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FROM PORTS TO POLICY



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EDITOR'S NOTE

From Ports to Policy is the inaugural edition of the Meridian Journal for Political Economy. This issue explores the role of trade in shaping economic outcomes, political priorities and international relations. As trade becomes increasingly intertwined with both geopolitics and domestic policymaking, understanding its broader implications has never been more important.

The edition brings together three contributions that examine trade through distinct yet interconnected lenses. The first explores competing views on monetary systems and inflation, providing a foundation for understanding the broader economic ideas that influence policymaking. Building on this, the second is an empirical analysis that investigates the relationship between free trade and economic development across advanced and developing economies, highlighting both the opportunities and challenges created by global economic integration. The final contribution is a policy brief that turns to the EU-Mercosur Trade Agreement, examining how these broader debates are translated into policy decisions and international negotiations. Together, the contributions trace the progression from economic theory to policy implementation, illustrating how ideas, institutions and political choices shape economic outcomes.

— MJPE Editor-in-Chief —



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Can Modern Economies Function Under Deflation?

Examining the relationship between monetary regimes, debt dynamics and long-term economic stability.

Author: Paolo Torreborre

Autumn 2025



Introduction

THE INFLATION TARGETING CONSENSUS

“We also continue to view a longer-run inflation rate of 2 percent as most consistent with our dual-mandate goals.”

— Jerome Powell, Chairman of the Federal Reserve (2023)

“An inflation rate of 2% is low enough for the economy to fully reap the benefits of price stability (...) while providing a margin against deflation.”

— European Central Bank Policy Brief (2024)

Whether it's the Fed, the ECB, or any other central bank, it has always been instilled that these institutions share two primary goals: promoting economic growth and maintaining low, stable inflation. Over the last thirty years, through trial and error, a 2% became the target inflation rate for most advanced economies, first set by Don Brash at the RBNZ in 1989. Despite Economics being a social science, although that is contested, the idea that economies should aim for, and can only thrive under, a 2% inflation rate is almost treated as a scientific law in university-level economics courses. In spite of this, almost all economists agree that rising productivity and innovation tend to exert downward pressure on prices. This begs the question: if productivity naturally makes goods cheaper, why do we fear falling prices so much?

According to the OECD (2023), inflation is a sustained rise in the general price level of goods and services in an economy over a period of time, usually measured by the Consumer Price Index (CPI). From this, we can derive the definition of deflation as a sustained fall in the general price level of goods and services in an economy over a period of time, also measured by CPI. Whenever deflation is suggested as a potential remedy for economies, it is immediately dismissed amid warnings of debt-deflation, delayed spending, or the ineffectiveness of conventional monetary policy. Conversely, it's striking that, despite widespread public discontent, high inflation and its consequences, such as uncertainty, wage-price spirals, and the erosion of savings, are often accepted as a natural by-product of modern economies: harmful, yet inevitable.

Whilst high or sudden deflation is damaging, a regime of mild, stable deflation, particularly when driven by productivity, might promote long-term stability and preserve purchasing power more effectively than perpetual inflation. This essay explores the alternative of operating under low and stable deflation, analysing the consequences and policy challenges it would pose in a fiat-currency world, whilst also comparing them with those of our current inflation-prone system.

How Deflation Shaped Modern Economic Thinking

Economists tend to separate deflation into “good deflation” or “bad deflation”, depending on their causes and how economies respond to them. Good deflation is determined by the supply side of the economy and is characterised by productivity growth, increased competition, and efficiency (Bordo and Filardo, 2005). Goods and services become cheaper because technological innovation leads to more efficient production and resource allocation, or because an increase in producers and trade leads to currency appreciation, making imports cheaper (Atkeson and Kehoe, 2004). Bad deflation, on the other hand, is determined by the demand side and is characterised by falling aggregate demand. Goods and services become cheaper because spending declines, businesses accumulate excess inventory, and are therefore forced to lower prices. For deflation to occur, supply must outpace demand, but the underlying reason for that imbalance determines whether it is good or bad deflation.

Historically, there are many instances of good deflation. Towards the end of the 19th century (1870 - 1896), both the US and the UK experienced annual deflation between 1-2% (Friedman and Schwartz, 1963). This was mainly due to the monetary system at the time, the gold standard. Every dollar or pound of conventional money was backed by a reserve of gold of equivalent value, and because there is a finite amount of gold, the money supply was naturally constrained. During this period, huge technological advances stimulated efficiency and productivity. The economy naturally grew because there was not enough gold to support the expanding money supply, supply outpaced demand, and prices fell, creating “good deflation.” A more recent and impressive example is Switzerland's steady deflation over

the 2010s, despite operating under a fiat currency system (IMF, 2016). After the Global Financial Crisis, investors rushed to the Swiss franc, which was seen as a “safe-haven” currency. The currency appreciated, making imports cheaper, and produced low and stable deflation of around 0.5% per year, while the economy maintained GDP growth of 1–2% and an unemployment rate of roughly 3%.

Naturally, it would be wrong to discuss historical examples of deflation without mentioning possibly the worst economic event of all time — the Great Depression. The Great Depression is perhaps the best example to highlight the pitfalls of deflation and is arguably one of the key reasons why modern economies operate within an inflation-averse framework. Following the 1920s credit boom and speculative surge in the U.S. stock market, the 1929 crash wiped out enormous household wealth and shattered business confidence. As firms and households rushed to repay their debts, spending collapsed, banks failed, and industrial production fell by nearly half (Bernanke, 1983). Since the U.S. operated under the gold standard, monetary expansion was restricted, preventing the Federal Reserve from injecting liquidity or lowering rates aggressively. The inability to expand the money supply meant that falling prices and output reinforced each other, creating the deflationary spiral that Irving Fisher later formalised through his “debt-deflation theory” (1933), explaining how falling prices increase the real burden of debt and trigger self-reinforcing downturns. This concept will be further explored throughout this essay.

The U.S. ultimately abandoned the gold standard in 1933, allowing the Federal Reserve to reflate the economy. After World War II, a modified version of this system was introduced under the Bretton Woods Agreement (1944). Currencies were pegged to the U.S. dollar, which itself was convertible into gold i.e a halfway house between the classical gold standard and today’s fiat money. This event, however, clearly traumatised an entire generation who sought to avoid deflation at all costs. It is perhaps no surprise that U.S. President Richard Nixon, under whose administration the Bretton Woods era ended and the world transitioned to a fiat currency system, was only sixteen when the Great Depression began, and would later pursue policies designed to prevent deflation from ever occurring.

Contemporary Dynamics of Inflation and Deflation

Many economists see inflation as useful because it creates a buffer against potential deflation and, in theory, prevents nominal interest rates from hitting the Zero Lower Bound (ZLB) (Bernanke, 2002). The ZLB occurs when inflation is near zero or negative, causing real interest rates to rise even if nominal or policy rates are already very low. Since interest rates generally cannot fall below zero, as people would simply hold cash rather than pay banks to store cash, central banks lose their ability to stimulate the economy through conventional rate cuts during downturns. Hence, the need for a 2% target helps ensure that monetary policy remains effective. Inflation can also provide benefits such as wage flexibility and debt management, as moderate inflation erodes the real value of public and private debt. However, it simultaneously diminishes savings, reduces purchasing power, and distorts asset prices, creating distributional and financial stability challenges (IMF, 2013).

Having already explored the potential upsides of deflation, it is important to address one of its main criticisms: the ineffectiveness of conventional monetary policy when nominal interest rates hit the ZLB. When this so-called liquidity trap occurs (Keynes, 1936; Krugman, 1998), policymakers are forced to turn to unconventional monetary policy, a strategy employed twice in the last two decades. Both instances followed major crises: the Global Financial Crisis (2008) and the COVID-19 pandemic (2020). In both cases, central banks implemented Quantitative Easing (QE) to stimulate growth by lowering long-term interest rates and supporting credit conditions. QE is the process by which a central bank purchases large quantities of bonds, usually government securities such as gilts, from financial institutions, thereby injecting liquidity into the economy and encouraging lending and investment (IMF, 2013).

