**DOES A FREE TRADE AGREEMENT (FTA) WITH MERCOSUR
MAKE SENSE FOR THE EU?**

"The European Union hopes to reach an accord with Mercosur by mid-2011 as negotiators iron out details on tough issues such as farm aid and intellectual property"- said Trade Commissioner Karel De Gucht. This follows a proposal by the Commission last May to breathe new life into the negotiations with Mercosur with the aim to create the world's largest free-trade area with 750 million people encompassing the EU and Argentina, Brazil, Paraguay, Uruguay and soon Venezuela. Talks had been suspended in 2004 because of disagreements.

There has been a growing concern in Europe's agricultural sector about the compatibility of such an FTA with the objectives of the CAP. EU farm Ministers have contested it.[1] This is not to say that agricultural market opening is rejected (the EU has offered in the WTO Round), but much depends on the 'what', the 'when' and the 'with whom'.

The decision to re-launch Mercosur talks has not been properly thought through. It is dissociated from any rational trade strategy. It represents a move away from multilateralism and EU neighbourhood policy towards bilateral ad-hoc accords. It ignores the Union's foremost geopolitical interests, and risks being counterproductive for Europe's relations with Mercosur.[2]

An overall strategy towards preferential and free trade agreements has been a red herring in the Commission since the College first discussed this matter in 1998. Its Communication on Free Trade Areas avoided establishing any priorities because it was thought that no agreement could be found thereafter in Council. While a case-by-case approach was considered unsatisfactory, that choice was made by default, thereby conferring on the Commission a considerable margin of maneuver to take new free-trade initiatives depending on circumstances (not to mention personal preferences), even without sufficiently solid, objective motivations.

The College should actually have questioned more exhaustively, whether a FTA with Mercosur should be a priority for the Union, whether it makes geo-strategic sense or not, how it might go down in the WTO and what impact it might have on other EU partners. I will argue how ill conceived this initiative was from the very beginning, how it was pursued in spite of internal criticism, how insufficient were the impact assessments (particularly the first), and how inappropriate is the timing.

In my view, the initiative is not in the interest of the Union. I hope the European Parliament will evaluate it thoroughly and do what it can to reverse it. Alternatively, it could always consider refusing to ratify an agreement in the event it is concluded.

Preconditions

A decision to embark on FTA negotiations with Mercosur should be based on eight prerequisites and queries:

[1] When on 7-8 May 1996 the informal Council of Agriculture Ministers took this issue up, Trade Commissioner Sir Leon Brittan was so worried about it that he wrote a letter to Fischler before that Council downplaying those concerns, and trying to demonstrate that the proposed agreement posed no fundamental threat to the CAP. Also Commissioner Joao Pinheiro was so worried that he proposed to Sir Leon to "seek to influence GATT jurisprudence in a way which would allow duty free tariff quotas and trade covered by entry prices to count towards the 90% goal of free trade.

[2] Realistic and initially questioned trade initiatives risk failure. Suffice to mention the Millennium Round, the partnership with the Gulf Cooperation Council, the first attempt at an FTA with Mercosur, and the Euro-Mediterranean Partnership (which ignored the paralyzing effect for Arabs of Israel's presence, the lack of a regional counterpart to the EU such as the Arab League, the South Mediterranean interest in infrastructural investments and labour mobility etc.).

1. That there is a true overall EU strategy on FTAs,
2. That there is an objective, deep and transparent impact assessment regarding the economy, EU common policies and EU external relations;
3. That there are good prospects for a balance of concessions and benefits
4. That they will respect the CAP and its reform process,
5. That there will be no additional burden for the EU budget
6. That the accord will not affect the WTO Round negatively
7. That it will not damage trade with EU neighbours
8. That it will not increase pressures on the EU to negotiate FTAs with other regions or countries situated far away from Europe

In my view, an FTA negotiation with Mercosur would fail all eight tests. Let's take these points in that order.

First Query: FTA Strategy

The Santer Commission's Communication on Free Trade Areas failed to come up with the design of a clear, sound FTA strategy, because it was thought that no agreement on geographical priorities could be found in Council. Hence, while a case-by-case approach was considered unsatisfactory, that choice was made by default, thereby conferring on the Commission a considerable margin of maneuver to take new free-trade initiatives depending on circumstances. Things have not changed since. FTA priorities still need to be set in line with EU geo-political and geo-economic interests taking into full account the Union's internal policies such as agriculture, competition, environment, health and transportation. I believe EU trade liberalization ought to proceed primarily within the WTO, and with EU's immediate neighbours, and not through a proliferation of ill-conceived FTAs with countries that are not in its immediate proximity. The choice of prioritizing Mercosur is especially problematic.

Second Query: Impact Assessment

The Commission's internal rules stipulate that important decisions must be accompanied by an accurate impact assessment. Some such assessments are far from exhaustive. The assessment of 1998 regarding the first proposal for a FTA with Mercosur was unacceptably weak and unbalanced.[3] Commissioner Marin, its proponent, clearly wanted to rush it through the Commission; contrary arguments were unwelcomed and speedily dismissed.

