Policy Contribution
Issue n˚11 | September 2019

[illegible] (michael.baltensperger@bruegel.org) is a former research assistant at Bruegel

[illegible] (uri.dadush@bruegel.org) is a Non-resident Fellow at Bruegel and a Senior Fellow at the Policy Center for the New South

The authors thank Otaviano Canuto, Anabel Gonzalez, André Sapir, Guntram Wolff and participants in a Bruegel seminar held on 2 September 2019 for helpful comments, and Marta Dominguez and Kyra Whitelaw for research assistance.

Executive summary

[illegible] from the Free Trade Agreement between the European Union and Mercosur – Argentina, Brazil, Paraguay and Uruguay – are small on account of the small share of EU trade with Mercosur and the relatively modest ambitions of the deal in terms of liberalising agriculture in the EU and manufacturing in Mercosur. Nevertheless, the agreement, if ratified and accompanied by reforms that strengthen competitiveness, could represent a major departure for Mercosur, pushing it towards an outward-oriented development strategy. The deal could also mark a significant step forward for the EU in its efforts to reform agriculture. The agreement faces a difficult ratification process, but is worth having and fighting for. Incorporating mechanisms to deal with environmental, especially deforestation, concerns will be particularly important. The agreement constitutes an insurance policy against further deterioration in the rules-based multilateral trading system.

The EU-Mercusor Free Trade Agreement: a deal… finally

After nearly 20 years of on-o negotiations, the European Union and Mercosur – a customs union covering Argentina, Brazil, Paraguay and Uruguay – in June 2019 reached a political agreement on a trade deal[1]. e free trade agreement (FTA) agreement faces a di cult rati cation process, especially in Argentina where the market friendly government of Mauricio Macri could be replaced by a protectionist Peronist administration in an election on 27 October 2019. It is possible that a change of heart in Argentina could lead Mercosur – a troubled customs union (Veiga and Rios, 2019; Felter , 2019) – to splinter, given strong support for the EU-Mercosur FTA from the Bolsonaro administration in Brazil. Moreover, the parliaments of EU countries are expected to have their say on rati cation, given that the trade agreement is part of a wider Association Agreement between the two regions, which entails aspects over which EU member states are competent. Environmental concerns and agricultural interests will organise to oppose rati cation of the agreement in France and other member states, and the outcome is not certain.

Assuming the agreement is ultimately rati ed, the quanti able gains are likely to be small for Mercosur, because of the deal's modest scope in terms of liberalising trade in products such as beef and other sensitive agricultural products, and its correspondingly limited ambition to reduce tari s on manufactured goods entering Mercosur. e quanti able gains are smaller still for the EU on account of the modest liberalisation in agriculture and Mercosur's small size as an export destination for the EU. e less quanti able and potentially much larger gains that might accrue from the agreement relate to its potential to drive reforms and long-term productivity improvement in Mercosur's manufacturing sector and the EU's agriculture sector. As always, speci c sectors could see signi cant gains or losses from the agreement, even though the macroeconomic e ects are small. e fact that the agreement will take years to ratify and its implementation schedule is gradual and linear over ve to ten years, will make the changes on the ground virtually imperceptible in all but the most sensitive sectors, which should ease concerns about adjustment costs.

e EU-Mercosur deal was made possible by a con uence of reformist governments in Argentina and Brazil in the wake (or midst) of deep economic crises, and the EU's determination to counter new protectionist threats. Despite its small measurable e ects, wees, and the EU'tin by improving its preference margin even in the United States' backyard. Equally important, with the agreement the EU consolidates its position – even if modestly – as the bloc best able to function in the event of the World Trade Organisation faltering.

Third, even though the chapter on agriculture could have been more ambitious, by linking to the world's most competitive agricultural producers, the EU opens a new chapter in its long and chequered history of efforts to reduce support for this sector and open it to international competition. As happened in other deals, for example the FTA with Morocco and other countries in the Mediterranean, the agriculture chapter establishes a foundation on which liberalisation measures may be extended in the future, for example by increasing tariff-rate quotas, opening new ones or reducing the in-quota tariffs.

Fourth, the agreement goes far beyond reducing tariffs. Even though the full text of the agreement is not at time of writing finalised, and these potential gains are not quantifiable, they are likely to be significant, especially in areas such as financial and transportation services, trade facilitation, geographical indications and other areas where they go beyond present WTO disciplines (WTO+).

