Mercosur - EU: new trade agreement is a huge deal – if it goes through!

After precisely two decades of negotiations, the European Union concluded a sweeping trade deal with the four full members of Mercosur: Argentina, Brazil, Paraguay and Uruguay. If ratified, it will become one of the world's largest free trade areas, bringing together about a quarter of global GDP and nearly 800m consumers.

At a time of heightened global trade tensions and faltering multilateralism, the accord sends a powerful message that mutually beneficial economic openness is still worth striving for. The 2015 election of market-oriented Mauricio Macri as President of Argentina in 2015 gave some impetus to the discussions from 2016 onwards, while the rightward shift in Brazil, with the 2018 election of Jair Bolsonaro to the Presidency, further catalysed the conclusion of an agreement.

Reductionists have characterized the agreement as a 'cows for cars' deal, with European auto exporters gaining access to previously high-tariff Mercosur markets while the agriculture sectors of Brazil and Argentina, in particular, gaining limited tariff-free access to the similarly-protected and subsidized European market for farm produce.

EU exporters are set to benefit from cuts in tariffs amounting to €4bn on annual trade flows while securing improved access to raw materials. By becoming the first major trading block to secure preferential trade access to Mercosur, the EU gains a first-mover advantage over North America and China, for example.

For the Mercosur, the EU deal is much deeper and broader than any that it has concluded to date. It will widen access to a lucrative export market, particularly for its primary products, helping reduce dependence on China. This is likely to be a boon for the mining and agro-industrial sectors in all four Mercosur countries, while the fact that Paraguay and Uruguay are smaller and more open means that, in proportional terms, they may benefit even more than their larger neighbours.

Mercosur leaders also see the deal as a template for future deals, such as with Canada and EFTA countries. Within Latin America. The accord may also give further domestic impetus for market-oriented reforms in the Mercosur countries as well as regional impetus towards economic integration, including a further deepening of cooperation with the Andean Community and the Pacific Alliance.

The politics of ratification are fraught, both in the Mercosur and in the EU. One of the chief cheerleaders, Argentina's market-oriented President Macri, faces a tough re-election battle in October against an opponent that has already signalled dissatisfaction with the Agreement. Brazilian President Bolsonaro will not face re-election until October 2022, but to push through ratification before then will require he draws on a pool of political capital that is shrinking as his administration pursues pension reforms and faces multiple scandals.

On the EU side, the Agreement requires ratification by about 40 different bodies: the European Council, the European Parliament, 28 national parliaments and a number of regional legislative bodies. Any one of these can become a potential veto player, with a tactical coalition of farmers and environmentalists already mobilizing opposition in several countries.

To pre-empt opposition from civil society, EU negotiators pushed the inclusion of a dedicated chapter on 'Trade and Sustainable Development'. While it contains a range of safeguards for workplace rights and environmental protection, the dedicated dispute settlement procedure will amount to no more than moral suasion in the absence of further concrete enforcement mechanisms. Critically, it is domestic legal frameworks, and the political will and capacity to enforce them, that will be decisive.

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Full Analysis: Mercosur – EU Free Trade Agreement

Among the world's largest free trade agreement (FTA)

Twenty years to the day after the European Union and Mercosur opened trade negotiations, the two sides reached a broad-based agreement in principle in late-June 2019. For the EU, the accord promises to deliver greater tariff reductions for its exports than any of its previous trade deals, amounting to an estimated €4bn per year. For the Southern Common Market, as Mercosur (in Spanish, or Mercosul, in Portuguese) is known in English, the agreement will be an order of magnitude more significant than the series of bilateral trade agreements heretofore reached with a cluster of MENA countries. Together, the EU's 28[i] members and the 4 fully active Mercosur members – Argentina, Brazil, Paraguay and Uruguay[ii] – account for about a quarter of global GDP and have a combined population of nearly 800m. By these measures, it would become, if ratified, among the largest free trade agreements ever concluded.

