

Europe and the Americas: Toward a TAFTA-South?

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Five years ago, European officials proposed the negotiation of a transatlantic free trade area (TAFTA) linking the United States and the European Union in the world's largest free trade zone. Flush from their successful conclusion of extensive multilateral trade reforms in the Uruguay Round, it seemed logical that the two leaders of the world trading system could work together to resolve their remaining trade problems and in the process set powerful precedents for the rest of the world to follow. In so doing, they would accelerate progress toward the ultimate goal of "global free trade".

Transatlantic free trade seemed such an easy task. Bilateral trade and investment was already large and largely unfettered (except in agriculture) and the proposals garnered support from both business and labor organizations. After the acrimonious debate over the ratification of the North American Free Trade Agreement (NAFTA), proponents felt that the TAFTA would not raise the same concerns about social and environmental dumping that nearly killed the North American pact. However, the initial fervor for such talks soon dissipated when it became clear that sharp differences in US and European regulatory policies, as well as agricultural support measures, made the negotiating task exceedingly difficult. Moreover, officials failed to assess the potential damage to the nascent World Trade Organization (WTO) that could result if the world's most powerful trading nations struck a deal that discriminated against suppliers from the world's developing countries. The grand vision of TAFTA was shelved and replaced by

pragmatic and narrowly focused work on regulatory barriers and other “nuts and bolts” trade problems.

Even without a TAFTA, US-EU trade relations have grown significantly: bilateral merchandise trade totaled about \$400 billion in 2000 and cross-border direct investment in each other’s market exceeds \$1 trillion (on a historical cost basis). To be sure, major disputes continue to fester over bananas, beef hormones, aircraft and grain subsidies, genetically modified seeds and foods, and US subsidies provided under the Foreign Sales Corporation program. These problems demonstrate that TAFTA is more a vision than imminent reality for trade between Europe and North America.

Over the past few years, however, the European Union also has been quietly pursuing another TAFTA. New trade initiatives with its trading partners in Latin America and the Caribbean Basin presage the development of a free trade zone, or “TAFTA-South”, over the next decade. A comprehensive free trade agreement (FTA) is already in force with Mexico and negotiations initiated with the Mercosur countries (Argentina, Brazil, Paraguay, and Uruguay) and with Chile. In addition, the recently minted “Partnership Agreement” (discussed later) between the European Union and its developing-country partners in Africa, the Caribbean, and the Pacific seeks to establish a more reciprocal relationship than existed under the previous Lomé accords that eventually transforms into a FTA. Unlike its previous free trade ventures in the postwar period, these European initiatives involve countries outside of the regional neighborhood and seek reciprocal rather than preferential trade deals.

To be sure, the European Union itself has not proposed a broad free trade pact with Latin America similar to the “Free Trade Area of the Americas” under negotiation

between the United States and 33 other countries in the Western Hemisphere (see Schott and Hufbauer 1999). Given the diversity in size and level of economic development of Europe's trading partners in Latin America and the Caribbean Basin, a TAFTA-South agreement would be a daunting task. In some respects, it is comparable to, though much less well defined than, the pursuit of an FTAA among Western Hemisphere countries. Indeed, like the United States, the European Union has started the process by taking small steps with individual countries and regional groups; unlike the United States, it has not yet integrated those initiatives into a single negotiation that over time could create a super-regional free trade zone.

This paper examines Europe's trade and investment ties with Latin America and the Caribbean and prospects for the evolution of a TAFTA-South accord. We first summarize the progress to date in the various bilateral and regional trade initiatives. We then analyze bilateral trade and investment flows to determine each side's interests and objectives in pursuing free trade talks. We conclude with comments on the implications of European-Latin American trade arrangements for US-EU relations and for the FTAA negotiations.

Europe's Building Blocks for a TAFTA-South?

Commercial relations between Europe and Latin America date back more than 500 years to a time when trade was unbalanced and unsavory, involving slaves, silver, and spices. The era of colonial exploitation is long past; today, European relations with the Americas are based on shared democratic values and economic partnership.

Responding to the dramatic economic and political reforms adopted throughout Latin America over the past decade, Europe has undertaken numerous bilateral trade initiatives to deepen traditional ties and to facilitate European participation in Latin America's economic revival. To a surprising extent, the EU initiatives mirror US commercial policy toward the region since the mid-1980s, albeit with a lag of several years. The US strategy proceeded in incremental stages. First, the United States granted unilateral trade preferences to the smaller countries in the region, under the Caribbean Basin Initiative and the Andean Trade Preferences Act, and negotiated "framework" agreements to establish forums for bilateral consultations and future reciprocal trade talks. Second, the United States proposed integrating these bilateral and regional arrangements under the umbrella of a broader hemispheric trade pact (initially the Enterprise for the Americas Initiative and then the FTAA).

