＜研究論文＞

EU/Latin American Relationship: with Emphasis on MERCOSOR

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Abstract

The European Union (EU) has been having formal relations with Latin America (LA) ever since the 1960s when it was the European Communities (EC). This relationship has assumed increasing importance especially with the accession of Portugal and Spain to the EC in 1986. The relationship has evolved simultaneously at the national, regional and sub-continental levels, at each one of which a full range of political, trade and cooperation agreements have been concluded.

This article begins by exploring the relationship from the wider perspective of the two regions and in the most general of terms. It then concentrates on a most special part of this relationship, one in the process of negotiating a 'free trade agreement' (FTA) between the EU and MERCOSUR. It goes on to discuss the possible impact of the FTA and finishes by very briefly explaining why it has been long in the making.

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I. A Bird's Eye View of the Relationship

1. The political relations

Consider the sub-continental level. Just one year after the establishment of the *Rio Group* in 1986, ministerial meetings with the EU commenced and have been held annually ever since. The Rio Group was created with the object of promoting discussions on topics of common interest and initially had six members, but now comprises the whole of LA and includes Caribbean representatives. Also, summit meetings were first held in 1999 (28-9 June) in Rio de Janeiro and in 2002 (17-8 May) in Madrid with the aim of strengthening political, economic and cultural understanding so as to facilitate the development of a strategic partnership between the EU, LA and the Caribbean nations.

Consider the regional level. The EU is a strong advocate of regional integration on the premise that 'it helps foster better understanding between neighbouring countries and thereby strengthens the multilateral system on a global level' (EU website; more on this below); thus, its dealings with LA reflect this dimension. Within the LA region, the EU has relationships with three groups: Central America (CA between Colombia, Ecuador, Peru and Venezula), the *Andean Community* (AC) and MERCOSUR (the *Mercado del Sur*):

(a) In 1984, the EU and CA set up the *San José Dialogue* at a ministerial meeting, held in Costa Rica. The Dialogue, being essentially a forum for political discussion, had the aim of supporting progress towards the democratisation and enhancement of various CA peace processes. Since then, ministerial meetings have been held annually and the forum has been extended to other fields of political cooperation. Given what was stated earlier, it is natural that the EU should claim to be a strong supporter of the Central American Common Market (CACM) that was initiated in 1993 between all the countries of CA.

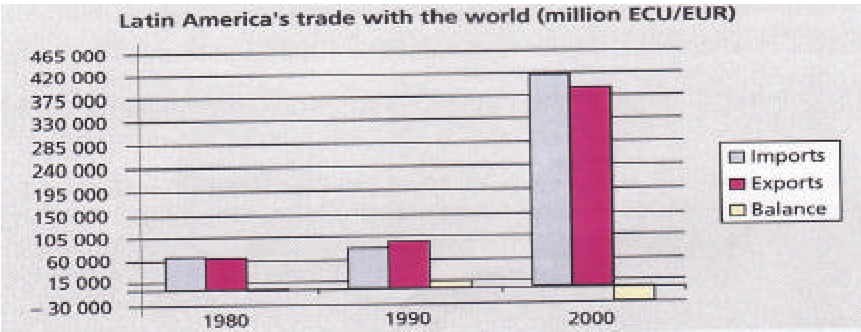
(b) The EU has supported MERCOSUR since its creation in 1991 by Argentina, Brazil, Paraguay and Uruguay. Less than one year after MERCOSUR's formation, the European Commission (hereafter, simply Commission) signed an agreement with MERCOSUR to provide technical and institutional support for the 'organisation's fledging structures'.

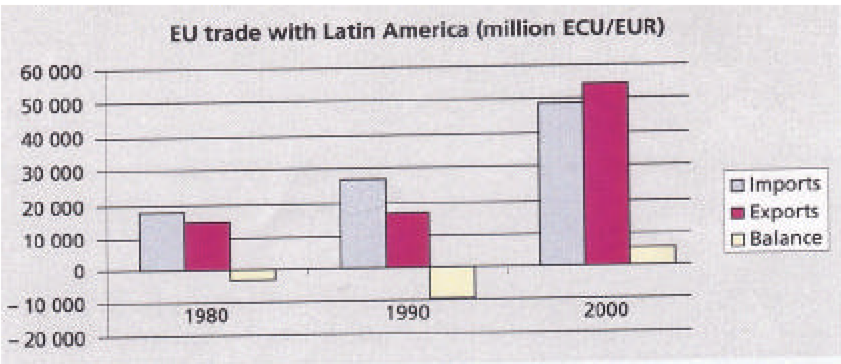
Consider the bilateral level. The EU has developed bilateral institutionalised relationships with several LA countries. Because Mexico and Chile do not fully belong to any LA integration scheme, they have developed strong bilateral links with the EU:

Mexico has now a full association agreement with the EU and Chile has recently concluded an FTA with it, completed just before the May 2002 Madrid LA-EU summit.

2. The trade and investment relations

With regard to *commercial exchanges*, the EU is LA's second largest trading partner, but is the first for MERCOSUR and Chile. The EU has gradually deepened its economic and trade links with LA both at the bilateral (with Mexico and Chile) and regional (with MERCOSUR) levels. As can be seen from the relevant parts of Figure 1 from the EU website, these links have coincided with a doubling of trade between 1990 and 2000. EU goods exports to LA totalled 54.5 million euros in 2000, mostly in machinery and equipment and chemicals. For the same year, EU imports from LA amounted to 48.8 million euros, 38% of which was in the form of agricultural products. However, over the longer period between 1980 and 2000, the EU's share of LA trade fell from 20% to 15%; Japan's respective equivalents were 7% and 5%, although





