

## CEPS WORKING DOCUMENT

*Thinking ahead for Europe*

# In Search of a Feasible EU-Mercosul Free Trade Agreement

**Renato G. Flôres Jr**

**No. 378/ February 2013**

## Abstract

This paper aims at identifying ways to pursue the EU-Mercosul negotiations leading to a free trade agreement (FTA). After reviewing their already long history, it outlines a basic framework, in goods, services and other themes, judged possible. The main point is that, given the prevailing conditions on both sides, an agreement to be signed within a reasonable time must be modest, i.e. along the described lines. It then clearly sets up the decisions confronting the negotiators: either to pursue the modest, feasible option or to terminate negotiations under the FTA heading. The latter, however, does not imply an end to the dialogue. Many actions and measures may be taken – which are easier to discuss and fix – that could pave the way for, in due time, a closer-to-ideal FTA to be considered again. These are the subjects of a last section.

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# In Search of a Feasible EU-Mercosul Free Trade Agreement

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## Prologue: *Rêver l'Impossible Rêve*

On 29 May 1992, a Joint Institutional Cooperation Agreement was signed between Mercosul's Common Market Council and the European Commission. On 15 December 1995, an Interregional Framework Cooperation Agreement (FA) was jointly signed by the European Union and the four Mercosul countries. Faithful to the pompous, ambitious and seducing rhetoric of Brussels, the FA comprised a broad set of initiatives and commitments, including economic issues and, notably, trade. In June 1996, under the umbrella of the FA, the first of several meetings of a Joint Commission on Trade took place. After three years of preparatory studies and discussions, the European Commission decided, in July 1998, to negotiate a free trade agreement (FTA) with Mercosul (and Chile). Meetings and discussions started in the same year.

As inevitably happens in FTA negotiations involving the integration of two regions - one more developed and sophisticated than the other, though in the latter case there was a big economy and somewhat diversified trader - the process was slow. On the Mercosul side, the great asymmetry represented by Brazil obliged a careful attitude by this country, in order to avoid hurting both the feelings and intentions of its smaller partners. On the European side, a developed bloc notoriously more protectionist than the US, the question of the common agricultural policy (CAP) - unacceptable to the competitive, agribusiness commodities exporters of Mercosul - plagued many of the discussions.

Even so, negotiations moved on.

In the more external realm, Mercosul - at that time - still struggled to attain an institutional level minimally comparable to that of the EU. The lack of this, though not an impediment to negotiations, was often raised by the European Commission as a nuisance, if not a real hindrance to the process. The EU, forced by exogenous pressures and powerful allies, sped up an enlargement that gave way to administrative and governance difficulties, many still prevailing today, beyond bringing further unknowns to the issues on the table.

From the European Commission, the head of the process was Pascal Lamy, then commissioner for DG Trade. Mr Lamy many times asserted that the enlargement had no influence at all on the process, a point not exactly confirmed by the analyses in Flôres and Perez-Liñan (2004). He strongly supported the EU position that systemic issues, like the CAP

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The author is indebted to Michael Emerson, for his encouragement and undeterred faith in this project, and to Patrick Messerlin for an always as pleasant as enlightening exchange of ideas. The author is entirely responsible for everything that follows - including the modest, indirect praise of the marvellous linguistic diversity of the EU - which in no way represents the views or positions of any of the institutions or programmes with which he is affiliated, not least to say those of Brazilian negotiators and representatives.

– and consequently any pledge related to it, including liberalisation – should be left to the ‘forum for systemic issues’, the World Trade Organization (WTO).

Mercosul tried to find acceptable liberalisation schedules that would consider a plethora of queries: from the specific aims of the Argentine producers of *galletitas* [biscuits] (many with considerable traces of transgenic soya – a nutritional sin for the sacred EU food regulations), to the fears and quarrels between the European carmakers and their own Mercosul-established plants (the former opposing liberalisation for fear that, thanks to an unexpected exchange-rate misalignment, their home markets would be ‘flooded’ by the cheaper clones made in Mercosul). At the same time, the industrial sectors in Brazil and Argentina experienced pains in finding a common liberalisation stance and, more difficult yet, one acceptable to the EU manufacturers.