Shifting politics of trade

The FTA would be a major win for both trading blocs

Amid heightened global trade tensions and a broader sense that multilateralism is faltering, conclusion of the Mercosur-EU trade deal sends a powerful signal that free-trade is still worth pursuing. Like the multilateral trade agenda more generally, the Mercosur-EU negotiations stalled after being launched in the mid-1990s[iii]. The 2015 election of market-oriented Mauricio Macri as President of Argentina in 2015 gave new impetus to the discussions from 2016 onwards, while the rightward shift in Brazil, with the 2018 election of Jair Bolsonaro to the Presidency, further catalysed the conclusion of an agreement. On the European side, trade tensions instigated by the United States since 2016 encouraged a diversification in trade partner.

Geopolitically, by becoming the first major trading bloc to secure preferential trade access to the Mercosur, the EU would steal a march on North America and China. The Agreement will benefit European industrialists who will face lower tariffs on their exports and more secure access to raw materials, helping them to optimize supply chains.

The deal is a geopolitical coup for the EU vs other major economies

For the Mercosur, the deal would widen access to a lucrative export market for its primary products, in particular, helping reduce dependence on China as an export destination. Mercosur leaders have also signalled enthusiasm for further such agreements with EFTA (European Free Trade Area; Iceland, Lichtenstein, Norway and Switzerland) countries, Canada and South Korea. The accord may also give further domestic impetus for market-oriented reforms in the Mercosur countries as well as regional impetus towards economic integration[iv].

Implications for LatAm neighbours

Non-members of Mercosur could lose market share of European imports

As reduced tariffs on Mercosur exports to the EU reduce their final cost to European importers, they will become relatively more attractive than similar goods exported from other countries in the region. In this way, free trade agreements tend to have an even bigger impact in terms of trade diversion than on the aggregate increase in trade flows. In this respect, neighbouring countries are likely to see their share of European imports fall relative to those of the Mercosur countries. This increases the returns to Mercosur membership, of particular relevance to Bolivia as an accession candidate country, and particularly disadvantages those countries and sectors with baskets of export goods closer to those of the Mercosur. While it will be of little relevance to sectors with relatively flat supply chains, such as natural resources and agricultural produce, there is some scope for neighbouring countries to benefit indirectly from the Mercosur-EU agreement by exporting intermediate goods to Mercosur countries as inputs for production that can ultimately be re-exported tariff-free to the EU

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Key components of the agreement – not just “cows for cars”

The FTA is comprehensive and covers 17 thematic chapters

Reductionists have characterized the Agreement as a ‘cows for cars’ deal, with European auto exporters gaining access to previously high-tariff Mercosur markets while the agriculture sectors of Brazil and Argentina, in particular, gaining limited tariff-free access to the similarly-protected and subsidized European market for farm produce. This only tells part of the story, however. As with many next generation trade deals, the Mercosur-EU agreement goes far beyond tariff reduction. Not only does it address issues such as public procurement, state-owned enterprises and intellectual property rights such as geographic indicators, it also covers labour and environmental issues. In all, it consists of 17 distinct thematic chapters.

Tariff reductions on over 90% of the blocs’ respective imports

Nonetheless, the headline-grabbing elements are the tariff reductions: Mercosur and the EU will eliminate tariffs currently levied on, respectively, 91% and 92% of their imports from the other over a period of 10 years. Mercosur will be allowed a phase-in period of up to 15 years for some of its most sensitive products, notably passenger vehicles.

In addition to autos and auto parts, the Mercosur sectors expected to face the most dramatic increase in competition from Europe are producers of machinery, chemicals and pharmaceuticals. EU producers will also gain duty-free market access for wine, spirits and a range of other agri-food products. Mercosur consumers, will face greater choice and keener prices while producers will have access to more and cheaper intermediate inputs imported from Europe.

Consumers are set to benefit from Increased market access

Meanwhile, Mercosur beef producers will be granted a reduced-tariff (to 7.5%) quota of 99,000 carcass weight equivalent (CWE) tonnes of beef exports, of which 55% fresh and 45% frozen. In addition, their pre-existing reduced-tariff quotas – the so-called Hilton quotas – will be retained, with their respective tariffs eliminated as soon as the Agreement comes into force. Similar quota arrangements are established for other agricultural products, notably poultry, pig meat, sugar, rice, honey, sweetcorn and, in particular, ethanol. An aggregate 650,000 tonnes of the latter will be subject to no or reduced-tariff quota, of which 450,000 tonnes for chemical uses will be duty free.

