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Foreword

This publication presents the results of a workshop on “Fast-tracking the EU-Mercosur Negotiations” and scenarios for untying the main knots in the biregional trade talks. The workshop was held on March 29, 2004 at the *Sala de Juntas del Rectorado* of the University of Barcelona. The meeting was part of the 2004 research program of the **Working Group on EU-Mercosur Negotiations** (WG), as was another workshop that focused on the main non-trade issues in the negotiations : the agreement’s regulatory impact and the regulatory reform and level of integration required in Mercosur; the question of how to manage the inevitable transitional costs of biregional trade liberalization; the cooperation programs needed to support trade capacity-building; the problem of how to finance growth and development in the framework of the agreement; and the matter of how to enhance the legitimacy of the final agreement in the view of civil society.

The WG, established in 1999 by the **Mercosur Chair of the Institut d'études politiques de Paris** (Sciences Po), serves as an interface between business, negotiators and civil society. A flexible structure of working contacts between the two regions, it seeks to contribute to the preparation and monitoring of the EU-Mercosur negotiations, and to the discussion of the two regions’ positions in the WTO and towards the Free Trade Area of the Americas (FTAA). It benefits from an independent academic framework and links the main partners involved : negotiators, entrepreneurs, public officials,

political representatives, academic specialists, and non-governmental and international organizations.

The EU-Mercosur trade negotiations are moving faster in the wake of the negotiators' exchange of their first detailed offers in April 2004; both sides hope to conclude an agreement by the final quarter of 2004. The core perspective of our work is to present the negotiators and all interested parties with practical inputs for the final rounds of the talks. The idea was to produce, for each main issue (agriculture, non-agricultural products, investment and services) and for the overall agreement, different scenarios for the conclusion of the negotiations. This study deliberately concentrated on *probable* or *feasible* scenarios for the conclusion. It was not designed as an academic exercise in which all possible outcomes would be weighed, analyzed and discussed.

In fact, the authors had to work with scenarios that involved a good deal of political analysis, knowledge and intuition. First, they had to define the political and technical limits of a feasible agreement : an optimistic (not the "best-case") scenario and a pessimistic scenario (not the "worst"). Then they had to define an intermediate scenario between these two. They also had to gauge the possible built-in agenda for further negotiations. Hence these are not classical academic studies but rather highly pragmatic contributions, wherein obstacles and opportunities are stated for each scenario, and some ideas are advanced on how to untie the different "knots" constraining the negotiations. In the interests of conceiving balanced scenarios, each chapter was prepared by two authors (one from Mercosur and one from the EU), and coordination was ensured through the use of a biregional pair of researchers.

This volume, produced under the astute and knowledgeable guidance of Félix Peña (Argentina) and Patrick Messerlin (France), brings together the contributions of distinguished European and Latin American experts on important aspects of the subject. The first study tackles the most intractable "knot" of all : market access for agricultural products. Two seasoned specialists, Marcos Jank (Brazil) and Jean-Yves Carfantan (France), coordinated a team of French and Brazilian junior researchers (Géraldine Kutas, Antônio Josino Meirelles Neto, André Meloni Nassar and Joaquim Henrique da Cunha Filho) to produce a very detailed analysis of the most important sensitive sectors – bovine, pork and poultry meat, sugar and ethanol, corn and wheat, powdered milk, tobacco, orange

juice, fruits – and to suggest scenarios for addressing them in the trade talks. The second study, a thorough analysis by Celina Pena (Argentina) and Pierre Sauvé (Canada), addresses a range of concrete policy options for the successful negotiation of some of the most sensitive issues in the area of services, investment, and government procurement rules and regulations. The third study, an insightful exploration of market access for non-agricultural goods by Sandra Rios (Brazil) and Mahrukh Doctor (United Kingdom), examines different scenarios for tariff liberalization, rules of origin, drawbacks, safeguards, anti-dumping, and infant industry protection and commitments.

The Chair Mercosur is grateful for the valuable contributions of the experts, business representatives and public officials from Europe, Mercosur and North America who participated in the “Fast-tracking the EU-Mercosur Negotiations” workshop. It extends its warm thanks to the *Observatori de la Globalització* of the University of Barcelona and its director Ramón Torrent for ensuring that the meeting could be held in such a magnificent and pleasant setting.

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Introduction

Feasible scenarios for a trade agreement and criteria for their evaluation

A moment of crucial definitions and factors that could play a significant role in the ambitiousness of an October 2004 biregional agreement

The EU-Mercosur negotiations are at a stage of crucial definitions. The offers presented by both parties (and their discussion by negotiators in their scheduled May meeting in Brussels) are already being perceived by the public in both regions, and by third countries, as a clear indication of their willingness to conclude a biregional strategic association agreement by the October 2004 deadline, and of the real possibility that an accord will be signed.

Above all, the May meeting will provide a concrete idea of how ambitious the agreement might finally be. This will be particularly important for the more sensitive issues of the *trade agenda*, those related to market access for agricultural and non-agricultural goods, services, investment and government procurement.

The challenge now facing the negotiators is to secure reasonable trade-offs within and between each of the main chapters of the negotiating agenda.

Clearly the political and economic cooperation chapters will also determine the ambitiousness of the biregional agreement. The non-trade issues in those chapters might help broaden the scope of the association, but those that might unexpectedly be included in the trade agenda, or that interfere with it excessively, could cause difficulties. That said, the main goal of our workshop's technical exercise

was to identify the most significant “knots” in each of the main issues of the *trade agenda*, and to suggest technical ways of untying them.

As regards trade, the agreement will most probably be only a first step, the core of which could be the substance of a WTO-consistent free trade area for goods and services. Further negotiations might be needed, however, especially after the end of the Doha negotiations, to take account of its results. In that case the biregional agreement might be perceived as “light”, particularly in view of the more ambitious goals expected from a strategic association.

Nevertheless, the real value of an agreement in terms of both free trade and non-trade issue, will depend on the strength of the “built-in” agenda and the institutional provisions that ensure a second step could really be “Doha-plus”. A sufficiently substantial and detailed “road-map” for this second step could feature prominently among the instruments that the two sides use to conclude the current negotiations.

The main formal agreement could also include provisions on the development of the biregional association, for the purposes of the future and agreed inclusion of other elements that go beyond a traditional and WTO-consistent free trade area.

The real practical value of the biregional agreement will also depend on the quality of the other non-trade chapters, especially economic cooperation. The differences in economic size and development level between the two regions are plain. Hence the economic cooperation chapter could involve a European Union contribution to Mercosur’s development. The Southern Cone economic integration process, according to the goals set by the member countries, entails the implementation of a complete customs union and a real common market within a reasonable period.

Thus one of the most original aspects of the biregional association will be its potential to enhance the efforts of a group of developing countries to work together within a deep integration process. This outcome of the association –economic integration among developing countries– will in itself be a significant European contribution to helping the Mercosur countries tackle some of their main social problems.

The main factors behind the agreement’s level of ambition

At least four factors could significantly determine the biregional agreement’s level of ambition and its feasibility.

Both sides assert a strong political interest in concluding an agreement by October 2004. This has been an important ingredient in all the rhetoric surrounding the initiative.

However, *there does not currently seem to be adequate political space or sufficient will to conclude an ambitious trade agreement, one that includes significant concessions in all sensitive areas (agriculture, manufactures, services, investment, and government procurement), as the two sides originally expected.*

a) **On the EU side**, for strategic and economic reasons, European political interest stems from its support to the consolidation of Mercosur, particularly as a common market.

One strategic reason is that a stronger Mercosur could play a significant role in advancing a more balanced and development-oriented international system in both political and economic terms. The Mercosur countries might have strategic value in view of the EU's long-term view of global political and economic competition, however, but this matter does not seem to be a significant strategic and political priority in the short term.

Perhaps large European firms with substantial investments in Mercosur could help EU members –and public opinion within them– to see the potential strategic interests of further developing the biregional strategic association.

– *Another strategic consideration* concerns the impact of an EU-Mercosur agreement –even with initially limited preferences– on the Doha agricultural negotiations. A successful agreement might be perceived as strengthening the WTO negotiations if it meets certain conditions : essentially, granting preferences for the dismantling of barriers at a later stage. Nobody would win if the agreement were to be seen as weakening the main negotiating interests of any of the two partners at those negotiations, mainly on market access and rules issues.

– *Economic reasons* arise because, from the viewpoint of global economic competition, the Mercosur markets are relatively significant to European firms willing to strengthen their position relative to competitors from other industrialized countries. This is plain in key industrial sectors, especially services sectors such as telecommunications, energy, banking and insurance.

There are marked asymmetries between the two sides' economic size and technological capabilities. These explain many of the diffi-

culties in attracting the necessary level of European interest to meet Mercosur expectations, especially in the sensitive agriculture sector.

b) **On the Mercosur side**, interest in the accord also springs from significant strategic and economic considerations.

– As regards *strategic reasons*, if a biregional association agreement is concluded in October it could strengthen Mercosur's negotiating position in the FTAA talks, especially the negotiations with the United States.

This is only true, however, if the biregional agreement is not perceived as too "light", and if there is some prospect of a significant future "second step" and a further evolution in a reasonable period.

– *Economic interest* stems from the positive impact that improved access to the European market could have on investment decisions and employment in sectors where Mercosur has clear competitive advantages, such as agriculture and agribusiness. Again, this economic interest is related to the level of ambition of the accord's first stock of trade preferences, or the likelihood and scope of the concessions in all the main issues for both partners in a "second step".

The biregional negotiations could probably be concluded before completion of the WTO and FTAA talks.

There have been strong links between the three negotiating fronts since they began in the 1990s, very largely because they all address agricultural issues related to export and production subsidies.

As regards Mercosur's main negotiating interests in agriculture, in the biregional negotiations and the FTAA talks, the EU and the United States have made clear that they will only consider Mercosur expectations in the WTO discussions.

From the EU perspective, however, the almost certain disappearance of investment and government procurement from the Doha Round somewhat alters the strong link between the three fora. The same could be true for intellectual property rights, depending on the fate of the discussions about geographical indications.

The prospect that the biregional negotiations could end before the talks on the other two negotiating fronts *will incline the negotiators towards a "two-step" EU-Mercosur agreement*. In that case, two elements of a feasible trade agreement seem to be the most important and also the most difficult to achieve, from both a political perspective and a technical standpoint.

One concerns the scope of the initial trade preferences and a reasonable “trade-off” package among the different chapters of the negotiations.

The other is related to the matter of how to devise a “built-in agenda” for the second step, one that would assure both sides that at some point there will be a stock of “Doha-plus” preferences that are reasonably ambitious and balanced in value.

All the players seem to have adopted a “race to the bottom” attitude.

Hence, for the moment, they are more interested in trying to avoid exerting greater additional pressure on important and sensitive domestic constituencies, and they might prefer to gain less in the negotiations if that course of action is less costly.

The most feasible scenario for the biregional agreement

The most feasible scenario for the further development and conclusion of the EU-Mercosur negotiations in October 2004 is one in which neither the WTO nor the FTAA talks will be concluded, nor even perhaps be in their final stage.

That is almost certainly true of the WTO negotiations. The best-case scenario today is agreement on a “framework” by next July, perhaps with a series of technical negotiations in the second half of the year (the peak of the US presidential campaign). These discussions should be intense enough to swiftly restore new momentum before March 2005, when the newly-elected US president, if he wishes to do so, will have to rush to secure congressional approval for the renewal of trade promotion authority (TPA).

In both cases, however, it is reasonable to suppose that there could be substantial progress in the WTO negotiations by the end of the first half of 2005 at the earliest. It might even be later, in which case the Doha Round will amount to a minimal package, as happened in some earlier GATT Rounds.

Though it is possible to do it, the workshop exercise declined to consider a scenario in which both the WTO and FTAA negotiations then still lack a clear deadline or have reached an impasse. Similarly, no consideration was given to the possibility that the EU-Mercosur talks fail to secure some concrete results by October 2004.

Complete failure is still possible, but we deliberately chose not to address this negative scenario.

Within the feasible scenario framework considered by the workshop, for some biregional EU-Mercosur agreement to be concluded in October there must be some continuous negotiating process to deepen the initially limited stock of trade preferences. As mentioned above, that goal could be met by adopting a built-in agenda for a “Doha-plus”, second-part agreement after the end of the WTO negotiations.

Within this feasible scenario, we worked on a distinction between “more optimistic” and “less optimistic” options, with a view to untying the chief knots in the current negotiations.

This distinction mainly concerns the ambitiousness of each of the accord’s elements. We consider the agreement from the perspective of both the original EU and Mercosur expectations, and of the possible “trade-creation” and “investment” effects of the limited stock of trade preferences finally included.

Most of the discussions in the workshop centered on the conclusions to the chapters produced by our team of experts on how to untie the main knots in the agriculture, market access for goods, and services and investment chapters. Those chapters are included with this introductory report as a technical contribution to the development of the biregional negotiations.

Some criteria for assessing the trade elements
of the biregional association agreement

What could be the main criteria for assessing the value of the stock of trade preferences and the quality of the “built-in agenda” that might emerge from biregional negotiations?

These criteria are important in light of the most feasible scenario of a two-step trade agreement : a form of “interim agreement” followed by a “Doha-plus” accord. This means that the biregional association would initiate a continuous process of trade negotiations between the two sides. In that case the institutional dimension of the process would be very important, including mechanisms to ensure the effective participation of civil society representatives.

A credible and a feasible “built-in agenda” and its “roadmap”, included in an instrument signed simultaneously with the main

agreement, will give an impression of the two sides' willingness to go beyond what might be perceived as a "light" conclusion to the present negotiations.

We suggest the following main criteria for assessing the first step's limited stock of trade preferences, from both the European and Mercosur perspectives, and for evaluating the considerations that could be taken into account in the subsequent steps :

- *The competitive and investment effects of the limited stock of trade preferences finally included in the agreement.*

These effects will depend on the scope and effectiveness of the market access commitments covering all sectors, including agricultural and non-agricultural goods, services and government procurement.

The significance of the stock of trade preferences will be measured by the impact on trade flows and the investment decisions made by European firms in Mercosur, in both the industrial and services sectors.

In particular, the competitive and investment effects should be considered from the viewpoint of the medium and small firms of each of the Mercosur and EU countries. Incentives that could spur investment for the development of export platforms in Mercosur will also be important in assessing the agreement.

Additionally, it will be important to note the impact of the stock of preferences on strengthening the current trend towards the integration of competitive production chains in Mercosur, as well as in the biregional economic area arising from the strategic association. This impact could be enhanced through substantial economic cooperation from the EU.

Obviously, these competitive and investment effects will not materialize if the first step is highly concentrated in a few and small TRQs, with limited impact on value-added products, both for agricultural and non-agricultural goods.

- *On the Mercosur side, the effects on economic integration and collective disciplines, effects that that could stem from the economic stimulus afforded by a significant stock of preferences, should be among the criteria for assessing the agreement.*

This is particularly important in view of the member countries' willingness to strengthen Mercosur along the lines of a model of

open regionalism, and given the EU's political interest in supporting an effective integration process in the region.

- *The concrete effects of the biregional agreement* on the development of the other key trade negotiations in which the Mercosur countries (WTO and FTAA) and the EU (WTO) are involved.

In particular, *the effect on the WTO negotiations is an important criterion in assessing the biregional agreement*. If it has a positive impact on the conclusion of the Doha Development Agenda in a reasonable period, the appraisal will surely be positive.

- Finally, the other main criterion for evaluating the results of the EU-Mercosur negotiations is *the agreement's capacity to have a demonstration effect on other "North-South" trade negotiations*.

The EU's extensive experience in facilitating the transition of Central European and Mediterranean countries toward more stable democracies and modern economies with social cohesion should help ensure the same effect in Mercosur.

One aspect of the model arising from the biregional strategic association is the link that could emerge between the accord's trade component and its economic cooperation component. This would be particularly important for strengthening the capacity of Mercosur's small and medium firms to compete, both in the economic area created by the agreement and in third countries.

Félix PEÑA
Patrick MESSERLIN

Abstracts

Scenarios for Untying the Agriculture Knot

The International Context of Agriculture Negotiations

The importance of EU-Mercosur negotiations for the creation of a bi-regional free trade area (FTA) has been significantly enhanced by the failure of the September 2003 WTO ministerial conference in Cancun and the recent difficulties encountered in the Free Trade Area of the Americas (FTAA) negotiations.

Given that Mercosur exports 29 billion dollars worth of agricultural products and that the EU imports 35% of these, market access for agricultural goods is a core issue in the bi-regional negotiations. Reforms of trade distorting instruments used in the EU's Common Agricultural Policy (CAP) are nevertheless progressing very slowly, indicating that current subsidies to domestic production and exports will not be fully eliminated in the course of the negotiations. Discussions are therefore supposed to focus on the reduction of tariff rates and market access through tariff rate quotas (TRQs).

The accession of 10 new members to the EU in May 2004 may influence the outcome of the current EU-Mercosur agricultural negotiations. Accession to the single EU market is likely to have significant implications for most new members' trade regimes and

commercial flows. Recent trade developments between the EU-15 and the new member states show a growing EU share in these countries' trade flows that is already restricting or reducing third country market shares in Europe. Upon accession to the EU in 2004 or later, applicant countries will apply the EU's common external trade policy, starting with the conversion of their current import tariff rates to those of the EU. Under WTO rules, a country has a right to claim compensation for the loss or reduction of market access if it loses preferential access or faces higher tariff rates as a consequence of its trading partner joining a customs union. This point will certainly influence the EU-Mercosur negotiations on farm trade liberalization. Mercosur members will certainly apply for compensation for loss of or less favorable access to Europe's markets.

Sensitive Issues in the Agriculture Discussions

Market access negotiations in agriculture involve a list of sensitive products that could deadlock the overall trade negotiations due to their importance in EU-Mercosur inter-regional trade and the current restrictions they face, mainly in the EU market.

These products basically include bovine, chicken and pig meats, sugar and ethanol, cereals, dairy products, tobacco and fruits. All are important products for Mercosur, and all face high tariffs and limited TRQs upon entry into the EU market. A feasible agreement for Mercosur would therefore include substantial tariff reduction and the concession of exclusive TRQs.

Some products such as wines and spirits that are significant to the EU may also complicate discussions, since they involve the harmonization of geographical indication (GI) rules. As an important producer of traditional beverages, the EU is pushing for the establishment of a strict agreement on GIs.

After conducting a sector-by-sector analysis for the most important sensitive products in bi-regional agriculture negotiations, it is possible to identify more flexible positions and different scenarios for each product, which will lead to a more realistic outcome for the overall negotiation on agriculture.

Scenarios for EU-Mercosur Negotiations

In order to identify scenarios for the outcome of the bi-regional negotiations, this paper takes into account the complexity of each party's interests and the genuine constraints they face. To complete

this exercise, we have examined the two most radical positions regarding agriculture negotiations, which are those of France and Brazil. Since there is almost no point of consensus among the two positions, “feasible” scenarios must necessarily lie somewhere in between them and should be built on a product-by-product approach.

Optimistic scenario

This scenario would entail positive prospects for inter-regional trade as well as considerable changes in the EU domestic market. In this scenario both parties should agree on a substantial and horizontal liberalization for the most important agricultural products of the EU and Mercosur, thus enhancing inter-regional trade flows through preferential access for products exported by both regions. This process could take place gradually but should include the following changes:

- a) Substantial reduction of over-quota tariffs allowing products such as cereals, meat, sugar and dairy products to enter the EU market.
- b) If over-quota tariffs were not substantially reduced, a considerable amount of TRQs with preferential access should be allocated exclusively to Mercosur.
- c) Special Safeguard measures (SSG) should be suspended.
- d) Quota administration methods should be revised.
- e) Successful agreement on geographical indications for wines and spirits.

Pessimistic scenario

A pessimistic scenario for agricultural products would maintain the *status quo* of EU domestic market protection in the most sensitive products. This scenario would, however, establish in-quota preferential access. It would thus include:

- a) Expansion of preferential access for some strategic products (i.e. meats and dairy products). Access conceded through quotas would be limited compared to Mercosur’s export potential for agricultural products.
- b) No reductions in high over-quota tariff rates.
- c) No suspension of special safeguard measures.
- d) No reform of quota administration methods.

Feasible and Most Probable Scenario

A feasible –and the most likely– scenario would be more complex, involving a combination of approaches to the different needs of each sensitive sector. Some problems –such as TRQs and TRQ administration, which are horizontal to most sensitive sectors– would receive special attention in the negotiations, implying reforms and new access in this area. For some products, new access could be achieved through a two-step approach. According to this modality Mercosur goods would be granted some preferential and limited access to the EU market through the EU-Mercosur FTA. Subsequently, Mercosur would receive an [X] percent share of the global volume that the EU will offer to third countries in the WTO. Some particular sectoral demands would also shape the results of the EU-Mercosur FTA.

The result of the negotiations will nevertheless depend on the level of ambition of trade-offs with other areas under negotiation (non-agricultural market access, services, government procurement, etc.). If the proposed trade-offs are ambitious, significant quotas and tariff preferences may be offered to Mercosur exports. In contrast, if proposed trade-offs are not significant, only small preferences on quotas and tariffs could be conceded. As regards trade-offs, it is important to emphasize that Mercosur's acceptance to remove export subsidies and domestic support from the list of issues to be negotiated bilaterally is in itself a significant concession that should be taken into consideration in the global trade-off. In addition, to compensate for the absence of measures to eliminate export subsidies, the EU would have to accept the creation of intra-bloc safeguards to neutralize the impact of EU export subsidies to products that are exported to Mercosur, especially in the case of dairy exports. In addition, if Mercosur members accept the two-step approach proposed by the EU, they will have to support the EU proposals for the agriculture negotiations in the Doha round. This concession should also be part of the global trade-off.

Scenarios for Untying the Knots in Services and Investment

This chapter offers some thoughts on the possible elements of successful EU-Mercosur negotiations in the fields of services and investment. There are reasons to believe that real advances in these areas are well within the reach of negotiators, and there is strong business sector support for progress.

The chapter presents a range of policy options that may help both sides' negotiators shape the main elements of an agreement that would help to deepen biregional trade and investment relations, promote good governance, enhance economy-wide performance, and set useful precedents worthy of subsequent consideration in the WTO.

Services

At first sight, there appear to be relatively few Gordian knots for EU and Mercosur negotiators to untie in the services field, where both parties have professed a clear preference for replicating a GATS-like approach for the purposes of improving the *status quo* prevailing at the multilateral level.

There are essentially two means to that end, both of which offer ample room for policy innovation :

1. Enhancing the rules governing trade and investment in services. This can relate both to a strengthening of *existing* WTO disciplines and to possible *new* disciplines. In this context, the paper points out the possibility of exploring the following :

– *Government procurement for services* : additional commitments specifying conditions for gradual liberalization.

– *Services-related subsidies* : best endeavors (hortatory, for example) commitment to agree subsidies on a national treatment basis and fix deadline to complete negotiations in the area. Envisage some element of variable geometry in any possible subsidy disciplines, in particular within Mercosur countries. At the least,

additional commitments (for transparency purposes and some best endeavors provisions to avoid distorting effects) would represent a step forward.

– *Domestic regulation* : Confine any disciplines on domestic regulation solely to sectors, sub-sectors and modes of supply subject to scheduled commitments. Explore the types of criteria that any necessity test for services would require. Agree disciplines on transparency to set the main criteria prevailing for an economic needs test.

– *Overlap between market access and national treatment commitments in the case of discriminatory market access impediments* : clarify the GATS provision through a footnote.

– *Competition-related issues* : proscribe, jointly investigate or consult private anti-competitive practices. Adoption of pro-competitive disciplines in network industries

– *Transparency* : prior notification rights before the enactment of any proposed measure affecting trade and investment services.

– *E-commerce and “digital trade”* : possible new rules.

– *Mutual recognition* : draw up a work program that allows all possible configurations of MRAs to emerge among interested parties, without having to wait for all of them to be on board.

– *Citizenship or permanent residency requirements* : elimination of both as conditions for professional licensing.

