

BILATERAL AGREEMENTS: HOW THE EU IS WIDENING ITS TRADE HORIZONS

In addition to the multilateral liberalisation process of the 153 members of the WTO, trade policies have continued to develop at regional and bilateral levels. In parallel to its commitment to the Doha Round, the European Union (EU) is attempting to consolidate its trade relations with some partners by means of bilateral agreements. The EU is negotiating with two groups of countries in particular: mercosur and ASEAN. The terms of the negotiation make the prospective agreement with mercosur a sort of miniature Doha; with ASEAN, it is a question of going further than the multilateral proposals, particularly in the field of services. Simulations carried out with the mirage model give an accurate idea of the issues involved in these two projects.

■ Preventing the diversion of trade

From resounding failures (Seattle, Cancun) to partial progress, the Doha Development Round, launched in 2001, has reached a consensus on a large number of subjects but has not managed to conclude an overall agreement. On the fringes of these multilateral discussions, many countries or groups of countries have been increasing bilateral discussions in order to reduce barriers to their reciprocal trade. The WTO estimates that around 400 agreements of this type will be applied by 2010¹. These agreements signed between members of the WTO are only accepted by the organisation if their purpose is reciprocal free trade (Article xxiv of the gatt). These bilateral preferences create diversion effects: the tariff preference granted to an exporter-partner diverts the flow of imports in favour of this exporter to the detriment of the others. As a reaction, these diversion effects cause a profusion of bilateral agreements. Thus, over and beyond its neighbourhood policy and its Economic Partnership Agreements with 77 ACP² countries, the European Union has entered into discussions with several countries, such as South Africa, Mexico and Chile, to prevent the trade diversion linked to the free trade between these countries and nearby large developed countries (the United States, Canada or Australia and New Zealand).

The EU is also thinking of reaching free trade agreements with two regional groups, MERCOSUR³ and ASEAN⁴, in order to forestall these diversion effects. It has been interested in the South American market since soon after the launch of the American Free Trade Area (FTAA)⁵ project in 1994. Since the abandonment of this project, an agreement with the mercosur countries has become less urgent and its interest has been subject to a radical shift in perspective: mainly centred on agricultural issues, its contents now depend on the result of the Doha cycle negotiation. The negotiations with ASEAN were launched in 2004 (at the same time as with Korea and India). As well as facilitating the trade of goods between the two areas, the ue-asean agreement will be used to look in depth at subjects that are passed over, or not dealt with in detail, in the framework of the Doha Round, notably those related to services; from this point of view, it seems strongly complementary with the multilateral round. Simulations carried out with the MIRAGE⁶ general equilibrium model have been used to identify the reasoning behind these two projects by giving figures for the impact they could have on the economies of the countries signing these agreements.⁷

1. See the "Regional Trade Agreements" gateway on the WTO website. Also see "Regionalisation and regionalisme" in CEPII, *L'économie mondiale 2006*, Repères, La Découverte.

2. African, Caribbean and Pacific countries. See "Economic Partnership Agreements: the impact of trade liberalisation", *La Lettre du CEPII*, n° 276, March 2008.

3. Since 1991, the MERCOSUR, a Southern common market, has linked Argentina, Brazil, Paraguay and Uruguay. Venezuela signed a membership agreement in 2006.

4. The five founder countries of the Association of South-East Asian nations in 1967, Indonesia, Thailand, the Philippines, Malaysia and Singapore, were joined by Brunei in 1984, then by Vietnam (1995), Laos and Burma (1997), and Cambodia (1999).

5. The EU-MERCOSUR (1995) cooperation agreement opened the way to the launch of negotiations, in 2000, on an association agreement providing for reciprocal free trade.

6. Y. Decreux & H. Valin (2007), "MIRAGE, updated version of the model for trade policy analysis: focus on agriculture and dynamics", *Document de travail CEPII*, No 15, October.

7. See D. Laborde & M.P. Ramos, (2008), "The Ongoing on the EU-MERCOSUR bi-regional negotiations: a CGE assessment", *Document de travail CEPII* to be published; H. Boumellassa, Y. Decreux & L. Fontagné (2006), "A quantitative assessment of an eu-asean FTA", Report for the European Commission, DG Trade, Study report on www.cepii.fr.

