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# THE EU-MERCOSUR FREE TRADE AGREEMENT: MAIN FEATURES AND ECONOMIC IMPACT

Jacopo Timini and Francesca Viani

## ABSTRACT

This article describes the main characteristics of the trade agreement reached between the European Union (EU) and the Common Market of the South (MERCOSUR) in 2019 and presents estimates of its possible impact on trade and GDP in the two areas.

It is an ambitious agreement involving the full liberalisation of almost all of the goods trade between the two blocs, facilitating the provision of services and the reduction of non-tariff barriers, and envisaging reciprocal liberalisation of public procurement. Similarly, it includes provisions on the protection of the environment and workers' rights.

The agreement's estimated effects on trade and economic activity will be significant for MERCOSUR. The impact for the EU will be more modest, yet always positive, since trade with MERCOSUR is less significant for EU members. Spain is among the EU member countries whose economies will benefit most from the agreement.

**Keywords:** international trade, trade agreements, EU, MERCOSUR, structural gravity model.

**JEL classification:** F13, F14, F15.

# THE EU-MERCOSUR FREE TRADE AGREEMENT: MAIN FEATURES AND ECONOMIC IMPACT

The authors of this article are Jacopo Timini and Francesca Viani, of the Directorate General Economics, Statistics and Research.

## Introduction

In June 2019, after nearly 20 years of negotiations, the European Union (EU)[1] and the Common Market of the South (MERCOSUR)[2] reached a wide-ranging trade agreement.[3] The agreed lowering of barriers goes beyond tariffs, which traditionally affected goods, since the agreement also facilitates the provision of services and access to public procurement in both areas. Measures were also laid down on investment and minimum standards for labour market regulation and some items relating to climate change mitigation.

The agreement is particularly opportune because it was reached against a global backdrop of a growing deterioration in multilateralism. In fact, in recent decades multilateral trade negotiations based on World Trade Organisation (WTO) rules have undergone a protracted stagnation.[4] This paralysis is partly due to the difficulty of making progress in negotiations with emerging countries with agriculture-focused productive structures. Furthermore, as a result of the inflexible decision-making arrangements at the WTO,[5] it is difficult to update its rules. This is essential to address the challenges posed by the practices of members that habitually involve government support for business (e.g. China). During the last two decades this has meant that most countries' trade policy has been focused on bilateral and plurilateral, as opposed to multilateral agreements. 220 new agreements came into force worldwide in that period (see Chart 1.1). The EU has been the most active region in this regard, worth noting are its agreements with Canada (2017), Japan (2018) and, more recently, MERCOSUR. The agreement with MERCOSUR is analysed in this article. Lately, international trade relations have been affected by the United States' shift towards protectionism including, most notably, the increase in bilateral tariffs between the United States and China since 2018.

1 The figures for the EU include the United Kingdom.

2 Comprising Argentina, Brazil, Paraguay and Uruguay.

3 Although the agreement has not yet been signed and ratified by the respective member countries, the European Commission published the details of the "agreement in principle". The text published by the European Commission is available at http://trade.ec.europa.eu/doclib/docs/2019/july/tradoc_158249.pdf.

