



The EU-Mercosur FTA: prospects and risks

The deal is worth fighting for, according to Michael Baltensperger and Uri Dadush, and the agreement could be as significant for the globe's climate as it is for the global economy

After nearly 20 years of on-off 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. But to derive the full benefits from the EU-Mercosur agreement, major reforms will be needed.

The quantifiable gains 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-Mercosur Free Trade Agreement: a deal... finally

After nearly 20 years of on-off 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 deal¹. The free trade agreement (FTA) agreement faces a difficult ratification 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 *et al*, 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 ratification, 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 ratification of the agreement in France and other member states, and the outcome is not certain.

The main gains from the agreement relate to its potential to drive reform and long-term productivity improvements in Mercosur manufacturing and EU agriculture

Assuming the agreement is ultimately ratified, the quantifiable 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 tariffs on manufactured goods entering Mercosur.

The quantifiable 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. The less quantifiable 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, specific sectors could see significant gains or losses from the agreement, even though the macroeconomic effects are small. The fact that the agreement will take years to ratify and its implementation schedule is gradual and linear over five 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.

The EU-Mercosur deal was made possible by a confluence 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 effects, we view the EU-Mercosur free trade agreement as important for the EU and as a landmark shift in Mercosur, for four reasons.

First, for Brazil and Argentina, which account for 95 percent of Mercosur's GDP and which are respectively the world's tenth and twenty-fourth largest economies, the proposed FTA represents a historic departure from an inward-looking development model based on import substitution. By signing the FTA with the EU, the world's largest and most diverse source of industrial goods and agri-food products, the Mercosur nations accept the reality of global markets – the vast size, the opportunities and the competition.

The effect of this shift on productivity and innovation cannot be quantified with any precision, but could be very substantial when conditions are right. The FTA will also impose greater discipline within Mercosur, where non-tariff barriers of various kinds impede internal trade and where the four countries' external tariffs differ on a vast array of products².

Second, by the agreement, the EU sends a message that it will not yield to protectionism (Gonzalez, 2019). On the contrary, the EU is responding to protectionism in the United States 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 Organization 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 presence of world-class firms on their domestic markets for industrial goods and agri-food products. These reforms are essential if Mercosur firms are to respond by raising productivity and becoming more innovative.

For the agreement to enhance economic development, Mercosur members will need to exploit the opportunities to export to the EU and elsewhere across all sectors, not just in agriculture.

Long experience with trade agreements, ranging from the disappointment with the North American Free Trade Agreement's effects on Mexico, and with the Euro-Med agreements on Tunisia and Egypt, to the evident successes of countries in eastern Europe arising from EU accession and of China from WTO accession, point unequivocally to the centrality of domestic reforms.

Any trade agreement provides only opportunity, not certainty. In the case of Mercosur, the FTA with the EU should be seen as an essential step, but one that is only the first of a long journey.

In the rest of this Policy Contribution, we examine selectively some key issues relating to this vast agreement. These issues include the gains from the agreement, reforms in agriculture, the ratification process and the need for complementary reforms.

The agreement in brief³

Under the FTA, the EU will remove tariffs on 100 percent of its imports of industrial goods from Mercosur, while Mercosur will remove tariffs on 90 percent of industrial goods imports from the EU, expressed in value of present imports. The EU will remove tariffs on 82 percent of agricultural goods while Mercosur will remove tariffs on 93 percent.

It is important to note that where liberalisation (ie. the removal of tariffs) is less than 100 percent, the numbers cited overstate the degree of liberalisation since trade in the most protected products is repressed to start with. Moreover, long transition periods will apply, up to 10 years for some sensitive goods, and 15 years for Mercosur's imports of motor vehicles. For agricultural products not fully liberalised, market access will be governed through tariff-rate quotas with lower in-quota tariffs.

In agriculture, important concessions by Mercosur countries include the elimination of tariffs on wine, chocolate and several other agri-food products, and the establishment of a tariff-rate quota for cheese. The interests of EU agricultural exporters should be further enhanced by recognition of some 350 geographical indications, such as Parmesan cheese.

Mercosur pledges to not impose export taxes and to eliminate monopolies in products sold to the EU, increasing the likelihood that the EU's terms of trade for products such as beef and ethanol will be favourable. The EU will partially or wholly liberalise the import of Mercosur products including orange juice, instant coffee and fruit, and will increase tariff-rate quotas for beef, poultry, pig meat, sugar, ethanol and other products.

Crucially, the EU will get greater access or total access in manufactured goods, most of which face high tariffs, including cars and parts (35 percent tariff), machinery (14 to 20 percent), and chemicals (18 percent).