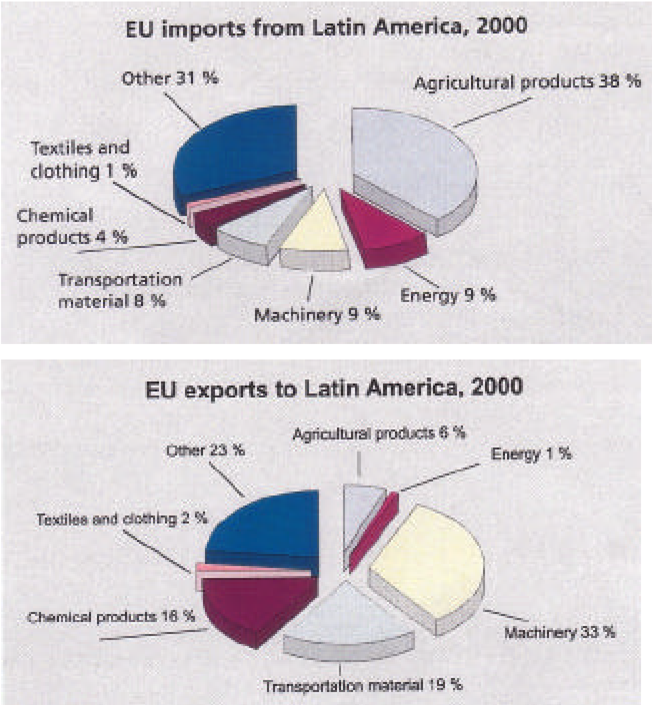


Figure 1: LA and LA/EU Trade

Japan's flows with the US increased. Note that the EU's shares are expected to rise since the agreement with Mexico is regarded as far reaching in terms of freeing trade and the FTA with Chile is expected to have the same prospects. Also, all LA countries are entitled Generalised System of Preferences (GSPs) which provide them with privileged access to EU markets. Moreover, all the nations of the AC (Bolivia, Colombia, Ecuador, Peru and Venezuela) and CA as well as some other LA countries are extended 'super GSP' which is meant to help them fight against the illegal production of drugs.

Table 1 corroborates these data by calculations made by Vaillant and Ons (2002), based on data from the Latin American Integration Association (LAIA). The table is also useful for providing the growth rates for 1990-2000. Note, however, that because the data come from a different source and are in US dollars, they will not match perfectly with those from the EU.

Table 1: LAIA/EU Trade (percentages and US$ billions)

	Total trade		LAIA imports from the EU		LAIA exports to the EU	
			Structure	Growth rate	Structure	Growth rate
	1990	2000	1998-2000	1990-2000	1998-2000	1990-2000
Argentina	23.1	25.3	29.8	17.8	23.7	2.1
Brazil	71.2	71.3	66.2	11.4	73.0	3.8
Paraguay	2.4	0.9	1.2	2.5	1.2	-9.0
Uruguay	3.4	2.4	2.8	8.2	2.1	-1.4
MERCOSUR	47.6	49.9	50.1	12.4	56.7	3.1
Chile	11.6	8.9	6.6	4.1	12.2	3.1
Bolivia	3.8	3.8	3.7	6.5	4.8	-0.6
Colombia	31.9	30.5	32.7	4.2	35.0	-0.8
Ecuador	7.1	8.4	7.9	-0.6	13.0	8.2
Peru	16.0	20.4	16.4	6.8	23.8	3.1
Venezuela	41.1	36.9	39.3	4.5	23.5	-3.1
AC	22.3	14.7	14.5	4.4	17.0	-0.1
South America	81.5	73.5	71.2		85.9	
Mexico	18.6	26.6	28.8	12.7	14.1	5.2
Total (US$b)	45.0	83.0	48.1	10.3	34.8	2.8

Source: adapted from Vaillant and Ons (2002).

With regard to *Foreign Direct Investment* (FDI) in LA, it reached $31,179 million in 1996 and jumped to $73,915 million by 1999. This was mainly due to the privatisation programmes undertaken by certain LA countries, originally in the industrial and later in the services sector. During the same years, EU investment in LA was, respectively, $13,289 and $42,266 million. Thus, in percentage terms, EU investment accounted for 42.6% and 57.2% respectively and these substantial shares made the EU the largest source of FDI in LA; Figure 2 provides information for 1980-2000 and includes that for MERCUSOR (see below). EU firms, notably those from Spain, have played a significant role in the privatisation process in the public sector and in the banking, telecommunications, aviation and energy fields. Note that according to

OECD/DAC data, FDI fell by 22% in 2000, largely due to the slowing down of the massive programme of acquisitions in Brazil.

The European Investment Bank (EIB) has been active in LA since the early 1990s and has signed framework agreements with fifteen LA nations.

3. Cooperative Relations

The agreements the EU has concluded with LA countries and regional partners have evolved from being purely concerned with economic matters, to much more wide-ranging ones. For example, each one now includes a democracy clause, enshrining cooperation and respect for democratic principles and human rights. They also now provide new perspectives for economic, industrial, scientific, technical and environmental cooperation, as well as the fight against drugs. Likewise, decentralised cooperation has come about in the last decade, which has provided an increasingly important role for civil society in the implementation of EU initiatives. These take three forms: (a) cooperation towards development, (b) economic cooperation and (c) EU humanitarian aid.