4 The progress made in the last round of negotiations, which began in Doha in 2001, was very limited.

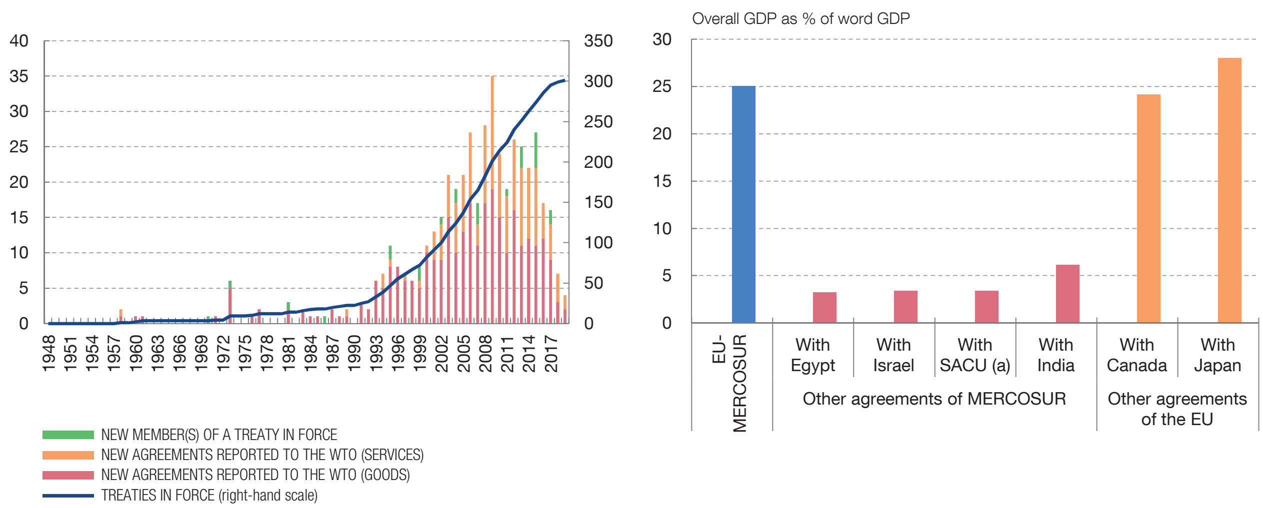
5 For example, new decisions have to be approved unanimously by the 164 members.

Chart 1
**THE EU-MERCOSUR AGREEMENT AGAINST A GLOBAL BACKDROP**

The EU-MERCOSUR agreement, which is part of the global trend of increasing numbers of bilateral and plurilateral trade agreements, accounts for a significant share of world GDP.

1 BILATERAL AND PLURILATERAL TRADE AGREEMENTS

2 GLOBAL SIGNIFICANCE OF TRADE AGREEMENTS




**SOURCES:** World Trade Organization and International Monetary Fund.

**a** The South African Customs Union (SACU) includes Botswana, Lesotho, Namibia, South Africa and Swaziland.

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This article describes the main features of the EU-MERCOSUR agreement in the light of current trade relations between the two blocs and presents estimates of the possible impact that the agreement could have on trade and GDP in the two areas as a whole and in each member country.

## The EU-MERCOSUR agreement

As for trade in goods, the agreement envisages that within ten years most of the tariffs on the trade flows between the two areas will be removed. Specifically, the EU will fully liberalise all its imports of manufacturing output from the Latin American bloc and 82% of agricultural imports. In turn, the MERCOSUR countries will liberalise 90% of industrial goods imports from the EU (including vehicles and machinery) and 93% of agricultural products. The EU will partly liberalise some more sensitive products, such as meat and sugar, through a system of tariff quotas whereby higher tariffs will be applied to imports exceeding a specific amount. Furthermore, the agreement provides that 357 European food products with designation of origin or geographical indication, will be protected from possible imitations of MERCOSUR countries.

The agreement includes non-discrimination clauses on trade in services which prohibit foreign suppliers from being subject to more stringent rules and requirements than those applied to national suppliers. These provisions focus, in particular, on postal services, telecommunications and financial services.

The agreement also contains provisions which reduce non-tariff barriers by simplifying customs procedures and removing technical barriers, and measures aimed at facilitating SMEs' access to new markets. Similarly, it provides for reciprocal access to public procurement markets. This means unprecedented access for MERCOSUR economies which, since they are not party to the WTO plurilateral Government Procurement Agreement, had not allowed foreign firms access to date.[6]

Lastly, in line with the trade agreement model that has gained traction in recent years, the agreement includes provisions on environmental protection and workers' rights whereby both parties undertake not to lower labour and environmental standards in order to boost trade and attract investment. In the section on labour standards, the freedom of association and the right to collective bargaining are guaranteed. Additionally, the EU and MERCOSUR commit to implementing the Paris agreement on climate change[7] by reducing greenhouse gas emissions and protecting the ecosystem of the Amazon rainforest.