Although without the full text of the agreement it is difficult to evaluate the gains from liberalisation of services, from the reduction in trade costs and from the elimination of non-tariff barriers, there appear to be significant measures in each of these areas.

According to the EU's summary note describing the agreement, regulatory reforms in Mercosur are expected to facilitate EU services exports and the establishment in Mercosur of EU firms from sectors such as financial services, transport and communications. The trade facilitation provisions reportedly go beyond the WTO Trade Facilitation agreement.

Other WTO+ provisions are reported to include more transparency in the use of trade defence instruments, explicit public consultation and cooperation mechanisms on sanitary and phytosanitary standards and on technical standards, and more transparent and inclusive government procurement procedures.

Since the Mercosur countries are not party to the WTO's Agreement on Government Procurement, the government procurement chapter of the new agreement will improve firms' access to services and government procurement markets in both blocs. In all cases, effective implementation will be critical for the agreement to deliver on its promise.

The EU-Mercosur deal renews the parties' commitments to the Paris Agreement, which for Brazil includes pledges to meet targets on carbon emissions and reforestation, as well as prevention of deforestation in the Brazilian Amazon. The FTA also provides for a monitoring mechanism that includes civil-society representatives in monitoring implementation of these environmental commitments.

Present trade flows and tariffs

Unless the agreement makes possible a very large expansion of trade, the quantifiable gains are likely to be small because trade between the EU and Mercosur is small. Table 1 shows two-way trade in goods between the blocs from 1998 to 2018. Total EU exports to Mercosur amount to \$48.6 billion, equivalent to just 2 percent of extra-EU exports and about 0.26 percent of EU GDP. Mercosur's exports to the EU are \$43.7 billion, representing 1.8 percent of Mercosur GDP. These numbers overstate the importance of trade because exports are expressed in gross terms and the domestic value added is about 10 percent less⁴.

The relative importance of the European Union as an export destination for Mercosur 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. This 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

EU exports to Mercosur	1998	2008	2018
Agricultural, forestry, and fishery	0.2	0.2	0.5
Mineral commodities	0.1	1.7	3.5
Manufacturing	25.9	44.6	44.7
Total exports	26.1	46.5	48.6
Mercosur exports to EU	1998	2008	2018
Agricultural, forestry, and fishery	5.3	16.0	8.0
Mineral commodities	1.9	12.9	5.7
Manufacturing	11.9	44.2	30.0
Total exports	19.1	73.1	43.7

Source: Bruegel based on UN Comtrade data. Note: Mercosur is Argentina, Brazil, Paraguay and Uruguay. EU is EU15 in 1998, EU27 in 2008 and EU28 in 2018. Trade values in current US\$.

The EU's loss of relative position as a trading partner for Mercosur might have been mitigated were Mercosur's and the EU's trade barriers not so high. Tariffs faced by the EU in Mercosur are about 13 percent for agriculture and 10 percent for non-agriculture (manufacturing and mining), all trade-weighted.

Mercosur's exports to the EU are mainly manufacturing and mining, which face a combined tariff of around just 1 percent, but also include a significant share of agricultural products, which face a combined tariff of around 8

percent. We estimate that EU exporters pay about \$4.4 billion in tariffs to Mercosur while Mercosur exporters pay about \$1.6 billion⁵ in tariffs to the EU.

Quantifiable gains

To evaluate the potential gains from the EU-Mercosur FTA we can use a simple example. This example is intended to underscore the importance of ambition in resource reallocation for the FTA to work, and it also sheds light on the important distributional effects of the FTA.

Assume that when all tariffs are removed, exporters do not reduce prices but capture all the tariff reduction in increased profits. This is not entirely far-fetched, since exporters can enjoy monopoly positions (such as quota rents) or face a very inelastic demand curve for their products.

The 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 tariffs.

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, reflecting the greater importance to Mercosur of trade with the much larger EU economy, and despite Mercosur tariffs being higher than EU tariffs.

However, the absolute gains for the EU are greater because it pays more tariffs 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 tariff revenue, consumers not affected (since prices do not change) and gains accruing primarily to EU manufacturers and, most of all, to agricultural producers in Mercosur whose profitability, expressed as the return on capital and land, could increase very significantly⁶, even as the Mercosur economies lose on aggregate.

If we assume instead, as is more realistic, that exporters reduce prices to some extent once tariffs are removed and resources are reallocated, the gains to both the EU and Mercosur parties from full liberalisation could be substantial since Mercosur has a highly competitive agricultural sector and the EU has a highly competitive manufacturing sector⁷.

Moreover, if the EU's agriculture sector is fully exposed to Mercosur competition, and vice versa in manufacturing, both blocs could see big so-called dynamic gains, ie. ongoing improvements in productivity and innovation triggered by increased competition and assisted by scale economies.