The Barroso II Commission did recognize key weaknesses of the previous impact assessment by launching a new external impact study[4] (SIA Study). SIA estimates the economic impact to be positive both for the EU and for Mercosur, with larger effects on real income for Mercosur, but highlights substantial differences in agricultural models and related problems.

The study recalls that agriculture in Mercosur ranges between two extremes: technologically developed commercial farms (240m hectares in Brazil alone) and subsistence based farming involving family labour and landless farmers. It admits that unequal land distribution is an important social and economic issue, and one of the main factors contributing to rural poverty. In Brazil alone, 12 million farmers are landless. Land conversion to pasture for cattle continues to cause displacement of many landless farmers. The SIA sees problems with the sustainability

[3] I refer to the assessment made by DG1B that even ignored critical elements of a previous external assessment to the point that the College did not recognize it as a document of the Commission Services (but only as a DG1B document). Its purpose was clearly to support a proposal to launch the negotiations.

[4] Trade Sustainability Impact Assessment (SIA) of the Association Agreement under negotiation between the EU and Mercosur, finalized in March 2009, and commented in a position paper by the Commission services of July 2010

of agricultural production in Mercosur, stresses that the expansion of agriculture in the Mercosur could cause social problems to "traditional agriculture" and "result in loss of livelihoods for indigenous people", and holds that small scale farmers would be losers of that process. It admits the obvious regarding an expected increase in Mercosur use of agrochemicals, including pesticides and fertilizers, and "significant adverse impacts on Mercosur natural resources, forest coverage and biodiversity, "which would require adequate measures". It recognizes that loss of competitiveness in the EU agricultural sector may depress land prices, reduce the capital stock, encourage greater intensity of production and involve important adjustment costs particularly for the new members and for meat, cereal and sugar production. The consultants suggest that tariff reductions for environmentally/biodiversity sensitive products should be conditional on compliance with a set of sustainability criteria, and advise to strengthen environmental regulations in Mercosur countries to offset adverse impacts of forest conversion and expansion in agricultural conversion. They consider the economic impact of an FTA with Mercosur so small that one wonders why the FTA is necessary at all.

The SIA recognizes that Mercosur is highly competitive for meat, cereals, sugar, ethanol and fruits, but fails (unlike a CEPS study) to stress that this is already the case at the MFN rate. It indicates that processed food exports could shoot up sevenfold for Paraguay, more than fourfold for Brazil and more than double for Uruguay as a result of an FTA with the EU. But this may still underestimate the true costs for EU farms of such a deal. If given free access to the EU market, Mercosur's capacity to supply farm products (already and also not yet exported) is staggering. This is notably the case of Argentina due to its low level of population compared with its land resources and low production costs, notably for its main current exports, wheat, maize, oilseeds, meat, apples, fishery products, milk products and tobacco.

The SIA study does mention that increased imports from Mercosur will cause price reductions for EU producers and processors, particularly at the lower end of the commodity market. But it ignores the enormous price differentials in some areas. For instance, Brazilian orange juice sells at a fraction of the price of the world's most competitive product, Florida juice, and Argentinean and Brazilian meats sell for a fraction of US meat prices. It is for such reasons that the US would never enter into a FTA with Mercosur! The SIA study is also too optimistic about the benefits the EU would reap from better access to the Mercosur agricultural and food markets. It overestimates the potential to offset increasing food imports from Mercosur through increasing exports of higher value added products, because Mercosur competition there will increase with freer trade (except for Denominations of Origin). For instance, it highlights an EU export potential for EU olive oil ignoring that Argentina has been planting like mad for years olive bushes than can be machine-harvested allowing the selling of olives and olive oil at unbeatable prices as soon as the EU market opens up.

The impression one draws from the study is that it has pointed to several problems, but couched in a language allowing to draw optimistic conclusions as to the likely impact of a FTA with Mercosur on the CAP and the least competitive EU farmers. And where the SIA assessment was still considered too critical – as regarding adverse social effects and the challenge for sustainable development - a position paper of the Commission services commenting on that study (quite unusual) tried to dismiss or weaken the negative arguments. In this regard, the paper comments, "sustainable development should be considered one of the FTAs' overarching objectives" in accordance with core ILO labour standards and multilateral environmental agreements." Those prepared to believe that this objective would actually be pursued (how?) would be kidding themselves.

Neither the SIA impact study, nor the Commission's position paper give any consideration to the current world context of agricultural trade, nor to the geostrategic factors of a FTA with Mercosur affecting relations with other EU trade partners (which are dealt with under points 7 and 8). Both seem to neglect to take into account the realities of the world's food markets, which are managed with food security objectives without as well as within FTAs.[5]

Third Query: Balance of Concessions

After a long story of trade deficits with the EU, Mercosur has been recording growing trade surpluses since 2002, with agricultural exports some twenty times bigger than imports from the EU. These exports compete with those from the EU10 within the Single Market. Talks so far have shown that Mercosur has focused on agriculture (as was the case with the WTO Round) giving little leeway for equivalent market-opening offers by Mercosur to European industry and services. It is clear that Mercosur wants free trade in exactly the areas that we seek to exclude, and wants to keep protection in sectors of interest to us. It would be naïf to believe that this will change if talks resume. Mercosur needs only to remind the EU of its support for "special and preferential treatment" for developing countries in the Doha context in order to get more on agriculture than it offers on other sectors (although one may question whether Brazil should not be graduating out of the DC category). Moreover, when talking about benefit distribution, one should not neglect internal factors, and notably the risk that EU agricultural market access would mostly profit a few l*atifundistas* in Latin America, without significant trickle-down for poorer people there. As access to the EU market improves, it is difficult to avoid that a privileged few, large Mercosur farmers will reap all the benefits and transfer a substantial part of their profits to the major financial centers or safe havens instead on investing them at home so as to spread those benefits within their own countries. The losers would be European farmers, particularly the smaller ones, as well as Latin American farmers, evicted from the large plantations that would develop thanks to new export market prospects. Let's not forget that Mercosur is far from a social-market economy and suffers from a greater democratic deficit than the EU.