Even so, negotiations went on.

It is the subjective feeling of this author that, at the end of Mr Lamy’s mandate in 2004, with a little luck the FTA could have been signed. Yet, trifling arguments and vacuous objections – some frankly ridiculous – led to a lost opportunity. Naming and shaming ensued, useless and pointless: both sides had perhaps the same degree of responsibility for the failure.

In May 2005, the ‘enlargement of the ten’ took place, setting the number of EU member states at 25.

As usually happens after such anti-climaxes, the FTA idea hibernated for a while, with expectations being fixed on Geneva, where the Doha Round was still active.

But then world changed surprisingly fast.

An encompassing financial crisis, with deep roots and a wild unfolding, took hold of the developed world and nowadays poses serious problems to the subset of EU countries in the eurozone – problems whose solution perhaps does not exist within the present architecture of the zone.

The WTO Doha Round also reached a climax, but optimists were defeated at Potsdam – an ironically gloomy place for fixing a positive, solar agreement. Since then, it has been trailing the usual path of moribund rounds: it will not die at all, but provided half a dozen ‘ifs’ take place, it will be concluded in a low key manner.

The dynamics of several internal markets have changed accordingly.

The entry of Asia as a global customer, particularly though not only China, has opened new opportunities for commodity exporters, Mercosul countries included. The CAP did change and continues to do so, owing to many constraints, demographic ones helping, but the point is that it became less relevant to Mercosul exporters.

The invasion of Asian goods in the developed markets has contributed to altering perceptions on many sides. Trade alliances are progressively shifting; South-South trade, which used to be mocked as a silly diversion by a few emerging countries, is now taken seriously; and the big US and EU markets, though still big (if declining), are looked at with different eyes. Technology, more than prospective buyers, is what the emerging horde wants.

During all these *tempi sconvolgenti*, like a Pirandellian or Samuel Becket character, the EU-Mercosul FTA would irregularly surface to quickly fall back again into oblivion a few months later. As expected, the rhetoric of the authorities involved remains impeccable: Brussels pursues its *florilège* of niceties and fatherly lectures on how to do things properly – i.e. just mirror its way – and announces that the coming agreement will be very ambitious. Mercosul leaders gather their best possible *faccia di legno* and second their European

counterparts in singing the affirmative *ομιλία*. The *Sturm und Drang* of the whole affair, apparent even to a fifth-rate Schiller, is deftly swept below the table.

In the midst of the present euro-hurricane, while Mercosul lives temporarily with a suspended Paraguay and a newly received Venezuela, it is again trumpeted that the FTA will move on. *Rêver l'impossible rêve*, sang the great Jacques Brel...

The following sections outline what seems feasible nowadays as the Mercosul-EU FTA, taking into account the stage set in this prologue. Section 1 deals with trade in goods, 2 with services and 3 with other themes. Section 4 sketches some political economy considerations, most of them working against the negotiations. Section 5 is a needed pause, inviting a serious, definite positioning in this already half-rotten, half-ridiculous affair, while the last section outlines a constructive, more realistic path to be trodden.

## 1. The classical arena: Trade in goods

In spite of the many years in which the EU-Mercosul FTA has been discussed, there are not many quantitative studies of the impact of such an agreement on the trade flows.

Among the perhaps half-dozen existing efforts, Calfat and Flôres (2006) is a pervasive, partial-equilibrium analysis of the prospective gains. Although the base years for the simulations are the couples 1997-98 and 2000-01, the study is still useful.

On the Mercosul side, in spite of the significant trade deviation to China and southern partners in general, as the exercise is a partial equilibrium one, most of the effects are at least valuable as an upper bound for gains at the individual product level. On the EU side, the situation is more debatable, as its trade pattern might have changed in a more pronounced way. The overall message, however, *that EU gains are much more widespread, distributing themselves among various manufactured goods, while Mercosul will reap advantages from a few number of commodity exports*, still seems plausible today.