In the presence of wage and other rigidities that cause unemployment, all resources could become more fully utilised as incomes rise and new export opportunities open up. This means, for example, that even though Brazil might lose out on net tariff payments to the EU, it can more than make them up by greatly expanding its agricultural exports to the EU, expanding employment in that sector and accelerating productivity in its manufacturing sector.

To illustrate how these different assumptions could potentially lead to big gains, we refer to Diao *et al* (2003), who used a global computable general equilibrium (CGE) model covering 38 products when the EU had 15 members and Mercosur was assumed to include Chile and Bolivia. The model includes wage rigidities (and so can account for unemployment) and assumes that total factor productivity accelerates with trade.

Assuming full trade liberalisation, Diao *et al* (2003) concluded that GDP increases in both blocs: the EU's GDP increases by 0.34 percent, while Argentina's GDP increases by over 4 percent and Brazil's by nearly 3 percent. It is important to note that only a small part of these gains is derived from resource reallocation and increased employment alone (ie static gains). About 80 percent of the gains are derived from the increase in total factor productivity.

These numbers provide important pointers to what is possible in an ideal situation, but must be treated with caution since there is no accepted way of linking increased competition to acceleration in productivity and, in any event, the link depends crucially on reforms to the business environment.

In any event, the EU-Mercosur agreement certainly does not go as far as full trade liberalisation, as simulated by the Diao *et al* model. No study is available that simulates the present agreement, but Burrell *et al* (2011), using a purely static model that might underestimate the benefits of the agreement, simulated the 2004 EU offer⁸, consisting of full liberalisation for goods, full liberalisation for non-sensitive agricultural products and a modest gradual expansion of tariff-rate quotas for sensitive products⁹, in exchange for less-than-full liberalisation for Mercosur goods.

Burrell *et al* (2011) also simulated the 2006 Mercosur offers, 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 offers, so Burrell *et al* (2011) provides useful pointers.

Based on the EU and Mercosur offers, Burrell *et al* (2011) concluded that by 2020 EU total exports to Mercosur would increase by 9-10 percent, while Mercosur total exports to the EU would increase by 3-4 percent (and about 6-9 percent in agriculture).

However, the GDP gains for the EU15 would be only 0.02 percent in both scenarios, while the gains for Mercosur would be bigger in proportional terms than for the EU, but still very small at 0.12 percent of GDP under the EU offer and 0.16 percent of GDP under the Mercosur offer¹⁰. The GDP estimated gains in Burrell *et al* (2011) appear to us to be on the low side. Other simulations arrive at 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.

Box 1. Comparison of the EU-Mercosur FTA with previous offers

Industrial goods

In the FTA, all EU tariffs on industrial products will be eliminated in due course, as per the EU offer of 2004 (EU04) and the Mercosur offer of 2006 (M06).

In the FTA, tariffs on 90 percent of industrial products will be eliminated by Mercosur, somewhere in between EU04 and M06 offers. Note that M06 proposed even greater liberalisation for goods in exchange for greater liberalisation for agriculture in the EU.

Agricultural products not subject to tariff rate quotas

In the FTA, the EU will eliminate all tariffs on these products, in line with both EU04 and M06. However, whereas in those offers only 70 percent of all agricultural exports to the EU were not subject to tariff rate quotas, in the FTA 82 percent of all Mercosur agricultural exports to the EU will not be subject to tariff rate quotas.

Thus, the FTA represents significant liberalisation compared to the most-favoured nation (MFN) regime and Mercosur agricultural exports that can enter the EU duty-free will increase from about 30 percent to 82 percent. These exports currently face MFN tariffs of around 12.5 percent and EU consumers will probably see some price reduction for these products.

In the FTA, Mercosur will reduce tariffs on 93 percent of agricultural imports from the EU; this is more than the EU04 offer but less than what was offered under M06 in exchange for greater liberalisation for agriculture by the EU.

Agricultural products subject to tariff rate quotas

The FTA opens several new tariff rate quotas at zero in-quota tariffs, in line with EU04. However, some of these are small. Ethanol, which was not envisaged in EU04, is a big exception, at 650,000 tonnes. The most important pre-existing tariff rate quota is for beef, where the FTA envisages an additional 99,000 tonnes, in line with EU04, and only about one third of the expansion proposed by M06. The FTA proposes a big expansion for poultry, more than under EU04 but far less than M06 proposed. These provisions are unlikely to have a big effect on EU consumers or on EU producers.

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 sources¹¹.

