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TRADE SIA OF THE ASSOCIATION AGREEMENT UNDER NEGOTIATION BETWEEN THE EUROPEAN COMMUNITY AND MERCOSUR

UPDATE ON THE OVERALL PRELIMINARY TRADE SIA EU-MERCOSUR AND SECTORAL TRADE SIAs

INCEPTION REPORT

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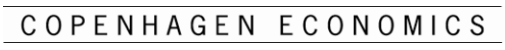


CONTENTS

ABBREVIATIONS

AMS	Aggregate Measure of Support
CAP	Common Agricultural Policy
CGE	Computable General Equilibrium
CCA	Causal chain analysis
CIFOR	Center for International Forestry Research
CGE	Computable General Equilibrium
CoC	Chain of Custody
CSR	Corporate Social Responsibility
CTA	Technical Centre for Agricultural and Rural Cooperation ACP-EU
DDA	Doha Development Agenda
DFID	UK Department for International Development
DG	Directorate General
EBA	Everything But Arms
EC	European Commission
EFTA	European Free Trade Area
EU	European Union
ERRT	European Retail Round Table
FAO	Food and Agricultural Organization of the United Nations
FDA	Food and Drugs Administration
FDI	Foreign Direct Investment
FERN	Forests and the European Union Resource Network
FLEGT	Forest law Enforcement, Governance and Trade
FOB	Free On Board
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
GFT	Government Financial Transfers
GFW	Global Forest Watch
GTAP	Global Trade and Protection
HPDC	Highly Protected Developing Country
HACCP	Hazard Analysis Critical Control Point
IDPM	Institute for Development Policy and Management
IARC	Impact Assessment Research Centre
IEEP	Institute for European Environmental Policy
IISD	International Institute for Sustainable Development
ICTSD	International Centre for Trade and Sustainable Development
IFF	Intergovernmental Forum on Forests
IFPRI	International Food Policy Research Institute

IPF	Intergovernmental Panel on Forests
ITC	International Trade Commission
ITTA	International Tropical Timber Agreement
ITTO	International Tropical Timber Organisation
IMF	International Monetary Fund
LDC	Least Developed Country
LIDC	Low Income Developing Country
M and E	Mitigation and Enhancement
MFN	Most-favoured-nation
MOU	Memorandum of Understanding
MEAs	Multilateral Environmental Agreements
MEDC	Major Exporting Developing Country
MENA	Middle East and North Africa
MFA	Multifibre Arrangement
MFN	Most-favoured-nation
MOU	Memorandum of Understanding
NAFTA	North American Free Trade Agreement
NAMA	Non-agricultural Market Access
NGOs	Non-governmental Organizations
NSDS	National Sustainable Development Strategies
NTB	Non-Tariff Barriers
NTM	Non-Tariff Measure
ODC	Other Developed Country
ODI	Overseas Development Institute
OECD	Organization for Economic Co-operation and Development
PPP	Public Private Partnerships
RA	Representative Agent
ROO	Rules of Origin
SADC	Southern African Development Community
SCM	Subsidies and Countervailing Measures
S & D	Special and Differential
SD	Sustainable Development
SIA	Sustainability Impact Analysis
SME	Small and Medium-sized Enterprises
SPS	Sanitary and Phytosanitary Measures
SSA	Sub-Saharan Africa
TBT	Technical Barriers to Trade
TD/BU	Top Down/Bottom Up
TOR	Terms of Reference
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UN	United Nations

UNCED	United Nations Conference on Environment and Development
UNCTAD	United Nations Conference on Trade and Development
UNDESA	UN Department of Economic and Social Affairs
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
US	United States of America
USAID	United States Agency for International Development
USDA	United States Department of Agriculture
WHO	World Health Organization
WTO	World Trade Organization
WWF	World Wide Fund for Nature

EXECUTIVE SUMMARY

As part of its commitment to ensuring that its policy choices are consistent with the overarching objective of sustainable development, the European Commission has since 1999 been engaged in an ongoing programme of Sustainability Impact Assessment (SIA) studies of all EU trade negotiations. Within this programme an SIA study has been commissioned for the current negotiations for a trade agreement between the EU and the Mercosur trade area composed of Argentina, Brazil, Paraguay and Uruguay. The study will assess the potential economic, social and environmental impacts of the proposed agreement in Mercosur and EU countries, and propose measures for avoiding or mitigating adverse impacts and enhancing beneficial ones.

There will be four main components of the study: an update of a preliminary overall trade SIA for the proposed EU-Mercosur agreement that was conducted previously; three sectoral SIAs providing greater detail on agriculture, the automotive sector and forests.

This Inception Report for the project provides background information that will be used in the study, identifies the key sustainability issues that will be investigated, and presents proposals for the methodology that will be used.

There are seven sections in the report. Section 1 provides a general introduction and overview. Section 2 describes the proposed methodology, including significant extensions to the methodology used in previous SIAs. As in previous studies, economic modelling of the changes in trade flows and production levels that are expected to occur as a result of the trade agreement will provide the starting point for the assessment of the economic, social and environmental impacts. Many of the previous SIAs have used economic modelling results available in the literature, while in others it has been necessary to undertake modelling work as part of the SIA. Relatively little modelling has been done for an EU-Mercosur agreement, and so a dedicated model will be developed for the SIA. This will use the latest available data and techniques, and will incorporate features which allow some of the social and environmental impacts to be estimated directly within the model.

Section 2 summarises the current status of EU Mercosur negotiations, and gives an outline of the pattern of trade and investment in the Mercosur region, with particular reference to trade with the EU. Section 4 presents a preliminary scoping of the key sustainability issues for the update of the overall SIA for the EU – Mercosur agreement. Section 5 gives a similar preliminary scoping of sustainability issues for each of the three sectoral SIAs, for automobiles, agriculture and forests.

Consultation with stakeholders in both the EU and its trading partners is a key component of the SIA methodology. Section 6 of the report describes the strategy for stakeholder consultation and for dissemination of information and findings. Finally, Section 7 summarises the future activities in the project and the expected contents of the mid-term and final reports.

1. INTRODUCTION

The EU has been engaged in conducting Trade SIAs as part of its trade policy-making process since 1999, based on a common Trade SIA methodological framework.[1] The negotiations for an Association Agreement between the EU and Mercosur (comprising Brazil, Argentina, Paraguay and Uruguay) began in June 2000 with the ultimate objective of achieving a greater level of political and economic cooperation and integration within the Mercosur group itself, and with the EU.

In 2004 the EU and Mercosur held intensive negotiations aimed at concluding trade talks by the end of October 2004. However, at a ministerial meeting held in Lisbon on 31st October 2004, both parties agreed that the negotiations required more time. Although the parties met several times in 2005, they have been unable to re-launch successfully the bi-regional discussions. A calendar of meetings has been set up for the year 2006. It is in this context that the Commission has decided to undertake a Trade SIA of the Mercosur – EU Association Agreement.[2]

The Trade SIA of the Association Agreement currently under discussion between the European Commission and Mercosur comprises two components:

- Update of the Overall Preliminary Trade SIA EU - Mercosur
- Sector Trade SIA studies for Agriculture, Forests and Automobiles

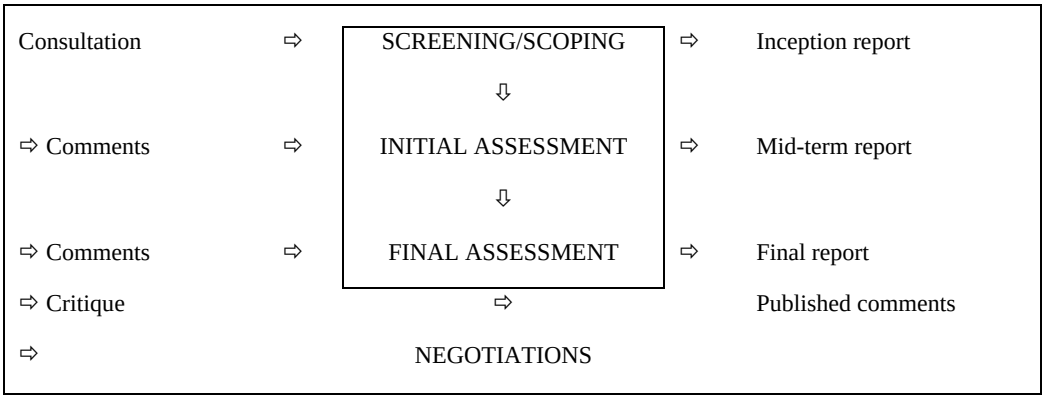
The studies will be carried out within a standard methodological framework. This framework has two complementary elements:

- *Trade sustainability impact assessment*, comprising a balanced and integrated assessment of potential economic, social and environmental impacts.

- *Consultation process*, whereby consultation with, and dissemination of results to, partners and key stakeholders in the EU and its Mercosur trading partners is an integral part of the assessment process. Consultation and transparency are essential processes for ensuring the credibility and legitimacy of the Trade SIA.

There will be three reports produced: this Inception Report, a Mid-Term Report and a Final Report. The consultation process will be an integral part of the assessment and the results will be integrated into each of the three reports (Figure 1).

Figure 1: Overview of the SIA process



[1] Kirkpatrick C and Lee N (1999), EC (2006a)
[2] The work completed in the preliminary Trade SIA of the EU Mercosur negotiations (Global Preliminary SIA EU-Mercosur. Final Report, September, 2003) provides the starting point for the current EU-Mercosur Trade SIA.

In accordance with the Terms of Reference, this Inception Report provides the Commission with:

- An overview of the consultant's proposed approach to the study, including a presentation of the conceptual framework of the sustainability assessment analysis.
- A description of preliminary methodological developments or changes from past studies.
- A review of literature, list of tools and references to be used, list of contact in Mercosur countries.
- A preliminary screening exercise for the key sustainability issues/impacts associated with the trade agreement, based wherever possible on quantitative indicators.
- A preliminary discussion on the selection of sector specific indicators relevant for this study.
- Outlines of the contents for both the mid-term and final reports.

There are seven sections in the Report:

1. Introduction
2. Methodology for the EU-Mercosur Trade SIA
3. Current conditions and context for the baseline scenario
4. Update of the overall preliminary EU – Mercosur Trade SIA
5. Sector Studies: preliminary screening of key sustainability issues
    - Automobiles
    - Agriculture
    - Forests
6. Consultation and dissemination strategy
7. Way forward and contents of mid-term and final reports

2. METHODOLOGY

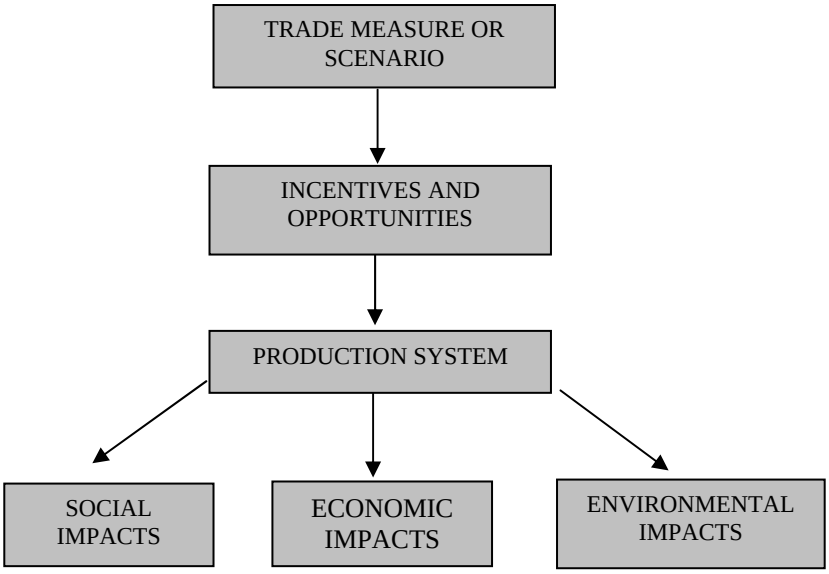
2.1 Overall SIA methodology

The methodology for the Mercosur SIA will build on the experience gained in applying the Trade SIA methodology originally developed for carrying out a *preliminary* SIA[3] and subsequently refined and adapted for carrying out more detailed SIAs of sectoral level trade measures.[4] This methodological framework will be retained in the EU-Mercosur SIA, but will be significantly different in detail, to reflect both the different purposes and context of the study, and to integrate recent advances in linking sustainability factors to economic modelling studies.

The cornerstone of the SIA methodology is *causal chain analysis*. Causal chain analysis (CCA) is used to identify the significant cause-effect links between the proposed trade measure (scenario) and its eventual economic, social and environmental impacts. The aim of CCA is to distinguish the *significant* cause-effect links in the chain, where the analysis is undertaken in logical sequence, from 'cause' to 'effect'. The explanation of the causal chain analysis is derived from theoretical reasoning, modelling and other analysis, and expert interpretation of the evidence derived from existing studies.

The causal chain analysis can be represented in the form of a causal chain diagram, which shows each of the main linkages in their logical order of causality (Figure 2).

Figure 2: Causal Chain Analysis of Impact of a Trade Measure on Sustainable Development



A change in trade policy will alter the incentive structures and opportunities in the markets directly and indirectly affected by the measure of trade liberalisation specified in the scenario. A rules change,

[3] Kirkpatrick C and Lee N (1999) *WTO New Round: Sustainability Impact Assessment Study*. Report to DG Trade under Framework Contract SIA of Proposed WTO Negotiations; Lee N and Kirkpatrick C (2001) 'Methodologies for sustainability impact assessment of proposals for new trade agreements' *Journal of Environmental Assessment Policy and Management*, vol 3, no 3, September

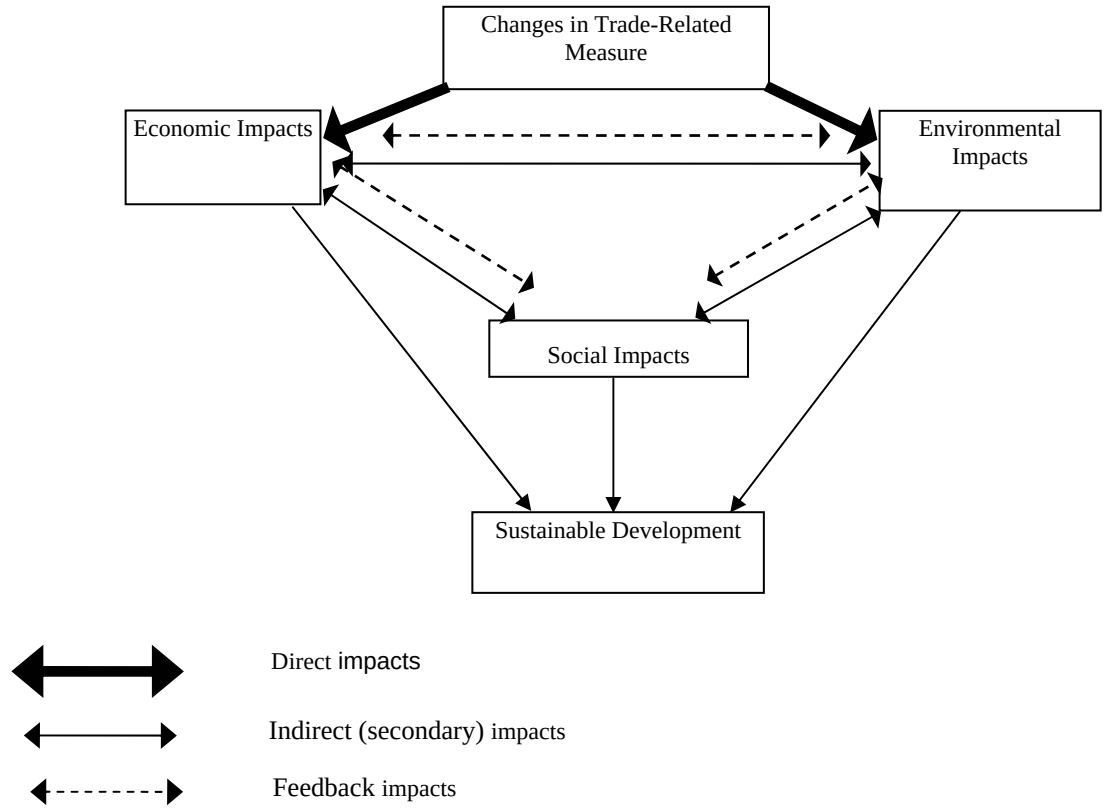
[4] Kirkpatrick C and Lee N (2002) 'Further Development of the Methodology for a Sustainability Impact Assessment of Proposed WTO Negotiations. Report to DG Trade under Framework Contract SIA of Proposed WTO Negotiations; George C and Kirkpatrick C 'Trade and Development: Assessing the Impact of Trade Liberalisation on Sustainable Development' *Journal of World Trade*, vol 38, no 3.

for example, alters the market conditions for producers and consumers. The new structure of incentives and market opportunities will induce a change in the economic behaviour of enterprises (producers) and households (consumers).

The next stage in the causal chain analysis is to assess the significance of the linkages from the changes in enterprise and household behaviour, to the economic, social, environmental and process indicators of sustainable development.

Figure 3 illustrates, in its simplest form, the causal chain approach which is used in SIA to assess significant linkages and final impacts on the sustainable development indicators. It does not convey the full complexity of the linkages between each stage in the causal chain, nor does it convey the cross-linkages between the social, economic and environmental impacts (Figure 3). Further, the direct and indirect impacts from individual measures may have cumulative impacts, which need to be considered in the appraisal of the trade agreement as a whole. The 'routes' through which these cause-effect relationships operate may be numerous and complex.

Figure 3: Types of Impact of a Trade Agreement on Sustainable Development



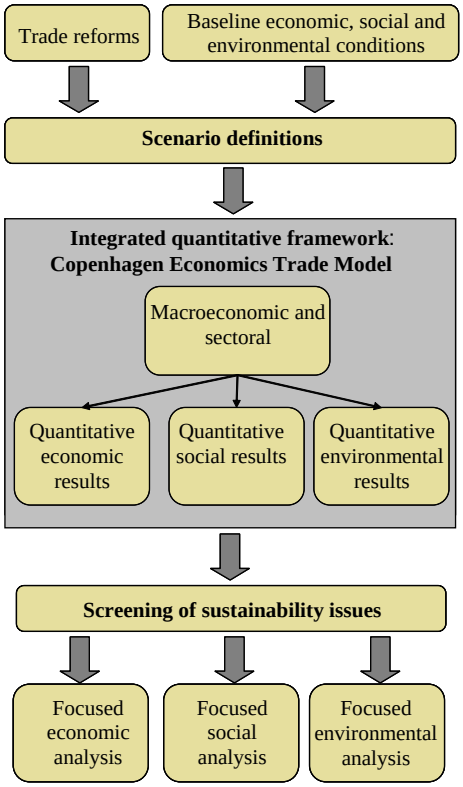
Both Figure 2 and Figure 3 abstract from the intertemporal or dynamic nature of the causal links between the initial change in the trade measure and the final impact in terms of sustainable development. The changes represented in Figures 2 and 3 do not occur instantaneously or simultaneously and the speed of adjustment will vary in different parts and at different stages in the causal chains. There may also be feedback processes during the intermediate stages of the cause-effect relationships, before the final impacts on sustainable development occur.

The SIA methodology uses a set of core indicators, complemented by second tier and process indicators (Kirkpatrick and Lee, 2002). The core indicators are used to show the impact of the trade measures on sustainable development in its economic, environmental and social dimensions. The

second tier indicators are intended to allow the presentation of results at a lower level of aggregation than the core indicators. The inclusion of process indicators allows for the assessment of impacts on the key procedures, processes and practices that are needed for longer-term advancement of sustainable development.

We propose to extend the existing Trade SIA methodology for the EU-Mercosur SIA by including an integrated CGE modelling component which will provide a quantitative framework for identifying major economic impacts and linking these to the analysis of social and environmental impacts (Figure 4). This analytical framework will enable the subsequent stages of the SIA to have a common quantitative foundation. All of the modelling assumptions and data will be made fully explicit, in order to maintain the transparency and logical consistency of the SIA methodology.

Figure 4: The Integrated Framework



2.2. Incorporating the Copenhagen Economics Trade Model in the trade SIA

The core of the quantitative framework is the Copenhagen Economics Trade Model (CETM), a global computable general equilibrium (CGE) model incorporating environmental and social parameters. The CETM captures all linkages between the different sectors and regions of the world economy, and allows for an economy-wide assessment at both the national and global level.

The CETM model incorporates features such as imperfect competition, increasing returns to scale, labour-leisure choice and product differentiation according to firm varieties and geographic origin. The GTAP database, version 6, provides the majority of the data for the empirical implementation of the model.

Figure 4 shows the impacts that can be modelled directly in the CETM, in relation to the corresponding core indicators of the SIA methodology. Generally, the main use of the general

equilibrium model is to provide estimates of the economic effects of the trade agreement, but there are social and environmental indicators included as well in the output of the model.

An important part of the output from the model is the information on which sectors are expected to contract or expand (for each country/region), and the relative magnitude of these sectoral shifts. If combined with information on sector characteristics from a social and environmental perspective, this information provides a good starting point for the social and environmental analysis.

Table 2.1: Indicators modelled in the CETM

Core Indicator	Output from the CETM
Economic indicators	
Real Income	Savings, Consumption, Expenditure
Fixed capital formation	Indication of the incentives to invest and build up capital stock
Employment	General and per sector
Social indicators	
General	General information on sectoral and country-level effects (expansions and declines)
Equity	Wage effect for skilled and unskilled labour
Environmental indicators	
General	General information on sectoral and country-level effects (expansions and declines)
Environmental quality	Energy usage and CO_2 emissions

The model can calculate impacts on a wide range of economic variables for each individual country, such as:

- Economic welfare (measured as equivalent variation)
- Real income
- Total employment
- Employment by sector and skill-level
- Real wages
- Return on capital
- Economy-wide value added (GDP)
- Value added by sector
- Real prices for both domestic and imported goods and services
- Output and market sizes for goods and services
- Imports and exports by sector
- Tariff revenues
- Energy usage
- CO_2 emissions

Regarding social impacts, the CETM can analyse the distributional effects of macroeconomic and sectoral effects following trade reforms. The output includes quantitative changes in real wages and sectoral employment for skilled and unskilled labour. Due to the detailed regional and sectoral disaggregation of the CETM that is used for this study, this output from the CETM will immediately provide important quantitative information on poverty and equity impacts. The results will show in which sectors jobs will be lost, in which sectors employment will increase, and the aggregate effect on wage levels for skilled and unskilled workers in each country. The model will therefore provide a direct first insight into where the most crucial social effects can be found, giving focus for the subsequent social impact analysis.

The focus of the environmental modules in the CETM is energy usage (electricity, oil, coal, gas) and greenhouse gas emissions (CO_2). The GTAP energy data set (EDS) is used, which covers among other variables the quantity of energy usage by energy commodity and energy use class. The energy and CO_2 impacts of international transport are included in the model as well, and will also be assessed separately by considering the estimated changes in trade flows.

Additionally, the estimates of sectoral activity levels will provide important inputs for assessing other environmental impacts. For example, if a sector that is known to have strong negative effects on biodiversity grows, this provides a warning that this sector may need to be analysed further, outside the model.

2.3. Regions and sectors in the CETM

The GTAP6 database provides the majority of the data for the empirical implementation of the model. The database is the most recently updated source for internally consistent data on production, consumption and international trade by country and sector on a global level. It is based on detailed national accounts and balance of payments data from both national sources and international organisations. Compared to previous versions of the GTAP database, version 6 includes several important improvements with respect the EU-Mercosur context, all of which are incorporated in the CETM:

- improved domestic databases for Argentina and Brazil
- improved treatment of data on services trade
- improved tariff coverage using MAcMaps data on preferential rates

The GTAP6 database originally consists of 57 different sectors and 87 regions; however, a practical maximum of sectors and regions in a general equilibrium analysis is less. As a minimum, each of the four Mercosur countries will be modelled separately, along with the EU15, the new member states, the USA, Canada, the rest of the Free Trade Area of the Americas (FTAA), and the rest of the world. Where appropriate, some individual EU countries may also be modelled separately, as may the two new accession countries for which GTAP6 provides data (Bulgaria and Romania).

Paraguay is not incorporated directly in the GTAP database. As a proxy for Paraguay we use the GTAP region “Rest of South America”, a group of countries consisting of Paraguay, Guyana and Surinam. The two latter countries together account for 20 % of total GDP in this group, while Paraguay accounts for 80% of total GDP in these three countries. Hence, we think that using this group of countries will provide a good approximation for the effects on Paraguay, but we will keep the approximation in mind when analysing the results.

Table 2.2 shows the sector aggregation in the CETM model. The 57 sectors from the GTAP database have been aggregated into 25 sectors reflecting the most common goods traded in the Mercosur region. For instance, agricultural products are among the most exported goods from Mercosur to the EU, while motor vehicles and transport equipment are important import goods. Besides the agricultural and manufacturing sectors, the service sectors are important. For all four Mercosur countries more than 50% of total value added stems from the service sectors and the main part of the labour force works in these sectors as well. Should other specific sectors turn out to be of specific importance, the aggregation of sectors can be adjusted to reflect this.