There will also be reciprocal duty-free quotas introduced for cheese, milk powders and infant formula. At the same time, EU access to lower-cost, high-quality, raw materials is to be improved by reducing or eliminating export duties on products like soybeans (used as feed for EU livestock).

Mercosur countries will all benefit economically

Even if Argentina and, in particular, Brazil are set to benefit most in nominal terms, given their sheer economic weight, the gains to Paraguay and Uruguay could be significant. According to Moody’s, the fact that they are smaller and more open economies, and therefore more exposed to global trade policies and macroeconomic dynamics, means that the potential benefits of the Mercosur-EU agreement could be proportionally larger for them than for their larger neighbours[v].

As in Argentina and Brazil, beef and soy producers in Paraguay and Uruguay are poised to reap much of the benefit. Higher value-added sectors in which each have carved out regional export niches – such as pharmaceuticals in Paraguay and software in Uruguay – could come under pressure from European competitors, however, particularly for market share in Argentina and Brazil.

Implications for the Sustainability agenda

Environment and deforestation are a key concern for this deal

Other than the protectionist impulses of affected European farmers and Argentine industrialists, it is the environmental lobby that has thus far been leading the charge against the agreement. Particular concerns have been raised around Amazonian deforestation, where land is cleared to make way for ranching as well as sugar and soybean plantations[vi]. This results in a direct loss of global carbon sequestration capacity and poses risks to biological diversity. There is also an acute social impact, since much of the cleared land comes at the expense of indigenous populations who reside there even though nobody has legal title to the land.

Local legal framework and political will remain decisive in protecting the environment

At the margin, there is little doubt that the increased market and demand for Brazilian agricultural exports implied by the Mercosur-EU agreement would generate incentives to increase production. Indirectly, this could increase the financial returns to land-grabbing and deforestation in the Amazon region. Critically, however, it is the domestic legal framework, as well as the political will and capacity to enforce it, that will continue to be decisive.

The introduction of zero and reduced tariff ethanol quotas, as outlined above, is sure to incentivize increased production in the Mercosur countries, leading to increased supply, lower prices for consumers and reduced incentives to invest in production in the EU. This is likely to have divergent environmental impacts: on the one hand, lower ethanol prices in Europe should lead to greater take-up of biofuels and associated technologies, and therefore lower carbon emissions. On the other hand, increased ethanol production in Brazil, for example, could increase the financial returns to land-grabbing and deforestation in the absence of countervailing action by the Brazilian government.

The FTA includes various commitments on the social and environmental side

Cognizant of perceptions of downside risks in the social and environmental spheres, the EU negotiators worked to build in commitments as well as redress measures to avoid or mitigate them, similar to those included in its recent trade agreements with Mexico and Japan. The problem, however, is that the enforcement mechanisms are essentially toothless. First, the good news; a full chapter of the Agreement is devoted to 'Trade and Sustainable Development'. It commits the Parties to respecting ILO conventions on i) forced and child labour, ii) non-discrimination at work, iii) freedom of association and the right to collective bargaining. There are also commitments on health and safety at work as well as on labour inspection. Specifically, it commits the Parties to promoting the OECD Guidelines on Responsible Business Conduct and the UN Guiding Principles of Business and Human Rights.

But enforcement mechanisms are essentially toothless

On the environmental side, the accord includes commitments on biodiversity, fisheries and forestry, including safeguarding private sector initiatives such as zero deforestation supply chains (like the moratorium recently introduced by EU purchasers on soybeans produced on forestland). Importantly, it recommits Parties to respecting multilateral environment agreements such as the Paris Agreement on Climate and the CITES Convention on Wildlife Trade. A dedicated dispute settlement procedure is envisaged whereby a panel of independent experts can be convened to report and make recommendations on social and environmental issues, which will then be published. Essentially, however, this amounts to no more than moral suasion, since there are no further enforcement mechanisms

Next steps

Ratification process would take at least two to three years

Following the agreement in principle reached on 28th June 2019, official texts of the trade accord were released on 12th July, although these do not have any formal legal basis and remain subject to modification during the process of legal revision. Once finalized, the official texts will need to be formally signed, but the agreement will not come into force until it has been ratified by all Parties. At best, this process is expected to take two to three years, while the scope for delay is significant, and the final outcome far from clear.

