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The EU New Trade Policy and the Perspectives for an EU-Mercosur Agreement

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This article aims to address the European Union's new trade policy, expressed by the European Commission Communication "Global Europe: Competing in the World", and the ongoing negotiations to form the EU-Mercosur FTA. The Communication selected Mercosur as a priority, based on two economic criteria: The market potential and the level of protection against EU exports. Mercosur also considers such an agreement as a top priority in its agenda since it already has the EU as its main trade partner and faces many tariff and non-tariff barriers to its exports to the bloc. However, the ongoing negotiations among the two blocs that began in 1999 are still far from conclusion.

Key Words: Regional Integration; Trade Policy; European Union; Mercosur.
JEL-Codes: F13, F15, F53

1 Introduction

One of the most prominent features of the last decade in world trade has been the revival of regional agreements, a phenomenon that has been recognized as the second wave of regionalism, in contrast to the first wave that took place in the late 1950s and 1960s.¹ This second wave regionalism has gained momentum since the 1990s. The literature points out substantial differences between each trend. The new regionalism shows a much wider coverage of both goods, in most cases involving substantially all trade between its bloc members, and economic sectors, comprised of services and investments. It is also much deeper, in the sense that it goes beyond the removal of border barriers, involving common disciplines for regulatory regimes, and addresses issues such as technical barriers and competition policies.²

The European Union has followed this new wave of regionalism having been very active in forming new Free Trade Agreements (FTAs) all over the world.³ Recently, the European Commission issued a new Communi-

1 See WORLD BANK (2000) describing the revival of regional agreements during the 1990s.

2 See LAWRENCE (1997) and ETHIER (1998) for a description of the differences between the two waves of regionalism.

3 The EU has notified, by July 2005, 20 FTAs under GATT's article XXIV to the World Trade Organization (WTO) since its formation, but half of them (10 FTAs) were notified to WTO since the year 2000 (EUROPEAN COMMISSION 2006). The bloc is also negotiating 11 agreements, including the EU-Mercosur agreement.

cation (THE COMMUNICATION 2006, hereinafter) on its external trade policy, which established market potential and the level of protection against EU export interests as the key economic criteria to guide the formation of a new generation of FTAs. Based on these criteria, Mercosur⁴ alongside ASEAN and Korea emerged as priorities. The Communication also sets up a more comprehensive and ambitious coverage for these new FTAs, beyond the simple removal of import tariffs, including liberalisation of trade in services, investment, public procurement and competition, following the issues of the new regionalism.

This paper is divided into three sections, excluding this introduction. Section two discusses the new EU trade policy expressed by THE COMMUNICATION (2006) and briefly describes the Communication's economic criteria to form new FTAs. Section three compares the EU ambitious plans with the difficulties faced by the ongoing negotiations to form the EU-Mercosur Agreement, especially the EU opposition to fully address the liberalisation of agricultural products and the Mercosur denial to deal with issues typical of the new regionalism, like services and investments. The last section offers some concluding remarks.

2 The New EU Trade Policy

THE COMMUNICATION (2006) represents a radical change in the EU strategy to reach the objectives that are at the heart of the European Commission's agenda, which is to create growth and jobs. It is worth to note that the EU strategy and its instruments since its formation until the end of the 1990s was to achieve those objectives through the single market. The key element of the single market was the organisation of different markets by protecting the common market frontiers and a strong regulation. In the specific case of agriculture, which is emblematic to understand the model, the regulation included the intervention in prices and the subsidy concessions both to produce and to export.

Thus, by definition, the previous model presupposes the lock up of the internal market, being the aim of the trade policy only to filter the external markets' signs in order not to disturb the good functioning of the internal market. In this sense, the new strategy proposing a greater openness to trade

4 Mercosur (Southern Common Market) was created in March 1991 by the Treaty of Asuncion and its ultimate goal is to form a Common Market among Argentina, Brazil, Paraguay and Uruguay.

and investment to equip the EU for globalisation means a profound change in the European position.