Fourth Query: Respect of the CAP

There are major differences between the EU and Mercosur in agriculture. Mercosur's land devoted to crop production (814.870 km2) is nearly as large as that of the EU15 (874.850), but still represents less than 7% of total land, as against 30% for the EU15. Mercosur's permanent pastures are six and a half times larger than Europe's. Argentina alone has a land surface (2.7 million km2) nearly as large as that of the EU15, most of which is currently unused, and pastureland per inhabitant 26 times larger than the EU15. Mercosur has over 250million cattle (2005), an increase of more than 10 million since 1996, three times more than the EU15. It produces more than 25% of the world's beef meat. Brazil is the world's third biggest world meat producer; it produces more than double the quantity of France and Germany. Brazil is the world's largest sugarcane producer, and has increased production more than threefold since 1999. Corn production in Brazil and Argentina is more than ten times larger than Europe's biggest growers, Romania and Hungary. Argentina, Paraguay and Brazil are the world's leading soybean producers.

Agricultural products, including food, already represent 55% of Mercosur exports to the EU (€19.4bn in 2009, up 4% since 2005), and they account for 20% of all such EU imports. By contrast, Mercosur absorbs less than 3%, of all EU exports, one half of all its exports to Latin America. The EU deficit in

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5 International markets for agricultural products are still regulated restricting the performance of all big net-exporters, in particular the most competitive ones like the Mercosur. Looming food shortages are likely to increase food market management, including export taxes and controls (like even Argentina has recently done *erga omnes* when food self-sufficiency was in doubt). Mercosur and a FTA with Mercosur could not stop managed food markets and land grabbing when believed necessary for food security. It could even aggravate the latter if food export prospects rise.

trade with the Mercosur countries was €14.6bn in 2008, a large increase since 2000 when it stood at just over one billion. More than half of EU imports of meat, meat preparations, oilseeds and animal fodder already originate in Mercosur; with a 77% share of the market, Mercosur is approaching the position of single supplier of animal fodder. EU soybean imports from Mercosur doubled in five years (1999-2004). Brazil and Argentina's potential for beef exports, at a price half as high as the EU price, is staggering (they doubled in 1999-2004 alone). Even more worrying is the case of olive oil that accounts for 7% of EU exports to Mercosur. Argentina's production poses a threat to Europe's leadership. It shot up from 6000 tons in the early nineties to 100,000 tons in 2008, and is predicted to rise to 170,000 tons in the short term and at a very low cost of production.

There are also major differences regarding agricultural policies. The CAP, one of the few common EU policies, has no equivalent in Mercosur. The latter is highly competitive and has an enormous production potential in farm products. This means a major challenge for the EU in a FTA with Mercosur. On the other hand, unlike the EU, Mercosur has major problems applying a Common External Tariff.

While a small number of Mercosur agricultural products are complementary to Europe's due to seasonal production structures, the majority enters or would enter in direct competition with European produce. The largest share of these agricultural products enters the European market duty free, but within the framework of import quotas or linked to specific calendars. The other farm products are mainly subject to quantitative restrictions. Their liberalization would considerably increase the incentive to produce also products that are not currently traded. Constraints to Mercosur commodity production have been the availability of markets, which Mercosur is keen to expand. Given opposition in the US Congress against a free trade area with Mercosur, the latter has set its sights on the EU to boost its agricultural exports.

Make no mistake. Reconciling a FTA with the Mercosur with European agriculture is clearly the biggest concern. The potential of agricultural exports to the EU with easier access to our market is huge, and an FTA with Mercosur could put into question the very existence of the CAP as we know it. The reserve of land that can be made available for agricultural production in South America is enormous. Economic growth within Mercosur will not, as some believe, ensure much additional domestic consumption of food. This is notably the case for beef, as per capita consumption in Mercosur countries already is among the highest in the world, and cannot increase much further. Let me take Brazil as the main example. Its potential can be described in a few figures. While its GDP grew by 16% from 1989 to 1998, its agricultural GDP grew by 27% and its exports of farm products doubled to $19 billion, and now account for 40% of all exports. While in the EU the cost of production of a ton of red meat is $3.000, Brazil's is between $1.000 and $ 1.200; and EU chicken meat production costs are 80% superior to Brazil's. The production cost of Brazilian sugar at 7.5 cents a pound is half that of the world's second most efficient exporters and the Brazilian fruit juices are produced at half the cost of its chief competitor, Florida (these are Brazilian calculations).