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 marginally¹² 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 2019¹³, 40 percent of EU applied tariff lines in agriculture exceed 10 percent. Moreover, 13.5 percent of agriculture tariff lines at the six-digit level¹⁴ are covered by tariff-rate quotas and 23 percent of agriculture tariff 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 tariffs on about half of EU imports from Mercosur that are not already entering duty-free under the EU's MFN applied tariffs – a significant step. However, products that are subject to tariff rate quotas present a very mixed picture.

Our review of the EU's tariff 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 such¹⁵ by the European Commission.

The liberalisation is also limited compared to Mercosur production and exports (ethanol is a clear exception). Moreover, while Mercosur will derive significant tariff savings from lower in-quota tariffs 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 tariff reductions imply lower EU tariff revenues.

Table 2 lists the EU's most important sensitive products as they affect Mercosur. In 2018 Mercosur exported \$8 billion worth of agriculture, forestry and fishery 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.

The EU is a major export destination for Mercosur countries for several of the sensitive products, despite very high tariffs. For example, 42 percent of income from Mercosur's fresh beef exports, which face a 59 percent MFN tariff 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

Product	in tonnes	in \$ millions	Share of total Mercosur exports			EU MFN tariff
			Price \$/t	by weight	by value	
Beef fresh	118,065	967.2	8,192	25%	42%	59%
Beef frozen	75,619	380.3	5,029	4%	6%	74%
Poultry meat	391,927	948.9	2,421	7%	13%	53%
Honey	33,926	90.1	2,657	32%	30%	17%
Sugar	468,914	227.4	485	2%	2%	83%
Ethanol	46,467	20.7	446	3%	2%	21%
Rice	117,247	53.9	460	4%	5%	8%
Sweetcorn	2	< 0.1	4,513	2%	8%	14%
Pork meat	35	0.1	2,143	< 1%	< 1%	27%
Cheese	37	0.1	3,603	< 1%	< 1%	40%
Milk powder	< 1	< 0.1	14,263	< 1%	< 1%	64%

Source: Bruegel based on UN Comtrade.

Note: Weight of meat products converted to carcass weight equivalent. Export data is average of 2016-2018.

Mercosur countries already have access to various tariff rate quotas when exporting agricultural products to the EU. Table 3 reports the size of EU quotas at the time of writing which are either for specific Mercosur countries (column D) or for third countries, which include at least one Mercosur country (column E).

The EU-Mercosur agreement foresees several new quotas which will be opened by the EU for Mercosur exporters (column F). To evaluate the significance of these quotas, columns G and H express the quotas in percentage of total Mercosur exports to the EU.

Take Mercosur's exports of beef to the EU, which all studies show has the greatest potential for expansion and for reduction of prices paid by EU consumers. Expressed in tonnes, 25 percent of fresh beef and 4 percent of frozen beef exports from Mercosur go to the EU.

In the case of fresh beef, Mercosur countries have an exclusive yearly quota of 46,000 tonnes and access to an *erga-omnes* quota (ie. a quota open to all WTO members, usually on a first come- first serve basis) of 45,000 tonnes.

Furthermore, Mercosur can export frozen beef on the basis of several quotas which allow 110,000 tonnes of frozen beef into the EU. The EU-Mercosur agreement foresees additional quotas of 55,000 tonnes of fresh and 44,000 tonnes of frozen beef exclusively for Mercosur exporters, which come with a 7.5 percent in-quota tariff, phased-in over six years.

Additionally, the agreement foresees lowering the in-quota tariff rate on the existing fresh-beef quota from 20 percent to duty free. Despite a high out-of-quota tariff of 59 percent¹⁶, current Mercosur exports to the EU exceed the existing quota sizes substantially, underscoring the competitiveness of Mercosur beef.

According to the European Commission, the new quotas represent only 1.2 percent of EU beef consumption, which is 8 million tonnes per year, and are not expected to lead to a significant increase in production by Brazil. In addition, fresh beef imports from Brazil are expected to replace some current imports which are subject to the high MFN tariff¹⁷.

Otherwise stated, existing and new quotas together amount only to 86 percent of current fresh beef imports and 58 percent of current frozen beef imports. Since beef exports exceed already the new quotas, it is unlikely that the new beef quotas will lead to more EU beef imports or will have much of an impact on EU beef prices.

It is likely that the new quotas will be filled by Mercosur exporters who already export to the EU¹⁸, and that those exporters will capture the near totality of the tariff reduction, except in cases when they confront a big and organised purchaser on the EU side.

For poultry meat, the EU currently grants Brazil a quota of around 330,000 tonnes with in-quota tariffs between 8 and 25 percent. The EU-Mercosur agreement creates an additional quota of 180,000 tonnes, which will be duty-free. Current and new quotas together are 30 percent more than what Mercosur currently exports to the EU.