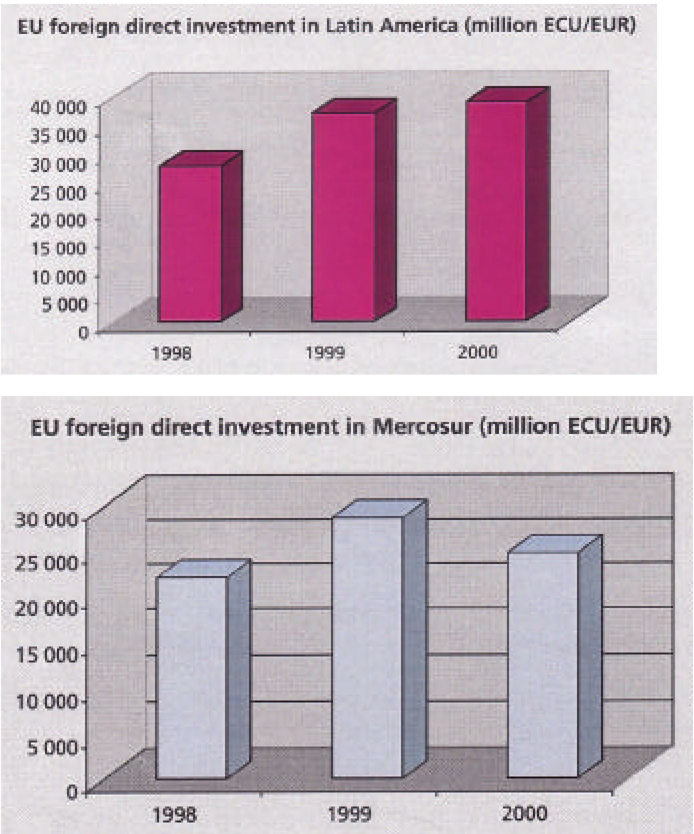


Figure 2: EU FDI in LA and MERCOSUR

With regard to *cooperation towards development*, EU financial and technical contributions are designed to help LA achieve more equal wealth distribution; reinforce the rule of law and democracy; and protect the environment. As to *economic cooperation*, the purpose is to support regional integration, increase the international competitiveness of the enterprises of LA and facilitate the transfer of technical know-how. Indeed, a number of decentralised programmes have been adopted to provide economic assistance:

a **AL-INVEST** provides help to small and medium-sized companies which operate internationally by encouraging European firms to invest in the enterprises of LA seeking such cooperation;

b **ALFA** focuses on the promotion of cooperation in higher education between the two regions;

c **URB-AL** is to establish direct and lasting links between cities in the EU and LA;

d **ALURE** encourages the optimal and most rational use of energy;

e **@LIS** aims to promote the benefits of using information technologies and tries to bridge the so-called digital divide; and

f **Alâan**, launched in 2002, aims at the reinforcement of EU-LA cooperation in the area of higher education and covers studies for postgraduates as well as higher training for LA professionals and future decision makers in EU institutions or centres.

EU humanitarian aid benefits displaced people and victims of natural disasters and also allows for the provision of emergency food aid.

II. The Special EU/MERCOSUR Relationship

1. The background

As already mentioned, during the past three decades or so, the EU has signed a series of bilateral agreements with MERCOSUR. These became progressively more ambitious and were known as first-, second- and third-generation agreements. The establishment of MERCOSUR in 1991, which transformed itself into a customs union (CU), albeit an imperfect one, at the beginning of 1995, was the motivation behind the *Framework Cooperation Agreement,* signed in December 1995 between the EU and MERCOSUR. The explicit objective of this agreement is to establish an interregional association linking the two blocs in a political, economic, financial, social and cultural relationship. The implicit, now explicit, objective is to reach an agreement on free trade.

To further the aims of the framework agreement, a joint EU-MERCOSUR working party was created to examine trade in goods and services and trade standards and disciplines. Each of these working groups provided a ‘snapshot’ of the relationship between the EU and MERCOSUR; their work is therefore described as ‘photography’. The latter was considered sufficiently encouraging for the Commission to ‘make a detailed examination of the possibility of taking the Framework Cooperation Agreement to its logical conclusion by establishing an Inter-Regional Association between the EU and MERCOSUR’ (Commission, 1998, p. 3).

The Commission’s examination of the relationship, published in April 1998, argued the case for an FTA as part of the interregional association. On that basis, the Commission, after internal discussions that by all accounts were not easy (IRELA, 1998, pp. 12-15), drafted a mandate to negotiate an FTA with MERCOSUR, taking into account ‘sensitive’ products (those that compete with domestic ones). After Commission negotiations with the Council, a mandate was agreed on 21 June 1999, a few days before the first ever EU-MERCOSUR summit, held in Brazil.

2. The motivation

Both the EU and MERCOSUR had (and continue to have) specific interests to defend in promoting an interregional association. Although at the time, the EU conducted most of its trade with itself (61.2% for exports in 1996), which meant that intra-regional trade was significantly more important than extra-regional trade for the EU, the EU share of intra-regional trade had been falling (it was 66% for exports in 1990) as a result of an increase in the share of exports sold to developing countries. This rose from 17.2% in 1990 to 22.0% 1996 (IMF 1997, 78).

Most of this increase could be explained by the rise in exports to the non-EU European countries, such as Poland, as well as to Southeast Asia. The share of exports sold to LA and the Caribbean, however, rose by one-third, from 1.8% in 1990 to 2.4% in 1996. The Asian financial crisis since 1997, furthermore, has taken the gloss off EU exports to Southeast Asia, leading to a new interest in the emerging markets of the Western Hemisphere.

In LA, MERCOSUR occupied for the EU a special place. As Table 2 shows, in 1990 the EU sent about one-third of all its exports to LA to MERCOSUR and received half of all its LA imports from MERCOSUR. By 1997, the export share rose to 50.9% to match that for imports. Thus, by 1996, the four MERCOSUR member countries represented slightly more than half of all EU trade with LA.