Massive episodes of QE took place in 2009 and again in 2020, marking some of the most significant expansions of central bank balance sheets in modern history. Following the 2008 Global Financial Crisis, the Federal Reserve’s balance sheet rose from roughly \$900 billion in 2007 to over \$4.5 trillion by 2015, while the Bank of England’s increased from £200 billion in 2009 to around £895 billion by 2021 (Federal Reserve, 2022; Bank of England, 2022). In response to the COVID-19 pandemic, both institutions launched additional QE rounds, and by 2022, the Fed’s assets exceeded \$8.9 trillion, while the BoE’s balance sheet reached the equivalent of around 40% of UK GDP (FRED, 2023; Bank of England, 2022). These interventions successfully lowered long-term yields, stabilised credit markets, and supported post-crisis recovery, demonstrating that even when traditional monetary policy becomes ineffective near the ZLB, unconventional tools like QE can still provide powerful stimulus (Bank of England, 2022).

The Economic Fallout of Losing Control

We have established that both inflation and deflation can be beneficial when low and stable, and that various forms of monetary policy, both conventional and unconventional, can be employed during periods of high inflation or deflation as a remedy. It is important to note that, despite what policymakers might claim, neither low and stable inflation nor deflation can ever be guaranteed. Economic shocks, geopolitical crises, and behavioural expectations all play a role in destabilising price levels. This section explores which of the two extremes, runaway deflation or high inflation, poses the greater threat to economic stability.

Seen as the most damaging consequence of high deflation, debt-deflation has the capacity to cripple most developed economies today. As seen earlier, while inflation erodes the real value of debt, deflation has the opposite effect. When prices fall sharply, the real value of existing debt increases, leading to defaults, bankruptcies, and a downward spiral in spending, output, and prices (Fisher, 1933). Economies experiencing deflation rarely enter this spiral spontaneously; there is usually an initial shock, such as a financial crisis or credit bubble collapse, as was the case in 1929 with the Wall Street Crash. Since debts are fixed in nominal terms, repayment becomes harder as prices and incomes fall, forcing households and firms to deleverage by selling assets, which in turn drives asset prices down further. As collateral values fall, banks are forced to pull back lending, shrinking the money supply and intensifying deflation. This vicious cycle, first observed by Fisher, is described as the debt-deflation spiral (Bernanke, 1983).

Debt-deflation is particularly damaging because it amplifies recessions, turning a normal downturn into a depression as falling prices increase real debt burdens and trigger widespread defaults. Rising real interest rates further discourage borrowing and spending, while asset-price collapses erode wealth and collateral values, tightening credit conditions. At the same time, monetary policy becomes ineffective near the ZLB, and expectations of further price declines undermine confidence and delay spending, trapping the economy in a self-reinforcing cycle of contraction. Economists are especially fearful of debt-deflation in today's high-leveraged, fiat-money economies, as debt levels are astronomically higher than those in 1930 (Eggertsson and Krugman, 2012).

While Debt-deflation can clearly paralyse an economy, its inflationary counterpart, hyperinflation, can be equally destructive. Hyperinflation can also be triggered by economic shocks, but it often hinges on unanchored inflation expectations (Cagan, 1956). Normally, inflation expectations are “anchored” around a target such as 2%, which helps stabilise wage and price-setting behaviour. However, when the public begins to expect ever-rising prices, workers demand higher wages to preserve purchasing power, and firms pre-emptively raise prices, creating a wage–price spiral that fuels itself (Blanchard, 2016). Because wages are typically “sticky”, they adjust slowly relative to prices. Workers are always chasing inflation, which can sustain prolonged, high inflation or escalate into hyperinflation.

There are multiple examples of this throughout history. The Weimar Republic (Germany, 1921–1923) experienced one of the most extreme hyperinflations ever recorded: prices doubled every 3.7 days, and the exchange rate collapsed from 4.2 marks per U.S. dollar in 1914 to 4.2 trillion by 1923 (Bresciani-Turroni, 1937; Ferguson, 1995). The government printed vast quantities of money to pay war reparations and domestic debts, ultimately rendering the currency worthless and wiping out savings. Similarly, Zimbabwe's hyperinflation in the 2000s peaked at 79.6 billion percent per month in November 2008, as money printing was used to finance government spending amid a collapsing economy (IMF, 2009). Across Latin America during the 1980s, countries such as Argentina, Brazil, and Peru faced chronic high inflation, often exceeding 100% annually, as fiscal deficits and weak policy credibility eroded public confidence (Dornbusch and Fischer, 1993).

Hyperinflation devastates economies because it destroys the value of money, erodes savings, and collapses real incomes, forcing citizens to barter, dollarise, or rely on foreign currencies. Prices become meaningless, planning becomes impossible, and living standards deteriorate sharply. Beyond economics, hyperinflation undermines social cohesion and political legitimacy, as seen in both Weimar Germany and Zimbabwe, where extreme price instability contributed to political radicalisation and social unrest.

Which Framework Delivers Greater Stability?

Having explored both deflation, inflation and their respective pitfalls, it becomes clear that deflation driven by productivity can raise real wages, strengthen purchasing power stability, benefit savers, and discipline credit creation and speculative bubbles (Bordo and Filardo, 2005). By encouraging efficiency and deterring excessive borrowing, mild deflation acts as a natural check on financial exuberance, fostering more sustainable long-term growth. However, in practice, low and stable deflation would be difficult to sustain in today's fiat-money system, which depends on continuous money-supply growth and debt expansion. Such economies cannot tolerate prolonged price declines, since governments rely on mild inflation to service public debt and maintain fiscal flexibility (Eichengreen, 1996; Mishkin, 2007).

When comparing the extremes of debt-deflation and hyperinflation, both are devastating, but debt-deflation tends to be more sensitive to external shocks, whereas hyperinflation can spiral more autonomously once expectations become unanchored. Moreover, debt-deflation has occurred under both commodity-backed and fiat-currency regimes, meaning it is not inherently a symptom of operating under low and stable deflation. Modern monetary policy tools, such as Quantitative Tightening (QT), also lack the stimulative potency of QE, since reducing central-bank balance sheets contracts liquidity rather than boosting it. This asymmetry highlights how monetary policy is structurally biased toward expansion, reinforcing the preference for mild inflation over deflation (IMF, 2013).

Inflation can also be viewed as a "hidden tax," disproportionately affecting lower-income groups while benefiting asset holders and the wealthy elite (Piketty, 2014). Because it erodes the real value of savings, inflation advantages those whose wealth is concentrated in appreciating assets such as real estate, equities, and financial instruments. Meanwhile, households with little or no exposure to such assets experience a decline in purchasing power, as wages typically fail to keep pace with rising prices. Over time, this dynamic widens wealth inequality, transferring value from wage earners and savers to those who already possess capital.

Conversely, mild and stable deflation could theoretically have the opposite effect. Falling prices would increase the real value of savings and wages, strengthening the financial position of lower-income households that rely more on cash and fixed incomes. However, because deflation raises the real burden of debt, it would disadvantage borrowers and highly leveraged institutions, making it politically and financially difficult to sustain in modern, debt-driven economies. While lower-income households with debt would still face challenges, they would at least no longer operate in a system that is built to repress them from achieving financial stability and independence.

Ultimately, the persistent 2% inflation target reflects not just economic reasoning but institutional self-interest and narrative reinforcement within academia, central banks, and the media (Mishkin, 2007; Stiglitz, 2018). The modern fiat framework rewards credit expansion, asset accumulation, and short-term fiscal convenience, ensuring that inflation remains the "path of least resistance." As such, while productivity-driven deflation could, in theory, enhance long-term prosperity and purchasing power, our current system is structurally and politically incapable of embracing it.

Conclusion

In conclusion, while both inflation and deflation carry risks, a regime of mild, productivity-driven deflation could, in theory, offer greater long-term stability, strengthen purchasing power, and restore a more equitable distribution of wealth. Unlike inflation, which silently erodes value and encourages debt dependence, deflation rewards efficiency, savings, and genuine productivity growth. Yet, in practice, such a system remains incompatible with the modern fiat-money framework, which relies on continual credit expansion and mild inflation to sustain debt-laden economies. The challenge, therefore, is not proving that deflation can be beneficial, but recognising that the current economic architecture is too dependent on inflationary mechanisms to allow it. Until that structure changes, the pursuit of permanent price stability will remain constrained by a system designed to inflate.

Who Benefits from Free Trade? An Empirical Analysis of Economic Gains Across Countries

Examining whether the benefits of trade liberalisation are distributed evenly between advanced and developing economies.