The European Union has followed the first part of this script by providing trade preferences for developing countries under the Lomé conventions and negotiating framework agreements with either individual countries or regional groups. To date, however, it has not formulated a hemisphere-wide trade initiative like the FTAA. Rather its free trade strategy is more diversified and is proceeding at different speeds in various regions of the Americas. The European Union already has concluded an FTA with Mexico, but free trade talks with Mercosur and Chile are advancing at a snail's pace.¹ Discussions on a reciprocal trade agreement with the Caribbean countries are expected to begin within a few years, while such initiatives with the Andean Community and the Central American countries are only in the planning stage. In short, the European Union

is in the process of assembling the building blocks for a TAFTA-South but is a long way from putting such an initiative into effect.

The following subsections summarize progress to date in talks between the European Union and each country or region.

EU-Mexico FTA. Europe's first FTA in the Americas was concluded with Mexico in late 1999 and entered into force on July 1, 2000. The agreement culminated a decade of Mexican overtures to the European Union that included efforts by President Carlos Salinas in 1989 to lure European capital to aid Mexican development and by President Ernesto Zedillo to dilute somewhat his country's strong dependence on the US market.² European and Mexican interests finally converged with the signing of the Agreement for Economic Partnership, Political Coordination and Cooperation in Mexico on 8 December 1997. That broad agreement established a framework for promoting bilateral trade and investment, and set the stage for the start of formal negotiations of the European Union-Mexican Free Trade Accord in 1998.

Like the NAFTA, the EU-Mexican trade accord is comprehensive.³ The pact covers not only trade in industrial goods, agriculture and services, but also rights and obligations on investment, intellectual property rights, competition policy, and government procurement, as well as dispute settlement procedures. Under the agreement, the European Union immediately provided duty-free access to 82 percent of Mexican

¹ Negotiations thus far have focused on non-tariff issues such as intellectual property and public procurement with talks on tariff issues postponed until July 2001. Internal EU disagreements, especially over sensitive agricultural issues, have hampered progress.

² Ironically, the European rebuff of Salinas in 1989 led to Mexico's dramatic decision to request a FTA with the United States in early 1990. In turn, the trade preferences granted to Mexico in the ensuing NAFTA negotiations prompted renewed European interest in free trade talks with Mexico to offset the discrimination European traders faced in the North American market.

manufacturing exports. Tariffs on the remaining 18 percent will be progressively lowered and eliminated by January 1, 2003. In return, Mexico agreed to eliminate its customs duties (from currently applied rates) under a slightly longer transition period. As of July 2000, tariffs on 47 percent of EU industrial exports to Mexico were eliminated; by 2003 an additional 5 percent will receive duty-free access to the Mexican market; and tariffs on the remaining products will be phased out incrementally between 2005 and 2007. While Mexico is afforded a longer period to phase out bilateral tariffs, it agreed to establish by January 2003 a maximum tariff level of 5 percent for European imports.

Special provisions were included to cover the transition to free trade in the auto sector. Mexican auto tariffs were reduced immediately from 20 to 3.3 percent, and will be phased out completely by January 2003 (the same time that Mexican auto exports to Europe become duty-free). Mexican auto parts tariffs will fall to 4 percent by January 2005 and disappear two years later. These tariff preferences will also be accorded to European producers that have not established in the Mexican market unless imports from those firms exceed 15 percent of the domestic market.⁴ This quantitative restriction will be eliminated by January 2007.

Unlike the US-Mexico FTA, the EU-Mexico accord does not provide for free trade in agriculture. Overall, only 62 percent of bilateral trade in agricultural products will be fully liberalized under the trade accord. Major products such as sugar, dairy, beef and grains have been excluded. However, the European Union secured access to the Mexican market for a number of its key exports such as wine, spirits, and olive oil. In exchange, the agreement includes partial liberalization for certain products of interest to

³ For the EU Commission summary of the pact, see *Inside US Trade*, 21 January 2000, 17-19.

Mexico such as concentrated orange juice, avocados, and cut flowers. The agreement also includes rights and obligations on sanitary and phytosanitary measures and establishes a special committee to address remaining farm trade problems.

With regard to services, the agreement specifies that within ten years the two parties will progressively liberalize bilateral trade in all service sectors with the exception of audio-visual, air transport and maritime services. In the interim, EU service providers will be accorded at least equivalent access to the Mexican market as that provided to those from other countries with which Mexico has preferential trade arrangements (including its NAFTA partners). Liberalization of investment is to start in three years whereas progressive liberalization of payments related to investments begins immediately. The accord also provides the European Union with access to Mexican procurement market that is practically equivalent to that of Mexico's NAFTA partners.