Table 2.2: Sector aggregation in the CETM model

Sector	GTAP sector	Corresponding ISIC/CPC codes
Vegetables, Fruits, Nuts	Vegetables, fruit, nuts;	CPC 012-013
Oil Seeds	Oil Seeds	CPC 014
Other Agriculture	Oil seeds; Sugar cane, sugar beet; Plant-based fibers; Crops nec Paddy rice; Wheat; Cereal grains nec. Bovine cattle, sheep and goats, horses; Animal products nec; Raw milk	CPC 015-017, 019, CPC 0111-0116, 0119, CPC 0211-0212, 0291-0295, 0297-0299
Forestry	Forestry	CPC 03
Fishing	Fishing	ISIC 015
Energy, minerals	Coal; Oil; Gas; Minerals nec	ISIC 101-103, 111-112, 12-14
Meat Products	Bovine meat products; Meat products nec;	CPC 21611-21620, 21132-21260
Sugar	Sugar	CPC 1542
Food Products	Vegetable oils and fats; Dairy products; Processed rice; Sugar; Food products nec; Beverages and tobacco products	CPC 216-218, 22-25
Textiles and wearing	Wool, silk-worm cocoons; Textiles; Wearing apparel; Leather products	CPC 0296, ISIC 17-19, 243
Wood and paper	Wood products; Paper products, publishing	ISIC 20-22
Petroleum, coal products	Petroleum, coal products;	ISIC 23
Motor vehicles and parts	Motor vehicles and parts	ISIC 34
Transport equipment	Transport equipment nec	ISIC 35
Electronic equipment	Electronic Equipment	ISIC 32
Machinery	Machinery and equipment nec;	ISIC 29-31, 33,
Other Manufacturing products	Chemical, rubber, plastic products; Mineral products nec; Ferrous metals; Metals nec; Metal products; Manufactures nec	ISIC 24-25, ISIC 26-28, 36-37
Electricity, gas, water	Electricity; Gas manufacture, distribution; Water	ISIC 40-41
Construction	Construction	ISIC 45
Distribution services	Trade	ISIC 50-55,
Communication	Communication	ISIC 64
Transport service	Transport nec; Water transport; Air transport	ISIC 60-63
Financial services	Financial services nec; Insurance	ISIC 65-67
Business services	Business services nec;	ISIC 70-74
Other services	Recreational and other services; Public Administration, Defence, Education, Health; Dwellings	ISIC 75, 80, 85, 90-99

Source: Copenhagen Economics and GTAP database ver. 6

2.4. Analysis of the trade agreement

Although the GTAP6 database provides improved data on services trade, the data remain burdened with considerably more uncertainty than for trade in goods, and the modelling of services barriers entails a particularly high degree of approximation. It is therefore proposed that the CETM model will be used only to give a broad indication of the possible magnitude the economic impacts of the agreement on services, for comparison with other estimates available in the literature.

For tariffs on agricultural and non-agricultural goods, the CETM includes a set of consistent and exhaustive *ad valorem equivalents* (AVEs) of applied border protection across the world. The data originates from the MAcMap database, which is the result of a joint effort by the International Trade Centre (governed by UNCTAD and WTO) and CEPII. The source information concerns various instruments, such as specific tariffs, mixed tariffs and quotas, which cannot be directly compared or summed, and which are not readily usable in a CGE model. Therefore, each instrument is converted into an AVE. Importantly, we will replace the standard tariff information in GTAP. In the standard information the detailed tariffs for individual products are aggregated into GTAP sector level with a simple import-weighted average, which gives insufficient weight to high tariffs, due to their distorting nature. For example, an extremely high tariff reduces imports to zero, which results in a weight of zero in a simple import-weighted average. We will therefore use a tariff data set based on region-group

clustering aggregation (for more information, see Bouët et al, 2006). The welfare effects of agricultural and non-agricultural liberalisation will be identified separately.

The modelling studies will compare a scenario or scenarios for the postulated trade agreement with a baseline scenario which takes into account other global trade reforms that are likely to have a substantial impact on the EU-Mercosur trade agreement. The baseline scenario will allow for full implementation of the Uruguay round, China's accession to the WTO, and current expectations for the outcomes of the Doha round and the potential Free Trade Area of the Americas (FTAA).

All trade modelling entails significant strategic assumptions, choices of parameters and uncertainties in data. Sensitivity analysis is therefore an important part of general equilibrium analysis, and will be used to give an indication of the level of uncertainty in the results.

2.5. Previous economic modelling studies

Both CGE models and gravity models have been used to assess either the regional integration process of Mercosur countries or the EU-Mercosur agreement. Whereas GCE models are predictive, gravity models consider the role of geographical distance on observed changes in trade flows, in order to elucidate causal relationships.

Gravity models have been used to measure the role of a range of economic variables for Mercosur and regional integration, such as transportation costs (Amjadi & Winters 1997, Head & Mayer 2000, Mayer & Zignago 2004) or geographical distances (Martínez-Zarzoso & Nowak-Lehmann 2002). These models have been used to estimate the determinants of trade exchanges (Narbona 2004, 2005) and how Mercosur's export could penetrate the European market (Castilho 2001a, 2002a). Castilho (2002b) has presented a review of literature assessing the impact of regional integration on the Brazilian economy. Cuadros, Ramos *et al.* (1999) have employed specific econometric techniques to model Mercosur exports to the EU.

Studies using a CGE approach include Flôres (1997), Giordano & Watanuki (2000, 2001b), Giordano (2001a), Balistreri, Decreux and Guérin (2001), Bchir et al (2001), Bchir, Decreux and Guérin (2002), Devlin and Giordano (2002), Planistat (2003) and Monteagudo and Watanuki (2003). Chaire Mercosur (2003a) has carried out three computable general equilibrium analyses. The first of these considers the effects on Mercosur of the FTAA and the EU-Mercosur agreement, the second analyses the costs of the FTAA for the EU with and without an agreement with Mercosur, and the third examines the costs and benefits of different scenarios in the specific case of Brazil.

All of these studies used GTAP5 or earlier data, and so their results are not directly comparable with those that will be obtained from the CETM model. Nonetheless, a comparative analysis will be undertaken, taking account of the data differences. Where relevant, comparisons will also be made with partial equilibrium studies that have been carried out for particular sectors. All of these comparisons will complement the sensitivity analysis in giving an indication of the level of uncertainty associated with different modelling assumptions.

2.6 Scenarios

The SIA methodology deploys scenario analysis in the assessment of potential sustainability impacts. Two scenarios will be assessed in the Overall and Sectoral SIAs for the EU-Mercosur trade studies:

Baseline Scenario: continuation of current trends and existing levels of trade measures

Liberalisation Scenario: full liberalisation for all sectors

3. CURRENT CONDITIONS AND CONTEXT FOR BASELINE SCENARIO

The trade SIA methodology incorporates a baseline scenario, which represents an assessment of the economic, social and environmental context and policy environment, that would occur in the absence of the trade agreement or policy change that is the subject of the ex ante sustainability impact assessment. The sustainability parameters for defining the baseline scenario are identified in section 4. In this section, the existing trade and economic conditions and related policy environment which will be used in defining the baseline scenario, are described.

3.1 Current State of EU – Mercosur Negotiations

The Mercosur Treaty

Mercosur was created in 1991 with the signature of the Treaty of Asunción by four Latin-American countries (Argentina, Brazil, Paraguay and Uruguay). It was the result of a convergence process between the two biggest economies (Peña 1995), Brazil and Argentina, in the region during the 1980s, just after democracy was re-established (Chudnovsky & Porta 1989, Behar 1991, Rozemberg & Svarzman 2002, Averbug 2002b).

Since its foundation, many studies have been requested to provide detailed analyses of this integration project (Menem 1996, Arocena 1997) and its philosophical and legal basis (Garnelo 1998, Galeano Perrone 1995, Ciuro Caldani 1996 y 1997, Jardel & Barraza 1998, Ruiz Diaz Labrano 1998). The first attempts to define the most appropriate institutional structure for Mercosur were developed (Sanguinetti 1994), using the EU as the standard to be followed (Rimoldi de Ladmann 1995, De Luis Romero & Agramunt 1996, Mata Diz 1999, Narbona 1999, Velasco San Pedro 1998).

Different stages in the evolution of Mercosur can be identified according to the main results of the integration process (Narbona 2005). Sometimes the bilateral relationship between Argentina and Brazil have been decisive to Mercosur's evolution (Machado & Ribeiro 1999, Bouzas & Da Motta Veiga 2001a). After an initial transition period where intra-regional trade strongly increased (Lucangeli 1994) (Frankel *et al.* 1995, Bouzas 1999), the regional bloc suddenly deadlocked (1999, Faria 2002) and Mercosur fell into a structural crisis (Preusse 2001, Bouzas & Da Motta Veiga 2002d, 2002f, 2002g). The consequences of this *impasse* were observable in many sectors, for example, in the exchange rate instability of the regional bloc (Machinea 2003, Devlin *et al.* 2001a). The Conference "Mercosur: In search of a new agenda"5 held in the Getulio Vargas Foundation in Rio de Janeiro (June 2003) and was devoted to examining future directions for Mercosur regarding several aspects, such as the institutionalisation agenda (see Da Motta Veiga, 2003), the dilemmas and alternatives for the trade agenda (Rios, 2003), the exchange rate instability (Machinea, 2003) and Mercosur's insertion into a globalised world (García Pelufo, 2003). Economic and political solutions have been proposed to be able to cope with the great constraints and problems in each particular field. When Luiz Ignacio Lula da Silva arrived in the Brazilian government, he provided a new impetus to the regional integration (Haddad 2002, Bouzas & Da Motta Veiga 2003b). Since the election of Lula, the integration process has faced various crises and most of the studies on Mercosur are dedicated to elaborating options for the future of this regional initiative (Peña 2000 y 2002, Ríos 2003, Secretaría del MERCOSUR 2004).

Many academic works propose an assessment of the evolution of Mercosur and an evaluation of the main problems it has faced (Almeida 2002, Bouzas & Da Motta Veiga 2001c, Chudnovsky & Fanelli 2001b, Da Motta Veiga & Rios 2003e, 2001c). The problems addressed relate to the institutionalisation agenda, the insertion into a globalised world, the trade agenda, the internal

[5] MERCOSUR: In search of a new agenda (INTAL, 2004)

enlargement process and Mercosur external relations. One of the most important barriers to be surmounted is the lack of an appropriate institutional framework (Baptista 1998, Garnelo 1998, Gonzalez 1999, Pena & Rozemberg 2005). Mercosur is a hybrid integration process in the midst of a supranational and intergovernmental scheme (Roberto de Almeida 1999). Its "institutional deficit" is due to the low degree of effectiveness of assumed commitments.[6]

Two new issues have recently emerged and both constitute perhaps the most important challenges for the internal enlargement process of Mercosur. The first challenge is the impact of different fiscal policies on the integration process (Villela, Barreix & Taccone 2003, Barreix & Villela 2003 and Villela, Roca & Barreix 2005). Tax issues directly affect Mercosur in the area of competitiveness, investment promotion, tax collection and its distribution among the sectors. This topic is closely related to the limited efforts for macroeconomic coordination made by Mercosur countries. The second challenge relates to the asymmetries within the framework of the regional integration project. There are asymmetries between the regional integration process and local development (Giordano, Lanzafame & Meyer-Stamer, 2005) that have to be faced to achieve structural convergence inside Mercosur. Moreover, there are specific asymmetries in the smallest member state, Paraguay (Giordano; Moreira & Quevedo, 2004a; Giordano 2004b) demanding specific measure such as the Structural Convergence Fund (Consejo del MERCOSUR 2005; Zerbino 2004).

Trade agreements

Mercosur has signed various trade agreements, mainly with Latin American partners (Table 3.1). Recently, Mercosur has also concluded preferential trade agreements with developing countries from other regions, such as India and South Africa. However, these agreements are only partial scope agreements and they do not cover all the trade flows between the members. Mercosur has never concluded any trade agreement with a developed country, although two are currently in the process of negotiation.

[6] Da Motta Veiga (2003) argues that an institutionalised Mercosur does not imply the creation of new institutions per se, but rather the strengthening of credibility through a production of rule and a system of implementation at the subregional level.

Table 3.1: List of trade agreements negotiated by Mercosur

Agreements Established		
Members of agreement	**Signature Date**	**Description**
MEROCSUR/Chile	July, 1996	**Objectives:** to form a free trade area between Mercosur and Chile in 10 years, starting in 1997; to crease a wide economical space to facilitate circulation of goods/services, establish juridical and institutional base for economic/physical cooperation; to promote economic, evergetic, scientific and technological cooperation and complementation
MERCOSUR/Bolivia	Dec., 1996	**Objectives:** form a free trade area in 10 years (max.) leading to total trade liberalization and all forms of non-tariff restrictions should be eliminated by this time
MERCOSUR/Mexico	July, 2002	**Objectives:** Crease free trade/eliminate all tariffs, restrictions and other obstacles; diversification of trade and the establishment of a juridical basis granting transparency for economical agents; establishment of juridical background to promote and stimulate reciprocal investments; promotion of economic complementation and cooperation
MERCOSUR/Mexico (automobiles)	July, 2002	**Objectives:** Establish reciprocal reduction on import tariffs for automobiles
MERCOSUR/Peru	Nov., 2005	**Objectives:** Establish tariff preferences, with a view of a free trade area
MERCOSUR/Andean Community (Columbia, Ecuador, Venezuela)	Dec., 2003	**Objectives:** Establish tariff preferences, with a view of a free trade area
MERCOSUR/India (preferential trade agreement)	Jan., 2004	**Objectives:** Framework agreement; signed to establish first stage of tariff concessions and preferences for eventual creation of free trade area
MERCOSUR/SACU (South African Customs Union)	Dec., 2004	**Objectives:** Establish fixed tariff preferences between Mercosur and SACU; main sectors concerned: agro-industrial, chemical, automobiles and plastic
Free Trade Area of the Americas		**Objectives:** Wide-scope agreement; create a free trade area in the Americas; areas in discussion include: education, investment, sanitary and phytosanitary measures
MERCOSUR/European Union		**Objectives:** bilateral trade liberalization of goods/services following WTO rules; better access to government procurement; promotion of open and nondiscriminatory environment for investments; establish effective dispute settlement mechanisms

Mercosur countries are also members of the Latin American Integration Association.

EU – Mercosur Relations

The EU has supported the integration process of Mercosur since shortly after its inception. In May 1992, one year after the conclusion of the Asunción Treaty, Mercosur and the EU signed an inter-institutional agreement which served as a vehicle for technical assistance, personnel training, and institutional support for the then recently founded Mercosur. The two blocs signed an inter-regional Framework Agreement in December 1995. It was the first agreement of its kind that the EU was negotiating outside Europe. This agreement was designed to facilitate further negotiations on commercial and economic cooperation while putting in place immediately a political dialogue between the two regions.

The negotiations of the EU-Mercosur Association Agreement, which has three components (political, cooperation and trade), were launched in the first EU-Latin America meeting of Heads of States and Governments held in Rio de Janeiro in June 1999. The EU-Mercosur Bi-regional Negotiations Committee (BNC) is the main forum for negotiations. The first round of negotiation was celebrated in April 2000. Since then, sixteen negotiating rounds have taken place.

The year 2004 brought many hopes and a great deal of disillusion to the EU-Mercosur negotiators. During the spring 2004, substantial progress in the trade chapter allowed both parties to realistically envisage a conclusion of negotiations by the end of October 2004. But the year concluded on the failure to meet the deadline of October 31 for the completion of the negotiations. Following a number of technical contacts in 2005 to discuss the ways to re-engage the process, Ministers met again in September of 2005 and Trade Commissioner Peter Mandelson visited the region in March of 2006.

Since then, discussions have continued at the technical level, but no new negotiating offers have been exchanged and the discussions are currently at a standstill.

The main difficulties met by the negotiators are:

- The central role played by agricultural issues on both sides: agriculture is the main objective for Mercosur, whilst it remains the most sensitive issue for the EU.
- The defensive position of Mercosur regarding services and public procurement, where main EU interests are concentrated.
- The negative environment created by the *impasse* in the Doha Round and the FTAA
- Internal difficulties in Mercosur, where the need to negotiate "bloc to bloc" with the EU requires the consolidation of an internal consensus prior to an external one. This requirement creates an additional step in the process of defining common positions. Furthermore, the regional bloc has been back-pedalling on the implementation of both customs union and free circulation of goods.
- EU enlargement, which implies new interests and priorities in the negotiations.

During recent negotiations different proposals for tariff elimination have been advanced. Mercosur proposes a less than full reciprocity approach:

- For Mercosur imports from the EU the categories for tariff reduction are: A: 0 years; B: 8 years; C,D,E: 10 years, with different levels of reduction per category
- For EU imports from Mercosur, reductions are: A: 0 years; B: 4 years; C:7 years and D: 10 years.

The EU meanwhile proposes the same tariff reduction periods for both EU and Mercosur imports but considers five categories (A to E) instead of the four proposed by Mercosur.

- For Mercosur imports from EU and for EU imports from Mercosur, the categories for tariff reductions are: A: 0 years; B: 4 years; C: 7 years; D:10 years and E: not defined.

Regarding TRQs, the EU proposes a two-step approach. In the first step, the EU would grant Mercosur the right to export an additional but limited quantity of product X within the framework of the EU-Mercosur agreement. In the second step, the volume granted to Mercosur is linked to the WTO negotiations in the Doha Round. The second quantity that Mercosur will effectively obtain will be inversely linked to the increase in the current volume of the EU WTO TRQs that will be negotiated at the WTO. For every percentage point of increase in the EU bound WTO TRQs, the second quantity devoted to Mercosur shall be reduced by a corresponding five percentage points (Kutas, 2006).

Although the parties met several times in 2005 and 2006, they have been unable to successfully re-launch the bi-regional discussions.

3.2 Economic Characteristics

Population, per capita income, economic growth rates and total trade activity vary significantly between the four countries. As of 2004, per capita GDP was highest in Argentina (12,723 US$ PPP) and lowest in Paraguay ($4,868 US$ PPP).[7] Of the Mercosur countries, Brazil has the largest economy (GNI 584,859 million US$). Paraguay falls at the other end of the spectrum as the smallest trading partner (1%), with the smallest GNI (7,133 million US$ in 2004) and slowest rate of per capita annual GDP growth (0.4%). The principal economic data for the partner countries are presented in Table 3.2

[7] LAC Databook (World Bank), 2005

Table 3.2: Mercosur: Economic Characteristics

	Argentina	Brazil	Paraguay	Uruguay
Population[1]				
Population (m)	38.37	183.91	6.02	3.44
Population (% rural)	10	17	43	7
Real Income				
GDP (current $USb) PPP[2]	486	1483	28	32
GDP growth (annual %)[8]	9	5.2	2.9	12.3
GDP/Capita (current US$) PPP[2]	12723	8297	4868	9465
GDP/Capita growth (%)	8	3.9	0.4	11.6
GINI Coefficient (Total av. 1984-2002)	52	59	57	45
GINI Coefficient (urban)	53	58	58	45
Fixed capital formation				
Gross capital formation (% of GDP)	19	21	22	13
Gross capital formation (annual % growth)	35	11	3	32
FDI net inflows (% of GDP)	3	3	1	2
Employment				
Unemployment rate (total) % of labour force[3]	20	9	7	19
Unemployment rate (urban) % of labour force	14	12	10	13
Real Average Wage (2000= 100)	92.2	85.5	90.5	77.9
Trade				
Exports (% of GDP)	25	18	36	30
Imports (% of GDP)	18	13	37	28
External Debt				
Total debt service (% of GNI) 2003	12	12	5	8
Total debt service (% of exports) 2003	38	64	10	26
Total External Debt (% of GDP) 2003	128.25	46.55	53.24	105.20

Notes:

1: All Table 1 data for 2004 unless otherwise indicated

2: Paraguay income data for 2002

3: Data Argentina (2002); Brazil (2001); Paraguay(1999); Uruguay(2002)

Sources:

World Bank World Development Indicators (WDI) 2004; WTO; LAC Databook 2005 (World Bank);

3.3 Trade Flows

Mercosur is the main trading partner of the European Union (EU) in Latin America. Between 1995 and 2004, 42% of EU sales to Latin America went to Mercosur and 48% of its imports from this region originated in the bloc of the Southern Cone[9]. However, the share of Mercosur as a recipient of EU exports has been declining over the period (from 50% to 36%) to the benefit of countries such as Chile and Mexico (Table 3.3).

Table 3.3: Mercosur main trading partners

		Value ($USm)			Growth (%)		Share (%) by region		
Export		**1995**	**2000**	**2004**	**95/00**	**00/04**	**1995**	**2000**	**2004**
	Asia	9171	7971	17537	-13	120	13	9	13
	European Union	18012	20025	30078	11	50	26	24	22
	Intra Mercosur	14451	17741	17114	23	-4	21	21	13
	USA	10773	16930	24678	57	46	15	20	18

[8] Annual growth is for the period 1976 to 2003

[9] Data provided IADB (2006)

	Rest of the world	18087	22196	44453	23	100	26	26	33
	World	**70493**	**84863**	**133861**	**20**	**58**			
Import									
	Asia	7920	10085	15029	27	49	10	11	16
	European Union	21949	21069	20007	-4	-5	27	24	21
	Intra Mercosur	14439	17713	17879	23	1	18	20	19
	USA	17635	18693	15696	6	-16	22	21	17
	Rest of the world	17915	20882	26210	17	26	22	24	28
	World	**79858**	**88441**	**94821**	**11**	**7**			
Total Trade	Asia	17091	18055	32566	6	80	11	10	14
	European Union	39961	41094	50086	3	22	27	24	22
	Intra Mercosur	28890	35453	34994	23	-1	19	20	15
	USA	28407	35623	40374	25	13	19	21	18
	Rest of the world	36001	43078	70663	20	64	24	25	31
	World	**150351**	**173304**	**228682**	**15**	**32**			

Note: ASIA includes ASEAN members, Bangladesh, Hong Kong, Macao, Japan, Pakistan.
Source: COMTRADE

The EU-Mercosur trade relation is characterized by sharp asymmetries. The first imbalance relates to the weight of the bilateral trade relation in each partner's total trade. In 2004 Mercosur accounted for only 2.5% of EU imports and for 1.7% of EU exports[10]. But for Mercosur countries, the EU is a strategic trading partner. In 2004 the EU was the main client of the bloc of the Southern Cone, absorbing 22.5% of its exports, and also its main provider (21.1% of Mercosur imports). Mercosur exports measured in terms of value are more than twenty times greater than imports in 2004. Moreover, this asymmetry increased from 1999 to 2004, due to both an increase and decrease of trade flows, respectively from Mercosur and the EU (Table 3.4).

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Table 3.4: Trade flows between EU and Mercosur (measured in thousands of euros)

Year	EU imports from Mercosur	EU exports to Mercosur
1999	9 191 944	866 242
2000	10 574 162	980 777
2001	12 040 351	840 914
2002	12 182 517	638 612
2003	12 296 726	590 788
2004	13 537 979	582 381

Source: COMEXT database

The second asymmetry that can be observed in the EU-Mercosur trade relation regards the trade balance. For a long time, the Mercosur trade balance with the EU was systematically negative. However, in 2002, the trend was reversed and since then Mercosur has posted continuous trade surpluses. This surplus reached 12,955 million euros in 2004. Although Mercosur trade with the EU has increased in absolute terms, as illustrated in Table 3.3, the relative share of the EU as a trading partner has been declining.

The Netherlands, Germany, Italy and Spain are the main recipients of Mercosur exports to the EU while approximately 70% of Mercosur imports from Europe originate in Germany, France, Italy and Spain. It is interesting to note that despite their strong historical links, trade flows between Portugal and Brazil are very low (3% of the EU total trade with Brazil). Considering the size of the Brazilian economy, it is not surprising that Brazil is responsible for 75.7% of Mercosur trade with the EU, while Argentina accounts for 21%, Uruguay for 2.3% and Paraguay for 1%[11].

[10] Eurostat (2006)
[11] Data for 2004. Source: Eurostat.

Intra-Mercosur trade increased significantly during the period that followed the creation of the common market (+23% for the period 1995-2000), but from 2001 to 2004 trade flows between the partners slowed down and in 2004 the share of intra-Mercosur trade decreased from 20.5% to 15.3% of Mercosur total trade.

The composition of Mercosur exports to the EU is very different from the composition of exports to the US (Table 3.5). More than 50% of Mercosur sales to the EU are composed of food and raw agricultural materials and this export profile has varied little over time. On the contrary, the composition of Mercosur exports to the US is characterized by a much lower share of agro-food products (9.9% in 2002). Between 45% and 50% of Mercosur exports to the world are manufactured goods. On the other hand, it is interesting to note that a high percentage of Asian imports from Mercosur are ores and metals, and agro-food products. This shows that Mercosur countries have benefited from the expansion of the Asian economies, through a significant demand for raw materials[12].