Author: Paolo Torreborre

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Abstract

This paper examines whether free trade primarily promotes the interests of powerful economies. Drawing on competing perspectives from international political economy, it evaluates three potential mechanisms through which asymmetries may emerge: the distribution of trade flows, unequal domestic capacity to benefit from liberalisation, and institutional advantages embedded within the global trading system. Using a harmonised exporter–importer panel covering 1995–2020, the analysis combines structural gravity models, an event-study framework, and tariff-based specifications to assess the relationship between economic power and the gains from trade liberalisation.

The results provide only partial support for the proposition that free trade disproportionately benefits powerful economies. The baseline gravity model finds that preferential trade agreements (PTAs) are associated with approximately 8% higher bilateral trade flows. However, once dyad and year fixed effects are introduced through a structural gravity model estimated using Poisson Pseudo-Maximum Likelihood (PPML), neither PTAs nor their interaction with economic size are statistically significant. Similarly, tariff reductions do not appear to generate larger trade-flow gains for economically powerful states.

The strongest evidence of asymmetry emerges through the domestic gains channel. While the average effects of liberalisation on domestic value added (DVA) and terms of trade are largely insignificant, interaction effects between liberalisation and GDP are consistently positive and statistically significant. These findings suggest that larger economies are considerably more successful at converting trade liberalisation into domestic economic gains, reflecting differences in productive capacity, industrial diversification, and integration into higher-value segments of global supply chains.

The paper concludes that free trade does not inherently privilege powerful economies through greater access to trade itself. Rather, inequalities arise from differences in countries’ ability to capture and retain the benefits generated by openness. Consequently, policies aimed at making trade more inclusive should focus less on restricting liberalisation and more on strengthening the productive and institutional capacities of smaller and developing economies.

Introduction

The concept of free trade is often presented as a simple extension of David Ricardo’s theory of comparative advantage. In practice, however, it has evolved into a far more complex system shaped by institutions, rules, and negotiated procedures. Intergovernmental organisations such as the IMF, the UN, and most prominently the WTO sit at the centre of this system, acting as mediators, facilitators, and referees. Although these institutions are formally neutral, scholars of International Political Economy, including critics such as Martin Khor and Dani Rodrik, have long questioned whether free trade genuinely benefits all nations or whether it functions as a tool that disproportionately advances the interests of global powers.

This paper argues that free trade does not inherently promote the interests of the most powerful economies. On paper, free trade does not favour any particular category of states. Yet in practice, powerful economies often appear to gain more. This raises a central question: why do stronger economies seem to benefit disproportionately if the rules of free trade are, in principle, universal? Several explanations emerge from different strands of IPE theory. One liberal perspective, rooted in commercial peace theory, suggests that all economies share common interests, most fundamentally the avoidance of conflict, and that free trade promotes these shared interests rather than privileging the powerful. By contrast, historical and structural perspectives emphasise how colonial legacies, unequal capacity for diversification, and gendered labour markets leave many weaker economies unable to take full advantage of liberalisation, even when access to markets is formally equal.

Before examining these claims empirically, it is necessary to clarify key terms. In this study, free trade refers to cross-border exchange that is not impeded by protectionist measures, consistent with the original principles of GATT (1947). Questions of “fair trade”, while normatively important, fall outside the technical definition used in IPE. The term “powerful economies” is understood pragmatically as referring to the G20 countries, which together account for approximately 85% of global GDP and 75% of world trade. Finally, interests are interpreted broadly. Although economic interests are central, political and strategic interests are also relevant, particularly in the negotiation and design of trade agreements.

To assess whether free trade disproportionately favours powerful economies, the remainder of the paper integrates these conceptual debates with quantitative evidence. The next section reviews how theories of commercial peace, structural inequality, and institutional bargaining map onto testable economic mechanisms. The Data and Methodology section then introduces a harmonised panel dataset (1995–2020) and sets out three empirical models: a structural gravity analysis of the distribution of trade flows (Models 1A–1B), an event-study examining domestic value added following liberalisation (Model 2), and a tariff-based PPML model assessing institutional asymmetries in trade policy (Model 3). The Findings section presents results for each mechanism, followed by a discussion of their theoretical implications and a conclusion summarising the contribution of the paper.

Literature Review

This section explores three distinct strands of international political economy and international trade theory. Each one aims to highlight a particular mechanism through which free trade may, or may not, primarily promote the interest of powerful economies. These three mechanisms form the conceptual foundations for what the models aim to answer.

I Common Interests vs. Distributional Asymmetries

Debates about the political consequences of free trade often begin with the liberal tradition, particularly the idea of commercial peace. Commercial peace, sometimes referred to as capitalist peace, parallels the democratic peace theory in international relations. While democratic peace theory suggests that democratic states are less likely to engage in war because of shared norms and aligned interests (Doyle, drawing on Kant’s Perpetual Peace), commercial peace extends this logic to economic interdependence. According to Norman Angell and later Thomas Friedman, expanding cross-border trade ties reduces the likelihood of interstate conflict because the economic costs of war grow prohibitively high. Friedman’s famous claim that “no two countries with McDonald’s have fought a war against each other” embodies this intuition: free trade promotes a set of common interests shared across states. Viewed through this liberal lens, free trade promotes the interests of all economies, powerful and weaker alike, by lowering the risk of conflict and increasing economic welfare. States, regardless of their status, share the fundamental interest of survival, and avoiding economic crisis or military confrontation is part of that shared interest. However, this emphasis on common interests overlooks a crucial question: how are the gains from free trade distributed? From a realist or structural political economy perspective, even if free trade creates aggregate welfare gains, these gains may be skewed toward powerful economies with greater productive capacity, market size, and bargaining leverage. The commercial peace argument does not rule out distributional asymmetries; it simply does not address them. If free trade generates unequal gains, then the structure of global trade flows should exhibit heterogeneous effects by economic power. More powerful economies should be disproportionately embedded in global trade networks and benefit more strongly from integration measures such as PTAs.

II Historical Legacies and Unequal Capacity to Benefit

The second mechanism concerns not trade flows themselves but the capacity of states to capture domestic gains from trade. Free trade does not operate on a level playing field. Contemporary economic hierarchies are deeply shaped by colonial legacies, which continue to affect the productive structure, bargaining power, and institutional capacity of many developing economies. As Karl Polanyi argued, markets are embedded within society, meaning economic exchange cannot be separated from the legal, social, and political structures that shape it. Colonial rule fundamentally altered these structures in many LEDCs, entrenching patterns of extraction and underdevelopment. Nathan Nunn’s influential research demonstrates the long-lasting economic harm associated with the Trans-Atlantic Slave Trade, showing that historical extraction has persistent negative effects on income, institutional quality, and diversification even centuries later. These historical forces have shaped contemporary trade patterns in several ways:

1. **Limited diversification:** Many formerly colonised states continue to depend heavily on primary exports and face barriers to upgrading into higher-value-added sectors,
2. **Economic and political instability:** Colonial borders and institutions often produced fragile political orders, corruption, or civil conflict, further constraining economic development.

3. Dependence on advanced economies: LEDCs and NICs often lack the bargaining leverage or industrial base needed to fully benefit from FTAs.

A related but distinct channel concerns gender inequality, which interacts with historical legacies to further reduce productive capacity. Labour participation rates remain dramatically skewed in many African, Asian, and Latin American economies; 4:1 in parts of Africa, 3:1 in Asia, and 2:1 in South America (Verick, 2014). Colonial-era norms frequently entrenched gendered divisions of labour (King & Hill, 1993), limiting education and formal employment opportunities for women. These labour constraints reduce diversification and slow structural transformation, which in turn limit the capacity of these economies to benefit from trade liberalisation. In contrast, countries whose postcolonial trajectories enabled industrial upgrading, such as India, illustrate that historical disadvantage does not mechanically determine outcomes but significantly shapes the range of feasible gains. If historical legacies reduce states' ability to convert liberalisation into domestic gains, then after PTAs or tariff reductions, we should observe unequal improvements in domestic value-added (DVA%) and terms of trade, with powerful economies showing much larger post-liberalisation gains.

