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Preferential Trade Agreements:

The Case of EU-Mexico

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Abstract

The paper evaluates the political and economic incentives to conclude the EU-Mexico Free Trade Agreement (FTA). It discusses EU and Mexican trade policy as well as the multilateral context for FTAs. In addition, using a disaggregated approach at the three-digit Standard International Trade Classification, it identifies the commodities that will be particularly affected by the FTA. The results show that considerable trade effects can be expected in a narrow range of products and that the EU is likely to gain much more than Mexico.

Zusammenfassung

In diesem Papier werden die politischen und ökonomischen Anreize zur Vereinbarung des Freihandelsabkommens zwischen der EU und Mexiko bewertet. Dafür werden die europäische und mexikanische Handelspolitik analysiert und der multilaterale Zusammenhang der Bildung von Freihandelsabkommen betrachtet. Darüber hinaus werden die Auswirkungen des Freihandelsabkommens auf der disaggregierten dreistelligen Ebene des internationalen Warenverzeichnisses für den Außenhandel geschätzt. Die Ergebnisse zeigen, daß in einem begrenzten Bereich von Produktgruppen signifikante Handelseffekte zu erwarten sind und daß die EU stärker als Mexiko vom Abkommen profitieren wird.

JEL classification: F15, F17

Key words: Free Trade Agreement, European Union, Mexico

1. INTRODUCTION

The Free Trade Agreement (FTA) between the European Union (EU) and Mexico is the first comprehensive and reciprocal trade pact of the EU with a country of the western hemisphere and *vice versa* of Mexico with European states. For the EU, it is also a way to get better access to the preferential trading area created by the North American Free Trade Agreement (NAFTA) between Mexico, the United States and Canada, and a precedent to further arrangements with Latin American countries such as the members of MERCOSUR (Mercado Común del Sur). For Mexico, the agreement is part of a diversification strategy to reduce its dependence on the US. From an economic viewpoint, the internal effects of the FTA on its members, the external significance for third countries and the "systemic" implications for the world trading system as a whole are most interesting.

The quantitative analyses of the impact of a free trade area on trade flows are typically performed in either a partial or general equilibrium framework. By their very nature, partial equilibrium models allow for highly detailed studies on the impact of trade policy changes. In contrast, general equilibrium models attempt to describe the effects of discriminatory tariff preferences on the economy as a whole and the intersectoral linkages in particular. Since the overall trade effects of the EU-Mexico FTA are likely to be small - with respect to total trade - due to relatively low trade barriers on average, sectoral repercussions will gain in significance. Therefore, we chose a partial equilibrium framework.

With regard to the EU-Mexico FTA the following three questions have to be answered: (1) What are the economic and political incentives of both the EU and Mexico to conclude a bilateral FTA, (2) what are the consequences of the agreement for members and non-members, and (3) which disaggregated commodities will be affected by the FTA in particular.

The structure of the paper is as follows. Section 2 surveys the structure of EU-Mexican bilateral trade and highlights central features of the FTA treaty. Section 3 discusses EU and Mexican trade policy as well as the multilateral context for FTAs. A method to analyse the elimination of a preferential tariff is presented in Section 4. More specifically, the model of Clague (1971, 1972) will be used to estimate the impact of the

FTA on trade flows. Section 5 describes the estimated trade effects, and some concluding remarks as well as a summary of the major results are found in Section 6.

2. STRUCTURE OF BILATERAL TRADE AND ESSENTIAL FEATURES OF THE FTA

To date, Mexico has only been a minor trading partner for the European Union. Unlike MERCOSUR, for instance, and especially the Central and East European Countries (CEECs), Mexico also took little advantage of increasingly outward oriented EU trade patterns during the 1990‘ s. In fact, the EU’s profile in Mexico‘ s foreign trade actually declined quite dramatically during this period, largely reflecting the fact that NAFTA came into force in 1994 (Table 1).[1]