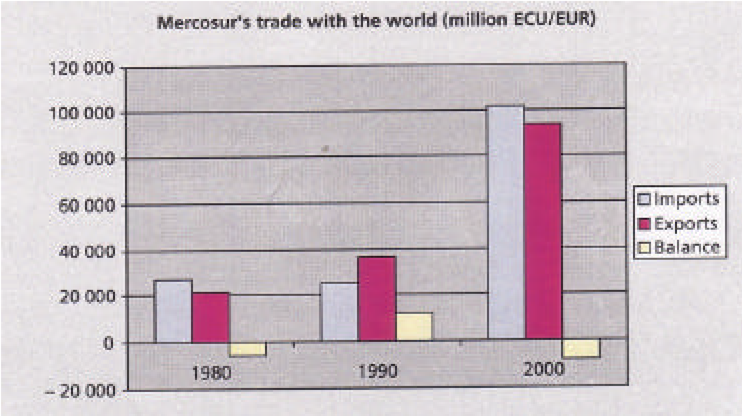
The data in Table 2 demonstrate the rapid growth of EU exports to MERCOSUR in the 1990s; Figure 3(a,b) provides a wider perspective. This growth came primarily out of the external trade liberalisation launched unilaterally in Argentina and Brazil, as a result of which average tariff rates had fallen sharply. It also benefited from the recovery of the MERCOSUR economies after the lost decade of the 1980s.

Table 2: EU Trade with Latin America (US$ billions)

	Exports		Imports	
	1990	1997	1990	1997
Total	20.3	53.6	29.5	37.9
MERCOSUR	6.9	27.3	14.8	19.3
% of Total	34.0	50.9	50.2	50.9

Source for this and Tables 3-5: IMF (1988); IRELA calculations.

The growth of its exports to MERCOSUR had been so rapid that the EU was able to increase its market share despite the preference by MERCOSUR for intra- over extra-regional imports in the 1990s. This is demonstrated in Table 3, showing that the EU share of MERCOSUR imports rose from 23.4% in 1990 to 26.2% in 1997, with a peak of 27.7% in 1994. Since 1990, the US also increased its share of MERCOSUR imports, but the EU managed to retain its position as the most important source of imports for MERCOSUR throughout the 1990s. Of the major external trading partners, only Japan lost market share.



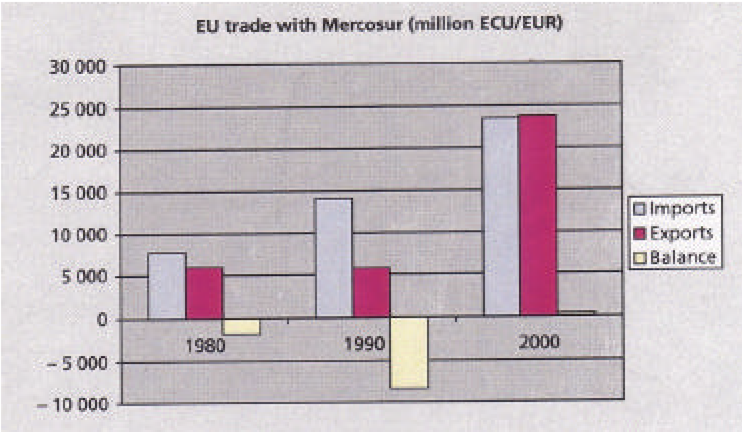


Figure 3a: MERCOSUR and MERCOSUR/EU Trade

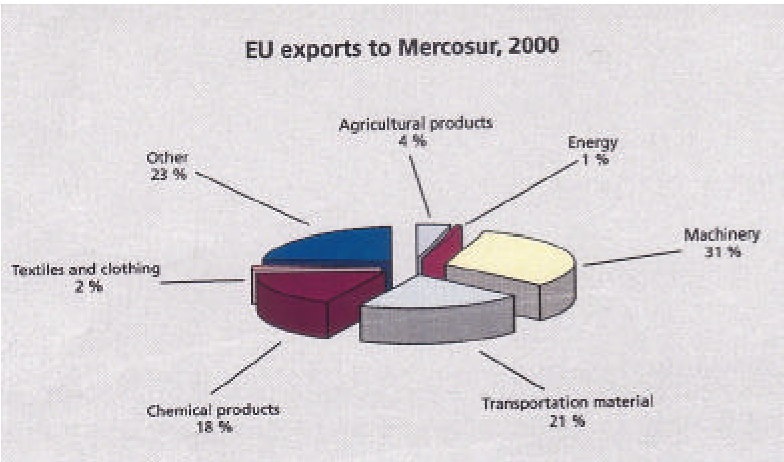


Figure 3b: MERCOSUR and MERCOSUR/EU Trade

Table 3: MERCOSUR Trade Shares (%)

	1990	1992	1994	1996	1997
Imports from:					
EU	23.4	23.9	27.7	26.1	26.2
USA	19.3	22.3	20.1	21.0	22.0
Japan	6.7	5.4	5.4	4.4	5.1
Exports to:					
EU	31.8	31.9	26.9	24.5	23.5
USA	20.7	16.7	17.3	15.3	14.1
Japan	5.9	5.2	4.8	4.9	4.6

Viewed in terms of EU exports to MERCOSUR, Tables 2 and 3 show a very similar picture: rapid growth coupled with increasing market share. EU trade with LA was now concentrated in the MERCOSUR market, and exports to MERCOSUR had been growing faster than exports to almost any other market since 1990. It is therefore not surprising that an important lobby in the EU favoured an FTA with MERCOSUR.

Seen from the other side, i.e. MERCOSUR exports to the EU or EU imports from MERCOSUR, the picture was much less dynamic. As Table 2 implies, EU imports from MERCOSUR, although still represented 50% of all EU imports from LA, had grown much less rapidly than EU exports to LA. Table 3 shows that the EU had become a much less important market for MERCOSUR exports, with the share falling from 31.8% to 23.5%.

These trends had affected the trade balance between the two regions. In 1990, as Table 4 shows, MERCOSUR still had a large trade surplus with the EU. This almost disappeared by 1994, and since then MERCOSUR has been having a growing trade deficit. Thus, there was a strong lobby inside MERCOSUR in favour of an FTA in order to reduce or eliminate the negative trade balance through greater market access to the EU.

