be the effects on downstream industries. South Africa has one of the lowest cost bases for steel and aluminium production, and capacity far in excess of local demand. The restructuring already undergone by the industry in the past decade, and the ongoing improvements, means that upstream industry is in a very strong competitive position. At issue is the fact that these advantages do not flow through to downstream firms for whom basic metals are a major input cost.

An FTA could yield large efficiency gains from effectively ensuring South Africa is part of a larger market with greater competition to discipline the behaviour of dominant firms. It is important not to over-emphasise the effects of tariff liberalisation, however. Effective protection is also provided by transport and related costs. Efficiencies in these areas as a result of greater trade between the two regions would also have an important effect in reducing the margins which local firms are able to charge.

In addition, South African firms have used anti-dumping measures very effectively to prevent erosion of their position. In the context of an FTA, a common approach could be explored to anti-dumping.

Downstream metal products fabrication is more difficult to assess but is much more important than upstream activities in terms of employment. And, little if any assessment appears to have been made of South Africa in relation to Mercosur. Downstream activities require competitive cost conditions and developed skills and capabilities. Increased specialisation as a result of an FTA could be part of this process of developing competitive capabilities and increasing exports of beneficiated products, however, there are also significant risks given the similarities in the economies. This is an area warranting much closer examination.

### *Motor vehicles*

Motor vehicles and components is one of the most sensitive groupings. Despite being 'under-traded' in both directions, indicating gains to be achieved from an FTA covering autos, there are good reasons to be very careful and to adopt a defensive position.

The Brazilian market is large and all the main OEMs are represented. The Argentinean auto industry is also larger than South Africa's but there is a greater bias towards the main French OEMs. Under the Mercosur agreement, the Argentinean industry had been very concerned that they would lose out to the larger Brazilian firms

which had capacity and greater scale economies. To address these fears a policy of matching-trade was put in place together with a requirement of 60% Mercosur content.

As long as the markets in both countries were expanding this worked well and auto trade within Mercosur expanded rapidly, with greater intra-Mercosur specialisation by firms, yielding efficiencies. However, the Argentinean industry in particular became very focused on the Brazilian market. When demand weakened and the devaluation of the Brazilian Real meant that Argentina was suddenly much less attractive, it meant major problems for the Argentinean auto industry.

Similar concerns arise for South Africa in the context of an FTA, as for Argentina in Mercosur. Having developed a competitive motor vehicle industry through the Motor Industry Development Programme, integration with Mercosur brings the attraction of relocating to the much larger Brazilian economy for the South African located assemblers and component suppliers. The MIDP works precisely because of the existence of protection in the South African market. Auto firms increased South African production volumes and exports in order to receive the right to import duty free. With the lowering of duties with Mercosur, that incentive disappears. In addition, the big investment incentives offered by some Brazilian states, which have attracted Argentinean firms to relocate to Brazil, would also be attractive to South African firms.

The risk to South Africa is clearly that of becoming a periphery location to the Brazilian 'core'. Cost advantages relative to Europe, North America or Japan that mean South African production has been maintained and grown, do not apply in comparison to Brazil. While the MIDP has brought some success in maintaining and growing the South African industry, the deepening of local components linkages is being realised under the current phase of the programme, when increasing local content requirements and exports to meet the same import levels are inducing sourcing of more integral components such as engine parts and plastics from local

firms. Ultimately the ongoing reductions in tariff protection mean that South Africa's industry must be internationally competitive in the longer-term, however, Brazil represents perhaps one of the most challenging competitors given the similar cost base and much larger market. In addition, there are non-tariff obstacles to importing to Brazil, while the Brazilian states' incentives to invest would mean the risk of auto firms being able to play off governments on both sides of the Atlantic to achieve bigger and bigger tax breaks.