Table 3.5: Composition of Mercosur exports (%)

	Food			Agricultural Raw Materials			Ores & Metals			Fuels			Manufactured Goods			Goods not elsewhere		
	95	**00**	**02**	**95**	**00**	**02**	**95**	**00**	**02**	**95**	**00**	**02**	**95**	**00**	**02**	**95**	**00**	**02**
World	35.5	30.5	33.9	5.2	3.9	3.3	7.3	7.6	7.1	3.7	6.6	8.3	45.7	49.1	45.4	1.4	2.3	2.1
LAC	24.3	19.5	19.2	2.9	1.7	1.6	2.4	2.5	2.7	8.3	13.2	15.3	61.8	63.0	61.2	0.3	0.1	0.1
USA	16.3	11.6	9,9	5.6	4.4	3.7	4.8	4.4	3.7	3.9	9.3	10.9	67.5	68.1	70.4	1.9	2.2	1.6
EU-15	51.4	46.5	51.7	8.0	6.4	4.9	8.7	11.3	10.4	0.8	0.5	2.2	30.5	34.6	29.6	0.6	0.6	1.1
ASIA	34.3	36.5	40.1	7.6	7.5	6.1	25.6	26.4	23.3	0.8	0.8	3.5	31.5	28.8	26.9	0.2	0.1	0.1

Source: IADB (2004)

Mercosur's export portfolio is fairly diversified, but with wide variation across countries. More than 50% of Brazil's exports are composed of industrial goods, but this percentage decreases to 14.6% for Paraguay. Non agricultural raw materials and fuels account for 34% of Paraguay's exports, while this sector only represents 11.6% of Uruguay sales to the world. Agricultural raw materials and food account for 48.4% of Uruguay's exports, 42.9% for Argentina, 34% for Paraguay and 22.7% for Brazil[13].

Mercosur countries are major producers and net-exporters of agro-food products. In 2003, Brazil ranked third in the top-10 list of agro-exporters and Argentina ranked seventh. Both countries are also the second and third EU providers of agricultural products, behind the US. The agricultural sector is a key component of Mercosur economies. In all the member states, agriculture accounts for more than 10% of GDP. In addition, it is a very dynamic sector with an impressive rate of growth (except in Paraguay). The data presented in Table 3.6 illustrate that the sector is also an important source of employment. However, Table 3.6 does not include employment data for the agro-business sector. In Brazil, if agricultural jobs are added to employment in food processing industries, the percentage of the labour force employed in the sector reaches 35%.

Table 3.6: Importance of the agricultural sector in Mercosur economies

	Argentina	Brazil	Paraguay	Uruguay
Agricultural share (%) of GDP (2004)	11.2	10.4	27.2	12.4
Growth (%) agricultural GDP (2004)	7	5.3	2.1	9
Agricultural population (% of total) 2003	9.4	14.8	38.9	10.8

Sources: World Bank, FAO.

Mercosur exports of agricultural products are diversified. Table 3.7 shows that the most important products exported by Mercosur are: soybeans and soy products, bovine and poultry meats and

[12] IADB (2004)
[13] Data for 2003. Source : INTAL

preparations, sugar, fruits juices, coffee, corn, wheat, tobacco, fruits and vegetables (fresh and prepared).

Mercosur imports mainly mineral fuels and oils (15.5%), nuclear reactors, boilers and machinery (14.4%), electrical machinery and equipment (13.8%), organic chemicals and chemical products (8.1%), vehicles (7.1%), plastics and their products (4.2%) and fertilisers (3.8%)[14].

Table 3.7: Value and destination of Mercosur agricultural exports (2004)

	World ($USm)	Share of Mercosur total agricultural exports (%)	Asia (%)	EU 15 (%)	Mercosur (%)	North America (%)	Other (%)
Beverages/Spirits	824	1.8	27	23	8	20	22
Bovine Meat/Preparations	4343	9.3	14	35	2	17	32
Coffee	1759	3.8	12	56	2	20	10
Corn	1825	3.9	42	19	3	0	36
Dairy products/Bird's eggs/natural honey	1014	2.2	12	16	10	9	53
Poultry meat/preparation	2875	6.2	58	7	8	6	21
Soybeans/soya products	18665	40	49	24	0	1	25
Sugar	2707	5.8	1	1	80	1	17
Swine meat/preparation	745	1.6	44	37	3	1	15
Tobacco	1666	3.6	33	2	1	7	58
Vegetables/fruits (fresh and preparation)	1456	3.1	15	4	7	0	74
Fruit juices	1657	3.5	23	33	4	16	24
Wheat	1613	3.5	2	44	21	16	17
Other agricultural products	5565	11.9	11	63	0	20	5
TOTAL AGRICULTURE	46714	100					

Source: COMTRADE

3.4 Tariff rates

In 1995, Mercosur countries adopted a common external tariff (CET). As a result, the four countries share the same level of tariffs with a few exceptions (2% of the tariff lines). With an average MFN[15] tariff that is approximately 11% and a maximum rate of 35%, Mercosur tariff structure presents a low level of dispersion. The MFN average tariff for agricultural products is 10% while the MFN average tariff for non-agricultural goods, capital goods and information technology and telecommunication goods is 10.75%. Mercosur has a simple tariff structure: all the tariffs are expressed in *ad-valorem* terms and there is only one tariff rate quota (TRQ).

Although the main agricultural products exported by Mercosur to the EU enter the European market duty free (soya products and coffee), the access for many Mercosur key export products – such as bovine and poultry meats, sugar, wheat, corn and ethanol, is restricted by TRQs and/or high tariff barriers (Table 3.8). It is necessary to differentiate between sensitive products under the GSP where there are low or zero tariffs and those sectors where individual Mercosur countries have graduated.

Table 3.8: MFN rates on main exports by Mercosur

	Share of Mercosur agricultural exports to the EU	Tariff Rate Quota	EU MFN minimum tariff	EU MFN maximum tariff

[14] Data for 2004. Source : COMTRADE
[15] MFN: Most favored nation

	(2004)					
				Equivalent *ad valorem*		**Equivalent *ad valorem***
Oilcake from soya bean	32.23%	No	0.0%		0.0%	
Soya beans	19.25%	No	0.0%		0.0%	
Coffee	5.94%	No	0.0%		11.5%	
Bovine meat, fresh or chilled	4.50%	Yes	20.0%		12.8%+ 3,034 €/t	85.2%
Orange juice, not frozen	4.26%	No	12.2%		15.2%+206 €/t	85.2%
Maize	3.18%	Yes	0.0%		90 €/t	73.2%
Bovine meat, frozen	2.43%	Yes	20.0%		12.8%+ 3,041 €/t	141.8%
Raw Tobacco	2.96%	No	18.4 MIN 22€ MAX 24€/100 kg	2.9%	11.2 MIN 22€ MAX 56€/100 kg	11.2%
Poultry preparation	1.94%	No	8.5%		867 €/t	33.2%
Poultry meat	1.92%	Yes	6.4%		1,024 €/t	87.9%
Preparation of bovine meat	1.65%	No	16.6%		16.6%	

Notes: The tariffs refer to the tariff lines where trade flows between the EU and Mercosur do exist. *Ad valorem* equivalents have been calculated by the author according to the WTO methodology currently used in the negotiation of the Doha round.
Sources: COMEXT database, TARIC, author's calculations for *ad valorem* equivalents.

Table 3.9 shows that there are protectionist tariffs in both EU and Mercosur markets and gives an indication of levels, although these would need to be reviewed in the light of more up-to-date data during the next phase of this study. There also exist non-tariff barriers for some products, such as the use of technical standards and labels.

Table 3.9: Trade restrictions on selected manufactured products

	EU tariffs	Export tax by Mercosur	Mercosur tariff	Non-tariff barriers
Motor vehicles	10.0%			
Untanned leather		9% (Brazil) 5% (Argentina)		Yes
Processed bovine leather	6.5%			Yes
Other processed leather	3.5%			Yes
Footwear	3.5%		17.7%	Yes
Other leather good, e.g. handbags	3.0%		17.7%	Yes
Metal products	1.2%		18.4%	Yes
Electrical machinery			17.3%	Yes
Other machinery			16.3%	Yes

Sources: COTANCE, European Commission TARIC database, Estevadeordal and Krivonos (2000).

3.5 Foreign direct investment

The liberalisation process of the Mercosur economies during the 1990s fostered the adoption of measures to promote the attraction of foreign direct investment (FDI). During this period, many public enterprises have been privatised and foreign firms have invested massively in the region. Between

1996 and the year 2000, Mercosur attracted 52% of the net FDI flows received by Latin America and the Caribbean (Table 3.10). But since 2001, the flows directed to Mercosur decreased for two main reasons: firstly, privatisation plans came to an end, and secondly, the economic crisis in Argentina provoked distrust among investors. Mercosur only attracted 34% of the FDI in Latin America over the period 2001-2005. However, after a three year period of continuous decrease, FDI flows resumed with growth in 2004.

Table 3.10: FDI flows to Mercosur

	1991-1995**		1996-2000**		2001-2005**	
	$USm	**(% total)**	**$USm**	**(% total)**	**$USm**	**(% total)**
Argentina	3,781.5	59	11,561.1	31	2,980.6	15
Brazil	2,477.4	38	24,823.6	68	16,480.7	83
Paraguay	103.8	2	185.1	1	53.9	0
Uruguay	82.5	1	187.2	1	367.9	2
MERCOSUR	**6,445.2**		**36,757.1**		**19,883.1**	

* This does not include financial centres. FDI figures are equal to inflows of FDI minus capital outflows generated by foreign investors. The figures differ from those presented in the Preliminary Overview of the Economies of Latin America and the Caribbean, as the latter shows the net balance of foreign investment, i.e., direct investment in the reporting economy minus direct investment abroad.
** Annual average
Source: ECLAC (2005)

The EU is the biggest investor in the region. The majority of European FDI is directed to Brazil. In 2003, the FDI stock of the EU in Brazil amounted to US$ 47,997 millions and to US$ 23,193 in Argentina (IADB, 2006). Spain is the EU member with the largest stock of FDI in Mercosur, followed by France, the Netherlands, the United Kingdom, Italy, Germany and Portugal. EU investment is located in areas as diverse as telecoms, energy, financial services, the automotive industry, the agro-industry and the retailing sector. It should be noted that Mercosur does not have a common policy in terms of FDI, and corporate and social taxes vary widely across countries.

3.6 Overview of Mercosur Members[16]

Argentina

Of the Mercosur countries, Argentina has the second largest economy and largest per capita income as of 2004 and the second highest rate (%) of annual and per capita growth (behind Uruguay). After increasing in the mid 1990's, GDP per capita declined until the end of the financial crisis in 2002. Recovery in overall GDP and per capita GDP can be seen between 2002 and 2004 and despite the economic collapse of 2001-2002, income inequality has risen steadily since the mid 1990's.. Nonetheless, Argentina has one of the highest standards of living for an emerging economy in the region with above average education, purchasing power and levels of health.[17]

Argentina joined the WTO in January of 1995. Agricultural goods dominate exports (50%), while manufactures dominate imports (87%). In 2003, Argentina was ranked 7th in the world in the top 10 list of agro-exporters and it is the second largest exporter to the EU overall and 3rd for agricultural goods.[18] Argentina exports primarily to the EU (18.3%) and Brazil (15.8%) with imports likewise originating from Brazil (32.5%) and the EU (18.2%).[19]

Like all Mercosur countries, Argentina adopted an open-market policy in the early 1990's to attract FDI, including trade and capital account liberalization. With one of the most successful bank

[16] Annex 2 contains the main economic indicators for each of the four Mercosur countries.
[17] Cline, W. (2003), *Restoring Economic Growth in Argentina*, World Bank Policy Research, WP 3158
[18] See Chaire Mercosur
[19] http://wto.stat.org

regulatory systems among emerging economies in the 1990's,[20] foreign investment increased rapidly in Argentina showing a nearly 750% increase from 1994 to 1999. FDI began to decrease from 2000 and dropped dramatically in light of the financial crisis of 2001-2002. In 2004, strong signs of recovery were seen with an increase in FDI between 2003 and 2004 of more than 325%.[21]

Development assistance declined significantly in Argentina in the latter half of the 1990's and official development assistance totalled only $90,000 in 2002—a 100% decrease from 2001. In the post crisis period, a new development agenda is underway in Argentina signalling improved political and macroeconomic stability and overall development assistance has improved since 2002.[22] Main development goals in Argentina are infrastructure, health for mothers and children, income transfers and institutional strengthening in the public sector.[23] There is still a relatively high risk of default on present loans in Argentina, thus limiting necessary international financing.[24] Argentina is classified by the World Bank (as of 2005) as severely indebted with total government debt equal to approximately 170 $USb in 2003.[25] The debt service ratio equalled approximately 4% of GDP in 2001 before the default.[26]

Brazil

Brazil has the largest economy and population (and 5th largest in the world) of the four Mercosur countries, and the third largest per capita earnings. Real GDP growth (%) in Brazil declined between 1994. After a period of stagnation in the wake of the financial crisis in the whole of the Southern Cone, economic recovery began in 2004.[27] Inflation in Brazil has been rising steadily since 2000, for both the production and consumption of national goods. Alongside improved per capita income, inequality in the distribution of earnings continues to remain amongst the world's highest, despite a recent downward trend in inequality.

Brazil joined the WTO in January of 1995 and it is currently the 8th largest import market power in the world (by GDP) and the largest trading partner of the EU.[28] Dominating trade between Mercosur and the EU, Brazil was ranked 24th in world exports for 2004 and 3rd in 2003 in the top-10 list of agro-exporters.[29] Manufactured goods (53%) and agricultural products (32%) dominate exports[30]; the main trading partner of Brazil is the EU (26% of all exports and 24 % of all imports in 2004), followed by the United States and Argentina.[31]

In an effort to attract foreign investment, a key step in Brazil's economic reforms in the 1990's was the improvement of integration through trade and capital account liberalization.[32] Foreign investment in Brazil increased significantly between 1994 and 2000, after which investment began to decline do mainly to the end of privatisation plans and the economic crisis in the region.[33] FDI accounted for nearly 3% of GDP in 2004.

[20] Calomiris, C., Powell, A. (2000), Can emerging market bank regulators establish credible discipline? The case of Argentina 1992-1999, NBER WO 7715, http://www.nber.org/papers/w7715
[21] CAS world bank 2006
[22] CAS Argentina 2006
[23] CAS Argentina 2006
[24] USAID 2005
[25] As reported in Cline,2003 ; varies by source
[26] Cline, 2003
[27] The OECD Economic Survey of Brazil, 2005
[28] Chang, W., Winters, L., (2002), *How regional blocs affect excluded countries: The price effects of MERCOSUR*, The American Economic Review, Vol 92(4), pp. 889-904
[29] See Chaire Mercosur
[30] http://wto-stat (WTO Country Trade Profiles, 2006)
[31] ibid
[32] Arbache, J., Dickerson, A., Green, F., Trade liberalisation and wages in developing countries, The Economic Journal, 114(493)
[33] Chaire Merosur, p. 6 section 3: FDI

Development assistance in Brazil collapsed just prior to the economic crisis of 2001-2002, but has improved significantly in recent years due primarily to improved government and fiscal stability in the country. Brazil is classified as severely indebted by the World Bank (as of 2005), however, as a share of GDP, Brazil has one of the smallest debt burdens of the Mercosur countries. Net public debt increased before 1999, due primarily to significant fiscal restructuring in the country to increase transparency and stability.[34] The debt/GDP ratio has been relatively stable in the period 1994 to 2003, however, the debt service/exports ratio has shown significant variation over the same period, peaking in 1999 due primarily to depreciation and high interest rates.[35]

Paraguay

Paraguay is the poorest of the four Mercosur countries, with the 3rd largest population and the highest rate of population growth. After a prolonged period of economic stagnation, rates of per capita and GDP growth in 2004 were the slowest of all the Central American countries.[36] GDP per capita fell significantly between 2001 and 2002 due to general turmoil in the Southern Cone, combined with severe political instability in the country; new elections in 2003 brought greater political and economic stability with widespread economic reforms to encourage stabilisation and foreign investment.[37] The situation started to improve from 2003 and economic growth is expected to reach 3.5% by 2007 (or 1% per capita).[38] Poverty is concentrated in rural areas and of the four Mercosur countries, Paraguay has the largest rural population (43% in 2003).[39] Income inequality in the country rose significantly between 1990 and 1995 and has stayed relatively high in recent years.

Paraguay joined the WTO in January of 1995 and has a relatively open trade regime.[40] Paraguay is the smallest trading partner with the EU of the Mercosur countries, accounting for approximately 1% of all trade with the EU. Paraguay is vulnerable to economic and trade conditions in its larger, stronger neighbours—mainly Brazil and Argentina. More than 80% of Paraguay's exports are to developing countries, and the "triangular-trade" model in the country used to represent 20% of GDP but has fallen significantly in recent years primarily as a result of Mercosur tariffs.[41] Paraguay's number one export partner is Uruguay (27.8%) followed by Brazil (19.2%). Imports are primarily from Brazil (27.8%), Argentina (21.4%) and China (15.7%). Agricultural goods dominate exports (86%) while manufactures constitute the largest share of imports (71.7%).

FDI to Paraguay was lagging in the latter half of the 1990's and began to increase significantly after 2002 due to greater political and economic stability. In recent years there has been significant investment in agriculture (particularly soybeans and meat) and cellular telecommunications in the country.[42]

International development assistance in Paraguay has increased in recent years. A comprehensive development strategy was approved in 2003 by the World Bank totalling US$ 325 million between 2003 and 2007 to improve fiscal and financial stabilization, public sector governance and access to social services.[43] Paraguay is classified by the World Bank (as of 2005) as a low to moderately indebted country. Although debt service is relatively low due to reasonably low interest rates, external debt rose significantly after 1999, and equalled approximately 53% of GDP in 2003. The devaluation of local currency in Paraguay has led to an increase in the debt-to-GDP ratio in recent years, with the overall public debt equal to US$2.7 billion in 2004.[44]

[34] CAS Brazil, 2006
[35] CAS brazil 2006
[36] CAS Paraguay 2006; LAC Databook (2005)
[37] CAS 2006
[38] ibid
[39] http://www.fao.org
[40] http://wto-stat.org; http://www.unctad.org/en/docs/tdr2005ch4_en.pdf
[41] CAS 2006; http://www.unctad.org/en/docs/tdr2005ch4_en.pdf (Unctad, ch.4)
[42] CAS Paraguay 2006
[43] ibid
[44] ibid

Uruguay

Of the Mercosur countries, Uruguay has the 3rd largest economy and 2nd largest per capita income. The country has the smallest population and very low population growth, averaging .06% between 1994 and 2004. Uruguay showed impressive economic growth in 2003 and 2004, with the highest annual and per capita GDP growth rates (%) out of the other Mercosur countries. A prolonged recession at the end of the nineties brought on significant financial crisis and the country is said to have been hit harder than its neighbours, including Argentina, during the social and economic crisis of 2001-2002.[45] High levels of unemployment followed the economic collapse, with total and urban unemployment the second highest of the Mercosur countries behind Argentina. Income inequality in Uruguay is the lowest of the four countries and has shown only slight real variation between pre and post-crisis periods. Economic turnaround in the country since 2003 has been due in large part to significant macroeconomic adjustments to strengthen the financial system.[46]

Uruguay joined the WTO in January of 1995 and, as one of its founding members, the country is an active participant in the multilateral trading system.[47] Uruguay has an open-trade regime and recognizes Mercosur as a key component to its present and future growth strategy.[48] Uruguay is the 3rd largest trading partner with the EU from among the Mercosur countries, constituting 2.3% of total EU-Mercosur trade. Uruguay's main exporting partners are the US (21%), EU (20%) and Brazil (16.5%). Imports into Uruguay are primarily from Argentina (22.2%), Brazil (21.7) and the EU (11.8%). FDI into Uruguay began to increase after 2002, reaching nearly 4% of its GDP in 2003. The government is open to foreign investors except in key public sectors such as water and transport.[49] There is significant foreign investment in Uruguay's forestry sector and overall foreign direct investment reached US$312 million in 2004, a 15% increase from 2003.[50]

Development assistance declined steadily in the 1990's in Uruguay and has yet to reach pre-crisis levels. The IMF, World Bank and IADB are all currently involved in promoting economic turnaround in Uruguay; development assistance is focused primarily on debt stability by promoting economic growth, stable fiscal policy and exchange rates.[51]

A primary economic concern and development challenge for Uruguay is its current level of foreign debt. In 2003, public debt accounted for more than 65% of Uruguay's GDP. After significant debt restructuring in 2003, the ratio of public debt to GDP reached nearly 90%.[52] Uruguay is thus classified by the World Bank (in 2005) as severely indebted and, together with Argentina, has amongst the highest external debt of the Mercosur countries as a ratio of its GDP.

[45] CAS Uruguay 2006
[46] Trade Policy review, 2006 http://www.wto.org/english/tratop_e/tpr_e/tp264_crc_e.htm
[47] ibid
[48] ibid
[49] WTO TPR
[50] Authors' calculations based on LAC Databook 2005
[51] CAS Uruguay 2006
[52] ibid

4. UPDATE OF OVERALL PRELIMINARY EU – MERCOSUR TRADE SIA

4.1 Introduction

The SIA will update the findings of the preliminary overview SIA that has already been undertaken for the proposed EU-Mercosur trade agreement (Planistat 2003). This section of the report reviews the economic, social and environmental situation as described in the previous study, updated with more recent information. It identifies potentially significant impacts related to the nine core indicators and two process indicators of the SIA methodology.

The scenarios assessed in the previous study are described, along with its methods of analysis, its principal findings, and its recommendations for more detailed assessment of specific sectors and issues. Proposals are then presented for the updated overview SIA that will be conducted in the present study.

4.2 Current situation and potentially significant sustainability impacts

The previous SIA was undertaken in the context of the economic crisis that had struck the Mercosur countries in 2002, most strongly in Argentina, but also in Uruguay and Paraguay. Most economic indicators have since returned to conditions more typical of the preceding decade (see data in Annex 2). In other respects the economic, social and environmental conditions remain broadly as described in the Inception Report for the previous study. The final report for the study identifies the main potential impacts of an EU-Mercosur trade agreement, in the EU as well as Mercosur countries.

In the European Union, the main issues identified in the Planistat SIA are social, associated with potentially adverse economic effects for particular economic sectors in specific regions of some Member States. Pockets of unemployment and social exclusion exist in old urban areas or remote rural areas. In Belgium, Germany and the UK, high unemployment tends to be associated with declining industrial regions, particularly in former East Germany. In Greece, Spain, France and Italy, the high unemployment regions are mainly agricultural. In both cases, and similarly in the new Member States, greater access for Mercosur products could in principle exacerbate existing problems.

For the Mercosur countries, the following sections summarise information on the main issues for which the agreement could have significant impacts on the core SIA indicators.

Economic indicators

The general economic situation in the Mercosur countries is described in Section 3, and additional statistical data are given in Annex 2. The data are summarised below in relation to the three core indicators.

Real income

Argentina and Uruguay are classified as upper middle income countries in the World Bank classification, and Brazil and Paraguay as lower middle income. Argentina and Uruguay showed strong growth in 2004, primarily in recovery from decline since 1999, which was exacerbated by the 2002 crisis. Inflation is still a significant issue throughout the region.

Fixed capital formation

Data on gross capital formation and foreign direct investment (FDI) are given in Annex 2. A recent acceleration throughout the region has followed low levels of capital formation and FDI from the late

1990s. The privatisation programme since the 1990s has contributed to inward investment flows, with a decline between 2000 and 2003 that has subsequently been reversed.

Brazil has invested fairly heavily in technological development, spending 1.0% of GDP on Research and Development (UNDP 2005). Argentina has also invested significantly (0.4%), while Uruguay and Paraguay lag at 0.2% and 0.1%.

As the poorest of the four countries, Paraguay is the only one with a significant dependence on development aid, including for many infrastructure projects.

Employment

Unemployment is particularly severe in Argentina and Uruguay, at around 20% of the labour force. In both countries, rural unemployment is significantly higher than in urban areas. In Brazil and Paraguay overall unemployment levels are lower (recorded as less than 10%), and are higher in urban than rural areas.

Social indicators

Population growth

While not a core indicator, population growth is a cross-cutting issue which affects all the social parameters. The poorest country in Mercosur, Paraguay, has the highest growth rate (2.2% per annum). The rate of growth is significantly lower in Argentina, Brazil and Uruguay (1.0%, 1.2% and 0.6%)[53].

Poverty

Paraguay is the poorest country in the region (GDP per capita US$4868), with the highest rural population (43%). Brazil is the second poorest (US$8297), with the second highest rural population (17%). Argentina (US$12723) and Uruguay (US$9465) have the highest GDP per capita and are more highly urbanised (10% and 7% rural population). Poverty is not however confined to rural areas, with many of the rural poor migrating to the cities.