Adherence to the above reasoning implies that, even now, a minimally acceptable agreement regarding the flow of goods is not very difficult. It suffices that the EU makes a (not necessarily) bold gesture of fully liberalising half a dozen agricultural goods, most in the broad 'meat' category, and the Mercosul arrives at conceding immediate or short-run liberalisation to a spectrum of about 50-100 manufactures, for the outcome to move quickly to the neighbourhood of a Pareto optimum.

Is this feasible? This author thinks it is, provided two mechanisms are successfully at work:

- i) the EU couples its nice words to its gestures and really ensures the liberalisation of the few commodities. The evolution - or optimistically, progressive dismantling - of the CAP and the present crisis might be intelligently used in favour of this argument; and
- ii) Mercosul mainly selects recalcitrant Brazilian protectionists and quite a few sectors of Argentina's vanishing manufacturing industry and manages to agree to an upfront liberalisation that would nevertheless still give room for protecting so-called 'sensitive items' with longer liberalisation periods.

The above conditions are not easy, but are not insurmountable either, being fairly attainable. They also presuppose that both sides lower their expectations and work towards the *possible*, not the *ideal* agreement.

## 2. Trade in services

During the second phase of the Uruguay Round, the EU joined forces with key developing countries, notably Brazil and India, in trying to fashion a more conservative format for the inclusion of services in the (then) General Agreement on Tariffs and Trade (and soon after the WTO), contrary to the more aggressively free trade stance of the US. Ironically, during the FTA negotiations, the European Commission tried to enforce a much broader and encompassing liberalisation of services, not exactly congenial to the mood prevailing among Mercosul members.

Brazil, within the regional market, had consistently kept a fairly conservative position towards services trade, and small Uruguay had skilfully and successfully managed to keep its peculiar and not exactly open view on this matter, something that spilled over into the negotiations.

Time, however, has changed this state of affairs. For select sectors, like telecoms, the technology and investment dynamics have significantly altered the status quo. Most European operators – such as Telefónica, Telecom Italia and Vodafone – are present in Mercosul, and the local regulatory framework has advanced considerably. Moreover, for most of them, these are the markets where they reap the biggest profits nowadays, compensating many times for losses in their domestic (European) turfs. Finally yet importantly, the presence of the same operators on both sides of the Atlantic has raised awareness of the need for closer cooperation, in the regulatory frameworks as well as in their (somewhat tense) relations with value-added providers, many US-based.

The pressing requirements for infrastructure upgrading and better logistics have also been slowly making Mercosul conscious that it actually (and desperately) needs the know-how of sophisticated ancillary services for the functioning of the manufactures and commodities production networks, if not for the whole productive system. The recent arrival of the fragmentation wave in South America will also eventually contribute to a more open mentality as regards the need for such services.<sup>1</sup>

In a less positive tone, veiled or diplomatically justified protectionist trends have been promoting the revival of state champions in key service sectors in Mercosul, telecoms being but one relevant example. But the euro crisis has probably also exacerbated protectionist views on the European side, in certain important sectors. The most notorious examples are in the financial and insurance domains where, contrary to its free trade rhetoric, the European Commission has been a fierce advocate of the conservative positions of individual member states.

What is then possible within this context?

Again, the approach must aim at the feasible, which would amount to liberalisation in specific, workable areas and not an encompassing attempt at many sectors. Some aspects of telecoms might be on board, with a few other examples being industrial services and those related to energy generation and extraction, retail and distributive trade, and some parts of air and maritime transport.

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<sup>1</sup> Production *fragmentation*, usually coupled with international value-added chains, though well known for decades in select manufacturing sectors like the car industry, gained momentum with the rise of China, when the US, Japan and later South Korea strongly displaced different production stages to Chinese territory. The successful way with which China managed its climb up the value-added chains led to a sizeable spill-over of the phenomenon to South-East Asia, with the chains now, beyond the three original providers, heavily interwoven with Chinese firms themselves. See among many, Athukorala and Yamashita (2006) and Flôres (2010a).