■ EU-MERCOSUR: a miniature Doha

MERCOSUR exports as many agricultural products (high quality beef, poultry, maize, wheat, fruit and vegetables) as industrial products (minerals, steel and metal products, leather, engines) to the EU (table 1). These products are complementary to those exported by the EU (vehicle parts, engines, specialised machines, aeronautics, chemicals), so that the gains from reciprocal liberalisation should well exceed the costs. The current bilateral protection constitutes a real limit on trade between the two regions (table 2). Due to the exceptions permitted in the common external tariff, some MERCOSUR countries are highly protective of their automotive industries (this is particularly the case of Brazil) or their machines and equipment sectors (tariffs applied are higher than 20%). For its part, Europe strongly protects its agricultural market and the MERCOSUR countries derive little benefit from the EU's Generalised System of Preference given their level of competitiveness on certain products. Bananas are taxed at more than 60%, dairy products at almost 100%, sugar at more than 200%; beef is subject to tariff rate quotas.⁸ The main stumbling blocks that the bilateral negotiations are coming up against are beef and sugar. The opening of the European sugar sector is subject to two priority objectives: the implementation under good conditions (i.e. protected from the shock of external competition) of the long negotiated reform of the CAP sugar protocol; the protection of the European sector's traditional suppliers, the ACP countries. The opening of the European beef market is just as difficult. European production, made up of smallish stock rearing establishments, is not competitive on an international scale – but the Europeans (particularly the French and Irish) are determined to maintain this sector's activity. The South American stock raisers are very competitive. Brazil bases its competitiveness on price and Argentina on quality.

In spite of the existing barriers, the MERCOSUR countries have already conquered a significant share of the European beef market (6% of consumption) and it is clear that they are the countries best placed to benefit from a wider market access in the event of a multilateral liberalisation. This clearly shows that any proposals the EU may make to MERCOSUR are not independent of those made to the WTO. According to the single-pocket⁹ approach, the more generous the agricultural market opening granted by the EU to the WTO, the less generous the preferential access that remains to be offered to MERCOSUR; conversely, if the EU affords the WTO little market opening, it will be ready to offer MERCOSUR a wider preferential access.

Table 1 – Trade in goods EU-MERCOSUR and EU-ASEAN, 2006

	MERCOSUR		ASEAN	
	Exports to the EU	Imports coming from the EU	Exports to the EU	Imports coming from the EU
	<i>In billions of dollars</i>			
All products	33	25	76	52
Agribusiness	16	1	7	3
Industrial	17	24	69	49
	<i>in % of trade of each region (excluding intra)</i>			
	Exports	Imports	Exports	Imports
All products	24%	30%	17%	15%
Agribusiness	32%	33%	18%	15%
Industrial	19%	30%	17%	15%
	<i>in % of trade of the EU (excluding intra-EU)</i>			
	EU import	EU export	EU import	EU export
All products	2%	2%	6%	4%
Agribusiness	17%	1%	8%	3%
Industrial	1%	2%	5%	4%

Source: CHELEM, CEPII.

Along with this uncertainty, another question, related to Venezuela's membership of MERCOSUR, may affect the bilateral agreement. Apart from its political consequences, is this membership, which dates from 2006, likely to modify the economic interest of the two partner regions in reaching an agreement?

Starting from these two types of questions, we consider the same bilateral liberalisation scenario in three different contexts, characterised by: (S1) the absence of new multilateral liberalisation (failure of Doha), (S2) the conclusion of the Doha Round¹⁰ and (S3) the complete joining of MERCOSUR by Venezuela (simulated here in a world context identical to S1). The bilateral liberalisation that we simulate is an average of the latest trade proposals formulated by the two parties (October 2004): MERCOSUR and the EU eliminate customs duties on their bilateral trade for, respectively, 86% and 79% of their imports by 2014; for the other products, the so-called sensitive products (mainly agricultural for the EU, agricultural and industrial for MERCOSUR),¹¹ liberalisation is less extensive: it is slower for MERCOSUR and the EU retains protection by tariff rate quotas.

Table 2 – Bilateral protection – Average applied tariffs*

Markets	Exporter	Total	Industrial	Agriculture
MERCOSUR	EU	13.6%	13.6%	14.1%
EU	MERCOSUR	7.2%	2.1%	18.1%
ASEAN	EU	5.6%	5.2%	9.2%
EU	ASEAN	2.9%	5.0%	23.5%

* The average duties are calculated by the reference groups method. See A. Bouët *et al* (2004). "A consistent, ad-valorem equivalent measure of applied protection across the world: The MAcMap-HS6 database", *Document de travail du CEPII*, n° 2004-22, December.

Source: MAcMapHS6v1.

8. Tariff rate quotas combine quantitative restrictions and a two-tier tariffs regime: below the quota, the preferential tariff and above the quota a higher tariff, generally prohibitive.

9. The expression is used to characterise the EU's position in its negotiations with MERCOSUR. In particular, it was used in 1999 by P. Lamy, the European Trade Commissioner: "The EU does not have a multilateral pocket and a bilateral pocket, but one single pocket for the two sets of negotiations".

10. On the WTO Round proposals, see "Agreement at the WTO: a bird in the hand is worth two in the bush", *La Lettre du CEPII*, n° 263, January 2007.