The global importance of the agreement is significant since the areas involved represent in total 25% of world GDP (see Chart 1.2). For MERCOSUR, the agreement with the EU is the most important agreement reached to date since all its previous agreements account for only 7.4% of world GDP and it is the first to regulate trade in services.[8]

## Current trade links between the EU and MERCOSUR

The EU accounted for 17.3% of MERCOSUR's trade in goods in 2018 and is currently the Latin American bloc's second largest trading partner behind China, which represented almost 22%. Furthermore, EU countries account for 26.5% of the Latin American bloc's international trade in services. By contrast, trade in goods and services with MERCOSUR represents less than 1% of the EU's foreign trade.

The European trade balance with the Latin American bloc has been close to equilibrium both in trade in goods and services (0.02% of GDP in 2018 and 0.08% of GDP in 2017, respectively). Nevertheless, this result masks important differences at sector level. The EU is a net supplier of the various services activities (see Chart 2.1). The EU's goods imports from the Latin American bloc are concentrated in agricultural and food products

6 Up until now, European firms were only able to participate in public procurement in MERCOSUR through their subsidiaries in member countries.

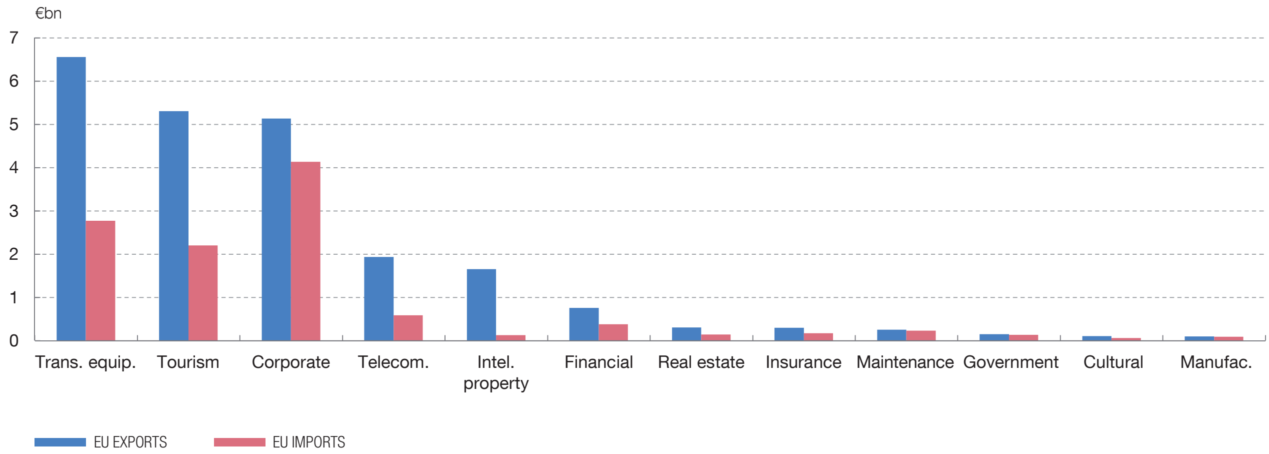
7 See https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement.

8 MERCOSUR currently has trade agreements in force only with Egypt, India, Israel and the SACU.

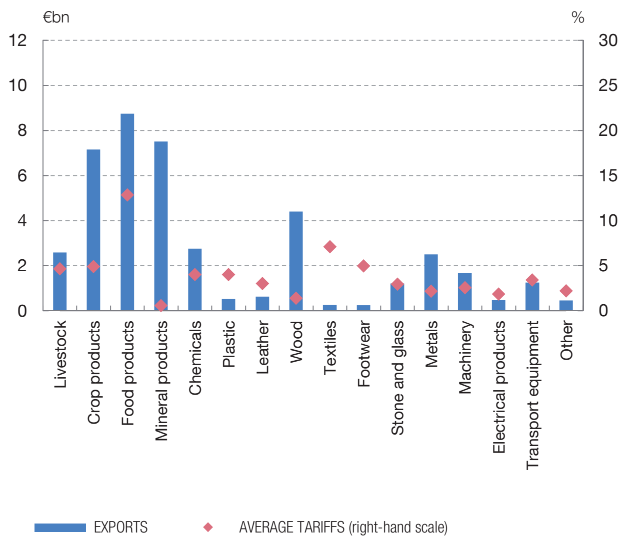
Chart 2
## CURRENT TRADE RELATIONS BETWEEN THE TWO BLOCS

The EU is currently a net exporter of all types of services to MERCOSUR. The EU's goods imports from the Latin American bloc are concentrated in agricultural and food products, whereas European exports to MERCOSUR mainly comprise chemicals, pharmaceuticals, machinery, vehicles and electrical products.