2. By extending the liberalization (access) boundaries beyond what has proven possible to date under the GATS. This can relate both to an improvement in current levels of access and *de novo* commitments in new sectors or modes of supply. Priority attention should be paid to the followings areas :

– Progress in the liberalization of *temporary movement of service suppliers (Mode 4)*.

– Deep liberalization in the core infrastructure sectors of *finance, telecoms, and transportation services* (all modes). Incorporate existing GATS sectoral annexes and their disciplines by reference, and aim to add to, deepen or improve (even in the future, as phased-in undertakings) current WTO commitments in a biregional setting.

– Consider adopting a rule mandating *status quo* commitment under a GATS-like approach (in conjunction with a strict and temporary change of schedules clause).

- Broaden the sectoral coverage of the services chapter in areas such as *air transport* and *energy services*.
- Intensify cooperation in *audio-visual, health and education services*.
- Agree on forms of regulatory cooperation among relevant institutions aimed at addressing current obstacles to *cross-border* trade.

Investment

As international production networks demonstrate, many globally active firms manage investments in both goods (manufacturing) and services under the same corporate roof. Subjecting such activities to potentially differentiated investment rules is unlikely to promote policy coherence.

This is not a trivial matter, since most cross-border investment activity currently takes place in services and the vast majority (over 80%) of investment barriers are in services. Indeed, it can be argued that most foreign investors in manufacturing enjoy better than national treatment. There are certainly investment barriers outside of services and manufacturing, but the scope for liberalizing restrictions in sensitive areas such as ownership of land and natural resources seems quite limited.

Worthy of serious consideration by both parties, however, is a general set of principles that would favor development, improve home country investment climates, and promote good governance through enhanced transparency disciplines.

One possible way of adding some value in this area, at least from a Mercosur prospective, could be to include the *objective of development*, either as part of the preamble or as a provision in the agreement's investment chapter.

Another question is whether the rules on investment should aim to preserve the regulatory *status quo*, despite the retention of a hybrid approach to scheduling.

The *rule of origin* applied to those investors and investments deemed eligible for preferential treatment must also be analyzed. The agreement should reflect a more restrictive ownership and control test (most likely to be preferred by Mercosur), or a more liberal test of substantial business operations. The potential impact of the first alternative is unclear in the context of the EU market, especially

its influence on third country investors with a presence in the EU, since such firms would be denied equal access to the Mercosur market on nationality grounds.

Finally, one issue that could be considered in the services chapter and/or the investment chapter is the level of ownership required for the investment or commercial presence to be deemed a covered measure. The GATS does not cover minority shareholdings. Mercosur-EU negotiators should explore the scope for further progress in this area.

Final Comment

Whatever the final details of the structure and content of both chapters' main disciplines, the prevailing uncertainty about the fate of the Doha Round and other regional negotiations (notably the FTAA) supports the impression that both sides will approach negotiations in these complex and sensitive areas with considerable caution. This should not, however, preclude useful progress in both areas. Such progress could provide a solid basis for deepening economic relations. It could also provide useful rule-making precedents and liberalization outcomes for subsequent consideration in the WTO.

Scenarios for Untying the Knots in Market Access for Goods

The International Context of the Negotiations

Progress on fast-tracking a Mercosur-European Union agreement will depend crucially on whether agriculture is satisfactorily addressed in the biregional talks, although scenarios for untying the knots in the area of market access will also be influenced by developments in the WTO Doha Round and the negotiations for the Free Trade Area of the Americas (FTAA). The outlook for the negotiations in these latter two fora is unpromising, at least in the short term. In both arenas the main actors seem to be promoting a “race to the bottom”.

In view of the close links between the three negotiations, we posit three scenarios for the conclusion of the Mercosur-EU negotiations by October 2004. These combine different outlooks for the WTO and FTAA negotiations with different degrees of political will on the part of both blocs towards the biregional talks. The two extremes (the best- and worst-case scenarios) are disregarded. The “feasible scenario” combines realistic assumptions on developments in the other two negotiating processes with a good measure of political will and a pragmatic approach. The other two scenarios are deviations of this basic one. The optimistic scenario supposes that the Mercosur-EU initiative will be fostered by progress in the other two sets of talks. The pessimistic scenario considers how deadlock in the FTAA and the WTO could lead to a “minimalist” approach to the biregional negotiations.

The Main Knots in Market Access for Goods

While progress on agriculture is crucial, the main knots in market access for non-agricultural goods fall into two categories: tariff-related and non-tariff related. In the case of the former, agreement must be reached on issues such as tariff liberalization timetables and tariff offers, which are very conservative and could be more inclusive. The two blocs also differ on issues such as the scope of liberalization, special and differential treatment, reciprocity, infant

industry protection and sectoral commitments. The non-tariff related knots cover issues such as rules of origin, antidumping, drawback and safeguards.

Scenarios for Untying the Knots

Optimistic Scenario

In this scenario, the biregional negotiations move forward and meet the October 2004 deadline. Some of the main differences between the two blocs' positions on the characteristics of the liberalization offers are overcome following the exchange of improved offers in April 2004.

The EU submits a proposal for the liberalization of a large number of products currently included in category E (undefined liberalization), and Mercosur responds with a reform of its tariff liberalization schedule. Mercosur also reframes its offer to hasten the phased elimination of tariffs, reduce backloading, and increase the number of products included for tariff elimination. The EU accepts the principle of special and differential treatment for Mercosur members, with less than full reciprocity in the liberalization process. This encourages improved offers and helps the two sides find common ground on other market-access related issues, such as rules of origin, safeguards and antidumping.

The two blocs agree to negotiate an improvement of concessions within two years, so as to further accelerate the tariff phase-out schedule and include products initially subject to less than full liberalization. At the same time, the two sides assess the rules of origin regime and negotiate any changes deemed necessary.

Feasible Scenario

In this scenario, the parties agree to adopt a "two-step approach" in the biregional negotiations. To bypass the links between the Mercosur-EU and Doha negotiations on agriculture, the blocs decide to sign an "interim agreement", which includes an agenda for the second step. This agreement would commit negotiators to return to the table immediately after the conclusion of the multilateral talks.

In the first step, both blocs offer a comprehensive and substantial tariff liberalization program. Given the EU's stance towards the "single pocket", however, and Mercosur's position on the full liberalization of biregional goods trade, they decide that Mercosur will

receive preferential margins on MFN tariff rates for some products and small tariff-quotas for the most sensitive EU products. In return, Mercosur would be allowed to leave a small group of industrial products in the TBA category. Negotiations would include those products that had been subject to less than full liberalization in the first stage.

The agenda for the second step of market access for goods is likely to include an increase in the tariff-quotas granted by the EU, treatment of the out-of-quotas duties, the inclusion of products that were exceptions in phase one, and an improvement in the liberalization schedules. Negotiators could also consider eliminating quotas in the long run.

Pessimistic Scenario

In this scenario, uncertainties about the Doha Round's future increase and there are no obvious or credible clues as to how the main obstacles will be overcome. The FTAA Trade Negotiations Committee is unable to prepare a guide for the negotiating groups, and the talks stall.

Without the pressure of the FTAA, European interest in the biregional talks wanes and preferential treatment for the most sensitive products is not contemplated. The EU proposes tariff-rate quotas for most of the products presently listed in category E. Mercosur's assessment of the EU offer remains negative and it fails to respond with significant changes to its own offer.

The two blocs agree to limited market access liberalization in order to avoid a complete failure in the negotiations. Mercosur accepts the TRQ regime proposed by the EU and uses the same mechanism to deal with its sensitivities in the industrial sector. The introduction of quotas for the liberalization of biregional trade is a step backwards in terms of Mercosur's current protection instruments. The two blocs nonetheless agree to resume trade talks within two years. They also agree to resume negotiation of improved market access for goods if the Doha Round fails.

The Consolidation of Mercosur

The lack of progress, and even some recent setbacks, in the consolidation of Mercosur's free trade area and in the full implementation of the customs union are evident; the impact on Mercosur-EU negotiations is significant, especially for trade in goods. Several

difficulties stem from the incomplete nature of the Mercosur customs union, including non-harmonized intraregional customs clearance procedures, double incidence of and exceptions to the common external tariff, and differing rules of origin regimes. EU negotiators and entrepreneurs are increasingly aware that the smooth implementation of the biregional agreement demands that these significant obstacles be overcome sooner rather than later.

It is important to recognize, however, that if the current deadlines are to be met, Mercosur countries will not have a chance to address and resolve the intra-bloc agenda before the biregional agreement is phased in.

As the negotiations enter their final stage, therefore, it is important to take more pragmatic approaches to the consolidation of Mercosur. One alternative could be that the two blocs agree on a list of priority measures to facilitate trade and complete the customs union, and specify targets that can be met within a reasonable period. They could also consider adopting a notification mechanism for specific obstacles faced by EU companies in their operations and activities within Mercosur.

Scenarios
for a Feasible Agreement

Chapter 1

Scenarios for Untying the Agriculture Knot

Introduction

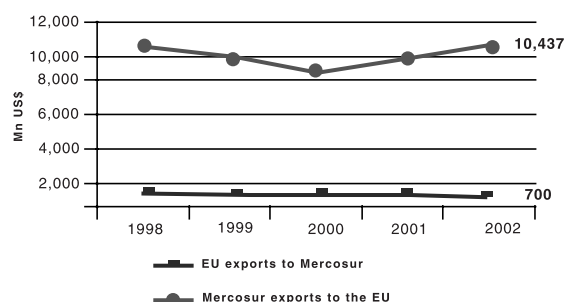
Negotiations between Mercosur and the European Union (EU) began in April 2000 in the EU-Mercosur Bi-regional Negotiations Committee (BNC). Created in late 1999, the Committee is entrusted with conducting bi-regional talks aimed at the conclusion of an Interregional Association Agreement by the end of 2004.

Market access for agricultural goods is one of the main issues in the current free trade agreement (FTA) negotiations between the EU and Mercosur. Both groups have already defined modalities and methods for completing the negotiations. These are aimed at substantial trade liberalization and a consequent increase in trade flows between the two regions.

The EU is a net importer of agricultural products from Mercosur. The latter has clear comparative advantages in exporting high-quality and low-priced agricultural goods to the Community market. Table 1 shows that agricultural exports to the EU account for 35% of Mercosur's total agricultural exports to the world. Agricultural products represent around 48% of the group's total exports to the EU. Meanwhile, EU agricultural exports to Mercosur are not significant. In 2002, the EU exported around €700 million worth of agricultural goods to Mercosur. This represents only 3% of total EU

exports to the group. The Community's main farm exports are wines, spirits, malt and olive oil.

Figure 1. *Evolution of EU-Mercosur Agricultural Trade*



Source: DataIntal, IDB.

Mercosur's strong interest in exporting agricultural goods to Europe has put pressure on the EU to negotiate an ambitious market access package for these goods. This has caused difficulties in bi-regional negotiations.

Table 1. *Mercosur Agricultural Exports – 2002*

Million US\$	Total exports	Agricultural exports to the EU	%
Argentina	11,245	3,422	30.4
Brazil	16,910	6,773	40.1
Paraguay	770	35	4.5
Uruguay	853	208	24.4
Mercosur	29,778	10,437	35.0

Sources: DataIntal/Brazilian Ministry of Industry, Development and Foreign Trade.

In fact, Mercosur's most competitive agricultural export products face substantial barriers of entry into the EU market. These restrictions are usually a consequence of EU domestic policies, such as domestic support to producers. However, high tariffs, restrictive tariff rate quotas (TRQs), minimum entry prices, special safeguards and sanitary measures are also applied to Mercosur's competitive agricultural exports. At the same time, the EU grants a large number of preferences to several third countries that are sometimes less competitive.

Despite Mercosur's interest in discussing export subsidies and domestic support in the bi-regional negotiations, the EU wants to address these issues in the multilateral negotiations of the World Trade Organization (WTO), and stresses that provisions concerning national treatment should not prevent the practice of subsidizing domestic producers. Mercosur's position is that export subsidies should not be applied on bi-regional trade and should be eliminated as soon as the FTA enters into force. Mercosur moreover wants to discuss mechanisms such as safeguards to compensate for trade distortions resulting from EU domestic subsidies.

The failure of the September 2003 WTO ministerial conference in Cancun postponed any effort to tackle such issues in bilateral negotiations between the two blocs. In addition, the fact that negotiations for a Free Trade Area of the Americas (FTAA) are proceeding somewhat timidly weakens the incentive to negotiate an ambitious preferential trade agreement between the EU and Mercosur.

The outcome of the current EU-Mercosur agriculture negotiations could moreover be influenced by the accession, in May 2004, of ten new countries (including eight Central and East European countries, CEECs) to the EU. Two more countries may join the Community a few years later. Accession to the single EU market is likely to have significant implications for most new members' trade regimes and commercial flows. Recent trade developments between the EU-15 and the new member states show a growing EU share in these countries' trade flows that is already restricting or reducing third country market shares in Europe. Upon accession to the EU in 2004 or later, the applicant countries will apply the EU's common external trade policy, starting with the conversion of their current import tariff rates to those of the EU. Under WTO rules, a country has a right to claim compensation for the loss or reduction of market access if it loses preferential access or faces higher tariff rates as a result of its trading partner joining a customs union. This point will certainly influence the EU-Mercosur agriculture negotiations. Mercosur members will certainly apply for compensation for loss of or less favorable access to Europe's markets.

The objective of this chapter 1 is to develop feasible scenarios for the EU-Mercosur negotiations in agriculture, taking into account the complexity of each party's interests and the genuine constraints they face. To complete this exercise, we have examined the two most radical positions in the agricultural negotiations, which are those of France and Brazil. Since there is almost no point of consensus

between the two positions, “feasible” scenarios must necessarily lie somewhere in between them and should be built on a product-by-product approach. The chapter is essentially analytical and intends to show how import regimes work for the most sensitive sectors that are at stake in the current negotiations, in order to identify possible changes that could be part of a bi-regional FTA. It will examine the evolution of protection for these products through an historical review of Common Agricultural Policy (CAP) reforms, the current status of protective regimes and certain aspects that may influence the decision-making process, such as EU enlargement. The first section of this paper will review the evolution of EU trade policy, focusing on CAP reforms and on the preferential trade agreements concluded by the EU. The second section is dedicated to a product-by-product analysis of the most important sensitive products that are hampering the negotiations. The study focuses on customs duties (tariffs and TRQs) that are applied to imports originating from both regions. Tariff reduction and/or elimination, TRQ expansion (although a second-best option) and TRQ administration are discussed for these products. Finally, three feasible scenarios are proposed for untying the agricultural knot of the EU-Mercosur negotiations.

Evolution of EU Trade Policy

The experience of the last ten years indicates that the EU is still trying to combine trade preferences and WTO market access commitments with the protection of domestic production, manipulating its concessions in order to avoid radical changes in consolidated trade flows. As a huge market, the EU has enormous bargaining power in a bilateral negotiation such as that with Mercosur. As a result, EU preferential agreements have generally not challenged the existence of strong protection for EU agriculture. No one can imagine that a bilateral negotiation involving Latin American countries and the EU will create conditions whereby the EU has to eliminate or radically reduce its border protection in all products. Such a result could only be obtained as a consequence of a successful WTO round of multilateral negotiations. Thus, in negotiations with Mercosur, the EU is pursuing freer trade in non-agricultural goods and services, while trying to avoid liberalization of its highly protected agricultural market.

The choice of a pragmatic and limited liberalization framework is based on two main considerations: the very limited market access

provided by CAP reforms that have already been implemented, and the nature of the different regional and preferential trade agreements signed by the EU over the last ten years.

The CAP Reforms

While moving in the right direction, the CAP reforms already implemented or agreed are too limited and too gradual to provide a framework for a radical liberalization of EU-Mercosur agricultural trade. EU border protection is still very high for some commodities, including sugar, dairy products, meats or fruits. Such protection has not been dismantled and will be extended to new EU members. The experience shows that changes in border protection only come about as a result of a very strong exogenous pressure, rather than endogenous factors. The Uruguay Round Agreement on Agriculture (URAA) was a first step towards a reduction in trade barriers and elimination of discriminatory treatment of trade in agricultural products. Tariffs, however, remain high in the EU, like in many countries. The average tariff level is only one aspect of the problem. Many tariff peaks remain and tariff dispersion is still very pronounced.

Table 2. *Average Ad-valorem Equivalent Tariffs for Agricultural Products in the EU and Mercosur*

Tariff Profile	Mercosur	EU
Mean	9.9%	29.3%
Median	10.0%	14.4%
Standard deviation	5.0%	40.3%
Maximum	20.0%	277.2%
Minimum	0.0%	0.0%
Coefficient of variation ..	0.51%	1.37%

Ad-valorem tariffs are calculated as a percentage of the value of goods, which is normally calculated as cost, insurance and freight (cif).

The arithmetic mean, or what is commonly known as the average, is the sum of all the scores divided by the number of scores. Dispersion is measured through standard deviation, which measures the degree to which a value varies from the distribution means. The median is the midpoint of a tariff schedule's distribution in ascending order of value: half the scores are above the median and half are below.

Sources: European Commission and Brazilian Ministry of Industry, Development and Trade.

From the Mac Sharry Reform to Agenda 2000

In response to the General Agreement on Tariffs and Trade (GATT) negotiations that lead to the URAA, the EU implemented a comprehen-

sive reform of the CAP in 1993. The so-called MacSharry reform included two major components: the reduction of price guarantees for a number of products and the introduction of direct payments to producers as compensation for the lower prices. The products involved were cereals, oilseeds and protein crops for which producers receive acreage support. A similar system based on direct payment per head of animal (head age premiums) was applied to the production of feeding cattle, sheep, lambs, and goats. The implementation of support for compulsory land set-aside was also part of the reform. The introduction of acreage and head age support was a compromise between the United States (US) and the EU in the Uruguay Round negotiations, where the two parties agreed on reducing price support and on compensating farmers through direct support.

In 1999, in preparation for the enlargement process and the continuation of the multilateral trade negotiations, EU Heads of State reached an agreement on a second reform, the so-called Agenda 2000 reform package. At a time of financial constraints, the cost of agricultural support was an additional incentive for reform.

Covering the period 2000-2006, the reform package was built on the principles of the policies established in the MacSharry reform. It involved reductions in guaranteed prices for a number of agricultural products and the introduction of income compensation to farmers in the form of direct support. It gave an indication of how far the EU was willing to go in reducing trade barriers. For cereals, the intervention price was reduced by 15%, and compensatory payments were increased by 17% over the period 2000-2002. To be eligible for acreage payment, farmers had to set aside productive farming land (compensated by acreage payments). As regards dairy products, the intervention prices for butter and skimmed milk powder were reduced by a similar amount, and producers were compensated via direct payments. For beef and veal, prices were to be reduced by 20% in three steps from 2000 to 2002, effectively bringing down the intervention price by 25%, and producers were compensated through direct support. This was a way of extending various support schemes.

The Agenda 2000 reform package was very far from a radical revolution. It did not include any of the substantial liberalization assumed in most studies that have modeled the international effects of a CAP reform. These more radical reforms are unlikely to happen before 2010. Instead, Agenda 2000 limited CAP reform to measures designed to address more immediate worries about the WTO, the EU

budget, and the forthcoming EU enlargement. The 1999 reform was primarily concerned with a small number of products, of which cereals and beef are likely to be more important for third countries. Other sectors of interest, notably sugar, were not causing the same level of concern in terms of meeting the EU's GATT commitments and some of them had already been dealt with in separate negotiations. The broad objective of this second reform was to reduce the level of intervention prices –that is, the prices at which the EU steps in as a buyer of last resort in order to maintain prices– and to partially offset this reduction through an increase in direct income support to farmers. One of the main goals was to enable producers to export at world market prices, thus avoiding any Uruguay Round restrictions on subsidized exports.¹

The overall level of support for agriculture has been little affected by the reform, the main effects being the conversion of price support to direct support linked to land use or to the number of animals. The compensatory payments were placed in the WTO “blue box”, which is exempted from reduction. Because such support is linked directly or indirectly to production, its maintenance can nevertheless be considered as a serious loophole as regards market access improvement and an obstacle to more unrestricted competition in world markets. With respect to market access, the only positive aspects of the Agenda 2000 reform package are that it brought border protection in the EU close to the *de minimis* level for wheat, and that it reduced border protection for beef, veal and dairy products, albeit from very high levels. A number of products were not affected by the Agenda 2000 reform; they include pork and poultry meat, fruits and vegetables, and sugar, which is subject to very high protection in the EU.²

1. Another goal was to contain the budgetary cost of the CAP. The ultimate aim was to prepare for EU enlargement. The prospect of accession by CEECs, many with large agricultural sectors, made the resolution of both WTO and budgetary problems more urgent. If an unreformed CAP were applied to the acceding countries, both the budgetary cost and the volume of surplus production eligible for storage or subsidised export would spiral.

2. With the acceptance of the *Everything But Arms* proposal in March 2001, the EU has opened its markets to free imports of all products except arms and munitions from the world's 48 Least Developed Countries (LDCs). For sugar and rice there will be a transition period to 2009, and for bananas the transition period will end on 1 January 2006. As imports of these products may already be subject to preferential trade agreements, the scheme is expected to have only a marginal impact on trade between the parties involved.

Questions of both strategy and principle were involved in the Agenda 2000 package. The EU saw advantage in deferring liberalization until the next round of WTO negotiations. Since negotiations take the form of trading different concessions, any unilateral liberalization implemented at the beginning of the new decade could have been seen as reducing the EU's stock of bargaining power with which to buy improved access to foreign markets during the next WTO Round.

The 2003 Fischler Reform

Because the Agenda 2000 reform was disappointing and limited and did not seriously address the enlargement issue, the "mid-term reviews" scheduled for 2003 became the new reform objective of the European Commission. In 2002, the European Commission stated that it remained committed to support of the EU's farm sector. However, it was also challenged in meeting this objective by four concerns:

- The requirement to incorporate 10 new member states into the EU within the constraint of a limited farm budget.
- The need to meet growing consumer expectations regarding environmental, food quality and animal welfare standards and the desire to make production more market and consumer-focused and less dependent on intervention.¹
- The goal of increasing the proportion of budgetary spending on rural development initiatives as opposed to commodity price support.
- The obligation to design EU agricultural policy in a way that will allow an optimal outcome for the EU in future WTO agriculture negotiations.

In the face of EU expansionary pressures, a fixed budget, increased consumer awareness and external political factors, the Commission argued that existing EU agricultural policies would not deliver the best outcomes for those involved in farming. Taking this into account and following the line of the Agenda 2000 reforms, a relevant strategy for the EU would have been to remove price guarantees for products for which the EU is still maintaining high border

1. At the beginning of the new century, an interesting new set of developments provided a new boost to reform efforts. European citizens have become increasingly concerned about food quality and safety issues.

protection (sugar, dairy products, beef and veal in particular); compensate farmers through increased direct payments (“blue box” measures); fix the compensatory payments under the auspices of the WTO, and subsequently reduce the support over a fixed period of time. Such a strategy would have made it easier to comply with WTO rules, lower the cost of direct support to agriculture, and improve market access for developing and developed countries. The final agreement nevertheless diverges from that strategy in a number of ways, as deep adjustments to the initial proposal were made to achieve a political compromise.

The Commission’s initial proposals involved a very extensive decoupling of aid payments from the production of individual products. When the debate with Member States began, it nevertheless became apparent that exceptions to decoupling would be required in order to secure approval of the Commission’s proposals. The Commission therefore recognized that partial decoupling or deferment of decoupling would be necessary in order to reach a political agreement on moving towards a system of single decoupled farm aid payments (a modification nominally justified by the need to avoid the abandonment of production in marginal farming areas). According to the Commission’s initial proposal, the overall aim of the proposed reforms was to “enhance the competitiveness of EU agriculture by setting intervention as a real safety net measure, allowing EU producers to respond to market signals while protecting them from extreme price fluctuations”. In reality, given that the single decoupled farm aid payment adopted is to be based on payment entitlements over the 2000-2002 period, the new system will effectively freeze, under a new, nominally less trade-distorting system, the trade distortions generated under the old system. In addition, the link between the single farm-payment scheme and various environmental, food safety and animal-welfare issues cannot disguise the fact that the scheme will serve to maintain EU agricultural production in the commodities concerned at higher levels than those that would prevail if farmers’ production decisions were determined solely by the market.