EU Talks with Mercosur and Chile. European initiatives in the southern cone of Latin America began in the early 1990s and resulted in two similar accords: the December 1995 framework cooperation agreement with Mercosur (covering trade and political and development cooperation) and the June 1996 agreement on economic association, political dialogue and cooperation with Chile. Like the EU-Mexico framework accord, these agreements subsequently laid the foundation for more formal bilateral trade negotiations.

At the Rio Summit of heads of state from Latin America, the Caribbean, and the European Union in June 1999, leaders of the European Union, Mercosur, and Chile

⁴ This quota is currently non-binding since imports from EU producers account for only 2 percent of the Mexican market.

agreed to launch negotiations in November 1999 to promote the gradual and reciprocal liberalization of trade. Interestingly, their commitment omitted any concrete reference to the aim of establishing a free trade area. Although the leaders did not exclude any sector from the prospective talks, concerns about liberalization of agriculture and some service sectors were reflected in this less ambitious approach. Disagreements between EU member countries, in particular over sensitive agricultural issues, led to EU demands that initial talks should only cover industrial nontariff barriers, and that negotiations on tariffs, other market access issues, services, and agriculture would be put off until July 2001. Anticipating the closer integration of Chile in the Mercosur, the leaders also agreed that the results of both the Mercosur-European Union and the Chile-European Union negotiations should constitute a single undertaking to be implemented as an indivisible whole by the parties.

Through December 2000, the European Union has held three sets of negotiating sessions with their Mercosur and Chilean partners under the structure of the Biregional Negotiating Committee (BNC) established at the foreign ministers' meeting in Brussels in November 1999.⁵ At the first meeting of the BNC in Buenos Aires (and Santiago) in April 2000, negotiators established three technical working groups covering:

- trade in goods, including inter alia rules of origin, customs procedures, import licenses, and sanitary and phytosanitary regulations;
- trade in services, investment, and intellectual property rights; and
- competition policy issues (including antidumping), government procurement, and dispute settlement.

⁵ For a more detailed assessment of this process, see INTAL (2000).

The second round of negotiations in Brussels in June 2000 involved technical discussions regarding the exchange of information and the identification of nontariff barriers that would be covered in future negotiations. At the third round of negotiations of the BNC in November 2000, negotiators decided to start the process of drafting negotiating texts addressing the various trade areas.

EU-Caribbean Initiatives. Relations between the European Union and the African, Caribbean and Pacific (ACP) group have been governed by successive Lomé Conventions since 1975. Under those arrangements, almost all goods could enter the EU market free of duties or quotas. However, restrictions were maintained on certain agricultural products in which the Caribbean countries are competitive (for example, sugar, bananas, rum, and rice).

The fourth Lomé Convention expired in February 2000. To take its place, the European Union and the ACP States concluded negotiations on 3 February 2000 a new “Partnership Agreement”, which encompasses political relations between these two groups, development cooperation strategies, financial cooperation, as well as trade relations. The new pact seeks over time to promote a more reciprocal trade relationship culminating in a free trade agreement. It provides for a preparatory period of 8 years during which the European Union will continue to grant to products originating in the ACP countries non-reciprocal preferential treatment similar to that accorded under the Fourth Lomé Convention.

Negotiations on new trade arrangements aimed at progressive and reciprocal removal of trade barriers are set to begin in September 2002 and the new arrangements

shall enter into force by 1 January 2008. The preparatory period will be used to enhance competitiveness of the ACP countries, to strengthen regional organizations and regional trade integration initiatives. The parties agreed to a comprehensive review of the progress of negotiations and arrangements in 2006 to ensure that no further time is needed for preparation or negotiation. In 2004, the European Union will examine the possibility of alternative trade arrangements with those countries that decide that they are not in a position to enter into a partnership agreement with the European Union.

Andean Community and Central America. In late 1990, the European Union provided preferential access for exports from the Andean Community to help assist in the war against drugs in the region. Most industrial and a number of agricultural products enter the European market duty free. The European Union intends to extend these preferences to the Andean region to the year 2004. To prepare for possible negotiation of a Partnership Agreement, Foreign Ministers of the Andean Community and the European Union agreed to commission a study of the current state and prospect for economic and trade relations between the two regions at a meeting in Vilamoura, Portugal, on 24 February 2000.