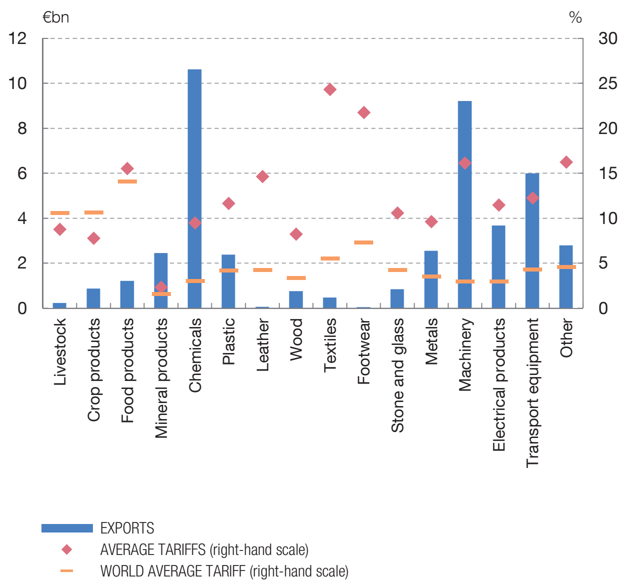
1 SERVICES: BILATERAL TRADE FLOWS
2017 data




2 TRADE IN GOODS: MERCOSUR EXPORTS TO THE EU AND AVERAGE TARIFFS
2018 data




3 TRADE IN GOODS: EU EXPORTS TO MERCOSUR AND AVERAGE TARIFFS
2018 data




**SOURCES:** Organisation for Economic Co-operation and Development (OECD), World Trade Organization, Eurostat and Banco de España calculations.

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(see Chart 2.2), whereas European exports to MERCOSUR mainly comprise chemicals, pharmaceuticals, machinery, vehicles and electrical products. The latter sectors are currently subject to high tariffs (see Chart 2.3)[9] with the result that the advantages of the agreement may be more significant for the EU than those of other previous agreements.[10]

The disaggregated data show significant heterogeneity of the trade links by country. In MERCOSUR, trade relations with the EU are more significant for Uruguay (see Chart 3.1). Similarly, the sectoral breakdown of exports to the EU is very uneven by country, although specialisation in raw materials, commodities and agricultural products generally predominates (see Chart 3.3). Most notable is Argentina where one sixth of its exports to the EU are chemicals. On average, trade between EU countries and MERCOSUR represents a small share of their GDP which is close to 1% for Spain and Portugal, and stands at around 1.5% for the Netherlands and Belgium (see Chart 4.1). There are marked differences in the bilateral trade balances between the various European countries and the Latin American bloc (see Chart 4.2). Spain, in particular, runs one of the higher deficits in the trade in goods and one of the higher surpluses in services.

## The impact of the agreement on the economies of the EU and MERCOSUR

This section presents an exercise quantifying the expected effects of the EU-MERCOSUR agreement on trade and GDP in both areas by using a "structural gravity"[11] econometric model. The estimates should be treated with some caution owing to the limitations of the data used. In particular, they are based on aggregate bilateral flows, namely, they do not take into account the sectoral dimension and they do not consider flows of services which, as shown in the previous section, are an important component in bilateral trade.

Likewise, due to the limitations of the model used, broader considerations are not included, for example the environmental consequences of the agreement.[12]

9 Although the MERCOSUR economies undertake to apply common external tariffs, in practice exceptions to this policy are accepted. Chart 3 shows the average tariffs applied by the largest economies in the bloc (Argentina and Brazil) which represent more than 90% of trade with the EU.

10 In particular, the European Commission calculates that the agreement with MERCOSUR will save €4 billion (0.03% of EU GDP), compared with an estimated saving of €1 billion from agreements with Canada or Japan. See https://ec.europa.eu/commission/presscorner/detail/en/IP_19_3396.