The Key Points of the 2003 Fischler Reform

A new single farm payment for EU farmers will replace the plethora of existing direct payment schemes in the arable, beef and sheep sectors, breaking the link between farm subsidies and production. This new support system is supposed to enable farmers to produce for the market rather than for the subsidy.

The deal allows member states to retain limited coupled elements in order to avoid abandonment of production. This could lead to different policies operating across Europe and, thus, to market distortions.

The implementation of the package will be delayed until 2005. Moreover, member states have the option to delay implementation even further, until 2007.

The single farm payment will be linked to respect of environmental, food safety, animal and plant health and animal welfare standards, as well as the requirement to keep all farmland in good agricultural and environmental conditions (“cross-compliance”).

Support for rural development will be increased through the introduction of modulation on an EU-wide basis. Modulation will start in 2005 and will transfer support from production subsidies to environmental and rural development objectives.

New measures to promote the environment, quality and animal welfare and to help farmers meet EU production standards will be added to the rural development program from 2005.

These considerations raise a very important point, namely that of the production effects of the agreed reforms. The Commission’s initial proposals were designed to avoid any abandonment of agricultural production in the EU, and member states’ modifications were aimed at further strengthening this policy. The reform is nevertheless likely to increase the incentive to produce in a number of sectors, leading to a rise in EU agricultural production under a reformed CAP compared to current levels of production. Increased production is likely to occur in all sectors except beef and rye, and in many sectors the surplus available for export will increase, albeit at much lower prices than those previously prevailing. Third countries could therefore face increased volumes of EU agricultural exports at lower prices. In addition, with lower priced inputs, some EU manufacturers of value-added food-products will be able to obtain their raw materials at around world market prices and thereby exploit economies of scale by serving the huge internal EU market. This could lead to lower imports of raw materials and

increased exports of lower priced EU value-added food products to world markets. Such a trend was already apparent following the 1992 CAP reform and the Uruguay Round of tariff reductions, after which EU exports of value-added food products increased at an average rate of 25% per year.

Preferential Agreements

Except for the “Everything but Arms” initiative, the various regional and preferential trade agreements signed by the EU over the last ten years include provisions that carefully accommodate the CAP. The maintenance of high CAP prices has been possible because high, trade-restricting MFN tariffs were maintained for the most sensitive products (allowing other CAP mechanisms to effectively facilitate and control desired imports). The EU’s ultimate protection mechanism for these sensitive products (meat, sugar, cereals, dairy products, fruits) has been to exclude them from preferential trade agreements, providing no import concessions, or granting such concessions within the limits of TRQs.¹ The EU provides no tariff concessions for grains, grain products, or the main meat and dairy products in the General System of Preferences (GSP). The EU has bound some of its preferential access commitments to developing countries as TRQ commitments. The most important cover sugar and beef imports from ACP² countries, meat and banana imports from Latin American suppliers³, and manioc imports from Thailand and Indonesia.

Such principles were fully respected when the candidate countries (Poland, Hungary, the Czech Republic, Slovenia, Estonia, Latvia, Lithuania, Slovakia, Bulgaria, Romania, Malta and Cyprus) signed the Europe Agreements and concluded bilateral trade arrangements with the EU. These arrangements lowered trade barriers over 10 years and have been the legal framework for EU relations

1. EU imports of sensitive products commonly occur within TRQs, which allow some amount of imports at a tariff far enough below the MFN rate to facilitate trade. On additional imports, a tariff up to the MFN rate may be applied. Although the GATT bans absolute quotas, the EU’s prohibitive MFN tariffs still effectively limit trade to the TRQ amount, achieving the same result. While EU commitments to GATT required the EU to establish 87 TRQs, WTO data indicate that the EU actually has some 257 tariff lines under TRQs.

2. Africa, Caribbean and Pacific countries (71 members).

3. Banana quotas have been the subject of successive WTO disputes and TRQs will be eliminated when a tariff-only regime for banana imports is introduced no later than 1 January, 2006.

with applicant states since the nineties. Although the Europe Agreements provide for imports of some sensitive products from East European countries, most of these concessions are TRQS or other variations of quantitative restrictions. This means that the preferential tariff rates apply to small quantities or for limited periods. Substantially lower tariff rates are available to CEECs for their exports of beef carcasses and boneless beef (duty free imports in the case of Poland, Hungary and Romania). It should be noted that all of these significant concessions are limited to small TRQS (59,280 tons for all CEECs, *i.e.* 0.77% of 2003 EU beef consumption).

***Market access rules in recently concluded
preferential trade arrangements***

The 2003 EU-Morocco agreement on agricultural trade liberalization is part of the so-called Barcelona process for integration between the EU and the countries of the Mediterranean basin, which includes a call for gradual liberalization of farm trade. Under this agreement, Morocco has gained an increased TRQ for tomato exports to the EU. In the EU-Lebanon association agreement signed one year earlier, the EU offered full liberalization (no duty, no quota) for all agricultural imports from Lebanon, with a list of exceptions covering sensitive areas of EU domestic production (potatoes, tomatoes, garlic, olives, citrus, table grapes, pears, apples and wine). For these products, the EU has established individual zero duty tariff quotas, with an annual increase.

The EU-South Africa FTA was signed in 1999. Its trade chapter provides for a gradual establishment of an FTA: the EU has 10 years to abolish all restrictions on 95% of imports from South Africa and South Africa has 12 years to liberalize 86% of imports from the EU. The 5% exclusion on the EU side is all agriculture, including traded sensitive products (fruits and vegetables) and non-traded but potentially sensitive products (sugar, beef, etc.).

The EU-Chile Agreement of 2002 establishes the gradual elimination of customs duties on a list of agricultural and processed agricultural imports from Chile up to January 2013. For some sensitive products included in the list for which the Common Customs Tariff provides for the application of an *ad valorem* duty and a specific duty, the tariff elimination will only apply to the *ad valorem* duty. The most sensitive agricultural products do not benefit from tariff reductions. The Community allows duty-free TRQS for these products with an annual increase of 10% of the original quantity. Furthermore, tariff concessions do not apply to EU imports of Chilean products that are covered by denominations protected in the EU. Summing up, for most of the CAP protected products, liberalization has been provided only within tariff quotas.

Trade Impact of EU Enlargement

EU enlargement is expected to change European agriculture and trade patterns. A number of studies have been conducted on the impact of enlargement on agricultural markets in the EU. The most recent of these (European Commission, 2003) estimates that cereal and beef exports from the EU (including the 10 CEECs) would increase, with a growing share of these exports coming from the new members. Oilseed imports to the enlarged EU would rise slightly as all import tariffs go to zero. Butter and cheese exports are expected to increase, with both old and new members contributing. Poultry production and exports shift from the EU-15 to the CEEC-10 and the opposite is projected to happen for pig meat, with some export contraction in both sectors as a result of enlargement. Most of these likely changes are not too surprising, given the changes in border protection and in market support measures. In addition, most of the candidate members have population densities below the EU average and a likely comparative advantage in more extensive production activities. The poultry result is less intuitive, given that poultry is currently relatively more protected and not as technically advanced in most candidate countries.

As regards tariffs, various studies indicate that for most commodities, rates will increase when new member states adopt EU border protection measures. Mercosur's current share of CEEC imports gives some indication of the potential impact of these adjustments on Mercosur's farm exports. For the ten CEECs expected to join the EU single market in 2004 or later, agricultural imports from Mercosur are still relatively limited. Imports from Brazil and Argentina, however, have grown in recent years. Some CEECs already provide significant markets for Brazilian exports of sugar, beef and pig meat. One should, moreover, not underestimate the potential growth of CEEC imports in the future.

To assess the impact of EU enlargement on third country exports, some studies have looked at current applied tariff rates in the applicant countries to see how far they will have to adjust upon joining the EU. These comparisons focus on the relatively more sensitive and often traded commodities. The tariff rate evaluation is based on the main traded items (such as frozen carcasses in the case of meat). Admittedly, these studies overlook some export commodities that are important for Mercosur (such as fresh and processed fruits). They nonetheless permit an evaluation of the main issues of

***Negotiations with trading partners for compensation
under GATT Article XXIV 5 and 6.***

The original GATT Article XXIV 5 and 6, complemented by the *Under-standing on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994* requires that when a customs union is formed or enlarged, the resultant level of external trade protection must not be greater than the previous level in the constituent members, taken together. If protection is increased, compensation in the form of tariff reductions or other improved market access mechanisms must be negotiated with other WTO trading partners who are adversely affected by the increase.

In the past, negotiations with other GATT trading partners for compensation under Article XXIV 6 took place after each enlargement. Such negotiations lasted for several years after Spain and Portugal's accession to the EU in 1986. In recent years efforts have been made to avoid long and complex negotiations. The candidate countries' tariffs have been aligned as far as possible with the eu tariff before accession. Their trade policies and procedures have been coordinated with those of the Community in advance. In this context, the first-wave accessions will not create difficult problems of trade compensation under wto rules, except for the very sensitive farm sector.

enlargement for the South American bloc. They show that most applicant countries (except Poland) will have substantial increases in tariff rates upon joining the EU, for example in the cereals sector. For oilseeds and oil meals, two applicant countries that have non-zero tariffs will see rates fall to zero (Poland and the Czech Republic). For white sugar, tariffs in Slovenia and Romania are low relative to the rest of the CEECs and the EU. For beef products, tariff rates in the EU are generally higher than CEEC tariffs. In this sector, too, most countries will have substantial increases in tariff rates once they become EU members. In most CEECs there is no difference between tariff rates on carcasses and semi-processed products like boneless beef. For pork carcasses, most countries are relatively close to EU rates, but Poland and Hungary will have substantial reductions. All candidate countries except Slovenia will witness substantial reductions in poultry tariff rates.

In cases where import tariffs will rise with respect to third countries, imports from world markets will probably be replaced by imports from the enlarged single European market. This trade diversion already began with the implementation of preferential

trade arrangements (the Europe Agreements) between the EU and each candidate country, including the double-zero lists. But those were relatively limited in scope. One way to view the potential magnitude of this trade diversion is to consider the potential for growth of consumption in applicant countries

Sensitive Agricultural Products in the EU-Mercosur Negotiations

In the EU-Mercosur negotiations, each bloc has presented different proposals for tariff elimination. Mercosur has opted for a “less than full reciprocity” approach. According to this proposal, Mercosur imports from the EU would be subject to the following categories of tariff reduction: A: 0 years, B: 8 years and C, D, E: 10 years, knowing that said categories would be subject to different levels of reduction. Mercosur nevertheless proposed a different schedule for EU imports from Mercosur, which would have four categories for tariff reduction: A-0 years, B-4 years, C-7years and D-10 years. The current offer from Mercosur still presents a number of products as not classified in the mentioned categories.

The EU has meanwhile selected a list of 2139 agricultural product tariff lines. Products have been divided into five categories (A to E) that should determine tariff reduction periods for trade in both directions: A- 0 years, B- 4 years, C- 7 years, D- 10 years and E- not defined. For the EU, category “E” is a special schedule for a large range of agricultural and processed products, for which tariff elimination applies only to ad-valorem duties.

Of all agricultural products to be negotiated, the EU placed 939 lines (43.9% of total tariff lines) in category “E”. When analyzing the EU proposal, it is important to note that Mercosur’s main export products, including meat (bovine, poultry and pork) and sugar, were included in list “E”, with most of them subject to TRQs.

Concerning products included by the EU in category “E”, Mercosur proposes to re-classify a “substantial number” of these tariff lines into other categories of tariff reduction. The remaining products should benefit from a significant tariff reduction or receive special TRQs on a case-by-case basis in order to ensure substantial and effective market access for Mercosur exports.

Another important component of the EU's negotiating position is the proposed "two-step approach", whereby the EU would offer preferential access to Mercosur's sensitive farm products through the concession of additional TRQs in two phases. Thus, as a "first step" the EU would grant Mercosur the right to export an additional but limited quantity of product "X" under the EU-Mercosur agreement. Then, in a second step, Mercosur would receive an exclusive percentage of the EU's global offer to third countries for product "X" in the Doha multilateral negotiations.

TRQ administration is also an issue to be negotiated. Since some quotas are controlled by importers, it will be important to identify the pros and cons of quota administration methods for each product analyzed in order to see how this can affect trade flows between the EU and Mercosur.

Some products under negotiation between the EU and Mercosur should be analyzed separately. These products have been classified as "sensitive" because of their importance in EU-Mercosur trade and the level of restrictions they face.

With the objective of providing feasible solutions to untie the "agricultural knot" in the EU-Mercosur negotiations, this study has identified the 11 products that can be classified as "sensitive" for Mercosur. These products are: meat (bovine, pork and poultry), sugar, ethanol, tobacco, powder milk, corn, wheat, orange juice and fruits.

Table 3. *EU Production, Consumption and EU-Mercosur Trade Flows in 2002*

1000 T	Mercosur exports to the world	EU imports from the world	EU imports from Mercosur	EU production	EU consumption
Bovine meat.....	1,613.0	519.0	397.0	7,408.0	7,552.5
Pork meat.....	590.0	65.0	0.0	17,825.0	16,666.0
Poultry meat.....	1,595.0	395.5	230.7	6,850.0	6,410.0
Sugar ...	13,609.1	2,025.0	57.4	16,153.0	14,088.0
Fuel ethanol.	218.3	86.7	86.7	p174.6	50

Tobacco	559.0	491.7	128.7	n.a.	n.a.
Powder milk	141.0	87.0	0.0	1,070.0	838.0
Corn.....	12,544.9	2,715.4	1,799.1	39,450.0	40,800.0
Wheat ..	9,130.6	12,921.0	51.3	103,894.0	97,100.0
Orange juice	1,055.0	895.5	686.6	n.a.	n.a.

Ethanol volumes are expressed in million liters. EU imports from the world represent Brazilian exports to the EU according to 2003 statistics.

Corn trade flow data refers to corn in grains, but not for seeding.

Wheat trade flows do not include *durum* wheat.

Brazilian exports of orange juice represent 99% of total Mercosur exports of this product.

Sources: COMEXT, DataIntal and FAS/USDA

Mercosur exports around 29 billion dollars worth of agricultural products, of which 35% go to the EU. However, Table 3 shows that some of the selected products exported by Mercosur have very limited access to the EU market. EU sugar imports from Mercosur top the rank: while Mercosur is the leading sugar exporter in the world, its exports to the EU represent only 0.4% of total EU sugar consumption.

Although Mercosur countries –mainly Brazil and Argentina– are net exporters of bovine and poultry meat, EU imports from these countries represent only 5% and 4% of EU consumption, respectively. These numbers can be explained, in part, by the high import duties that the EU applies to these products, as shown in Table 4. Compared to Mercosur’s export potential vis-à-vis the European market, TRQs available to Mercosur products have a very limited capacity. Thus, a significant proportion of Mercosur exports are entering the EU out-of-quota, and therefore face very high tariffs. Over-quota tariffs can reach prohibitive levels in the case of sugar and restrictive levels in the case of meat and cereals.

Another important information displayed in Table 4 is the list of the EU’s proposed offers. Mercosur’s main export products are placed in category “E” – an indication of their sensitivity in the bi-regional negotiations.

Table 4. *EU Tariffs, TRQs and SSGs for Sensitive Agricultural Products*

	MFN tariffs		In-quota tariffs		TRQs	SSGs	EU Offer
	From	To	From	To	Existence of TRQS	Application of Special Safeguards	Elimination Schedule
Bovine meat	98.2%	176.7%	20.0%	135.2%	x	x	E
Pork meat	0.0%	40.4%	0.0%	20.2%	x	x	E
Poultry meat	93.1%	94.5%	0.0%	73.4%	x	x	E
Sugar ...	138.3%	198.8%	0.0%	46.5%	x	x	E
Ethanol	18.2%	46.7%	-	-	-		E
Tobacco	26.5%	108.6%	-	-	-		D
Powder milk	62.9%	91.8%	-	-	-	x	E
Corn.....	84.9%	84.9%	45.2%	45.2%	x	x	E
Wheat ..	71.2%	71.2%	0.0%	0.0%	x		E
Orange juice	12.2%	15.2%	-	-			D
Fruits ...	2.4%	210.9%	0.0%	23.3%	X		All categories*

MFN tariffs are duties applied to products that are exported over-quota.

In-quota tariffs are duties applied to products that are imported under the quota regime.

Table contains only the main tariff lines exported from Mercosur to the EU.

EU offer: A-0 years, B-4 years, C-7 years, D-10 years and E-not defined.

* Classification depends on the fruit.

Sources: CAP Monitor, European Commission and Institute for International Trade Negotiations - ICONE.

Because negotiations are usually deadlocked in sectors where Mercosur is very competitive and where the EU has a highly protective import regime, a feasible agreement should be based on a product-by-product analysis. Some of the selected products are mostly protected through high tariffs and limited TRQs, so a product-by-product analysis should focus on strategic products that are likely to shape the results of the bi-regional negotiations. For each of these sensitive products we present the most radical negotiating positions in each bloc. The positions have been elaborated based on official statements and interviews conducted with government officers as well as with agriculture and agri-business private sector associations in Brazil and France.

Bovine Meat

EU domestic consumption of bovine meat has grown by 10% in the year 2001/2002, recovering from the BSE¹ crisis that caused a significant reduction in EU bovine meat production and consumption. In 2002, 5,481 thousand tons were consumed in the EU, representing a 3% increase compared to the 2000 pre-BSE crisis level.

Imports from third countries remained stable after the establishment of the URAA. Currently they represent around 6.9% of EU domestic consumption, of which 5% originates in Mercosur countries, mainly Brazil and Argentina.

Mercosur is a net exporter of bovine meat. Access to the EU market is governed by a complex system of import quotas as a result of different agreements, including GATT, Lomé and Cotonou and association agreements with East European countries.

The EU grants some quotas with special ad valorem tariff rates of 20% for bovine meat imports from Mercosur. In-quota tariff rates for frozen bovine meat, however, have additional specific duties due to applied administration methods, as shown in Table 5.

Quotas available for Mercosur bovine meat exports are quite limited compared to the group's export potential in this product. In addition, the existing quotas are not available to Mercosur as whole, but are distributed individually among each country. It is possible to identify at least three import quota regimes established under the WTO Agreement that are available to Mercosur countries:²

a) 53,000 tons (GATT Quota) of frozen bovine meat imported under a 20% ad valorem duty. This quota is mostly covered by Brazil (44,000 tons), Argentina (6,000 tons) and Uruguay (3,000 tons) and is distributed among importers based on the historical allocation method.

b) 38,500 tons (Individual Tariff Quota - ITQ) are offered to frozen beef imports intended for processing in the EU and are totally covered by Mercosur exports. This quota is divided into two different regimes (A and B), depending on the final product that will result from this import (A-products or B-products). Thus a different tariff is applied for each regime: imports under regime A must pay

1. Bovine Spongiform Encephalopathy.

2. All volume measures shown in Carcasse Weight Equivalent (CWE).

Table 5. *Tariffs and TRQS for Bovine Meat Exports from Mercosur, 2002/2003*

1000 tons	Country	Total quota volume available	In-quota exports	Over-quota exports	Other ³	In-quota tariffs	Over-quota tariffs
Frozen	Brazil	53 (GATT) + 38.5 (Reg. A and B) ¹	73.1	5.4	2.2	20% + 2,000 €/ton for licensing (GATT) 20% + 2,138.4 €/ton (ITQ-RegimeB) 20% (ITQ – Regime A)	12.8% + 3,041€/ton or 176.7% (AVE)
	Argentina		11.7	3.6	1.1		
	Uruguay		7.2	3.7	1.1		
	Paraguay		0.0	0.5	0.0		
	Mercosur		92.0	13.2	4.4		
Fresh or chilled	Brazil	65.6 (Hilton beef) ²	5.0	41.2		20%	12.8% + 3,034€/ton or 98.2% (AVE)
	Argentina		38.0	5.7			
	Uruguay		6.3	1.5			
	Paraguay		0.0	0.0			
	Mercosur		49.3	48.4			

1. Frozen beef quotas are distributed through historical allocation and are, therefore, currently and totally covered by Mercosur countries.

2. Hilton quota was established at 69,100 tons for the agricultural year 2003/2004.

3. 4,400 tons of frozen bovine meat imports from Mercosur are exported under the frozen meat quota regime. A significant part of these imports are destined to supplying foreign diplomatic missions in the EU member countries. Under this scheme, Brazil exports 2,200 tons, Argentina 1,100 tons and Uruguay 1,100 tons.

Sources: COMEXT, WTO, TARIC, Brazilian Ministry of Industry, Development and Foreign Trade

a 20% ad-valorem duty while imports under regime B must pay the same 20% duty plus a specific rate of €2,138.4 per ton. Brazil exports around 28,100 tons, Argentina 6,000 tons and Uruguay 4,400 tons under this quota.

c) 69,100 tons (Hilton Quota)¹ are offered for high quality meat imports (Hilton beef). This is the only beef quota that is distributed among exporters who are responsible for its fulfillment. License certificates are granted to importers on a “license on demand” basis. This quota is divided among 10 meat-exporting countries. 5,000 tons are offered to Brazil, 38,000 to Argentina, 6,300 to Uruguay and 1,000 tons to Paraguay. Under the Hilton quota, Mercosur countries jointly export 49,300 tons since Paraguay does not use its 1,000-ton quota. The other 19,800 tons are offered to the United States and Canada (11,500 tons), Australia (7,000 tons) and New

1. Since 2003, this Hilton quota was increased to 69,100 tons. Before this period, an amount of 65,600 tons was available under the Hilton quota.

Zealand (300 tons). It is important to note that the quota offered to meat from the United States and Canada is not filled due to the high level of hormones incorporated into such meat.

Table 5 shows that there is room for considerable improvements in market access for bovine meat. An over-quota tariff of 176.7% (calculated in% AVE)¹ is currently blocking Mercosur's access to the EU frozen beef market. It is also important to take into account that even in-quota exports, which face lower tariffs of 20%, face additional specific charges related to the quota license (€2,000/MT for GATT quota). The quota license payment occurs under an existing "quota market" among importers who can sell their quotas if they are not going to use them. Exporters, however, pay the charge.

Concerning high quality bovine meat, Table 5 shows that current quotas available to Mercosur countries are very small for Brazil. Paraguay, meanwhile, does not use its quota due to the country's foot and mouth disease problems. Brazil receives only a 5000 ton quota while exporting 46,200 tons of high quality meat to the EU. On the other hand, Paraguay receives a 1,000- ton quota that is not used. Argentina and Uruguay are filling their quotas and exporting 5,700 tons and 1,500 tons over-quota, respectively.

Other EU Preferences to Third Countries

Preferences granted to third countries other than Mercosur are another concern that should be taken into consideration. Bovine meat quotas with preferential tariff rates are offered to ACP countries and to Associated East European countries, but they are not filled.

ACP countries receive a total quota of 52,100 tons under which they can export bovine meat to the EU paying a tariff 92% lower than the applied MFN tariff. This quota is divided among Botswana (18,916 tons), Kenya (142 tons), Madagascar (7,579 tons), Namibia (13,000 tons), Swaziland (3,363 tons) and Zimbabwe (9,100 tons). Most exports from these countries originate in Namibia, Botswana and Zimbabwe. According to 2002 data², how-

1. *Ad Valorem* Equivalent (AVE) tariffs have been calculated as follows: first, an international reference price was adopted based on COMTRADE data, then the value of the tariff was converted into US dollars using FED exchange rates for 2002. Finally, tariff value was divided by the reference price adopted. The maximum possible protection was considered.

2. United States Department of Agriculture, USDA.

Table 6. *Main Preferences for EU Imports of Bovine Meat in 2002*

Tons	Total Beef exports to the EU	Total quotas offered	Annual increase	In-quota tariffs
ACP Countries	18,955	52,100	0	92% less than MFN tariffs
EU applicant countries	18,776	47,070	3	80% less than MFN tariffs

Sources: CAP Monitor 2003/2004 and FAS/USDA

ever, exports to the EU did not exceed 7000 tons in any of these countries, and represented less than 1000 tons in the other ACP beneficiary countries.