Hence, an increase in the quantity of poultry exports is likely. However, the new quotas represent only 1.2 percent of EU consumption, which is growing rapidly, so are unlikely to result in significantly lower consumer prices.

Sugar is highly protected in the EU with an MFN tariff of 83 percent. Despite an existing quota of 412,000 tonnes for Brazilian sugar exports to the EU, sugar exports from Mercosur to the EU are only 2 percent of Mercosur's total sugar exports. This is partly because the current specific tariff rate is high at €98/tonne for a quota of 334,000 tonnes and €11/tonne for a quota of 78,000 tonnes.

Despite the very high out-of-quota tariff, Mercosur exports more sugar to the EU than what could go through the quotas, again underscoring the bloc's competitiveness. The 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 different story. Imports to the EU are subject to the 21 percent MFN tariff. The 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. The 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.

These quotas are very large when compared to current trade. They are almost half the size of Mercosur's total exports of ethyl alcohol to the world. The European bioplastic and biochemical industries, major buyers of ethanol, are expected to grow significantly 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.

To gauge the benefits that will accrue to Mercosur exporters from the tariff rate quotas in the EU-Mercosur agreement, we estimated tariff savings that could result from the new agricultural tariff rate quotas in the EU-Mercosur agreement. Table 4 lists estimated tariff savings in the last column¹⁹.

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

A	B	C	D	E	F	G	H	J
Product	Mercosur exports		Existing EU quotas 2018 for		New additional quotas under the FTA	F/B	(D+F)/B	Phase-in period for new quotas
	to EU	to world	Mercosur	<i>Erga omnes</i> *				
Beef fresh	118,065	480,923	46,076	45,000	55,000	47%	86%	0/6 years
Beef frozen	75,619	2,142,545	0	109,578	44,000	58%	58%	6 years
Poultry meat	391,927	5,345,730	331,084	36,684	180,000	46%	130%	6 years
Honey	33,926	107,533	0	0	45,000	133%	133%	6 years
Sugar	468,914	26,722,917	412,054	295,734	10,000	2%	90%	Immediate
Ethanol	46,467	1,333,885	0	0	650,000	>1000%	>1000%	6 years
Rice	117,247	2,914,373	0	77,185	60,000	51%	51%	6 years
Sweetcorn	2	97	0	0	1,000	>1000%	>1000%	Immediate
Pork meat	35	691,166	0	74,628	25,000	>1000%	>1000%	6 years
Cheese	37	84,502	0	59,897	30,000	>1000%	>1000%	10 years
Milk powder	0	273,231	0	68,537	15,000	>1000%	>1000%	10 years

Source: Bruegel based on UN Comtrade, WTO and European Commission documents.

Note: All measures are in tons, for meat in carcass weight equivalents. *Erga omnes = quotas open to all WTO members. Export data is average of 2016-2018.

The largest absolute tariff savings accrue for the new poultry 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 *ad-hoc* 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

Product quota	Average trade price \$/t	Quota size	All quotas as share of current Mercosur exports to EU	In-quota tariff rates		Estimated tariff savings (in \$ millions*)
				Old/MFN tariff	New tariff	
Beef fresh WTO	\$8,192	46,076	86%	20%	0.0%	75.5
Beef fresh new		55,000		59%	7.5%	229.8
Beef frozen new	\$5,029	44,000	58%	74%	0.0%	163.1
Poultry meat	\$2,421	180,000	130%	53%	0.0%	231.1
Honey	\$2,657	45,000	133%	17%	0.0%	20.7
Sugar Uruguay new	\$ 485	10,000	90%	83%	0.0%	4.0
Sugar Brazil WTO		180,000		\$112/ton	0.0%	20.2
Ethanol chemical	\$ 446	450,000	>1000%	21%	0.0%	42.0
Ethanol for all uses		200,000			7.0%	12.4
Rice	\$460	60,000	51%	8%	0.0%	2.3
Sweetcorn	\$4,513	1,000	>1000%	14%	0.0%	0.6
Pork meat	\$2,143	25,000	>1000%	27%	\$95/tonne	12.3
Cheese	\$3,603	30,000	>1000%	40%	0.0%	43.0
Milk powder	\$14,263	15,000	>1000%	64%	0.0%	136.1

Source: Bruegel based on data from UN Comtrade and Commission Regulations.

Note: Tariffs in euros converted to \$ using an average exchange rate of 1.14. * See footnote 19 for assumptions.

Will the EU ratify?

The EU-Mercosur trade agreement is part of an association agreement that also includes provisions related to broader political cooperation. Once the legal text is finalised, 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 ratification, or an EU-only agreement, which requires ratification by the Council and the European Parliament only.