Fifth Query: EU Budget Impact

Quite apart from representing an unsustainable competition for EU farmers, a FTA agreement with Mercosur, would involve additional costs to the EU budget. (Calculated at the time in 1998 as ranging from 5.7 to 14.5 billion a year). A first estimate by DG VI/AGRI (1998) of the net cost of liberalization was around €(ECU) 11bn a year, if farmers in the EU were fully compensated for price reductions to world market or Mercosur levels. <u>But this did not account for products that were not sensitive because not traded yet due to protection</u>. In order to make the agreement WTO-compatible, the Community will be obliged to substantially reduce the list of sensitive products excluded from liberalization, and should consequently compensate its farmers' revenue losses by way of direct payments. Some senior Commission officials are well aware of this and seem to believe this would require additional EU budget payments. Letting EU farmers believe that they could then obtain additional farm support soon after the next CAP reform and New Financial Perspectives lacks credibility.

Sixth Query: WTO Impact

Considering that the WTO Round is still open, it would seem inappropriate to revive the Mercosur talks now. How could we agree on duty free access for the most competitive partner, and limit it for the others in the WTO context? Also, how can we believe that Mercosur will support a new global round, if they can get preferential access bilaterally with us?

A FTA with Mercosur would put us in an impossible position in the WTO:

- The CAIRNS Group, that is, the most free trade oriented countries in the world, who seek the abolition of the CAP, would ask us to expand our concessions made to Mercosur, and possibly push for more drastic dismantlement of EU agricultural protection, and the end of the CAP
- The US, whose USTR has all but abandoned hope to negotiate a FTA with Mercosur because of opposition on the Hill, would try to oppose or disrupt an EU-Mercosur FTA, because it would allow the EU to occupy their trade home ground and encourage Mercosur to adopt EU standards different from those in America.
- If the EU grants free trade in commodities to countries that are among the most competitive, how can it defend a certain import protection for its farm products within the WTO round?

"The extent to which agricultural products are included (in a FTA with Mercosur) is the most difficult part of the analysis of WTO compatibility. This is linked to the very existence of the CAP".[6]

Nobody can be sure whether the final FTA agreement will be compatible with WTO rules.[7] Article XXIV on customs unions and free trade areas, which requires reciprocal coverage of "substantially all trade", is pretty vague.[8] The interpretation reached in the Uruguay Round leaves much to be desired, particularly after the strengthening of the dispute settlement system that is now specifically applied to agreements covered by Article XXIV. The WTO may well consider that a 90% minimum coverage of current trade (before the FTA) is enough. There are precedents. But, can one exclude that it may ask to extend the 90% coverage to <u>all</u> tariff lines?[9] In any event, sensitive products such as meat, main cereals (wheat, barley, corn and rice) and derivatives, milk butter and cheese, and main fruit and vegetables and sugar cannot be excluded from a WTO-compatible FTA. It is hardly realistic to suppose that the Mercosur could agree to a

6 From Sir Leon Britain's draft paper for the meeting of RELEX Commissioners of 18 March 1996.

7 Originally, it was thought that regional trade agreements would apply to highly interdependent, neighbouring partners. For the WTO, FTAs must be trade creating, not trade diverting. This is a key aspect in the WTO's assessment of FTAs. According to the literature, the less trade interdependence in a FTA, the greater the trade diversion as compared to the trade creation. An FTA with Mercosur would involve very unequal reciprocal trade dependence. The EU currently imports five times more from Mercosur than the US, making it the group's main trading partner. However, Mercosur's share of total EU imports and exports remains tiny at 3% and 2.5% respectively.

8 A safe interpretation (by DG RELEX, 1998) requires coverage of "substantially all trade", meaning at least 80% and preferably 90% of overall two-way trade, and that no major sector could be excluded. Concessions such as reduced duties, even within quotas, may be useful to further ensure WTO consistency for products not falling within the 90% or so which should entirely be free at the end of the transition period… Free trade coverage cannot include trade covered by duty-free tariff quotas, or duty-free trade under entry price system… In the case of sensitive sectors (such as agriculture or textiles), which may amount to a limited percentage of overall trade, a lower proportion than 90% may be subject to free trade. There is no safe guidance as to what that percentage should be and clearly, the higher it is, the easier the WTO defence will be.

9 The EU proposal of 1998 had an agricultural exclusion list covering at least 11% of trade, but if suggested exclusions regarding industrial products and fisheries had been added,, it would have covered as much as 16% of EU trade.

series of exceptions from the main CAP products because different Mercosur countries have key interests in each of the main products.[10]

It might therefore prove difficult to defend within the WTO a FTA agreement with Mercosur with the necessary exclusions to make it acceptable to us, especially if other WTO members were to invoke WTO-incompatibility of the new FTA. If we cannot defend the FTA within the WTO, we can of course forget to obtain a waiver as an alternative. The WTO will in any event have the last word.

Seventh Query: Loss of Preferences

An FTA with Mercosur would diminish (if not nullify) the advantages granted by the EU to the 49 Least Developed Countries through the Everything-but-Arms (EBA) initiative, as well as the trade preferences enjoyed by Europe's Mediterranean partners and the ACPs, and seriously add to the competitive difficulties of the new EU members and candidate countries on the EU market. It would also limit potential new market openings regarding our neighbours to the East and the South Mediterranean.