Professional services, especially those related to Mode IV (presence of natural persons) and, in a few instances, also to Mode III (right of establishment) of the General Agreement on Trade in Services, offer an interesting case in point. Moura (2003) draws attention to the fact that, in spite of its varied needs, the EU was adamant in opening a negotiating position on this area.

The present situation, with unemployment rates at unimaginable levels in many member countries, is at first sight a strong motivation for the EU to close *ab initio* any prospects along this line. At the same time, Mercosul, particularly Brazil, faces shortages of qualified people, partially owing to its demographic evolution.<sup>2</sup> Although this could be a bargaining asset for Mercosul, in case the EU spreads its ambitions across too many areas, an innovative compromise could be struck here.

### 3. Other themes

Another characteristic of FTA negotiations during the years following the North American Free Trade Agreement, was to include on the agenda for the agreement a series of issues, some still in direct line with WTO texts, like property rights and subsidy policies, while others were of a more debatable nature, like labour and environmental clauses or money laundering.

In the present context, these inclusions should be kept to a bare minimum. Actually, only property rights, and even then not in a TRIPS-Plus endeavour but rather as a mutual commitment to joint enforcement against specific and costly violations, seems possible. Although quite reluctant to take any further step in this area, Mercosul countries have moved to a position where discussion, at least, is accepted. EU countries, in their turn, should profit from this gap in a pragmatic way: rather than asking for progress in rules or further regulations, they should secure the full protection of their rights for those goods, brands or designs where they identify the greatest losses.

A new point, however, owing to the regulatory frenzy of the European Commission, producing directives that end up creating serious trouble and costs for its trading partners, could be treated as part of this item.

Directives like REACH (Registration, Evaluation, Authorisation and Restriction of Chemical Substances, published on 18 December 2006), which triggered an incredible amount of red tape and imposed unwontedly high costs to exporters of anything that contains chemical substances – from the substances themselves to goods, like furniture or toys, where painting, varnishing or the addition of any chemical compound took place – are actually a technical barrier to trade.

A mutual agreement on trade facilitation measures, in which not only the European Commission would agree to help its partners comply with its myriad of excessive regulations, but also a common dialogue is established in order to minimise the effects of REACH-like directives, would be a plus. Of course, reciprocity in consultation when elaborating rules affecting trade would be mandatory.

### 4. The political economy of the proposed talks

The negotiating environment, as previously noted, could perhaps not be worse. If the European state of affairs does not need any qualification, in Mercosul one cannot say that conditions are auspicious. More than the ‘Paraguayan incident’, which will be streamlined in

<sup>2</sup> For more on this see Rios-Neto (2005) and the report by OECD (2011).

one way or other, the situation in Argentina demands care and attention: the country is living through a most unfavourable period, with actually no mindset for a negotiation like the one at stake.<sup>3</sup>

Moreover, in comparison with the classical locus of long trade negotiations, the WTO, the prospects are even worse. The Uruguay Round lasted 8 years, while the Doha Round has just completed 11 years of unfinished negotiations, although it is progressing and new ideas have arisen. The EU-Mercosul FTA debate has already reached 14 years of no progress at all, and more than 16 if we include the preparatory years when much effort was spent! How can this pursuit still be credible?

Brazilian multinationals are looking at Singapore, Jakarta, Hanoi and even New Delhi and other bases to penetrate in the Asian market. Studies and projects are underway to connect them to global production chains in the ASEAN (Association of South-East Asian Nations) region, plus Japan, South Korea and of course, China (ASEAN+3). The ASEAN+3 FTA, pre-empted by many as impossible, will be a reality in maybe less than ten years. Irrespective of the fate of the more doubtful Trans-Pacific Partnership (TPP), it will change the pattern of world trade.

Mercosul countries, now with the addition of the important Venezuelan market (a key Amazon country), are also concerned with their South American neighbourhood where China has been slowly gaining market share. Developments are expected under the umbrella of the Union of South American Nations (UNASUL) – beyond the very successful cooperation in joint defence and public health actions – not only in infrastructure and services but also in production complementarities.

