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EU Preferential Trading Agreements: Heightened Competition for U.S.

The European Union (EU) is the world's largest agricultural importer and the second-largest exporter, making it an important market for the U.S. as well as a competitor. Although the EU has pursued global multilateral trade negotiations within the World Trade Organization (WTO) and extends most-favored-nation (MFN) treatment to WTO members, it also participates in more non-global preferential trading agreements than does any other WTO member. Over two-thirds of EU imports come from countries with such agreements. The only countries having no preferential access to EU markets are the U.S. and nine others: Australia, Canada, Hong Kong, Japan, the Republic of Korea, New Zealand, Singapore, China and Taiwan.

Preferential trading agreements (PTAs) provide lower tariffs and other more favorable terms for imports from preferred trading partners. The EU's many preferential agreements create a mosaic of tariffs, quotas, and other import restrictions that vary considerably even among preferred partners. EU preferential agreements disadvantage U.S. exports to EU markets while providing advantages to EU exports in the markets of their preferred partners.

In what is called trade diversion, exporters without preferences may see their exports displaced by exports from higher cost preferred partners. Some preferred partners also may be displaced by other preferred partners benefiting from even lower tariffs and fewer restrictions. Preferential agreements, while advantageous to participants, can limit competition through trade diversion and could detract from global multilateral trade negotiations.

Recent Changes & The Implications

Recent EU trading arrangements have departed from historical practices, and further changes are likely. Since March 2001, the EU's "Everything But Arms" (EBA) policy provides free entrance to the EU market for 42 least developed countries (LDCs): no tariffs, quotas, or other restrictions are applied to agricultural products. Although some EU agricultural producers consider the EBA a threat, preliminary analyses by the EU Commission indicate that export potential from the least developed countries is low except for rice, sugar, and bananas, for which 7 years of gradual transition give time for necessary adjustments.

Other changes in EU preferential agreements could have negative impacts on U.S. agricultural exports. Unlike early agreements beyond Europe with former colonies and developing countries, which provided no reciprocal advantages to EU exports, the more recent agreements do provide such advantages. The potential for displacement of low-cost exports from the U.S. by EU exports has increased.

Recent and proposed conversions from nonreciprocal to reciprocal arrangements with Mediterranean and African, Caribbean, and Pacific countries are partially motivated by legal challenges to nonreciprocal agreements. Nonetheless, recently negotiated preferences for EU exports have been significant, including olive oil, wines, and spirits to Mexico, and 800,000 tons of wheat annually to Mediterranean countries. Additional free trade agreements with Chile and MERCOSUR (Argentina, Paraguay, Uruguay, and Brazil) are under negotiation and could provide preferences to EU products.

Also a concern for the U.S. is the impact of expanding EU preferential agreements on prospects for liberalizing trade through multilateral trade negotiations. As a huge market, the EU has enormous bargaining power in bilateral negotiations, allowing EU preferential agreements generally to continue strong protection for EU agriculture. The EU is pursuing freer nonagricultural trade while avoiding liberalization of its highly protected agricultural markets. In multilateral trade negotiations, however, the EU finds it harder to resist the collective influence of countries seeking liberalized world agricultural trade.

The Special Case of EU Agricultural Trade

The EU is largely an open market for nonagricultural products (except for textiles and clothing), with an average tariff of only 4.2 percent in 1999. EU agricultural markets, however, are restricted and highly managed. Starting in the 1960s, the EU chose to protect domestic producers by restricting trade through the Common Agricultural Policy (CAP).

CAP support for EU producers includes the maintenance of prices of domestically produced or "sensitive" agricultural prod-

EU Trading Arrangements

EU trading arrangements include multilateral most-favored-nation (MFN) treatment, which the EU extends to all World Trade Organization (WTO) members, and preferential trading agreements with specific countries or blocks of countries. Products from MFN countries, including the U.S., made up about one-third of EU's imports in 1998-2000, while products from countries with preferential agreements accounted for the other two-thirds.