Although Uruguay has a lower GDP per capita than Argentina, it has lower levels of absolute poverty. The proportion of the population living at less than US$ 1 per day is 16.4% in Paraguay, 8.2% in Brazil, 3.3% in Argentina and less than 2% in Uruguay. The numbers of people with incomes below $US 2 per day are 33.2% in Paraguay, 22.4% in Brazil, 14.3% in Argentina and 3.9% in Uruguay.

The countries' rankings in the broader measure of the Human Development Index follow the same order as GDP per capita, with Argentina at 0.863, Uruguay at 0.840, Brazil at 0.792 and Paraguay at 0.755.

Poverty levels vary significantly between regions, particularly between the more prosperous cities and remote rural areas. In Paraguay a very skewed distribution of land ownership, with the overwhelming majority of peasants without formal land titles, contributes to a high level of rural poverty.

Health and education

Life expectancy at birth is the highest in Uruguay, at 75.4 years, followed by Argentina at 74.5 years. Brazil (70.5%) has the lowest life expectancy, with Paraguay slightly higher at 71.0%. Life expectancy in Brazil has however improved significantly in recent years, from 68.3 years in 2001.

[53] The social data in this section are from UNDP (2005), Human Development Report 2005, United Nations, New York

Although Paraguay is the poorest country Brazil has a lower adult literacy rate, at 88.4% compared with 91.6%. The two richer countries have significantly higher literacy rates, at 97.2% in Argentina and 97.7% in Uruguay. Brazil has however made strong progress, with a combined enrolment ratio the second highest in the region at 91%, after Argentina at 95%. Uruguay has a combined enrolment ratio of 88%, with Paraguay lagging far behind at 73%. Secondary education in Paraguay is particularly weak, at 51% of children.

Equity

Income inequality is the lowest for the four countries in Uruguay, with a Gini index at 44.8 (compared with 25.8 in Norway and 40.8 in the USA). The figure has shown only slight variation between the pre and post-crisis periods. In Brazil income inequality is among the highest in the world, improving somewhat between 1994 and 2003 to a figure of 56.9, then falling sharply back in 2004 to the 1994 level of 61.5. Inequality in Paraguay is similar, at 57.9, with Argentina rather lower at 52.7. The figure in Argentina has been rising steadily since 1996, when its Gini index was 48.5.

Although per capita income in Argentina rose in the early 1990s, the distribution of income worsened and the income of the poorest 20% declined. Since 1995, average income for nearly all groups fell, except for the highest 20%. Similarly in Paraguay, income inequality rose significantly between 1990 and 1995 and has stayed relatively high. With rising unemployment in both countries, many of the poor have resorted to work in the informal sector, with limited social protection. Poverty in Brazil is similarly linked with large disparities in income, both between regions and in the social exclusion of some groups.

As well as income inequalities, the rural poor often have limited access to social services, and lack the power to exercise rights to land or employment. Indigenous peoples and other ethnic minorities are particularly affected, with a close connection to environmental issues, for example in the Amazonian forest.

As measured by the Gender-related Development Index, Argentina has the highest levels of gender equity at 0.854, followed by Uruguay at 0.836. Paraguay has the lowest level of gender equity, at 0.742, with Brazil at 0.786.

Environmental indicators

Biodiversity

Mercosur has the largest reserves of arable lands and forests in the world. The expansion of agricultural activities combined with logging has led to a rapid deforestation in many areas, especially in Brazil and Paraguay. Other activities such as mining and road construction have also contributed to deforestation.

Biological diversity is also high coastal zones, where it is threatened by population pressures and commercial activities such as shrimp farming and oil extraction. Fisheries, especially in Argentina, have suffered from over-exploitation of some species. Catches are difficult to monitor, with limited implementation of fishing licenses.

Concerns have also been expressed about the impact on biodiversity of transgenic crops, particularly in Argentina and in Brazil, used both legally and illegally.

Environmental quality

The main threat to air quality comes from emissions of pollutants in urban areas, particularly from road transport. Industrial emissions are also significant in some areas. In Brazil and Argentina oil extraction and the chemical industry are significant pollution sources.

Water quality management is a major issue in some areas. The agriculture sector has grown rapidly since the 1990s, with potential for pollution from fertilisers and pesticides. Other concerns arise from pollution from mining and the chemical industry.

Natural resource stocks

Water is abundant in most parts of the region, and water quantity is not a major issue in most areas.

Increased oil exploration (notably through foreign direct investment in Brazil), may accelerate the decline of the resource. Brazil has however invested heavily in the development and use of biofuels, and much of the electricity production in the region comes from hydropower.

As noted in terms of biodiversity, over-exploitation of fish stocks has threatened the resource.

4.3 Scenarios assessed in the previous SIA

The baseline scenario of the first preliminary overview SIA included the assumption of a successful conclusion to the WTO Doha Round, and implementation of the Free Trade Area of the Americas (FTAA). These were implemented in the SIA as shown in Table 4.1, along with the scenario for a postulated EU-Mercosur agreement.

Table 4.1: Scenarios assessed in the Planistat SIA of an EU-Mercosur agreement

Trade Measure & Field of Application	**Measure Applied**	**Implementation in model**
Baseline		
WTO Doha Round	Tariff reduction and reduction of barriers to trade in services. Agricultural subsidy reduction	30% reduction in agricultural subsidies. 50% reduction in all tariffs.
FTAA incorporating Mercosur	Free Trade	All Western-hemisphere border tariffs removed with the exception of 'Other Agriculture', where tariffs reduced by 50%.
	Government Procurement: 40% of purchases open to regional competition.	Reduction in tariff equivalent on inputs to public administration and water
EU-Mercosur		
Agricultural and non-agricultural goods		
A) Elimination of Customs duties		
Agricultural & processed agricultural products HS01-02, 04-24	EU proposal: Tariff elimination covering €2.2bn of Mercosur exports currently covered by tariffs (80% of agricultural sector trade subject to tariffs) + €5.8bn products which already have 0% duty => 90% coverage of MERCOSUR's agricultural exports. More limited tariff reductions on remaining 10% of trade: cereals, olive oil, dairy products, beef, tobacco, sugar, certain processed fruit, vegetables.	Reduction of tariffs by 65% from Doha baseline

Trade Measure & Field of Application	Measure Applied	Implementation in model
	EU export subsidies and other factor payments are not addressed by Mercosur negotiations. But they are addressed by Doha round negotiations.	Incorporated into baseline: subsidies reduced 30%
	Mercosur Export taxes	Elimination of those remaining
Fish - HS03	Complete elimination of duties over 10 year period	Elimination of tariffs
Industrial Products HS25-97	100% elimination of duties over a timetable, possibly faster in EU than Mercosur	Elimination of tariffs
B) Non-tariff measures		
i Internal taxes	Re-statement of multilateral agreements. Progressive elimination of tax discrimination	Reduction in non-tariff taxes on international trade by 80%
ii rules of origin	Agreed application of rules of origin	Reductions in implicit taxes
iii standards	Elimination of use of standards as a means of protection	Reduction in tariff equivalents.
Sanitary / Phytosanitary measures	Recognition of equivalence of technical methods in food and related sectors	Reduction in tariff equivalents on agriculture-based sectors.
Services & Establishment		
	Sector-based agreements. Reduction in frictional trading costs, including between Mercosur countries	Reduction in tariff equivalents both within Mercosur and between regions, specified as changes in elasticities for all services sectors and construction.
Other sectors / other types of measure		
Foreign Direct Investment (FDI)	FDI considered under Services & Establishment	Foreign Direct Investment is endogenous in the model. Nevertheless, reduction in tariff equivalents in all manufacturing sectors, water, electricity and gas, construction, communications, financial services, wholesale & retail trade.
A) Government Procurement	Partial (40%) opening of public procurement, especially at federal level where applicable.	Reduction in tariff equivalent on inputs to public administration and water
B) Intellectual Property Rights	Specific agreement on wines and spirits. Increased general protection for intellectual property. Note difficulty in modelling pharmaceutical impact.	Reduction in tariff equivalent for food products, beverages & tobacco products, textiles & wearing apparel, electronics, machinery and other manufactures, business services, recreational and other services, wholesale & retail distribution.
C) Competition	Harmonisation and greater enforcement of competition policy	Suggested reduction in Mercosur tariff equivalents in water, electricity and gas, transport, communications, financial services.
D) Transparency	Incorporated into other measures	

For the present study, the baseline scenario will be updated for the more modest outcome of the WTO Doha negotiations that is currently anticipated. The assumptions for the FTAA remain broadly unchanged.

The EU-Mercosur negotiations have yet to reach a conclusion, with many options still remaining open. To facilitate comparison with the previous study, the current SIA will as far as practicable use the same scenario for the EU-Mercosur agreement as previously, amended as appropriate to enable fuller analysis of the negotiation options.

4.4 Methods of analysis in the previous SIA

Except for services and foreign direct investment (FDI), the analysis in the first preliminary overview SIA of the EU-Mercosur trade agreement was based on a purpose-developed Computable General Equilibrium (GGE) economic model. For services and FDI it was considered that the economic model would not be able to fully capture the impacts of trade policy changes, and so these were assessed separately in a parallel analysis.

The model used in the Planistat study included a dynamic link, through which the direct income effects of trade liberalisation induce shifts in the regional pattern of savings and investment. Such effects can magnify income gains or losses. The results estimate changes in the capital stock, and the welfare and other implications of such changes. In practice, the results of the study showed little difference with and without the dynamic link.

The model allowed wages to vary, and kept total employment effectively constant. Its results included changes in wage rates for skilled and unskilled labour, and changes in employment by sector, under the equilibrium conditions that would occur once the economy has adjusted to the change in trading conditions. Impacts during the period of adjustment were assessed qualitatively, as were other long term impacts such as on overall employment levels.

Other results for the new equilibrium included changes in GDP, national welfare and income, total export quantity and export value, terms of trade, consumer prices, and production output by sector.

The equilibrium changes in production levels predicted by the model were used to estimate environmental impacts, outside the model.

The data came primarily from the GTAP5 database, which has since been superseded by GTAP6.

4.5 Findings and recommendations of the previous SIA

The main overall impacts on sustainable development identified by the previous study were:

- Relatively small overall economic impacts in both Mercosur and the EU.
- Larger positive or negative economic impacts on particular sectors.
- A danger that short-term problems of employment restructuring might dominate and outweigh the longer term benefits.
- Only a limited contribution towards reducing unemployment in Mercosur.
- Potentially extensive agricultural restructuring in Mercosur.
- For agriculture, possible environmental effects in Mercosur on water resources and water quality, soil quality and biodiversity; possible social effects on employment (formal or informal) and rural poverty. In particular as these may be gender or ethnically differentiated.
- For food products and meat and dairy products, environmental effects in Mercosur on air emissions or water or ground pollution.
- For petroleum and related chemicals and plastics, potential environmental effects in Brazil.
- For transport: environmental effects in Argentina, Brazil and Uruguay on air emissions from transport, and land quality or water supplies from car disposal.
- For the retail and wholesale sector, social impacts in both the EU and Mercosur associated with the economic and employment impacts.

The screening and scoping exercise conducted in the SIA identified the following priority sectors for more detailed study:

- Agriculture, Food products and Meat & Dairy products: Mercosur
- Agriculture, Food products and Meat & Dairy products: EU-25
- Food products and Meat & Dairy products - Environmental analysis, Mercosur
- Petroleum refining, Chemicals, Rubber, Plastics – Brazil
- Electronics & Machinery – Capital Goods: Mercosur
- Wholesale & Retail – Mercosur and EU
- Transport - Argentina, Brazil and Uruguay

The study also identified impacts in other sectors that were potentially significant, but considered to be of lower priority:

- Forestry and Wood products. Potentially significant impacts were identified associated with agriculture. It was envisaged that a detailed SIA on agriculture would examine these in more detail.
- Fishing – Argentina. Several studies of this area had already been conducted. Insufficient information was available to indicate that further study would be worthwhile.
- Leather Products. It was considered unlikely that the potential impacts would be sufficiently significant to warrant further analysis.
- Motor Vehicles – Mercosur and EU. Several potentially significant impacts were identified, arising from increased trade between the EU and Mercosur in both directions. It was envisaged that the most significant of these would be examined in a detailed SIA on the transport sector.

4.6 Proposals for the updated preliminary overview SIA

The terms of reference for present SIA of the EU-Mercosur agreement provide for detailed SIAs on agriculture, forests and the automobile sector. These will cover many of the issues recommended for further study in the previous SIA. The other priority issues identified previously will be examined in the updated preliminary overview SIA. These are:

- Food products and Meat & Dairy products. The overview SIA will examine this aspect of the non-agricultural market access provisions in conjunction with the detailed SIA for agriculture.
- Petroleum refining, Chemicals, Rubber, Plastics. This sector will be given particular attention in the analysis of non-agricultural market access, and will be coordinated with the agriculture SIA in relation to ethanol..
- Electronics & Machinery – Capital Goods. Similarly, this sector will be examined as part of the overall analysis of non-agricultural market access.
- Wholesale & Retail. This sector will be given particular attention in the services component of the updated overview SIA.
- Transport. Transport services will be examined in the overview SIA in conjunction with the detailed SIA for the automobile sector.

The study will cover four main areas:

- agriculture
- non-agricultural market access
- services and investment

- trade facilitation and other rules-based measures

For agriculture, and for the forest products and automobile sectors of non-agricultural market access, the overview SIA will draw primarily on the parallel sectoral SIAs, in order to assess the cross-sectoral and cumulative impacts likely to result from the implementation of the EU-Mercosur trade agreement as a whole.

As defined in the Terms of Reference, the overall preliminary Trade SIA will:

- Draw together the results of the earlier study and complement this with further analysis in order to update the preliminary overall Trade SIA results in light of the progress made so far in trade negotiations.
- On this basis, identify, as far as possible in quantitative terms, the likely impacts on the three key areas of sustainability – economic, social and environmental development – of the different aspects of the proposed EU-Mercosur trade agreement.
- On the basis of identified impacts, propose mitigation and enhancement measures in different areas of public policy, including trade policy.
- Identify the generic issues (potential sustainability impacts and policy options for optimising outcomes) which can inform negotiators and policy-makers.
- Evaluate the Trade SIA methodology and identify areas for further development and refinement in future Trade SIAs.
- Provide proposals for the ongoing monitoring of key sustainability indicators affected by trade liberalisation and for ex-post evaluation of the overall preliminary Trade SIA EU-Mercosur.
- Contribute to enhancing the dialogue concerning the overall preliminary Trade SIA EU-Mercosur with interested stakeholders, inside and outside of the EU.
- Produce an SIA-Trade Newsletter and distribute in electronic and paper format.
- Contribute to the development of a credible international network of Trade SIA experts in other countries and within other international organisations, particularly in relation to Mercosur.

The methods of analysis for the updated preliminary overview SIA will be broadly similar to those used for the previous study. The analysis will make use of a new purpose-developed GGE economic model, as described in Section 2, based on the more recent GTAP6 database and incorporating several features not available previously. These include the numerical analysis of some of the potential environmental impacts within the model itself, as well some of the social impacts such as sectoral employment levels and wage effects for skilled and unskilled labour. As in the previous study, other impacts will be analysed qualitatively, and where possible quantitatively, outside the model. All of the modelling assumptions and data approximations will be made fully explicit, with an indication of the level of uncertainty associated with the results.

The model will be used primarily to give quantitative indications of the magnitude of effects for agricultural and non-agricultural tariff changes. The model will also include the services sectors, and will give a broad indication of the possible order of magnitude of the economic effects. Because non-tariff measures cannot be modelled with any great certainty, the results will be used alongside qualitative considerations and, where available, other quantitative estimates, in the evaluation of potential impacts. The assessment of investment, trade facilitation and other rules-based measures will similarly be based on qualitative analysis, supported by quantitative information where available.

The study will assess both short term and long term impacts on the economic, social and environmental aspects of sustainable development, during the period of adjustment to the changed trade conditions, and those expected once adjustment is complete. The long term impacts assessed will include both equilibrium effects, arising directly from movements in production between countries and sectors, and potential indirect effects on economic growth rates and processes of social and environmental change.

The principal aim of the assessment will be to identify appropriate mitigation and enhancement measures, which may be taken within the trade agreement itself or in parallel EU-Mercosur action or domestic policy measures, in order to enhance beneficial impacts and avoid potentially adverse ones, or reduce them to an acceptable level. In support of this, the study will also provide proposals for the ongoing monitoring of key sustainability indicators.

5. SECTOR STUDIES

5.1 Introduction

In accordance with the Terms of Reference (Annex 1), the contractors are required to undertake three sector level trade SIA studies, covering the forest, automobile-motor vehicle and agriculture sectors.

Each of the Final Sector SIA Reports should aim to achieve:

- An update of the Trade SIA methodology for these sectors and assessment tools to be used.
- A clear overview of the current trade situation in the three sectors, together with a definition of the options/scenarios to be considered and a clear analysis of causal chain analysis and the mechanisms through which the different options will affect social, economic and environmental areas.
- An analysis of the expected significance of these impacts for the sector, using appropriate measures and indicators for assessment of impacts and making use of appropriate qualitative and quantitative techniques.
- Identification cross-cutting links between these sectors and other sectors.
- Propose preventive as well as flanking measures or other adjustments that would prove effective in tackling any adverse impacts of liberalisation, and/or in promoting its positive impacts, in these three sectors.
- Contribute to enhancing the dialogue concerning the above Trade SIA with all interested stakeholders: inside and outside of the EU, particularly in Mercosur countries.
- Contribute to the development of a credible international network of Trade SIA experts through participation in policy debate on Sustainability Impact Assessments with experts in other countries and within other international organisations.

Each of the sector studies will use the basic SIA methodology, as described in section 2. The basic components of the SIA methodology are:

- Scenarios for negotiation outcomes – initially assessed by screening and scoping;
- Development and use of indicators of impact, especially second tier indicators that are specific to forestry;
- Causal Chain Analysis (CCA) using pre and post (equilibrium) adjustment scenarios;
- Identification and implementation of case studies for countries representative of key groupings, especially for sub-sets of developing countries;
- Development and use of mitigating and enhancement measures.

Throughout the implementation of the methodology, consultation and stakeholder participation are of key importance.

Each of the sector studies will include a country case study.

The purpose of this Inception report is to provide the Commission with an overview of the consultant's proposed approach to the sector studies, a preliminary screening for the key sustainability impacts/issues for each sector, and a preliminary discussion on the selection of sector specific indicators relevant for each study.

5.2 Forest Sector Study

1. Proposed Approach

The approach to the study has been considered against the basic methodology developed by IARC (Lee and Kirkpatrick 1999, 2002), the Handbook for Trade Sustainability Impact Assessment (EU External Trade March 2006), the findings of the forestry sector SIA for the WTO Negotiations (Katila and Simula, 2005) and a rapid literature review of forestry and related issues in South America and the MERCOSUR countries in particular.

The first stage of SIA (the Preliminary Assessment) has been concluded and on the strength of this, a decision has been made to include the forestry sector. Consequently, the Forestry Sector SIA will comprise four sequential steps:

- Screening,
- Scoping,
- Detailed Assessment,
- Results

This inception report effectively covers the first two steps. The findings of the preliminary screening exercise are contained in Section 3. The purpose of scoping is to establish the appropriate coverage of a Trade SIA, taking each of the measures identified in the screening exercise and identifying which components of those measures are likely to give rise to significant impacts. This process is described in Section 4. Screening and scoping analysis, as well as covering trade negotiation outcomes, also provides a preliminary assessment of the types of mitigating and enhancement (M and E) measures that may need to be included in later analysis.

A key component of an SIA is the encouragement of extensive discussion and debate amongst key stakeholders, especially from within those countries that are party to the intended trade agreement. At a practical level the resources available for individual sector studies place limitations on the scope for face-to face meetings, but the use of the internet and e-mail opens up wide-ranging possibilities for engaging international experts and commentators.

For this study, Land Use Consultants intends to collaborate with ECOSTRAT Consultants, Brazil. Both companies will approach named individuals (identified from their written contributions to international literature) who represent particular viewpoints. Individuals will be selected from:

- International NGOs working in the forestry and trade sectors,
- Forest Industry representatives (International companies/saw millers/investors/export/import agencies),
- Leading Researchers in forestry, trade and poverty reduction,
- Community interests (within countries with major forest product exports)
- Development Cooperation Agencies (E.g. DFID, GTZ,)

The consultation process will be conducted in English and Spanish.

A provisional list of stakeholders who will be consulted during the course of the SIA is given below:

- European Commission, i.e. DG Trade and Development;
- Civil Society Organisations in both developed and developing countries;
- DFID Forestry Advisers;
- Commonwealth Secretariat;
- International Centre for Trade and Sustainable Development;
- Forestry Departments in both developing and developed countries;

- Organisation of Economic Cooperation and Development;
- International Centre for Trade and Sustainable Development;
- United Nations Environment Programme;
- United Nations Food and Agriculture Organization.

Diverse conditions often exist between the political, social and economic characteristics of countries within the same trading block so that although membership benefits all, some countries will stand to gain or lose more than others. This is certainly the case in relation to forestry interests and the MERCOSUR countries, but also applies to those EU members who have significant forestry sectors.

It is also important to consider what implications trade liberalisation within one economic grouping may have on other existing economic trading partnerships. For the four countries which currently form MERCOSUR, this is a relevant issue because they also have important intra-regional trading links and involvement in negotiations on the Free Trade Area of the Americas (FTAA).

For the present SIA on the Forestry sector it is proposed that the study should concentrate on:

- The European Union,
- MERCOSUR (Brazil, Paraguay, Uruguay and Argentina)

It has proved difficult to differentiate between impacts where there is little change in the scenario criteria.[54] For this reason it is proposed that the present study should focus on the baseline and on the situation in which all tariffs are assumed to be removed. As a further test, an attempt will be made to anticipate trading conditions under the situation in which environmental benefits of forests are given monetary values.

Clear guidance is given in the Handbook (March 2006) that key sustainability themes should reflect the Millennium Development Goals, and that indicators should be selected that can be applied in a coherent and consistent manner, with relevance for other general policy objectives and comprehensively dealing with the three pillars of sustainability.[55] Indicators should also be transparent, specific, reliable, credible, measurable, and capable of showing trends over time. A provisional list of indicators is given for this study in Section 6.

Although there are only four existing members of MERCOSUR, conditions within and between each country vary significantly. Brazil dominates the group in overall size and importance of the forestry sector and it is logical that a case study should be sited within it. Paraguay also exhibits many common characteristics in terms of the nature of its forests and the social, environmental and economic pressures that it experiences. However, although the study resources will not extend to a second case study, particular attention will be given to the forestry sector in Uruguay, where almost half the total forested area consists of commercial plantations.

It is self evident that any attempt to anticipate how conditions will alter in response to adjustments in trade agreements is unlikely to provide a completely accurate forecast; if it did there would be no need for negotiation. Predictions need to be accompanied by a risk assessment that represents the worst-case scenario and considers the degree of confidence that can be placed in baseline data, assumptions and estimates of probability. These requirements will be built into the study.

2. Preliminary Methodological Developments

Previous SIA studies have recognised non-tariff standards and regulations as potential barriers to trade and in conflict with the principle objectives of liberalisation. This view is staunchly supported by

[54] Handbook for Trade Sustainability Impact Assessment, European Commission, External Trade (March, 2006)
[55] ibid

countries such as Malaysia. At the same time, there is a strong body of opinion which argues that measures for environmental protection should have a recognised economic role in promoting more sustainable forestry. For example, the United Nations Forum on Forests (UNFF) and the World Trade Organisation Committee for Trade and Environment Division (WTO CTE) have argued that better economic policies are required to make sustainable forest management profitable as ecologically unsustainable practices, including deforestation, ignore replacement costs. Such policies, therefore, would recognise the non-timber benefits of forests such as carbon storage, watershed protection and the value of non-timber forest products (NTFPs) which play a major role in the informal economies of many developing countries but are not accounted for in trade statistics (IUCN 2002).

There is a live debate over the extent to which mandatory or voluntary certification schemes mighty constitute a non-tariff barrier to trade (UNESC 2002), which needs to be considered in the context of this SIA and is particularly relevant as international trading in carbon credits gets under way. Steps will therefore be taken to assess whether meaningful indicators can be introduced to cover forestry assets relating to carbon storage, water protection, and NTFPs.

There is an extensive literature on economic, social and environmental issues relating to forest management and one of the challenges of this inception phase has been to limit the search for relevant information. Key word searches have been undertaken using the Google search engine to isolate references based on the following categories:

- South America, EU/MERCOSUR trading agreements, forest management, economic, environmental, social impacts.
- Forestry development by individual country (Brazil, Paraguay, Uruguay and Argentina).

In addition, statistical data has been sought on each individual country's economic performance.