As to the ten EU candidate members from Eastern Europe, an Association Agreement gives them a total quota of 47,070 tons, which is distributed among Hungary (15,020 tons), Poland (19,200 tons), the Czech Republic (3,500 tons), Slovakia (3,500 tons), Romania (4,000 tons) and Bulgaria (250 tons). The quotas allow imports from East European countries under tariff rates 80% lower than MFN tariffs. As with ACP countries, these quotas are not filled. Poland is the main exporter, filling 86% of its quota. Hungary comes in second, exporting 3,770 tons, which represents only 25% of its quota. It is important to note that an annual quota increase of 1365 and 1,600 tons is provided for Hungary and Poland, respectively, from the year 2003 on.

Apart from the ACP and candidate members' schemes, a 10,500 ton quota is offered to Slovenia. A 3,775 ton quota with an annual increase of 625 tons is also granted to the Baltic States.

Enlargement

According to European Commission previsions, opportunities in the bovine meat market are projected to grow with enlargement. With the accession of 10 new members, bovine meat demand is expected to increase in the EU-25. Even though the European Commission calculates that consumption of bovine meat in new member countries will decrease by 2% until 2009, production is expected to decline more rapidly, by 20%. This scenario is based mainly on the recent intensification of privatization of collective farms, the lack of capital among pri-

vate farms and the intensification of milk production. New market shares will therefore be available to fill this production deficit. The European Commission calculates that 214,000 tons will be needed to supply new members¹.

***Suggestions for discussions on bovine meat
in EU-Mercosur negotiations***

The Brazilian position on possible improvements in access of bovine meat to the EU is the following:

a) Substantial reduction of over-quota tariffs for high quality beef (Hilton) and meat intended for processing, allowing Mercosur to improve its participation in supplying EU demand.

b) The GATT quota is distributed according to the historical performance of the importer (historical allocation). This system generates a “quota market” among importers implying more costs for exporters, who are supposed to pay for the quota license of €2,000/ton. Besides, the “past trading performance” requirement applied to this quota limits the number of companies authorized to import into the EU market. Apart from the historical allocation, which concerns the country of origin, the past trading performance concerns the companies of origin.

The French position is much more restrictive as regards market access for bovine meats:

a) Special TRQs could be created for live bovine animals.

b) An increase in import volumes of Hilton beef could eventually take place through a very small expansion of import-quotas. However, consolidation of traditional trade flows is excluded. Therefore, the in-quota import expansion would not reach the level of current in and over-quota imports of bovine meat from Mercosur.

c) Because of the reform of the EU milk sector, EU bovine meat supply is expected to grow and the possibility of absorption of extra-EU imports will be reduced.

d) Import quotas would be attributed to Mercosur as a bloc.

Other bovine products are excluded from the negotiation.

1. Vincent Chatellier, Hervé Guyomard, Katell Le Bris. *Production bovine: entre économie de marché et politique de territoire*, Déméter 2004, Paris, Armand Colin, 2003 (p. 67-179).

Chicken Meat

Poultry is another strategic product for EU-Mercosur trade negotiations. From the URAA on, EU poultry imports grew considerably. Mercosur, Thailand and the ten EU candidate members are the main suppliers of the EU domestic market. Imports from Mercosur represent 58% of total extra-EU imports. Brazil is the main supplier, accounting for 99% of Mercosur's total exports to the EU.

Table 7. *Mercosur Chicken Meat Exports to the EU – 2002*

Tons	Exports to the EU	Available quota volume	In-quota exports	Over-quota exports	Over-quota exports as% of total
Brazil	278,355	7,100	7,100	254,300	91%
Argentina	3,054	0	0	3,054	100%
Paraguay	0	0	0	0	
Uruguay	0	0	0	0	
Mercosur	281,409	7,100	7,100	257,354	91.4%

Sources: Brazilian Association of Poultry Exporters (ABEF), COMEXT and The Brazilian Ministry of Industry Development and Foreign Trade.

Table 7 presents the volume of Mercosur poultry exports to the EU. The 2002 numbers show that 91% of all poultry exports are entering the EU market through out-of-quota regime. High tariff rates are thus applied on 257,354 tons of chicken meat exported by Mercosur.

Table 7 explains the current regimes for EU poultry imports. After the Uruguay Round, four TRQs were created for poultry imports:

- a) 15,500 tons of frozen chicken cuts to compensate the Soybeans Panel. This quota is mostly covered by Brazil (7,100 tons) and Thailand (5,100 tons).
- b) 6,200 tons of frozen or fresh whole chicken.
- c) 4,000 tons of frozen or fresh chicken cuts.
- d) 700 tons of boneless chicken cuts.

Only 7,100 tons of the in-quota preferential scheme are covered by Mercosur (compensation to Brazil regarding the Soybeans Panel). The other imports are subject to out-of-quota rates, as shown in Table 7. Since Mercosur exports of whole chicken represent only 6% of total chicken exports, most EU imports from Mercosur pay a 94.5% (AVE)

tariff rate. In 1998/1999, Brazil started to export salted chicken cuts, which were subject to lower tariffs of 15.4%. However, after the publication of European Commission regulation 1223/2002, salted chicken imports were incorporated into the 0207.14.10 tariff line, which is subject to an out-of-quota tariff of 94.5% (AVE).

TRQs for chicken meat are distributed under the “license on demand” method. An additional “past trading performance” requirement may nevertheless act as a barrier to imports from Mercosur. Likewise, for bovine meat, “past trading performance” requirements limit the scope of companies that are allowed to import into the EU.

Table 8. *Current Tariffs Applied to EU Imports of Chicken Meat*

	Specific tariffs		<i>Ad-valorem</i> equivalent (%)	
	In-quota	Over-quota	In-quota	Over-quota
Whole chicken	131 €/ton to 162 €/ton	325 €/ton	8.6 to 16.5	33.1
Chicken cuts fresh or frozen	93 €/ton to 512 €/ton	187 €/ton to 1,024 €/ton	5.1 to 27.9	94.5
Chicken cuts (Soybean Panel)	0	1,024 €/ton	0	94.5
Chicken cuts frozen and boneless	795 €/ton	1,024 €/ton	73.4	94.5

Until the publication of eu Commission regulation 1223/2002, Brazilian exports of salted chicken were subject to a 15.4% tariff rate. Subsequent to the publication of the regulation, this product has been subject to the 0207.14.10 tariff line code, which is €1024 /T.

Source: EU Commission

Special Safeguard Measures (SSG)

The EU applies safeguard measures to some chicken meat exporters, including Brazil. These measures represent an additional duty of around 0.06 euros per kilo on Mercosur exports.

Larger Preferences for Bilateral Agreements

It is important to note that the majority of preferences granted by the EU to imports of chicken meat are established in bilateral agreements. Besides the 26,400 tons that the EU offers to chicken meat exporters, around 200,000¹ tons are offered to East European

1. Source: OFIVAL. The figure includes chicken meat preparations and whole chickens.

countries (Association Agreements), ACP countries, Baltic States and Slovenia. 94% of these quotas are offered to the East European countries that will join the EU-15. Nevertheless, these countries do not fill the available TRQs. In 2002, their fill rate remained at 58.7%.

In-quota imports from these countries enter the EU duty-free, except for Slovenian chicken meat, which is supposed to pay tariffs ranging from 0 to 20%.

***Suggestions for discussions on poultry meat
in EU-Mercosur negotiations***

The Brazilian position defends the following points:

- a) A significant reduction of high over-quota tariff rates should be one of the main objectives of a bi-regional FTA.
- b) Another option would be to establish special TRQs provided exclusively to Mercosur with new preferential import regimes.
- c) If additional TRQs are established, their administration methods should be revised.
- d) The special EU safeguard measures should be negotiated.

The French position is totally opposed to any negotiation regarding market access improvements for chicken meat.

Pork

EU pork production supplies internal demand and is also exported to non-EU countries. In 2002, EU domestic production reached 17,825 thousand tons while domestic consumption was 16,666 thousand tons. As a result, 1,194 thousand tons were exported to third countries and only 65 thousand tons were imported from non-EU members to the EU-15. Total extra-EU imports thus represent an insignificant part of EU consumption of this product.

The main suppliers of pork to the EU market are East European countries. As with bovine and poultry meat, the EU established a preferential agreement with large import quotas through which imports of pig meat take place duty-free. The candidate members are, therefore, the EU's main trade partners for this sector.

Table 9 shows how large the quotas offered to East European countries are compared to the small quantities available for pork imports from the rest of the world.

Trade flows of pork between the EU and Mercosur are not impressive. Argentina imported small amounts of 70 thousand tons

of processed meat in 2002, but there were no imports by the other Mercosur members because Mercosur's small pork production supplies the domestic market in the region.

Table 9. *Main Tariffs and TRQS for Pork Imports into the EU 1*

	Quota volume (1,000 MT) ²	Specific tariffs		Ad valorem Equivalent	
		In-quota	Over-quota	In-quota	Over-quota
Carcasses	15.0	268 €/ton	536 €/ton	17.1	34.3
Cuts of swine, fresh or chilled	5.5	233 €/ton to 434 €/ton	778 €/ton to 869 €/ton	22.5 to 30.8	45.1 to 61.7
Loins and cuts	7.0	0	467 €/ton to 869 €/ton	0	27.9 to 40.4
Boneless loins and hams	34.0	250 €/ton	869 €/ton	10.8	40.4
Carcasses and cuts of swine, chilled or frozen (CEECs & Baltic States) ³	133.1	0	Same tariffs	0	Same tariffs

1. Volumes established for the agricultural year (from July to June).

2. Does not include TRQS for processed products, which total 9,100 tons.

3. Only Romania is subject to an in-quota tariff rate of 20%.

Source: CAP Monitor

SPS Requirements

Since Mercosur is considered a risk zone for pork diseases, such as Classical Swine Fever, exports of pork to the EU are currently restricted. Even though some Mercosur regions are already considered to be free of risk of Classical Swine Fever, imports from these regions would not be allowed since the EU adopts stricter sanitary standards than those established by the International Office of Epizootics (IOE). Therefore, in order to assess compliance with SPS standards, the EU could apply a region-by-region method, to be developed as part of the FTA between the EU and Mercosur.

Another problem concerning SPS standards for pork is that Mercosur does not have an integrated region of pork production, which makes it very difficult to carry out traceability requirements.

***Suggestions for discussions on pork
in EU-Mercosur negotiations***

According to the Brazilian position:

- a) The most important point would be the establishment of feasible and secure standards for both EU and Mercosur exports.
- b) Preferential schemes should be established in order to facilitate pork trade between these two regions.

The French position states that:

- a) Market access for pork could take place through the creation of a special import quota. However, considering the crisis that pork producers currently face this measure could face high resistance in France.
- b) SPS issues should be discussed in the corresponding negotiating group and not in the market access negotiations.

Sugar and Ethyl Alcohol

Sugar and ethanol fuel are two important products in the bi-regional negotiations because Brazil is Mercosur's traditional producer and exporter of both sugar cane and derived products. Brazil alone produced around 22.5 million tons of sugar in 2002 and exported almost 13.3 million tons in the same period.

In 2002, the EU produced 18.6 million tons of sugar and consumed 14.3 million tons. 5.6 million tons were exported to third countries, while extra-EU imports amounted to 2.1 million tons, of which only 57148 tons were imported from Mercosur.

EU production and export of sugar is heavily subsidized. These domestic policies cause important trade distortions in the international market, affecting prices and artificially competing with more efficient producers such as Mercosur. In addition, some preferences benefit less competitive sugar imports from ACP countries. These import preferences are benefiting mostly the large sugar producers in the EU and in ACP countries.

Current sugar exports to the EU take place through a quota regime as shown in Table 10. The majority of sugar imports originate in ACP countries and India. Mercosur has, through Brazil, the right to export 28% of the "Finland quota" for raw sugar. Table 11 shows, however, that even small in-quota volumes exported by Mercosur through the Finland quota are subject to a 98€/ton tariff rate.

Table 10. EU Sugar Imports - 2003/03 (1000T)

Quotas ¹	Volumes (1,000 tons)
ACP and India	1,304.7
Finland (for refining) ²	82.0
Special Preferential Sugar ³	229.0
“Everything But Arms” (EBA) ⁴	74,185 (2001/2002)
	197,335 (2008/2009)

1. Does not include imported volumes from the Balkans since this quota is suspended.

2. Brazil has 28% of the Finland quota volume, which is distributed only among producers from the northeast region.

3. The European Commission calculates the volume of the SPS quota annually. This quota is allocated to ACP countries and India and is currently duty free.

4. From 2006/07 onwards, tariffs on over-quota imports will be gradually reduced to 0% by 2009/2010.

Sources: CAP Monitor; European Commission.

For raw sugar, over-quota tariffs reach the “prohibitive” level of 170% (AVE), which makes exports impossible. White sugar import tariffs stand at €419T or 140% (AVE), which can also be classified as “prohibitive”. Therefore, considering that sugar is a very competitive export product for Mercosur and that the sugar industry is one of the main sectors of Brazilian agriculture, a plausible scenario for the EU-Mercosur trade negotiations should include significant modifications to the EU sugar import regime.

Table 11. Tariffs, Entry Prices and Guaranteed Prices for Sugar in the EU

	Tariffs	Guaranteed price	Entry price ¹
Raw sugar	Intra-TRQ: 0% for ACP, Special Preferential Sugar and EBA.98 €/ton for Finland sugar quota	523.7 €/ton	Not applied
	Extra-TRQ: 339 €/ton (170%)		
White sugar	419 €/ton (140%)	631.9 €/ton	531.0 €/ton
Ethanol	192 €/m ³ (64%) (denaturated) 102 €/m ³ (undenaturated)	Not applied	Not applied

1. Special safeguard measures are applied if CIF import prices fall under entry prices.

Source: European Commission

Ethanol Fuel

It is important to consider ethanol fuel as a trade-off in the current negotiations. Fuel ethanol is a popular technology mainly used in the Brazilian and US automotive sector as well as in selected European countries. Production of this fuel in Brazil increased to 14 billion liters in 2002. Producers are thus prepared to supply possible demand from the international market. The EU's current demand for this fuel is still very limited and fulfilled by its internal production, mainly in France and Spain, and small quantities imported by Sweden.

However, with the adoption of the recent Directive 2003/30/EC, bio-fuels such as ethanol fuel may be required in the EU since member states are supposed to comply with a target of adding at least 5.75% of bio-fuels to traditional fuels in the market by the year 2010.

Thus, as shown in Table 12, some projections for the expansion of the ethanol fuel market are positive. Currently, Mercosur ethanol exports would have difficult access to the EU market since a high tariff of 102€/m³ is charged, making the product less attractive than traditional fuels.

Suggestions for discussions on sugar and ethanol in EU-Mercosur negotiations

The Brazilian proposal entails the following measures:

- a) Substantive reduction of EU sugar import tariffs with the objective of making exports from Mercosur possible.
- b) Creation of special preferences for EU sugar imports from Mercosur.
- c) Reduction of import tariffs for ethanol.

The French position is categorical: sugar and ethanol are excluded from the negotiations. Many arguments are put forward to defend this position, such as:

- a) Sugar cannot be negotiated before the reform of the common EU sugar regime.
- b) Sugar has not been liberalized under the Mercosur agreement. It is therefore inconceivable to negotiate this product with third parties.
- c) There is no current demand for ethanol in the EU. It is not possible to grant trade concessions for a market that does not exist. In addition, EU ethanol production needs to be protected to have a chance to develop. Ethanol trade liberalization could be reevaluated once ethanol demand and production in the EU are significant.

Table 12. *Ethanol Fuel Production and Consumption in the EU*

Million liters	2003	2012
Production ¹	174.6	5,100
Consumption ²	254.6	6,000
Extra-EU Imports ³	80.0	900

1. Production in 2012 is projected to represent 85% of consumption.

2. Consumption in 2003 is the result of production plus imports in that year. In 2012, the EU is expected to fulfill 50% of Bio-fuel Directive objectives with ethanol fuel.

3. EU imports in 2003 represent Brazilian exports to Sweden. For 2012, consumption is calculated by the difference between production and consumption.

Sources: European Commission; Brazilian Ministry of Industry Development and Foreign Trade; ICONE.

Fruits

Access to the fruits market could be considerably improved in the EU-Mercosur negotiations. EU imports from Mercosur represent 11% of total EU imports from third countries.¹ Despite difficulties of market access for Mercosur's main exportable fruits in the EU, Table 13 shows that elimination of customs duties is seriously considered in the bi-regional talks. Bananas and oranges, however, seem to be the more sensitive products in this sector. Special attention should be paid to bananas since exporters face a prohibitive tariff of 210% (AVE).

Table 13. *Tariffs, TRQS and Offers for Main Mercosur Fruit Exports*

Products	Tariffs	Quotas	EU offer
Apples ¹	11.2% + 23.8 €/ton	600 tons	A
Pears ¹	10.4% + 23.8 €/ton	1,000 tons (5% less than MFN tariff)	B
Bananas	680 €/ton 210% (AVE)	2,200,000 tons 75 €/ton	E
Oranges ¹	6.4% + 256 €/ton	20,000 tons (10%)	D
Grapes ¹	27.6%	1,500 tons	C

1. Entry prices.

Source: European Commission.

1. Source: COMEXT. This includes bananas, oranges, lemons, grapes, apples, pears and apricots.

SPS Requirements

Both parties should take into consideration the current SPS treatment given to fruit exports from Mercosur. The EU has established very strict limits regarding the presence of pesticides and other residues on the peel of exported fruit. However, some fruits, such as bananas, oranges and papayas, should not be restricted by these rules since the eatable part of the fruit is protected by its peel. Therefore, talks between both parties should include proposals on the facilitation of fruit trade by revising some SPS rules that are not necessary.

Orange Juice

Orange juice is not a product that could threaten or deadlock the results of the EU-Mercosur negotiations. It can nevertheless be considered a sensitive product given Mercosur's export potential and the current EU tariff reduction offer for this product.

Almost all orange juice imports from Mercosur (99%) come from Brazil and represent 75% of EU orange juice imports from third countries.¹ Mercosur orange juice tariff lines (concentrated juice with Brix value >20 but <67) are charged with duties of 15.2% and 12.2%.²

In the EU-Mercosur trade negotiations, the EU offered to allocate frozen and concentrated orange juice in category "D", which means that it will take 10 years to achieve full liberalization. The Brazilian and French positions are closer on this topic. According to Brazil, current talks should establish a better category for this product given its importance in both EU and Mercosur markets. France is not opposed to a gradual liberalization of orange juice imports through the creation of import quotas.

Dairy Products

Although 15% of Mercosur's dairy exports to the world are sold in the EU market, such exports account for less than 1% of the group's total agricultural exports to the EU. Milk and milk products account for only 0.70% of the group's dairy exports to the EU.

1. Source: COMEXT.

2. Source: European Commission.

Table 14 – Mercosur Selected Dairy Exports – 2002

	Share in total dairy exports to the world	Share in total dairy exports to the EU (%)
Milk powder	49	0.15
Cheese.....	14.6	0.5
Butter.....	4	0

Source: DataIntal.

As shown in Table 14, the difference in Mercosur’s export performance in dairy products sold to the world versus the EU is particularly striking for cheese and milk powder and illustrates Mercosur’s interest in securing a more favorable access to the EU market for these products. These trade figures can be partly explained by the level of protection imposed by the EU on each product. For instance, EU tariffs on imports of milk powder and cheese oscillate between 71% and 74% and between 24% and 47% respectively. Tariffs applied to these products can reach 91%.

Apart from the imposition of high tariffs, many milk products are also subject to TRQs when imported into the EU. Mercosur receives no country-specific quota; it only benefits from the GATT quota granted to third countries. Table 15 shows that in-quota tariffs for Mercosur products are much higher than those applied to CEECs or ACP countries. Edam is the main cheese exported by Mercosur to the EU. No specific import volume has been allocated to this product; Edam imports take place through a TRQ of 19100 tons that is open to 36 cheese tariff lines. A 47.5% AVE is currently imposed on over-quota imports of Edam. In bilateral trade agreements, the EU has also granted preferential TRQs to selected partners, such as Switzerland and Norway.

The quota administration method for dairy products is license on demand. Operators must, however, be approved before they ask for import licenses; this implies the existence of past trading performance. Licenses are transferable once to avoid the accumulation of unused licenses that are not redistributed.

EU imports of dairy products are also subject to numerous and stringent SPS requirements that are often difficult to meet for third countries. Because national standards can be more demanding than international standards (provided they are scientifically justified), the EU often sets standards higher than, or not considered in, international provisions. This is the case for animal welfare and the

traceability process, for example. As regards milk and milk products, SPS measures range from the maximum level of contaminants authorized in milk products to specific packaging requirements for plant approval by EU authorities.

Table 15 – *Tariffs and TRQS for Selected Milk Products to the EU*

		Tariffs	Quotas (tons) ¹
Skimmed milk powder		In-quota	
	Third countries	47.5€/100 kg	68,000
	CEECs	0% ²	
	ACPs	65% less than MFN tariffs	
	ALL	Over-quota 118.8€/100 kg	
Butter		In-quota	
	Third countries	94.8€/100 kg	10,000
	CEECs	0%	21,615
	ACPs	86.88€/100 kg	76,667
	ALL	Over-quota 189.6€/100 kg to 231.3€/100 kg	
Cheese		In-quota ³	
	Third countries	13€/100 kg to 106.4€/100 kg	83,400
	CEECs		51,165
	ACPs	65% less than MFN tariffs	1,000
	ALL	Over-quota 139.1€/100 kg to 221.2€/100 kg	

1. Quotas may be divided into sub-categories of the product.

2. Imports from Slovenia are subject to a 20% tariff.

3. Some cheese products are not subject to TRQS. The MFN tariff rates they face vary between 6.58€/100 kg and 221.2€/100 kg

Source: European Commission.

Export subsidies are another policy instrument that affects international trade in milk and milk-products. Dairy is the EU agricultural category that receives the highest level of export refunds, reaching 1,156.9 million euros in 2002 (33.7% of total EU agricultural export refunds). Even though a reduction of EU export refunds for dairy products is planned, if Mercosur countries liberalize trade in milk products they could face a surge in some dairy imports from the EU.

***Suggestions for discussions on milk and milk products
in EU-Mercosur negotiations***

In the EU-Mercosur negotiations, Brazil and Argentina's position on possible improvements of dairy access to the EU is the following:

- a) Reduction of in and over-quota tariffs.
- b) Creation of exclusive preferential quotas for Mercosur for powder milk, butter and cheese.
- c) Revision of TRQ administration methods.
- d) Establishment of special safeguards to neutralize the intra-bloc effects of EU export subsidies.

In contrast, the French position on trade liberalization of dairy products is much more limited:

- a) Powder milk should be totally excluded from the negotiation.
- b) Trade liberalization for butter and cheese could take place within small quotas.

Cereals

Maize

Mercosur supplies 66% of total EU imports of maize.¹ Two quotas are offered for maize imports into the EU: 2,000,000 tons and 500,000 tons. The first is available for exports to Spain and will be reduced by any quantity of grain substitutes imported into Spain in the same year. The second quota is available for imports into Portugal. Quota administration is governed by "license and demand" criteria, but a requirement of "past trading performance" is also applied, which benefits the importer.²

In-quota tariffs are 45.2% (AVE) and over-quota duties are calculated at 84.9% (AVE), representing important restrictions to imports. The EU negotiating offer places maize in the category "E", while Mercosur allocates the same product in category "C".

Wheat

EU wheat production exceeds domestic consumption. However, because the EU does not produce sufficient quantities of all types of wheat demanded by its internal market, it also imports wheat from third countries. These imports reached 12.9 million tons in 2002.

1. Source: COMEXT.

2. Source: European Commission.

*Suggestions for discussions on cereals
in EU-Mercosur negotiations*

As regards trade liberalization in maize, Brazil and Argentina have a strong interest in improving market access to the EU since both are major world producers of this product. The following measures are suggested:

- a) Significant reduction of high import tariffs applied by the EU.
- b) Special preferences granted to Mercosur.