Beyond ratification, the challenges faced by the two blocs in realising the gains from the agreement are big but quite different. The EU must improve its farmers' ability to compete and find ways to extend progressively the scope of the agricultural chapters. The EU must also monitor implementation in crucial areas such as removal of non-tariff barriers in Mercosur, and Brazil's compliance with the Paris Agreement – a condition on which the deal is based – including fighting deforestation in the Amazon.

Mercosur, meanwhile, faces the greater challenges. Mercosur members will need to put in place profound economic reforms to strengthen their competitiveness to face the increased

countries has decreased since 1997. In 1997, 25 percent of Mercosur countries' total exports including exports to other Mercosur countries went to the EU; 20 years later this share is at 16 percent. In terms of extra-Mercosur exports, exports to the EU were 32 percent of the total in 1997 and 18 percent in 2017. is is despite the EU adding 13 countries during that period. China has played a role in determining these trends. Exports to China were 4 percent of extra-Mercosur exports in 1997, 12 percent in 2007 and 25 percent in 2017, making China the most important export destination for Mercosur countries. Meanwhile, the United States, the third most important trading partner for Mercosur, has also been declining in relative terms. In 1997, 22 percent of extra-Mercosur exports went to the US and 19 percent of extra-Mercosur imports came from the US. In 2017, these shares stood at 13 percent and 17 percent respectively.

Table 1: EU-Mercosur trade over time in $ billions

E [illegible] M [illegible]	199[illegible]	[illegible]00[illegible]	[illegible]01[illegible]

their products. e assumption that exporters do not reduce prices implies that there is no resource reallocation and there are no net gains from trade as a whole, only redistribution of existing gains because of the reduction in tari s. In that case, the gains to EU exporters amount to 0.026 percent of EU GDP, while the gains to Mercosur exporters amount to 0.6 percent of Mercosur GDP. Proportional to GDP, the gains to Mercosur are about 2.3 times greater than the gains to the EU, re ecting the greater importance to Mercosur of trade with the much larger EU economy, and despite Mercosur tari s being higher than EU tari s. However, the *t* gains for the EU are greater because it pays more tari s to Mercosur than Mercosur does to the EU. So, without reallocation of resources, Mercosur is a net loser from the agreement to the tune of about $2.8 billion, or about 1 percent of GDP. Additionally, the agreement would also have sharp domestic distributional consequences, with governments losing tari revenue, consumers not a ected (since prices do not change) and gains accruing primarily to EU manufacturers and, most of all, to agricultural producers in Mercosur whose pro tability, expressed as the return on capital and land, could increase very signi cantly[6], even as the Mercosur economies lose on aggregate.

If we assume instead, as is more realistic, that exporters reduce prices to some extent once tari s are removed and resources are reallocated, the gains to both the EU and Mercosur parties from full liberalisation could be substantial sio s a modest gradual expansion of tari -rate quotas for sensitive products[9], in exchange for less-than-full liberalisation for Mercosur goods. Burrell [illegible] (2011) also simulated the 2006 Mercosur o ers, which proposed greater liberalisation than the EU for agriculture in exchange for even greater Mercosur liberalisation for goods. As it turns out, the present agreement contains elements of both o ers, so Burrell [illegible] (2011) provides useful pointers.

Box 1: Comp[illegible]m2tisation for goods. As it tds. As .

somewhat larger gains for the EU (Estrades, 2012). While under full liberalisation, the EU could gain 0.2 percent of GDP and Brazil, for example, could gain 0.4 percent of GDP, under the limited liberalisation envisaged for sensitive products by both blocs, the gains would be around 0.1 percent for both the EU and Brazil. The distributional effects of the FTA are estimated by Burrell et al. (2011) to be modest in the EU (small losses in terms of agricultural incomes and land values) and notably greater in Mercosur where agricultural incomes would increase significantly.

The stark differences between different studies arise mainly from different assumptions and/or model specifications – notably the inclusion of dynamic gains estimates – but they also underscore the importance of full liberalisation for goods by Mercosur and for agriculture by the EU. A rough comparison of the proposed FTA and the Burrell et al. (2011) scenarios (Box 1) suggests that the FTA as currently envisaged lies somewhere between the 2004 EU offer and 2006 Mercosur offer – implying that the quantifiable static gains are small for both parties, though larger for Mercosur.