Table 4: MERCOSUR Trade Balance (US$ billions)

	EU	USA	Japan
1990	7,925	3,968	793
1992	7,239	11	615
1994	60	-1,361	-263
1996	-4,970	-7,262	-307
1997	-8,042	-11,423	-1,605

The above related to only the trade relationship at the time between the EU and MERCOSUR. When the data on FDI were examined, they also showed an increase in the importance of the MERCOSUR market to the EU. As Table 5 shows, not only had EU FDI flows to LA increased rapidly since 1990, they had also become increasingly concentrated in MERCOSUR. By 1996, no less than two-thirds of all EU FDI flows to LA were destined for MERCOSUR countries. Thus, MERCOSUR then accounted for half of EU exports to LA, half of imports from LA, and two-thirds of FDI; see Figure 2. No data were available on the geographic origin of service imports, but it would have been surprising if they had not presented a similar picture: an increasingly important MERCOSUR market for EU exports of services to LA.

Table 5: EU FDI to Latin America (US$ billions)

	1990	1996
Total	1.669	7.069
MERCOSUR	0.927	4.702
% of Total	54.6	66.3

The attraction for the EU of an FTA with MERCOSUR, therefore, was the rapid growth of MERCOSUR imports (at least up to 1998) coupled with the high EU market share. The EU interest was particularly strong in sectors such as automobiles, where MERCOSUR trade restrictions were considerable. For MERCOSUR, the attraction was the prospect of exploiting its comparative advantage based on agro-industrial products and, in the process, reducing its bilateral trade deficit with the EU.

Both regions also had defensive reasons for promoting an FTA. The motivation for EU was the stronger, because a Free Trade Area of the Americas (FTAA, more on which below) involving the US without an FTA with the EU would have been expected to lead to a reduction in the EU's market share in MERCOSUR and possibly to a reduction in the absolute value of EU exports. MERCOSUR, on the other hand, viewed with some concern the EU enlargement to the east, for the new members were MERCOSUR competitors in many products (including high value-added goods, such as automobile parts). Thus both regions had interest in avoiding the diversion of trade to other countries as a result of the widening of the EU and MERCOSUR.

That was the picture at the time and it has not changed much since then. However, a note of warning is called for, in view of the Argentine crisis and the maxi-devaluation of the Brazilian real at the beginning of 1999. The Argentine crisis is having a major impact on MERCOSUR through a fall of about 60% in Argentine imports. The Brazilian economy went into recession in 1999, lowering its demands for imports from all sources. This caused problems for neighbouring countries, particularly Argentina, which sends 30% of its exports to Brazil. The Brazilian recession exacerbated recession in other MERCOSUR countries; and MERCOSUR as a whole reduced its imports in 1999, making it a less attractive market for EU exports in the short term. At the same time, the MERCOSUR countries may be reluctant to grant trade concessions while they face the need to reduce imports. Thus, the negotiations for an FTA have recently been taking place in a much less favourable environment than was envisioned when the framework agreement was signed at the end of 1995.

3. Simulating the EU/MERCOSUR FTA

Thus the motives for an FTA between the EU and MERCOSUR are understandable, but what would be its economic impact if it became a reality? To answer this question, let us briefly examine the simulation exercises carried out for the purpose at the time the FTA became a serious proposition.

The literature on FTAs distinguishes between three methodological approaches: partial equilibrium analysis; general equilibrium analysis; and welfare analysis (see, *inter alia*, El-Agraa 1997). Partial equilibrium analysis is the most straightforward: it considers the impact of tariff reductions on the imports of each partner, taking into account the level of customs duties before the FTA, the volume of imported goods, and the price elasticity of demand. General equilibrium analysis is much more complicated and normally requires the construction of a computable general equilibrium (CGE) model, incorporating the income effect of tariff reductions, the growth effect of higher exports to the partner, and sometimes terms of trade effects. Welfare analysis compares trade creation (the replacement of high-cost domestic production with cheaper imports from a partner country) and trade diversion (the replacement of cheaper imports from the rest of the world with more expensive, in foreign exchange terms, imports from the partner), with net trade creation normally seen as evidence of welfare improvement. Given space constraints, I shall deal with the partial equilibrium approach, but make a brief reference to the other two.

(a) *The partial equilibrium simulation*

The Commission has carried out a partial equilibrium analysis on EU imports from MERCOSUR assuming the elimination of all tariffs. The results are reported in Table 6. On the assumption of full liberalisation ('high hypothesis'), the increase in MERCOSUR imports is set at 1.4%; this falls to 1.3% when restrictions on some sensitive products are retained ('low hypothesis'). In both cases, the impact on total EU extra-regional imports is negligible.

Table 6: Impact of the FTA on EU Imports, 1996 (%)

	Impact on Whole EU Market	Impact on Imports from MERCOSUR
Low hypothesis	0.023	1.317
High hypothesis	0.024	1.394

Source: EU Commission (1998).

The simulated rise in MERCOSUR imports is very small, and this might at first seem surprising. The main reason is that 61% of MERCOSUR imports currently enter the EU without paying duty. The case is similar for industrial (59%) and agricultural products (63%, with 52% having an MFN customs duty of zero and 10.5% having a customs duty of zero within the GSPs). Thus, the simulations in Table 6 take into account only the reduction in tariffs on the remaining 37% of imports.

The results in Table 6 should be interpreted as minimum values, for two reasons. First, they do not include the elimination of non-tariff barriers on existing exports. Second, they do not account for the export of new products from MERCOSUR if all restrictions are lifted. Even if the increase in imports were doubled, however, it would still mean that MERCOSUR exports to the EU would rise by less than 3%. This is the amount by which, in any case, they could be expected to increase annually as a result of EU economic growth.