The French position on market access for maize is very cautious and tends toward the exclusion of this product. Two reasons can be put forward:

a) First, the gap between Mercosur and EU production costs is larger for maize than for any other important cereal.

b) Second, liberalization of trade in maize would have dramatic consequences for other EU sectors, mainly wheat. Contrary to the situation prevailing in many countries, wheat – rather than maize – is massively used for animal feeding purposes in the EU. If cheap Mercosur maize exports could enter the EU market duty-free, wheat would be substituted by Mercosur maize for animal feeding. As a result, both maize and wheat production in the EU – which are less competitive than Mercosur's – would be dramatically affected.

There might, however, be small possibility for the opening of limited import-quotas for some types of maize used in the transformation industry (maize starches and meals).

Argentina, more than Brazil, is really the one interested in liberalization of wheat trade. It ranks fifth in the list of top world wheat exporters and advocates the following measures:

- a) Establishment of special TRQS provided exclusively to Mercosur with new preferential import regimes.
- b) If additional TRQS are established, their administration methods should be revised.

The French position refuses any concession in the wheat sector.

Although Mercosur exports 9.1 million tons of wheat¹ to the world, its share in extra-EU imports is small (0.4%).

For extra-EU high quality wheat imports, a very small quota of 300,000 tons is offered at zero import duty. However, over-quota tariffs may reach 75.1% (AVE). “Past trading performance” is more-

1. Source: European Commission.

over required for wheat imports. As regards medium and low quality wheat, a maximum annual TRQ of 2,981,600 tons is open. A country-specific quota of 572,000 tons is earmarked for imports from the United States and 38,000 tons for those originating in Canada. The remainder is split into four equal segments of 592,000 tons each on a quarterly basis, open to other third countries on a first come first serve basis. The duty inside the quota is set at 12 €/ton, while over-quota imports are subject to a tariff of €95/ton.

EU Offensive Interests in Agriculture

Wines, Whiskeys and Other Alcoholic Beverages

Although EU exports of agricultural products to Mercosur are not significant, the EU has some offensive interests in liberalizing market access for transformed products for which external demand stands in the European tradition and “savoir faire”. Spirits have an important role in the EU trade balance since they account for 5.5 billion euros of EU exports to third countries, with a positive trade balance of 45 billion euros for the EU. Moreover, production of spirits involves more than 1.6 billion liters of wine, 2 million tons of cereals and 2.5 million tons of sugar beet and 300,000 tons of fruits.¹

With exports to Mercosur amounting to approximately 139 million euros in 2002, the wines and spirits trade balance is clearly positive for the EU and this sector represents 20% of EU agricultural exports to Mercosur. Despite being a very important sector in EU trade with third countries, wine and spirit industries are going through an economic crisis. Thus, the establishment of an FTA with significant improvement in market access for this sector is of great interest to the EU. Mercosur is currently imposing a 20% ad valorem tariff on these products² and did not classify them in any tariff reduction category in the bi-regional negotiations. Along with lower priced imports from Mercosur associated countries such as Chile, imports from the EU compete with Mercosur domestic production.

Both parties are currently negotiating an agreement on wines and spirits that will address issues such as geographical indications and oenological practices. The EU insistence on geographical indica-

1. Source: European Confederation of Spirits Producers.

2. Table wines are an exception in Mercosur's Common External Tariff. In Brazil, they are subject to a 27% import tariff.

tions reflects longstanding grievances among European agricultural producers, who complain that competitors in other countries have effectively stolen many names and applied them to their own products. Wine trade is especially affected by this practice, with European names such as Bordeaux, Burgundy, Chablis, Champagne and Porto used freely by producers in other countries to promote the sale of wines produced thousands of miles away from the regions that their appellations designate.

Geographical indications are protected at the multilateral level through the WTO TRIPS¹ agreement. Article 22 of the agreement, which covers all products, defines a standard level of protection. This states that geographical indications have to be protected in order to avoid misleading the public and to prevent unfair competition. Article 23 provides a higher or enhanced level of protection for geographical indications for wines and spirits (subject to a number of exceptions, they have to be protected even if misuse would not cause the public to be misled). Among the exceptions that the agreement allows are: when a name has become a common (or “generic”) term and when a term has already been registered as a trademark.

In the EU-Mercosur negotiations, the EU proposes a greater protection for geographical indications than the provisions provided by the TRIPS agreement. The EU proposal suggests eliminating the exceptions (generic, semi-generic, homonyms and trademarks) included in the TRIPS agreement on wines and spirits. However, this agreement has been incorporated into the legislation of the four Mercosur countries. The exceptions therefore constitute a property right granted by law. The cancellation of trademarks would create a legal problem in Mercosur because trademark holders have a private right. They could claim economic compensation if this right is cancelled and the state would have to bear the cost of such compensation. As a result, Mercosur countries are opposed to any provisions that go beyond WTO TRIPS obligations.

Olive Oil

Olive oil is one of the EU’s main agricultural products. Europe, in fact, is the leading world producer, accounting for 80% of the world’s olive oil production and consuming 70% of it. Production

1. TRIPS: trade-related aspects of intellectual property rights.

of olive oil uses around 4% of EU arable land and involves approximately one third of all EU farmers.¹

In 2002, the EU exported 34 million euros worth of olive oil to Mercosur. This accounts for only 6% of total EU exports of this product. The EU has nevertheless already positioned itself as Mercosur's main olive oil supplier, representing 79% of total Mercosur imports.

Despite the importance of olive oil for EU-Mercosur bi-regional trade flows, Mercosur maintains few import restrictions on olive oil tariff lines. A 10% ad valorem common external tariff is charged on Mercosur imports. So far, the block has not allocated olive oil in the established categories for tariff reduction, which shows that an instant liberalization is not likely.

On the other hand, aiming for a possible trade-off between access for European olive oil exports and access for other Mercosur agricultural exports would be a difficult way of conducting negotiations, since the level of reduction of import restrictions would not be proportional for both parties. Given the importance of this product for EU agricultural exports, however, its allocation in a feasible tariff reduction category may become an important issue in the overall discussions on agriculture.

Malt

The EU malt industry is currently expanding in the direction of new markets. Increased beer consumption in the CEECs has motivated the sector to explore new markets. Currently, malt is one of the most competitive EU export products sold to Mercosur. Due to growing demand in Brazilian beer industries, exports of malt to Mercosur represent 11% of total EU malt exports. In 2002, Mercosur imported 215,700 tons of the 4,6 million tons of malt produced in the EU.²

Mercosur applies a common *ad-valorem* external tariff of 14% on imported malt. It has allocated this product to the "D" list, which implies a period of 10 years for tariff reduction according to Mercosur's proposed liberalization schedule.

Efforts to liberalize malt trade between the EU and Mercosur are quite timid from the point of view of EU offensive interests. Since Argentina is an important cereals exporter, the EU is reticent about

1. European Commission. DG Agriculture.

2. Source: European Commission.

the full liberalization of malt trade, despite the fact that this product is one of the few examples of a positive trade balance for the EU in its trade relations with Mercosur. From this perspective, Mercosur's position may progress in the direction of a more liberalization-oriented proposal than the EU's.

Furthermore, despite EU interests in the Mercosur malt market, there are some very conservative positions among EU members concerning this product's liberalization. France, for example, is clearly pushing for the exclusion of malt –as well as other cereals– from the current negotiations.

Scenarios and Conclusions

Considering the radical positions defended by Brazil and France (which have been explained in this paper) and the discussions that have taken place during the last five years (which could be called a “dialogue of the deaf”), we acknowledge that no political progress has been made during this period. As a result, it is very difficult to develop a probable scenario for the conclusion of these negotiations. This is because there are virtually no points of consensus between the French and the Brazilian positions in agriculture and therefore no balanced and realistic options. In fact, the most pessimistic scenario for Brazil is still too optimistic for France and vice-versa. These positions, however, are extreme. A feasible scenario for the conclusion of a bi-regional agreement that could be acceptable for the two regional blocs –not for individual members– would lie somewhere between these two positions.

The three scenarios that we present below fit in the broad space between the two most radical positions expressed in this negotiation. All three scenarios are therefore realistic and plausible. Because the purpose of any FTA is to increase trade flows among its members, the qualification of our scenarios –optimistic, pessimistic and feasible– is directly related to the capacity of the agreement to create more or less trade. Thus, our optimistic scenario relates to an agreement that would foster substantial trade creation. In contrast, our pessimistic scenario refers to an agreement that would not promote significant trade creation in agriculture. Our medium-range scenario is qualified as “feasible” because it is, in our opinion, the most likely one. The trade creation capacity of an agreement based on this scenario would be moderate but tangible, reflecting the

goodwill of the partners but also the genuine constraints imposed by their current domestic policies.

Optimistic Scenario

This liberalization scenario would entail positive prospects for inter-regional trade as well as considerable changes in the EU domestic market.

In this scenario both parties should agree on a substantial and horizontal liberalization for the most important agricultural products of the EU and Mercosur, thus enhancing inter-regional trade flows through preferential access for products exported by both regions. This process could take place gradually but should include the following changes:

- a) Substantial reduction of over-quota tariffs allowing products such as cereals, meat, sugar and dairy products to enter the EU market.
- b) If over-quota tariffs were not substantially reduced, a considerable amount of TRQs with preferential access should be allocated exclusively to Mercosur.
- c) Special Safeguard measures (SSG) should be suspended.
- d) Quota administration methods should be revised with the objective of improving the use of available quotas and increasing competition among importers.
- e) The establishment of an agreement on geographical indications for wines and spirits.

Pessimistic Scenario

A pessimistic scenario for agricultural products would maintain the status quo of EU domestic market protection in the most sensitive products. This scenario would, however, establish in-quota preferential access. It would thus include:

- a) Expansion of preferential access for some strategic products (i.e. meats and dairy products) through the creation of special quotas of [X] tons for the more demanding sectors. This would not improve general access for most products. Access conceded through quotas would be limited compared to Mercosur's export potential for agricultural products.
- b) No reductions in high over-quota tariff rates.
- c) No suspension of special safeguard measures.
- d) No reform of quota administration methods.

Feasible Scenario

A feasible –and the most likely– scenario would be more complex, involving a combination of approaches to the different needs of each sensitive sector. Some problems –such as TRQs and TRQ administration, which are horizontal to most sensitive sectors– would receive special attention in the negotiations, implying reforms and new access in this area. New access, for some products, could take place through a two-step approach. According to this modality Mercosur goods would be granted some preferential and limited access to the EU market through the EU-Mercosur FTA. Subsequently, Mercosur would receive an [X] percent share of the global volume that the EU will offer to third countries in the WTO. In addition, some particular sectoral demands would also shape the results of the EU-Mercosur FTA.

The result of the negotiations will, however, depend on the level of ambition of the trade-off with other areas under negotiation (non-agricultural market access, services, government procurement, etc.). If the proposed trade-off is ambitious, significant quotas and tariff preferences may be offered to Mercosur exports. In contrast, if the proposed trade-offs are not significant, only small preferences on quotas and tariffs could be conceded. As regards trade-offs, however, it is important to emphasize that Mercosur's acceptance of a removal of export subsidies and domestic support from the list of issues to be negotiated bilaterally is in itself a significant concession that should be taken into consideration in the global trade-off. In addition, to compensate for the absence of measures to eliminate export subsidies, the EU would have to accept the creation of intra-bloc safeguards to neutralize the impact of EU export subsidies to products exported to Mercosur, especially in the case of dairy exports.

In addition, in the two-step approach, the level of improvement in access for Mercosur exports into the EU will depend on the ambitions of third countries that also have demands for access. The two-step approach may therefore be interpreted as a strategy to reduce Mercosur's ambition concerning market access in the Doha Round, which seems unacceptable from Mercosur's point of view.

Bovine and poultry meat

a) Reduction of [X]% on over-quota tariffs for high quality beef (Hilton) and chicken cuts, allowing Mercosur to improve its participation in supplying EU demand.

b) Creation of a quota with preferential customs duties that should be offered exclusively to Mercosur countries.

c) Reform of administration methods for quotas, which are currently distributed according to the historical performance of importers. The historical allocation method is applied for bovine meat; a past trading performance requirement is moreover applied for both bovine and poultry meat.

Pork

A probable scenario for liberalization of pork trade would be the improvement of SPS rules governing bi-regional trade and the definition of preferential quotas. The clarification of SPS rules and the creation of preferential TRQs would in themselves constitute an interesting result for the sector.

Sugar and ethanol

Substantial liberalization of sugar trade seems unlikely in the EU-Mercosur negotiations since this sector is very sensitive not only for the EU, but also for its former colonies that benefit from preferential trade schemes (i.e. ACP and EBA agreements). However, the EU could grant a tiny quota to Mercosur to prove its goodwill to the international trading community.

Ethanol fuel tariff rate reduction or the creation of a preferential TRQ is a good possibility for a trade-off. Since it is not so explored by the EU and very important for Mercosur, the improvement of ethanol access into the EU market could be part of a probable scenario.

Orange Juice

Since orange juice is not a polemic question in this negotiation, the likely scenario would be a better tariff elimination classification. The product is currently classified under list "D", meaning that full liberalization would take place only 10 years after negotiations.

Cereals

Although cereals are very sensitive products for the EU, a probable scenario should consider that cereals include key products for both parties. The concession of preferential quotas for Mercosur exports and tariff reduction will probably ensure greater market access in the context of a bi-regional agreement.

Wines and spirits

A feasible agreement for this sector would be to allow preferential tariffs for Mercosur imports of alcoholic beverages from the EU. However, these preferences would not reach important levels as this industry is still growing in Mercosur countries and oriented to the domestic market. It is also possible that the EU and Mercosur would reach an agreement on geographical indications for wines and spirits.

The FTA between the EU and Mercosur could also entail a built-in agenda. The purpose of such a modality is not to exclude the sensitive products from the current negotiations but rather to accept a review of the treatment of some sensitive farm products periodically, after the completion of the Doha Round or following EU domestic reform of sectors left out of the Fischler CAP reform, such as sugar.

The path and scope of the EU-Mercosur negotiations are also deeply influenced by external factors. Currently these factors raise some pessimism: agricultural talks in the Doha round are deadlocked and the FTAA negotiations tend towards the conclusion of a “light” agreement or a deadlock. These developments provide no incentive for the conclusion of an ambitious EU-Mercosur FTA. These circumstances could nevertheless change in the next months. A substantial proposal by the EU and Mercosur could have a positive influence on other international trade negotiations and could help such negotiations regain momentum at the multilateral and regional level.

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ABBREVIATIONS

ACP	Africa, Caribbean and Pacific Countries (71 members)
AVE	<i>Ad Valorem</i> Equivalent
BNC	Bi-regional Negotiations Committee
BSE	Bovine Spongiform Encephalopathy
CAP	Common Agricultural Policy
CEEC	Central and East european Countries
EBA	Everything But Arms Initiative
EU	European Union
FAPRI	Food and Agriculture Policy Research Institute
FTA	Free Trade Agreement
FTAA	Free Trade Area of the Americas
GATT	General Agreement on Tariffs and Trade
GI	Geographical Indication
LDC	Least Developed Countries
MERCOSUR	Common Market of the Southern Cone
MFN	Most-Favored-Nation status
OFIVAL	Office National Interprofessionnel des Viandes, de l'Elevage et de l'Aviculture
PTA	Preferential Trade Agreement
SPS	Agreement on Sanitary and Phytosanitary Measures
SSG	Special Safeguard Measures
TRIPS	Trade-Related Aspects of Intellectual Property Rights
TRQ	Tariff Rate Quota
URAA	Uruguay Round Agreement on Agriculture
US	United States
USDA	United States Department of Agriculture
WTO	World Trade Organization

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Chapter 2

Untying the Knots in Services and Investment

Background

This chapter offers some thoughts on possible elements of successful EU-Mercosur negotiations in the fields of services and investment. Producing a value-adding package of rules and liberalization commitments in these two policy areas is always and everywhere an arduous task. This is because of the technical complexities involved and the sensitivities, both economic and political, that arise in both areas. Possible progress, however, is further related to the time that the Mercosur countries need to implement their own protocols in both areas, and to overcome the difficulties thus far encountered in doing so.

Nonetheless, relative to other contentious areas under discussion there are reasons to believe that genuine progress on services and investment is well within the negotiators' reach. EU and Mercosur officials have so far reached broad agreement on the methods and modalities that should govern negotiations in services trade and investment. Moreover, as can be inferred from the recent Declarations of the Mercosur-European Union Business Forum (MEBF), there is strong business sector support for progress in these two important chapters of the biregional talks.

Accordingly, this chapter's main contention is that there is scope for the two parties to consider a range of policy options that may help intensify biregional trade and investment relations, promote good governance, enhance economy-wide

performance, and set useful precedents for subsequent consideration in the WTO.

For such progress to be made, however, and for the attendant benefits to be reaped, both sides must reaffirm and send clear signals as to their overall commitment to an ambitious negotiating agenda in services, investment, and other key areas of the talks.

For instance, the Mercosur countries' policy latitude in the fields of services and investment will probably be influenced by expected outcomes in areas of priority interest to Southern Cone exporters, particularly in agriculture. At the same time, the ability of EU countries to afford Mercosur nationals greater temporary access to their service markets will probably be conditioned by the outcome of negotiations on non-agricultural market access.

The rest of this chapter is divided into two parts. Part I considers various policy and rule-making options for furthering talks on trade in services. Part II examines the possible ingredients of a value-adding outcome in the field of investment.

This chapter focuses in particular on the main abiding knots in the current negotiations and suggests possible solutions to them. In services, such knots are related to issues of sectoral coverage; the scope of application of the disciplines on domestic regulation; the criteria for economic needs tests; and the procedures for modifying schedules of commitments.

In the investment area the situation looks different. Although the final outcome seems to be far from a comprehensive body of investment disciplines, the following remaining contentious issues are discernible: the scope of application of the disciplines and commitments, including their application to sub-national entities; the possible treatment of incentives and tax regulations; and disciplines on domestic regulation and the right to regulate.

Services

At first sight, there appear to be relatively few Gordian knots for EU and Mercosur negotiators to untie in the services field. Unlike investment, where no comprehensive set of multilateral rules serves as a reference or starting point for biregional discussions, the services negotiations take place against the backdrop of a body of multilateral rules that are highly developed (if still unfinished and

relatively novel) and quite consensual (at least at the intergovernmental level).

Furthermore, both sides have professed a clear preference for replicating a GATS-like approach to services trade liberalization in their biregional talks. Such a shared policy orientation is in keeping with the GATS-based nature of Mercosur's own services disciplines, which are found in the Montevideo Protocol. It also reflects the GATS-centric nature of services disciplines that the EU has already embedded in its own regional trade agreements, including most notably those with Mexico and Chile.

Such a commonality of views on the broad parameters and negotiating modalities of a prospective EU-Mercosur service chapter contrasts with the bruising battles that have tended to pit proponents of Mercosur –and NAFTA– like approaches to services and investment liberalization in the FTAA discussions.

Such architectural convergence is to be welcomed, since it implies that EU and Mercosur officials can set aside time and political capital to focus on the key questions of whether, how and over what time-frame to pursue a value-adding, WTO-plus agenda in services.

There seems to be little purpose in pursuing a preferential trade agreement that replicates a WTO instrument (the GATS, for instance) if the parties to such an instrument are unprepared to go further at the biregional level than at the multilateral level. There are basically two means of improving the *status quo*. First, the negotiations can seek to enhance the *rules* governing trade and investment in services. This can relate both to a strengthening of *existing* WTO disciplines and to possible *new* disciplines. Second, value can be added by extending the *liberalization* (that is, the access) borders beyond what has proven possible to date under the GATS. Once more, this can relate both to an improvement in *existing* levels of access as well as new commitments in new sectors or modes of supply. Both of the above policy options, on rules and access, offer EU and Mercosur negotiators ample space for useful innovation. They are considered in turn below.

Enhancing the Services Rule Book

Some 17 years after the Uruguay Round was launched and services made their way onto the multilateral trade agenda, and nearly a decade after the Marrakech Agreement establishing the WTO-GATS entered into force, the multilateral framework of rules

governing trade and investment in services remains unfinished. Indeed, outstanding rule-making discussions are continuing in four key areas: (i) emergency safeguards; (ii) subsidies for services; (iii) government procurement of services; and (iv) domestic regulation (pursuant to the work program foreseen under GATS Article VI:4).

While an EU-Mercosur services chapter could break new ground in all four of these issues, none is particularly easy to address. Accordingly, in all these areas, expectations of significant breakthroughs in the context of EU-Mercosur negotiations must be tempered, even as the scope for progress might be greater in some areas than others.

On the thorny issue of *emergency safeguards*, for instance, the EU members and most other OECD countries have consistently questioned the desirability and feasibility of such an instrument. It is doubtful that the EU's attitude will shift in a regional context, most particularly since the Mercosur countries have not been key *demandeurs* in the WTO process.

On the question of *government procurement for services*, the issue arises of whether a generic approach focusing on the development of horizontal disciplines applicable to both goods and services procurement might be preferable to separate rules for goods and services. To date, neither side has suggested that this matter be taken up in the services chapter, though the MEBF is adamant that any agreement address this important good governance-promoting issue, particularly in light of the strong need to promote higher levels of investment, public and private, domestic and foreign, in infrastructure development within Mercosur.

One option that negotiators could contemplate in the services field, as with Mode 4 commitments (see below), is to schedule circumscribed procurement undertakings in the form of additional commitments that would specify the conditions and limitations of such gradual liberalization. Such targeted market opening could be a significant complement to possible parallel market opening in professional services such as architecture and engineering, as well as a means of promoting FDI in key infrastructure sectors where the state (at both the federal and sub-national levels) may be a prominent purchaser of services.

There might be greater scope to develop regional disciplines on *services-related subsidies*, given the greater regional salience of locational competition in services markets (a particularly important

consideration in the case of disciplines on trade- and investment-distorting incentives programs). Indeed, studies show that distorting practices in these areas occur most intensely at the regional level, especially within and among countries that are geographically close. This has potentially significant implications for the most appropriate level of governance in which to tackle such practices (that is, in deciding between regional and multilateral levels of rule-making). The EU and Mercosur, plainly, are not contiguous, but the Mercosur countries might have an interest (including on fiscal grounds) in limiting location-related competition within and across borders.

Little meaningful progress has been made to date in this area under the GATS, and EU and Mercosur negotiators could usefully direct greater policy –and rule– making attention to the issue. Of course, caution is necessary because of the matter’s sharp sensitivity. Possible outcomes could range from a best endeavors (hortatory, for example) commitment to agree subsidies on a national treatment basis while deciding on a fixed deadline to complete negotiations in the area. Alternatively, signatories could agree, as is the case under the GATS, to subject such measures to the agreement’s national treatment and MFN disciplines, subject to possible reservations listed in the country’s schedules of commitments. More comprehensive lists of investment incentives and related subsidy programs could help inform the design of adequate rules, by allowing governments to draw up a typology of various types of measures and better gauge their differentiated distorting effects, as well as to identify categories of investment-support measures that could be approved as under the WTO’s Agreement on Subsidies and Countervailing Measures.

Because of the limited scope for rapid movement in this area (largely the result of the Mercosur countries’ reluctance to tackle the issue for fear of losing flexibility in development policy), some element of variable geometry might be desirable in any possible subsidy disciplines, especially in Mercosur countries, so as to allow additional space for the development of domestic services sectors.

Undertakings in the form of additional commitments (for transparency purposes, and some best endeavors provisions to avoid distorting effects) would be a step forward in this area.

A final, weaker option, found in the EU-Chile FTA (Title III, Chapter I, Article 95:4), consists of excluding subsidy practices

from the scope of the biregional agreement, pending the adoption of disciplines mandated under GATS Article XV.

Finally, as regards the relationship between services trade liberalization and *domestic regulation*, Mercosur and EU negotiators could usefully explore the kinds of criteria that any necessity test for services would require, in order to determine the circumstances under which non-discriminatory regulatory conduct can raise unnecessary hurdles to cross-border trade and investment. Progress on this sensitive issue has proven elusive in the GATS, given the reluctance of some OECD countries to subject regulatory activity to greater trade policy scrutiny. It has also prompted civil society groups to voice concerns about the potential erosion of regulatory sovereignty.