Indications so far are that the agreement will most likely need to be ratified by member states according to their national procedures, which in most cases involves approval by national parliaments²⁰. Outgoing trade commissioner Cecilia Malmström has said the ratification 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 ratified 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 tariff reductions on deforestation, especially in Brazil. Opponents will be galvanised by the epidemic of fires in the Amazon during 2019.

European farmers, especially in France, Ireland and Belgium, have criticised the agreement heavily, arguing that the reduction of tariffs and the extension of quotas for agricultural products, in particular beef and chicken, threaten their businesses. Besides the much lower production costs in Mercosur countries, EU farmers argue that they are

particularly disadvantaged because Mercosur producers face lower environmental and labour protection standards and because products from Mercosur face lower quality standards and laxer controls than European agricultural products²¹.

The European Commission insists that EU food-safety standards will apply to all imported products. The Commission also argues that for beef, poultry and sugar, the new quotas (or reduced tariff rates) will not necessarily lead to increases in imports but that the new quotas will substitute export quantities that currently pay full tariffs (see the preceding section).

Furthermore, for ethanol, honey and rice, the Commission argues that the new quotas are no threat to European agricultural producers because they will replace existing imports from third countries²². Our assessment broadly aligns with the Commission's, though we would expect some increase in imports in some commodities subject to quotas, such as poultry, and we would certainly expect increases in imports of products not subject to quotas and which are not already entering duty free.

On environmental and human rights protections, civil society wants the EU to take a tough position to prevent any deterioration in Brazil²³. Indeed, Amnesty International has criticised the Bolsonaro government for its anti-human rights rhetoric, efforts to hinder the work of civil society organisations and, in general, for *"measures and actions that threaten and violate the human rights of all people in Brazil"*²⁴. Furthermore, deforestation rates have increased since President Bolsonaro came to power in January 2019²⁵.

A third reason why some members of the public and members of the European Parliament oppose the EU-Mercosur agreement is concern that the agreement will incentivise further deforestation in Mercosur countries.

Cattle ranching and soybean (feedstock for ethanol and meat) and sugarcane (feedstock for ethanol) cultivation are considered major drivers of deforestation in Argentina and Brazil, through direct and indirect land-use change²⁶.

As we have noted, the new beef quotas under the EU-Mercosur agreement are not large enough to lead to significant increases in Mercosur beef production. However, the new ethanol quotas are significant and production and trade of ethanol is expected to increase substantially.

Kirkpatrick and George (2009) evaluated the environmental impact of a possible EU-Mercosur agreement on Brazilian natural forest, concluding that increases in demand for agricultural products and in agricultural production will likely lead to intensification of land use and increased productivity but also to expansion of total land area and increased pressure for conversion of natural forest.

The Commission argues that the wider Association Agreement, which includes the FTA but also agreements on political cooperation, places the EU in a better position to encourage social and human rights protection in Mercosur countries.

Specifically, the FTA includes a Trade and Sustainable Development (TSD) Chapter which contains commitments to respect the ILO's Fundamental Labour Conventions, to promote corporate social responsibility and responsible business conduct as outlined by the United Nations Guiding Principles for Business and Human Rights, to respect multilateral environmental agreements, to fight deforestation and encourage sustainable management of forests, and to effectively implement the Paris Agreement, which also includes commitments to reforestation and forest preservation.

Since the official legal text is at time of writing not available, it remains unknown how these commitments in the TSD Chapter will be enforced. So far, commitments in the TSD Chapters of EU FTAs have been subject to dedicated dispute settlement mechanisms, including civil society consultation mechanisms and establishment of panels of independent experts to produce public reports with recommendations. The European Commission has opened formal consultations on the failure to uphold TSD Chapter commitments in some cases.

For example, the Republic of Korea has, despite its commitment in the 2011 FTA with the EU, failed to ratify several of the ILO's Fundamental Labour Conventions²⁷. However, no expert panel has so far been established to investigate a partner country that has failed to uphold a TSD Chapter commitment.

We agree with the Commission's view that the wider Association Agreement is the best approach to engage with Mercosur countries on human rights and the environment. It is however not possible to dismiss the threat that increased agricultural production constitutes for the Amazon.

Given the high visibility of the deforestation issue, the EU will probably have to insist on tighter environmental conditions and more active implementation and monitoring to win ratification. The EU should also visibly intensify its monitoring and strengthen enforcement of commitments made in the TSD chapter.

The European Commission (2018) looked at how TSD chapters could be strengthened, finding no consensus on the use of trade sanctions, but broad support for more assertive implementation and enforcement of TSD chapters, including through full involvement of civil society organisations, an increase in resources dedicated to implementation and strengthening of TSD chapters in relation to climate change (European Commission, 2018).

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 Amazon²⁸.

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 shown²⁹.