To establish the potential for an interest in EU exports to MERCOSUR, use can be made of a list of products the Commission identified as 'promising' and 'very promising' (Commission 1998, 13-15). These products represented 47% of total EU exports to MERCOSUR in that year and consisted mainly of goods in which the EU had demonstrated its competitive advantage in many markets: cars, goods-transporting vehicles and parts, machinery and mechanical appliances, electrical machinery and equipment. MERCOSUR applies high tariffs to all these goods, particularly automobiles.

The results of the partial equilibrium analysis are given in Table 7. Because the price elasticity for the EU imports is not known, a low of 0.3 and high of 0.5 estimate have been used; it is unlikely that the price elasticity of demand will be higher for the high technology goods exported by the EU. In Table 7, the 'low hypothesis' refers to the assumption of the lower price elasticity of demand, and the 'high hypothesis' to the assumption of the higher one. Irrespective of the assumption used, the results in Table 7 suggest that the impact of free trade on EU exports to MERCOSUR will be greater than on MERCOSUR exports to the EU (compare with Table 6).

Table 7: Impact of the FTA on MERCOSUR Imports, 1996 (%)

	Impact on Whole MERCOSUR Market	Impact on Imports from EU	Impact on Imports from EU excluding vehicles
Low hypothesis	0.6	2.38	1.73
High hypothesis	1.0	3.96	2.88

Source: Bulmer-Thomas (2000).

FTAs between two regions or countries are not expected to lead to a zero bilateral trade balance. Nevertheless, MERCOSUR countries may wish to impose some restrictions on free trade (subject to WTO compatibility) to ensure that the increase in exports from the two regions is more 'equitable'. Indeed, this may be politically essential if the agreement were to be 'sold' to the public in the MERCOSUR countries. Just as the EU had a list of sensitive products, so MERCOSUR had its own list of products it wished to keep out of the agreement. The most important was automobiles. If automobiles were excluded from the agreement, this would have the effect of reducing MERCOSUR imports from the EU (see Table 7).

(b) The general equilibrium simulation

The partial equilibrium analysis suggested that an FTA would have a greater impact on EU exports than on MERCOSUR's. This remains the case even when general equilibrium analysis is applied (see, Calfat and Flores, 1997) and this is confirmed by, inter alia, Giordano and Watanuki (2000). Giordano and Watanuki found that the EU would increase its total exports by 0.22% (still higher than for the FTA with Mexico with 0.05%), to Argentina by 13%, and Brazil by 14%. Exports increase in all sectors, the most dynamic being light manufactures (25%). Animal products increase fastest in Argentina (23.7%) while other agricultural products do so in Brazil (24.5%). The equivalent percentages for MERCOSUR were 4% for overall exports, 11% for Argentina and 9% for Brazil, with the effects being dominant in food crops (19%) and food processing (14%). In different terms, unrestricted free trade now would lead to a rise in real income of $6.2 billion compared with $5.1 billion for MERCOSUR. These are large numbers in absolute terms, but they would amount to much less than one year's normal growth in real GDP. MERCOSUR, for example, with its one-trillion-dollar economy in 1995, would achieve an increase of $30 billion each year with 3% growth.

Neither partial nor general equilibrium analysis can capture all effects. For example, the impact of the FTA on trade in services remains very difficult to assess. MERCOSUR is a net importer of services and is moving towards the liberalisation of the service trade within the region. A MERCOSUR *Framework Agreement in Services* was signed in 1997: it follows the methodology of the General Agreement on Trade in Services (GATS). The MERCOSUR party states have also made commitments in most service sub-sectors within the framework of GATS/WTO. The number of commitments varies from 36 in Paraguay to 208 in Argentina.

The Commission is eager to see the FTA include services, given that the EU already has a strong presence in MERCOSUR in banking, insurance, telecommunications, transportation and engineering. MERCOSUR has only a modest presence in the EU market in services, so the liberalisation of services is likely to bring greater benefits to EU exports; it should, of course, benefit MERCOSUR consumers of services. MERCOSUR negotiators, therefore, will probably be cautions in opening up the market for services to preferential access by EU exporters. One should note that 'preferential trade agreements (PTAs) in services (WTO calls them Economic Integration Agreements) are also governed by GATS rules.

The impact of an FTA on capital flows between the two regions is also very difficult to predict. European FDI in MERCOSUR has increased rapidly despite the absence of an FTA. One of the reasons has been the privatisation programme in the region, which has not yet completed its course. Any increase in trade (in both goods and services) consequent on an FTA, however, is likely to have a positive effect on investment flows. The reason is that, contrary to some orthodox international trade theories, there is a complementarity between trade and investment, mainly because an increase in trade leads to improved information about investment opportunities. This effect has been highly visible for US investment in Mexico following the launch of NAFTA. A similar process can be expected in MERCOSUR following an FTA. The impact on MERCOSUR investment in the EU, however, is likely to be much more modest, because it starts from such a low base.

(c) The welfare simulation: impact of the FTA on the US

Although referred to as an FTA, the proposed association between the EU and MERCOSUR is technically a 'free trade area'; hence it is a PTA. In other words, it extends concessions to the parties to the agreement, but also involves discrimination against non-members in terms of exclusive trade privileges.

Discrimination against non-members is a matter of serious concern for the World Trade Organisation (WTO), but it can be avoided only if the establishment of the FTA is combined with a reduction in trade barriers to non-members (more on this below). Employing a model of utility to calculate welfare effects, Frankel and Wei (1998) use plausible assumptions about the number of trade blocs, initial tariffs, transportation costs, and other factors to estimate the fall in external trade barriers required to prevent non-member trade from declining in absolute terms. They estimate the necessary drop in external trade barriers to be a minimum of 32% and maximum of 90%.