There are, however, some opportunities with regard to Mercosur. The concentration in Brazil has been in smaller vehicles while in South Africa there have been notable successes in luxury models such as the BMW 3-series and Mercedes C-class (although the South American market requires left-hand drive models). Some of the smaller models (such as VW Polo) have also won international export orders in competition with Brazil. Components manufacturers have perhaps more to fear, and this is also where employment creation possibilities are largest.

The implications of an FTA would clearly be greater specialisation and the development of product niches in South Africa. The net effects of this could be in either direction. The TNC nature of auto, however, suggests that any deal be accompanied by a common industrial policy approach to be worked out with long-term credible commitments in order to influence firms' location decisions. The current time frames committed to in the South African MIDP framework suggest that any trade deal look to the much longer-term and that in the shorter-term there may be more to be gained from interaction and co-operation around mechanisms to build production capabilities. Moreover, large excess capacity currently exists in the auto industry in Mercosur.

### *Machinery and equipment (including electrical and electronic products)*

This is a highly heterogeneous industry grouping. Competitiveness in international markets generally depends on having developed capabilities in meeting local demand. And, in some areas, such as domestic appliances, there are important scale economies. The SACU market may well be used to absorb production resulting from excess capacity in Mercosur. In machinery and equipment, much is already imported by SACU as the local market is too small to support production.

The larger Mercosur market also provides opportunities for South African firms to further specialise and expand. The greatest opportunities for producers clearly exist where there are already well-developed capabilities, the most obvious of which is in mining equipment. Opportunities also exist in the export of prepayment systems pending the adoption of this as a legal method of service delivery in Mercosur countries. In telecommunications, by comparison, there are already very well-developed industries in Mercosur.

A key dimension to machinery and equipment is the development of improved technological capabilities. This underpins the Advanced Manufacturing Technology Strategy of the Department of Science and Technology.<sup>9</sup> The National Tooling Initiative currently underway in South Africa is another closely related development. Brazil has also established capabilities in machinery and equipment with technology support — and this is a potentially fruitful area for cooperation between countries in SACU and Mercosur.

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<sup>9</sup> NACI/DST, *Advanced Manufacturing Technology Strategy*, 2003.

### *Electrical and electronic equipment*

There are strong similarities between Brazil and South Africa, but the South African industry is dwarfed in size. Both have large trade deficits, with the presence of multinationals. And, there is a very high degree of overlap in the products made and exported by each country. The high costs of capital in Brazil, high taxes and other obstacles, do suggest that there may be opportunities for South Africa, especially in niches. Countering this is the much greater scale economies available in Brazil (and Mercosur) due to the size of the economies.

### *Machinery (capital equipment)*

Brazil has a well-developed industry, with significant levels of exports (although an overall trade deficit). South Africa by comparison does not have a developed machinery manufacturing sector, apart from in certain niches such as mining equipment. A recent study found that South Africa's capabilities were best in medium technology products where competitiveness depends on a combination of price and non-price factors, including drawing on international production networks, local capabilities, and relatively good infrastructure.<sup>10</sup> There are also big opportunities for South African companies in niches which have developed based on supplying mining, who are in any event already exporting to Mercosur countries. The big competitors are American and Australian firms.

Local content requirements on capital equipment have apparently been set at 60% in Mercosur (and higher on some products). An

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<sup>10</sup> Fund for Research into Industrial Development Growth and Equity (FRIDGE), 'Study to facilitate the formulation of an integrated strategy for the retention and creation of employment in the South African Metals and Engineering Sector', October 2003.



important issue would be treatment of South African exports in terms of these requirements.

### *Chemicals, rubber and plastic products*

This is a very large and diverse grouping of industries, however, there are similar issues to those in metal products, above. South Africa has well developed upstream capabilities in a number of chemicals products and synthetic fibres, with large net exports. In downstream and more labour-intensive products, South Africa's trade performance is generally much poorer.

Mercosur, and Brazil in particular, has a very large chemicals industry. The sector is inward-oriented, with a high reliance on imported intermediates (industrial chemicals) in many areas, and an overall trade deficit. The industry is characterised by competitive weaknesses, and low returns.