Eighth Query: Pressures for More FTAs

Apart from our multilateral commitments**,** the EU has a web of plurilateral and bilateral agreements: the Cotonou Convention moving towards free trade with its various component regions, the Customs Union with Turkey, the Neighbourhood Agreements, the EURO-MED agreements, more recent FTA agreements such as with South Korea, and so forth. The greater the Mercosur product penetration of the EU agricultural market, the smaller the EU's possibility to grant agricultural trade concessions to other countries, and the greater the risk of discrimination against less competitive partners.

These dynamic effects acquire their full significance if one takes into account that:

- Mercosur participates actively in the creation of a free trade area of the Americas (which would include NAFTA). At the Santiago de Chile Summit in April 1998, 34 Heads of State decided to launch negotiations to that effect.
- Mercosur Members have been negotiating free trade areas with other Latin American countries in the framework of ALADI.[11] All Mercosur countries are members of the 14-countries-strong CAIRNS Group[12] and collectively seek the abolition of the CAP
- Any EU trade concessions to Mercosur could lead other CAIRNS members and the US to demand similar concessions jeopardizing the CAP, or using the WTO dispute settlement system to similar effect.

An extension of EU free trade with Mercosur to all of Latin America (except Mexico) would concern about double a share of EU agricultural imports (around 27% as compared to 19%) This percentage would rise to as much as 50% in case of a FTA with all the Americas.

Any trade concessions given to third countries have a cumulative effect with previous concessions. Those made to one preferential partner inevitably mean preference degradation for other trading partners, and lead the latter to request higher trade preferences, with EU neighbours having the strongest claims. On the other hand, if the US Congress, as it seems, will continue to refuse to engage in free trade with Mercosur, whereas the EU goes ahead, this would leave the EU alone to be more fully exposed to Latin American competition in agriculture.

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[10] Argentina for grains and milk products, Uruguay for rice and sheep meat, Brazil for sugar, and for beef.

[11] Currently 12 members –Argentina, Brazil, Venezuela, Bolivia, Ecuador, Peru, Paraguay, Uruguay, Cuba, Colombia, Chile, Mexico; open to new membership from Central America

[12] Fourteen countries including Australia, Canada, New Zealand, and South Africa.

General considerations on FTAs.

It would stand to reason for the EP, drawing on the experience of international trade experts, to make a thorough assessment of the Commission's approach outlined in its recent paper on trade strategy.[13] This is the sense of ECIPE Director Razeen Sally's brilliant intervention at the EIN Seminar on "Free Trade Agreements and the Future of Global Trade" that took place at the ASP Building on 16 November 2010 (which unfortunately very few MEPs attended). The strategy paper, apart from some truisms about the benefits of trade (economic growth, consumer benefits, employment effect, diffusion of innovation…), seems to have as the main objective to pursue the current trade voyage.

Dr. Razeen reported that the current failure and poor prospects of the Doha Round had triggered a world FTA-race. In his expert opinion, virtually none of these FTAs could be considered a WTO-plus FTA (the EU-South Korea FTA being an exception). Most are FTA-light, i.e. of low quality, more deals negotiated on foreign-policy grounds - and hence often called "strategic"- than trade agreements with teethe. Sometimes this was obvious from the ministerial involvement and/or the legal basis.[14] FTAs mostly eliminated custom duties on 90% of tariff lines (as requested by the WTO), without true trade liberalization on the ground (most non-trade barriers, far more efficient trade impediments than customs duties, remained). Some included investment agreements, but EU MS were reluctant to *communitarize* them. The shift from multilateral liberalization to discriminatory liberalization through FTAs had **not** lead to major trade liberalization, nor had it prevented stalling WTO talks; disconnected from domestic policy restructuring, they had had little impact, but fortunately had not caused so far major trade damage either. The US FTAs were the most comprehensive (safe agriculture), strongly weighted in favour of the US, with disciplines on labour and environmental standards and strong dispute settlement provisions. US negotiations had been concluded only with few small and medium sized countries such as Australia, Colombia, and South Korea, but failed with others such as Malaysia, Singapore, South Africa and Thailand. No further FTAs had proved capable of approval by the US Congress since 2008, as protectionism had been increasing with both the Democrats and the Republicans.

Overall Dr. Sally feared a revival of protectionism, and the past record caused him doubts about the benefits of bilateral FTAs. He felt the existence of vast supply chains in globalised markets helped resist protectionism, but FTAs were of no help in extending supply chains, because they focused on individual markets.