Multilateral most-favored-nation (MFN). Treatment. Bound maximum tariffs and other trading conditions apply to imports from all WTO members. EU tariffs are prohibitively high on many sensitive agricultural products, while low or zero tariffs are applied to many agricultural products in short supply. Despite the nomenclature, MFN treatment generally is the least favorable treatment provided imports.

Preferential trade agreements (nonreciprocal). Preferential tariffs below MFN tariffs and other trading conditions are provided unilaterally by the EU without reciprocal preferences for EU exports. Nonreciprocal trade agreements or preferences include:

Generalized System of Preferences (GSP). Reduced tariffs are provided on selected products to 146 developing countries. The GSP provides reductions in *ad valorem* tariffs of 15 percent for "very sensitive" products and reductions of 30, 65, and 100 percent for "sensitive," "semi-sensitive," and "non-sensitive" products. No quotas are imposed. Many agricultural products are more than "very sensitive," however, i.e. no reductions are provided.

Least-developed-country (LDC) preferences. The GSP always has provided the LDCs with larger tariff reductions on a larger set of products. Since March 2001, the "***Everything But Arms***" (EBA) policy provides 42 LDCs duty-free access to EU markets without quota or other restrictions for all agricultural primary and processed products. EU imports of sugar, bananas, and rice are subject to transition arrangements until 2009.

Africa, Caribbean, and Pacific (ACP) preferences. Tariff reductions are provided to 77 former EU colonies that are larger and for more products than those of the GSP or those provided for the LDC before the EBA. Many larger tariff reductions are available only within quotas. Special protocols provide for EU imports of sugar, beef and veal, from a few ACP countries at high EU prices. The WTO waiver for ACP preferences expired in 2000. A new waiver has been requested but has been controversial and remains pending. The EU intends to negotiate new reciprocal ACP arrangements by 2008.

Preferential trade agreements (reciprocal). Bilateral agreements, referred to in the General Agreement on Tariffs and Trade (GATT) as free trade agreements (FTA), provide preferential tariffs below MFN tariffs and other preferential treatment for the exports of the EU as well as for the preferred partner. The provisions of these agreements, including agricultural product coverage, vary considerably, but most provide significant tariff reductions although only within quotas. FTAs with neighboring countries extend the EU internal market throughout Western Europe for industrial products, but exclude agriculture. EU's FTAs include:

Europe Agreements with Hungary, Poland, the Czech Republic, the Slovak Republic, Bulgaria, Romania, Estonia, Latvia, Lithuania, and Slovenia, provide for reciprocal free trade (zero tariffs) in industrial goods in preparation for EU membership. "Double zero" provisions eliminate export subsidies in bilateral trade and provide duty-free access for some products within quotas. Similar agreements provide some agricultural preferences to countries in southeast Europe, but without the prospect of membership. Sensitive agricultural products are excluded.

Euro-Mediterranean Agreements (EMA) are FTAs with the Palestinian Liberation Organization (1997), Tunisia (1998), and Israel and Morocco (2000). Agreements with Jordan and Egypt await implementation. The EMAs provide for free trade in nonagricultural products, while agricultural trade is limited by quotas largely to historical flows. The EMA replace nonreciprocal agreements from the 1970s, which remain in force for Algeria, Lebanon, and Syria pending EMA negotiations. The EU envisions a Euro-Mediterranean free-trade area by 2010.

Other agreements include bilateral FTAs with ***South Africa*** (1999) and ***Mexico*** (2000) that provide for free trade in nonagricultural goods. Some agricultural concessions are provided within quotas, but sensitive products are excluded. The FTA with Mexico covers 62 percent of historical agricultural trade. FTAs are under negotiation with ***Chile*** and ***MERCOSUR*** (Brazil, Argentina, Paraguay, and Uruguay).

ucts considerably above world prices (sometimes more than double). The CAP also isolates many domestic prices from movements in world prices. Sensitive products include grains, sugar beets, nontropical fruit, vegetables, wine, olives, poultry, eggs, pork and pasture-based livestock, including dairy products, beef, and sheep meat. Also sensitive are processed forms of these products, such as flour, starch, pasta, and preserved fruit and vegetables.