The EU and eurozone configuration will perforce change, at least in regulatory terms, entailing new dynamics in the common market and, very likely, in many services sectors. At present, not only reforms aiming at a common – or something resembling it – fiscal policy, and a really unified banking system for the eurozone, are stumbling along. Progress is not absent, but far from the minimally ideal levels. Moreover, financial markets for European securities are still volatile, if not shaky, bringing further uncertainty to a negotiating mood.

Alongside the above matters, sooner or later, the eurozone will have to face the question of the euro exchange rate. The current levels are unsustainable, and this transition (and to what new level) is a huge unknown. The US, for its part, is abusing the quantitative easing (QE) device, causing macroeconomic trouble not just for strong allies in South America, such as Chile and Colombia,<sup>4</sup> but for nearly all of the emerging countries, including Brazil and South Korea. This exacerbates a declining euro trajectory.

This author, while recognising the inevitable relationship between exchange-rate policies and trade, is not quite in favour of ideas aired by friends and foes alike, on tying such measures, under certain circumstances, to WTO-like trade defence mechanisms.<sup>5</sup> That notwithstanding, it is an old truth that trade agreements need minimally stable currency markets, at least among the nations involved, and this is hard to foresee in the near future.

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<sup>3</sup> To this must be added the recent (official) query by Bolivia to become a full Mercosul member, and the slight likelihood of Ecuador following suit within a year or two.

<sup>4</sup> See the interesting statement by Felipe Larrain, “Remember the effect of QE on the emerging economies” (*Financial Times*, 5 February 2013), Chile’s minister of finance. The piece is doubly significant given that the country of its author is perhaps the most faithful follower of the US spirit in South America.

<sup>5</sup> I’m aware that this theme is going to be discussed as part of another sub-topic of the Project, and I’ve no intention to intrude upon this discussion here.



Finally, the recently re-elected US President, Barack Obama, has signalled that two main trade agreements will rank high in his priorities. These are the TPP and the long-dreamt of bilateral EU-US transatlantic trade deal. Despite scepticism about the former, as noted above, the official launch of negotiations for the transatlantic deal will amount to a considerable diversion of the already feeble incentives for the other, southern Atlantic FTA.<sup>6</sup>

Very ironically, at the time of writing, both the EU and the US announced this pursuit. All the headaches plaguing the EU nowadays, briefly outlined in this section, also act as deterrents to these negotiations, and the size of the two partners is a double-edged sword, cutting knots as well as hurting deeply. But in spite of all the difficulties in this venture it will unavoidably reduce the tepid enthusiasm for the Mercosul deal.

## 5. Intermezzo: The *gravissimo* pace of the negotiations

The problems outlined in the previous section, and the modest stances favoured in the preceding ones, lead to the tough conclusion that *at least for the next two to three years*, the priority of this (already) zero-credibility FTA is, in plain English, close to zero.

What is the way out? Is it possible to change the *gravissimo* pace to at least a *larghetto*, or better yet, *andante*?

Two alternatives are offered here, the second having a nearly mandatory follow-up:

- i) the first is to engage, as soon as possible, in a restricted agreement along the lines of sections 1-3, keeping in mind that the top priority is to sign something within a very sharp deadline, say December 2014. This amounts to a substantial change in the ambitious and vapidly proud announcements of an encompassing FTA, and a deeply concerned endeavour for arriving at minimally (WTO) acceptable results; and
- ii) the second starts by putting a full stop to the lingering rhetoric of the FTA. Close the book: no more cheap talk about a meeting that will turn the state of world affairs, no more Panglossian-smiling authorities saying that the FTA is alive and well, in the best of all possible trade-negotiating environments. *Finito*. More than precious time, *über-precious* credibility has been lost!

Once – and if – both sides have gathered sufficient courage to take this healthy, transparent decision, signalling a frank and realistic *Weltanschauung*, a simple, progressive strategy may be adopted. Its purpose is to strengthen trade ties and prepare the ground for a likely closer trade association that would start afresh, two to three years from now. The outline of such a route is in the next, concluding section.

## 6. Conclusion: (Re)Starting from the very beginning, a very good place to (re)start

Mercosul displays weak governance and needs technology; the EU's governance oftentimes sets those who interact with it *al borde de un ataque de nervios* and plenty of trouble, but still holds solid technological capital.