While Dr. Razeen was optimistic about EU prospects of negotiating deeper FTAs with Canada and Singapore, who had the right domestic policies and were engaged in other meaningful FTAs, he raised serious doubts about the content of potential EU FTAs with ASEAN, India, Mercosur, Malaysia and Viet-Nam, particularly as regards regulatory issues. It was an illusion to believe, he said, that an FTA with India (who had not signed an FTA with any country yet) would provide the extra access to European companies once inside the Indian border. Eliminating customs duties was nothing compared with overcoming the barriers created by licensing regulations, extra taxes, labour market regulations and practices, and all other non-tariff regulations. These were "big nuts to crack". The same could be said regarding Mercosur. Dr. Sally saw a danger that in its race to deliver deals, the EU might end with concluding FTAs that were not commercially serious leading to distortions, especially with countries with high regulatory protection. He felt EU trade policy was unable to achieve its purpose without stronger international rules and

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13 European Commission, "Trade, Growth and World Affairs: Trade Policy as a Core component of the EU's 2020 Strategy

14 China FTAs with neighbours did not involve the Trade Ministry, which dealt with the WTO, but the Foreign Ministry. India's FTAs were presented to the WTO under the enabling GATT clause rather than under GATT Article XXIV with its higher standards.

continuing internal market liberalization. (The Commission's Strategy Paper concurs with this view). Trade policy should be accompanied by a strengthening of the Internal Market. The Europe 2020 Strategy could not act as a substitute for that. He hoped that the stronger involvement of the European Parliament in FTAs following the Lisbon Treaty would not follow the US Congress' record in pressing for basic labour and environmental standards possibly detracting from commercial liberalization.

Conclusion

The EU has always (rightly) had sympathies for supporting new regional integration efforts elsewhere. Mercosur has taken the EU as a model, a "federator", and a counterweight to US political, economic and cultural influence. Despite its tendency to enlarge (often a false sign of health) Mercosur continues to have serious internal difficulties in making headway due to its 100% intergovernmental structure and to the internal imbalance caused by the presence of a regional super-power, Brazil. It reckons that by turning and talking to the EU, and getting its advice can strengthen it and hopefully help it to prosper. The prospect of a FTA with Europe might actually help it overcome serious internal divisions and succeed, provided the implementation of Mercosur legislation is made obligatory, which it currently is not. Without that, what does it actually mean negotiating with Mercosur?

That the Commission's FTA initiative was ill conceived was clear from the very beginning. This was not simply due to inconsistencies vis-à-vis the CAP. The very EU/Mercosur trade picture did not fit the original concept of a free trade area, which applied and should still apply to countries with a high degree of interdependence in trade. Without FTA, the EU already is Mercosur's first market (almost 50% of all Mercosur agricultural exports; 20% of total EU agricultural imports in 2009), whereas Mercosur is a minor market for the EU, and an FTA agreement would not change that substantially (Brazilian economic dynamism is another thing, independent from Mercosur).

It is all a matter of policy coherence. "We <u>can</u> pursue agricultural reform, we <u>can</u> pursue the WTO negotiations and we <u>can</u> negotiate enlargement…but not if such reform is forced through by agreements such as Mercosur".[15]

An EU-Mercosur FTA agreement makes sense for the Latin Americans, as Europe is their largest agricultural market, but does not make much sense for Europe unless it means a major, effective opening of Mercosur's manufacturing and services market, which is not on the cards. In any event, the CAP and EU farmers would be the losers; expectations for a boost in high value added food exports to Mercosur are overblown. Insofar as such an FTA would enhance agricultural production in Mercosur countries, it remains to be seen what consequences that would have for small farmers in those countries, the Amazon forest and the world's environment in general. Much would depend on the extent to which those countries can be brought in line with European sanitary, phytosanitary and environmental standards, and led to undertake land reforms and to engage in multifunctional, sustainable agriculture. This is a daunting challenge. As almost everyone knows, European promises to make FTA implementation dependent on agro-forest sustainability in Mercosur are wishful thinking.

The timing of this FTA initiative is particularly odd considering that Europe's main competitor in the Americas, the US, is in the throngs of a new protectionist phase and reluctant to engage in a FTA with the Americas, or even a FTA with Brazil alone, and given that there is deadlock in the Doha Round.

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15 See Commissioner Fischler's statement (enclosed) in the minutes of the Commission meeting of end July 1998. It remains word-by-word relevant today.

One may therefore wish to ask two questions: why were the FTA negotiations with Mercosur re-launched at this time? And who would benefit most from a deal? There are probably no simple answers to either question.

Rumor has it that, when Prime Minister Zapatero lamented with President Barroso that achievements under the Spanish Presidency had been insufficient, he was promised a restart of the FTA negotiations with Mercosur. Whether true or not, back room deals are common, and the FTA initiative may have benefited from one.

I have argued the reasons why reviving FTA negotiations with Mercosur is a mistake: poor prospects for a balanced deal, lack of a clear strategy on FTAs, weak impact assessments, lack of coherence with EU policies such as the CAP and regarding the environment, costs for the EU budget, weakening of multilateralism and the WTO, negative consequences for trade with other EU partners, and unforeseeable dynamic effects if and as Mercosur enlarges to include other American countries.

It is conceivable that impact assessments may be undertaken, or managed with the purpose of supporting a proposal for action, not to endanger it, emphasizing the pros and undervaluing the cons. The Commission proposal and the impact assessment so far have focused on the pros. I have tried to highlight the cons as I see them. This should help complete the picture of the relevant arguments. I hope it will help improve policy coherence, and avoid the frustration of failure.[16]

As in other cases before, once a goal is considered (realistically or purposefully) a matter of high politics, counterarguments tend to be under stressed if not ignored in order to facilitate passage in Commission, Council and Parliament. The latter institutions might occasionally feel, as it were, defrauded of an insightful decision based on the knowledge of <u>all</u> the facts. This is in my view what happened with the Commission EU-Mercosur FTA proposal of 1998 (the Commission will of course claim total transparency). It is not a unique occurrence in politics. If this note has provided at least some valid arguments not yet submitted to Parliament, this means that the Commission briefs on EU-Mercosur and on a FTA strategy for that matter are deficient.