In fact, the FTA includes liberalisation for non-sensitive products, but only limited liberalisation for sensitive agricultural products – where some of the greatest gains could be – and essentially no action on the EU's agricultural subsidies. Correspondingly, Mercosur commits to significant – but only partial – liberalisation for goods. Agriculture liberalisation by the EU is central to determining outcomes, not only because of its inherent value, but also because modest EU ambition on agriculture implies that Mercosur's motivation and offer in all other aspects of the agreement is reduced. The next section delves into the EU's concessions on sensitive agricultural products in more detail.

The EU's concessions on sensitive products, Mercosur tariff savings and prices in the EU

Even though the EU is a net agricultural exporter, including of products referred to as sensitive by the EU, such as beef, poultry and sugar, EU agriculture remains highly subsidised and protected, with EU farmers receiving 37 percent of their income on average from public sources[11].

EU agricultural subsidies distort production decisions over specific crops less than they used to (having been largely delinked from production), but nevertheless represent an enormous source of advantage for EU farmers relative to non-EU producers and Mercosur producers in particular. The EU plans some reduction in subsidies under its regular budget cycle, but the subsidies will not be affected by the EU-Mercosur FTA and might even increase marginally[12] on account of a small adjustment compensation scheme.

In addition to direct public support in the form of various subsidies, EU agriculture is artificially propped up by severely restriction of competition from overseas. According to the World Tariff Profiles 2019[13], 40 percent of EU applied tariff lines in agriculture exceed 10

11 [illegible] 2013-2017 [illegible] 26%. [illegible] 20% [illegible] 40% [illegible] 37% [illegible]. See https://ec.europa.eu/agriculture/sites/agriculture/files/cap-post-2013/graphs/graph5_en.pdf.

12 [illegible] E[illegible]-M[illegible] F[illegible] A. H[illegible], [illegible] CAP [illegible] 1[illegible]-15 [illegible] (M[illegible], [illegible]).

13 A[illegible] https://www.wto.org/english/res_e/publications_e/world_tariff_profiles19_e.htm.

percent. Moreover, 13.5 percent of agriculture tari lines at the six-digit level[14] are covered by tari -rate quotas and 23 percent of agriculture tari lines are subject to special safeguards that can be applied automatically in the event of prices dropping below a benchmark.

As already mentioned, the EU-Mercosur FTA will involve elimination of tari s on about half of EU imports from Mercosur that are not already entering duty-free under the EU's MFN applied tari s – a signi cant step. However, products that are subject to tari rate quotas present a very mixed picture. Our review of the EU's tari rate quotas under the proposed FTA suggests that the proposed liberalisation for most products is very limited compared to EU consumption and will imply little change in EU production. Indeed, the agreement has been presented as such[15] by the European Commission. e liberalisation is also limited compared to Mercosur production and exports (ethanol is a clear exception). Moreover, while Mercosur will derive signi cant tari savings from lower in-quota tari s and their expansion, these gains are likely to be largely appropriated by Mercosur producers and not passed on to EU consumers because the quota expansions are very small relative to EU consumption. Of course, the tari reductions imply lower EU tari revenues.

Table 2 lists the EU's most important sensitive products as they a ect Mercosur. In 2018 Mercosur exported $8 billion worth of agriculture, forestry and shery products to the EU. Mercosur exports of products excluded from full liberalisation were on average $3 billion per year between 2016 and 2018, though the volume would potentially be much larger if there was no protection. e EU is a major export destination for Mercosur countries for several of the sensitive products, despite very high tari s. For example, 42 percent of income from Mercosur's fresh beef exports, which face a 59 percent MFN tari out of quota, is realized in the EU, and a third of Mercosur's honey exports and around 10 percent of poultry meat exports go to the EU (Table 2). Often, Mercosur exporters realise a higher price per tonne in the EU than in other export destinations because products exported to the EU, for example beef cuts, are in the high-quality segment.