Why not start with a comprehensive, honest and Pareto-improving agreement on technology transfer? Brazil has signed a model one with Canada, which has been bearing extremely interesting fruits; it can be a source of inspiration. The French are reasonably good in this area – the contract on nuclear submarines with the Brazilian Navy, including a progressive transfer of technology, makes another interesting source. The UK can also do this very well,

<sup>6</sup> This view is also shared by Patrick Messerlin in his paper, dual to this one.

if motivated, while Germany is an old and solid partner and the Belgians and Dutch can, without much effort, come on board.

The family of FAs always mentions and opens moves in this direction, though reasonably vapid. Moreover, we are not talking about education, the exchange of either students or professors; the focus should be on industrial, business applications that would generate connections and more business, and put in closer contact plants, laboratories and SMEs on both sides.

Such an approach, if seriously undertaken, would take one or two years. But it would produce something concrete – reasonably independent of the crises on both sides of the Atlantic – to be presented to decision-makers and to the business community, the ultimate engines of trade negotiations.

Then we should move to regulations.

Here, the European Commission, with the help of the European Parliament, should make a bold gesture and create a mechanism to give Mercosul a word in the making of directives and all kinds of rules.<sup>7</sup> It does this already, though in an imperfect way and with oscillations in its commitment, with the US. Mercosul is a much less menacing competitor and, exactly because of this, it would be easier to craft a scheme for it. Mercosul would undoubtedly be proud to participate – even if indirectly and with strings attached – in such an effort. The effects until now of the present lack of dialogue, at least for Brazil, have been devastating to our trade relations.

The methodology proposed by Messerlin (2013),<sup>8</sup> of mutual recognition, could be a relevant stepping stone towards deepening mutual confidence and establishing a positive environment for joint actions and a closer, transparent collaboration in this context.

An additional, valuable complement would be a wise probing of existing Mercosul legislation that would either open specific service markets to EU providers or globally facilitate trade in services. As previously noted, the telecommunications sector, where sizeable gains of the EU operators come from Mercosul, is a significant example. In air transport, Brazil signed the Open Skies agreement with the US – something deemed nearly impossible 20 years ago – beyond having countries like Qatar as partners in similar treaties. Although the one with the EU is still hostage to bureaucratic details, an encompassing EU-Mercosul deal on open skies is not inconceivable.

Moving from the above to a streamlining of cross-investment legislation in both regions is not a very bold step, and could open the way to creating incentives for more diversified and substantial investment flows, either greenfield or under the fragmentation logic.

These initiatives may be pursued by specific, thematic groups, which are less demanding in human resources, time and complex political considerations. The targeted sectors or regulations should be directly addressed and bottlenecks or constraints clearly identified. Deadlines would be easier to set and higher-level coordination could be conducted at the trade organisms of both blocs. The initiatives would also serve as a preliminary display of seriousness and commitment.

At the same time, Mercosul, and notably Brazil, should do long-overdue homework. The common external tariff must be thoroughly re-examined and a wise reformulation, keeping in mind the modern realities of world production and the new requirements of its members, should be undertaken.

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<sup>7</sup> See Flôres (2010b) on possible roles for the Parliament in this context.

<sup>8</sup> His paper is a companion to this one in the Project.

Perhaps this is the most difficult task outlined in these pages, aggravated by the present protectionist sentiment in the bloc. It is neither a necessary nor sufficient condition for (later) fixing the agreement, but beyond helping considerably in future negotiations, it is something that should be undertaken as a top priority by Mercosul itself independent of any existing or likely negotiation.

If two or three of the above things are fixed, something like three years from now will have elapsed. That is enough time to see how far the euro streamlining went, to evaluate the mood about Doha and to settle the Mercosul quibbles. Then there might be incentives to open negotiations for a very well-defined FTA: a classical, somewhat restricted one, with the broad lines for achieving it being those set out above in sections 1-3.

If this classical FTA is signed, and only then, this author believes credibility will have been restored to go for more ambitious settlements.

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