The information gathered (see References) is by no means comprehensive, but from cross-references and the degree of repetition, it is judged that most of the key issues have been identified from the chosen sources. An important part of the next phase of work will be to invite comment on the list of references from consulted parties and to request any additions.

3. Screening

In accordance with standard practice for SIA, four basic criteria have been examined. Each of these criteria is considered below.

Are there current economic, social and environmental stresses in the Region?

A review of literature sources (see References) has confirmed that extensive deforestation has occurred within MERCOSUR countries over the last two decades, contributing directly to global warming and at the same time reducing the capacity of tropical and equatorial ecosystems to absorb carbon from the atmosphere. Conflicts over land use have been severe in some parts of the region with serious social and cultural consequences. While it remains to be shown whether trade measures are likely to have a significant bearing on these specific problems there is a clear need for action at both the national and international level.

Are trade measures likely to have significant economic, social or environmental impacts?

Previous studies suggest that liberalisation of forest trade is unlikely to have a major impact on sustainability issues (see 2005). However, based on past trends, rising population, economic growth and competing pressures for land within the MERCOSUR countries, liberalisation is likely to have a significant effect on local economic, social and environmental conditions within the region. It is also likely that international investment, with a major stake from EU member countries in the forest sector, will have important ramifications in terms of the development of local forest-based industries. Other topics that need to be given careful consideration are the issue of non-timber forest products which are

often traded informally, new developments in carbon-trading that have the potential to have a major impact in reducing global warming and values that can be difficult to quantify like the maintenance of gene pools within forest environments. It may be argued that a number of these issues fall outside the normal territory of international trade agreements, but they are rising rapidly up the international agenda in terms of good governance and forest management and their implications should be considered as non-tariff based influences on international policy decisions.

Are significant cumulative effects likely to occur?

Forestry, as with other forms of natural resource development, has a direct effect on the environment, social and local economic conditions of the areas in which it is practiced. In addition to social and economic effects of land use change, there is also scope for significant cumulative effects including micro-climatic change, rates of natural run-off and alterations in soil type.

Is the existing regulatory framework sufficient to implement appropriate mitigating/enhancement measures?

Although substantial progress has been made in developing international standards for forest management, the literature covering the MERCOSUR Region indicates that existing regulations do not provide adequate protection for the natural forests. Such concerns are not restricted to South America but also apply to conditions within EU member states for regulating imports of timber which may have been harvested from unsustainable sources.

The conclusion from this screening exercise is that there is a *prima facie* case for examining the existing trade measures governing the forest sector and potential flanking measures under any revision to the EU-MERCOSUR Trade Agreement.

4. Scope of the Forestry SIA

Introduction

This scoping assessment begins by confirming the main focus of the study. It then provides an overview of the key findings from the final report for the forest sector study (Savcor 2005) which provides an international context for this review of forestry in MERCOSUR countries. This is followed by a discussion of forestry production, consumption, and trade patterns within MERCOSUR and South America. It should be noted that at this stage only key aspects of relevance to the analysis are highlighted rather than attempting to carry out a comprehensive literature review.

Focus of the Study

This review has confirmed that the approach to the SIA should be modelled closely on earlier work in the forestry sector, but should pay particular attention to the cross-links between trade liberalization issues affecting forestry and agriculture. The basic structure of the causal chain analysis (CCA applied to the forestry sector by Katila & Simula (Savcor, 2005) will be followed. This document is available at www.sia-trade.org .

The main focus of the study will be to capture the potential economic, social and environmental impacts arising from trade measures relating to market access, subsidies and other regulatory procedures. These trade measures include:

- Market access, as part of the negotiations on non-agricultural market access (NAMA):
    - Tariff measures, i.e. changes in the tariff structure (e.g. reduction or elimination of tariffs on timber and processed timber products).

- Non-tariff measures, e.g. Sanitary and Phytosanitary (SPS) measures and Technical Barriers to Trade (TBTs). Although these may not form part of the current negotiations they represent an ongoing trade issue. The assumption is that these regulations are irreversible and hence possible changes in future refer to offsetting measures that can be taken.

- Subsidies to the forestry sector in different forms (e.g. management; transport, etc),
- Other issues - Eco-labelling, certification and services incidental to the forestry sector.

Key Findings from the WTO Negotiations Forestry SIA

The principal conclusion of the WTO study conducted in 2005 was that, on a world scale, trade liberalisation is unlikely to have much influence on forest product consumption and production because import tariffs are already low and only a relatively small share of forest products is traded internationally. However, overall trade in forest products is expected to increase in response to population and economic growth. Where trade liberalisation occurs this will affect countries differentially. Adverse effects are most likely to be experienced in those countries with poor forest governance. Significant negative sustainability impacts in biodiversity hotspot countries (including Brazil) can be irreversible. In developed countries the removal of import tariffs could incur considerable environmental and social costs due to industrial downsizing. This suggests a precautionary phased approach should be followed for trade liberalisation in the forest sector.

The main effect of reducing or removing tariffs is likely to be felt in trade between developing countries, since these have tended to raise barriers to protect their indigenous industry. This may lead to increased trade in south-south countries, within South America and between South America and Asia. Trade liberalisation will also benefit forest-rich-export-oriented countries (including Finland and Sweden) rather than developing countries, and could assist new EU members and accession countries.

Non – tariff standards and technical regulations to promote environmental objectives are having an increasing impact on trade. This applies particularly to log export bans and prohibitive log export taxes designed, in part, to reduce illegal logging in developing countries. From an economic standpoint, the best alternative would be to promote efficient wood pricing, linked with domestic resource taxes and incentives to encourage sustainable wood production, but this may only be possible where governance and institutional reform ensures the required level of environmental protection.

Forest sector trade is affected by many complex cross-cutting issues including the balance to be struck between clearing forest to expand agricultural production (as in Brazil).). The WTO study concluded that liberalisation of trade in edible oils, soybean, cocoa and coffee is likely to pose risks in countries such as Brazil, Indonesia and West African countries, although this finding is challenged by the Brazilian Mission to the European Communities on the grounds that Brazil is a net importer of cocoa and palm oil and coffee production takes place mainly in regions that have been used for agriculture for decades. In the case of soya production only a small share comes from areas originally occupied by the Amazon forest. In spite of the small level of production the Brazilian Association of Vegetable Oils (ABIOVE) and the National Association of Cereal Exporters (ANEC) have agreed (July 2006) to stop purchases of soya originating in the Amazon Biome until the end of 2008 and to start a dialogue with all relevant stakeholders to enhance long-term sustainable practices in this sector.

Specific recommendations from the WTO study included the merits of involving voluntary forest certification, voluntary import licensing schemes and voluntary (third party) legal compliance schemes. Technical barriers to trade, including safety requirements, are not regarded as a serious constraint at present but they add to production and marketing costs and may encourage substitution of other materials for wood products.

Other measures that could benefit trade in forest products would be regional trade agreements, bilateral memoranda of understanding, increased harmonisation on standards, standardised testing systems and more help for small and medium enterprises in developing countries. One of the most critical requirements is to provide support for strengthening of institutions in countries with capacity constraints and governance problems.

The report includes a case study on Brazil which provides useful insight into many of the issues that are relevant to trade agreements between the EU and MERCOSUR and this is referred to later in this document.

Commentary on WTO Forestry SIA Findings

Most developing countries, including Brazil, Argentina, Uruguay and Paraguay, enjoy no or minimal tariffs in exporting to the European Union as beneficiaries of the European Union's Generalised System of Preferences (GSP). Consequently, the broad conclusions of the WTO Forestry SIA are likely to be supported in terms of the marginal impact of removing the remaining trade restrictions on MERCOSUR imports to the EU. However, several MERCOSUR countries (notably Brazil) maintain significant tariffs on imports of machinery, equipment and services in order to provide support to their own developing manufacturing capacity. Adjustments to these tariffs could have a significant effect on sustainability.

The effects of new non-tariff regulations and standards are also likely to be significant in the development of MERCOSUR-EU trade. Perhaps the most significant issue of all, however, is likely to be the potential for shifts in the balance between the use of forest resources and competing land uses (including agriculture and urban development) due to the complex cross-linkages between these sectors of the global economy.

Forest Resources in MERCOSUR Countries

The status and condition of the forest sectors differs markedly within the four current member countries. This reflects the range of climatic zones and the geographic extent of natural forest cover, historic patterns of harvesting and replanting of indigenous forest and development of plantation forestry. Brazil is unique in having an equatorial climate and possessing equatorial rain forest and tropical forest, whereas the other three countries have largely temperate climates. An overview and brief introduction to current conditions in each country is therefore appropriate.

Table 5.1: Current extent of forests within MERCOSUR Countries

Country	Area (000 km^2)	Climate	Total forest (000 ha)	Natural Forest (000 ha)	Forest as % total land area	Change in natural forest cover (%) (1990-2000)	Plantations (000 ha)	Plantation as % of forest area
Brazil	8456	Equatorial/ Tropical	543,905	538,924	64.3	-4.0	4,982	0.9
Argentina	2737	Temperate/Cool Temperate	34,648	33,722	12.3	-10.0	926	2.7
Paraguay	397	Warm temperate/Savannah	23,372	23,345*	58.7	-5.0	27	0.1
Uruguay	147	Warm temperate/Savannah	1,292	670	7.4	-5.0	622	48.1

*The true extent of Paraguay's natural forest is unknown (Mongabay.com quotes 18,475,00 ha in 2005 or 46.5% of total area)

Brazil

Brazil, the World's fifth largest country, extends from 5^{0} north of the Equator to 34^{0} south. Most of the country lies in the equatorial or tropical zone with high rainfall and temperature. Tropical forest covers 64% of the land surface area and it is one of the world's most endangered high biodiversity areas. Extensive clearance of natural forest has occurred over the last two decades under competing pressure for agricultural development.

Brazil is the world's largest producer and consumer of tropical timber. 86% of the 26 million m^3 of timber harvested annually from the Amazon is utilised internally (Smeraldi & Verissimo 1999). Sao Paulo state alone consumes 5.6 million m3 a year which is more than the volume of tropical timber used annually by France, Great Britain and Spain. Although a substantial proportion of all timber is cut from natural forest, Brazil also has 5 million hectares of pine and eucalyptus plantations. These yielded 103 million m3 of industrial roundwood in 2001 half of which comprised renewable fuelwood and charcoal. Much of the remainder is used in the pulp and paper industry. Only 14% of Amazon timber production is exported to international markets with 40% going to Europe and Japan and the balance to neighbouring Southern Cone countries.

The Brazilian forest sector was one of the first to be criticised by civil society and environmental campaigners for its record on child labour and near slavery (IIED 1996), poor watershed management and destruction of rain forest. These issues remain, as they do in most tropical rain forest environments, but Brazil has also sought to adopt international forest certification schemes and to develop its own forest standards (May 2004).

Paraguay

Paraguay, only a twentieth the size of Brazil, straddles the tropic of Capricorn, lying between 18^{0} and 26^{0} south. Low lying areas in the centre and south east parts of the country support fast growing tropical forest but the western part is dry and semiarid as the land rises towards the foothills of the Andes Cordillera. Like Brazil, Paraguay has extensive tropical forest accounting for between 46 and 60% of the total land area, but this has been subjected to intense pressure. A major issue in Paraguay is the unreliability of forestry and other land use statistics. Under Paraguay's forest law private forest owners have historically been permitted to convert 75% of their holding to agricultural use. It is estimated that between 1990 and 2005, Parguay lost 12.7% of its natural forest cover amounting to around 2,682,000 hectares (Mongabay.com 2005). In December 2004 a new law was introduced which has forbidden any further conversion of the native forests in the eastern region for two years. The affected area, the Upper Parana Atlantic Forest, is one of the most endangered rainforests in the world. It has exceptionally high biodiversity containing over 90% of all amphibian species and 50% of all rainforest plants on earth (WWF 2004).

Uruguay

Uruguay is the smallest of the four MERCOSUR countries occupying an area half the size of Finland and only 2% of the area of Brazil. It has a population of only 3.2 million people. The total area under forest is 7% (the lowest of the four MERCOSUR countries) but almost half of this is plantation which is being rapidly extended. The main species grown are eucalyptus and pine for pulp production. More than 3.6 million hectares are suitable for forestry and will support growth rates that are amongst the fastest in the world. The Government has declared forestry to be of national importance and has established Forestry Priority Areas with a programme of credits and fiscal incentives. These include subsidies of up to 50% of planting costs, exemptions from land tax for plantations, no capital gains tax on proceeds from plantation forestry, duty free import of equipment and 'soft' loans for up to 12 years. International investment has been provided from Finland, Holland, Spain, Chile and Canada (W.McKennie, 1996). Compania Forestal Oriental SA (FOSA), 60 % owned by Finnish pulp producer Botnia, is the country's largest wood producer. In 2004 it received a supplementary loan of 7 million US$ from Finnfund to increase its eucalyptus plantings. The company is planning to build the

first pulp mill in Uruguay with an annual output of 1 million tonnes. This will require a doubling of the existing plantation area under FOSAs ownership.

Argentina

Argentina is the second largest country in South America, and is one third the size of Brazil. It extends from the tropic of Capricorn (23^0 South) to the Straits of Magellan at 54^0 south. Its climate ranges from warm temperate to cool oceanic and is ideally suited to growing trees. Over 1 million hectares of plantation forestry exist, most of which consists of eucalyptus, southern pine, willow and cottonwood. A further 20 million hectares is assessed as suitable for forestry without competing directly with agriculture or natural woodland. The forestry sector is deregulated and has been provided with substantial subsidies in the past, although this has not resulted in good quality timber due to poor management practices and inefficiencies. Most timber is exported to North American, European or Asian markets.

In recent years the government has treated the forestry sector as an integral component of its economic reform plan and is actively encouraging international investment, but progress has been adversely affected by high transportation costs, low domestic demand and an underdeveloped forest products industry. However this position is changing, due, in part, to the success of MERCOSUR which has provided the forest industry with a new economy of scale buy opening up the Brazilian and Chilean markets and attracting strong investment from Chilean forest product companies. Chilean investments have exceeded 60% of all foreign capital in forestry over the last decade. Both pulp and paper industries offer long term potential. Fletcher Challenge a New Zealand company has developed a modern composite mill to process timber form the northern plantations and is producing high quality lumber, plywood, veneer and mouldings (Cintrafor 2006).

Deforestation

Statistical information on rates of deforestation and conversion to other land uses is of mixed quality and reliability, but the FAO summary concludes that the countries of Latin America will fall into four broad groups in terms of their land use trends over the next 15 years. By 2020 it is predicted that the following changes will have occurred unless radical changes are introduced

Group 1: *Uruguay, Chile, Guyana and Venezuela*
Forest cover will be reduced by less than 10% except in the case of Uruguay where the area of forest is expected to increase.

Group 2: *Bolivia, Peru, Argentina, Costa Rica, Suriname, Honduras and Columbia*
Land use pressures are higher than in Group 1, but forest cover is not expected to be reduced by more than 12 %

Group 3: *Ecuador, Guatemala, Mexico, Panama, Paraguay and Brazil*
Land pressure is not as great as for Group 2 countries but deforestation is nevertheless expected to increase by more than 15%.

Group 4: *El Salvador, Nicaragua and Belize*
High rates of deforestation are anticipated.

Current Trading Patterns

The four MERCOSUR countries are also members of the Latin American Integration Association (ALADI) which includes 11 South American countries and Cuba. ALADI provides an indication of the overall level of trade in forest products in South America which amounts to 1.7% of total exports. This figure, however, masks the significant production of forest products from Chile and Paraguay

which represent 9.7% and 7.4%, respectively, of their total exports. Brazil, Paraguay, Ecuador and Chile are net exporters of forest products (1996-2000 ALIDI, 2000), but there is a great difference between Brazil's outputs and the rest of the ALIDI countries in terms of value of exports. Brazil alone produces 48.8% of ALIDI forest exports worth US$ 2250 million a year. Table 5.2 gives a breakdown of the contributions that MERCOSUR countries make to ALIDI Forest trade.

Table 5.2: Import and Export of Forest Trade for MERCOSUR Countries

Country	Exports ($USm)	Imports ($USm)	Balance ($USm)	%ALADI Exports	% ALADI Imports
Argentina	202	178	25	4.4	9.8
Brazil	2251	274	1977	48.8	15
Paraguay	72	1.2	71	1.6	0.1
Uruguay	45	32	12	1.0	1.8

Source: FAO 2004

The four MERCOSUR countries have strong trade links with the European Union, which remains their largest export market. In the rest of South America, the United States and Canada have become the main external trade partner, increasing their share of Latin American trade from 45% in 1991 to 57% in 2000. This trend has important implications in terms of trade agreements on forest products. Ambitions exist to create the Free Trade Area of the Americas (FTAA) which would create the largest free trade area with 800 million people, but there are also north-south rivalries and deep concerns that the process would result in 'economic annexation' of South America by the United States.

Existing Trade Agreements

In addition to MERCOSUR, Brazil, Paraguay Uruguay and Argentina are members of the World Trade Organisation (WTO) and the General Agreement on Trade and Tariffs (GATT). Two other agreements which have important ramifications for world trade are the Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES) and the International Tropical Timber Agreement (ITTA). It is significant that Paraguay is not a signatory to the ITTA.

The WTO allows members to support their own rural economies under the Agriculture Agreement, although domestic policies that have a direct effect on production and trade are due to be cut back progressively within developing countries. The new rules on agricultural products stipulate that only tariffs may be used to control market access so all WTO members are required to reduce subsidies for exports.

Other relevant agreements within WTO that affect forest products include:

- Sanitary and Phytosanitary measures (SPS)
- Technical Barriers to Trade (TBT)
- Trade related Investment Methods (TRIM)
- Trade Related Intellectual Property Rights (TRIPS) and,
- Antidumping, customs valuation, pre-shipment inspections, rules of origin, import licensing, subsidies and safeguards.

SPS and TBT are of particular interest in the forestry sector because they could be held to represent non tariff barriers as discussed above.

The international trade agreements are only one part of the equation in terms of access to markets in Latin America. Sub-regional associations also exist, including the Customs Unions of the Andean Community (CAN), the Central American Common Market (CACM), and the Caribbean Community Common Market (CARICOM). These bodies encourage "deep integration" to stimulate trade but also to promote policy related access to market services, competition policies and regulatory environment (CEPAL/ECLAC, 2002).

The overview of trading patterns in Latin America prepared by FAO (2004) concludes that both intra-regional and international trade in forest products is expanding rapidly. Between 1991 and 2000 trade between the EU and MERCOSUR expanded from US$ 22.7 billion to US$ 36.3 billion. During this

period EU exports to MERCOSUR rose by US$ 11.1 billion, while MERCOSUR's exports to the EU rose by US$ 2.5billion.

Existing Trade Barriers

Currently, MERCOSUR countries permit the import of wood products without tariffs or duty. However, different principles and rates apply to capital goods including those used in timber processing. Paraguay, for example, protects its domestic industries for furniture stationary paper and packing cases by imposing an extra 10% on the tariff for imports of these goods. Tariffs on newsprint paper are levied by all MERCOSUR countries at between 6 and 12 %. Argentina encourages imports of forest processing equipment by applying zero tariffs on dryers and pulp and paper making machinery, chainsaws and presses for the manufacture of particle board and fibreboard, but both Argentina and Brazil protect their forestry and agricultural tractors and trailer industry by imposing tariffs of 28.4% and 35% respectively (FAO 2004). In general, MERCOSUR countries have agreed deadlines to adjust their exemptions on capital goods and converging on a Common External Tariff (CET), which Argentina and Brazil have been applying since 2001 and Paraguay and Uruguay are due to adopt in 2006.

Velarde et al, FAO (2004) conclude that subsidies are likely to have much more significant implications for forest trade than tariffs since these can provide financial benefits for production, manufacturing and distribution of goods and services.

In the short term, certification of forest products could confer a trading advantage on companies and even countries that are perceived to be acting in an environmentally sustainable manner. Interest in eco-labelling and certification is strongest amongst developed countries like the UK, Germany and the Netherlands and retailers see a potential commercial advantage in selling only FSC products. In the long run, however, this advantage would diminish as more countries adopt voluntary certification.

Official Development Assistance

Forestry has been regarded as a priority for international assistance and development cooperation for many years since it allows funds to be targeted at specific groups of the rural poor and multi-purpose livelihood, social and environmental programmes. However, figures presented by FAO do not suggest that there is any marked skewing of resources although Paraguay received overall development assistance of 1% of GDP in 2000, whereas Argentina received 0.03%, Brazil 0.05% and Uruguay 0.08%. These latter rates are typical for most Latin American countries with the exception of Surinam, Bolivia, Guyana and Nicaragua, which received 4.02%; 5.75%; 15.15% and 27.18 %, respectively.

Foreign Direct Investment

In general, macroeconomic stabilisation, trade liberalisation, privatisation and policy deregulation has encouraged private investment and foreign capital especially from Spain and Portugal, although the Argentina economic crisis in the late 1990's dented confidence very significantly in this part of the region.

FAO has conducted a competitiveness analysis of forestry for investment. It quotes an IDB forest cluster study for South America which concluded that:

- There is great potential for Argentina, Brazil, Chile, Colombia and Mexico to develop forest clusters along the Nordic model;
- Brazil and Chile will be in the best position to expand their forest production, due to existing but still young forest plantations and relatively stable macroeconomic conditions;

- Argentina has one of the best forest development potentials on the continent, but its financial crisis may delay medium to long term investment in the sector;
- Any internationally competitive large industry has to be based largely on plantations rather than natural forest;
- Small and medium size enterprises dominate in the forest product processing industries

For both Argentina and Brazil the report concludes that there are obstacles to be overcome. In the case of Argentina, there is urgency for the government to formulate new policies for natural forest management and eliminate the illegalities and tax evasion of SMEs. In Brazil, negative factors include corruption, uncontrolled deforestation and unsettled land tenure issues. In terms of governance it is argued that there needs to be a major change in traditional attitudes of politicians, landowners and other stakeholders by giving forestry an equal land-use value as it does for agriculture and grazing. Realistic values should be applied to all uses and services of forest land, including forest grazing. Stable land ownership is required together with the cessation of perverse incentives, land grabbing and corruption which lead to uncontrolled, unnecessary deforestation and degradation of the natural forest.

5. Sector specific indicators

For analytical purposes the study will use sustainability definitions developed initially as a common methodology for other SIA studies (Kirkpatrick and Lee 2002). This definition comprises three categories of core indicators covering the economic, social and environmental dimensions, plus a fourth category of process indicators which assist in analysis of sustainability and sustainable development issues.

Each of these categories of impact can be assessed using core indicators (Kirkpatrick and Lee 2002), as shown in Table 3 below.

For each of the core indicators in turn there are more detailed second tier indicators which are more specific to forestry. These build on the indicators developed by Katila and Simula (Savcor, 2005).

Table 5.3 includes the draft second tier indicators (which will be subject to refinements as the analysis is developed beyond the inception stage). The criteria for selection of second tier indicators are:

- Second tier indicators need to cover each of the nine core and two process indicators;
- As far as possible there should be (reliable) data available to measure each indicator;
- Where quantitative information is not available it must be possible to at least provide indicators of significance (and change);
- Indicators should be such that changes in indicators can be linked to changes in trade measures;
- Indicators should be chosen that illuminate specific forestry impacts that are of value to trade negotiators.

Table 5.3: Sustainability indicators for forestry SIA

Sustainability dimension	Core indicators	Second tier indicators
Economic	***Real income***	Quantity and value of production and trade in timber and non-timber forest products, income levels of different stakeholder groups, consumption - payment in kind*, Government revenues (License fees, taxes, etc);
	Employment	Changes in levels of income and employment in forestry and timber processing industries, artisan employment*;
	Fixed capital formation	Size and type of saw mills / pulp mills; etc
Social	***Poverty***	Number of forest dependent people livelihoods and development, Land tenure and user rights Community relations and workers' rights;
	Health and education	Health and safety of forest workers; welfare of rural forest communities;
	Equity	Employment and income distribution, Asset ownership* (timber processing industries); Gender distribution – income and assets*
Environmental	***Natural resource stocks***	Total area of forest cover as %age of all land cover; area of plantation forest; %age change in natural forest and plantation forest over time
	Environmental quality	Percentage of forest certified as sustainable by international standards, Changes in forest areas managed primarily for the protection of soil and water
	Biodiversity	Extent of forest areas protected against logging, protection of endangered species, change in extent of protected areas; Changes in gene stocks,
Process	***Consistency***	Domestic policies, , control over forest licences, International commitments – stock conservation;
	Institutional capacity	Government capacity and commitment, government use of revenues from forestry; capacity to police/ monitor timber harvesting, forest sector management capacity.

* Indicators where data are more likely to contain qualitative elements.

6. Content of the mid-term and final reports

The preliminary outline for the Mid-term report is shown in the Box below. It is anticipated that the final report will follow the same format.