Table 2: Mercosur exports to the EU of products excluded from full liberalisation by the EU

			M			E MFN
P		$	P $/			
B	11[illegible],0[illegible]5	9[illegible] [illegible]	[illegible],19[illegible]	[illegible]5%	4[illegible]%	59%
B	5,[illegible]19	[illegible]0.	5,0[illegible]9	4%	[illegible]%	4%
P	91,9[illegible]	94[illegible].9	[illegible],4[illegible]1	%	1 %	5 %
H	,9[illegible][illegible]	90.1	[illegible],[illegible]5	[illegible]%	0%	1 %
	4[illegible][illegible],914	[illegible][illegible] .4	4[illegible]5	[illegible]%	[illegible]%	[illegible] %
E	4[illegible],4[illegible]	[illegible]0.	44[illegible]	%	[illegible]%	[illegible]1%
	11 [illegible]4	5 .9	4[illegible]0	4%	5%	[illegible]%
	[illegible]	< 0.1	4,51	[illegible]%	[illegible]%	14%
P	5	0.1	[illegible],14	< 1%	< 1%	[illegible] %
C		0.1	,[illegible]0	< 1%	< 1%	40%
M	< 1	< 0.1	14,[illegible][illegible]	< 1%	< 1%	[illegible]4%

2016-2018.

14 https://unstats.un.org/unsd/tradekb/Knowledgebase/50018/Harmonized-Commodity-Description-and-Coding-Systems-HS.

15 As stated by EU Agriculture Commissioner Phil Hogan 2 ()83 (t)1 (e)-3 (d b)11.1 (y E)3 (U Agr)-7 (ic)0 (hil H)g/216

more sugar to the EU than what could go through the quotas, again underscoring the bloc's competitiveness. e additional quota of 10,000 tonnes for sugar originating in Paraguay, foreseen under the EU-Mercosur agreement, will lift total sugar quotas to just 90 percent of what is currently exported from Mercosur to the EU, a very small change.

Ethanol presents a di erent story. Imports to the EU are subject to the 21 percent MFN tari . e EU-Mercosur agreement grants a large quota of 650,000 tonnes per year. Of this, 450,000 tonnes will be reserved for ethanol for chemical purposes, which will be duty free. e remaining 200,000 tonnes will have an in-quota duty of a third of the MFN rate and is open for all uses, which means particularly for fuel use. ese quotas are very large when compared to current trade. ey are almost half the size of Mercosur's total exports of ethyl alcohol to the world. e European bioplastic and biochemical industries, major buyers of ethanol, are expected to grow signi cantly in the short to medium term. Hence a major increase in ethanol exports from Mercosur to the EU can be expected, implying lower prices in the EU, and implying increased production in Brazil, as well as some reorientation of present ethanol exports from other destinations. Brazilian ethanol producers can also be expected to displace EU imports from third parties, particularly the United States.

Table 3: EU tari rate quotas on agricultural products: current and new under EU-Mercosur agreement

A	B	C	D	E	F		H	J
	M		E E [illegible]01[illegible]		N	F/B	(D+F)/B	P -
P	E		M	[illegible] *	F A			
B	[illegible]	[illegible]	[illegible]	45,000	55,000	4 %	[illegible]	0 / [illegible]
B	5,[illegible]19	[illegible]	0	109,5[illegible]	44,000	5[illegible]%	5[illegible]%	[illegible]
P	91,9[illegible]	5, 45, 0	1,0[illegible]4	[illegible]	1[illegible]0,000	4[illegible]%	1 0%	[illegible]
H	[illegible]	10 ,5	0	0	45,000	1 %	1 %	[illegible]
	[illegible]	[illegible]	[illegible]	[illegible]	10,000	[illegible]%	90%	
E	[illegible]	[illegible]	0	0	[illegible]50,000	>1000%	>1000%	[illegible]
	[illegible]	[illegible]	0	[illegible]	[illegible]0,000	51%	51%	[illegible]
	[illegible]	9	0	0	1,000	>1000%	>1000%	
P	5	[illegible]	0	[illegible]	[illegible]5,000	>1000%	>1000%	[illegible]
C		[illegible]4,50[illegible]	0	59,[illegible]9	0,000	>1000%	>1000%	10
M	0	[illegible]	0	[illegible],5	15,000	>1000%	>1000%	10

. *Erga omnes . 2016-2018.