Table 1: Regional Structure of EU and Mexican Trade, 1980-1998

	EU trade (%)			Mexican trade (%)		
	1980	1990	1998	1980	1990	1998
EU-15	59.3	64.6	61.7	15.7	15.5	6.4
Other Western Europe	5.0	4.9	4.2	0.7	1.2	0.4
CEEC[1)]	1.8	1.4	3.4	0.2	0.2	0.2
MEDC[2)]	3.0	2.4	2.7	2.0	0.6	0.2
United States	6.8	7.2	7.9	63.0	67.6	81.0
Mexico	0.3	0.3	0.4	-	-	-
Japan	1.8	3.3	2.6	4.7	4.9	2.2
Asian NIC´s[3)]	1.7	2.3	2.9	0.4	1.2	1.8
Latin America[4)]	2.7	1.8	2.1	5.7	5.3	3.6
World ($ billion)	1,561	1,518	2,210	33	29	121

Source: IMF Direction of Trade Statistics, own calculations. [1)]Czech Republic, Slovak Republic, Hungary, Poland, Bulgaria, Romania; [2)]Algeria, Egypt, Israel, Lebanon, Jordan, Syria, Morocco, Tunisia, Turkey; [3)]Hong Kong, Singapore, South Korea, Malaysia, Thailand; [4)]Excluding Mexico.

A sectoral breakdown of bilateral EU-Mexican trade reveals a heavy EU reliance on exports of manufactures, in line with the global structure of EU exports, against relatively big agricultural and mining (mainly fuels) components on the Mexican side which surpass the respective shares in Mexico’s global exports by a considerable margin (Table 2). Within the manufacturing sector, the structure of bilateral trade by

1 The Europe Agreements with the CEECs, on the other hand, seemingly provide little scope for trade diversion away from Latin American countries in the EU market, as the degree of similarity between the exports to the EU of the two regions has been found to be low (Brenton, 1996).

industry displays a relatively high degree of similarity suggesting sizeable amounts of intra-industry trade. The biggest European export items to Mexico are non-electrical machinery, chemicals and automotive products, while Mexican exports of manufactures to Europe concentrate on automotive products, chemicals and office and telecommunications equipment.

Table 2: Sectoral Structure of Bilateral EU-Mexican Trade, 1998

	EU exports to Mexico			Mexican exports to the EU		
	$ mill.	% total		$ mill.	% total	
Agricultural products	441	4.3	(7.6)	559	14.4	(7.0)
Mining products	167	1.6	(4.4)	856	22.0	(7.7)
Manufactures	8,847	87.1	(85.0)	2,442	62.7	(85.1)
Iron and steel	505	4.9	(2.4)	124	3.2	(2.0)
Chemicals	1,309	12.9	(12.7)	416	10.7	(3.7)
Other semi-manufactures	765	7.5	(9.1)	148	3.8	(5.3)
Non-electrical machinery	2,575	25.4	(17.0)	153	3.9	(5.5)
Office and telecommunications equipment	730	7.2	(8.5)	313	8.0	(18.5)
Electrical machinery and apparatus	580	5.7	(5.1)	171	4.4	(13.2)
Automotive products	1,194	11.8	(9.6)	673	17.3	(18.6)
Other transport equipment	274	2.7	(5.5)	86	2.2	(2.2)
Textiles	163	1.6	(2.8)	65	1.7	(1.7)
Clothing	100	1.0	(1.9)	30	0.8	(5.6)
Other consumer goods	651	6.4	(10.4)	264	6.8	(8.8)
Total	10,157	100.0	(100.0)	3,894	100.0	(100.0)

Source: WTO, own calculations. Note: Figures in brackets represent the respective share of trade with all countries, in the case of the EU with all third countries.

In most cases, industries' share of bilateral trade in manufactures is higher than their share in the total manufacturing trade of Mexico and the EU, which is an indicator that the bilateral trade intensities for these industries exceeds the industrial average. Even so, due to the small volumes of trade involved, the intensity of bilateral trade links between the EU and Mexico is low in all the industries considered. This shows up in Delta values for EU exports to Mexico, and likewise for Mexican exports to the EU, which

are invariably far below the "normal" size (i.e. unity) that represents the average intensity of trade relations between individual countries or regions (Table 3).[2]

Table 3: Intensity of EU-Mexican Bilateral Trade Links, 1998[1)]