While South Africa does export to Mercosur, the trade flows are both a small proportion of Mercosur's chemical imports and a small proportion of South Africa's exports. The most important South African exports are of phosphoric acid, solvents, pesticides, and ammonium nitrate (fertilizer). Much of South Africa's imports of basic chemicals are of products not manufactured locally.

In pharmaceuticals, Brazil has a large and well-developed industry. While South African trade flows with Mercosur are relatively small, imports are around ten times the size of exports.

In polymers and plastics there are several products in which South Africa has large exports, led by polypropylene, but there is little penetration of the Mercosur market. There is a similar situation in synthetic fibres. An FTA would enable the redirection of exports to Mercosur. But, it should be noted that this industry (as with much of basic chemicals) is highly capital-intensive. Of greater importance for employment creation and the growth of downstream industries is

the extent to which the FTA would limit the market power of South Africa's major upstream producers by enabling stronger competition.

Downstream consumer chemicals (such as toiletries, soaps and detergents) are largely produced in South Africa by transnational corporations, many of which are also present in Mercosur. Trade flows are currently very small, but there may be opportunities in niche products within cosmetics and toiletries.

Although South Africa has a competitive explosives industry, oriented largely to mining, mining explosives have not been exported into Mercosur, representing an important opportunity.

### *Textiles and clothing*

Liberalisation of textiles, clothing and footwear in South Africa has led to a far-reaching restructuring. The industry most at risk from a Mercosur FTA, footwear, has already contracted. In clothing and textiles, exported-oriented firms have either focused on specific niches such as within industrial textiles, household textiles and worsted woollen suits, or (principally in Lesotho) focused on the US market under AGOA.

Brazil is very competitive in knitted articles and in some wovens (for example, denim jeans). But, the more important question is whether the FTA would be sufficient to give South African firms an edge over Asian competitors in the Mercosur market. Opportunities should exist in areas where firms have already developed niche capabilities. This is particularly the case in products such as worsteds for countries such as Argentina with climates that are cooler than in Brazil. There is also the potential for firms located in SACU of Asian origin that currently export to the North American market to also export to Mercosur countries.

It is notable that Brazil implements a minimum reference price to prevent under-invoicing. Clothing and textiles is one of the sectors in which this applies. It should ensure that South African firms are at

less of a competitive disadvantage vis-à-vis Asian firms. With an FTA, it is in South Africa's interest that tariffs are properly applied on imports to Mercosur from other sources

### *Agriculture and food products*

The Mercosur countries are very large agricultural producers and exporters, in many cases of the same products as South Africa. This means that there are large competitive threats from an FTA and few immediate benefits. For example, they are major producers and exporters of beef, poultry, sugar, maize and citrus. There is currently trade between SACU and Mercosur, with the trade balance overwhelmingly in favour of Mercosur.

While Mercosur's tariffs on agricultural products are higher than the average for all goods, there are also a wide range of non-tariff barriers including sanitary and phytosanitary regulations, administrative procedures and licensing.

In the specific case of wine, one of South Africa's most successful exports, similar issues present themselves. Argentina is the world's fourth largest wine producer, ahead of South Africa in fifth position, although higher consumption in Argentina means that South Africa is the larger exporter. There are presently minimal trade flows between Mercosur and South Africa and, while there exists a threat from imports from Argentina under an FTA, South Africa's unique varieties and quality of wines mean there are significant opportunities in the large Mercosur market.

### *Summary*

The industry review reinforces the basic picture — that static advantages from an FTA appear limited and that increased trade as a result of liberalisation will serve to reinforce South Africa's existing patterns of comparative advantage. Opportunities do exist in several areas, but the impact will depend on ongoing development of South

African firms' production capabilities as envisaged in the IMS and AMTS.