Since 1984 the San Jose Dialogue has governed political and economic cooperation between the European Union and Central America. Within the framework of this cooperation, the European Union grants the Central American countries preferential access to its market for agricultural and, since 1 January 1999 for industrial products, under its Generalised System of Preferences. At the most recent ministerial conference of the San Jose Dialogue in February 2000, Central American ministers expressed their

desire to see the system of preferences continue for “a considerably longer period” while a new model for future economic relations based on reciprocal trade benefits is being discussed.⁶ Ongoing discussions on strengthening trade and investment relations are taking place within the European-Central American Trade Forum, which has met twice to date through December 2000.

Trade and Investment Flows

At first glance, the volume of European trade with the TAFTA-South region does not seem to warrant a flurry of negotiating activity. Two-way merchandise trade amounted to less than \$100 billion in 1999, or about 5.5 percent of total extra-EU trade (i.e., omitting trade among EU member states). Almost half of that trade was between the European Union and the Mercosur countries. By comparison, EU trade with North America totaled \$400 billion or about one-quarter of the EU trade with third countries (see table 1).

Like the United States, however, the European Union sees the TAFTA-South region as a growing and increasingly important export market. EU exports to the TAFTA-South region were \$50 billion in 1999, down from a peak of \$57 billion the previous year. EU exports to the region more than doubled over the past decade despite the sharp fall in shipments in 1999 due to repercussions throughout Latin America from the Brazilian financial crisis (see table 2). Export growth was particularly strong in the Mercosur market, with EU exports expanding threefold over the decade (though growth has been stagnant since 1995).

⁶ XVIth Ministerial Conference of the San Jose Dialogue Joint Communique, Vilamouira, 22 February 2000.

The European Union has run a trade surplus with the TAFTA-South region since 1993, in large measure due to very modest growth in EU imports from Latin America. TAFTA-South exports to the European Union increased by only 22 percent during the 1990s and growth has been virtually stagnant since 1995. In part, low commodity prices and high EU barriers to Latin American agricultural exports have dampened sales for primary products (SITC 0, 1, 2, and 4) that account for more than half of TAFTA-South shipments to Europe (see table 3). In part, this weak record reflects overvalued currencies that have hampered Latin American exports of manufactured goods.

While bilateral trade between Europe and the TAFTA-South region is not substantial for the European Union, it does matter a lot for some countries in Latin America, particularly in the southern cone (see table 4). For Chile and the Mercosur countries, EU trade represents more than one-quarter of their total trade (compared to a US trade share of about 20 percent). But for much of the northern half of South America, as well as the Caribbean Basin, trade with the European Union represents a relatively small share (between 10 and 15 percent) of total merchandise trade. For Mexico, the EU trade is even smaller; the NAFTA region is and will remain the centerpiece of its economic relations. For most countries in the TAFTA-South region, the United States remains the most important trading partner.

So why are countries in Latin America and the Caribbean Basin so intent on new trade talks with the European Union? In brief, three reasons underpin their interest in expanding their commercial partnership with Europe.

First, Latin American and Caribbean Basin countries want to deepen longstanding cultural and political ties with Europe. Free trade pacts usually serve both political and

economic objectives; in many instances, the political goals far outweigh the commercial interests at stake.⁷ The two regions have had a rich history of political, cultural, and commercial ties, and hope that new trade initiatives will form part of a broader partnership between their democratic societies.

Second, TAFTA-South countries want to increase their exports to the European market. FTAs offer an opportunity to reduce EU trade barriers, even though the EU-Mexico accord suggests that the scope of farm trade reform would be less than satisfactory for the region's competitive grain, sugar, and citrus producers. Nonetheless, half a loaf of farm trade reform in a FTA, on a preferential basis, would still be nourishing.

Third, and perhaps most important, the TAFTA-South countries want new accords with the European Union to help attract foreign direct investment (FDI) in their economies. To be sure, trade pacts may encourage such inflows only if they are part of a broader set of policy reforms, both macroeconomic and microeconomic, that spur economic growth and create attractive investment opportunities. But after a decade or more of reform, most countries in the TAFTA-South region have substantially restructured their economies, strengthened their financial sectors, and privatized or deregulated their telecommunications and transportation networks.⁸ FTAs with the European Union, as well as the FTAA with the United States, would provide valuable insurance against the reversal of those policies, and thus added incentives for domestic and foreign investors to locate in their markets.

⁷ For example, US and EU FTAs with Israel had more to do with Mid-East politics than bilateral trade. Similarly, the US-Jordan FTA signed in October 2000 was designed to promote Jordan's ability to support the peace process in the region.