III Institutions, Rule-Making, and Bargaining Asymmetries

A third perspective focuses on the institutional architecture of the international trading system, particularly the role of the WTO/GATT in shaping liberalisation outcomes. Trade governance is formally rules-based, yet the influence of powerful economies is evident in agenda-setting, dispute settlement, and negotiation outcomes. Developing countries have often found themselves at a disadvantage within these processes. While WTO membership is nearly universal, the ability to shape rules varies dramatically. Scholars such as Narlikar (2003) show that developing countries have made institutional gains only when forming coalitions, such as the G20 (trade group), the African Group, or the Cairns Group, allowing them to collectively bargain against larger economies. Without such coalitions, liberalisation rules often reflect the preferences of the most powerful members. This institutional asymmetry matters because tariff reductions and trade rules are not neutral: they may be designed or sequenced in ways that benefit powerful economies disproportionately. Even when free trade is formally reciprocal, countries with larger markets, deeper capital bases, or stronger negotiating positions may extract more favourable terms or adjust more quickly to openness. If trade institutions amplify asymmetries in bargaining power, then identical reductions in MFN tariffs should generate stronger export responses for powerful economies.

Data and Methodology

I Datasets

To assess whether free trade disproportionately promotes the interests of powerful economies, this study constructs a harmonised exporter–importer–year panel spanning 1995–2020. The dataset combines bilateral trade information, structural gravity variables, preferential trade agreement indicators, domestic value-added measures, macroeconomic aggregates, and trade policy data. This integration enables the analysis of not only cross-country variation in trade flows but also the domestic gains and institutional implications of trade liberalisation.

The core bilateral trade data are sourced from CEPII's BACI database, which provides harmonised merchandise export flows at the exporter–importer–year level. These flows are merged with structural gravity variables from the CEPII Gravity dataset, including weighted distance (*Distw*), contiguity (*Contig*), and common official language (*Comlang_off*). Although these variables are absorbed by dyad fixed effects in the preferred PPML specification, they remain essential for validating the structural gravity framework and constructing the baseline log-linear benchmark. Preferential trade agreements are recorded using the dyadic (*RTA*) indicator from CEPII's RTA dataset.

To examine domestic gains from liberalisation, exporter-year indicators of domestic value added in gross exports (DVA%) are imported from the OECD TiVA database. Broader macroeconomic variables, including GDP (used as a proxy for economic size and structural power) and terms-of-trade indices, are obtained from the World Development Indicators. Finally, time-varying measures of trade policy restrictiveness are constructed using MFN applied tariff rates from the WTO Integrated Database, merged at the exporter–year level.

The resulting merged panel contains approximately 700,000 observations. Variables that vary only by exporter and year; GDP, tariffs, DVA%, and terms of trade, are merged onto each bilateral dyad through the exporter identifier. This structure supports the estimation of both bilateral gravity models and exporter-level event-study designs within the same consolidated empirical framework.

II Key Variables

(a) Dependent variables

1. Bilateral Exports ($Trade_Value_{ijt}$)

The dependent variable in the gravity model is the value of exports from country o (origin) to country d (destination) in year t . These flows serve to quantify the structure and distribution of global trade.

2. Domestic Value Added ($Dvashare_{it}$)

For the event-study analysis, the principal outcome is the share of domestic value added embodied in an exporter's gross exports. This captures the extent to which export revenues translate into domestic production benefits.

3. Terms of Trade (ToT_{it})

As a secondary event-study outcome, the terms-of-trade index reflects the purchasing power of a country's exports relative to its imports.

(b) Trade Policy and Liberalisation Variables

1. Preferential Trade Agreement (RTA_{ijt})

A binary variable taking value 1 when a bilateral PTA is in force. PTA adoption is used as a discrete trade-liberalisation event in both gravity and event-study models.

2. MFN Tariffs ($Tariff_{it}$)

The exporter's applied MFN tariff rate, varying by exporter-year. This variable is central to Model 3 and is also used to define tariff-based liberalisation episodes.

(c) Economic Size and Structural Controls

1. Gross Domestic Product (GDP_{ijt})

Exporter GDP is used as a continuous measure of economic "power," capturing market size, bargaining strength, and structural capacity to benefit from liberalisation.

2. Gravity Controls

Time-invariant bilateral characteristics: distance, contiguity, and common official language, are taken from CEPII Gravity. These variables are absorbed by dyad fixed effects in PPML specifications.

III Identification of Liberalisation Events

Liberalisation episodes are defined through two complementary mechanisms. The baseline event is the year in which a bilateral preferential trade agreement ($RTA_{ijt} = 1$) first enters into force. This captures institutional liberalisation arising from formal negotiated agreements. As a robustness approach, a tariff-based liberalisation event is defined as the beginning of any three-year period during which an exporter's MFN tariff rate declines by at least the 75th percentile of all observed tariff reductions in the sample. This identifies episodes of unilateral or broad-based liberalisation not

captured by PTA adoption. For each exporter, the first qualifying event defines t_0 , and event-time indicators are constructed over a symmetric ± 5 -year window. These indicators are used to trace dynamic adjustments in DVA% and terms of trade around liberalisation.

IV Models

Model 1A – Baseline Log-Linear Gravity (OLS)

The benchmark gravity equation is first estimated in log-linear form using ordinary least squares, where Year fixed Effects (γ_t) control for global shocks. Standard errors are clustered at the dyad level to account for serial correlation within pairs. Model 1A provides the traditional benchmark elasticities and illustrates the “common interest” pattern predicted by classical gravity theory.

$$\ln \text{trade}_{ijt} = \alpha + \beta_1 \ln \text{GDP}_{it} + \beta_2 \ln \text{Dist}_{ij} + \beta_3 \text{Contig}_{ij} + \beta_4 \text{Comlang}_{ij} + \beta_5 \text{RTA}_{ijt} + \gamma_t + \varepsilon_{ijt}$$

Although widely used, the log-linear OLS specification suffers from two key limitations: zero trade flows and heteroskedasticity. Logging the dependent variable requires dropping all observations with zero trade i.e observations that are economically meaningful and informative about trade barriers. Variance in trade flows increases with their level. Under such conditions, log-linear OLS yields inconsistent estimates because the log transformation distorts the error structure (Santos Silva & Teneyro, 2006). To address these issues, the preferred specification employs Poisson Pseudo-Maximum Likelihood (PPML), which: models trade flows in levels, naturally handles zero flows, remains consistent under heteroskedasticity, and preserves the multiplicative structure of the gravity model.

Model 1B – Structural Gravity PPML

This model applies the structural gravity framework using Poisson Pseudo-Maximum Likelihood (PPML). The interaction term tests whether PTAs expand trade disproportionately for large economies, directly corresponding to the first mechanism. Dyad fixed effects (μ_{ij}) absorb all time-invariant bilateral trade costs such as distance, contiguity, and shared language, while year fixed effects (γ_t) capture global shocks and common macroeconomic trends. Standard errors are clustered at the dyad ($i-j$) level to account for serial correlation within country pairs.

$$E[\text{trade}_{ijt}] = \exp(\beta_1 \ln \text{GDP}_{it} + \beta_2 \text{RTA}_{ijt} + \beta_3 (\ln \text{GDP}_{it} \times \text{RTA}_{ijt}) + \mu_{ij} + \gamma_t).$$

Model 2 – Event-Study of Domestic Gains

To analyse whether trade liberalisation yields asymmetric domestic benefits, Model 2 estimates the dynamic response of the outcome variable (Y_{it}), either domestic value added (DVA%) or terms of trade, around each exporter’s first liberalisation year (t_{0i}). The specification traces event-time adjustments using a set of indicators that capture relative years before and after liberalisation. Exporter fixed effects (α_i) absorb all time-invariant country characteristics, while year fixed effects (γ_t) control for global shocks. Standard errors are clustered at the exporter level. Positive post-event coefficients indicate domestic gains from liberalisation, and interacting event-time indicators with GDP allows testing for heterogeneous effects by economic power.

$$Y_{it} = \sum_{\tau=-5, \tau \neq -1}^{+5} \delta_{\tau} I(t - t_{0i} = \tau) + \alpha_i + \gamma_t + \varepsilon_{it},$$

Model 3 – Tariff Liberalisation and Institutional Asymmetry

Model 3 assesses whether reductions in MFN tariffs disproportionately expand trade for powerful economies. The specification estimates the semi-elasticity of bilateral exports with respect to exporter–year MFN tariff rates ($Tariff_{it}$), and includes an interaction term with exporter GDP to test whether larger economies convert tariff cuts into greater trade gains. Dyad fixed effects (μ_{ij}) absorb all time-invariant bilateral characteristics, while year fixed effects (γ_t) capture global shocks. Standard errors are clustered at the dyad level. A positive coefficient on the interaction term would indicate that tariff reductions benefit large economies more strongly, consistent with institutional–power asymmetry mechanisms.

$$E[trade_{ijt}] = \exp(\beta_1 Tariff_{it} + \beta_2 \ln GDP_{it} + \beta_3 (Tariff_{it} \times \ln GDP_{it}) + \mu_{ij} + \gamma_t)$$

Findings

Table 1: Descriptive Statistics

Variable	Observations	Mean	Std. Dev.	Min	Max
Trade value	708,341	1,318.95	51,967.73	0.001	17,000,000
GDP	681,517	322 billion	1.07 trillion	11.9 million	27.7 trillion
Distance	653,520	7,504.85	4,541.40	23	19,778
RTA	653,671	0.143	0.350	0	1
Tariff	412,976	9.82	5.65	0	47.24
Domestic value added	334,295	125,400.30	228,437.10	8.06	2,781,581
Terms of trade	633,840	101.63	23.40	19.5	955.5

Notes: RTA refers to preferential trade agreement status. Domestic value added refers to domestic value added embodied in gross exports. Terms of trade are index values. GDP and trade value are reported in current values from the underlying dataset.