The adverse effects of the FTA on non-members can be illustrated by reference to EU's trade with Mexico before and after NAFTA's creation. Table 8 provides the relevant statistics. The proportion of EU exports to LA sold to Mexico fell from 25.6% to 18.5%, while the EU share of Mexican imports fell from 17.4% to 9.0%. While it is true that EU exports to Mexico rose in absolute terms, this must be seen in the context of the huge rise in Mexico's imports since the start of trade liberalisation. In relative terms, the share fell sharply: the same is true of EU investment in Mexico.

Table 8: EU Trade and Investment with Mexico and LA

	1990	1997
EU exports to Mexico (US$ billion)	5.2	9.9
As percentage of exports to LA	25.6	18.5
As percentage of Mexican imports	17.4	9.0
EU FDI to Mexico (US$ billion)	0.49	0.647[a]
As percentage of FDI to LA	28.8	9.1[a]

Note: [a] 1996.

Source: IRELA calculations.

The data in Table 8 are not sufficient to demonstrate cause and effect. It is widely accepted in the EU, US and Mexico, however, that NAFTA is at least partly responsible for the fall in EU trade shares. Thus, in the context of the proposed FTA between the EU and MERCOSUR, and assuming no FTAA, it is worth considering whether the US would suffer the same effect (that is, the NAFTA effect in reverse).

Bulmer-Thomas (2000) simulates the impact of the FTA on the US and his results are given in Table 9. Assuming a modest price elasticity of supply of 2.0, EU exports would expand by $6.8 billion (that is, almost one-third of the increase in imports). Under this assumption, US imports could still rise by $4.7 billion, which would imply only a small drop in the US share of MERCOSUR imports. As the price elasticity of supply for EU exports increases, the EU would meet an increasing share of the additional imports, so that the rise in US imports would be smaller. When the price elasticity reaches 6.0, virtually all the increase in MERCOSUR imports would come from the EU, and US imports would be almost unchanged. This implies a substantial drop in the US share of MERCOSUR imports.

Table 9: Impact of the FTA on US Imports, 1997

EU Price Elasticity of Supply	Percentage Increase in EU Imports	Absolute Increase in EU Imports	Absolute Increase in Non-EU Imports[a]	Absolute Increase in US Imports[a]
2.0	25.0	6.8	14.2	4.7
3.0	37.5	10.2	10.8	3.6
4.0	50.0	13.7	7.4	2.4
5.0	62.5	17.1	3.9	1.3
6.0	75.0	20.5	0.5	0.15

Note: [a] In US$ billions.

Source: Bulmer-Thomas (2000).

Noting that models of international trade often assume that the partner (in this case the EU) would meet all the increase in imports, Bulmer-Thomas argues that this need not be true if the price elasticity of supply were less than infinite. The price facing US exporters may fall (they still have to pay tariffs) so that a big increase in imports from the US would be implausible. He therefore claims that the safest conclusion would be that an FTA would raise total imports, the US would increase modestly the absolute value of its exports to MERCOSUR and its share of MERCOSUR imports would fall. However, it would be difficult to condone this as trade diversion.

The proposed FTA would have other effects on the US. EU preferences for imports from MERCOSUR would cause some trade diversion, from which the US would suffer. This is likely to be most serious in agricultural exports where (in dollar terms) the US would often be a cheaper source of supply than MERCOSUR. Nevertheless, the simulations in Table 6 suggest that the aggregate impact on US trade would be small.

The FTA could also affect US exports of services and US investment in MERCOSUR. To the extent that services and investment were complementary to trade in goods (as argued above), a faster growth in EU-MERCOSUR trade than in

US-MERCOSUR trade would imply a loss of market share for the US in both services and investment.

III. Why Has the FTA Been Long in the Making?

Several reasons can, briefly, be advanced for why the FTA is still to be finalised.

The first concerns GATT's Article XXIV, on preferential trading arrangements (PTAs), which demanded that 'substantially all trade' between the partners had to be freed. This condition has been unofficially interpreted to mean at least 90% of all trade, with no major sector excluded. Hence, agriculture had to be included. Also, the EU had stated that it would not endorse FTAs incompliant with WTO (GATT's successor) rules. Thus, any FTA would have to include some sensitive products when these exceeded 10% of total EU imports. The relevance of both ensured tricky, hence lengthy negotiations.

Second, past EU experience suggested that the negotiations would be lengthy. The negotiations for the FTA with South Africa lasted from 1995 to 1999, bedevilled by lack of progress over sensitive products. Although the November 1998 negotiations with Mexico led to an agreement in only one year, agricultural trade was not a major issue between the two. It would therefore have been surprising to expect the EU/MERCOSUR negotiations to be completed quickly given that sensitive products were a big issue.

Third, MERCOSUR was then negotiating with 30 other countries the FTAA. These negotiations were not expected to end before 2005, so it was unlikely that MERCOSUR would have wanted to end negotiations with the EU beforehand. This was because the MERCOSUR countries, particularly Brazil, saw negotiations with the EU as one of their strongest weapons in extracting concessions from the US.

Fourth, both the EU and MERCOSUR were then already engaged in a process of deepening and widening their integration schemes. Both blocs had complicated agendas, of which the proposed FTA was only a part. Thus, the negotiations for an FTA would be concluded only if the outcome were consistent with those wider agendas.

The EU agenda included enlargement, with serious implications for the Common Agricultural Policy (CAP), and EMU, with its Maastricht criteria (later *Stability and Growth Pact* for those adopting the euro) imposing severe macroeconomic constraints which required lengthy adjustment periods (El-Agraa, 2002). CAP was to be reformed to make it consistent with WTO commitments. The WTO, under the Uruguay

Round agreement, committed itself to a further review of agricultural trade policy, and this was endorsed at the December 1999 WTO ministerial meeting in Seattle and now forms the main agenda for the Doha Round which commenced in November 2001. Thus, further reform of the CAP would take place as the EU struggled with its obligations for agricultural liberalisation under the WTO. In doing so, the Commission needed to be sure that negotiations with outside countries were consistent with its commitments under the CAP and the WTO, even though the full extent of these commitments was not yet known.