In this context, it is not fruitful to discuss whether the previous strategy was wrong or not. Or even to discuss if the strategy had fulfilled its objectives in periods in which it was in force. In fact, given the original aim of the European integration process to establish a broader agenda and not a merely economic integration, one may argue that the European system was a relative success. Some important non-economic objectives were accomplished. The well succeeded integration process involving countries that had battled two World Wars on opposite sides in the 20th century is the biggest proof that the results were positive.⁵ The Common Agricultural Policy (CAP) played an important role in creating a common spirit in the community since even in the most remote areas of Europe its results could be felt. The appeal of the CAP helped to develop the feeling of participation in a community bigger than the national states. As a result one may argue that the CAP was the cement that allowed the building of the EU, with its economic inefficiency being neglected.

However, as recognized by THE COMMUNICATION (2006), the globalisation process has changed the relations between countries, posing new challenges that could not be dealt with the old strategy. It clearly states that the EU should not try to compete where it cannot, but to make sure it succeeds as a provider of top quality, highly specialised goods and services in a knowledge based economy. In addition it states that keeping low-productivity jobs or to perpetuate sectoral structures in the EU could only artificially maintain people in jobs that are unsustainable in the long run. This statement may represent a window of opportunity to Mercosur since it is a major provider of agricultural and low skilled industrial goods and, alongside with ASEAN and Korea, was considered a priority for the EU trade policy.

The Communication's economic key criteria to form new FTAs were market potential, expressed by economic size and growth, and the level of protection (tariffs and non-tariff barriers) against EU exports. While the level of protectionism is still high in Mercosur and even increased after its formation (AZEVEDO 2004), the market potential of the bloc is questionable, since Brazil, its largest member, has showed an average annual growth rate of only 2,5% from 1995 to 2005, well below the average of other emerging

5 If the highly interventionist model, in particular in agricultural products, was a necessary condition to this success is another discussion.

economies. The other two secondary criteria also taken into account by the EU to select the priorities to form FTAs Mercosur seems not to fit very well either: (i) the potential partner's negotiations with EU competitors and (ii) the risk to erode the preferences currently enjoyed by the EU developing country partners. With regards to the first, since the collapse of the negotiations of the Free Trade Area of the Americas (FTAA), Mercosur is not negotiating with any other direct EU competitor. And in relation to the second, a FTA between the EU and Mercosur including a good deal of preferences for agricultural products would indeed erode the preferences of other current EU developing partners. Thus from the four basic criteria chosen by the EU to form new FTAs, Mercosur seems to be eligible just for one.

3 The EU-Mercosur Agreement ongoing negotiations

The new developments in the EU trade policy described in the previous section elects Mercosur as a priority to form a new FTA due to its market potential and the high level of protection against EU exports. Moreover, the importance that the EU already has for Mercosur trade and the barriers it still imposes on many products in which Mercosur is internationally competitive make this agreement also potentially attractive for Mercosur.⁶ In terms of trade, despite the trade barriers in force, the EU is Mercosur's first market for its agricultural exports, accounting for 48% of total EU imports from Mercosur in 2005. EU goods exports to Mercosur largely rely on industrial products, with machinery and transport equipment alone representing over 50% of total exports, followed by chemicals and related products at 20.6% (EUROPEAN COMMISSION 2006).

The EU-Mercosur relations are based on the Inter-regional Framework Cooperation Agreement that entered into force in 1999.⁷ Its main goal was to prepare the negotiations in order to create a free trade area between the two blocs. Negotiations on the trade chapter are governed by three main principles (EUROPEAN COMMISSION 2006):

- (i) A region to region approach, which constitutes the basis of discussions on all regulatory areas;

6 While the share of the EU trade with Mercosur was only 2,3% in 2005 (with intra-EU trade excluded) (THE COMMUNICATION 2006), the share of Mercosur total trade with the EU was 25% (IDB 2006b).

7 The EU-Mercosur talks about a FTA started in the mid 1990s. In 1994, the EU demonstrated the interest in forming an inter-regional association agreement with Mercosur (KUME et al. 2004).