FTA negotiations with the Mercosur risk creating more frustration than satisfaction on both sides. One can of course try and reach a minimalist outcome and declare it a success. But is this good politics? In the unlikely event that the negotiations were pursued and reached a successful conclusion, one can anticipate the results to be divisive, and eventually to be rejected by Council and/or Parliament. If not, they would complicate the necessary CAP reform process, because of their prospective impact on farm incomes and EU budget outlays. This would make it more difficult to reward EU farmers, not just for producing healthy food, but also for improving eco-systems.

Surely, the EU should try to ensure that trade policy initiatives are consistent with existing policies, and avoid (at least outside the WTO framework) that trade initiatives force it to adjust policies it has not decided to change for their own sake. Policy coherence become even more

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[16] Among the Commission's foreign trade ideas that failed in the past, I may recall a Free Trade Area with the US, vented by Sir Leon Brittain, which was transformed into a proposal for the New Transatlantic Market Place, and his proposal of a Millennium Round including new issues such as anti-dumping, anti-trust and investment provisions. The FTA proposal was stillborn. It would have meant the end of the WTO. The TMP discussions are not dead, but regulatory convergence is anathema to the prerogatives of the US Congress. The Millennium Round proposal was rejected within the WTO. The same fate awaits Turkey's accession to the EU, which may be rejected by at least one EU Member State and/or by Turkey itself when it realizes the constraints accession involves for its internal policies.

important when one deals with FTAs-light such as the one pursued with Mercosur, with greater costs for European agriculture than benefits for European industry and services, and unpredictable negative consequences for poorer EU agricultural producers, and EU neighbours in the East and the South. Common sense suggests that EU trade priorities should again focus on the WTO and on Deep Comprehensive Free Trade Agreements within the Eastern Partnership and the Euro-Mediterranean Partnership.

Corrado Pirzio-Biroli 7 December 2010
RISE Foundation

Annexes:

1. Background Information
2. Declaration to the Commission Minutes on an FTA with Mercosur

ANNEX I

SOME BACKGROUND INFORMATION

History

The Southern Cone Common Market (MERCOSUR) was created with the Asunción Treaty in March 1991 by Argentina, Brazil, Paraguay and Uruguay and entered into force in 1995. Venezuela is joining as a full member, Bolivia, Chile, Colombia, Ecuador and Peru are Associate members and Mexico is an observer. Mercosur aims at creating a customs union with free circulation of goods, services, capital and labour as well as a common currency. However, implementation has been held up by internal disagreements and a power imbalance between the Brazilian colossus and the rest. It has set up a common external tariff (CET) with 11 different rates, which is in theory applied since 1995 but with exceptions for sensitive products and serious implementation delays (only one quarter of Mercosur imports pay the CET). The absence of clear basic Mercosur import duties makes it difficult to negotiate a FTA.
Following the creation of MERCOSUR, its approaches to the EU and a steep fall in EU exports to Mexico to the advantage of its NAFTA partners, the Commission undertook to respond by issuing a **Communication on Free Trade Areas** of March 1995. In response to the Communication, the Council requested the Commission "before taking any steps towards establishing a free trade area" and "assess the compatibility of the planned agreement with WTO rules" as well as "assess the implications of such an agreement for the Union's common policies and for its relations with its main trading partners…with view to the approval of negotiating directives."

Three months later, Council and Commission concluded, "in future, before taking steps towards establishing a free trade area, the Commission should:

- Assess the compatibility of the planned agreement with the WTO rules;
- Assess the implications of such an agreement for the Union's common policies and for its relations with its main trading partners."

In the same year, an Interregional Framework Co-operation Agreement was signed with the ultimate objective to achieve a greater level of political and economic co-operation and integration within the MERCOSUR group itself, and with the EU. Similarly, on 13 September 1999, the Council approved negotiating directives for a Political and Economic Association Agreement between the EU and Mercosur/Chile.

The first round of negotiations took place in April 2000 in Buenos Aires, followed by a first phase in June that was initially dedicated to bringing down non-tariff trade barriers. Progress was slow; Mercosur, seeking a long conceptual debate about the CAP, held it up. Both sides were divided internally, with Brazil taking the lead in harassing the EU until it admitted not having enough weight to force the EU to change the CAP, considered a WTO Round essential to address agricultural policies. On the other hand, the EU side doubted it could get the necessary concessions in the non-agricultural sector in bilateral, as against WTO talks. Mercosur wants free trade in exactly the agricultural areas which the EU seeks to exclude, and wants to continue to protect those manufacturing and service sectors the EU is interested in. The FTA negotiations were suspended in 2004, mainly due to continuing disagreements on agriculture. The FTA and WTO negotiations did not prove mutually supportive and became an exercise in frustration.