MERCOSUR was also pursuing a complex agenda, including elements of both deepening and widening. Moreover, the Brazilian currency devaluation of January 1999 highlighted MERCOSUR's vulnerability to the absence of agreement on macroeconomic harmonization among the member states. This not only unleashed a wave of trade disputes amongst them, but also complicated MERCOSUR's relations with the outside world (Bulmer-Thomas 1999). Furthermore, MERCOSUR was still an imperfect CU since up to 15% of tariff headings had not yet been harmonised. In the next few years, MERCOSUR was due to implement a common external tariff for computer equipment, telecommunications, and capital goods, and to expand the number of national products subject to free trade within the region. Unlike the EU, MERCOSUR had no powerful supranational institutions to make sure that the member nations stuck to their agreements. Thus, completing the CU would not be an easy task for the MERCOSUR countries. In addition, MERCOSUR was also in the process of revising its controversial automobile regime, which imposed high external tariffs on imports of finished vehicles and preferential treatment for firms already investing in the region. Although tariffs were due to be lowered by 2000 to comply with commitments made under the WTO, the nominal rate of protection would, at 35%, still be very high. And, EU exports to MERCOSUR were concentrated in precisely the products where MERCOSUR was expected to deepen in the next few years: automobiles, computers, telecommunications and capital goods. This would complicate negotiations with the EU, as MERCOSUR countries would not want to commit themselves to trade concessions until the final shape of the MERCOSUR CU had become clear.

The widening of MERCOSUR began with the associate membership of Chile and Bolivia in 1996. This was followed by a framework agreement with the rest of the AC, which was reached in April 1998. Although the talks broke down, Brazil was able in

1999 to reach a separate agreement for liberalising trade with the AC countries. However, the most ambitious part of the widening programme involved the FTAA. This project was launched in December 1994, and formal negotiations began in November 1998. One reason for slow progress was that the US Congress had by then failed to grant the Clinton administration 'fast-track' negotiating authority. Another was that the most sensitive issues were likely to be delayed until 2003-4, when the co-chairs of the negotiations would be Brazil and the US.

It was very much in the interest of MERCOSUR to advance in parallel towards both the FTAA and the FTA with the EU. MERCOSUR trade concessions, for example in automobiles, towards one partner would lead to pressure to extend the same trade concessions to other partners. The MERCOSUR countries, especially Argentina and Brazil, had been quite explicit about the need for such parallel negotiations. At the same time, MERCOSUR would not wish to table its own trade concessions until it had seen the shape of its partner's offers. Thus the serious bargaining was likely to be left to the end of the process, and this, in the case of the FTAA, had been set as 2005. Although negotiations with the EU did not have a completion date, it was difficult to imagine that they would end before the FTAA talks. Even if the negotiations led to a successful conclusion, the launching of the FTA was not expected until 2005 at the earliest, and by then the regional and global context could be very different.

IV. Conclusions

The relationship between the EU and LA started soon after the creation of the EEC in 1957. Since then, it has been intensified, not only because of a general commitment on the part of the EU to promote global relations with individual nations, regional blocs, sub-continents, continents and even multi-continents, but also, and understandably, due to the accession of the Iberian countries to the EU in 1986. Within this general framework, the relationship between the EU and MERCOSUR is a truly special one since about half of EU trade with LA is conducted with MERCOSUR, with both exports to and imports from LA performing on par; hence the interest of the two in the FTA. This special relationship is augmented through EU aid, with the EU now being the leading donor of aid to MERCOSUR; indeed, EU financing for regional and bilateral cooperation during 2000-06 is expected to reach about 250 million euros (EU website).

This sum goes to MECOSUR as a group as well as to its party states: 48 million euros for MECOSUR, 65.7 for Argentina, 64 for Brazil, 51.7 for Paraguay and 18.6 for Uruguay.

The FTA is not expected, *ceteris paribus*, to make much difference in the volume of trade as a percentage of total imports. Indeed, the impact on EU imports is most likely to be very small. However, other things are not equal, and it is clear from the experience of NAFTA that preferential arrangements can make a big difference. The reason is that the increased share of trade accruing to a partner in an FTA occurs every year, while at the same time total trade is growing for reasons that may have nothing to do with the FTA. The United States, for example, has been enjoying a higher share of Mexican imports since the creation of NAFTA, while Mexico's imports have multiplied tenfold in the last 15 years, mainly as a result of unilateral trade liberalisation.

The importance of the PTA between the EU and MERCOSUR, therefore, can be fully assessed only if the future growth of trade in both regions can be predicted. While EU trade can be expected to increase in line with the past rate of growth, it is much more difficult to predict the growth rate of MERCOSUR trade. Exports are almost certain to grow rapidly in the next few years, but imports will be constrained by the need to reduce current account deficits as a proportion of GDP. In the long term, MERCOSUR imports will again increase, and the FTA will put EU exporters in a strong position to increase market share. With the increase in trade will go an increase in exports of services and direct foreign investment. These three – trade in goods, trade in services, and foreign direct investment – appear to be more and more complementary.

Finally, three points need emphasising. First, many methods will tend to underestimate the gains since they suppress feedbacks. Second, one cannot treat the EU relation in isolation and must ask what the US in particular would do in terms of making concessions or threats to lose market share. Third, the political economy of the balancing of interests is going to be the driving factor, not simply any trade, GDP or welfare calculations. Because trade is an EU-level competence, the EU thinks much more strategically here than on some other issues, which is fortunate because the US certainly thinks relatively politically and in strategic economic terms.

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