	EU exports to Mexico	Mexican exports to the EU
Agricultural products	0.12	0.18
Mining products	0.07	0.15
Total manufactures	0.13	0.06
Iron and steel	0.35	0.22
Chemicals	0.19	0.34
Other semi-manufactures	0.10	0.07
Non-electrical machinery	0.10	0.08
Office and telecommunication equipment	0.08	0.03
Electrical machinery and apparatus	0.06	0.02
Automotive products	0.25	0.16
Other transport equipment	0.09	0.07
Textiles	0.08	0.09
Clothing	0.06	0.01
Other consumer goods	0.08	0.06
Total trade	0.14	0.08

Source: WTO, own calculations. [1)]For definition of Delta values see footnote 2.

The FTA between the EU and Mexico came into force on July 1, 2000. It is claimed to establish a free trade area in the sense of Article XXIV of the GATT and Article V of the GATS (WTO, 2000b, p. 10). It is the first FTA between a Latin American country and the EU and thus the first step towards free trade between the two regions. It is also a "new-generation" trade agreement in that it goes beyond goods, trade and border issues to include services, investment, public procurement, intellectual property, and competition.

In the field of tariffs on industrial goods, the EU's negotiating aim was to achieve NAFTA parity, i.e. duty-free market access by the same year (2003) as the US and Canada. In the end, Mexico agreed to abolish tariffs vis-à-vis the EU on 52% of its

2 Delta values compare bilateral trade flows between trading partners with their overall trade, thereby adjusting for different country sizes. In the present case, EU exports to Mexico, for instance, as a percentage of total EU exports, are related to Mexico's imports from the world as a share of total world imports (net of Mexican imports from the EU and world imports from the EU, respectively). The formula is as follows:

$D_{ij} = X_{ij} / (X_i * M_j) / (M_w - M_i)$, where X_{ij} denotes exports from country i to country j, X_i total exports of country i, M_j total imports of country j, M_w total world imports and M_i total imports of country i.

industrial products by 2003 and on the remaining 48% either in 2005 or 2007, depending on the sector (EC Commission, 2000). The EU, for its part, will provide duty-free access for all Mexican industrial products by 2003. In agricultural trade, which accounts for 7% of total bilateral trade, tariffs on slightly more than 60% of each other's commodities will be removed over a period of up to 10 years (for the more sensitive goods). Altogether, the FTA will free about 95% of bilateral goods trade from tariffs. With respect to rules of origin, the complex EU rules apply in most cases of EU-Mexican trade in goods.

Trade in services - with the exception of audiovisual services, cabotage and air transport - between the partners will be liberalised over a maximum ten-year period. With regard to public procurement, EU suppliers obtain the same access to Mexican markets as NAFTA firms while Mexico will enjoy similar treatment in the EU as the EU's partners under the (plurilateral) WTO Public Procurement Agreement (to which Mexico is not a signatory). In competition policy, the EU-Mexican agreement – similar to NAFTA – merely seeks to ensure compliance with the two signatories' domestic legislations. To sum up, while the EU gains close-to-NAFTA rank in Mexico through the bilateral agreement, Mexico moves up from GSP (Generalised System of Preferences) to associate status in the EU pyramid of preferences.

The formation of the European Common Market or European Economic Community was a first test of Viner's (1950) proposition that in the case of a customs union trade diversion might exceed trade creation. It called into question the conventional wisdom of the time that regional free trade agreements were welfare-improving *per se*. European integration was also the major – and only successful – event in the first wave of regionalism ("old regionalism") that began in the late 1950s and was mainly characterised by the removal of border restrictions.

The EU-Mexico agreement, by contrast, is part of the second wave of regionalism ("new regionalism") that began in the late 1980s. It is distinct from the first wave in several quantitative and qualitative respects. Whereas old regionalism was very much centred around (western) Europe, new regionalism has at least two centres, namely Europe and America, even though European predominance is still evident. New regionalism also has a growing inter-regional dimension of which the EU-Mexico agreement is an example. It is a case of non-natural (i.e. non-proximate) trading partners

removing trade barriers between each other on a preferential basis while at the same creating a link between two major centres of regionalism.