The four Mercosur countries typically score in line with, or better than, their per-capita income in the World Economic Forum's (WEF) competitiveness rankings and the World Bank's *Doing Business* report. However, their manufacturing sectors will, if the FTA is ratified, confront direct competition from firms in European nations that are

ranked some 60 to 100 slots higher. For example, while Brazil ranks 72 in the WEF rankings, and Argentina ranks 81, Germany, the Netherlands, the UK, Sweden and Denmark, all rank in the top ten.

Mercosur nations must get better at enabling their firms. There is no doubt that Argentina and Brazil have enormous development potential, particularly because of their natural resources. One measure of that potential is that, despite the many weaknesses in their business environments, Argentina has attracted respectable amounts of FDI in recent years (around 2.5 percent of GDP) and Brazil even larger amounts (around 3.5 percent of GDP).

The political consensus needed to make progress on reforms in Mercosur is difficult to achieve, partly because Mercosur nations have some of the highest levels of income inequality and a large part of the population is in poverty or at risk of relapsing into poverty (Estrades, 2012).

For example, whereas the Gini coefficient of inequality is close to 0.3 in France and Germany, it is over 0.4 in Argentina and a shade above 0.5 in Brazil (with higher numbers indicating greater inequality). The Mercosur nations badly need first generation reforms, notably improvements to macroeconomic management, reductions in public debt and rationalised trade regimes³⁰. They also need investment in infrastructure (Italy ranks 21 in terms of its infrastructure according to the WEF, whereas Brazil is ranked 81).

To improve competitiveness, structural reforms in Mercosur must aim to improve the quality of public services, provide high-quality public education, remove barriers to competition and improve all-round governance and regulation, all areas in which Mercosur nations lag significantly behind EU countries. Also critical for competitiveness is the level of the exchange rate.

According to IMF (2019), whereas the real exchange rates of Argentina and Brazil are substantially in line with fundamentals following their recent devaluations, Germany's is substantially undervalued. Unless the broader domestic reform agenda in Mercosur makes great advances, the net effect of their opening to trade with the EU will be minuscule. The FTA can bring new impetus to these reforms.

Nevertheless, and despite its rather small quantifiable gains, the EU-Mercosur FTA is an agreement worth having and fighting for. If accompanied by vigorous domestic reforms, it could represent a landmark shift in Mercosur's development path towards higher growth, and, over time, present opportunities for more far-reaching agricultural liberalisation in the EU.

The agreement sends an important signal to protectionists in the United States that their policies are refuted by two of their largest trading partners, and will lead only to an erosion of the US's competitive position.

The FTA includes several WTO+ provisions that are inherently useful and can point the way to better trade deals across the world, for example in setting standards and in trade facilitation.

Finally, the reaffirmation of the Paris Agreement by economic blocs at very different levels of development, and both so critical to the path of global carbon emissions, is also of great value. ■

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Endnotes

1. See <https://trade.ec.europa.eu/doclib/press/index.cfm?id=2039>
2. Otaviano Canuto (2019) 'Mercosur-EU trade agreement: Better Late than Never...,' Opinion, 3 July, Policy Center for the New South, available at <https://www.policycenter.ma/opinion/mercotur-eu-trade-agreement-better-late-never#.XV2COvZFzD4>
3. A fairly detailed description of the agreement in principle can be found here https://trade.ec.europa.eu/doclib/docs/2019/june/tradoc_157964.pdf
4. The share of domestic value added in total gross exports is estimated at 88 percent for the EU, 90 percent for Brazil and 93 percent for Argentina. See the OECD 'Statistics on Trade in Value Added' dataset, available at <https://doi.org/10.1787/36ad4f20-en>
5. Argentina's manufactured exports to the EU, which are about an eighth the size of Brazil's, are subject to higher tariffs of around 5 percent in the EU, while Argentina's agriculture exports to the EU, which are about half of Brazil's, are subject to lower tariffs of around 5 percent.
6. By about 6 percent of the land and capital stock per annum. Calculated as the percentage increase in GDP x the share of agriculture in GDP x the share of capital and land in agriculture value added, or $0.6 \times 23.5 \times 0.4$.
7. The fact that both blocs are highly competitive in sectors of comparative advantage means that full liberalisation would bring little to virtually no cost from trade diversion.
8. Available via http://www.sice.oas.org/TPD/MER_EU/MER_EU_e.asp
9. The EU 2004 offer on sensitive products included "goods subject to TRQs: expansion of existing TRQs (except for sugar and sheep meat) on a product-by-product basis. New TRQs created for rice, wheat, other cereals, pork, skim and whole milk powder, butter, cheese and ethanol. In-quota tariff equal to zero. We assume that the expansion is fully phased in by 2020" (Burrell et al, 2011).
10. All the studies we reviewed concluded that little trade diversion is expected from the EU-Mercosur FTA, since agriculture in Mercosur and manufacturing in the EU are among the most competitive in the world.