The EU does not support prices of agricultural products for which EU production is inadequate—including tropical products, oilseeds and their products, and cotton and numerous nongrain feed ingredients—allowing these to be imported close to world prices. Reductions in EU grain support prices during the 1990s and a weak *euro* also have brought EU grain prices much closer to world prices, and EU grain imports have increased in recent years.

The CAP focuses principally on management of supplies to achieve targeted price levels. Export subsidies facilitate the disposal of surpluses. When domestic supplies of CAP products are insufficient, the

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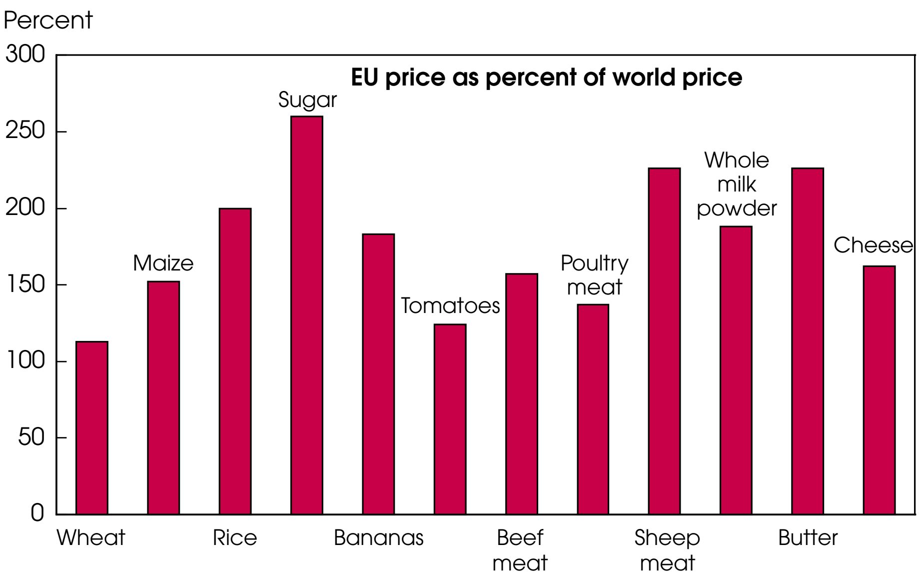
EU Prices for Agricultural Products Are Above World Prices



Based on 1999-2000 price data from the Commission of the European Union.
Economic Research Service, USDA

CAP carefully controls the quantity and pricing of imports to be consistent with price targets. Control mechanisms employed include high and variable applied tariffs, quotas (mostly negotiated within preferential agreements), minimum import price requirements, and seasonal restrictions. Preferential agreements are integral to CAP import management.

GATT Reforms— What Has Been the Result?

The General Agreement on Tariffs and Trade (GATT), adopted in 1947 and administered by the WTO since 1995, provides rules that govern most world trade. The foremost GATT principle is most-favored-nation (MFN) treatment, which requires WTO members to accord to all members the best trading conditions provided to any country. Implicitly, the MFN principle requires that all trading arrangements be global, precluding trade diversion. However, GATT rules provide two exemptions to MFN obligations.

One exception allows for free trade agreements (FTAs) among "adjacent countries" to "recognize the desirability of increasing freedom of trade." Trade barriers cannot be increased for any country, however, and all barriers within a free trade area must be eliminated on "substantially all trade" and "within a reasonable amount of time." But the EU has excluded sensitive high-priced CAP products by interpreting "substantially all trade" to mean substantially all historical trade, effectively allowing continuation of past trade restrictions and precluding increased trade.

The GATT provides a second exemption from MFN obligations which allows developed countries to provide a Generalized System of Preferences (GSP) for imports from developing countries, including special measures for the least developed countries. The GSP differs from free trade agreements in that concessions are provided unilaterally, without reciprocal concessions, and are nonbinding and revocable.