Table 1 presents summary statistics for the main variables used in the empirical analysis. The final dataset combines bilateral trade flows, macroeconomic indicators, trade policy variables and domestic value-added measures. The sample contains more than 700,000 bilateral trade observations, although coverage varies across variables due to differences in data availability. Preferential trade agreements are present in approximately 14% of observed dyad-year pairs, while the average applied tariff rate is just under 10%. The wide dispersion in trade values, GDP and domestic value added reflects the substantial heterogeneity between countries in the sample, making it appropriate to examine whether economic size affects the ability to benefit from trade liberalisation.

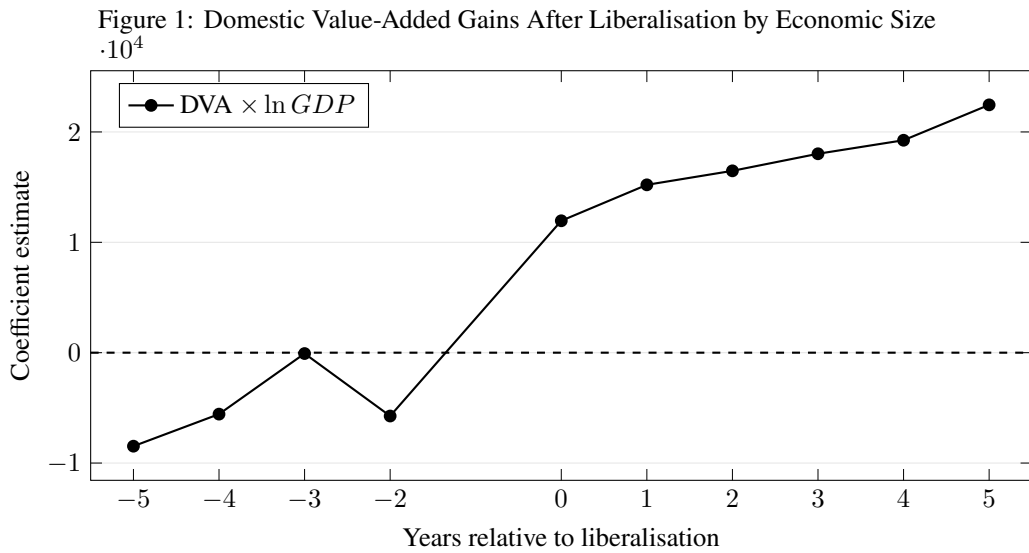
Table 2: Gravity Model Results

Model	$\ln GDP$	$\ln Distance$	Border	Language	PTA	$PTA \times \ln GDP$	Year FE	Dyad FE
OLS Gravity (1a)	0.205*** (0.004)	-0.222*** (0.013)	0.363*** (0.071)	-0.293*** (0.027)	0.080*** (0.027)	– –	Yes	No
PPML Gravity (1b)	0.404*** (0.102)	– –	– –	– –	-0.632 (1.879)	0.010 (0.076)	Yes	Yes

Notes: Robust standard errors clustered at the dyad level are reported in parentheses. Model 1A estimates a log-linear OLS gravity model. Model 1B estimates a structural gravity model using PPML with dyad and year fixed effects. Border refers to shared border; language refers to common official language; PTA refers to preferential trade agreement. *** p<0.01, ** p<0.05, * p<0.10.

Table 2 presents the gravity model results. In Model 1A, the baseline OLS specification produces results consistent with the conventional gravity literature. Economic size is positively and significantly associated with bilateral trade, while distance exerts a negative effect on trade flows. The coefficient on preferential trade agreements is also positive and statistically significant, suggesting that PTAs are associated with an approximate 8% increase in trade within the log-linear specification. Taken in isolation, these findings would appear to support the view that trade liberalisation promotes greater economic integration between countries. Model 1A is estimated on 623,658 observations.

Model 1B, however, produces a more cautious interpretation once the preferred PPML specification is employed. GDP remains positive and statistically significant, confirming that larger economies trade more overall. However, the PTA coefficient becomes statistically insignificant, and the interaction between PTAs and GDP remains close to zero. This suggests that the positive PTA effect observed in the baseline OLS model may partly reflect unobserved characteristics of country pairs rather than a causal effect of trade agreements themselves. More importantly, there is no evidence that trade agreements systematically generate larger trade-flow gains for economically powerful states. Model 1B is estimated on 628,557 observations.



Notes: The figure plots event-study interaction coefficients between liberalisation timing and $\ln GDP$, using year -1 as the omitted baseline. Positive coefficients indicate stronger domestic value-added gains for larger economies following liberalisation.

Figure 1 presents the event-study interaction coefficients between liberalisation and economic size. Unlike the average event-study effects, which are not statistically significant, the GDP interaction terms become positive and statistically significant from the year of liberalisation onwards. The coefficient rises from 11,951 in year 0 to 22,454 by year +5, suggesting that larger economies are increasingly better able to convert trade liberalisation into domestic value-added gains over time.

This represents the strongest evidence of asymmetry in the paper. The results suggest that free trade does not necessarily favour powerful economies by expanding their trade flows more directly. Instead, the advantage appears to arise through domestic value capture: larger economies are better positioned to retain and transform the opportunities created by liberalisation into domestic production gains.

Importantly, these results emerge despite the absence of significant average effects in the event-study analysis. Liberalisation does not appear to generate uniformly positive outcomes across all countries. Instead, the gains become increasingly concentrated among larger economies over time. This divergence suggests that economic size influences not whether countries participate in trade, but how effectively they are able to exploit the opportunities that liberalisation creates.

Table 3: Tariff Barriers and Economic Size

Model	Tariff Rate	$\ln GDP$	$Tariff \times \ln GDP$	Year FE	Dyad FE	Obs.
PPML Tariff (Model 3)	0.247 (0.176)	0.611*** (0.194)	-0.009 (0.007)	Yes	Yes	409,469

Notes: PPML gravity specification with dyad and year fixed effects. Robust standard errors clustered at the dyad level are reported in parentheses. The interaction term tests whether tariff barriers affect economies differently according to economic size. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$.

Table 3 examines whether tariff barriers affect countries differently depending on their economic size. Consistent with the previous gravity specifications, GDP remains positively associated with trade and is statistically significant. However, neither the tariff coefficient nor the interaction between tariffs and economic size is statistically significant.

The results therefore provide little evidence that tariff barriers systematically disadvantage smaller economies relative to larger ones. While tariffs may influence trade flows in individual cases, their effects do not appear sufficiently strong or consistent across the sample to generate a measurable asymmetry. This contrasts with the domestic value-added analysis, where economic size was found to play a significant role following trade liberalisation.

Taken together, the findings suggest that the primary source of unequal outcomes under free trade is not differential exposure to tariff barriers, but rather differences in countries' ability to capture and retain value once trade opportunities are created.

Discussion

The empirical results provide only partial support for the argument that free trade primarily promotes the interests of powerful economies. The gravity-model evidence suggests that larger economies trade more overall, but there is little indication that trade agreements themselves disproportionately increase trade flows for economically powerful states. While the baseline OLS specification identifies a positive association between PTAs and trade, this relationship disappears once the preferred PPML model controls for unobserved dyad-specific characteristics. The evidence therefore does not support the claim that trade liberalisation inherently advantages larger economies through greater market access alone.