11 The basic idea behind this type of models – by analogy with the law of gravity – is that the value of a country of origin's exports to a country of destination is directly proportional to the economic size of both countries (measured by the importance of the output of the country of origin and the expenditure of the country of destination) and inversely proportional to the distance between them (as an approximation of trade costs). Structural gravity models have sound theoretical bases and considerable predictive power. For more details on the specification, see Baier *et al.* (2019) and Yotov *et al.* (2016). The model is estimated with data from 53 countries for the period 1984-2015. The sample comprises OECD economies, Brazil, China, India, Russia, South Africa and the rest of Latin America. For other applications of the model and a more detailed description of the data set, see El-Dahrawy Sánchez-Albornoz and Timini (2020) and Timini and Viani (2020).

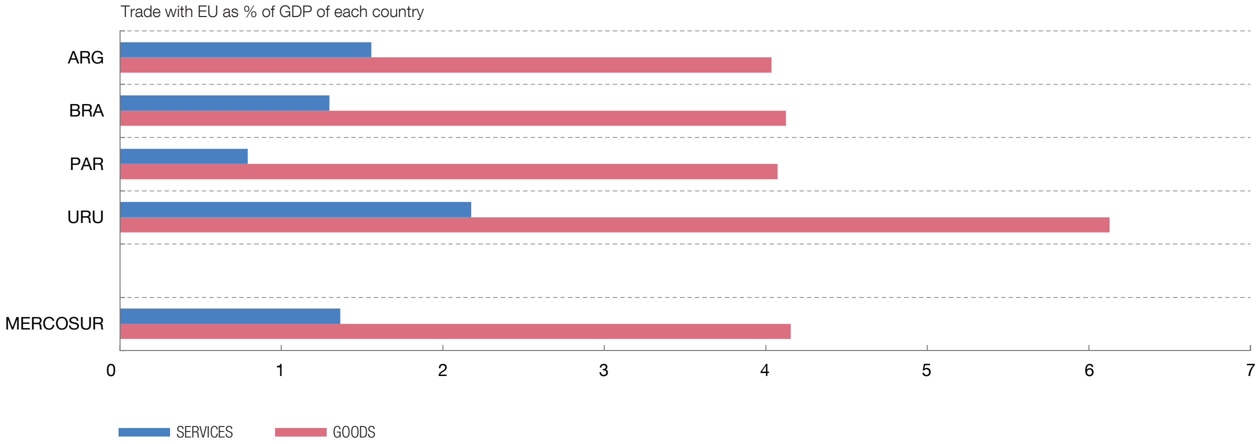
12 In practical terms, to consult the details of how the characteristics of the agreement (mainly tariffs and non-tariff barriers) were transferred to the modelling framework used, see Timini and Viani (2020).

Chart 3

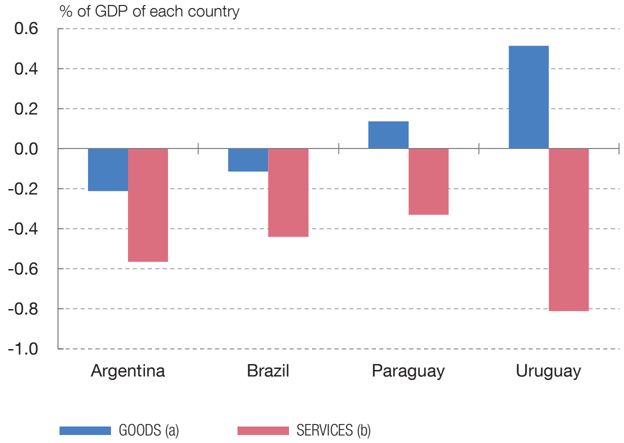
## TRADE RELATIONS BETWEEN MERCOSUR MEMBER COUNTRIES AND THE EU

The disaggregated data by country show some heterogeneity in the trade relations between MERCOSUR members and the EU since the smaller countries (Paraguay and Uruguay) are running a slight goods surplus and exports are highly concentrated by sector.