All nonglobal trading arrangements must conform to GATT requirements for FTAs or the GSP, unless three-fourths of WTO members consent to a waiver. The EU has established numerous trading arrangements under WTO waivers, including the agreement with African, Caribbean, and Pacific countries.

In the Uruguay Round of the GATT, disciplines were imposed on export subsidies and domestic support to agriculture, while quantitative restrictions and other nontariff barriers were eliminated, in principle. Tariffs, once bound at agreed MFN levels, cannot be increased without compensation to all affected countries. Throughout eight rounds of multilateral trade negotiations, however, the EU has maintained very high MFN tariffs on many agricultural products. In practice, GATT reforms have so far little affected EU management of agricultural imports.

Operating the CAP: Mechanisms to Manage Trade

Provisions of EU preferential agreements, except for "Everything But Arms," carefully accommodate the CAP, even providing for subsequent CAP changes. Maintenance of high CAP prices depends fundamentally on high MFN tariffs to restrict trade, allowing other CAP mechanisms to effectively facilitate and control desired imports. The value of preferences and the impacts on trade depend on the CAP mechanisms discussed below and the provisions of preferential agreements.

High MFN tariffs. The GATT requirement that imports be allowed at bound MFN tariffs means that high prices must be protected from cheap imports by tariffs at least as large as the gap between EU and world prices. Otherwise, lower priced imports would pour in, undermining domestic prices. Because EU agricultural prices are very high, EU agricultural tariffs also are high. The average maximum MFN tariff is 30 percent, 7 times the nonagricultural average, and for sensitive products subject to WTO quotas, the average is 78 percent. Eight percent of agricultural tariffs are over 100 percent. EU MFN tariffs for sensitive products often are greater than the normal gaps between EU and world prices and are mostly prohibitive.

Largely prohibitive MFN tariffs mean that little trade occurs without alternative arrangements. Tariffs actually applied on sensitive EU imports often are considerably less than MFN rates. EU price targets still can be achieved because many MFN tariffs are considerably larger than the gap between EU and world prices. The amount of MFN tariff in excess of the price gap, often referred to as "water" in the tariff, insures that other measures, including quotas and minimum import price requirements, can be employed to manage trade effectively. Adequate "water" also allows applied tariffs (and possibly also export subsidies) to be varied inversely with world prices, insulating EU prices from world market influences. Such price stabilization requires that MFN tariffs be at least as large as the price gap even when world prices are very low.

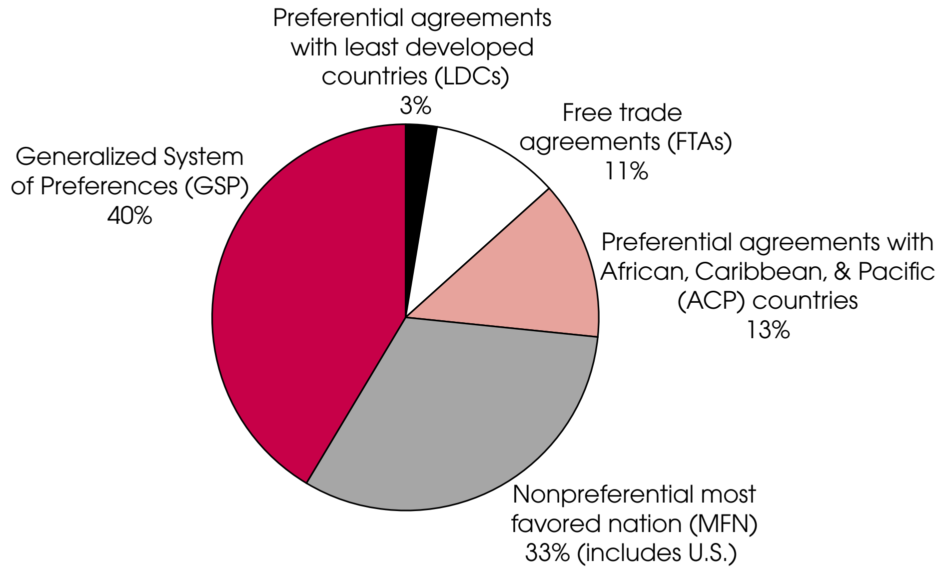
Tariff-rate quotas. EU imports of sensitive products commonly occur within tariff-rate quotas (TRQ), which allow some amount of imports at a tariff far enough below the MFN rate to facilitate trade. On additional imports, a tariff up to the MFN rate may be applied. Although the GATT bans absolute quotas, the EU's prohibitive MFN tariffs still effectively limit trade to the TRQ amount, achieving the same result. While the EU's commitments to GATT required the EU to establish 87 TRQs, WTO data indicate that the EU actually has some 3,000 TRQs in operation, mostly for agricultural and fishery products negotiated within preferential agreements.