- (ii) The agreement should be comprehensive and balanced, going beyond the respective obligations in WTO. No sector should be excluded, whilst taking account of product sensitivities;
- (iii) The agreement should constitute a single undertaking, implemented by the parties as an indivisible whole.

The two blocs initially exchanged liberalisation offers on goods in June 2001, but both proposals were considered not satisfactory as the EU and Mercosur sought to either postpone or even exclude their sensitive sectors from the agreement. Mercosur deemed particularly modest the EU proposal for agricultural goods, given the importance of such products in the bloc's exports to EU and the level of protection that is still constraining Mercosur exports.⁸ The Mercosur proposal, on the other hand, reflects its production and protection structure and is more aggressive to agriculture than to industry.⁹ The EU expected a much better offer regarding sectors like textiles, footwear and vehicle parts (IDB 2004).

It is worth to note that the two blocs are proposing the tariff reduction based on different schedules. The EU system divides the tariff reduction into four baskets (A: immediate opening; B: four years; C: seven years; and D: ten years). Mercosur offers six baskets from immediate liberalisation (basket A) to ten years plus grace (basket F). Besides the schedules, the number of positions also differs between the two offers. Mercosur's last offer of goods in September 2004 included an immediate tariff elimination of 12% of tariff positions, an additional 6,1% in three years reaching 41,2% in eight years (table 1). Without considering the goods that will face quotas and fixed preferences, Mercosur's offer totalised about 89% of positions to be liberalised in 12 years.

Meanwhile, the EU proposal contained wider immediate tariff elimination, reaching 34% of tariff positions, but encompassing a similar overall number of positions in ten years, or 93%, including processed agricultural products (table 2). It also offered fixed preferences of 20% and 50% for 99 items and quotas for another 241 items. Those 340 positions with restricted access to the EU market are mainly agricultural products (IDB 2006a).

8 According to IDB (2004), the EU imposes a variety of protectionist measures on Brazilian agricultural goods, from subsidies for crops like soya beans and sugar to tariffs for tobacco.

9 CASTILHO (2005) points out that 42% items at 06 digits of the Harmonised System would be vulnerable to EU competition.

Table 1: Mercosur Last Offer of Goods

Category	September 2004	
	N° of Positions	Mercosur Share (%)
A (immediate)	1168	12,0
B (3 years)	1760	18,1
C (8 years)	1077	11,1
D (10 years + 1 grace)	1889	19,4
E (10 years + 2 grace)	2784	28,6
F (quota + 18 years)	46	0,5
Fixed Preference 20% & 50%	185	1,9
Unschedule	821	8,4
Totals	9730	100,0

Source: IDB (2006a).

Table 2: EU Proposal to Mercosur

Category	n° NC	Share (%)
A (immediate)	3526	34
B (four years)	2449	23
C (seven years)	2079	20
D (ten years)	1310	13
Processed Agricultural Products (reciprocal)	288	3
Total Liberalisation	9652	93
Preference – 20%	43	0
Preference – 50%	56	1
Quotas	241	2
Total Preference and Quotas	340	3
Total not Included	435	4
General Total	10427	100

Source: IDB (2006a).

With regards to trade, the EU offer eliminated immediately the tariffs on 58,3% of Mercosur exports to its market and another 35,3% in ten years, while the 435 positions excluded represented only 0,3% of its imports from Mercosur. However, those products immediately liberalised by the EU already have a zero Most Favourite Nation (MFN) tariff as a result of previous multilateral negotiations and do not represent a preference for Mercosur. Another problem is that most items in which the EU conceded 20% and 50% preferences and quotas are agricultural products and foodstuff (IDB 2006a). Meanwhile, Mercosur offered to liberalise immediately only 11,1% of the EU exports and another 61,3% in ten years. Moreover the 821 items excluded from the liberalisation represented 9,9% of the bloc's im-

ports from the EU. Although these proposals represented an advance comparing with the first exchange of positions in 2001, they were not sufficient to guarantee an agreement between the two blocs.