One characteristic of the EU-Mexico agreement that distinguishes it from regional relationships like those between the EU and the CEECs or between Mexico and the US is the lack of a connection with labour migration. Capital and company mobility, on the other hand, is a common element of regional and inter-regional integration schemes alike, reflecting the close interaction between trade and investment in a globalising world economy. Besides generating conventional trade-creation and trade-diversion effects, the EU-Mexico FTA could greatly enhance the importance of Mexico as a location for European foreign direct investment and thus indirectly improve European access to the markets of other Mexican FTA partners as well and to the US market in particular (IRELA, 2000, p. 6).

3. EU AND MEXICAN TRADE POLICY AND THE MULTILATERAL CONTEXT

Trade policy in the *European Union* combines a variety of motives and policy areas. According to Pelkmans and Brenton (1997, pp. 28-29), the instruments of trade policy have routinely been used for at least seven types of EU policy. These are: Commercial Diplomacy, Agricultural Policy, Economic Integration, Development Policy, Competition Policy, Industrial Policy, and Foreign Policy.

The conclusion of Free Trade Agreements, i.e. reciprocal preferentialism, is at the very heart of EU trade policy. It is the centrepiece of "contractual" trade policy, its first pillar. The second pillar is "autonomous" trade policy, of a defensive or offensive nature, which entails restrictive measures like anti-dumping, anti-subsidy and safeguard policies that in most cases discriminate amongst trading partners as well as instruments like the Trade Barriers Regulation[3] or the granting of non-reciprocal trade preferences which are designed to open up, often selectively and conditionally, foreign and domestic markets, respectively. The third pillar is "multilateral" trade policy, i.e. the very antidote to preferentialism, discrimination, selectivity, and conditionality. In each of the three

3 The Trade Barriers Regulation of 1994, which is the successor to the New Trade Policy Instrument of 1984 and European "mirror" legislation to Section 301 of the US Trade Act, aimso eliminate "unfair" trade barriers facing European suppliers on foreign markets. It permits the EU authorities, on own initiative or upon request by industry, and pending prior approval from the WTO, to take punitive action against "non-conforming" countries.

areas, apart from "border measures", the subject of trade policy is increasingly behind-the-border policies such as the granting of subsidies or the imposition of product regulations and standards.

The most contentious of EU trade policies is the *Common Agricultural Policy*. According to a recent study (Borrell and Hubbard, 2000), the total economic cost of the Common Agricultural Policy amounts to at least $75 billion annually of which more than a third is borne by non-EU countries. The study claims that by restricting imports and subsidising exports the EU has depressed agricultural prices on world markets at a cost to the rest of the world of $26 billion a year.[4] Agriculture has also been largely excluded from EU preferential trade policies.

Nor have these policies, as could have been expected, led to a suppression of *anti-dumping measures*, the favoured policy of protectionists, by removing the economic rationale for action against dumping practices - namely the existence of barriers to market entry in the exporting country that prohibit arbitrage (via re-exports) between markets in the exporting and importing countries. Even where the agreements - such as the Europe Agreements with the CEECs - introduced EU-style competition policies in the partner countries in order to prevent distortions of competition in bilateral trade, the anti-dumping option was maintained in the EU.[5] This, of course, also applies to the EU-Mexico FTA. Overall, the number of new investigations into dumping practices in the EU has risen sharply in recent time, from 21 in 1998 to 66 in 1999, which suggests a renewed upsurge in the actually application of EU anti-dumping measures (unilateral imposition of extra duties on the respective goods or negotiation of "price undertakings" with the exporting countries) in the near future. The product categories most affected would be iron and steel products, consumer electronics, and chemicals (WTO, 2000a, pp. 67-69).

The EU has signed *Preferential Trade Agreements* (PTAs) with a large number of trading partners of which the four EFTA countries (Iceland, Liechtenstein, Norway, and Switzerland) are outstanding examples, since liberalisation with these countries is nearly complete. It has also been fully reciprocal and symmetrical and goes beyond the

4 $49 billion of the estimated $75 billion annual cost of the Common Agricultural Policy in the study is borne by the EU, in the form of subsidies and artificially high food prices.