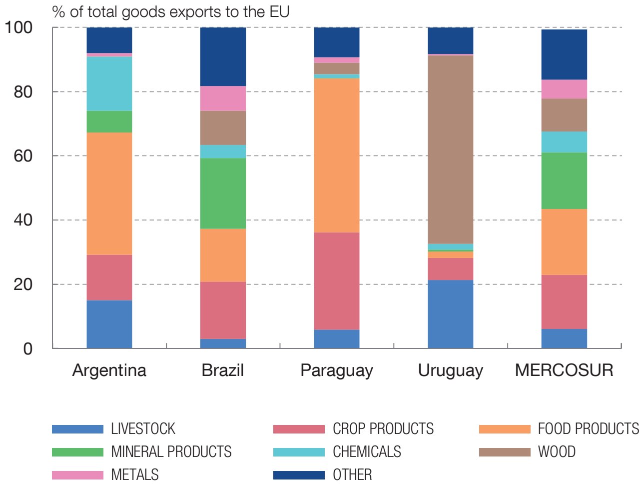
1 SIGNIFICANCE OF TRADE WITH THE EU
2018 data




2 TRADE BALANCES WITH THE EU




3 SECTORAL BREAKDOWN OF EXPORTS TO THE EU
2018 data




**SOURCES:** Eurostat, World Trade Organization, International Monetary Fund and Banco de España calculations.

**a** 2018 data.
**b** 2017 data.

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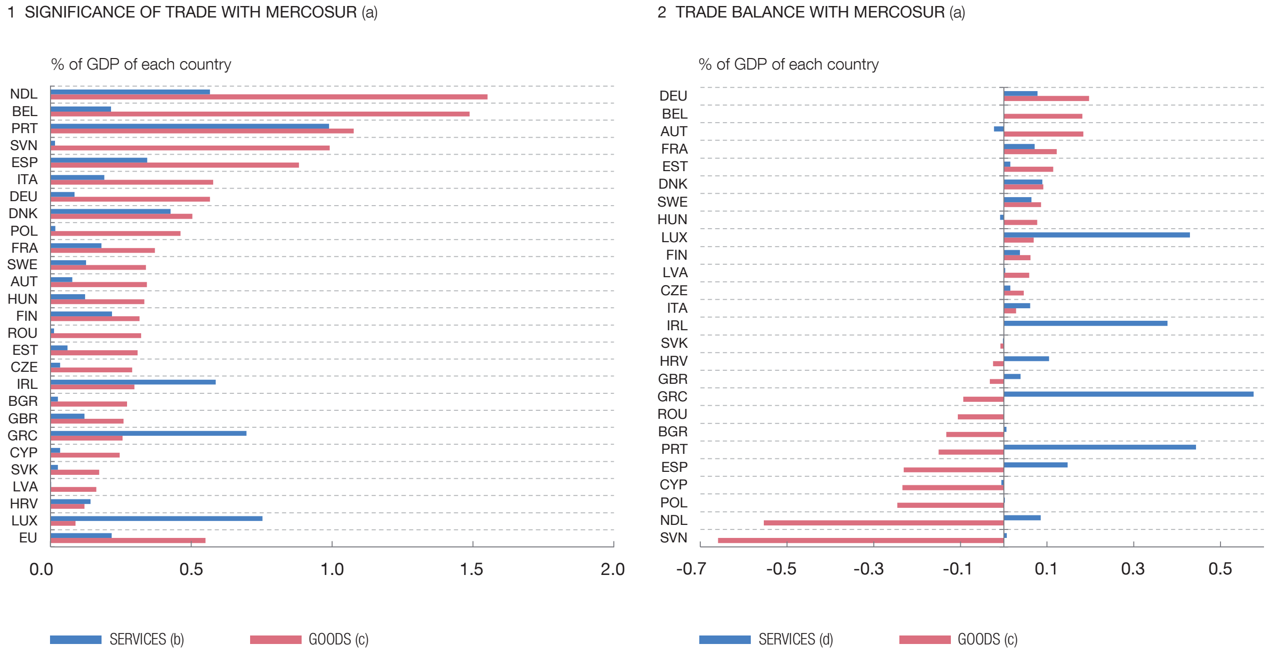
Chart 4

## TRADE RELATIONS BETWEEN EU MEMBER COUNTRIES AND MERCOSUR

Although trade with MERCOSUR represents a small percentage of EU GDP, it is distributed heterogeneously.