In the EU, 40 different bodies need to ratify the FTA

The politics of ratification are fraught, both in the Mercosur and in the EU. On the European side, the Agreement requires ratification by about 40 different bodies: the European Council, the European Parliament, 28 national parliaments and a number of regional legislative bodies. As was the case with Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU, for which the ratification process is underway since 2017, even one of the regional legislatures can become a potential veto player. Already, the national parliament of Ireland has signalled its opposition, albeit in a non-binding vote, on foot of environmental concerns and competition to its beef sector.

In the Mercosur, elections in Argentina could derail the deal

In the Mercosur, Mauricio Macri, Argentina's market-oriented President, faces a tough re-election in October 2019. His Peronist opponent, Alberto Fernández, has already signalled his dissatisfaction with the deal while his still-powerful running mate, former President Cristina Fernandez de Kirchner, has long been considered hostile to economic openness. It is not impossible that Argentina ultimately ratifies the agreement, even under Peronist leadership, but it would certainly be more challenging. The other key South American backer of the deal, Brazilian President Jair Bolsonaro, will not face his own re-election battle until October 2022, and he is likely to push ratification long in advance of this. It is by no means a given, however, that the ratification process will be completed, and the agreement in force, by the end of his mandate.

[i] At the time of writing, the United Kingdom is expected to leave the EU on 31st October 2019

[ii] Venezuela has been suspended since December 2016 due to its flouting of democratic norms and failure to meet its commitments within the four-year timeframe foreseen by its 2012 accessions agreement. Bolivia has been a candidate country since 2012 but continues to participate as an associate member together with Chile, Colombia, Ecuador, Guyana, Peru and Suriname. Brazil is the only full member not yet to have ratified the accession of Bolivia, the most significant remaining political barrier to the latter's full membership. French Guiana, technically an overseas department of France, is the only South American territory without any participation in Mercosur.

[iii] Negotiations between the EU and Mercosur on a trade agreement were first launched in the mid-1990s, not long after the 1993 establishment of the European Single Market and conclusion of the Uruguay round, which saw the General Agreement on Tariffs and Trade (GATT) evolve into the World Trade Organisation (WTO), and the 1994 conclusion of the North American Free Trade Agreement (NAFTA) between Canada, Mexico and the United States. The mid-1990s were to prove a high-water mark for multilateral free trade agreements, however. Talks stalled in the WTO's Doha development round, and little progress was made in the EU-Mercosur negotiations

[iv] Further deepening of cooperation with the Andean Community (of which Bolivia, Colombia, Ecuador and Peru are current members), with which Mercosur has had a mutual associate membership agreement since 2005, and with the Pacific Alliance (Chile, Colombia, Mexico and Peru), with which Mercosur participated in a first joint summit in 2018, may become more attractive in the event the new EU accord is ratified.

[v] https://www.cronista.com/economiapolitica/Para-Moodys-los-mas-beneficiados-del-acuerdo-UE-Mercosur-seran-Uruguay-y-Paraguay-20190701-0055.html

[vivivi] From a peak 21st century deforestation rate in the Brazilian Amazon of nearly 28,000 square kilometers in 2004, just short of its all-time high, a decade of sustained progress had brought the rate below 5,000km^2 by 2012, since when it has crept higher to reach nearly 8,000km^2 in the year to July 2018. Elected in October 2018, President Bolsonaro has been eager to roll back both environmental regulations and protections for indigenous populations, opening the Amazon region to ever more intense exploitation. Preliminary figures suggest the deforestation rate in the Brazilian Amazon in June 2019 alone was nearly double the rate for the same month in 2018.

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