This finding partially supports liberal theories of trade, which argue that trade liberalisation can create broadly shared gains. If free trade agreements directly favoured powerful economies through trade flows, we would expect the RTA-GDP interaction to be positive and significant. Instead, the coefficient is only 0.010 with a p-value of 0.897, which provides no support for that mechanism.

However, the event-study results support a more structural interpretation. The average country does not seem to experience major improvements in domestic value added or terms of trade after liberalisation. Yet larger economies do experience significantly stronger domestic value-added gains after liberalisation. The GDP interaction effects are positive and significant from year 0 through year +5, increasing from around 11,951 in the year of liberalisation to 22,454 five years later. This suggests that the asymmetry is not mainly about access to trade, but about the capacity to capture value from trade.

This finding aligns closely with the paper's theoretical argument regarding historical legacies and unequal productive capacity. Countries with larger domestic markets, more diversified industrial structures, stronger institutions, and deeper integration into global value chains are better positioned to exploit the opportunities created by market opening. Smaller or less developed economies may gain access to international markets, but often remain concentrated in lower-value stages of production, limiting their ability to translate liberalisation into sustained domestic gains.

The results therefore suggest that free trade is not inherently biased in its formal structure, but it operates within an unequal global economy. This means that formally equal rules can still produce unequal outcomes. Powerful economies do not necessarily benefit more because the rules explicitly favour them, but because they possess the structural capacity to make better use of those rules.

Conclusions

This paper examined whether free trade primarily promotes the interests of powerful economies. The findings provide partial support for this claim. The evidence does not show that trade agreements or tariff reductions directly produce larger trade-flow gains for powerful economies. In both the preferred PPML gravity model and the tariff model, the interaction terms with GDP are statistically insignificant.

The strongest evidence of asymmetry appears in Model 2. Larger economies experience significantly greater domestic value-added gains after liberalisation, with positive and significant GDP interaction effects from the year of liberalisation through four years afterwards. This suggests that powerful economies are better able to transform liberalisation into domestic economic benefits.

The main conclusion is therefore that free trade does not automatically favour powerful economies at the level of trade flows, but it does tend to favour them at the level of domestic value capture. The issue is not simply whether countries can trade, but whether they have the productive capacity to benefit from trade.

From a policy perspective, this means that making trade fairer requires more than reducing tariffs or signing new agreements. Developing and smaller economies need support to build productive capacity, diversify exports, improve infrastructure, and move into higher-value sectors. Trade agreements should therefore be accompanied by capacity-building measures, technology transfer, industrial upgrading support, and targeted development finance.

Ultimately, the findings suggest that free trade is neither purely exploitative nor automatically beneficial. Its effects depend on the structural conditions of the countries involved. Liberalisation may create opportunities for all states, but powerful economies remain better placed to convert those opportunities into lasting domestic gains.



Reassessing the EU–Mercosur Agreement and the Future of Sustainable Trade Policy

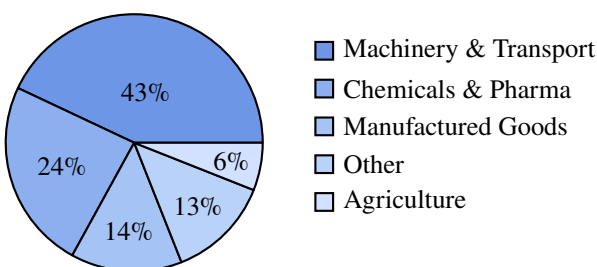
Assessing whether the benefits of the EU–Mercosur Agreement outweigh its environmental and political risks.

Executive Summary

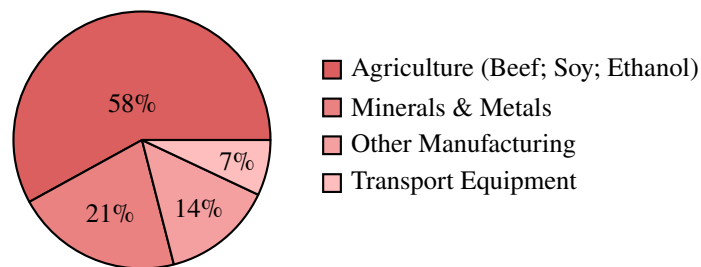
EU–Mercosur Trade at a Glance

- **€88 billion** in annual EU–Mercosur trade
- **91%** of tariffs eliminated under the agreement
- EU companies expected to save approximately **€4 billion/year** in duties
- The largest trade agreement ever concluded by the EU
- Combined market of **750 million consumers**

EU Exports to Mercosur



Mercosur Exports to the EU



Sources: European Commission (2019), EPRS (2025), Eurostat (2024), UN Comtrade (2023).

Following the update to the Trade Pillar Agreement between the European Union (EU) and Mercosur on 6 December 2024, the long-awaited Free Trade Agreement (FTA), negotiated over more than twenty-five years and marked by multiple suspensions, appears to be regaining momentum. The proposed agreement would eliminate tariffs on approximately 91% of goods traded, connecting two major economic blocs that together represent over 750 million people and a combined annual trade value of €88 billion (European Commission, 2019; EPRS, 2025).

This makes the EU–Mercosur FTA the largest trade agreement ever concluded by the European Union, surpassing the Comprehensive Economic and Trade Agreement (CETA) with Canada and valued at nearly €15 billion more in total trade volume. It also significantly exceeds the scale of the EU–Japan Economic Partnership Agreement (EPA), being nearly four times larger in trade coverage. Once implemented, the agreement could reduce duties for European companies and consumers by approximately €4 billion annually, bolstering competitiveness and export opportunities (European Commission, 2019).

However, the FTA remains politically contentious. The deal reached a major impasse in 2019, when environmental and political opposition, particularly concerns over Amazon deforestation, halted ratification efforts. The 2024 Trade Pillar revision sought to address these concerns through enhanced sustainability provisions, yet challenges persist. Under President Ursula von der Leyen, the agreement must now navigate renewed scrutiny, particularly regarding its compatibility with the EU’s emerging industrial and sustainability frameworks, including the recently announced REsource EU Plan.

Context and Background



In June 1999, the then European Communities agreed to begin negotiations with Mercosur, which formally launched in 2000. The FTA would represent the first major accord for Mercosur with another economic bloc, coming less than a decade after the Treaty of Asunción (1991) established the Southern Common Market. Despite the subsequent ascension of Venezuela in 2012 (later suspended), Bolivia's signed ascension protocol in 2015 (pending ratification), and the participation of several associate members such as Chile and Peru, negotiations were conducted exclusively with the founding members: Argentina, Brazil, Paraguay, and Uruguay.

Mercosur¹ functions as a customs union, meaning its member states apply a Common External Tariff (CET) and cannot independently conclude bilateral trade agreements with non-Mercosur countries. Under World Trade Organization (WTO) rules, specifically the Most-Favoured-Nation (MFN) principle (GATT Article I:1), tariff preferences granted to one trading partner must be extended to all WTO members, unless they are part of a recognised free-trade area or customs union under GATT Article XXIV.

Disputes have previously arisen regarding Mercosur's trade, most notably in the Brazil Retreaded Tyres (2007) case², where Brazil's import restrictions were challenged at the WTO for breaching MFN and national treatment obligations. This highlights how regional trade blocs must navigate global trade commitments while pursuing deeper economic integration, underlining the importance of a coherent external trade policy such as the EU-Mercosur FTA.



Source: European Parliamentary Think Tank (EP Think Tank).

A political agreement³ on the FTA was reached in 2019, but the EU soon grew increasingly critical over environmental concerns, particularly the surge in Amazon deforestation under the Bolsonaro administration (Energy Monitor, 2023). Many in the EU viewed this as incompatible with the Paris Agreement and the EU Green Deal, prompting the European Parliament in 2020 to declare that “the EU-Mercosur agreement cannot be ratified as it stands.” Negotiations were effectively frozen until Luiz Inácio Lula da Silva assumed office in 2022, restoring dialogue with Brussels.