11. Each country has the right to choose the sensitive products, on which the reduction in customs duties is lower than that provided for by the general tariff cut formula. In our simulations, the hypotheses made about this choice are based on the method expounded by S. Jean, D. Laborde & W. Martin (2008), "Choosing Sensitive Agricultural Products in Trade Negotiations", *Document de travail CEPII*, No 2008-18, September.

These simulations lead to three main conclusions:

- ✦ Whatever the reference context, MERCOSUR seems to be the main winner from an agreement with the EU: not only does its welfare (revenue allocated to final consumption) increase but there is a large increase in its trade (table 3). MERCOSUR's gains are particularly great in the beef and sugar sectors, even if the EU limits market access using tariff rate quotas. Brazil, the main beneficiary of European opening, will see its beef exports increase by 20% and those of sugar by 77%.¹² This competition reduces EU production by about 2% and 20% respectively.
- ✦ The interest of a EU-MERCOSUR preferential agreement does not disappear if the Doha Round is successful. A large part of the gains (of trade or well-being) would certainly result from the multilateral agreement and the benefits of the bilateral agreement would be relatively less important than if they arose in a less open environment. However, the two partners will still benefit from a greater opening of their markets in terms of welfare and trade. This is a good illustration of the fact that the progress of multilateralism may reduce the incentives to conclude bilateral agreements but does not eliminate the gains that the latter may afford.

Table 3 – Impact of a EU-MERCOSUR agreement on welfare and trade Differences with regard to the reference situations in 2020, in %

	Welfare			Exports to the EU		
	S1 Doha failure	S2 Doha success	S3 Venezuela	S1 Doha failure	S2 Doha success	S3 Venezuela
Argentina	0.12	0.10	0.11	3.2	2.6	3.1
Brazil	0.47	0.35	0.47	8.7	7.7	8.5
Uruguay & Paraguay	1.23	1.10	1.19	6.9	5.9	6.8
Venezuela	-0.01	0.0	-0.01	-0.1	-0.1	2.4
EU27	0.10	0.07	0.10	0.4	0.3	0.4

Source: MIRAGE, the authors' calculations.

- ✦ Venezuela's participation in the EU-MERCOSUR agreement is above all beneficial to Venezuela's exports to the EU but this impact remains relatively slight. Generally, to develop its trade and prevent diversion effects, Venezuela has an interest in acceding to full membership of this organisation by adopting its common external tariff and all of its preferential agreements. However, in the special case of the EU-MERCOSUR agreement, Venezuela does EU and is the only MERCOSUR country that benefits from the Generalised System of Preferences reserved by the EU for economies that are vulnerable, due to not being very diversified (GSP plus). In total, Venezuela's adherence to the EU-MERCOSUR agreement is not really an economic issue for any of the partners.

■ EU-ASEAN: beyond Doha

ASEAN, which brings together ten South-East Asian countries, is the oldest Asian agreement, concluded in 1967 on the basis of a political alliance between five countries. The economic purpose

of ASEAN was given concrete form in 1992 by an agreement providing for the creation of a free trade area (ASEAN Free Trade Agreement). There are very large differences in revenue between the member countries and the poorest among them benefit from special treatment, which allows them to gradually eliminate the customs barriers faced by their partners (by 2015 instead of 2010). The EU's trade with ASEAN (more than double the EU-MERCOSUR trade) is concentrated in industry (table 1). The trade between the two regions is partly of a complementary nature: ASEAN exports computer equipment, clothing and leather products to the EU and imports machinery and chemicals from it. However, intra-branch trade in electronic components is significant. On average, the protection of ASEAN markets is relatively low (table 2), further reduced by that of Singapore, which is particularly low. On the EU side, agricultural protection is, on average, stronger than that faced by MERCOSUR ; note, in particular, the very high protective barriers in some agricultural sectors (higher than 300%), especially oils and sugar beet.

Different scenarios were simulated using MIRAGE.

First of all, we analysed the impact of three variants of liberalisation, from the same reference situation which includes: (1) the success of the Doha cycle (2) the (progressive and differentiated according to country) implementation of intra-ASEAN free trade (3) the implementation, progressive up until 2015, of the 2002 ASEAN-China agreement.

Scenario S1A –total free trade of goods between the EU and ASEAN and a reduction of 10% in barriers to the trade in services¹³ – this would afford ASEAN significant gains in welfare (table 4). Its exports to the EU increase markedly, especially in the sectors defined as “priorities” by the regional Association: fishing, rice (European production would be reduced by half as a consequence in 2020), textiles, chemical products, etc., as well as in services.