Preliminary outline of mid-term report[56]

Executive Summary

Introduction
- Background
- Objectives of study

Methodology
- Overview of the methodology
- Case study selection
- Selection of trade scenarios
- Selection of indicators
- Causal chain analysis

7. Proposed work programme (Mid-Term Report)

July 2006	Drafting of inception report; including methodology section and briefing paper on the selection of case study countries.
July 2006	Selection of potential collaborators for country case studies.
16 July 2006	Visit to the European Commission in Brussels to meet members of DG Trade and discuss Inception Report
August-September 2006	Implementation of country case studies.. It is envisaged that drafts of the country case studies will be available by the end of September.
September-October 2006	Activities to be carried out by SIA Team: Further refining of methodology; Screening and scoping of individual trade measures; Causal chain analysis of specific trade measures; this will be based on reviews of published / grey literature and case studies, discussions with key informants, analysis of data bases held by national and international organisations.
October 2006	Preparation of Mid Term Report to be sent to University of Manchester by for submission to the European Commission
November 2006	Meeting in Brussels to present Mid Term Report to members of the Commission and to representatives of civil society organisations

5.3 Automobile Sector Study[57]

1. Overview of the global automobile industry[58]

The automobile sector has a historically international nature, with its products spread around the world and relative dominance by a small number of companies. Nonetheless, despite globalising trends, in certain respects the industry is more regional than global. Table 5.4 gives the size of each of the main markets.

[56] At this stage it is expected that the final report will follow a similar structure, however this may change based on comments received during the course of stakeholder consultations.
[57] The automobile sector study will be undertaken by IARC, University of Manchester.
[58] This section builds on Humphrey and Memedovic (2003), Humphrey (2003), Sturgeon and Florida (2000), Agudelo et.al. (2006).

Table 5.4: Global automobile market segmentation

Region	(% Share, by value, 2003)
United States of America	42.1
Europe	28.3
Asia-Pacific	15.2
Rest of the World	14.3
Total	100.0

Source: Datamonitor (2004).

During the 1990s, production in the industry grew overall by 4.2 per cent, while sales fell by 0.6 per cent. In the traditionally wealthy economies of North America, Japan and Western Europe (the Triad) the automobile industry is mature and plagued by overcapacity, cost pressures and low profitability. Contrary to this, in other countries the industry expanded both in terms of production and sales. While vehicle sales in the Triad regions rose by 230,000 units in the period 1990-97, in the rest of the world sales increased by 3.8 million units. For vehicle production, the respective figures were 1.7 million and 5.1 million units.[59]

This rapid growth has been concentrated in a small number of developing countries, namely the Republic of Korea and the emerging markets (Mexico, Brazil, China, India, the ASEAN countries[60] and Eastern Europe). The trend observed in the last 15 years shows that the move towards emerging markets has created over-investment, so that capacity increases have greatly exceeded any realistic short-term sales expectations.

The geographical spread of vehicle output and growing sales in developing countries has not been accompanied by a spread of ownership in the assembly sector. Instead, driven by oligopolistic competition between global auto companies, increased competition at a global scale has led to further concentration. At the beginning of the 2000s, the largest 20 firms produced more than 95 per cent of the world's vehicles.[61] Some 529 plants located in 45 countries are owned by 27 automakers.[62] As for supplier plant location, 2211 plants located in 60 countries are owned by 150 automobile suppliers. With respect to engine production, 168 plants are located in 24 countries and owned by 16 companies.

Finally, the automobile industry structure is clearly segmented both in terms of technological requirements (hence in creation of economic added value) and location. The global automobile industry is composed of several sections – assemblers, global mega-suppliers, first-tier suppliers, second-tiers suppliers, third-tier suppliers, and aftermarket—each of which has particular capability requirements (Box 1).

[59] Humphrey and Memedovic (2003)
[60] The Association of Southeast Asian Nations – ASEAN – include Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam).
[61] OECD (1996).
[62] Sturgeon and Florida (2000).

Box 1. Capability requirements in the global auto industry

Assemblers: Increasing scale required to spread costs of vehicle design and branding. Innovation and design capabilities remain critical as first movers in new markets sections can gain important rents while other companies catch up. Some companies, such as Ford, appear to believe that core competences lie more in branding and finance, and they are outsourcing parts of manufacturing. Others, such as Toyota, maintain an emphasis on manufacturing excellence and competence.

Global mega-suppliers: These firms supply major systems to the assemblers. They are sometimes referred to as "Tier 0.5" suppliers, because they are closer to the assemblers than the first-tier suppliers (see below). These companies need to have global coverage in order to follow their customers to various locations around the world. They need design and innovation capabilities in order to provide "black-box" solutions for the requirements of their customers. Black-box solutions are solutions created by the suppliers using their own technology to meet the performance and interface requirements set by assemblers.

First-tier suppliers: These are firms which supply direct to the assemblers. Some of these suppliers have evolved into global mega-suppliers. First-tier suppliers require design and innovation capabilities, but their global reach may be more limited.

Second-tier suppliers: These firms will often work on designs provided by assemblers or global megasuppliers. They require process-engineering skills in order to meet cost and flexibility requirements. In addition, the ability to meet quality requirements and obtain quality certification (ISO9000 and increasingly QS9000) is essential for remaining in the market. These firms may supply just one market, but there is some evidence of increasing internationalization.

Third-tier suppliers: These firms supply basic products. In most cases, only rudimentary engineering skills are required. A study by Leite (1997) of skills and training at different parts of the automobile value chain in Brazil showed that in the third-tier of the component chain, skill levels and investments in training were limited. At this point in the chain, firms compete predominantly on price.

Aftermarket: A further important segment of the automobile value chain is the market for replacement parts. This is the sector many firms in developing countries first moved into, even before local assembly sectors were developed. Nowadays, there is an international trade in aftermarket products. Firms in this sector compete predominantly on price. Access to cheaper raw materials and process engineering skills is important. Innovation is not required because designs are copied from the existing components, but reverse engineering capability and competence to translate designs into detailed drawings are important.

From: Humphrey and Memedovic (2003:22).

The automobile sector in the European Union

The automobile industry in Europe is one of the leading industries that combines added value, R&D and market power. In 2003, the European automobile market had a value of nearly $US 268 billion, and recorded sales of 16.9 million units. In terms of market segmentation, the leading sector for the European automobile market is passenger cars—generating 89.2 % of volume sales. Light commercial vehicles account for 10.8 % of sales. In terms of value, Europe represents 28.3% of the global automobile market.[63]

The German-based Volkswagen Group holds the largest market share within the European automobile manufacturers market, accounting for almost a fifth of the region's overall market value.

[63] Datamonitor (2004).

DaimlerChrysler, headquartered in Stuttgart, Germany, is the world's third largest car producer. Sales of the two French producers, PSA (the owners of Peugeot and Citroen) and Renault, are more highly concentrated in Europe, reflecting the absence of a globalisation strategy in the case of Peugeot, and the failure to establish a viable North American presence in the case of Renault. FIAT, headquartered in Turin, Italy, operates through fully owned subsidiaries or joint ventures and has a presence in around 190 countries.[64]

With the opening of Central European countries to global markets since 1989, the auto industry in Central Europe is now increasingly integrated into the European industry. Integration between the motor industries of Western and Central Europe has taken two forms. First, there was an increasing two-way trade in vehicles, in which Central Europe offered both growing domestic markets and low-cost production sites to Western European assemblers (including firms from Japan and North America with operations in Western Europe). Second, a number of export-oriented engine and component plants were built in Central Europe in the 1990s.

The automobile sector in Mercosur[65]

While the auto industry in Mexico has become strongly integrated with that of the USA, Brazil and Argentina have become more integrated with each other through Mercosur. Of the four Mercosur countries, Brazil and Argentina are those which, from the 1950s onwards, promoted the development of their domestic auto industries. In both cases, the initial strategy was import-substitution, which until the early 1990s meant the presence of self contained vehicle industries (autos and parts) basically oriented to domestic markets. Uruguay and Paraguay are net importers of vehicles and auto parts.

When global auto assemblers began to set up production operations in Argentina and Brazil in the 1950s and 1960s, they were obliged to source a large part of their inputs from within the domestic economy, and helped to create new supplier networks in the host country. Even though trans-national companies (TNCs) began to play a significant role in the components industry from the early 1970s, the auto industry still provided many opportunities for local companies. Subsidiaries in the two countries had some freedom to introduce design changes and in some cases country-specific models were developed. This meant the emergence of some significant locally owned suppliers in Brazil, some of which began exporting to Europe and North America.

During the 1980s the industry in both countries suffered a decline, associated with debt crisis, increasing vertical integration and departure of some of the trans-national companies.[66] Recovery began at the end of the decade and into the 1990s, based on export-led growth, return to macroeconomic stability, and regional trade integration. Seeing the regional bloc as a unit with improved macroeconomic conditions, foreign assemblers began to regard the industry as a promising emerging market. However, the development of the industry was undermined by exchange rate instability in the latter part of the 1990s.[67] The East Asian crisis had a direct impact on Brazil, where interest rates were doubled to defend the currency. Between 1997 and 2001 vehicle sales for Brazil and Argentina fell by 18.2% and 58.6%, respectively.

The integration of the auto industries of Argentina and Brazil began in 1990 with the signing of the Economic Complementation Agreement in Buenos Aires. This allowed for tariff-free trade in

[64] Datamonitor (2004), Humphrey and Memedovic (2003).
[65] This section builds on (Humphrey and Memedovic, 2003), Miozzo (2000), Humphrey (2003), Mortimore (2000), Sturgeon and Florida (2000).
[66] Laplane and Sarti (1997: 33–34)
[67] While the Argentine exchange rate was tied to the US$ between 1991 and January
2002, the exchange rate of the Brazilian currency was managed by the Central Bank. A steady devaluation of the Brazilian Real in the latter part of the 1990s was followed by an exchange rate crisis and a sharp devaluation in 1999. This devaluation disrupted the basis of the division of labour within Mercosur, making Argentine components production, in particular, uneconomic. The devaluation of the Argentine currency in 2001 did not resolve the problem. While it made Argentine exports to Brazil more competitive, it severely disrupted the domestic economy and led to a sharp decline in automobile production. (Laplane and Sarti, 1997).

automobile products between Argentina and Brazil, subject to trade balancing and quotas.[68] Regional trade in the industry increased as a result of three factors: the signing of the Mercosur agreement in 1995, the reversal of trade liberalization for vehicles adopted in Brazil in the early 1990s, and the development of similar auto industry sector policies in both Argentina and Brazil. By the late 1990s, a genuine regional automobile production system was developing in Mercosur, based on a division of labour in vehicle and components production between Argentina and Brazil. The major trans-national assemblers, all of whom planned to have assembly plants in both countries by the year 2000, were beginning to ration vehicle production and also to source major components from just one site in each country.

Of the 20 biggest investors in Argentina between 1990 and 1996, seven were car companies (five of European origin). American and European manufacturers have traditionally been strong in Latin America. In the 1990s, Japanese firms entered the Latin American market. Established producers and new entrants invested in light-vehicle assembly capacity at the end of the 1990s, bringing a significant increase of production capacity in the region.[69] The effect of increased FDI on the industry ownership meant the denationalisation in the components industry. The sale of leading Brazilian companies to TNCs was clearly evident after 1995, when 10 of the 20 largest component manufacturers in Brazil were wholly or partially locally-owned. By 1998, seven of these ten firms had been taken over by TNC's. There has also been a change in the ownership and control of automobile plants in Argentina, where Fiat and Renault took over former Argentine companies.

Imports of road vehicles and other transport equipment comprise about 15% of Mercosur imports from the EU. Mercosur exports to the EU for the sector are about a third of its imports from the EU (Table 5.5).

Table 5.5: Automobile industry trade between the EU-15 and Mercosur

	1999 ($USm)	2004 ($USm)
Road vehicles		
EU imports from Mercosur	862	585
EU exports to Mercosur	2558	2483
Other transport equipment		
EU imports from Mercosur	515	508
EU exports to Mercosur	1126	868
Total trade in goods		
EU imports from Mercosur	20464	34201
EU exports to Mercosur	22027	21895

Source: OECD (2005), Ferrero-Waldner (2000).

Potentially significant impacts of the EU-Mercosur trade agreement

Economic impacts

Duties on entry for cars and vehicles into Brazil and Argentina (up to 56% and 30 % respectively) were applied until 2001[70], and significant tariff and non-tariff barriers remain. The reduction of these barriers is expected to have significant effects on each of the three core economic indicators. Real income and employment will both be affected by increases or decreases in production, while greater market opportunities or closure of domestic firms may have significant effects on fixed capital formation.

The loss of tariff revenues in the Mercosur countries is not expected to be large, but will need to be investigated in the SIA.

[68] Roldan (1997), quoted in Humphrey and Memedovic (2003).
[69] Humphrey (2003).
[70] Duties in Uruguay and Paraguay are applicable until 2006.

Social impacts

It has been estimated that the automobile industry employs around 50000 people in Brazil and 16000 in Argentina[71]. The principal impacts in the sector associated with the EU-Mercosur trade agreement are expected to occur through increased or decreased employment, and changes in skill levels.

Employment effects may affect poverty levels, and distributional effects may also have impacts on social equity. Employment in the sector is predominantly male, but there may be some gender impacts. Incentives and opportunities for higher skill levels would have a beneficial educational impact, although impacts may also occur in the opposite direction if the industry were adversely affected.

Environmental impacts

The consumption of resources and generation of wastes and pollutants by the automotive industry can be significant. Management capabilities might improve through greater involvement of international corporations, or decline if the trade agreement were to stimulate component production in poorly regulated facilities. Effects such as these are not expected to be large in either direction, but will need to be considered in the SIA.

Larger environmental impacts would occur if the agreement were to stimulate vehicle sales and use. Technological improvements can be expected to ameliorate the adverse effects, and greater entry into export markets may induce the industry to adjust more rapidly to higher environmental standards. Nonetheless, motor vehicles continue to be a major source of air pollution, and can also cause significant water pollution through run-off of rainwater from contaminated roads.

No major direct impacts are expected on biodiversity, but indirect impacts may occur through pollution effects or the expansion of vehicle use and hence of road construction.

Process impacts

Development of a domestic motor industry has traditionally been a major factor in upgrading technology levels and skill levels in developing countries, and hence in stimulating their economic and social development. The trade agreement may have a significant impact, positive or negative, on Mercosur countries' ability to take advantage of the industry in this way. In evaluating the significance of potential process effects of this nature, the SIA will need to examine the possible future place of Mercosur within evolving global supply chains.

5.4 Agriculture Sector Study[72]

1. Overview

Agriculture is a sensitive issue in the EU-Mercosur discussions. Mercosur claims that its agricultural market is one of the most competitive in the world, and asks for a better access to the EU market. The EU market is open to a lot of products exported by Mercosur countries, such as tropical beverages, fruits, vegetables and soya products. However, market access remains very difficult for agricultural products produced in both regions, for example, sugar, beef meat, poultry meat, apples and pears. Many products, such as pig meat, are protected by SPS measures. Tariff quotas are often applied by the EU on these kinds of products, and off-quota tariffs remain very high, similar to tariff peaks.

[71] Estimates based on Sturgeon's & Florida's accounted average number of workers in plants of the type established in Argentina and Brazil.
[72] The agriculture sector study is being undertaken by GRET.

As Mercosur world market shares are continuously increasing in recent years, Mercosur is the main competitor of former agricultural world powers, such as the United-States and the EU. Opening EU internal markets to Mercosur products is a sensitive issue for EU farmers as Mercosur farmers are likely to be more competitive for products listed above. Agriculture remains an important employment sector in most new member states (particularly in the Baltic countries, Poland and Slovenia) and in the two accessing countries (Romania and Bulgaria)—countries where the competitiveness of the agricultural sector as a whole remains low. The difficulties and challenges of entry of Mercosur products in EU market may be more acute for new Member states and accessing countries than for old member states.

2. Proposed Approach

The study will focus on the potential economic, social and environmental impacts of the trade aspects for an Association agreement between the European Union and Mercosur. Impacts in both regions will be assessed.

Scenarios

The Association agreement scenario for these trade-related measures will assume that discussions are ongoing to address trade-related concerns for both the EU and the Mercosur countries. Policy recommendations will be developed to help negotiators and policy makers identify ways in which the Association agreements can address these issues in a way that supports economic, environmental and social sustainability, where it is currently not being supported or where the baseline situation could be improved. The study will employ two scenarios for tariff-related market access: a baseline scenario (current levels) and a full liberalisation scenario.

The SIA will in particular assess sustainability impacts for agriculture products that may be more sensitive - for instance, poultry, beef, soya, wheat, sugar, including ethanol, apples - (primarily for exports from Mercosur to the EU) and for wines and spirits (primarily for exports from the EU to Mercosur).

In addition to examining tariffs, other market access measures such as non tariff-barriers applied by the EU and Mercosur, including sanitary and phytosanitary measures and technical barriers, will factor into the SIA.

Case studies: Beef and Ethanol

Two case studies are proposed which will examine impacts in greater detail than is possible for all agricultural products.

Beef products:

Mercosur countries, in particular Brazil and Argentina, are very large beef producers. However, environmental and social issues related to beef production are already sensitive, including deforestation, greenhouse gas emissions (methane), soil degradation, displacement of landless farmers, etc. As tariff reduction for beef products may intensify beef production in Mercosur countries, these environmental and social impacts might be significant. In the EU, two thirds of beef is derived from dairy herds, and one third from suckler herds. Suckler cows are concentrated in France, Spain, Ireland, United Kingdom, Belgium and Portugal and in producing member states, suckler herds are usually in less favoured areas. Increasing Mercosur imports may reduce beef production in those areas, with economic, social and environmental impacts (see key sustainability issues section). However, other non trade-related factors such strategies of private sector exporters or EU consumers demand for Mercosur beef products might have an impact on beef products exports to the EU market. Such factors will need to be considered in the SIA.

Ethanol : a sugar by-product

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Sugar is likewise a highly sensitive issue in the EU-Mercosur negotiations and may likewise require a separate case study. Brazilian sugar production is highly competitive, and increased openness of the EU market to Brazilian sugar may cause a decrease in EU production. As a by product of sugar, ethanol also requires attention. Obtained biologically by the fermentation of sugar, ethanol can be blended with gasoline in varying quantities to reduce the consumption of petroleum fuels, as well as to reduce air pollution. Production of ethanol in Brazil increased to 18 billion liters in 2005, and consumption 15,9 billion liters making Brazil the world's main ethanol exporter. Comparatively, EU-15 production and consumption reached respectively 2,055 and 2,025 billion liters in 2005.

In order to meet the Kyoto goals, bio-fuels such as ethanol fuel may be required in the EU: Directive 2003/30/EC states that 'Member states should ensure that a minimum proportion of biofuels [such as ethanol fuel] and other renewable fuels is placed on their markets, and to that effect, shall set national indicative targets'. These objectives have been set at 2% of inclusion as for December 2005 and 5.75% as for December 2010.

Though the process of ethanol production presents risks of water pollution and soil degradation (that can be fought by appropriate regulations), the substitution of gasoline by ethanol fuel is an effective way to reduce greenhouse gas emission (principally CO_2), provided that in the production of the ethanol, the fossil fuel contribution is minimized (growing sugar cane requires tractors and specialised harvesting machinery; these take a lot of energy to build, and then of course they need diesel fuel to make them go).

As there exists 3 main types of biofuels: biodiesel, straight vegetable oil and ethanol all of which are produced in small quantities in Europe (in comparison with Brazilian ethanol), the extent to which Brazilian ethanol may be imported in Europe depends both on the degree of protection of the European market (hence is competitiveness), and the energy and environmental balance of each biofuel. Current Mercosur ethanol exports have to the EU market currently face tariff rates ranging from 102 to 192 euros per m^3.

3. EU-Mercosur Trade in Agriculture Products

3.1. Trade flows

Exports from Mercosur to the EU

Mercosur agricultural exports are concentrated on a small number of products. Table 5.6 shows the percentage of each main product among the total exports from Mercosur to the EU. The main export products (soya and coffee) have free access to the EU market. The share of each does not reflect the potentialities of Mercosur production to be exported to the EU, but a mix between potentialities and the level of EU protection, which is very high for some products (see section on trade measures).

Table 5.6: Share of Mercosur main products in exports towards the EU (%)

	1999	**2000**	**2001**	**2002**	**2003**	**2004**
Oilcake from soya bean	23.52	28.40	30.15	29.88	28.99	32.23
Soya bean	15.45	15.20	20.40	19.36	19.84	19.25
Coffee	11.35	9.92	7.44	6.41	5.95	5.94
Fresh or chilled meat of bovine animals	3.80	3.88	2.06	3.50	3.86	4.50

Orange juice	0.35	0.44	2.17	5.38	5.21	4.26
Maize	2.54	2.79	2.45	1.92	3.25	3.18
Frozen meat of bovine animals	3.02	2.79	2.16	2.38	2.04	2.43
Raw tobacco	3.89	4.04	3.46	3.39	3.43	2.96
Preparations of poultry meat	0.65	0.97	1.30	1.24	1.71	1.94
Poultry meat	1.11	1.11	1.23	1.04	1.66	1.92
Preparations of bovine meat	2.38	2.00	1.70	1.68	1.42	1.65
Apples	1.01	0.77	0.84	0.90	1.08	1.14
Lemons and limes	0.94	0.80	0.86	0.86	1.19	1.00
Pears	0.89	0.86	0.79	0.86	0.82	0.69
Oranges	0.81	0.41	0.96	0.38	0.55	0.60
Frozen orange juice	7.98	7.26	3.02	0.32	0.07	0.07

Source: COMEXT database

All products are not exported from all Mercosur countries. The following sections detail the origin of chosen exported products.

Soya bean and soya bean oilcake

Soya bean and soya bean oil represent the two main products exported by Mercosur countries among which Brazil and Argentina are the principal suppliers. Table 5.7 and 5.8 show that the share shipped to Europe and measured in thousands of euros steadily increased between 1999 and 2004.

Table 5.7: EU Imports from Mercosur for oilcake from Soya bean (measured in thousands of Euros)

	1999	2000	2001	2002	2003	2004
Brazil	985 303	1 447 143	1 917 075	1 768 044	1 711 552	2 178 188
Argentina	1 176 638	1 553 488	1 712 768	1 871 819	1 839 358	2 184 594
Mercosur	2 162 074	3 002 821	3 630 476	3 640 026	3 564 503	4 363 450

Source: COMEXT database

Table 5.8: EU Imports from Mercosur for Soya bean (measured in thousands of Euros)

	1999	2000	2001	2002	2003	2004
Brazil	1 111 547	1 428 676	2 149 134	2 015 775	2 124 918	2 242 955
Paraguay	132 733	90 917	146 179	56 755	193 601	232 486
Argentina	172 228	87 640	157 029	261 114	70 638	45 856
Mercosur	1 420 436	1 607 524	2 456 412	2 358 505	2 439 383	2 605 947

Source: COMEXT database

Bovine and poultry meat

Brazil and Argentina are the main exporters of bovine and poultry meat export, accounting for more than 1.6 billion Euros in 2004. Meat exports have increased significantly between 1999 and 2004, particularly for poultry meat and its preparation.

Table 5.9: Main meat EU imports from Mercosur (measured in thousands of Euros)

	1999	2000	2001	2002	2003	2004	Variation (1999-2004) (%)
Fresh or chilled meat of bovine animals	349 740	410 200	248 452	425 871	474 792	609 040	74
Frozen meat of bovine animals	277 899	294 651	259 506	290 434	251 342	329 513	19
Preparations of bovine meat	219 225	211 841	205 022	204 716	174 621	223 061	2
Poultry meat	101 893	117 739	147 874	127 044	203 514	260 420	156
Preparations of poultry meat	59 623	102 695	156 508	150 518	209 775	262 703	341
Total	1 008 380	1 137 126	1 017 362	1 198 583	1 314 044	1 684 737	67

Source: COMEXT database

Fruits and juices

Brazil is the main exporter for oranges and orange juice; Argentina for lemons and pears. Apple exports are split between the two countries. Apple exports increased by more than 150% between 1999 and 2004.

Table 5.10: Main EU imports for fruits and juices from Mercosur (measured in thousands of Euros)

	1999	**2000**	**2001**	**2002**	**2003**	**2004**
Apples	93 033	81 095	101 646	109 106	132 480	154 003
Pears	81 932	90 526	95 717	104 422	101 174	93 790
Oranges	74 017	43 821	115 563	46 811	67 406	81 279
Lemons and limes	86 214	84 408	103 673	105 356	146 807	135 472
Frozen orange juice	733 237	767 419	363 230	39 415	9 222	9 203
Orange juice	31 820	46 565	260 817	654 883	640 788	576 556

Source: COMEXT database

Other products

Brazil is an export leader for both Coffee (more than 99% of Mercosur share) and tobacco (varying between 80% and 90%). Maize exports are split between Argentina and Brazil (in 2004).