### *New growth sectors?*

Trade negotiations focus on what exists in identifying sensitive industries, rather than what might be. Given the importance of possible dynamic gains for South Africa's approach to the FTA, it is important to assess possible growth areas. One of these is undoubtedly aircraft and components. South Africa already has strengths in related activities due to the historical emphasis on defence while Brazil has one of the largest and most successful industries for aircraft. The FTA may threaten South Africa's nascent industry, or provide opportunities. A second area for more detailed attention is in machinery and tooling.

## **Some conclusions and reflections on future research**

### *Conclusions*

The initial analysis suggests that gains from trade in a static framework will be very limited, and that trade flows with Mercosur would reinforce South Africa's existing pattern of comparative advantage, being centred on primary products, basic metals and basic chemicals, which are highly capital-intensive in nature. South Africa would be expected to have increased imports from Mercosur countries in higher value-added products. And, there are significant risks, based on existing trade flows and given the size of the Mercosur economies, for many product areas such as agricultural products.

There are, however, opportunities in value-added product niches, such as mining equipment, but on current evidence these appear relatively limited. The key to an agreement for South Africa should be in looking beyond the narrow effects of tariff liberalisation, both

in examining non-tariff barriers to trade, and in going to the relationship between trade and economic development, including possible areas for co-operation.

The main points relating to different possible legs to an agreement are as follows.

### *Trade-related*

- More important than tariffs are probably other restrictions and rules (which are much more limited in South Africa). This means having a very good understanding of such measures lest key issues are missed by a negotiation focused around tariffs.
- The potential for realising dynamic gains relates to intra-industry specialisation, location decisions of TNCs, and government-led interactions in, for example, aerospace, machinery & equipment, and motor vehicles.
- There are potential gains from increased competition in disciplining large firms, especially in upstream industries, which would yield more competitive pricing of intermediate inputs for downstream and more labour-intensive manufacturing.
- The nature of the issues needing to be addressed, and dynamic concerns and sector specific issues such as in the motor vehicle industry, strongly suggests that negotiations be conducted under the Enabling Clause for developing countries rather than under Article XXIV.

### *Collaboration and institutional learning*

- The similarities between, in particular, the Brazilian and South African economies means there are potential gains from collaboration and learning in areas such as industrial and technology policy tools, small business development, development finance and competition policy. For example, SABRAE has been very successful in small business development in Brazil, while the Brazilian development bank BNDES has well developed

capabilities. The Brazilian competition authority, CADE, is also grappling with similar challenges to those facing the South African authorities.

- The use of a minimum reference price by Brazil for imports of goods such as clothing is also one option for addressing endemic under-invoicing of such products.
- Collaboration could be expressed in concrete initiatives such as a formal agreement drawing on Brazil's expertise in aircraft to develop the South African industry with a view to the potential African markets.

#### *Political economy considerations*

- Political economy considerations are a key driver of moves to an FTA, and suggest an emphasis on collaboration and interaction, rather than a narrow trade focus.
- There are clearly important gains for South Africa from building strong links with other large economies of the South in attempts to reform international trade fora.

#### *Future research?*

An important concern is that research is biased to well-organised industries dominated by a small number of large firms. This is generally not consistent with the emphasis of the DTI on greater benefits, value addition and employment creation. The latter would suggest a careful analysis of industries such as plastic products; metal products; and machinery and equipment. In addition, attention needs to be paid to industries in which initiatives are planned or are underway, such as in tooling and aerospace.

Moreover, if one is to take the possible dynamic, rather than just the static, trade effects into account this implies understanding industries at a relatively disaggregated level in order to address issues such as intra-industry specialisation.

The analysis here suggests more detailed and up-to-date research across a range of areas, including:

- Sectors which are not well represented by industry bodies, especially those which are relatively more labour-intensive;
- On issues where the industry interests are not necessarily in line with the national interest (for example, the gains from increased competition in disciplining firms with market power);
- Sectors which are new and/or potentially dynamic; and
- Possibilities for co-operation, collaboration and learning.



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