EU-ASEAN free trade then appears to be a real deepening of trade relations between the two regional groups in addition to the commitments of each of these in the multilateral liberalisation process. Note, in particular, that if services were excluded from the bilateral agreement (S1B), its impact, still positive, would be significantly weaker in terms of welfare; on the European side, the impact of the bilateral liberalisation (always weaker than for the ASEAN countries given the respective economic sizes of the two groups) would then become practically insignificant. Conversely, if an exception to bilateral free trade was allowed for the “sensitive products” (no reduction in their customs duties) (S1C), the ASEAN agricultural exports would progress less but those of industrial products and services would increase more. The improvement of welfare in ASEAN would thus be greater. This is an illustration of the fact that the development of agricultural activity allowed by the external market access (S1a) is not necessarily positive in so far as it leads to the retaining in agriculture of a workforce

12. This result is derived from a simplified representation of tariff rate quotas. A different share of gains between Brazil and Argentina could be provided by a finer modelling. See M.P. Ramos *et al* (2007), “Shipping The Good Beef Out: EU Trade Liberalization to MERCOSUR Exports”, *TradeAg Working Paper* No 17.

13. Services covered by mode 1 defined by the General Agreement on Trade in Services (GATS).

Table 4 – Impact of an EU-ASEAN agreement on welfare and trade – Differences from the reference situation in 2020, in %

	Welfare				Bilateral exports				
	S1A	S1B	S1C	S2	S1A	S1B	S1C	S2	
ASEAN	2.16	0.53	2.28	2.58	Agriculture	1.1	1.4	-1.6	0.7
					Industry	0.9	2.2	1.5	2.2
					Services	40.3	-4.4	42.2	40.4
EU 27	0.10	0.03	0.11	0.09	Agriculture	2.2	2.0	1.9	2.0
					Industry	0.9	0.5	0.9	0.7
					Services	3.3	0.3	3.2	3.7

Source: MIRAGE, the authors' calculations.

that could be employed in the industrial or service sectors with increasing return to scale. In a second simulation, scenario S2 re-uses all of the bilateral liberalisation hypotheses of scenario S1a, but starts from a reference situation that adds to the preceding international situation a stronger development of bilateralism, with the setting up of ASEAN-United States and ASEAN-Japan free trade, on the one hand, and eu-mercosur free trade, on the other. This situation creates a supplementary incentive to the conclusion of an eu-asean agreement. Without such an agreement, ASEAN would remain, in practice, the only large exporter, along with China, to face European customs duties; symmetrically, Europe would be the only developed country facing ASEAN customs duties. Under these conditions, a free trade agreement between these two groups of countries would not only be synonymous with reciprocal liberalisation but would also eliminate this discrimination. This is important for Europe, which exports to ASEAN the same types of goods and services as the other industrialised countries, in similar quality ranges. As for ASEAN, the agreements signed with the other developed countries will lead to a better allocation of resources, which will enable it to export more industrial products to the EU. Conversely, in agriculture, the possibility of exporting to the American and Japanese markets will take up a large part of its offer capacity so that its exports to the EU will grow less than in scenario S1.

■ A new context

The surge in bilateral negotiations that has occurred in the world since 2003 has not always led to an effective lowering of trade barriers, in spite of the economic gains that this could offer. The

proliferation of negotiations can be explained by the fact that many countries have not wished to remain aside from the dynamic of opening, in which each one chooses its preferred partners. However, the complexity of implementing pick and mix agreements and the global or sector based reticence to concede greater openness explains why they do not reach a rapid conclusion. For instance, on the 8th of August, Surin Pitsuwan, the President of asean, declared that the objective of signing an agreement with the EU in the next two years was too ambitious. He proposed a reduced agreement, which would initiate the process of trade integration with the asean countries ready to commit to dismantling tariffs and leave the others with the option of joining the agreement later. Whereas, Mercosur is attempting to re-open the negotiations with the EU in the hope of opening up new markets in Europe at a time when the United States is being hit by a recession. For the EU, the conclusion of the Doha Round is still a priority that conditions the progress of an agreement with MERCOSUR¹⁴.

In all of these cases, the sudden slowing of international growth and the depth of the financial crisis have created a new environment which could lead, if not to protectionist withdrawals, at least to greater prudence in the search for openness. The prospect of trade wars should not be excluded. However, the crisis has also forcibly underlined the need for worldwide governance institutions and for the redefinition of their roles and means of intervention. The conviction that the young wto is a public good that needs to be preserved and that the restarting of negotiations in the multilateral arena is the best method of preserving non-conflictual trade relations may then be more firmly held and widely shared. In this frame of mind, we might imagine that trade policies implemented at multilateral and bilateral levels could become more coherent.

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14. The Regional strategy document 2007-2013 sets the priorities for the EU's cooperation with MERCOSUR. The community financial aid of 50 million Euros will be mainly allocated to strengthening MERCOSUR and implementing the future EU-MERCOSUR association agreement.

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