Table 5.11: Other exports from Mercosur to the EU (measured in thousands of Euros)

	1999	**2000**	**2001**	**2002**	**2003**	**2004**
Raw tobacco	357 928	427 105	416 974	413 240	422 067	400 176
Coffee[1]	1 043 262	1 049 056	896 313	780 776	731 307	803 838
Maize[2]	233 283	295 354	294 657	233 850	399 100	430 242

Source: COMEXT database
Notes: 1: Coffee excluding decaffeinated and roasted; 2: Maize excluding seed

Exports to Mercosur from the EU

Whiskies, wines, olive oil and malt (Table 5.11) are among the European agriculture sector products entering the Mercosur market. With the exception of malt, EU exports of these products to Mercosur have been in continuous decline since 1999.

Table 5.12: Main Exports from EU to Mercosur (measured in thousands of Euros)

	1999	2000	2001	2002	2003	2004
Whiskies	144 206	128 055	117 407	76 152	79 180	79 672
Olive oil	45 845	64 974	56 721	47 654	43 802	57 069
Malt	29 304	43 029	81 262	58 704	69 324	52 742
Wines	83 539	87 921	72 354	47 963	48 871	48 267

Source: COMEXT database

Trade-related measures

European Union

Many products exported by Mercosur Countries such as soya bean, soya bean oilcake or any kind of 'tropical' products (coffee, cocoa, mangoes) are subject to few or no tariffs when entering the European market.

However, whenever Mercosur exports are in competition with European production, market access is restricted by different kinds of barriers, such as regular tariffs, tariff-quotas, entry prices and seasonal tariff rates.

A small selection of products and tariffs can be seen in Tables 5.12-5.17.

Table 5.13: Sugar & Ethyl Alcohol

Products	In quota tariffs	Off-quota tariffs	Representative price	Additional duty
Raw cane sugar for refining	98 €/ton	339 €/ton	307.4 €/ton	+ 20.6€/ton
Raw cane sugar, other	Not applied	419 €/ton	307.4 €/ton	+ 61.6 €/ton
White sugar	Not applied	419 €/ton	381 €/ton	+ 29.1€/ton
Ethanol, denaturated	Not applied	102 €/m^3	Not applied	Not applied
Ethanol, undenaturated	Not applied	192 €/m^3	Not applied	Not applied

Source: EC website: Export Helpdesk, European Commission
Notes: Additional duties (special safeguard clause for the CMO) are applied when the representative price falls below the 'trigger' price (set at 531 € per tonne for white sugar, 418for raw sugar for refining and 552 for raw sugar not for refining). The representative price is the cif import price excluding the fixed duty. It is close to the world price and therefore well below the 'trigger' price. Consequently, the safeguard clause has been applied permanently since 1995. (source: European Commission)

Table 5.14: Bovine meat tariffs

Products	In-quota tariffs	Off-quota tariffs
Fresh or chilled, boneless	20%	12.8% + 3034 €/ton
Fresh or chilled, carcasses		12.8% + 1768 €/ton
Frozen, boneless		12.8% + 2211 €/ton
Frozen, carcasses		12.8% + 1768 €/ton

Source: EC website: Export Helpdesk, European Commission

Table 5.15: Chicken meat tariffs

Product	In-quota tariffs	Off-quota tariffs
Chicken cuts frozen and boneless	795 €/ton	1024 €/ton
Chicken cuts fresh or chilled and boneless	512 €/ton	1024 €/ton

Source: EC website: Export Helpdesk, European Commission
Note: safeguard measures may apply resulting in additional duties.

Table 5.16: Apple tariffs

		OFF-QUOTA		IN-QUOTA		
Products	**Country**	**Standard import value**	**Entry prices**	**Total quota volume available**	**Ad valorem duty**	**Entry prices**
Apples, other	Brazil	928 €/ton	From 3% to 6.4 % + 11€ to 238€ per ton	600 t	0%	From 11€ to 238€ per ton
	Argentina	765 €/ton				
	Paraguay	1002 €/ton				
	Uruguay	1002 €/ton				
Apples in bulk (September 16th to December 15th)	Mercosur	No restrictions		Not applied		

Source: EC website: Export Helpdesk, European Commission
Notes: Standard import values and entry prices vary according to the time of the year. Data was retrieved at the end of June

Table 5.17: Pear tariffs

	Standard import value	Entry prices
Pears[1] (between May 1st and June 30th)	None	Not Applied
Pears[1] (between July 1st and April 30th)	From 0 to 667 €/ton	From 2,5% + 10 €/ton to 10,4% + 233 €/ton

Source: EC website: Export Helpdesk
Notes: 1: NTC code 08082050. Entry prices and standard import value vary according to time of the year; Pears between May 1st and June 30th benefit generalised preferences scheme (GSP)
Wheat

Table 5.18: Wheat tariffs

Product	In-quota tariff	Off-quota tariff
Medium and low quality common wheat and spelt	12€/ton	95€/ton

Source: EC website: Export Helpdesk

To enter to the EU market, Mercosur products have to comply with EU requirements. European Directives are focused primarily on SPS aspects and concerned with ensuring a high level of security for European health, veterinary health and environment (insects and diseases). The main EU regulations relevant for food imports are presented and summarised in Table 5.19.

Table 5.19: Main EU regulations on food products

Council Directive 2000/29/EC of 8 May 2000 on protective measures against the introduction into the Community of organisms harmful to plants or plant products and	Organisms harmful to plants or plant products= insects and mites, bacteria, fungi, viruses and parasite plants. This Directive subjects certain plants and plant products from other countries to a check on entry into EU territory. This involves a documentary check, an identity check and a plant-health check.

against their spread within the Community	
Regulation 396/2005 of the European Parliament and of the Council of 23 February 2005 on maximum residue levels of pesticides in products of plant and animal origin.	The Regulation establishes the maximum quantities of pesticide residues permitted in products of animal or vegetable origin that are intended for human or animal consumption. These maximum residue levels (MRLs) * include, on the one hand, MRLs that are specific to particular foodstuffs that are intended for human or animal consumption and, on the other, a general limit that applies where no specific MRL has been set
Commission Directive 2002/63/EC of 11 July 2002 establishing Community methods of sampling for the official control of pesticide residues in and on products of plant and animal origin	Set the analyzing process
Regulation 178/2002 of the European Parliament and of the Council of 28 January 2002 on food safety, which establishes traceability for food products	Traceability was defined as the ability to identify a unique product, and the raw materials used in its production, and to follow the progress of that product right through the production and distribution process. Operators in the food sector are now required to have product withdrawal systems as well as records identifying the source of their raw material and the businesses they supply.

No Mercosur tariff on agricultural products exceeds 20%. Whiskies and wines, EU's main exports towards Mercosur, are both subject to this rate. Olive oil and malt benefit from lower tariffs. EU exports need also to comply with Mercosur regulations.

Table 5.20: Tariffs for main EU exports

Products	**Tariff**
Whiskies	20 %
Wine	20%
Olive oil	14%
Malt	10%

Source: Mercosur website

4. Key sustainability issues

Economic, environmental and social impacts might be expected both in the European Union and in Mercosur countries. Similar impacts may occur but with a varying magnitude in both regions.

4.1 Impacts on the EU

Economic impacts

For most countries of the EU, there may be a negative output effect for a limited number of commodities, if the agreement improves market access for Mercosur products. The significance of the impact will depend on the degree of market liberalisation and the competitiveness of each country in the different agricultural sectors. Prices for European consumers may be reduced, depending on the structure of the internal wholesale, distribution and retail sectors.

Environmental impacts

In the European Union, a decline in agriculture can lead to abandonment of the countryside, in particular in less favoured areas (such as beef production areas in Ireland and in France). Landscape

maintenance, including terraces, hedges, rural paths, is a typical consequence of farming activities. During winter, maintaining a vegetal cover on soils helps to prevent floods. Agriculture therefore provides important ecological services, provided adequate production methods are followed (particularly with regards to agrochemical and water management). However, on the other side, a return to semi-natural habitat can have beneficial effects on biodiversity, and may be no less effective in flood prevention. Intensification of agriculture has had some significant impacts on the environment: contamination of groundwater, rivers and the sea, decreasing groundwater levels, soil degradation and biodiversity loss[73]. One of the goals of the Common Agriculture Policy in 1992 was to deal with these environment problems. Since 1992, other agri-environmental measures have been implemented to support sustainable agriculture in specific areas or sustainable methods. This policy context will be taken into consideration when analysing environmental impacts.

In order to remain competitive with respect to Mercosur products (for instance, beef, poultry, wheat, sugar cane, apples), European producers might have to implement new strategies: shifting to other products, develop higher quality products justifying higher prices (organic farming, geographical indication), or abandoning cultivation or farming. Impacts on the environment will depend primarly on these new strategies and in particular on whether they will use more or less environmentally-friendly methods.

Social impacts

In the European Union, about 5% of the total working population is involved in agriculture, but many jobs depend on it via upstream and downstream activities. Although issues of maintaining an agricultural sector in the EU has been less a matter of employment than of balanced land uses in past years, it could shift back to an employment concern. Indeed, rural people represent a large part of new EU member-states and of EU-accessing countries' populations. Agricultural employment represents between 10 to 32% of total employment in these countries[74]. Therefore, as some new Member-states and accessing countries (Rumania, Bulgaria) are important sugar beet, apples, wheat producers, the entering of Mercosur products into the European market may have significant impacts on employment.

Some of the new EU members-states are characterised by small-scale agriculture. This is the case of Latvia, Lithuania, Slovenia, and especially Poland and Romania (which should be part of the EU later than the other countries, in 2007). The latter two represent 60 % of the agricultural population of the whole Central and Eastern European Countries. This small-scale agriculture deals with hidden rural unemployment, and may be considered as a real safety net when taking into account the social costs of economic transition since 1990. With respect to beef production in particular, Western European producers may also be affected as most cow farming is located in remote and less favoured areas.
Employment effects may therefore affect poverty levels and have impact on social equity.

4.2 Impacts in Mercosur

Economic

Trade liberalisation may increase production levels of the key identified products (wheat, poultry, meat, sugar, apples) leading to production intensification. These potential impacts will be assessed in detail in the mid term report.

Environment

In Mercosur, increase of cultivation surfaces and pasture lands is considered as an important cause of deforestation but also of destruction of other natural habitats (savannas, natural grasslands)[75]. Destruction of such habitats has significant impacts on biodiversity. Intensification of agriculture has also contributed to soil degradation (nutriments erosion, pollution). Intensive use of agrochemicals has

[73] PNUE, L'avenir de l'environnement mondial 3, 2003.
[74] Sources: European Commission, FAO and UNSO.
[75] PNUE, L'avenir de l'environnement mondial 3, 2003

significant impact on water and soil quality[76]. Trade liberalisation between EU and Mercosur might reinforce these impacts. However, it will depend on effects of trade liberalisation on production levels, and its contribution to further agriculture intensification.

Some agriculture methods and practices may also have positive or negative effects on greenhouse gases emissions. For instance, harvesting methods used in sugar cane production such as slash-and-burn can be a source of emission of green-house gases and potential toxic substances[77]. Burning of leaves generates methane and nitrous oxide, which global warming potentials are much higher than carbon dioxide. Preventing such emissions would imply replacing these hand harvesting methods by mechanised methods. Cattle feeding can contribute to air pollution through methane, odours and dust. Issues related with greenhouse gases emissions and carbon sequestration will be further analysed in the SIA.

Social impacts

In the Mercosur countries, the rural population accounts for between 8% and 42% of the total population.[78] Agriculture is still directly (farming) or indirectly (upstream and downstream activities) a major source of employment and livelihoods; particularly since a large part of the poor lives in rural areas. Maintaining and developing agriculture in these countries is one of the major stakes of social cohesion, with the level of farmer income being a central issue. Agriculture in Mercosur is characterised by a dual structure: on the one hand, a very competitive and modern commercial agriculture, and on the other hand, family farms and landless farmers. In Brazil, modern agriculture represents 554,501 entities occupying 240 millions hectares; and family farms constitute 85.5% of all agricultural structures and 77% of the active population. This latter type of agriculture occupies 30.5% of the land area and provides 37.9% of the agricultural GDP. The very unequal land distribution is one of the major problems in many of the Mercosur countries, and one of the main factors contributing to rural poverty. For instance, in Brazil, 12 million farmers are landless and 50,000 people occupy 44% of such land. It is also worth noting that in Brazil land conversion to pasture for cattle has already caused displacement of many landless farmers.

The SIA will therefore assess to what extent trade liberalisation with the EU would affect both categories of agriculture systems, and may impact on equity and poverty in particular areas.

Mercosur countries are largely self-sufficient in basic foodstuffs and are net exporters of agricultural products. In some countries such as Brazil, nutrition related-indicators are improving. However, in spite of this situation, food insecurity still exists, particularly in Brazil and in Paraguay. Food insecurity is not a problem of food production and supply, but rather of insufficient income to have access to food. In the case of beef products, cattle production may be a "push" factor, displacing the rural poor and land-less farmers into fragile areas, restricting access to food.

If producers from smaller farming units were to abandon traditional cash crops and grow mainly export-oriented crops in the context of tariff barriers reduction on the European market, impacts on food security could be significant. They may therefore become more dependent on international market prices, and more vulnerable, from an economic and food security point of view. This will need to be investigated in the SIA.

Sugar cane production is currently labour-intensive, using traditional slash-and-burn methods to harvest cane. Impact of trade liberalisation between the EU and Mercosur may have significant impact

[76] According FAOSTAT, use of agrochemical has increased from 3.7 to 10.9 millions of tonnes from 1972 to 1997.

[77] Cerri C. C, Bernoux M., Feller C., de Campos D.C., de Luca E. F., Eschenbrenner V., 2003 – Canne à sucre : l'exemple du Brésil. Canne à sucre et séquestration du carbone, C.R.. Académie d'Agriculture, séance du 17 mars 2004,.

[78] In 2003, rural populations represented respectively in Argentina, Brazil, Paraguay and Uruguay, 10%, 17%, 44% and 8% of the total population.

on employment, and in particular in this sector. However impacts will depend on which extent producers will change harvesting methods and use mechanised ones.

Conditioning factors:

It is worth noting that impacts will depend on several factors such as farmers' adjustment strategies, production patterns and methods (level of inputs used, cultivation methods) and land property rights policies. Concerning environmental impacts, soil characteristic, existence of solid and liquid waste disposals, existence of energy valorisation techniques and capacities (for biofuels, heating, etc.), and existence and/or enforcement of environmental regulations will also influence the magnitude of environmental impacts.

6. CONSULTATION AND DISSEMINATION STRATEGY

6.1 Consultation Mechanisms

The trade SIA of the EU-Mercosur Negotiations aims to assess the impact on sustainable development of trade between the European Community and Mercosur countries. The following section outlines the consultation mechanisms in place to meet the objectives of the SIA, as detailed in Annex 1. The European Commission has set out clear guidelines for the communication of Trade SIA processes and consultation with civil society and all interested stakeholders.[79] Consultation and engagement are critical components of the Trade SIA process and will serve to promote dialogue and partnership with all stakeholders in the EU-Mercosur negotiations. The effectiveness of the consultation strategy will depend upon its ability to successfully promote dialogue and partnership with interested stakeholder groups within the parameters of the EU-Mercosur objectives. This will include identifying the concerns and perspectives of interested parties, engaging governments, regional experts and civil society in the impact assessment process and providing adequate and accessible information about the Trade SIA processes and assessment progress.

For effective consultation it is necessary to develop an extensive but targeted network of stakeholders and other interested parties in Europe and Mercosur member countries. Within this context, the target groups for consultation will fall within one or more of the following targeted stakeholder groups:

- Those affected by negotiations between the EU and Mercosur countries
- Those who will be involved in implementation of the negotiation results
- Those directly interested in EU-Mercosur negotiations

Within this context, the interested parties that will be targeted for consultation throughout the course of the project include:

- EU and Mercosur country governments (comprising Brazil, Argentina, Paraguay and Uruguay)
- European Parliament
- Civil Society in the EU and Mercosur countries
- Regional experts

To ensure focused consultation and dissemination for the three sector studies, representatives from Agriculture, Automotive-Motor Vehicles and forestry will be specifically included in the consultation process.

Every effort will be made to access regional networks and federations of associations who can relay information on the SIA process so as to reach the widest range of interested parties in the most cost-effective manner and present the consensus views of their member organisations. Particular attention will be payed to ensuring representation of disadvantaged groups such as the landless poor.

6.2 Dissemination

To foster a broad awareness on EU-Mercosur negotiations, every effort will be made to keep all interested stakeholders and parties abreast of timely and pertinent information. In order to reach as wide an audience as possible, the dissemination of information on EU-Mercosur activities will utilise:

- Mercosur networks
- The trade SIA Experts Network established by the consultants
- A newsletter outlining relevant meetings and discussions on impact assessment.

[79] Handbook for Trade Sustainability Impact Assessment, March, 2006; pp. 49

To allow the exchange of information between all interested parties/stakeholders, a website dedicated to EU-Mercosur negotiations has been established (http://www.sia-trade.org/mercosur). All stakeholders will have the opportunity to post and view comments via this forum.

Mercosur Networks

- Red Mercosur (www.redmercosur.org.uy) links 12 institutions in Mercosur with experience in the study of the Mercosur integration process. The site will be used in the dissemination of the EU-Mercosur Trade SIA outputs
- Chaire Mercosur (http://chairemercosur.sciences-po.fr) is an integrated hub of cooperation between Mercosur member states and neighbouring associate member states in South America and is structured around a core of 50 international experts from the Mercosur countries, EU and North America.

Trade SIA Experts Network

IDPM has developed an extensive network of Trade SIA experts in developed and developing countries; the network includes non-governmental organizations, academic and research institutions, government, inter-governmental and international organisations, consulting organisations and independents.

Newsletters

IDPM produces a regular Trade SIA Newsletter distributed in paper and electronic format. The newsletter will be used to provide information about the EU-Mercosur SIA processes and methodology, including upcoming consultative events and Mercosur project developments.

Project Website

This has been designed and activated (http://www.sia-trade.org/mercosur). The site includes provision for:

- Information about the project
- Reports and documents developed during the project
- Material that can be downloaded related to the SIA
- Electronic links to other related websites
- Electronic links to other public web sites dealing with trade liberalisation and SD at the global, regional and national level
- An electronic feedback function
- A forum for questions/comments and board to view feedback
- Electronic registration for dissemination of a 'SIA for Mercosur Newsletter'
- A dedicated e-mail address to facilitate expression of views and ideas by interested parties with regard to the assessment of the impacts of trade liberalisation on SD

Email forum

A sizeable contact database will be developed and used to notify stakeholders about the EU-Mercosur negotiations. The database will be classified in a manner to ensure an appropriate balance between targeted stakeholder groups. A dedicated project e-mail address will also be established, allowing interested parties to request additional information and discuss project issues.

6.3. Possible Contact Organisations in the Mercosur countries

Argentina

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CEDEP, Centro Brasileiro de Documentacao e Estudos da Bacia do Prata
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7. WAY FORWARD AND CONTENTS OF FUTURE REPORTS

Midterm report

The midterm report will summarise the work that has been undertaken on the project and its principal outcomes will be presented in November 2006. In particular, it will present the results of the detailed assessment for the overall SIA and for the three sector studies, including the sector case studies. The outputs will apply causal chain analysis using quantitative and qualitative data to assess the potential economic, social and environmental impacts of the trade measures as specified in the negotiation scenarios. The midterm report will also develop preliminary suggestions for flanking measures which could either enhance positive impacts or mitigate negative outcomes.

The mid term report will also describe the consultation activities and dialogue with external experts and civil society by summarising comments and suggestions received (via e-mail, web site comment function, ordinary mail, meetings etc.). The report will also explain in a transparent manner how the consultation process has been used to inform the detailed assessment findings.

Finally, the mid term report will present consultative proposals for the content of the Final Report and completion of the project in March 2007.

Final report

The final report will present the final results and outcomes of the assessment, based on the consultation results and comments received on the midterm report. Particular attention will be given to the development of proposals for flanking measures. The report will also contain details of the communication and dissemination activities undertaken during the project.

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Annex 1 Terms of Reference

Task specifications to Specific Contract No 1
(implementing framework contract No Trade 05-G3-01)

This annex specifies the tasks, activities and reporting which will be carried out during this specific agreement.

Requirements and timetables defined by the Commission must be strictly respected by the contractor.

For information related to the objectives and content of the Trade SIA methodological framework, see the terms of reference of the call for tender of the framework contract.

A) Main tasks and services of this specific agreement

This specific agreement 1 should assess how the trade aspects of the Association Agreement could affect sustainable development in the EU and beyond, in particular in the MERCOSUR countries.

The aims of this specific agreement are the following:

1) to up date the Overall Preliminary Trade SIA EU-MERCOSUR
2) to conduct three Trade SIAs including Automotives-Motor Vehicles and Agriculture

1) Up dated overall preliminary Trade SIA EU-Mercosur

The study will provide an overall assessment of the potential impact on sustainability of the trade aspects for an Association Agreement between the European Communities and Mercosur. The overall preliminary Trade SIA will allow for the cross-sectoral and cumulative impacts likely to result from the implementation of the trade aspects of the Association Agreement between the European Communities and Mercosur as a whole. The assessment will build on the preliminary overview Trade SIA done in 2003. The up dated overall preliminary Trade SIA will be based on an assessment of two scenarios:

i.) a baseline scenario, without agreement
ii.) a scenario with trade agreement

The overall preliminary Trade SIA will:

- Draw together the results of the earlier study and complement this with further analysis in order to up date the preliminary overall Trade SIA results in light of the progress made so far in trade negotiations.
- On this basis, identify, as far as possible in quantitative terms, the likely impacts on the three key areas of sustainability – economic, social and environmental development – of the different aspects of the proposed EU-Mercosur trade agreement.
- On the basis of identified impacts, propose mitigation and enhancement measures in different areas of public policy, including trade policy.
- Identify the generic issues (potential sustainability impacts and policy options for optimising outcomes) which can inform negotiators and policy-makers.
- Evaluate the Trade SIA methodology and identify areas for further development and refinement in future Trade SIAs.
- Provide proposals for the ongoing monitoring of key sustainability indicators affected by trade liberalisation and for ex-post evaluation of the overall preliminary Trade SIA EU-Mercosur.

- Contribute to enhancing the dialogue concerning the overall preliminary Trade SIA EU-Mercosur with interested stakeholders, inside and outside of the EU.
- Produce an SIA-Trade Newsletter and distribute in electronic and paper format.
- Contribute to the development of a credible international network of Trade SIA experts in other countries and within other international organisations, particularly in relation to Mercosur.

2) Three Sectoral Trade SIAs including Automotive-Motor Vehicles and Agriculture

Each of the sectoral Trade SIAs should aim to achieve:

- An update of the Trade SIA methodology for these sectors and assessment tools to be used.
- A clear overview of the current trade situation in the three sectors, together with a definition of the options/scenarios to be considered and a clear analysis of causal chain analysis and the mechanisms through which the different options will affect social, economic and environmental areas.
- An analysis of the expected significance of these impacts for the sector, using appropriate measures and indicators for assessment of impacts and making use of appropriate qualitative and quantitative techniques.
- Identification cross-cutting links between these sectors and other sectors.
- Propose preventive as well as flanking measures or other adjustments that would prove effective in tackling any adverse impacts of liberalisation, and/or in promoting its positive impacts, in these three sectors.
- Contribute to enhancing the dialogue concerning the above Trade SIA with all interested stakeholders: inside and outside of the EU, particularly in Mercosur countries.
- Contribute to the development of a credible international network of Trade SIA experts through participation in policy debate on Sustainability Impact Assessments with experts in other countries and within other international organisations.

B) Preliminary sustainability assessment of the overall preliminary Trade SIA and of the three sectoral Trade SIAs

The aim of preliminary assessment of the trade aspects of the Association Agreement EU-MERCOSUR is to present an overview of all the three dimensions of sustainable development (economic, social and environmental) at stake in the trade aspects of the Association Agreement between EU and Mercosur for each of the Trade SIAs to be developed in the scope of this specific agreement 1.

Attention should be paid to building a coherent and rigorous assessment framework. This should include quantitative analysis and modelling as set out in the consultant offer for the framework contract No Trade 05-03-01.

These preliminary assessments should rely on:

1) **scenarios and findings** delivered by the previous economic and trade analysis;
2) an analysis of the **underlying sustainability context** (economic, social and environmental context);
3) a clear **analysis of the mechanisms** through which the different scenarios of the agreement will affect social, economic and environmental areas.

The specific preliminary assessments should provide an analysis in the EU at a regional/national and if appropriate sub national (regional, NUTS 2) level with:

- a preliminary assessment of possible economic impacts of the trade aspect of the Association Agreement between EU and MERCOSUR;

- the preliminary social, and environmental impacts of the trade aspects of Association Agreement between EU-MERCOSUR with an analysis of the **causal chains** which identify the significant cause-effect link between a proposed change in trade policy and its social (including gender and poverty), environmental (including all media) and economic impacts. This analysis should as far as possible combine qualitative and quantitative approaches and a wide range of indicators.