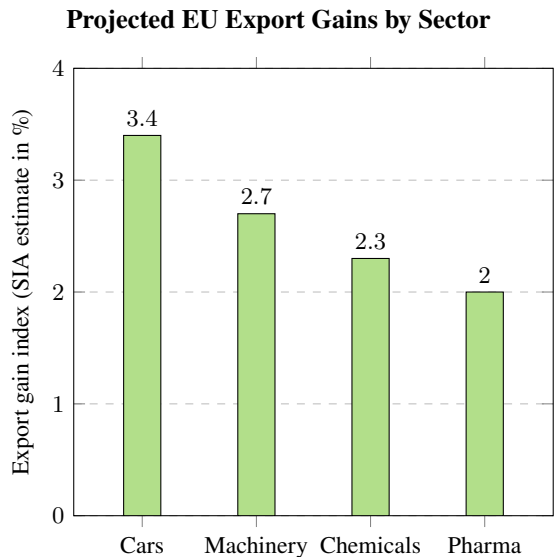
Under Ursula von der Leyen's leadership, renewed talks in 2024 led to the inclusion of a strengthened environmental clause within the updated Trade Pillar (ERPS, 2025). However, opposition remains, both France and Austria continue to resist ratification, with President Emmanuel Macron labelling the deal “unacceptable in its current form,” citing risks to European farmers and potential unfair competition in the agri-food sector (Reuters, 2024; LeMonde, 2025).

¹Under WTO rules, regional trade agreements such as the EU-Mercosur FTA must comply with GATT Article XXIV, which requires that customs unions and free-trade areas cover “substantially all trade” among their parties (WTO, 2024).

²The Brazil-Retreaded Tyres dispute (DS332) clarified the limits of environmental protection measures under WTO law, ruling that Brazil's import ban violated MFN rules but recognising the legitimacy of certain environmental exceptions (Dispute Settlement Body, 2007).

³The 2019 political agreement covered a comprehensive tariff-liberalisation schedule, sustainable development provisions, services, public procurement, and geographical indications, making it the EU's most ambitious agreement with a Latin American bloc (European Commission, 2019).

Economic Impact and Sectoral Gains



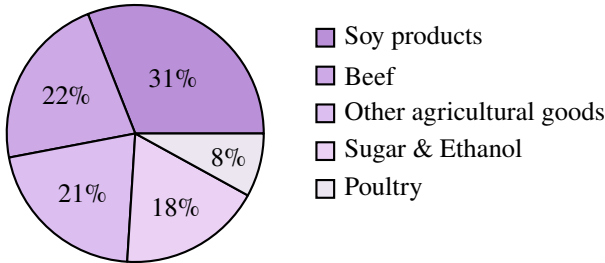
Source: Sustainability Impact Assessment (LSE Consulting, 2021); ERPS (2025).

Despite concerns among European farmers over potential competition from Mercosur agricultural exports, quantitative limits on sensitive goods are set to remain in place. The European Commission’s 2024 Agriculture Factsheet confirms that Mercosur beef exports to the EU will be constrained by a tariff-rate quota of 99,000 tonnes. In addition, safeguard mechanisms allow the EU to temporarily suspend preferences if import surges threaten market stability (Reuters, 2025; AP News, 2025). Consumer price effects are expected to be minimal in the EU. At the same time, Mercosur countries could benefit from a moderate decrease in consumer prices, estimated between –0.4% and –2.1%, primarily driven by cheaper imports of industrial and manufactured goods. Overall, the economic impact of the agreement is assessed as positive but moderate, with gains concentrated in EU industrial exports and improved agricultural market access for Mercosur.

The proposed EU–Mercosur FTA would eliminate tariffs on approximately 91% of goods traded between the two blocs, covering a total goods exchange valued at around €111 billion in 2024 (ERPS, 2025). Mercosur would progressively remove high import duties on EU industrial products, including cars, machinery, and chemicals, while the EU would phase out tariffs on 92% of Mercosur exports, notably agricultural goods such as beef, soy, sugar-based products, and ethanol.

According to a 2021 Sustainability Impact Assessment (SIA) conducted by LSE Consulting for the European Commission, the EU could see an increase in GDP of between €10.9 and €15 billion by 2032, accompanied by an export growth of 0.4–0.6%. Earlier modelled scenarios (2011) projected higher gains, though these relied on pre-COVID baselines and are therefore interpreted with caution.

Mercosur Agricultural Export Shares to EU



Source: European Commission, Mercosur trade database (2025).

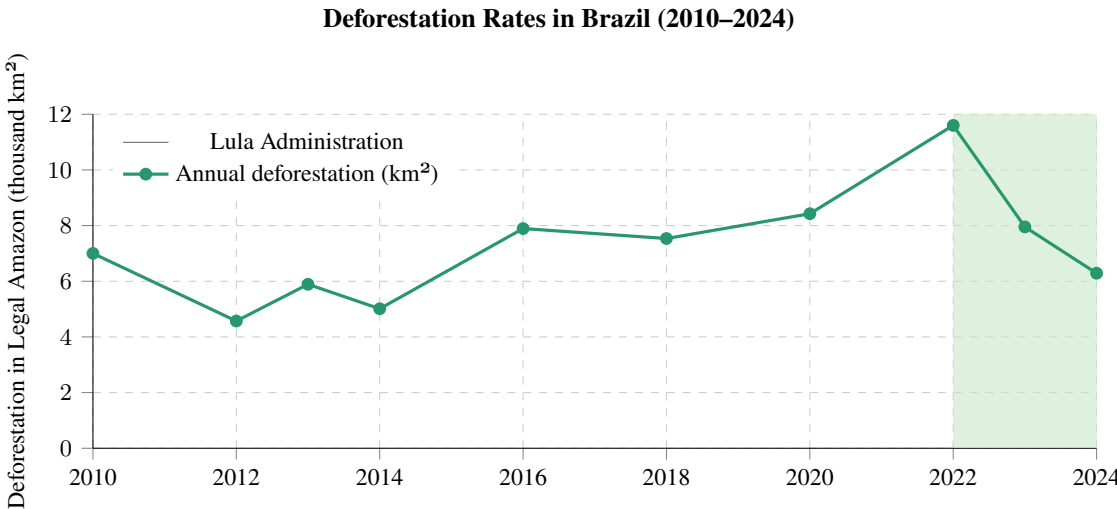
Table 4: Tariff Comparison: Pre- vs. Post-Agreement

Sector	Pre-FTA Tariff	Post-FTA Tariff	Notes
Cars	35%	0% (phased)	Major EU export gain
Machinery	14%	0%	Strong export increase
Chemicals	18%	0%	Competitive EU sector
Agricultural imports (beef)	50–70%	TRQ: 99,000 t	Strong safeguard

Source: European Commission (2024), EPRS (2025).

Environmental and Social Considerations

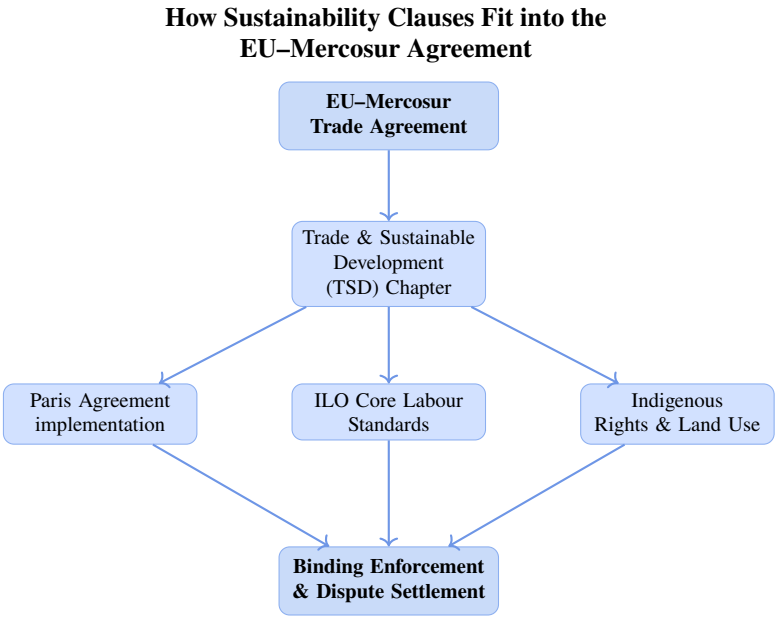
As aforementioned, environmental considerations have been one of the central obstacles to the ratification of the EU–Mercosur trade agreement, driven primarily by France and supported by several environmental NGOs. There are also significant social implications to take into account for this FTA. Despite France’s ongoing objections, deforestation rates in Brazil have fallen sharply in recent years, reaching their lowest level in over a decade, an 11% decline in 2024 alone, according to Brazil’s National Institute for Space Research (INPE) (Reuters, 2025). This improvement is largely attributed to President Luiz Inácio Lula da Silva’s renewed environmental policies, which have halved deforestation rates since he took office in 2023.