Attention could also usefully be paid to the criteria governing the use of economic needs tests (ENT) in services trade. Such a topic has a clear link to the exercise of domestic regulatory sovereignty, both as a general discipline and also in connection with liberalization commitments. A useful outcome would be for both parties to agree on some basic discipline on transparency, in order to set the main criteria prevailing for each ENT when these measures are inscribed in country schedules.

One last comment can be made about the scope of application of possible disciplines on domestic regulation. It seems reasonable to confine any such disciplines solely to sectors, sub-sectors and modes of supply subject to scheduled commitments. Otherwise it might be difficult to agree on this potentially contentious issue: the Mercosur countries seem reluctant to further constrain their right to regulate, particularly in new or less developed areas of regulation, if the intention is to establish disciplines of general application.

Tests of necessity and proportionality have long been used in the EU without seeming to pose a threat to domestic regulatory sovereignty. Accordingly, and despite the political sensitivities such discussions can entail with prominent NGOs, EU officials could usefully take the lead in trying to codify the elements of a necessity test for services. Given the complexities and sensitivities involved, such negotiations would probably have to be carried out after the conclusion of a biregional agreement, under a built-in agenda. Nonetheless, negotiators could agree on a date to complete such discussions. Progress at the regional level could be important in unblocking the current stalemate in Geneva. It is doubtful that much progress can be

expected in this area if EU and Mercosur negotiators agree merely to reflect future WTO developments in their accord.

Quite apart from furthering the unfinished GATS agenda, EU and Mercosur negotiators can also aim to strengthen, clarify or improve a number of provisions currently found in the GATS. Several possibilities arise in this regard, starting with the needless and confusing *overlap* in the GATS *between market access* (Article XVI) and *national treatment* (Article XVII) *commitments* in the case of *discriminatory* market access impediments. A simple, horizontally agreed convention among the parties could easily dispel further confusion in this area, thereby providing greater predictability and transparency. It seems to be a candidate for an early harvest.

There is also scope for strengthening existing GATS disciplines that are either weak or that today seem insufficiently developed in the light of policy and regulatory developments since the GATS entered into force almost a decade ago. This is the case, for example, of GATS disciplines on *competition-related issues* in Articles VIII and IX, where an attempt could be made to identify particular types of private anti-competitive practices in services trade (extending and possibly making generic those practices already addressed by the reference paper on pro-competitive regulation appended to the 1997 Agreement on Basic Telecommunications). The parties could then agree to proscribe, jointly investigate or consult on such measures, depending on their ambition in competition policy matters. Pro-competitive disciplines could also be addressed as additional commitments in sectors where there is scope for anti-competitive conduct to nullify or impair bound trade and investment commitments. This is notably the case of network industries such as energy or environmental services (water distribution).

Stronger, GATS-plus disciplines could also be envisaged with respect to *transparency*, where consideration could be given to providing interested stakeholders with prior notification rights before the enactment of any proposed new measure affecting trade and investment services. Such a provision would promote good governance and can be found in the financial services chapter of the EU-Chile FTA, though not in the services chapter itself. This rule could be binding or framed as a best endeavors undertaking.

Finally, EU and Mercosur negotiators can seek to break new ground on rule-making in areas that the GATS left untouched. One obvious example is the regulation of *e-commerce* and “*digital*

trade". This was not a commercial reality when the Uruguay Round was completed but a number of subsequent agreements (including most recently the EU-Chile FTA) have sought to address it, albeit with a modest level of ambition relative to the more detailed provisions in recent FTAs entered into by the United States, including the agreement with Chile. In Article 104 of the EU-Chile FTA the two sides agreed to do little more than discuss how best to promote the development of e-commerce between them.

To some extent, such language may reflect EU uneasiness over the boundaries between carriage and content in trade policy, and the implications for the preservation of policy space in audio-visual services. It is doubtful that EU sensitivities would be any different in the EU-Mercosur negotiations.

The area of *mutual recognition* and its contribution to the liberalization of trade in professional services could lend itself to value-adding progress at the biregional level, and could usefully complement greater liberalization of Mode 4 trade. There is little doubt that mutual recognition agreements tend to be more feasible among a smaller subset of participants. Flexibility should accordingly be sought to allow all possible configurations of MRAs to emerge among interested parties without having to wait for all of them to be on board. An MRA between Brazilian and Portuguese engineers should thus be possible, even if the terms of such an agreement are not acceptable to Argentine or Dutch licensing bodies.

An EU-Mercosur agreement would break new ground if it featured a provision that prohibited the maintenance of *citizenship or permanent residency requirements* as conditions of professional licensing. The latter should be based solely on competence and the ability to supply professional services. Hence there is scope for improving the terms of Article 102:4 of the EU-Chile FTA, which merely calls on the parties to consult periodically with a view to determining the scope for eliminating such restrictive practices.

Additionally, replicating a practice first introduced for foreign legal consultants and engineers in NAFTA, the EU-Mercosur agreement could feature explicit MRA work programs in a number of interested professions, to be carried out under agreed timetables by the relevant licensing bodies. Experience in NAFTA has shown that such hand-holding by governments (even if it is licensing bodies that actually conduct the MRA discussions) can help build confidence, raise awareness among stakeholders, and hasten what are

often highly time-consuming and easily “captured” exercises in regulatory convergence.

Stretching the Boundaries of Liberalization

Given that both parties want to retain the GATS-like, hybrid approach to scheduling liberalization commitments under an EU-Mercosur agreement, a GATS-plus outcome entails either improving existing commitments or making new commitments in sectors and modes of supply left untouched by the Uruguay Round.

In this connection, priority attention should be paid to deepening liberalization in the *core infrastructure sectors of finance, telecoms, and transportation services* (all modes), notwithstanding the clear economy-wide benefits to be derived from greater competition in a range of business, professional, or environmental-related services.

An important question in this regard is whether the parties could incorporate existing GATS *sectoral annexes* and their disciplines by reference, notably those governing telecommunications (basic and value-added) and financial services, and simply aim to add to, deepen or improve (even in the future, as phased-in undertakings) current WTO commitments in a biregional setting. There may be little purpose in recreating pre-existing disciplines if the parties are broadly comfortable with the terms of existing annexes. A cursory glance at the telecommunications and financial services chapters of the EU-Chile FTA reveals relatively few and generally minor differences between such sectoral annexes and those found in GATS.

A related, if more controversial, question is whether the parties might be willing to adopt a rule mandating *status quo* commitments under a GATS-like approach. As currently drafted, the GATS allows WTO members to schedule commitments below the level of access afforded by domestic legislation. Locking in the *status quo* while preserving the parties’ autonomy not to schedule a commitment could help promote a higher and more commercially meaningful level of bound liberalization, while also providing business operators with a more predictable regulatory environment.¹

1. This would have to be done in tandem with a change of schedules clause, especially since quite a large proportion of Brazil’s services sector (unlike the EU’s) is not covered by WTO commitments. This clause should allow for an exceptional and limited suspension of the commitments, obviously under strict surveillance. Compensation should also be required.

Services liberalization may also be deepened if the parties agree to broaden the sectoral coverage of the agreement's services chapter. This could entail scheduling liberalization commitments in areas that were explicitly carved out of the GATS, or in areas where WTO members largely eschewed commitments for a variety of regulatory, market structure or political reasons.

Civil aviation provides one example of the former category, since the bulk of *air transport services* were carved out of the GATS. This is a sector where the European Commission's authority to negotiate on behalf of EU countries, recently confirmed by a ruling of the European Court of Justice, could give new momentum to negotiations in the sector.

An attempt could accordingly be made in the EU-Mercosur negotiations to embark on deeper liberalization in civil aviation by extending the sector's coverage to a host of services such as ground handling, airport security, catering, airport management and seeking market access commitments in these areas. The parties could also consider a commitment to future negotiations on "hard" rights (landing rights, access to slots), as well as the progressive lifting of restrictions on ownership and control, so as to facilitate the needed recapitalization of their respective airlines. Part of this could be done in parallel in the investment chapter.

Commitments in *energy services* fall into the category of sectors where conditions were simply not right for progress in the Uruguay Round, but where significant regulatory reform and investment liberalization have subsequently altered market structures significantly. Hence there is scope to consider new liberalization commitments in areas such as gas and electricity production and, especially, distribution, as well as a host of ancillary services.

Because of the network characteristics of energy markets, and the attendant risk of market dominance by incumbent suppliers, care is needed to ensure that trade and investment liberalization in the sector is not nullified or impaired by underlying anti-competitive conduct. Accordingly, the EU and Mercosur might consider adopting provisions similar to those in the Reference Paper on pro-competitive regulatory principles appended to the ABT.

In keeping with a stance that the European Commission has reaffirmed many times in the Doha Round, and confirmed in its recent bilateral agreements, it is doubtful that the EU would consider commitments in a range of sensitive sectors of potential export interest

to Mercosur producers. This is notably the case of *audio-visual, health and education services*, where non-trade forms of international cooperation (such as co-production agreements in audio-visual production, and educational and scientific exchange programs) will probably continue to define the norm but where tangible benefits, including commercial benefits, may stem from such intensified cooperation.

Finally, the negotiators could usefully think of practical ways to improve the liberalization features of a services chapter along *modal* lines. This is especially true for Modes 1 (cross-border supply) and 4 (temporary movement of service suppliers).

For several reasons linked to technological or commercial feasibility, concerns over cross-border consumer protection, regulatory precaution and differences in cross-country approaches to service sector regulation, most agreements covering services (including GATS) have not to date achieved significant liberalization of *cross-border trade in services* (Mode 1).

The emergence of e-commerce, significant convergence in regulatory approaches, and the gradual adoption of international standards in key service sectors all suggest greater scope for Mode 1 trade in future. To facilitate such trade, EU and Mercosur negotiators could agree on forms of regulatory cooperation among relevant institutions, geared to addressing current obstacles to cross-border trade.

Areas where cooperation could be expected to spur the greatest liberalization dividends in this regard include: regulatory transparency; domestic regulation (avoiding trade-inhibiting non-discriminatory regulation); mutual recognition; government procurement (notably with regard to outsourcing/offshoring); identifying applicable jurisdiction; cross-border pooling of insurance/consumer protection instruments; data privacy; intellectual property; and taxation.

Finally, there is much scope to sweeten the deal on the *temporary movement of service suppliers* (Mode 4) at the biregional level. In its initial Doha Round offers, the EU has already signaled a readiness to consider ways of improving access to its markets in this area, particularly as regards independent foreign service suppliers (the movement of individuals who are unrelated to a commercial presence).¹

1. Argentina has presented an innovative offer on Mode 4 trade in the current WTO-GATS negotiations, a key element of which is that it would aim to lock in applied conditions.

There is little doubt that the EU market, especially (but not only) Spain and Portugal, offers significant opportunities for skilled and semi-skilled workers from Mercosur to export their labor temporarily. At the same time, many EU-based multinational firms would prefer greater freedom to locate key personnel in Mercosur countries. This shared interest creates scope for meaningful progress on both sides.

Here again, progress can take two forms. Since few countries maintain sector-specific immigration or labor market policies, EU and Mercosur negotiators could seek agreement on a model horizontal schedule governing the temporary entry of various types of service suppliers (business visitors, intra-company transferees, contractual service providers). This could be buttressed by additional disciplines on regulatory transparency and domestic regulation (targeting economic needs tests; addressing the conditions under which special temporary access visas would be granted and compliance with their terms monitored).

Greater allowance for contract-based supply could pave the way for temporary access by the individual (and typically higher-skilled) service suppliers noted above. This could also provide a means of addressing the temporary admission of teams of less skilled workers, such as those engaged in construction or environmental services.

The parties could additionally make use of the “Additional Commitments” column of their commitments schedules to specify the temporary entry conditions governing individual professions or worker categories (defined by specific skill or educational levels), above and beyond what may be addressed in a model horizontal schedule.

Investment

Investment is undoubtedly a harder knot to untie in the EU-Mercosur negotiations, for two main reasons. First, there is no multilateral precedent to facilitate consideration of whether and how to improve the *status quo* at the biregional level. Second, the political economy of investment rule-making tends to be more complex than that of trade (including trade in services), as shown by the failure of the WTO’s Cancún Ministerial meeting over (in part) the treatment of the Singapore Issues, and especially investment.

The Mercosur countries have extensive experience in –and knowledge of– cutting-edge investment rule-making. Their expertise was honed in a large and growing number of bilateral investment protection agreements;¹ in the failed MAI negotiations, in which Argentina and Brazil took part; and in the FTAA talks. The absence of a WTO platform on investment, however, is certain to exacerbate the precautionary instincts of negotiators faced with a blank page in the biregional talks.

Caution on Mercosur's part cannot easily be understood given that the region, with the rest of Latin America, has experienced the bulk of the decline in global FDI flows to developing countries in the last two years. Indeed, FDI in the region is nowhere near the level of just a few years ago, despite recent evidence of encouraging developments, particularly in Argentina. While such growth was in part attributable to a wave of privatizations that may well have run its course in several countries, including the Mercosur members, foreign investors' skittish attitude might also have been influenced by concerns over macroeconomic stability and the perception of adverse developments in host country investment climates.

On the other hand, it should be recalled that European firms enjoy access to Mercosur countries without significant limitations. This circumstance also prevailed in the past and was reflected in the impressive flows of European FDI to Mercosur in the 1990s.

Hence the EU-Mercosur negotiations offer a ready-made opportunity to exploit the “signaling” properties of international trade and investment agreements. Accordingly, Mercosur countries should be more proactive in an area that offers a chance to develop instruments that could help restore confidence in the region.

At the same time, and as MEBF position papers illustrate, investment negotiations are not one-way. Talks in this area are not of interest solely to firms in EU countries. In recent years there has been a significant rise in outward FDI from Mercosur countries, especially since a number of Brazilian firms in a wide range of sectors (breweries, aeronautics, steel, mining, banking, oil and gas, pulp and paper, auto parts and construction) have significantly

1. Note, however, that none of the investment agreements concluded by the Brazilian government has been ratified by the country's Congress. The Colonia Protocol governing intra-Mercosur investment has not yet been ratified by any Mercosur country, while the Buenos Aires Protocol on extra-Mercosur investments has been ratified only by Argentina and Paraguay.

expanded their presence in foreign markets.¹ EU enlargement can be expected to hasten such an expansion.

As Mercosur countries acquire home country interests, their negotiating stance on investment is likely to evolve, and their interest in providing Mercosur companies with adequate levels of protection and access in foreign markets can be expected to grow.

Despite the concerns noted above, to which should be added the Mercosur countries' difficulties in implementing their own investment protocols, it might still be possible for the EU and its Southern Cone partners to make headway. Doing so would probably have significant multilateral demonstration effects, because unlike the FTAA or other NAFTA-type agreements in the Western Hemisphere (the architecture and scope of whose investment disciplines stand little chance of being replicated in Geneva), progress between the EU and Mercosur stands a good chance of informing the shape and content of future WTO disciplines and negotiating modalities. Viewed thus, a blank page provides an opportunity to start from scratch and to learn from past failures in the field of investment rule-making.

The EU-Mercosur negotiations could provide an arena to consider the kind of investment agreement contemplated by the WTO Working Group on the Relationship between Trade and Investment in the run-up to the Cancún Ministerial Meeting.

The main features of such an agreement, which the collapse of talks on the Singapore Issues has all but derailed for the time being in the WTO, would include the following:

- (i) a focus on investment disciplines in "non-services" –that is, investment in primary (agriculture, fishing and mining) and manufacturing sectors (complementing disciplines applicable to services under Mode 3 of the GATS and to performance requirements applicable to investment in goods-producing industries under the TRIMs agreement);
- (ii) a focus on investment liberalization (that is, post-establishment non-discrimination) with a GATS-like, voluntary approach to pre-establishment commitments;

1. For the most part, such flows went to other Latin American countries; significantly less went to European countries. Within Europe, moreover, most FDI flows from Mercosur have gone to Portugal, Spain and Germany.

- (iii) core disciplines on regulatory transparency, national treatment, market access, MFN, and payments and transfers;
- (iv) a narrow, FDI-centric definition of investment, excluding portfolio investment;
- (v) liberalization modalities predicated on a GATS-like, hybrid approach;
- (vi) no disciplines on investment protection;
- (vii) no disciplines on the granting of investment incentives (other than possible GATS-like disciplines of national and most-favored-nation treatment subject to reservations in scheduled sectors);
- (viii) reliance on state-to-state dispute settlement;
- (ix) exceptions and balance of payments safeguards; and
- (x) development provisions.

There is little doubt that progress along such lines would set an important precedent for subsequent emulation in the WTO, but in light of the evolution of the WTO negotiations and their dynamic (unstable) balance, it is unclear whether the parties would be favorable to such a relatively soft, GATS-like (and hence development-friendly) rule-making configuration.

Before examining the kind of WTO investment agreement the EU has been championing, however, it is worth considering what value would be added by an EU-Mercosur investment chapter that excludes investment in services. Such a (largely bureaucratic) separation is found in a number of recent bilateral and regional agreements, but it is counter to the reality of international production networks, in which many globally active firms manage investments in both goods (manufacturing) and services. Subjecting such activities to potentially differentiated investment rules is unlikely to promote policy coherence. Unsurprisingly, such a measure has elicited limited support among the business community.

This is not a trivial matter, since most cross-border investment activity currently takes place in services and accounts for just under two thirds of EU-Mercosur flows. More importantly from a rule-making perspective, the vast majority (over 80%) of investment barriers are in services.

A quick look at Mercosur lists of non-conforming measures under the Montevideo and Colonia Protocols suggests that, relative

to services, investment in manufacturing is subject to few explicit barriers to entry and post-entry operation. This is especially so of barriers that a trade agreement and its traditional treatment provisions could meaningfully address (discriminatory and market presence-impairing impediments, as opposed to administrative/governance barriers). Similar conclusions may be drawn from looking at the investment measures inscribed by the EU in its FTA with Chile, which takes a positive list approach to scheduling liberalization commitments.

Given the declining incidence of performance requirements (which for EU and Mercosur countries are today banned under the TRIMs agreement) and the absence of multilateral disciplines on investment incentives, it can be argued that most foreign investors in manufacturing enjoy better than national treatment. Accordingly, for manufacturing investment, which accounts for some 30% of EU-Mercosur FDI flows, there are doubts about the value-added of the kind of agreement described above.

There are certainly investment barriers outside of services and manufacturing. Ownership restrictions are prevalent in agriculture, fishing, mining and other extractive industries. Nonetheless, the scope for liberalizing restrictions in sensitive areas such as ownership of land and natural resources (as distinct from the right to exploit and invest in such resources) seems quite limited. Many developed countries maintain similar restrictions. It is worth noting that such investment accounts for less than a tenth of global FDI activity.

The main locus of investment regime liberalization being in services, the question arises of whether an investment chapter distinct from the rules on investment in services is needed.

This question is significant in light of the other three main goals of international investment agreements: (i) *investment protection* and the attendant right of foreign investors to mount a direct challenge to host country measures before international arbitration procedures (“investor-state arbitration”); (ii) *investment distortions*, which encompass performance requirements, investment incentives, and a host of investment-related trade measures such as discriminatory sectoral rules of origin in preferential trade agreements, the maintenance of contingent protection instruments in RTAs beyond the achievement of tariff-free trade in goods, tariff peaks and tariff escalation; and (iii) *good governance*-promoting

measures, such as best practices in investment promotion activities, the adverse effects on investment of bribery and corruption, corporate social responsibility, or home country measures.

All three of the above policy –and rule– making agendas are either:

- (i) deliberately outside a prospective agreement for lack of a consensus on their desirability in a multilateral setting (this is the case for investment protection and investor-state arbitration, for instance);
- (ii) already under discussion in other chapters of the biregional or multilateral negotiations (for example, under non-agricultural market access and rules on tariff-related and anti-dumping issues); or
- (iii) best pursued by collective action outside the trading system, as is arguably the case of the good governance agenda described above.

As with services trade, the question arises of how an investment accord within an EU-Mercosur agreement would add value to existing multilateral rules and commitments. One way to add value in this area, at least from a Mercosur perspective, might be to include the goal of development, either as part of the preamble or as a provision in the agreement's investment chapter. The main benefit of such a provision could be to help countries interpret substantive obligations, with a view to allowing the development considerations to be taken into account in possible investment disputes. There is no straightforward answer to this question if the agreement is confined to non-services, given the lack of WTO disciplines applicable to investment in non-services disciplines beyond the TRIMS agreement's ban on performance requirements.

Should investment in services be governed by the agreement's services chapter, then a GATS-plus outcome could be secured either through enhanced biregional commitments (in financial services, for example) or *de novo* commitments such as those contemplated earlier in civil aviation or energy.

Again as with services trade, there is the question of whether prospective rules on investment should aim to preserve the regulatory *status quo*, despite the retention of a hybrid approach to scheduling. The signaling benefits of doing so are arguably greater in the investment field than in trade.

Another question worth considering in the context of preferential investment concerns the *rule of origin* applied to those investors and investments deemed eligible for preferential treatment. Mercosur is among the small number of regional agreements that have adopted a more restrictive (or less liberal) ownership and control test, so as to limit the benefits of intraregional investment liberalization to juridical persons that are owned and controlled by Mercosur nationals.

Such an approach contrasts with the reliance of most bilateral and regional agreements on a more liberal test of substantial business operations, under which any firm conducting normal business operations within an integrating area, regardless of its nationality, enjoys the full benefits of such integration. Simply put, a liberal rule of origin all but eliminates the preferential nature of intraregional investment regime liberalization.

Mercosur countries may prefer to maintain an ownership and control test, so that only investments owned and controlled by EU nationals would receive benefits under the agreement's investment chapter. The potential impact of such a discipline is unclear in the context of the EU market, especially its influence on third country investors with a presence in the EU, since such firms would be denied equal access to the Mercosur market on nationality grounds.

Finally, one issue that could be considered in either the services chapter (if it governs investment in services) or the investment chapter (should it cover investment in both goods and services or goods only) is the question of the level of ownership required for the investment or commercial presence to be deemed a covered measure. Under the GATS, the threshold is set at 50% plus 1. Hence the agreement does not cover minority shareholdings. Negotiators should explore the scope for further progress in this area, including recourse to the Additional Commitments column in commitments schedules.

An EU-Mercosur agreement could consider lowering the threshold in such a way as to enhance the investment protection and liberalization properties of any investment disciplines.

Other Areas Under Negotiation

This paper focuses on services and investment, but it is worth recalling that other important issues, like government procurement, are part of the overall negotiations and are of particular interest to the EU. A reasonable outcome on this issue, however, seems remote.

No progress has been made on the matter in Mercosur. Only in December 2003 was the Protocol on Government Procurement adopted by the Mercosur countries, and it requires congressional approval in at least two countries before it can enter into force.

Apart from the procedural aspects, note that the Protocol has limited coverage. It includes some disciplines on transparency and market access, but excludes coverage of concessions and application at a sub-federal level. Additionally, it allows much scope to introduce limitations on national treatment and the level of commitments, in terms of market access, is modest.

In these circumstances a significant outcome on this issue seems unlikely, although there could be agreement on some disciplines on transparency as a basis for future improvements.

Concluding Remarks

This chapter has suggested a number of policy alternatives to help EU and Mercosur negotiators surmount their current differences in the services and investments chapters. The chapter aims to offer concrete ways of untying the remaining knots, so as to strengthen biregional trade and investment links and further the development of rules and liberalization commitments in services and investment.

In the services chapter, the proposals aim to establish a delicate balance between adopting novel obligations that represent clear progress over the GATS, and preserving the flexibility that countries still seek in services trade and regulation.

It is important to swiftly overcome the current level of distrust and the concomitant reluctance to make improved offers, especially since some countries have not significantly bound parts of their services sector activities in the WTO.

As regards investment, there is real doubt about the value-added of a chapter dealing with investment in non-services. It would make little economic or legal sense to grant different treatment to investments in services than to those in other economic activities, especially since such investments are often carried out under the same corporate roof. Worthy of serious consideration by both parties, however, is a general set of principles that would favor development, improve home country

investment climates, and promote good governance through enhanced transparency disciplines.