**SOURCES:** Eurostat, Comtrade and Banco de España calculations.

**a** MERCOSUR: Argentina, Brazil and Uruguay.
**b** 2017 data (2016 data for Spain and Germany).
**c** 2018 data.
**d** 2017 data.

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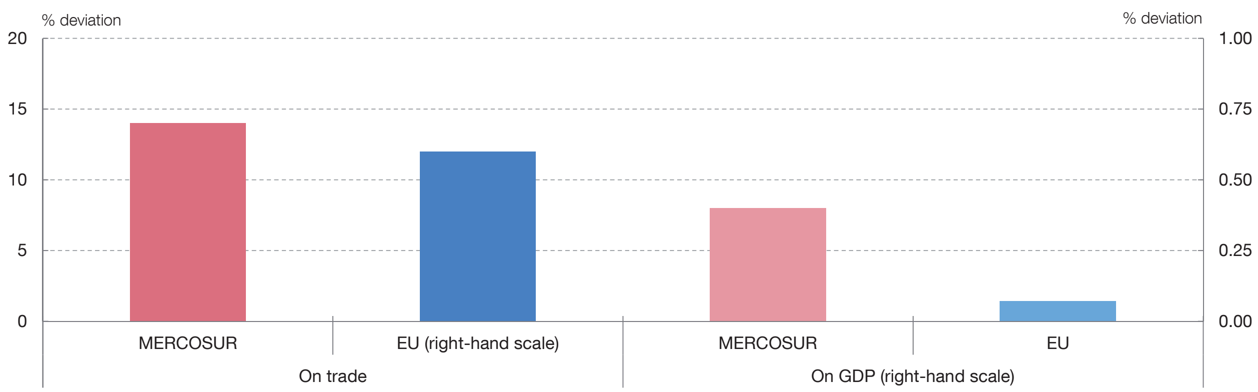
Chart 5

## IMPACT OF THE EU-MERCOSUR AGREEMENT ON TRADE AND GDP

The estimates obtained from a structural gravity model show that the agreement would have a positive impact on the trade and GDP of both areas.

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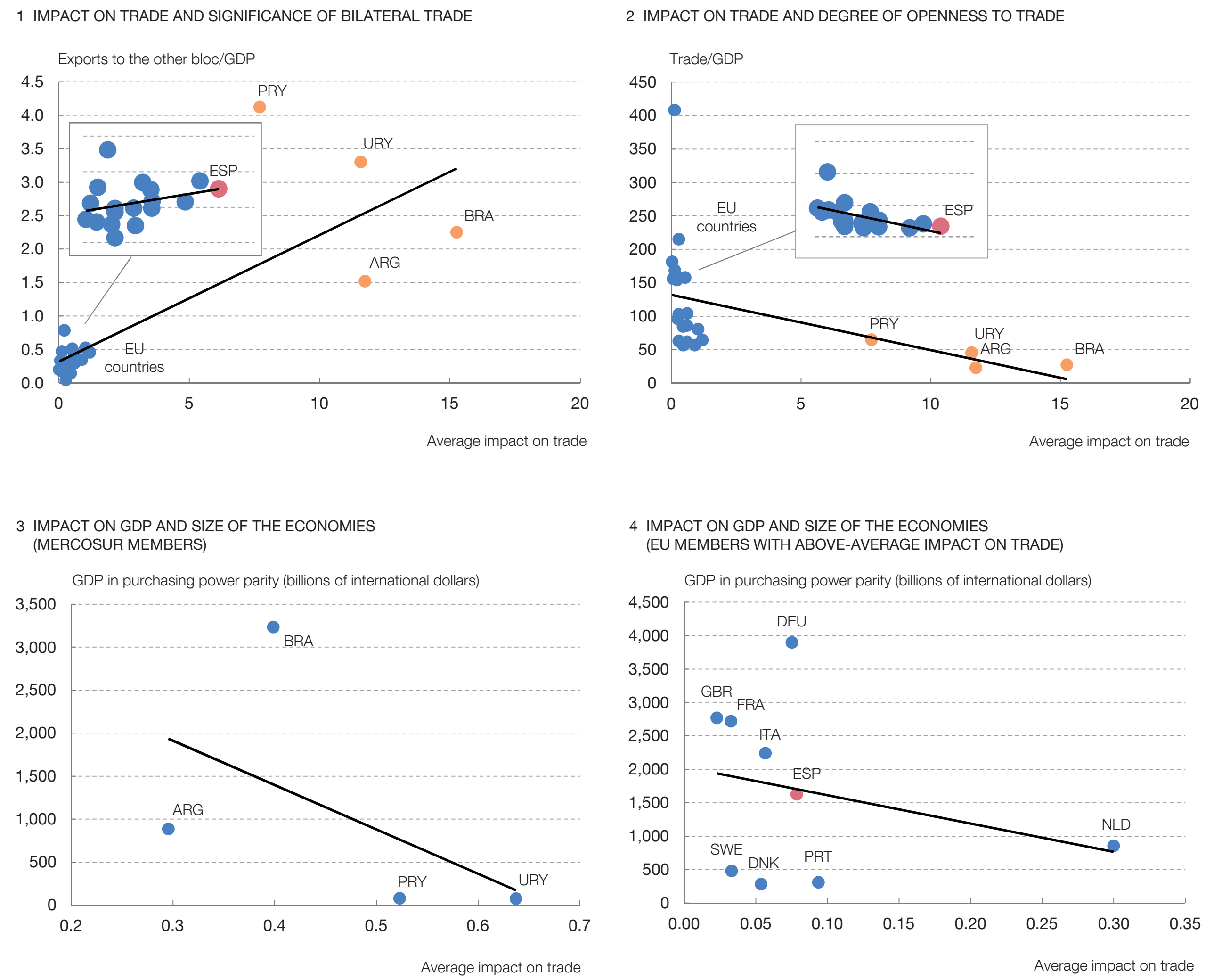
**SOURCE:** Banco de España calculations.