5 The exception is trade in industrial products with non-EU members of the European Economic Area (Iceland, Liechtenstein, and Norway) where the EU's competition policy framework applies.

stage of "shallow integration" (i.e. removal of border measures) into the area of "deep integration" (i.e. harmonisation or mutual recognition of economic or regulatory policies). Strong elements of the latter are also contained in the Europe Agreements with Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia while in the field of trade liberalisation these treaties provide for non-symmetric reciprocity (i.e. the EU liberalises faster than its partners). This holds for the Euro-Mediterranean association agreements with Israel, Morocco, Tunisia, and the Palestinian Authority, too, as well as for the free trade agreements with South Africa and Mexico, whereas "deep integration" remains relatively weak in these cases. The extension of reciprocal preferentialism beyond potential EU member countries is nevertheless regarded as a "new development" and "radical departure" in EU trade policy pointing to a "hub-and-spoke" strategy similar to that followed by the US (Sapir, 1998, p. 729).[6]

Altogether, the 20 trading partners with which the EU entertains a reciprocal preferential relationship account for about a quarter of EU trade with third countries.[7] Another 45% or so of this trade is with other developing countries which the EU unilaterally accords duty-free or reduced-duty treatment - depending on the degree of "sensitivity" of the traded (industrial and processed agricultural) products - under the Generalised System of Preferences, within the framework of the Partnership Agreement of Suva, with 71 African, Caribbean and Pacific (ACP) countries. The latter agreement, moreover, which replaces the strictly non-reciprocal Fourth Lomé Convention, provides for reciprocity after a transition period.[8] As a consequence, only a minority of countries (Australia, Canada, China, Hong Kong, Japan, New Zealand, Singapore, South Korea, and the United States)[9] face most-favoured-nation treatment in the EU, i.e. have to pay

6 As a possible solution to the internal and external problems caused by the hub-and-spoke approach, Sapir (1998, p. 730) proposes to build customs unions instead of free-trade areas, since the former would not require intricate rules of origin (the main internal problem) and limit frictions with third countries as the relatively low EU tariff would apply.

7 The share of these countries (not counting the Palestinian Authority) in EU exports to third countries was 27.4% in 1998 while the corresponding share in EU imports was 21.8% leaving an average share of exports and imports amounting to 24.6% (Source: IMF Direction of Trade Statistics).

8 Under the new agreement, industrial and processed agricultural products of ACP countries will enjoy non-reciprocal duty-free access to the European market until December 31, 2007, by which time new reciprocal arrangements will have to be concluded (WTO, 2000a, p. 34).

9 With effect from 1 May 1998, Hong Kong, South Korea and Singapore were "graduated" from the list of GSP beneficiaries.

the tariff rates agreed in the WTO. These have declined in manufacturing industry from 6% in 1995, at the beginning of the WTO, to 4.2% in 1999.[10]

As with EU trade policy in general, EU preferentialism is not just a question of comparing economic costs and benefits since it blends non-economic with economic considerations.[11] Preferential trade policies have always been a principal instrument of foreign policy for the European Community (Sapir, 1998). Moreover, the net economic gains to be derived by the EU from preferentialism seem to be rather modest given the relatively small size of the markets of its partner countries. At the same time, however, trade barriers in these countries are in many cases significantly higher than in the EU, at least in the industrial sector, while the respective liberalisation agreements increasingly provide for a reciprocal removal of trade barriers, as noted above, and cover a growing number of product groups (though market access in agriculture is still only granted selectively). In consequence, EU companies could earn considerable economic returns from both the trade creation and diversion to which preferential trade policies give rise.

Concerning trade policy in *Mexico*, after signing a Free Trade Agreement with El Salvador, Honduras, and Guatemala in June 2000, which will come into force on January 1, 2001, the number of countries with which Mexico trades under preferential regimes has risen to 27.[12] A similar agreement with Panama is to follow by the end of 2000. FTA negotiations are also under way with Ecuador, Uruguay, the EFTA countries, and Singapore. These activities are part of Mexico's strategy to diversify its trade relations away from NAFTA, in order to reduce US dominance, and to establish itself as a hub and a bridge in an expanding system of regional and bilateral trade liberalisation contracts. The proliferation of such preferential trading schemes, as far as

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10 Measured as a simple average of most-favoured-nation tariffs on products in the Harmonised System Chapters 25 through 97 excluding those classified as "agricultural" in the WTO. The average for manufactured products in ISIC category 3 fell from 7.4% in 1995 to 6.9% in 1999 (WTO, 2000a, p. 99).