Whatever the final details of the structure and content of both chapters' main disciplines, the prevailing uncertainty about the fate of the Doha Round and other regional negotiations (notably the FTAA) supports the impression that both sides will approach negotiations in these complex and sensitive areas with considerable caution. This should not, however, preclude useful progress in both areas. Such progress could provide a solid basis for deepening economic relations. It could also provide useful rule-making precedents and liberalization outcomes for subsequent consideration in the WTO.

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1. The views expressed in this chapter are personal and should not be ascribed to the government with which one of the co-authors is affiliated.

Chapter 3

Scenarios for Untying the Knots in Market Access for Goods

Introduction

Economic relations between the countries of Mercosur and the European Union (EU) are very significant: the EU is Mercosur's leading customer, supplier and source of foreign investment. In the 1990s, Mercosur-EU trade grew on average at twice the rate of world trade.

EU exports to Mercosur increased annually by about 25%, while Mercosur's exports to the EU grew by 4%. In general terms this performance mirrored the pattern of Mercosur's trade with its main partners, and reflected the commercial opening undertaken by the member countries in the 1990s.

For the Mercosur countries, the biregional trade negotiations should have two significant outcomes: greater access for Mercosur products to the European market; and incentives for greater European direct investment, especially that geared to export activities. The growth of Mercosur exports to the EU would be fostered by removal of the barriers facing Mercosur agribusiness products in the European market. The EU's average level of protection is very low but it varies widely among sectors, and Mercosur exports face some of the market's highest levels of protection.

For the EU, a biregional trade agreement should provide improved market access for industrial goods and services, as well as clear and enduring rules, thereby facilitating European companies' involvement in the global production process. European firms have made substantial investment in the Mercosur countries with a

view to exploiting the bloc's integrated market. In that regard the EU expects the biregional agreement to help consolidate Mercosur. The accord should encourage the bloc to commit itself to the free movement of goods among its members, as well as to transparent and more efficient customs procedures.

This chapter is divided into four sections: (i) the international context of the biregional negotiations; (ii) the main knots in market access for non-agricultural goods, including the Mercosur and EU tariff offers; (iii) three scenarios for untying the prime knots in the negotiations; and (iv) issues related to Mercosur's consolidation.

The international context of the negotiations

Untying the knots in the Mercosur-EU negotiations on market access for goods depends crucially on the extent to which the biregional negotiations satisfactorily address agriculture. Mercosur has argued that it can only improve its offer on tariff liberalization if the EU makes greater a commitment to dismantle tariffs on agricultural products. For its part, the EU argues for the principle of the "single pocket", meaning that it cannot be expected to pay twice (at the WTO and at the biregional level) for the liberalization of its agricultural sector. The EU's stance strengthens the links between the negotiations for the Mercosur-EU agreement and those of the Doha Round.

The difficulties in regaining momentum at the WTO talks early this year lessen the likelihood that the negotiators will meet the December 2004 deadline for the conclusion of the Doha Round. If the EU and Mercosur retain the goal of completing the biregional agreement by October 2004, the two sides' negotiators will have to overcome the challenge of unshackling the links between the two negotiating processes.

This chapter's scenarios for resolving the difficulties in the Mercosur-EU negotiations on market access for non-agricultural goods assume that the biregional talks advance without the main agricultural obstacles having been overcome in the WTO.

The scenarios are also influenced by developments in the negotiations for the Free Trade Area of the Americas (FTAA). From the outset, in fact, the biregional talks have not only been very sensitive to the ups and downs of the hemispheric negotiations but the latter have also affected the mood of the two sides' negotiators. The agreements reached in one negotiating arena, moreover, might have some demonstration effects in the other.

If the FTAA talks reach an impasse, EU interest in the biregional agreement might wane and it might make less of an effort to improve its offer on agriculture. If the FTAA talks make significant progress, on the other hand, the EU might be prompted to make a more comprehensive liberalization proposal.

Developments in the FTAA negotiations in the coming months will also influence Mercosur's positions in the biregional talks. In general, the Mercosur countries give more political support to the negotiations with the EU than to the FTAA talks. If the latter move forward, therefore, they are likely to reinvigorate Mercosur's efforts to reach an agreement with the EU.

The Main Knots in Market Access for Non-Agricultural Goods

Talks on market access for non-agricultural goods have been virtually paralyzed since June 2003, when the tenth round of Mercosur-EU negotiations were held. The last important step in the negotiations was in May 2003, when the two sides exchanged requests for an improvement in the offers on tariff liberalization, which had been presented in March 2003. Replies to these requests were expected in April 2004, in line with the schedule established at the November 2004 biregional Ministerial Meeting.

The issue of the calendar for tariff liberalization is undoubtedly the main obstacle facing this negotiating group, but it is not the only one. Others are related to the tariff-reduction process, as well as to rules of origin, the use of drawback, the certification and verification of origin, and the safeguards system. Finally, the EU's demand that goods move freely within the two blocs entails a series of challenges for the consolidation of Mercosur's regional integration agenda.

The following section presents a brief summary of the current situation in the talks on market access, and the main knots and dilemmas that each side confronts.

Tariff Offers

Since offers were presented before the two sides reached an understanding on methods and modalities, each bloc produced its own timetable for eliminating tariffs.

The first, basic difference concerns the scope of the offer. Mercosur's position is that all goods should eventually be subject to zero tariffs. The EU, for its part, indicates that its offer covers all relevant goods. In other words, "substantially all trade" in goods would be completely liberalized in 10 years and the rest is subject to negotiation. This suggests that some products might not be fully liberalized (they might, for example, be subject to quotas).

The EU's offer is conditional on a reciprocal pace of tariff reduction on Mercosur's part. The latter's offer, however, presupposes a degree of special and differential treatment in its favor, entailing a longer transition period and slower tariff-reduction.

Mercosur's Offer

Mercosur's offer comprises five categories of goods, with three different schedules for eventual zero-rating: immediate, at year 8, and at year 10. In addition to the five categories, the treatment of a number of products is yet to be defined. The tables below show the structure of Mercosur's offer and the distribution of goods in the various categories (in terms of tariff levels and import volumes).

Table 1. *Mercosur's Tariff-reduction Timetable*

(en %)

	Category				
	A	B	C	D	E
Year 0	100				
Year 1		50			
Year 2		50	10	10	10
Year 3		50	10	10	10
Year 4		50	20	10	10
Year 5		50	30	20	10
Year 6		50	50	40	20
Year 7		50	60	50	30
Year 8		100	70	60	50
Year 9			90	80	70
Year 10			100	100	100

Mercosur's proposed timetable for tariff reductions is quite conservative. In the fifth year of the agreement, for example, tariffs on category A products will be completely eliminated; category B products will be at 50% of their original tariffs; and the remaining categories will be at 10%-30% of their original tariffs.

Table 2. *Summary of Mercosur's Offer*

Categories	2001				2003			
	Exports from the EU Avg. 1998-2000, US\$ million				Exports from the EU Avg. 1998-2000, US\$ million			
	Products	%	Value	%	Products	%	Value	%
A	551	5.9	1,900	8.3	593	6.3	2,207	9.6
B	1,109	11.8	1,110	4.8	1,595	17.0	1,935	8.4
C	610	6.5	542	2.4	1,285	13.7	847	3.7
D	1,305	13.9	3,590	15.7	1,919	20.4	4,549	19.8
E	116	1.2	186	0.8	2,650	28.2	9,621	41.9
TBA	5,717	60.8	15,607	68.0	1,366	14.5	3,775	16.5
Total	9,408	100.0	22,934	100.0	9,408	100.0	22,935	100.0

The March 2003 exchange of revised tariff offers fostered a perception that negotiations had reached a new level. This was a justified perception, inasmuch as Mercosur's offer was substantially better than that presented in October 2001.

In the original offer, only 39.2% of all goods (accounting for 32% of Mercosur's imports from Europe) were included in the five categories scheduled for zero-rated tariffs by year 10. In the 2003 offer, however, these percentages rose to 85.5% and 83.5%, respectively. In other words, Mercosur's offer met the parameters deemed acceptable by the WTO's generic rules (according to which liberalization should cover "substantially all trade").

An examination of the internal composition of Mercosur's offer, however, makes plain that it is still too cautious. In reality, tariffs would be eliminated immediately on only 9.6% of imports from the EU; those on another 8.4% would be removed by year 8. Some 65.4% of imports would be tariff-free by year 10 (42% of imports in category E alone). It should be noted that these categories would also enjoy a two-year grace period. Thus, in year 10, some 16.5% of all imports would still be in limbo, their treatment still undefined.

The EU's Offer

The EU's timetable has four product categories with separate tariff-reduction schedules: immediate, at year 4, at year 7, and at year 10. A fifth category is for goods as yet unassigned. Europe's 2003 offer adds 1,235 products to its original 2001 offer. Some 385 products were added to category A (immediate tariff elimination) and 748 to category E (unassigned).

Table 3. *The EU's Tariff-reduction Timetable*

(en %)

	Category				
	A	B	C	D	E
Year 0	100	20	12.5	9	Unassigned products
Year 1		40	25	18	
Year 2		60	37.5	27	
Year 3		80	50	36	
Year 4		100	62.5	45	
Year 5			75	54	
Year 6			87.5	63	
Year 7			100	72	
Year 8				81	
Year 9				90	
Year 10				100	

Table 4. *Summary of the EU Offer*

Categories	2001				2003			
	EU Imports Avg. 1998-2000, US\$ million				EU Imports Avg. 1998-2000, US\$ million			
	Products	%	Value	%	Products	%	Value	%
A	2,998	32.7	5,530	48.4	3,514	33.8	11,541	61.7
B	2,622	28.6	1,807	15.8	2,464	24.7	1,997	10.7
C	2,997	32.7	2,370	20.7	2,997	28.8	2,176	11.6
D	353	3.9	1,551	13.6	362	3.5	1,709	9.1
E	195	2.1	173	1.5	963	9.3	1,281	6.8
Total	9,165	100.0	11,430	100.0	10,400	100.0	18,704	100.0

The improved EU offer had a paradoxical effect. On the one hand, the 385 new products in category A included a large number of products that feature significantly among Mercosur's exports to the EU. Thus category A products would account for 61.7% of exports to the EU, as against 48.4% in the original offer. On the other hand, the impact is virtually nil in terms of additional liberalization, since 375 of the 385 products already have tariff-free access to the EU.

Between the first and second offers there was a significant increase in both the number (from 195 to 963) and overall value (from 1.5% to 6.8%) of products in category E. Technically, those products are excluded from the timetable; they are listed, however, to indicate the EU's potential interest in discussing preferential access for them at a later stage.

The EU's offer, like Mercosur's, is also somewhat conservative. At the end of the agreement's fifth year, for example, tariffs would persist on 27.4% of value imported from Mercosur and 41.6% of the tariff lines would still be place. The latter number is the more significant, since it partly reflects the impact of trade barriers on trade flows.

Main "Knots" Related to the Tariff Offers

The issues presented in the table below are directly related to the way in which the liberalization offers are designed. The two sides were unable to overcome their differences on these issues during the first two years of negotiations, and began preparing their offers even before the parameters had been settled.

Table 5. *Brief comparison of positions on tariff-related issues*

Issues	Mercosur	European Union
Scope	All products will be subject to zero-rated tariffs.	Total elimination of tariffs for substantially all trade. Other goods will be subject to further negotiation.
Special and differential treatment	Longer terms and slower tariff elimination.	Reciprocity in the pace of tariff- reduction. The EU insists that Mercosur restructure its offer in line with the categories proposed by the EU.
Strict reciprocity	No reciprocity.	Strict reciprocity for textiles/clothing and footwear.
Infant industry	Prospect of raising tariffs on products whose production begins after the agreement enters into force.	Standstill and rollback. Base tariff should be the 1995 CET. Reductions introduced after the agreement will be considered base tariffs; tariff increases will not be considered.
Quotas*	Only during the transition period.	Applicable after the transition period on products not in categories A through D.
Sectoral commitments	Liberalization of all sectors in accordance with the timetable.	Accelerated tariff phase-out schedules for selected sectors.

* Although Mercosur's official position is to allow further quotas only during the transition period, some Mercosur countries believe that quotas could be permitted for a longer period.

In view of the offers' conservatism, the two blocs have substantial maneuvering room. Moreover, Europe's position on agricultural products will influence any blueprint for an agreement.

There is a need for hypotheses about the two sides' different positions on the methods of and approaches to tariff liberalization. Equally important is the need to improve the offers themselves. There is clearly scope for Mercosur to revise and improve its offer, given the EU's definition of agricultural products and agribusiness.

Other issues in the market access negotiations

In addition to tariff questions, other important matters feature on Working Group N° 1's market access agenda and significant differences persist, such as rules and certification of origin, the use of drawback, the introduction of a bilateral safeguard mechanism, and improving antidumping measures.

Table 6. *Comparison of Positions*

Issues	Mercosur	European Union
Rules of origin	Rules based on substantial transformation criterion, including change of tariff classification and/or aggregate value and/or specific requirements.	General goal is to adopt rules similar to those prevailing in previous agreements.
Drawback	Possibility of applying drawback even after the transition period.	Does not accept the use of drawback.
Safeguards	Adoption of bilateral safeguards applicable to the preferential agreement.	Recourse to the WTO's safeguards system.
Antidumping	Adoption of more precise rules than current WTO norms.	WTO rules.

Of the above issues, those on rules of origin and the safeguards system are the most complex and the most important for progress in the negotiations.

The next section sets out three possible scenarios for the Mercosur-EU negotiations, and examines the prospect that an agreement will be signed by October 2004.

Three Scenarios for the Mercosur-EU Talks

The outlook for the various main trade negotiations is unpromising, at least in the short term. In the WTO and FTAA negotiations, the main actors seem to be pursuing a "race to the bottom". The devel-

oped countries are trading off less ambition in areas where they used to be more demanding (investment, services and government procurement) in exchange for the prospect of preserving the main instruments of their protection policies (some tariff peaks, quotas and agricultural subsidies). In some developing countries, including the largest Mercosur members, governments join this race in an effort to retain some maneuvering room for the management of domestic “industrial policies”. Hence they are tempted to make fewer demands in the areas of market access and the elimination of subsidies, so as to avoid comprehensive obligations in liberalizing investment and government procurement.

The FTAA’s Miami Ministerial Meeting approved a new vision for the hemispheric negotiations, one geared to untying the main knots that were thwarting the process. The framework was reshaped in the interest of a two-level agreement. The first of these, the “baseline agreement”, will apply to all members. It will consist of a common set of rights and obligations applicable to all countries, and will include provisions in all the nine negotiating areas. At the second level, countries may choose to develop additional disciplines and to advance liberalization on a plurilateral basis. The Trade Negotiations Committee (TNC) is working to define a guide for this common set of rights and obligations in each negotiating area.

In view of the close links between the biregional and the Doha Round negotiations, and also between the biregional and the FTAA talks, there follow three scenarios based on possible combinations of progress in the multilateral and hemispheric arenas. Each bloc’s political commitment is given weight in the scenarios on reaching an agreement.

While the potential economic benefits of an agreement (higher exports, growth and income) are crucial, Mercosur also has several important political reasons for its commitment to the accord. A failure in the biregional talks, in the context of a lack of progress in the FTAA and WTO, would be highly negative for the Mercosur governments and economies. It would reveal the bloc’s inability to reach agreements with its most important trading partners. In the talks with the EU, moreover, Mercosur’s political attitude to the agreement is influenced by the degree of regional political support for the negotiations with the EU in comparison with the FTAA.

For the EU, an agreement with Mercosur has symbolic, political and economic significance, but most importantly it would signal the

EU's willingness to reform the common agricultural policy. An agreement with Mercosur would neutralize many of the criticisms facing the EU in this area, thus strengthening Europe's position in the Doha Round negotiations.

In this framework, the two extremes (the best- and worst-case scenarios) are disregarded. The best-case scenario for market access, which would entail the complete phasing out of tariffs, even if over more than 10 years, seems wholly unfeasible. Analysis of the worst-case scenario, wherein the biregional talks reach an impasse and the talks end, adds little to the debate on how to untie the knots in the negotiations.

Hence this chapter outlines scenarios that combine different outlooks for the WTO and FTAA negotiations with different degrees of political will on the part of both blocs towards the biregional talks. The "feasible scenario" matches realistic assumptions on developments in the other two negotiating processes with a good measure of political will and a pragmatic approach. The other two scenarios are deviations of this basic one. The optimistic scenario supposes that the Mercosur-EU initiative will be fostered by progress in the other two sets of talks. The pessimistic scenario considers how deadlock in the FTAA and the WTO could lead to a "minimalist" approach to the biregional negotiations. The three scenarios are described in Table 7 and in more detail in the sections below.

Scenario 1: Optimistic

The Doha Round acquires new impetus as the negotiating bodies in Geneva resume work, and there is the prospect of an extra Ministerial Meeting by mid-2004. A credible roadmap is announced, spurring renewed confidence in the success of the Round. There is a good chance that the negotiations will conclude by January 2005.

On the FTAA front, the reshaping of the framework, with new mandates for each of the negotiating areas, stimulates the talks. In the market access negotiating group, the negotiators bridge the gap between the Mercosur position of phasing out all tariffs and the US proposal to (i) negotiate all products, but not necessarily eliminate tariffs on all products; and (ii) define a small set of tariff lines for which countries could offer a substantial tariff preference rather than completely eliminate tariffs.

With the added stimulus of progress on the multilateral and hemispheric fronts, the European and Mercosur business communi-

Table 7. *Outline of the Three Scenarios*

Scenarios	Optimistic	Feasible	Pessimistic
WTO	The Round regains momentum. Negotiating frameworks are established by midyear at the latest. Bright prospects of concluding by January 2005.	The Round regains momentum. There is some progress on defining frameworks. In a high-level General Council meeting in July, members announce a new timeframe for the negotiations, postponing the deadline to the end of 2005.	The deadlocks in the Round are not overcome. No significant progress is made on establishing the frameworks by midyear. Talks continue in Geneva without new timeframes. There are growing uncertainties about the Round's future.
FTAA	A common set of rights and obligations is devised with new mandates for the Negotiating Groups for the "baseline agreement".	A common set of rights and obligations is devised for the "baseline agreement" with new mandates for the Negotiating Groups. But there is a lowering of the level of ambition.	Members are unable to devise the new mandates. There are some backward steps in the leading players' positions on the agreement reached at the Miami Ministerial Meeting. It becomes evident that it will not be possible to meet the December 2004 deadline.
Mercosur-EU	The EU significantly improves its market access offer on sensitive products. The main knots in other market access-related issues are untied. Mercosur reframes its offer in order to hasten the phasing out of tariffs and increase the number of products included in the offer. The agreement establishes a mechanism for the revision and improvement of the concessions to be implemented within two years.	Both sides agree on a two-step approach to the negotiations. In the first step they will sign an "interim agreement" and commit themselves to a new round of negotiations on market access immediately after the conclusion of the multilateral talks. Both blocs see this "interim agreement" as meaningful in terms of market access.	The EU presents a new offer for products listed in category E. For the most sensitive products, no preferential treatment is contemplated. For some other important groups of products a small quota is guaranteed for Mercosur. Mercosur responds with no significant movement. To avoid deadlock, the parties announce a minimalist agreement.

ties increase pressure on the authorities to implement the recommendations made in the May 2002 Madrid Declaration of the Mercosur-European Union Business Forum (MEBF). In that declaration, entrepreneurs from both blocs made specific recommenda-

tions that could help untie some of the most significant knots hampering progress in the negotiations.

In this scenario, the biregional negotiations would move forward and meet the October 2004 deadline. Some of the main differences between the two blocs' positions on the characteristics of the liberalization offers are overcome, following the exchange of improved offers in April 2004.

The EU submits a proposal for the liberalization of a large number of products currently included in category E (undefined liberalization), and Mercosur responds with a reform of its tariff liberalization schedule. Mercosur also reframes its offer to hasten the phased elimination of tariffs, reduce backloading, and increase the number of products included for tariff elimination. The EU accepts the principle of special and differential treatment for Mercosur members, with less than full reciprocity in the liberalization process. This encourages improved offers and helps the two sides find common ground on other market-access related issues, such as rules of origin, safeguards and antidumping.

The two blocs agree to negotiate an improvement of concessions within two years, so as to further accelerate the tariff phase-out schedule and include products initially subject to less than full liberalization. At the same time, the two sides assess the rules of origin regime and negotiate any changes deemed necessary.

Untying the Knots in Tariff-Related Issues

Some progress is made on untying the knots in tariff-related issues as the exchange of improved offers brings new impetus to the negotiations. Table 8 offers some suggestions on how to untie the knots identified in Table 5.

Improvement in Market Access Liberalization Offers

Improvement in the EU offer. The EU improves its offer by moving products from categories with longer liberalization periods (C and D) to categories A and B. For products currently listed in category E, three types of treatment are offered:

- i. a substantial number of products would be moved to categories C and D;
- ii. other products would not be subject to complete liberalization but would receive substantial preferential margins over the MFN tariff rates. These margins would increase during the transition period; and

Table 8. *How to Untie the Knots in Tariff-related Issues in Scenario 1*

Issues	Mercosur	European Union	Suggestions
Scope	All products will be subject to zero-rated tariffs.	Total elimination of tariffs for substantially all trade. Other goods will be subject to further negotiations.	For the substantial part of trade, products will be subject to zero-rated tariffs. For a small number of products, substantial preference margins on MFN rates are granted.
Special and differential treatment	Longer terms and slower tariff elimination.	Reciprocity in the pace of tariff reductions. The EU insists that Mercosur restructure its offer in line with the categories proposed by the EU.	Longer terms and slower tariff elimination are granted to Mercosur, taking as references the treatment offered by the EU to Mexico and South Africa in their bilateral agreements.
Strict reciprocity	No reciprocity.	Strict reciprocity for textiles/clothing and footwear.	No strict reciprocity. Mercosur would agree to consider reciprocity where possible.
Infant industry	Possibility of raising tariffs on products whose production begins after the agreement comes into force.	Standstill and rollback. Base tariff should be the 1995 CET. Reductions introduced after the agreement will be considered base tariffs; tariff increases will not be considered.	The parties agree to a new version of the infant industry clause that is more moderate than that previously proposed by Mercosur. The clause guarantees that for those products currently not produced in Mercosur and with very low tariffs, their tariff rates could be increased in the event of investment for their production in the region. The tariff increase would be limited to the level valid for similar products in the Mercosur liberalization schedule. The business sectors in both regions agreed to this formulation in the MEBF Madrid Declaration (M17).
Quotas	Only during the transition period.	Applicable after the transition period on products not in categories A through D.	Only during the transition period.
Sectoral commitments	Liberalization of all sectors in accordance with the timetable.	Accelerated tariff phase-out schedules for selected sectors.	Specific commitments only for the automotive industry.

- iii. for a very small number of products, tariff quotas would be created and remain valid during the transition period, which could be more than 10 years. The quotas would be eliminated after the transition period. The intra-quota tariff would be zero. The out-of-quota duties would be subject to preferential margins.

Improvement in the Mercosur offer. Mercosur improves its offer by reframing the tariff-reduction timetable. This initiative reduces the backloading currently present in the Mercosur offer.

The new offer would retain the five categories with across-the-board tariff reduction within each of them. The new categories could be: A – immediate; B – 5 years; C – 8 years; D – 10 years; E – 15 years. A new category F would be created to include products not subject to full liberalization, although Mercosur would offer an increasing margin of preference equal to 50% of the current tariff at the end of the transition period.

Should there be agreement on an infant industry clause, many of the products that are currently without offer or in category E are likely to move to categories A and B. The products listed in categories A to E would account for at least 85% of Mercosur's imports from Europe.

*Overcoming the Differences
in Other Issues Related to Market Access for Goods*

Among the issues listed in the table below, the rules of origin knot is the most important; a biregional agreement cannot be implemented until differences over this fundamental issue are overcome. Rules of origin, moreover, are extremely important: they not only affect trade but also influence investment decisions and the characteristics of production chains.