Chart 6
**FACTORS RELATING TO THE HETEROGENEITY OF THE IMPACT ACROSS BLOCS AND COUNTRIES**

The agreement will foreseeably have a greater impact on the economies for which trade with the other bloc is more important, on the countries with a lower degree of trade openness and the smaller economies.

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**SOURCE:** Banco de España.

The effects estimated should be interpreted as long-term differences, that is, once the agreement has reached its potential peak in terms of trade creation in respect of a counterfactual scenario in which there is no trade agreement.[13] The results show that the EU-MERCOSUR trade agreement entails positive effects for the trade and real GDP of both areas.[14] It is estimated that MERCOSUR's trade will increase by

13 Between eight and twelve years according to the literature: see Bergstrand et al. (2015).

14 The range of results presented is more conservative than the estimates of previous empirical literature based on simulations using computable general equilibrium models. See Diao *et al.* (2003), Kirkpatrick and George (2009), Boyer and Schuschny (2010) and Burrell *et al.* (2011).

14% and its GDP by 0.4%. The impact will be more modest for the EU: trade will increase by 0.6% and GDP by 0.07% (see Chart 5).

The varying scale of the impact estimated for the two areas is mainly related to two factors. First, since trade with the EU is more important for MERCOSUR members than trade with MERCOSUR for EU Member States, the agreement has a more pronounced impact on the trade flows of the Latin American bloc. Indeed, as shown in Chart 6.1, the countries engaging in more trade with those of the other area will experience a higher increase in trade flows. A second factor which seems to determine the more pronounced impact of the agreement on the trade of the Latin American economies is their relatively small degree of trade openness, since, as shown in Chart 6.2, the advantages of openness to trade are greater for those countries which in relative terms are more closed.

Furthermore, the results for MERCOSUR and the EU show high heterogeneity within each bloc. Broadly speaking, the patterns observed in the two areas taken overall are replicated at national level and the trade effects are sharper in economies which trade more with the other bloc (including Spain) and in those which are relatively more closed. Additionally, within each area (the EU and MERCOSUR) it is the smaller countries which record a greater impact from the increase in trade in terms of GDP (see Charts 6.3 and 6.4), since the significance of external demand for their growth is relatively greater than for economies with a larger internal market.

17.3.2020.

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