Since 2004, political relations have evolved, with an accord being reached at the last Summit in Lima (2008) to extend relations to new areas, science and technology, infrastructure and renewable energy, even if leaders could only notice the persistence of their disagreements.

Basic Data

Mercosur is the fourth world economic power, with a surface of 11.9 million km2, three times larger than the EU15, a population about half as large as the EU, and a GDP approximately one seventh of the EU. Brazil is by far the largest Mercosur economy with 79% of its GDP, followed by Argentina with 18%, Uruguay with 2% and Paraguay with 1%. Also Chile's economy is small compared to Brazils'.

EU imports from Mercosur rose by 123% from €18.5bn (98-99 av.) to €41.6bn (2008-09 av.), while EU exports to MERCOSUR rose by 130% from €23bn to €30bn. The EU currently imports five times more from Mercosur than the US, making it the group's main trading partner. However, Mercosur's share of total EU imports and exports remained tiny at 3% and 2.5%, and the negative trade balance has increased sharply from just over €1bn ten years ago to over €10bn recently, mostly due to a deficit in agricultural trade. About one half of all EU agricultural imports from MERCOSUR are agricultural products, which represent about one fifth of overall such imports. Mercosur currently provides a market for 4.2% of EU agricultural exports, while 19% of EU agricultural imports stem form the Mercosur group (2009). Mercosur's exports to the EU are principally concentrated in a small range of products, in particular soya and its derivatives, oilseeds, coffee, orange juice, tobacco, meat, fruit, peel and nuts. Three groups of products account for half of the EU agricultural exports to the Mercosur, comprised of alcoholic beverages, dairy and other edible animal products, olive oil and cocoa derivatives.

Mercosur agricultural exports are more dynamic than those of the EU. According to a French Memorandum, during the period 1990-1997, Mercosur's chicken exports increased from 340 to 900 million dollars, Argentina's maize and Brazil's sugar exports more than trebled, Chile's pear exports increased by 80%, Argentina's wheat production increased by 60% and its production of olive oil trebled from 6000t in the 1990s after introducing an import levy to that effect; it is expected to reach 170,000 tons in the next few years at a very competitive price, bumping it into the top ten world producers. In 1995, a Latin American study on the potential impact of a Mercosur/EU FTA on Brazilian agricultural exports to the EU concluded on a sharp increase by a factor of three for livestock and non-grains, and by over four times for grains, thanks to price differentials of 50-100%. (That has insufficiently been taken into account by the SIA study)

ANNEX II

Declaration to the Commission Minutes on a FTA with MERCOSUR – Agenda Point 9[17]

(Quote) "We disagree with the timing and the content of the proposal of a Free Trade Agreement between the EU and MERCOSUR (and Chile):

- regarding timing there are frankly more urgent priorities today: complete CAP Reform within Agenda 2000 and engage in the WTO Round on that basis. We cannot accept that a draft-negotiating mandate with MERCOSUR had to come first with the risk of jeopardizing both internal reform and the Union's effectiveness to negotiate in Geneva
- regarding substance, the proposal denotes a lack of a clear strategy and priorities concerning EU trade relations and a lack of coherence between CAP Reform, WTO negotiations and new FTAs. Our focus should be on multilateralism within the WTO, while preserving closer trade relations with our neighbours.

"We believe the proposal should have been postponed to a more convenient time…or would have had to be limited for the time being to negotiate further trade liberalization instead of a FTA.

"We expect that several of the following sensitive products will have to be excluded from the FTA: bovine, pig and poultry meat, main cereals (wheat, barley, corn, rice) and derivatives, butter and cheese, main fruit and vegetables, and sugar. Mercosur's production potential is likely to make in time sensitive also olives, olive oil, and fresh fruit juice (apple, orange and grape)."

"Limiting the exclusions of the most sensitive agricultural products amounting to 10.5% of current trade would require changes to market reforms included in the Agenda 2000 proposal, or, if these were left untouched, a radical opening up of our market for sugar and fruits and vegetables (not covered by Agenda 2000)."

"Any claim that the largest ever Free Trade Area in the world could be established in the full respect of WTO rules leaving the reformed CAP untouched, defies common sense."

"Any presumption that CAP adjustments which would be required in this connection would have little impact on the financial perspectives before 2006, not to say after that, would be a mistake."

"The compatibility clauses, which have been included in the proposal, regarding the need to preserve the CAP reform proposal and the financial perspectives in Agenda 2000 are insufficient to give any real guarantee."

"Any assertion as to what percentage of trade can be excluded from a FTA cannot be corroborated by legal texts or facts. Nobody can actually tell whether the GATT/WTO, which has never formally approved a FTA, will refrain from formally rejecting FTAs that will be notified to it in the future. This is a matter of interpretation of Article XXIV of GATT, which is not in our hands, and may well be made more restrictive in the course of the WTO Round."

"It is high time the Commission established clear priorities regarding external economic relations and assessed their coherence with internal policies. Moreover, a more thorough analysis is required of the possible impact of a proliferation of FTAs, notably with MERCOSUR, on the export prospects of our closest, less competitive partners (CECs, Mediterranean, ACPs) on the EU market. These risk being the big losers." (End Quote)

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[17] Sent by me to Secretary General Carlo Trojan on 22 July 1998 on behalf of Commissioner Fischler a.o.