This analysis should cover all trade-related aspects of each sector, highlighting the potential positive and negative effects on sustainability as well as preliminary reflections on possible complementary measures which such effects require.

The main output will comprise:

1) a first identification of **key sustainability** issues and most potentially-affected **social groups** and **geographical areas;**
2) as a next step, proposal of a set of sector studies for study in the next phase of the contract, to be agreed in consultation with the Commission and Civil Society.

C) Detailed study of sub-sectors and case studies

Sub-sectors will be analysed in detail notably with the help of **at least one case study** for each sector. This work will include:

- **Quantitative analysis** informed by modelling results according to the consultant offer for the framework contract No Trade 05-03-01 as well as qualitative assessments of the impact of potential outcomes in the sub-sector concerned. This work should be undertaken on the basis of case studies and economic, social and environmental analysis (including environmental impact assessment(s), using appropriate methodology, measures and indicators, and making use of both qualitative and quantitative techniques as appropriate. Impacts shall be as much as possible differentiated amongst **EU regions (in particular for the weakest regions of the enlarged EU)** - NUTS 2 level.
- Analysis of cross sectoral effects.
- Suggest possible amendments or adaptations (including phasing in) of the assessed trade measures or new rules whose potential sustainability impacts are expected to be important, taking into account the existing regulatory frameworks and domestic policies.
- Based on the existing regulatory frameworks and domestic policies of the countries/regions under review, suggestions on what complementary measures might be introduced to best address the negative impacts and maximise the positive impact of further liberalisation / changes in rule-making. This should include an assessment of the various options for mitigating and enhancing measures, including those which could be introduced on a domestic or regional level, in international fora, or in other areas of the ongoing negotiation processes. Identify inherent trade-offs where they exist and specify on which basis and principles the choices on measures have to be made (e.g. precaution, prevention, cost-effectiveness, internalisation of external environmental costs, Treaty obligation of a high level of environmental protection).

The consultants shall select an adequate team of local experts to assist them for the geographical case studies. The list of local experts should reflect the three dimensions of sustainable development in a balanced manner. Particular attention should be paid in finding suitably qualified environmental local experts (in Mercosur countries).

D) Process and consultation

Particular attention should be paid to the involvement of stakeholders, not only from the EU but also from developing countries, in particular Mercosur countries.

Recent experience of the Trade SIA shows a deficit of information and consultation both inside and outside the EU and in particular difficulty in involving third country representatives and stakeholders.

This need for better local consultation was also confirmed at the Trade SIA seminar organized by DG Trade in Brussels on 6-7 February 2003 (see more information on http://trade-info.cec.eu.int/civil_soc/docconsult.php?action=list).

Consultation in the EU and abroad is a major challenge which must be met in order for the EU's Trade SIA process to ensure its credibility and legitimacy.

The objectives of the consultation process are:

a) to ensure a **better understanding** of the Trade SIA process by society inside and outside Europe;
b) to **disseminate the Trade SIA methodology**, process and results inside and outside the EU. Trade SIA results should also be validated and complemented with opinions from experts in order to improve the analytical work and next steps;
c) to contribute to the **identification of priority areas** and **key issues** (see previous section);
d) to extend the **network of Trade SIA** expertise.

This specific agreement should look at maintaining and strengthening the existing Trade SIA consultation process by which the Commission can ensure transparency of the Trade SIA process and enable civil society and other stakeholders to provide inputs during the study. This will include:

- Presentations of the inception, mid-term and final reports at public meetings in Brussels.
- Electronic dissemination of the inception, mid-term and final report, using Experts Network and project website.
- Produce a SIA-Trade Newsletter and distribute in electronic and paper format.
- Participate in international meetings and consultations on impact assessment, and make oral or written presentations on the Trade SIA Trade methodology and work programme.

E) Composition and competence of the working team of the overall preliminary Trade SIA and of the three sectoral Trade SIAs

Before starting the work on this specific agreement the consultant should provide an indicative list which sets up a minimum qualification team for the overall preliminary Trade SIA and for the three sectoral Trade SIAs.

F) Working meetings in Brussels

The Contractor will be required to attend meetings in Brussels with Commission officials. These will include: working meetings at the launch of both studies, presentations and explanations by the Contractor of work completed, further information from the Commission on negotiating developments and discussion of future work.

This will usually entail, as a minimum, one meeting at the start of the specific contract 1 and thereafter one meeting for each phase of the Trade SIAs work (inception, mid-term and final reports), with other meetings arranged on an ad hoc basis as necessary. A set of six working meetings of one day should be foreseen within this specific agreement.

The consultant will be asked to draft a complete report for each of these meetings.

G) Public meetings

The Contractor will be required to participate in public meetings organised by the Commission involving representatives of Member States, the European Parliament and Civil Society. It must present and explain work completed and provide the opportunity for interested stakeholders to provide direct input.

This will usually entail a minimum of three meetings (held back-to-back with the meetings with the Commission).

The consultant will be asked to draft a complete report for each of these meetings.

H) Electronic documentation

The Contractor must create and maintain a web-site dedicated to the above SIA project with a link to the DG Trade web-site. All reports, meeting reports, outputs presented to the Commission including the news letter, the list of consultant networks and consultation documents will be published by the Contractor on this web-site.

The web-site should incorporate a feedback function allowing all interested parties to provide input and setting up of a forum of discussion to further stimulate the involvement of civil society.

I) Deliverables

i) Content of the reports for each of the four Trade SIAs:

The two first reports (interim and midterm) should aim to describe 1) the state of play of the study and 2) the way ahead and to propose some further developments to be discussed with the Commission.
The Commission draw the attention of the consultant to a necessity of transparency in reports which must include all the references, analytical paths needed to understand fully the outcomes and results of the study.

Interim report:

This interim report will provide the Commission with:

- An overview of the consultant's proposed approach to the study, including a presentation of the conceptual framework of the sustainability assessment analysis.
- A description of preliminary methodological developments or changes from past studies.
- A review of literature, list of tools and references to be uses, list of contact in Mercosur countries.
- A preliminary screening exercise for the key sustainability issues/impacts associated with the trade agreement, based as far as possible on quantitative indicators.
- A preliminary discussion on the selection of sector specific indicators relevant for this study.
- Outlines of the contents for both the mid-term and final reports.

Midterm report:

The midterm report summarise the work that has been undertaken on the project and its principal outcomes in September.

In particular, it will describe:

- Implementation of the methodology: a summary of the process by which the methodology has been implemented in the case of EU-Mercosur negotiations
- Information on communication activities:
    - Creation of the web site and links to other web sites. Number of hits.
    - Consultations and dialogue with external experts ad civil society: summary of comments and suggestions received (via e-mail, web site comment function, ordinary mail, meetings etc.) and the uses made of these.
    - Development of network of Trade SIA experts: contacts undertaken, information supplied and comments received.
- State of play of study underway, outcomes regarding the screening phase, design of sector studies
- The way ahead to complete the study

Final report:

The final report will entail the following elements

- The methodology used for the Trade SIA
- The outcomes and results of the assessment
- Proposals of flanking measures
- Communication actions, networking
- Conclusions
- References and key sources

ii) Timing:

Deliverables for this preliminary, will be produced in accordance with the following timetable:

	Inception Report	Mid-Term Report	Final Report
Overall preliminary Trade SIA	July 2006	November 2006	March 2007
Sectoral Trade SIAs:	July 2006	November 2006	March 2007

Annex 2. Key statistics for the Mercosur countries

Table 1 Argentina

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Argentina	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Real Income											
GDP annual growth rate (%)	5.8	-2.8	5.5	8.1	3.8	-3.4	-0.8	-4.4	-10.9	8.8	9
GDP/capita growth %)		-4.13	4.2	6.75	2.54	-4.6	-2.02	-5.54	-11.95	7.54	7.69
GDP $USb	257	258	272	293	299	284	284	269	102	130	
GINI Coefficient	-	-	48.58	-	49.84	-	52.24	52.52	52.75	-	-
Fixed Capital Formation											
Gross capital formation (% annual growth)							-6.8	-15.66	-36.45	38.17	34.5
Gross fixed capital (% of GDP)							16	14	12	15	19
FDI net inflows (% of GDP)							3.66	0.81	2.11	1.27	2.67
Employment											
Urban Unemployment (% total)		17.5	17.2	14.9	12.9	14.3	15.1	17.4	19.7	17.3	13.6
Unemployment (%)	12.1	18.8	17.2	14.9	12.8	14.1	15	17.4	19.6	-	-
Development Assistance											
% of GNI	0.06	0.06	0.05	0.05	0.03	0.04	0.03	0.06	0	-	-
US$/Capita	4.36	4.21	3.9	3	2.4	2.82	2.13	4.19	0	-	-
External Debt											
% of GDP	19.67	21.41	22.97	22.93	25.85	29.82	31.03	32.93	90.23	76.54	19.67
Debt Service/Exports (%)	25.2	30.2	39.4	49.9	57.5	75.4	70.8	42.3	16.5	37.9	25.2

Trade (2004)

	Exports (% of total)	Imports (% of total)
Manufactures	28.6	87.2
Fuels/Mining	20	6.6
Agriculture	49.6	5.1

Table 2 Brazil

Brazil	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Real Income											
GDP annual growth rate (%)	5.9	4.2	2.7	3.3	0.1	0.8	4.4	1.3	1.9	0.5	5.2
GDP/capita growth %)	5104	5248	5614	5719	5650	5620	5778	5795	5798	5754	5983
GDP $USb	546	704	775	808	788	537	602	508	461	492	546
GINI Coefficient	61.51	59.98	59.05	59.8	59.19	59.25	-	58.75	58.12	56.99	61.51
Fixed Capital Formation											
Gross capital formation (% annual growth)							9.98	-1.14	-4.27	-4.48	10.9
Gross fixed capital (% of GDP)							21.54	21.2	19.76	19.76	21.31
FDI net inflows (% of GDP)							5.45	4.43	3.6	2	3.01
Employment											
Urban Unemployment (% total)	-	4.6	5.4	5.7	7.6	7.6	7.1	6.2	11.7	12.3	11.5
Unemployment (%)	-	6.1	7	7.8	9	9.6	-	9.4	-	-	-

Development Assistance											
% of GNI	0.05	0.04	0.04	0.04	0.04	0.04	0.06	0.07	0.09	-	-
US$/Capita	1.61	1.71	1.78	1.76	2.02	1.11	1.9	2.02	2.15	-	-
External Debt											
% of GDP	17.46	13.96	12.44	10.81	12.47	17.21	15.58	18.47	21.05	19.29	-
Debt Service/Exports (%)	30	36.6	42.2	62.7	79.4	117.8	93.5	75.5	68.9	63.8	-
Trade (2004)											
	Exports (% of total)				**Imports (% of total)**						
Manufactures	32				6.7						
Fuels/Mining	13.5				22.5						
Agriculture	52.4				69.8						

Table 3 Paraguay

Paraguay	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Real Income											
GDP annual growth rate (%)	3.1	4.7	1.3	2.6	-0.4	0.5	-0.4	2.7	-2.3	2.6	2.1
GDP/capita growth %)	-	2.03	-1.29	0.04	-2.87	-1.96	-2.76	0.26	-4.63	-0.17	-0.57
GDP $USb	7.85	9.02	9.63	9.61	8.6	7.74	7.72	6.85	5.59	5.81	-
GINI Coefficient	-	59.13	-	56.52	-	56.85	-	-	57.98	-	-
Fixed Capital Formation											
Gross capital formation (% annual growth)							-4.76	-17.5	-10.76	7.96	2.69
Gross fixed capital (% of GDP)							26	25	19	20	22
FDI net inflows (% of GDP)							1.35	1.23	0.18	0.55	1.26
Employment											
Urban Unemployment (% total)	-	5.3	8.2	7.1	6.6	9.4	10	10.8	14.7	11.2	10
Unemployment (%)	4.4	3.4	8.2	-	5.4	6.8	-	-	-	-	-
Development Assistance											
% of GNI	1.2	1.53	0.91	1.13	0.89	1.01	1.05	0.9	1.01		
US$/Capita	20.75	29.7	18.49	22.04	15.24	15.16	15.52	11.39	10.29		
External Debt											
% of GDP	17.31	16.12	14.7	15.23	18.5	26.91	26.79	29.18	36.7	38.25	
Debt Service/Exports (%)	6.3	5.6	5.1	6.6	5.7	7.7	10.9	12.7	12.4	9.9	
Trade (2004)											
	Exports (% of total)				**Imports (% of total)**						
Manufactures	86				8						
Fuels/Mining	12.7				71.7						
Agriculture	0.8				19.1						

Table 4 Uruguay

Uruguay	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Real Income											
GDP annual growth rate (%)	7.3	-1.4	5.6	5	4.5	-2.8	-1.4	-3.4	-11	2.5	12
GDP/capita growth %)		-1.22	4.94	3.53	3.41	-3.3	-2.27	-3.49	-12.05	2.74	10.67
GDP $USb	17.44	19.3	20.52	21.7	22.37	20.91	20.09	18.56	12.28	11.18	
GINI Coefficient			43.76		45.18		44.56	44.96		44.83	
Fixed Capital Formation											
Gross capital formation (% annual growth)							-13.1	-9.41	-32.49	-11.4	32.07
Gross fixed capital (% of GDP)							14	14	12	13	13
FDI net inflows (% of GDP)							1.32	1.46	1.42	3.72	2.36
Employment											
Urban Unemployment (% total)	-	10.3	11.9	11.5	10.1	11.3	13.6	15.3	17	16.9	13.1
Unemployment (%)	9.2	10.2	-	-	10.1	11.3	13.6	15.3	18.6	-	-
Development Assistance											
% of GNI	0.55	0.77	0.43	0.36	0.17	0.16	0.12	0.11	0.09	0.09	0.11
US$/Capita	22.01	35.76	23.27	21.05	10.79	10.52	7.75	6.74	5.25	4.63	3.99
External Debt											
% of GDP	21.5	19.86	19.91	20.99	22.86	24.31	27.76	32.83	56.03	66.45	-
Debt Service/Exports (%)	15.2	22.1	15.4	15.6	23.8	24.7	29.4	35.9	40.3	26.3	-

Trade (2004)

	Exports (% of total)	Imports (% of total)
Manufactures	63	12.7
Fuels/Mining	4.9	25.3
Agriculture	30.2	62

Annex 3 Review of Literature on EU - Mercosur

Case studies and sectoral reviews on the EU-Mercosur negotiations

Most of the individual case studies related to the EU-Mercosur negotiations focus on sensitive sectors. This section presents a selection of case studies.

Still the agriculture knot (G. Kutas, in Chaire MERCOSUR 2006a)

Agriculture is the main point of divergence between the two blocs. Former analyses have already pointed out these problems, see: S. Page in Chaire MERCOSUR (2003c), M. Jank et al. in Chaire MERCOSUR (2004), Chaire MERCOSUR (1999) and Chaloult & Hillcoat (1997). Kutas examines this topic in both multilateral and bilateral scenarios highlighting that the main points of confrontation are related to tariff rate quotas (quotas volume, in and over quota tariffs, quotas administration and phasing out of the volumes).

The EU-MERCOSUR Interregional negotiations: Sanitary and phytosanitary measures and other potential obstacles to agricultural trade (R. Blasetti & M. Piñeiro, in Chaire MERCOSUR 2003c)

The Workshop on Agriculture and Agribusiness in the EU-Mercosur negotiations hold on January 2003 in Washington, DC focus on several key issues of the bilateral negotiation process. The paper by Blasetti et al. aims to identify and analyzes the main issues and obstacles related to the sanitary and phytosanitary rules that could arise in trade negotiations. In order to provide a real framework for negotiators, it also considers non-trade concerns such as animal welfare, traceability, labelling, and genetically modified organisms. Finally, it deals with the specific case of wines, reflecting the high importance of protecting European geographical indications in Mercosur countries.

EU-MERCOSUR services liberalization: Ideas for a pragmatic approach (C. Pena, in Chaire MERCOSUR 2006a)

The paper examines the impact of the services liberalization process on multilateral and bilateral negotiations. In fact, it is intended to identify possible reciprocal influences. However, one of the main questions posed is what are the expected results of these negotiations bearing in mind two facts: firstly, Mercosur, as almost all developing countries, has not identified its priority agenda in this sector yet, and secondly, most obligations and specific commitments have already been contained under the GATS[80] so further concessions will constitute a 'GATS-plus' proposal. In summary, the challenge for the bi-regional negotiations is to maintain a certain degree of flexibility on the process and to accept trade-offs that could arise across the negotiation process (e.g., services versus goods).

China and the EU-MERCOSUR relationship: Trade in goods and multilateral negotiations aspects (R. Flôres & G. Calfat, in Chaire MERCOSUR 2006a)

The authors shed light on the new role of China in the international trading system and its importance for the EU-Mercosur relationship. They consider two types of possible future scenarios: (i) China comes closer to Mercosur; (ii) China roughly keeps its present distance from both partners. There are two issues addressed in their analysis: on the one hand, the impact of China in trade in goods between the EU and Mercosur, and on the other hand, the evolution of China in the Doha Round negotiations. The authors conclude that both scenarios would probably converge to an intermediate situation. Further research including technological change and FDI activity as well as services and energy would be required to improve this paper, since these issues are not address.

[80] GATS : General Agreement on Trade in Services

The EU-MERCOSUR Agreement: Mutual advantages for business and the economic cost of failure (MEBF, in Chaire MERCOSUR 2004b)

This paper analyses the benefits and costs of concluding the association agreement between the EU and Mercosur. It points out the balance opportunities and the great gains for both partners due to the total trade liberalization of the top main products (1,20 billion US$ for the EU and 1,45 billion US$ for MERCOSUR). Otherwise, the total cost of lost opportunities for all the internationally competitive businesses in both regions will be around 3 billion US$ at least.

The "Civil Society knot": How to enhance the societal legitimacy of the EU-Mercosur agreement (S. Gratius, in Chaire MERCOSUR 2004a)

The chapter examines the role of civil societies in the EU-Mercosur bilateral negotiations to guarantee the political and social legitimacy of the agreement (see also Grandi, J. & Bizzozero, L. 1997). Gratius stresses three prerequisites for greater social legitimacy and a stronger interregional association: increasing transparency and democratic control, institutionalising the participation of interests groups, and creating academic networks. All of them should be achieved through a permanent dialogue between state and no state actors. However, this subject is also related with the reduction of asymmetries among the parties.

Rules of origin in FTAs in Europe and in the Americas: Issues and implications for the EU-MERCOSUR Interregional Association Agreement (A. Estevadeordal & K. Suominem, in Chaire MERCOSUR 2003b).

The purpose of this chapter is to analyze in depth the structure of different preferential rules of origin (RoO) in three regional blocs: the EU, Mercosur and the FTAA. It stresses the importance of these issues throughout the EU-Mercosur negotiation process. It emphasizes the central role that the EU's standardized RoO regime will play in the EU-Mercosur agreement. To avoid the trade and investment distortion caused by these rules, there is only one solution: to strength a more effective discipline on preferential RoO agreed multilaterally.

Synthesis studies of the MERCOSUR region

New Regionalism (Ethier 1998) as the most relevant phenomenon in the international economic system of the last decade has been also analysed in Latin America (CEPAL 1994) and in the specific case of Mercosur countries (Estevadeordal, Goto & Saez, 2000b). Peña (2005) analyses the effective "rule-oriented" approach of Mercosur as the key condition to preserve the strength of the multilateral trade system and the WTO. This alternative, in opposition to the "power-oriented" approach of other regional trade agreements (RTAs), enables Mercosur to protect the national interests of its smaller members and, at the same time, it really becomes a "building block" toward an open global economy.

Mercosur was created in 1991 with the signature of the Treaty of Asunción by four Latin-American countries (Argentina, Brazil, Paraguay and Uruguay). It was the result of an approaching process between the two biggest economies (Peña 1995), Brazil and Argentina, in the region during the eighty's, just after democracy could be re-established (Chudnovsky & Porta 1989, Behar 1991, Rozemberg & Svarzman 2002, Averbug 2002b).

Since its foundation, many studies have been requested to provide a detailed analyses of what is the meaning of this integration project (Menem 1996, Arocena 1997) and what are its philosophical and legal basis (Garnelo 1998, Galeano Perrone 1995, Ciuro Caldani 1996 y 1997, Jardel & Barraza 1998, Ruiz Diaz Labrano 1998) as well as its role in the international scene (Sthahringer de Caramuti 1996). Afterwards, the first attempts to define the most appropriate institutional structure for Mercosur were developed (Sanguinetti 1994), sometimes using the EU as the standard to be followed (Rimoldi de Ladmann 1995, De Luis Romero & Agramunt 1996, Mata Diz 1999, Narbona 1999, Velasco San Pedro 1998).

The Mercosur's economic agenda was subsequently defined in both the short and long term (Febrel Melgarejo 1996, Bouzas 1996). Trade flows (Machado & Ribero 1999, ALADI 2003) and investment flows (Chudvsky et al. 2002, Chudvsky 2003, Chudvsky 2001a) to Mercosur have been largely examined to finally conclude that Mercosur is the fourth economic bloc in the international system with a scarce level of intra-regional trade flows but with a huge power of attraction of FDI.

Different stages in the evolution of Mercosur can be identified according to the main results of the integration process (Narbona 2005). Sometimes the bilateral relationship between Argentina and Brazil has been decisive to the Mercosur's evolution (Machado & Ribeiro 1999, Bouzas & Da Motta Veiga 2001a). After an initial transition period where intra-regional trade strongly increased (Lucangeli 1994) due to the improvement of intra-industrial exchanges (Frankel et al. 1995, Bouzas 1999), the regional bloc suddenly deadlocked (1999, Faria 2002) and Mercosur fell into a structural crisis (Preusse 2001, Bouzas & Da Motta Veiga 2002d, 2002f, 2002g). The consequences of this impasse were observable in many sectors, as example, in the exchange rate instability of the regional bloc (Machinea 2003, Devlin et al. 2001a). The Conference "Mercosur: In search of a new agenda"[81] held in the Getulio Vargas Foundation in Rio de Janeiro (June 2003) was devoted to examine future directions for Mercosur regarding several aspects such as the institutionalization agenda (see Da Motta Veiga, 2003), the dilemmas and alternatives for the trade agenda (Rios, 2003), the exchange rate instability (Machinea, 2003) and the Mercosur's insertion into a globalized world (García Pelufo, 2003). Economic and political solutions are proposed to be able to cope with the great constraints and problems in each particular field. When Luiz Ignacio Lula da Silva arrived to the Brazilian's government, he provided a new impetus to the regional integration (Haddad 2002, Bouzas & Da Motta Veiga 2003b).Since the election of Lula, the integration process has faced various crisis and nowadays, most of the studies on Mercosur are dedicated to elaborate options for the future of this regional initiative (Peña 2000 y 2002, Ríos 2003, Secretaría del MERCOSUR 2004).

Many academic works propose an assessment of the evolution of Mercosur and an evaluation of the main problems it had faced (Almeida 2002, Bouzas & Da Motta Veiga 2001c, Chudnovsky & Fanelli 2001b, Da Motta Veiga & Rios 2003e, 2001c). The problems addressed relate with the institutionalisation agenda, the insertion into a globalized world, the trade agenda, the internal enlargement process and Mercosur external relations. However, one of the most important barriers to be surmounted is the lack of an appropriated institutional framework (Baptista 1998, Garnelo 1998, Gonzalez 1999, Pena & Rozemberg 2005). Mercosur is a hybrid integration process in the midst of a supranational and intergovernmental scheme (Roberto de Almeida 1999). Its "institutional deficit" is due to the low degree of effectiveness of assumed commitments and Da Motta Veiga (2003) argues that an institutionalised Mercosur does not imply the creation of new institutions per se, but rather the strengthening of credibility through a production of rule and a system of implementation at the subregional level.

Finally, two new issues have recently raised and both probably constitute the most important challenges for the internal enlargement process of Mercosur. First, the impact of different fiscal policies on the integration process. Several papers (Villela, Barreix & Taccone 2003, Barreix & Villela 2003 and Villela, Roca & Barreix 2005) deal with this question. Tax issues directly affect Mercosur's bloc in the area of competitiveness, investment promotion, tax collection and its distribution among the sectors. This topic is closely related to the scarce efforts of macroeconomic coordination made by Mercosur countries. These documents conclude on the necessity to coordinate tax policies within the deepening of the process, if the common market is to be achieved in the short term.

The second challenge deals with the asymmetries within the framework of the regional integration project. Generally speaking, there are asymmetries between the regional integration process and local development (Giordano; Lanzafame & Meyer-Stamer, 2005) that have to be faced to achieve

[81] MERCOSUR: In search of a new agenda (INTAL, 2004)

structural convergence inside Mercosur. Moreover, there are specific asymmetries in the smallest member state, Paraguay, (Giordano; Moreira & Quevedo, 2004a; Giordano 2004b) demanding specific measure such as the Structural Convergence Found (Consejo del MERCOSUR 2005). Zerbino (2004) examines the asymmetries in the productive integration scope of the four countries.