Mercosur is simultaneously negotiating two trade agreements that represent around 80% of its foreign trade. It is important that the bloc takes this opportunity to guarantee some convergence on rules of origin regimes, so that they are valid for both areas. The Mercosur business sector is shifting its position on rules of origin, demanding stricter and more specific rules.

The EU also prefers adopting similar rules of origin across its many trade agreements, and would favor adopting these systems in the EU-Mercosur accord. To untie this knot, it is important that the EU and Mercosur study proposals for specific requirements to settle this issue as soon as possible.

Table 9. *How to Untie the Knots in Other Issues Related to Market Access in Scenario 1*

Issues	Mercosur	European Union	Suggestions
Rules of origin	Rules based on substantial transformation criterion, including change of tariff classification and/or aggregate value and/or specific requirements.	General objective is the adoption of rules similar to those in its previous agreements.	Negotiation of specific requirements on a case-by-case basis, including accumulation of origin.
Drawback	Possibility of applying drawback even after the transition period.	Does not accept the use of drawback.	Possibility of applying drawback during the transition period.
Safeguards	Adoption of bilateral safeguards applicable to the preferential agreement.	Recourse to the WTO's safeguards system.	Adoption of bilateral safeguards applicable to the preferential agreement.
Antidumping	Adoption of more precise rules than those currently prevailing in the WTO.	WTO rules.	Agreement to cooperate in the WTO negotiations. Establish a consultation mechanism.

Scenario 2: Feasible

The major players at the WTO continue talks aimed at regaining momentum in the Doha Round. Members focus on agriculture and market access for goods and services. Although the negotiating bodies make some progress in defining a new framework for the most important negotiating areas, it becomes evident that it will be impossible to meet the agreed deadline. After a high-level meeting in the summer, the General Council announces a new timeframe for the negotiations, postponing the deadline to the end of 2005.

To establish a common set of rights and obligations for the FTAA "baseline agreement", members lower their ambitions in the most controversial areas. The negotiating groups receive new mandates. In the area of market access for goods, negotiators agree that for a small number of sensitive products a combination of tariff-quotas with lower extra-quota tariffs would be acceptable.

In the biregional negotiations the two sides agree to adopt a "two-step approach". To bypass the links between the Mercosur-EU and Doha negotiations on agriculture, the blocs decide to sign an

“interim agreement”, which includes an agenda for the second step. This agreement would commit negotiators to return to the table immediately after the conclusion of the multilateral talks.

In the first step, both blocs offer a comprehensive and substantial tariff liberalization program. Given the EU’s stance towards the “single pocket”, however, and Mercosur’s position on the full liberalization of bilateral goods trade, they decide that Mercosur will receive preferential margins on MFN tariff rates for some products and small tariff-quotas for the most sensitive EU products. In return, Mercosur would be allowed to leave a small group of industrial products in the TBA category. Negotiations would include those products that had been subject to less than full liberalization in the first stage.

Untying the Knots in Tariff-Related Issues

In this scenario, the key to untying the knots is the “two-step approach”. This allows each bloc to accommodate the other’s sensitivities in the short term, and to bypass the parallelism of the WTO and Mercosur-EU negotiations.

Improvement in Market Access Liberalization Offers

Improvement in the EU offer. The EU improves its offer by moving some products from categories with longer liberalization periods (C and D) to categories A and B. For products currently listed in category E, four types of treatment would be offered:

- i. some products would be moved to categories C and D;
- ii. other products would not be subject to complete liberalization but would receive substantial preferential margins over the MFN tariff rates. These margins would increase during the transition period;
- iii. some products would receive tariff-quotas, with intra-quota trade subject to duty-free treatment, although the quotas offered to Mercosur would not be very significant. Out-of-quota duties would be subject to some preferential margin on MFN rates; and
- iv. a very small number of products would receive no preferential treatment in this “interim agreement”.

Improvement in the Mercosur offer. Mercosur improves its offer on the basis of the current structure of the tariff liberalization timetable, re-classifying products into the extant categories. A new category F is created to accommodate sensitive products whose tariffs

Table 10. How to Untie the Knots in Tariff-related Issues in Scenario 2 –First Step

Issues	Mercosur	European Union	Suggestions
Scope	All products will be subject to zero-rated tariffs.	Total elimination of tariffs for substantially all trade. Other goods will be subject to further negotiations.	For the substantial part of trade, products will be subject to zero-rated tariffs. Some products will be subject to the reduction of tariff rates with substantial preference margins on MFN rates. Other products will be subject to tariff-rate quotas in the case of EU imports. Mercosur would be allowed to exclude some products from the liberalization program in the first step.
Special and differential treatment	Longer terms and slower tariff elimination.	Reciprocity in the pace of tariff reduction. The EU insists that Mercosur restructure its offer in line with the categories proposed by the EU.	Longer terms and slower tariff elimination are granted to Mercosur. The bloc improves its offer on the basis of the current structure of the liberalization timetable, reclassifying products into relevant categories.
Strict reciprocity	No reciprocity.	Strict reciprocity for textiles/clothing and footwear.	No strict reciprocity.
Infant industry	Possibility of raising tariffs on products whose production begins after the agreement enters into force.	Standstill and rollback. Base tariff should be the 1995 CET. Reductions introduced after the agreement will be considered base tariffs; tariff increases will not be considered.	The parties agree to a new version of the infant industry clause that is more moderate than that previously proposed by Mercosur. The clause guarantees that for those products currently not produced in Mercosur and that have very low tariffs, their tariff rates could be increased in the event of investment for their production in the region. The tariff increase would be limited to the level valid for similar products in the Mercosur liberalization schedule. The business sectors of the two blocs agreed to this formulation in the MEBF-Madrid Declaration (MI7).
Quotas	Only during the transition period.	Applicable after the transition period on products not in categories A through D.	The negotiations on the elimination of quotas after the transition period will be included in the agenda for the second step.
Sectoral commitments	Liberalization of all sectors in accordance with the timetable.	Accelerated tariff phase-out schedules for selected sectors.	Specific commitments only for the automotive industry.

would be dismantled in 15 years. A small number of products would receive no preferential treatment in this “interim agreement”.

*Overcoming the Differences
in Other Issues Related to Market Access for Goods*

Table 11. *How to Untie the Knots in Other Issues Related to Market Access in Scenario 2*

Issues	Mercosur	European Union	Suggestions
Rules of origin	Rules based on substantial transformation criterion, including change of tariff classification and/or aggregate value and/or specific requirements.	General objective is the adoption of rules similar to those in its previous agreements.	Negotiation of specific requirements on a case-by-case basis, including accumulation of origin.
Drawback	Possibility of applying drawback even after the transition period.	Does not accept the use of drawback.	Possibility of applying drawback during the transition period.
Safeguards	Adoption of bilateral safeguards applicable to the preferential agreement.	Recourse to the WTO's safeguards system.	Adoption of bilateral safeguards applicable to the preferential agreement.
Antidumping	Adoption of more precise rules than those currently prevailing in the WTO.	WTO rules.	Agreement to cooperate in the WTO negotiations. Establish a consultation mechanism.

Agenda for Second Step

The second step would begin immediately after the conclusion of the Doha Round. The agenda for the second step of market access for goods is likely to include an increase in the tariff-quotas granted by the EU, treatment of the out-of-quotas duties, the inclusion of products that were exceptions in phase one, and an improvement in the liberalization schedules. Negotiators could also consider eliminating quotas in the long run.

Finally, the second phase could see a revision of the agreed system for rules of origin.

Scenario 3: Pessimistic

The WTO's negotiating bodies resume their work and keep the Doha Round alive. There is no concrete progress in the following few months, however, and the process muddles through, awaiting

the next Ministerial Meeting at the end of 2004. Uncertainties about the Round's future increase, and there are no obvious or credible clues as to how the main obstacles will be overcome.

The FTAA Trade Negotiations Committee is unable to prepare a guide for the negotiating groups. Mercosur and the United States cannot overcome their differences on the scope of tariff liberalization. There are some backward steps in the major players' positions on the agreement reached at the Miami Ministerial Meeting. The Negotiating Groups resume their work with no clear orientation and are unable to surmount the main hurdles. The debates triggered by the US election campaign leave no room for the US government to compromise on the liberalization of some products of crucial export interest for the Mercosur countries. FTAA members agree to postpone the deadline for the conclusion of the negotiations.

Within Europe, the attention of the EU business sector is diverted away from the biregional negotiations towards EU enlargement. Without the pressure of the FTAA, European interest in the biregional talks wanes. In the subsequent rounds the EU proposes tariff-rate quotas for most of the products presently listed in category E. Mercosur's assessment of the EU offer remains negative and it fails to respond with significant changes to its own offer.

The two blocs agree to limited market access liberalization in order to avoid a complete failure in the negotiations. Mercosur accepts the TRQ regime proposed by the EU and uses the same mechanism to deal with its sensitivities in the industrial sector. The introduction of quotas for the liberalization of biregional trade is a step backwards in terms of Mercosur's current protection instruments. The two blocs nonetheless agree to resume trade talks within two years.

Untying the Knots in Tariff-Related Issues

Improvement in Market Access Liberalization Offers

Improvement in the EU offer. The EU improves its offer by moving some products from categories with longer liberalization periods (C and D) to categories A and B. For products currently listed in category E, four types of treatment would be offered:

- i. some products would be moved to categories C and D;
- ii. other products would receive preferential margins over the MFN tariff rates;

Table 12. *How to Unite the Knots in Tariff-related Issues in Scenario 3*

Issues	Mercosur	European Union	Suggestions
Scope	All products will be subject to zero-rated tariffs.	Total elimination of tariffs for substantially all trade. Other goods will be subject to further negotiations.	For the substantial part of trade, products will be subject to zero-rated tariffs. Some products will be subject to a reduction in tariff rates, with preferential margins on MFN rates. Some products will be subject to tariff-rate quotas (agricultural products in the case of EU and industrial products in the case of Mercosur). Some products remain on a list of exceptions.
Special and differential treatment	Longer terms and slower tariff elimination.	Reciprocity in the pace of tariff reductions. The EU insists that Mercosur restructure its offer in line with the categories proposed by the EU.	Longer terms and slower tariff elimination are granted to Mercosur. The bloc slightly improves its offer on the basis of the current structure of the liberalization timetable, reclassifying products into relevant categories. Mercosur creates tariff-quotas for industrial products.
Strict reciprocity	No reciprocity.	Strict reciprocity for textiles/clothing and footwear.	No strict reciprocity.
Infant industry	Possibility of raising tariffs on products whose production begins after the agreement enters into force.	Standstill and rollback. Base tariff should be the 1995 CET. Reductions introduced after the agreement will be considered base tariffs; tariff increases will not be considered.	The parties do not agree on a clause for infant industries.
Quotas	Only during the transition period.	Applicable after the transition period on products not in categories A through D.	Applicable after the transition period.
Sectoral commitments	Liberalization of all sectors in accordance with the timetable.	Accelerated tariff phase-out schedules for selected sectors.	Specific commitments only for the automotive industry.

- iii. some products would receive tariff-quotas, with intra-quota trade subject to margin of preferences on MFN tariff rates, although the quotas offered to Mercosur are not very significant. Out-of-quota duties would not be reduced; and
- iv. a small number of products would receive no preferential treatment.

Improvement in the Mercosur Offer. Mercosur slightly improves its offer on the basis of the current structure of the tariff liberalization timetable, re-classifying products into the extant categories. A new category F is created to accommodate products for which tariff-quotas would be created. A small number of products would receive no preferential treatment.

*Overcoming the Differences
in Other Issues Related to Market Access for Goods*

Table 13. *How to Untie the Knots in Other Issues Related to Market Access in Scenario 3*

Issues	Mercosur	European Union	Suggestions
Rules of origin	Rules based on substantial transformation criterion, including change of tariff classification and/or aggregate value and/or specific requirements.	General objective is the adoption of rules similar to those in its previous agreements.	Negotiation of specific requirements on a case-by-case basis.
Drawback	Possibility of applying drawback even after the transition period.	Does not accept the use of drawback.	Possibility of applying drawback during the transition period.
Safeguards	Adoption of bilateral safeguards applicable to the preferential agreement.	Recourse to the WTO's safeguards system.	Adoption of bilateral safeguards applicable to the preferential agreement.
Antidumping	Adoption of more precise rules than those currently prevailing in the WTO.	WTO rules.	Agreement to cooperate in WTO negotiations. Establish a consultation mechanism.

Built-in Agenda

As the uncertainties about the future of the Doha Round increase in this scenario, the blocs agree to negotiate improved market access for goods if the Round fails.

The Consolidation of Mercosur

At the outset of the talks, both blocs expected the biregional negotiations to be between two customs unions. The fact that this expectation was unmet has been a major challenge to the negotiators. The lack of progress (and even some recent setbacks) in the consolidation of Mercosur's free trade area and the full implementation of the customs union are evident; the impact on the Mercosur-EU negotiations is significant, especially for goods trade.

Several difficulties stem from the incomplete nature of Mercosur's customs union, including non-harmonized intraregional customs clearance procedures, double incidence of and exceptions to the common external tariff, and differing rules of origin regimes. EU negotiators and entrepreneurs are increasingly aware that the smooth implementation of the biregional agreement demands that these significant obstacles be overcome sooner rather than later.

It is important to recognize, however, that if the current deadlines are to be met, Mercosur countries will not have a chance to address and resolve the intra-bloc agenda before the biregional agreement is phased in. Furthermore, their commitment to signing an association agreement with the EU is not enough to induce a change in their attitudes towards some of the most basic issues of the Mercosur integration project.

As the negotiations enter their final stage, therefore, it is important to take more pragmatic approaches to the consolidation of Mercosur. One alternative could be that the two blocs agree on a list of priority measures to facilitate trade and complete the customs union, and specify targets that can be met within a reasonable period. They could also consider adopting a notification mechanism for specific obstacles faced by EU companies in their operations and activities within Mercosur.

Sandra RIOS
Mahrukh DOCTOR

Contributors, Seminar Program
and Participants

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Marcos SAWAYA JANK is Associate Professor of International Economics and Trade Policy at the Faculty of Economics and Business of the University of São Paulo (USP) and President of the Brazilian Institute for International Trade Negotiations (ICONE). In 2001/02, he has served as Special Expert in Integration and Trade at the Integration, Trade and Hemispheric Issues Division of the Inter-American Development Bank (IDB) in Washington (DC). A former Special Counsellor to the Brazilian Minister of Development, Industry, and Trade in 1999 (then Mr. Celso Lafer), he is also a member of the Academic Council of the Brazilian Center for International Relations (CEBRI), the USP International Conjuncture Analysis Group, the OAS NetAmericas Research Network on Trade and of the Working Group on European Union-Mercosur Negotiations at Sciences Po, Paris. Dr. Jank was also a visiting researcher at Georgetown University (School of Foreign Service) and University of Missouri-Columbia. He is author or co-author of over 150 publications and has conducted 270 presentations throughout Brazil and around the world on subjects such as multilateral and regional agricultural trade negotiations, comparative agricultural policies, international markets of agribusiness products, and globalisation and agri-food competitiveness. He holds a B.Sc. degree in agronomy from USP, a M.Sc. in Agricultural Policies (Montpellier, France), and a Ph.D. from the School of Economics and Business at USP.

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Celina PENA is an economist holding a degree from the Universidad de Buenos Aires and a Master in Economics from the Instituto Torcuato Di Tella de Buenos Aires. She is consultant for the United Nations programs in issues related to international trade and negotiations. She is consultant at the Ministry of Foreign Affairs of Argentina since 1992. She has been appointed by the Argentinean government as one of the Experts of the Protocolo de Olivos for the Mercosur's dispute settlement mechanism. She is also professor at the Centro de Estudios en Relaciones Internacionales of the Rosario University and she taught at the Universidad Católica Argentina and at the Universidad de Buenos Aires.

Félix PEÑA is a specialist in international economic relations, economic integration and foreign trade. He has a Law degree from the *Universidad del Litoral* Law School in Santa Fe (1962), a Doctor degree in Law from the *Universidad de Madrid* (1962-65) and a European Law degree from the *Catholic University of Louvain*, Belgium (1965), where he also studied economics. He is currently the director of the *Institute of International Trade- Bank Boston Foundation* and professor at *Universidad Nacional de Tres de Febrero* and Director of the Master in International Trade Relations. He was Under- Secretary of Foreign Trade at the *Ministry of Economy* of Argentina(1998-99), responsible for Mercosur affairs. He was previously Under-Secretary of Economic Integration at the

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Sandra Polónia RIOS is a partner in Ecostrat Consultants and her areas of expertise include trade negotiations (Mercosur, FTAA, WTO, etc.) and trade policy. She acts as a permanent consultant for the National Confederation of Industry –Brazil– and is in charge of the technical coordination of the Brazilian Business Coalition. She integrates the WTO Indicative List of Panelists, approved by the Dispute Settlement Body of the Organization. She is also coordinator of the market access group of the Mercosur-European Business Forum (MEBF), is member of the Superior Council of FUNCEX –Fundação Centro de Estudos de Comércio Exterior– and teaches at Fundação Dom Cabral and at Pontifícia Universidade do Rio de Janeiro (PUC-RJ). She was coordinator of the International Integration Unit of the National Confederation of Industry –Brazil and acted as coordinator of the International Business Centers Network– Brazil. She was a researcher at Instituto de Pesquisa Econômica e Aplicada (IPEA). She taught Microeconomics and International Economics at PUC-RJ and at the MBA in Trade at IBMEC. She is currently teaching Trade Policy at PUC-RJ. She is an economist with a Master degree by PUC-RJ.

Pierre SAUVÉ is Visiting Professor at the Institut d'Etudes Politiques (Sciences-Po) in Paris, France, where his teaching and research activities focus on a range of “newer generation” trade issues at the interface of trade, investment, competition and regulatory reform. Since January 2003, he has also served as a Paris-based consultant with the World Bank Institute, working on a range of trade-related capacity-building projects in Indonesia and Vietnam, authoring a WBI course on regionalism and trade in services, and contributing chapters on investment and labour mobility to the 2003 and 2004 editions of the Bank's flagship Global Economic Prospects publication. He is also currently working, in association with the Canadian government and the APEC Secretariat, a project aimed at developing tools to measure best practices in trade-related capacity-building and to promote their adoption. In his various activities, Mr. Sauvé has developed extensive contacts and worked closely with many of the leading international organisations, donor

agencies, universities, think tanks and civil society organisations concerned with development issues in Europe, the Americas and Asia.

Alfredo G. A. VALLADÃO is Professor in charge of the Mercosur Chair at the *Institut d'Etudes Politiques*, Paris. Coordinator of the *Working Group on EU-Mercosur Negotiations*. Senior Research Fellow at the *Instituto de Estudos Estratégicos e Internacionais*, Lisbon. Member of the Editing Board of the review *Questions stratégiques* (La Documentation française, Paris). Journalist, specialized in international politics, editorialist for *Radio France International*, he also contributes regularly to the *BBC*. He has been correspondent on diplomatic and defense affairs for the daily *Libération* from 1980 to 1993. Founder and member, from 1980 to 2000, of the Editing Board of the economic and geopolitical yearbook *L'État du Monde*. Documentary films author for French television. Recent publications include : *The 21st Century will be American*, Verso, 1995 ; *Le retour du panaméricanisme: La stratégie des États-Unis en Amérique latine après la guerre froide*, CREST, École polytechnique de Paris, 1995 ; *Le triangle atlantique. L'émergence de l'Amérique latine dans les relations Europe-États-Unis*, Les notes de L'IFRI -n° 16, Paris 1999 ; *Towards an Agreement between Europe and Mercosur* (with P. Giordano and M.F. Durand, dir.), Chaire Mercosur Sciences Po, Paris 2002, *Agriculture and Agribusiness in the EU-Mercosur Negotiations* (with Sheila Page ed.), Chaire Mercosur Sciences Po, Paris 2003 ; *The Costs of Opting Out : The EU-Mercosur Agreement and the Free Trade Area of the Americas* (ed.), Chaire Mercosur Sciences Po, Paris 2003 ; *Market Access for Goods and Services in the EU-Mercosur Negotiations* (with Roberto Bouzas ed.), Chaire Mercosur Sciences Po, Paris 2003 ; *Political Issues in the EU-Mercosur Negotiations* (with Pedro da Motta Veiga ed.), Chaire Mercosur Sciences Po, Paris 2003.



Chaire Mercosur

Mercosur Chair of Sciences Po
Working Group on EU-Mercosur Negotiations (WG)

First Cluster Workshop
Fast-tracking a « feasible » EU-Mercosur Agreement

with the support of
Inter-American Development Bank
and
the Government of Catalonia
and the **University of Barcelona (UB)**

March 29, 2004
9:00 am to 7:00 pm
Faculty of Law of the University of Barcelona (Room 13)
Av. Diagonal, 684
08034 Barcelona

Monday, March 29th

9:00 – 9:15 am
Opening Session

Alfredo Valladão – WG Coordinator – Professor - *Mercosur Chair of Sciences Po* – France
Ramón Torrent – Director – *Observatori de la Globalització* – University of Barcelona – Spain

9:15 – 10:40 am
Scenarios for untying the Agriculture knot

Moderator : Alfredo Valladão – WG Coordinator – Professor - *Mercosur Chair of Sciences Po* – France
Speakers : Marcos Jank – Professor – *USP* and President – *ICONE* – Brazil
Jean-Yves Carfantan – Economist – *Fédération des Ecoles Supérieures d'Ingénieurs en Agriculture (FESIA)* -
France
Commentary : Félix Peña – Director – *NIEI-Universidad Tres de Febrero (UNTREF)* – Argentina
Patrick Messerlin – Director – *GEM-Sciences Po* – France

10:40 – 11:00 am
Coffee Break

11:00 am – 12.20 pm
Scenarios for untying the Investments and Services knot

Moderator : Ramón Torrent – Director – *Observatori de la Globalització* – University of Barcelona – Spain
Speakers : Celina Pena – Consultant – *Ministerio de Relaciones Exteriores, Comercio Internacional y Culto* - Argentina
Pierre Sauvé – Visiting Professor – *GEM-Sciences Po* – France
Commentary : Félix Peña – Director – *NIEI-Universidad Tres de Febrero (UNTREF)* – Argentina
Patrick Messerlin – Director – *GEM-Sciences Po* – France

1:00 pm
Lunch at the Restaurant Julivert meu, C/ Jordi Girona 12, 08034 Barcelona

2:30 – 4:00 pm
Scenarios for untying the Market Access for Goods knot

Moderator : Ramón Torrent – Director – *Observatori de la Globalizació* – University of Barcelona – Spain

Speakers : Sandra Rios – Consultant – *Ecostrat* – Brazil
Mahrukh Doctor – Lecturer – *University of Reading* – United Kingdom

Commentary : Félix Peña – Director – *NIEI-Universidad Tres de Febrero (UNTREF)* – Argentina
Patrick Messerlin – Director – *GEM-Sciences Po* – France

4:00 – 4:30 pm
Coffee Break

4:30 – 6:00 pm
Scenarios for a feasible, comprehensive Agreement and a built-in agenda
Conclusions and Policy Recommendations

Moderator : Alfredo Valladão – WG Coordinator – Professor - *Mercosur Chair of Sciences Po* – France

Speakers : Félix Peña – Director – *NIEI-Universidad Tres de Febrero (UNTREF)* – Argentina
Patrick Messerlin – Director – *GEM-Sciences Po* – France

Commentary : Gustavo Martin Prada – DG Relex – European Commission
José Alfredo Graça Lima – Brazilian Ambassador to the EU

6:15 pm
Cocktail offered by the Dean of the Faculty of Law
(Professors Room, Faculty of Law)

Admission is restricted to registered participants only. Registration forms must be sent to : pilar.calvo@sciences-po.fr

The Working Group on EU-Mercosur Negotiations acknowledges the financial support of :
The Inter American Development Bank, the National Bank for Economic and Social Development of Brazil, the French
Ministry of Foreign Relations and the Brazilian Ministry of External Relations



Mercosur Chair of Sciences Po
Working Group on EU-Mercosur Negotiations (WG)

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March 29, 2004

9:00am to 7:00pm

Main building of the University of Barcelona (*Sala de Juntas del Rectorado*)
Plaza de la Universidad s/n
08011 Barcelona

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