Source: INPE (National Institute for Space Research)

One of the key amendments to the trade agreement came with the updated Trade Pillar in 2024, which strengthened its Trade and Sustainable Development (TSD) chapter. The TSD provisions explicitly link trade preferences to environmental and labour standards, requiring parties to effectively implement the Paris Agreement and to avoid lowering environmental or labour protections for competitive advantage (European Commission, 2024). Recent research has highlighted how the EU’s latest FTAs increasingly embed Paris-aligned enforcement mechanisms, shifting from cooperative to binding models (Dupont & Oberthür, Journal of European Integration, 2024).

Beyond environmental protection, labour rights and indigenous protections are equally central. The agreement commits both sides to uphold ILO core conventions and promote inclusive, sustainable agriculture, while establishing dialogues on indigenous rights and land use (European Commission, 2024, TSD Factsheet).



Nevertheless, political optics remain contentious. France, Ireland, and Austria maintain that ratification should not proceed without stronger environmental guarantees, echoing concerns from NGOs such as Greenpeace and ClientEarth that trade liberalisation could incentivise deforestation. In response, the EU proposed an “Additional Sustainability Instrument” in 2023, outlining cooperation on deforestation-free supply chains, traceability, and due diligence (European Commission, 2023).

Paris Agreement Commitments vs. EU–Mercosur Trade Provisions

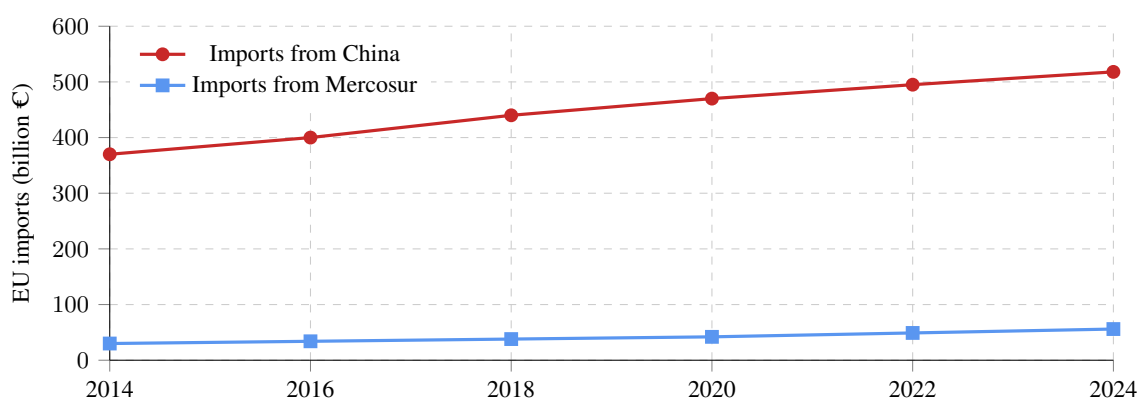
- **Paris Agreement:** temperature goal of 1.5°C, nationally determined contributions (NDCs), and commitments on forest protection and land-use monitoring.
- **Implementation obligation:** the TSD chapter requires both parties to “effectively implement” the Paris Agreement and not weaken environmental laws for competitive advantage.
- **Deforestation-free supply chains:** cooperation on traceability, due diligence, and monitoring of key commodities (e.g. beef, soy, timber).
- **Enforcement:** sustainability commitments can be addressed under dispute-settlement procedures, reflecting the EU’s move from cooperative to more binding TSD models.

Political Feasibility and Strategic Implications

Strategically, the aforementioned environmental initiative fits within the EU’s Open Strategic Autonomy and its 2023 EU–LAC Agenda, which frame Latin America as a key partner in building sustainable and diversified global value chains (European Commission & HR/VP Joint Communication, 2023). It also aligns with the EU Deforestation Regulation (EUDR), adopted in 2023, which restricts the import of commodities linked to forest loss, demonstrating the EU’s intent to reconcile trade liberalisation with environmental accountability.

One of the driving forces behind the EU–Mercosur agreement, now gaining renewed attention, is the EU’s ambition to reduce its strategic dependencies on China through ongoing “de-risking” initiatives. As part of this agenda, President Ursula von der Leyen’s REPower EU and REsource EU plans emphasise the need to diversify trade partnerships and secure access to critical raw materials, particularly those essential for the green and digital transitions. Latin America, with its vast reserves of lithium, copper, and rare metals, is viewed as a key partner in this effort to strengthen the EU’s geo-economic resilience (European Commission, 2023). This approach aligns closely with the EU’s broader framework of Open Strategic Autonomy, which seeks to preserve openness to global trade while reducing reliance on a narrow set of suppliers. The EU–Mercosur agreement thus carries not only economic but also strategic significance, serving as a cornerstone of Europe’s engagement with the Global South. Politically, the 2024–2025 period represents a crucial ratification window, following renewed momentum under the Spanish and Belgian Council presidencies, both of which have listed Mercosur as a top trade policy priority (Council of the EU, 2024).

EU Imports from China vs. Mercosur (2014–2024)



Sources: Eurostat COMEXT (China imports, 2014–2024); Council of the EU “EU–Mercosur Factsheet” (2024).

Policy Options

The first option is straightforward: proceed with full ratification of the 2024 text and the updated Trade Pillar, which includes enhanced sustainability provisions. This path would reinforce the EU's credibility as a reliable global trade partner and advance its Open Strategic Autonomy (OSA) objectives by deepening ties with Latin America and diversifying away from China (European Commission & HR/VP, 2023). It would also open Latin American markets to European producers and consumers alike, creating new opportunities in industrial and green sectors. However, this approach would likely provoke environmental backlash from NGOs and several Member States that view the current sustainability mechanisms as insufficient (Greenpeace EU, 2024). Enforcement of deforestation and climate provisions would also remain limited under existing frameworks.

The second option would be conditional ratification, revising the sustainability terms as proposed by France, Austria, and Ireland. This would involve binding deforestation targets more closely to Paris Agreement obligations, as outlined in the Additional Sustainability Instrument proposed in 2023 (European Commission, 2023). Such revisions could garner wider political support within the EU and help unify Member States long divided on the issue. Yet, this option risks delaying ratification and could face pushback from Mercosur, whose members have expressed eagerness to conclude the deal swiftly.

A third option would be to postpone negotiations and ratification until after 2025, providing a potential political reset. Upcoming leadership changes, most notably the 2026 European Commission renewal and France's 2027 presidential elections, may reshape the political landscape. However, prolonged delay risks the deal stalling indefinitely. The most drastic course, though increasingly unlikely, would be to abandon the agreement altogether. While this might appease European farmers and environmental groups, it would represent a major strategic setback for the EU's geopolitical ambitions, particularly as China continues to expand its economic footprint in Latin America (Bruegel, 2023).

Recommendations

Given the persistent environmental and social concerns surrounding the EU–Mercosur trade agreement, conditional ratification appears to be the only viable path forward. Ratifying the agreement immediately, without a robust and enforceable sustainability mechanism, would undermine the EU's credibility on climate and human rights, particularly at a time when global expectations for responsible trade are rising. Instead, the EU should finalise and legally anchor the Additional Sustainability Instrument (2023), ensuring independent monitoring of deforestation, labour rights, and Paris Agreement commitments before ratification proceeds (European Commission, 2023).

To guarantee transparency and accountability, the EU and Mercosur could establish a Joint Sustainability Council, modelled on existing Trade and Sustainable Development (TSD) advisory groups, comprising civil society, business, and environmental representatives (European Commission, 2022). Parallel to this, a dedicated SME and Agricultural Adjustment Fund could help support sectors most exposed to liberalisation pressures, ensuring a fair transition across Member States (European Commission, 2021).

Strategically, abandoning or indefinitely delaying the deal would be counterproductive. The growing competition between the United States and China for influence in Latin America reinforces the urgency for the EU to act decisively. Within the framework of Open Strategic Autonomy, conditional ratification, paired with credible environmental enforcement, offers the EU the best route to balance sustainability, competitiveness, and geopolitical resilience (European Commission & HR/VP, 2023).

In short, the EU must present this agreement not as a market-grab, but as a “Green Partnership”: a model for fair, sustainable, and strategic trade in a multipolar world.