Serious controversies surround the administration of TRQs. Most EU TRQs allocate market access to specific suppliers. EU banana quota allocations have been highly controversial because WTO dispute panels deemed them discriminatory and contrary to GATT requirements. For agricultural products, TRQ allocations have been the principal determinant of who supplies EU imports of many products.

Minimum import price (MIP) requirements. The EU directly manages some domestic prices by requiring that prices for imports, including applicable tariffs, be no lower than CAP prices—competition from cheap imports simply is not allowed. MIP requirements are applied to many fruit and vegetable imports. Imports observing MIP requirements may face relatively low tariffs. Again, the potential application of high MFN tariffs compels importers to observe MIP requirements. A few PTAs provide for some reduced MIPs.

Seasonal restrictions. The EU varies applied tariffs and tariff reductions, quota amounts, and MIP requirements during the year for seasonal and perishable commodities such as fruits and vegetables.

Two-Thirds of EU's Agricultural Imports Come from Countries With Preferential Agreements



Based on World Trade Atlas data for 1998-2000.
Economic Research Service, USDA

Seasonal restrictions protect producers during harvesting but allow for off-season imports. Some PTAs contain less seasonally restrictive conditions than others.

Product exclusion. The EU's ultimate protection for sensitive products has been simply to exclude them from PTAs, providing no import concessions. Although the Europe Agreements (EA) provide for imports of some sensitive products from Eastern European countries within quotas, the EU provides no tariff concessions for grains, grain products, or the main meat and dairy products in the GSP. Sensitive products also are excluded in the PTAs with Mediterranean countries, South Africa, and Mexico.

How Valuable Are Tariff Reductions?

All EU preferential agreements impose reduced tariffs below MFN levels for all imports of some products. However, the EU often provides much larger tariff reductions or even zero duties on imports within the tariff-rate quotas of particular PTAs. Zero tariffs are accorded the least developed countries (LDCs). Tariff concessions to former African, Caribbean and Pacific colonies also are significant, particularly for fruits and vegetables. Special quotas for 52,000 tons of beef for 6 former colonies and 1.2 million tons of sugar for 13 other former colonies are provided with minimal duties, making them among the most valuable of all concessions provided by any EU preferential agreement.

Tariff concessions for FTAs outside quotas are limited. The GSP provides average reductions of only 2 percent or less for sensitive and very sensitive products and perhaps 4 percent for semi- and nonsensitive products. No GSP reductions are provided for the most sensitive products. EU agreements also generally provide reductions for *ad valorem* tariffs only, leaving potentially prohibitive specific tariffs. Tariffs outside of special quotas are particularly high for meat, dairy, and cereals, remaining above 25 percent for all trading arrangements except for the LDCs.