To gauge the bene ts that will accrue to Mercosur exporters from the tari rate quotas in the EU-Mercosur agreement, we estimated tari savings that could result from the new agricultural tari rate quotas in the EU-Mercosur agreement. Table 4 lists estimated tari savings in the last column[19] meat quota ($231 million), the new fresh beef quota ($230 million), the new quota for frozen beef ($163 million) and for milk powder, including infant formula ($136 million).

These estimates are based on bold assumptions that quotas are fully used and average prices remain as currently. Particularly where total quotas exceed the volume of current trade, it is rather unrealistic to assume that prices will remain stable or that quotas will be fully exhausted. Column 4 of Table 4 reports the size of all quotas (old and newly added under the EU-Mercosur agreement) as a share of current Mercosur exports to the EU. In cases where this share is below 100 percent, the assumptions underlying our estimate are more likely to hold. If the share is far above 100 percent, it is less likely that the new quotas will be fully exhausted. If furthermore the absolute size of the quota is large, it is more likely that prices on the European market will go down.

New quotas for beef, sugar and rice are unlikely to have a substantial effect on European prices, and estimating the respective tariff savings at $495 million is reasonable. Quotas for poultry meat and honey exceed current trading volumes and might therefore have an impact on prices. If prices fall, tariff savings will be smaller than our estimate. Therefore, $250 million can be seen as an upper-bound estimate for the tariff savings accruing to Mercosur exporters of poultry meat and honey. The tariff savings on the remaining products are difficult to gauge, since the quotas exceed current imports by a very large amount and in some cases there was almost no trade in these specific product categories between 2016 and 2018. In conclusion, agricultural producers in Mercosur countries can expect tariff savings between $495 million and $993 million from the new tariff rate quotas. Further savings will of course accrue from the complete removal of tariffs on the remaining 82 percent of agricultural imports.

Table 4: Mercosur tariff savings under new tariff rate quotas

Will the EU ratify?

e EU-Mercosur trade agreement is part of an association agreement that also includes provisions related to broader political cooperation. Once the legal text is nalised, the Commission will submit it to the Council of the EU and indicate whether it considers it to be a mixed agreement, which requires national rati cation, or an EU-only agreement, which requires rati cation by the Council and the European Parliament only. Indications so far are that the agreement will most likely need to be rati ed by member states according to their national procedures, which in most cases involves approval by national parliaments[20]. Outgoing trade commissioner Cecilia Malmström has said the rati cation process in national and some regional parliaments could take two years to complete.

As with the EU-Canada Comprehensive Economic and Trade Agreement, the Council of the EU and the European Parliament could pass those parts of the agreement that concern EU exclusive competences, such as trade, and apply them provisionally until each member state has rati ed the agreement. However, if member states fail to ratify, the provisionally applied parts of the agreement must be retracted.

In Europe, opposition to the EU-Mercosur agreement is based on three main concerns: expected economic damage to EU farming, the attitude of the Bolsonaro government in Brazil to the protection of the environment and indigenous communities, and the possible impact of the tari reductions on deforestation, especially in Brazil. Opponents will be galvanised by the epidemic of res in the Amazon during 2019.

European farmers, especially in France, Ireland and Belgium, have criticised the

[24]. Furthermore, deforestation rates have increased since

Additional conditions could include cooperation mechanisms at the subnational level agreed with the Brazilian authorities and norms agreed with Brazilian and international companies operating in the Amazon[28].

Will complementary reforms follow?

To derive the full benefits from the EU-Mercosur agreement, major reforms will be needed in the EU and Mercosur. Mercosur's agricultural producers, which are among the world's most competitive, and EU farmers, who are among the world's most cossetted, will make for uneasy bedfellows in a free trade area. Gradual change towards less support via the EU's agricultural protection regime will be needed so that EU farmers, who have shown remarkable adaptability and – helped by subsidies – run a trade surplus, continue to adapt. EU farmers must continue to move into higher value-added products, and build on their comparative advantage in specialities, or they must exit the sector. As the EU's total labour force declines, thanks to population aging and restrictions on immigration, younger workers will tend to find increased opportunities in sectors other than agriculture. What needs to be done to accelerate this process is well known, but political will has been in short supply.

The reforms facing decision-makers in Argentina and Brazil are more complex, but their importance for the success of the agreement cannot be overstated, nor can the importance of the agreement for spurring the needed reforms. The reform task is formidable, as the struggles of the Macri government and massive corruption scandals in Brazil have shown[29]