Besides the issues related to goods, there were also disagreements in a long list of issues comprising services, investments, government procurement and intellectual property as the EU sought to impose its own rules which was not accepted by Mercosur negotiators (IDB 2006a). Services, as the Communication states, are a key issue for the new FTAs, since they represent almost 80% of EU GDP and employment and present the highest growth potential for EU exports. As a result, there is a long list of requirements made by the EU to Mercosur in this area, including the selling of cross-border services without the company having to be established in the country where it would provide the service and the inclusion of professional services, which would allow the transfer of skilled workers from EU companies located in Mercosur (IDB 2005). However, Mercosur is not willing to agree with those demands since they could increase the unemployment rates in the region.

In addition to the difficulties to conclude the ongoing negotiations, there are some structural problems that lie ahead. First, the continuous EU enlargement and the interest in forming new FTAs with ASEAN and Korea may distract the bloc from forming the agreement with Mercosur. Second, there is a diminished incentive to negotiate with Mercosur in the absence of the Free Trade Area of the Americas (FTAA), which could represent a risk of trade diversion for the EU.¹⁰ Third, Mercosur needs to resolve the gaps and loopholes related to its own integration process before engaging in an ambitious FTA with the EU.¹¹ Fourth, some authors point out that Mercosur, especially Brazil, has not been willing to deal with the deepening agenda proposed by the EU as the potential benefits from this are deemed to be smaller than the costs associated with the lost in sovereignty (PEREIRA 1999 and VEIGA 1999).

However, even if the agreement is signed in the future there is another problem related to its strategy. The integration strategy followed by the EU and Mercosur to initially remove the intra-bloc barriers in sectors without a major potential for trade conflicts and to postpone the liberalisation in

10 The literature has pointed out that the formation of NAFTA caused a significant loss of market share for the EU in Mexico.

11 See AZEVEDO (2004) and PREUSSE (2001) for details of the problems faced by Mercosur to fulfil its own agenda.

the most sensitive products reflects what PREUSSE (2001) defines as “selective problem solving”. This could lead to a trap in which the pressure groups that benefited from the remaining barriers in intra-bloc trade could try to perpetuate this situation. The continuous delays in implementing the rules agreed in those “problematic” sectors in Mercosur are signalling this. Moreover, according to GROSSMAN and HELPMAN (1995) the exceptions from intra-bloc trade are more likely to occur in sectors prone to trade creation since the political cost of trade diversion is higher than the political cost of trade creation in the importing country while the political gains are higher in the case of trade diversion compared with trade creation for the exporting country.¹²

4 Conclusion

The article points out the radical change in the EU strategy towards its trade policy proposed by the European Commission’s new agenda, based on THE COMMUNICATION (2006). The Commission clearly states that the EU should be a provider of top quality, highly specialised goods and services in a knowledge based economy, criticising the current artificially maintained low-productivity jobs in sectors where the EU has no comparative advantages. This represents a rupture with the previous model that presupposed the lock up of the internal market, especially in the agricultural sector.

As a result of the EU’s new trade policy, Mercosur emerged as a priority to form a new generation of FTAs, based on key economic criteria. However, it is argued that Mercosur does not fit most of those criteria. Moreover, the ongoing negotiations to form the EU-Mercosur FTA agreement have been unsuccessful, as both blocs sought to keep their vulnerable sectors outside the liberalisation process. Finally, even when the agreement is signed, the strategy to initially remove the intra-bloc barriers in sectors without a major potential for trade conflicts and to postpone the liberalisation in the most sensitive sectors may lead to a trap in which the pressure groups benefiting from the remaining barriers in intra-bloc trade could try to perpetuate this situation.

12 OLARREAGA and SOLOAGA (1998) using a model to explain the deviations from internal trade based on the political structure of each Mercosur member, confirm the GROSSMAN and HELPMAN (1995) view that those sectors with more tendency to trade creation tend to be exempted from internal free trade as far as tariffs are concerned. Given this evidence it seems that the bloc is still far away from exploiting all the trade potential it would obtain from a complete elimination of intra-bloc tariffs.

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