This strategy is already working. The TAFTA-South region has benefited from a sharp increase in EU direct investment over the past few years. Annual FDI inflows to the region from EU member states rose ten-fold from 1993 to a total of \$32.4 billion in 1998 (see table 5). These inflows have preceded and anticipated the conclusion of the new trade arrangements with the European Union, mirroring the Mexican experience prior to the completion of the NAFTA negotiations.

As of the end of 1998, the stock of EU FDI in the TAFTA-South region, on a historical cost basis, amounted to almost \$130 billion (not including reinvested earnings). Almost half of the total was placed in the Mercosur market. Much of that investment occurred since 1996 and has been tied to privatization of state-owned enterprises and mergers and acquisitions in the deregulated financial, telecommunications, and power generation sectors. In 1997-1998, FDI in the southern cone countries accounted for 62 percent of EU FDI in the TAFTA-South region. Spanish firms played a particularly active role in placing funds in this region.

The sharp increase in EU investment contributed in large measure to the tripling of overall FDI inflows into the TAFTA-South region from \$30 billion in 1994 to \$90 billion in 1999 (see table 6). During that period, the EU share of regional FDI inflows more than doubled to 44 percent in 1998.⁹ In contrast, investments by US firms were fairly constant over this period, with annual FDI in the region averaging about \$18 billion annually. As a result, the US share of FDI inflows into the TAFTA-South region fell from nearly 60 percent in 1994 to 21.5 percent in 1999.

⁸ Foreign capital already has helped revive ailing banking sectors in Argentina and Venezuela, connect electric power grids and gas pipelines in the Southern Cone, and modernize telecommunications services inter alia in Mexico, Brazil, Venezuela, and Argentina.

Implications for US -EU Relations

Nearly two hundred years ago, European incursions in the US neighborhood inspired the “Monroe Doctrine”, issued in 1823 to forestall potential colonial revivals in South America by European countries in the post-Napoleonic era. Today, the US response to the EU initiatives has not been as confrontational. Nonetheless, the new European trade initiatives in the Western Hemisphere clearly have important implications for the United States. Former US Trade Representative Charlene Barshefsky warned Congress on frequent occasions about the adverse effects that EU tariff preferences in Latin American markets already were having on the competitiveness of US exporters and argued that US negotiations—especially the FTAA—must be advanced to offset the US disadvantage.

To be sure, US exporters will continue to face increased competition in important growth markets in Latin America as a result of the new EU trade initiatives. Those trade pacts provide incentives for European firms to establish and win market share in the region. The immediate impact will not be substantial, however. Latin America and the Caribbean, excluding Mexico, accounts for only 10 percent of total US trade; including Mexico, the total rises to 20 percent.

More importantly, the EU initiatives should encourage the acceleration of domestic economic reforms and thus reinforce economic growth in the region. This result is good for the United States as well. Overall, the growth effects generated by the EU pacts should outweigh the adverse impact of the discriminatory trade preferences granted

⁹ This share understates the EU position because the European data do not include reinvested earnings by European firms in the region.

EU firms in the region. While this article cannot examine in detail the costs of trade diversion generated by the tariff preferences, two points bear mention:

- First, the margin of preference will be rapidly eroded as countries respond to globalization pressures and continue to reform their trade regimes unilaterally in order to source from the most efficient suppliers. In addition, some of the reforms undertaken pursuant to the trade pacts will be implemented on a nondiscriminatory basis for the simple reason that it makes no sense to have separate rules regulating investment, competition policy, and intellectual property rights.
- Second, trade diversion will be significant in a few industrial sectors but less so in agriculture due to exceptions to the trade rules or long transition periods to free trade. For example, the EU-Mexico pact already is prompting new EU investment in assembly plants and parts manufacturers in Mexico, and could lead firms to source their North American auto exports to Europe from Mexican rather than US or Canadian plants to take advantage of duty-free access to the EU market.

In short, US firms will have to compete more aggressively for market share--but in an expanding market. In addition, the EU pacts should contribute to the promotion of important US foreign policy objectives. Strengthening Latin American economic growth helps sustain the important political reforms achieved in the region over the past two decades. A stronger, more democratic region is a better neighbor and economic partner for the United States.

Finally, one should not forget that the EU initiatives are taking place at the same time, but over a longer period, as ongoing negotiations on a FTAA. As the EU pacts promote trade and investment in Latin America, those countries will have more flexibility in restructuring their economies to meet global competition. In turn, these reforms will make it easier for them to undertake and sustain free trade commitments with the United States under the FTAA. And, to some extent, Latin American countries will use the TAFTA-South initiatives as a foil to the FTAA, using each to pressure the United States and European Union in turn to reduce their own trade barriers, especially in agriculture. Both developed and developing countries can benefit from a dose of free trade medicine!

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