The value of EU tariff reductions is difficult to assess. For sensitive products with prohibitive MFN tariffs, a limited tariff reduction may not be enough to increase trade. Significant tariff reductions within

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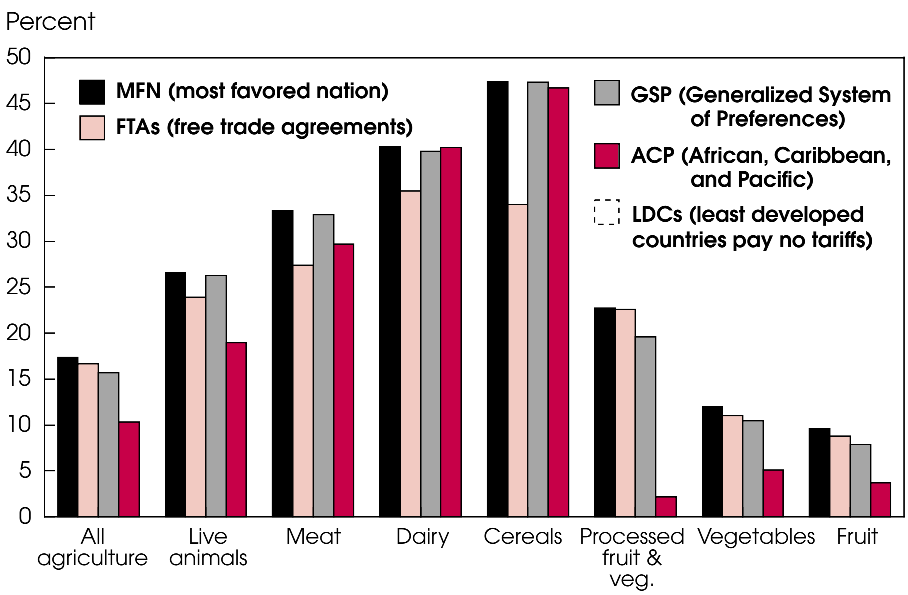
EU Out-of-Quota Tariffs Vary Among Products and Trading Arrangements



Based on WTO data for 1999. Percents are simple averages of tariffs across items and countries.
Economic Research Service, USDA

quotas may guarantee access, but only for the limited quota amounts. MIP requirements force suppliers to compete on quality rather than price and also impose quantity restrictions indirectly, because excessive imports would suppress EU prices, making imports at minimum prices unattractive.

The potential value of a tariff reduction is the amount by which the gap between EU and world prices exceeds the applicable tariff. Reduced tariffs potentially provide two options to preferred partners. They may capture some portion of the potential value as profit, or they may sell at a lower price and increase market share. The exporter's ability to capture the value of preferences is not assured, however. The EU often allocates import licenses to EU companies, leaving outside exporters to compete for importers. In the process, suppliers may bid away to importers some or all of the value of preferences.

The Impacts on Trade

Consumers benefit when lower priced imports displace domestically produced products. Despite consumer benefits, governments do restrict trade, usually because potentially displaced producers organize politically, and agricultural trade is among the most restricted. In the EU case, very high MFN tariffs clearly allow GATT-legal policy mechanisms to restrict and control trade.

Ultimately, EU preferential trading arrangements cannot be said either to create trade or to restrict trade. The basic objective of EU agricultural policy—the maintenance of targeted domestic price levels—determines the appropriate level of imports and has not been affected by the various EU preferential agreements. Preferential agreements are extensions of the CAP, allowing trade or restricting it depending on current policy objectives.

If EU preferential agreements do not generate trade, then what value are they to the preferred partners? EU preferential trading agreements do divert trade, and the preferred partners are the beneficiaries. They probably also capture some part of the value of the reduced tariff. Their advantage over less preferred partners helps assure some access to the world's largest market even if preferred partners bid away the value of preferences to importers.

Trade diversion is limited to some extent because large supplies of some products not produced by the EU can be obtained only from dominant world producers, who may not have preferential arrangements. Countries having no agricultural preferences still account for almost one-third of EU imports, while GSP countries, the least preferred of preferred partners, account for another 40 percent of EU imports. The U.S. is a major producer and thus a natural supplier of soybeans, tobacco, and almonds. The EU also depends heavily on imports for tropical products, cotton, and counter-seasonal fruits, nuts, and vegetables. The trade, therefore, is somewhat inevitable.

For the EU, preferential agreements provide enhanced control over the sources of imports. Recent reciprocal agreements also provide advantages for EU exports. The impacts of the "Everything But Arms" policy remain to be seen. AO

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