11. "The EU average share of direct payments in agricultural factor income in 2013-2017 stood at 26%. However, this masked considerable differences between Member States, ranging from 20% or less in Croatia, Cyprus, Malta, Italy and the Netherlands to more than 40% in the Czech Republic, Denmark, Luxembourg, Slovakia and Sweden. Taking all subsidies into account, total public support in agricultural income reached 37% of agricultural income on average in the EU." See https://ec.europa.eu/agriculture/sites/agriculture/files/cap-post-2013/graphs/graph5_en.pdf

12. There are plans to provide €1 billion to EU farmers to deal with adjustments related to the EU-Mercosur FTA. However, proposals for the CAP budget post-2020 at time of writing foresee a reduction of agricultural subsidies by 12-15 percent (Matthews, 2018).

13. Available at https://www.wto.org/english/res_e/publications_e/world_tariff_profiles19_e.htm

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

15. As stated by EU Agriculture Commissioner Phil Hogan on presentation of the EU-Mercosur FTA (28 June 2019): "We will only open up to agricultural products from Mercosur with carefully managed quotas that will ensure that there is no risk that any product will flood the EU market and thereby threaten the livelihood of EU farmers."

16. This is the ad-valorem equivalent of the MFN tariff which is specified as 12.80 percent + €1,768/tonne.

17. According to the European Commission the new quotas represent: "1.2% of the total European beef consumption (8 million tons every year). It will take 5 years until this amount is reached. [...] It is expected that, rather than creating an equivalent increase in imports, one of the effects of the new quota for 'fresh' beef will be to replace some of the imports that are already taking place. In addition, the agreed amounts will not lead to a significant increase in production on the Mercosur side. Brazil alone already produces 11 million tons of beef every year and the agreed quota of 99,000 tons will still be split among the four countries." See https://trade.ec.europa.eu/doclib/docs/2019/july/tradoc_158059.pdf

18. 35,000 tons of the erga-omnes quota for fresh beef (total 45,000 tons) will become exclusively available to US exporters over the next seven years. See <https://www.consilium.europa.eu/en/press/press-releases/2019/07/15/imports-of-hormone-free-beef-eu-us-agreement-confirmed/>

19. We assumed all tariff rate quotas are fully used and average prices remain as currently. We furthermore assumed that the composition of trade will not change.
20. The Irish government has said that it perceives the EU-Mercosur to be a mixed agreement. See <https://www.oireachtas.ie/en/debates/question/2019-07-04/177/>. The European Commission has noted that similar past agreements have “required a validation by all Member States according to their national constitutional procedures, in addition to the European Parliament and the ministers’ vote in the Council.” See <https://ec.europa.eu/trade/policy/in-focus/eu-mercoshur-association-agreement/agreement-explained/>
21. See for example, <http://www.jesuisagriculteur.be/> and John Lichfield (2019) ‘Why French farmers are plotting revolution’, UnHerd, 29 July, available at <https://unherd.com/2019/07/why-rural-france-hates-globalisation/>
22. See http://trade.ec.europa.eu/doclib/docs/2019/july/tradoc_158059.pdf
23. See for example, <http://s2bnetwork.org/letter-brasil-bolsonaro-eu-mercoshur/>
24. See <https://www.amnesty.org/en/latest/news/2019/05/brazil-bolsonaro-anti-human-rights-rhetoric/>
25. See for example, Letícia Casado and Ernesto Londoño (2019) ‘Under Brazil’s Far-Right Leader, Amazon Protections Slashed and Forests Fall’, New York Times, 28 July, available at <https://www.nytimes.com/2019/07/28/world/americas/brazil-deforestation-amazon-bolsonaro.html>
26. Jusys (2017) found that sugarcane cultivation indirectly explained 12.2 percent of deforestation in the Amazon between 2002 and 2012.
27. See https://trade.ec.europa.eu/doclib/docs/2018/december/tradoc_157586.pdf
28. See Bard Harstad (2019) ‘Trade deals could combat Brazil’s Amazon deforestation’, Financial Times, 22 August, available at <https://www.ft.com/content/5f123000-bf5e-11e9-9381-78bab8a70848>
29. Otaviano Canuto (2017) ‘Dissolving corruption in Brazil’, Center for Macroeconomics & Development, 5 October, available at <https://www.cmacrodev.com/dissolving-corruption-in-brazil/>
30. For example, Germany is ranked 1 in macroeconomic stability by the WEF, but Brazil is ranked 122 and Argentina 136.

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