11 A Council of Ministers report submitted to the European Council meeting of Amsterdam in June 1997 identifies seven "strategic questions" for the EU to consider, before new preferential agreements would be concluded, namely WTO compatibility, support of the development of the multilateral trading system, overall economic effect, achievement of "identifiable offensive economic interests of the EU", political and other benefits, impact on other EU external commitments, and impact on EU common policies.

12 Apart from the three countries mentioned, these are the two other NAFTA partners (US and Canada), the two other countries of the Group of Three (Colombia and Venezuela), two other central American countries (Costa Rica and Nicaragua) and from South America Bolivia and Chile (Financial Times of June 28: "Technocrat leads Mexico's world conquest").

the western hemisphere is concerned, is also a reflection of unwillingness in the US to open up NAFTA for new members.

Mexico - together with Chile - has been an early reformer of trade policy in Latin America (Bleaney, 1999, p. 92). It acceded to GATT in 1986 and was a founding member of the WTO in 1995. After nearly four decades of import-substitution industrialisation in this country, the trade reforms in Mexico, initiated by the government in 1985 and precipitated by the debt crisis of the early 1980s, led to a reduction in the average tariff from 23.5% in 1985 to 12.5% in 1990.[13] Import licensing, which effectively gives the government the discretion to impose import quotas at will, covered less than 20% of all imports in 1990 as against 92.2% in 1985 (Harrison and Hanson, 1999, pp. 15-16).

Up to 1999, import licensing was further reduced while tariffs were again raised.[13] The latter happened in two stages, in 1995 and in 1999, reflecting the "Tequila crisis" and the "Asian crisis", respectively. As a result, in May 1999, the (unweighted) average tariff in Mexico stood at 16.1% for all goods, 29.3% for consumer goods, 13.9% for intermediates and 14.5% for capital goods.[14] As only non-NAFTA trading partners were affected by the increases in tariff rates, the discriminatory effect of Mexican tariffs has grown since NAFTA started in 1994,[15] and it was reinforced through highly restrictive rules of origin designed to back up high tariff protection in critical industries.[16] This *de facto* protection (Krueger, 1993) has created an incentive *sui generis* for "outsiders" to seek Free Trade Agreements with Mexico.

Mexico's own demand for FTAs with foreign countries, on the other hand, was also influenced by the desire to firmly "anchor" or "lock-in" *domestic* pro-market economic reform policies in general and trade reforms in particular via *external* commitments. This was an important driving force behind NAFTA, together with the "safe-haven"

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13 In cases where import permits are still required, the Ministry of Commerce reviews the applications and relies on Mexican industry associations for advice regarding the local availability of the product and may reject applications if the product is already available.

14 Preliminary figures (Preuße, 2000, p. 28).

15 Due to the discriminatory Mexican trade policy, US firms, for instance, "have obtained more than an eight percentage point margin of preference compared to non-NAFTA competitors" (United States Trade Representative, 2000, p. 172).

16 In industries with high tariff protection, the respective rules of origin agreed in NAFTA are particularly restrictive, thereby excluding non-NAFTA suppliers of intermediate goods or forcing them to relocate production into the NAFTA area (Estevadeordal, 2000).

argument stressing the need to guard exporters against the vicissitudes of US trade policy (Whalley, 1993), and has made itself felt in subsequent FTAs, not least in that with the EU. It comes on top of the diversification motive for FTAs as mentioned above.

On a *global* scale, more than 200 Preferential Trade Agreements have been notified to the GATT or WTO over time of which over 130 agreements are still in force.[17] Most were concluded in the past 10 years. Whereas in the period from 1948 to 1994 the GATT received 124 notifications of PTAs (relating to trade in goods), 90 additional arrangements (covering trade in goods and in services) were notified between the creation of the WTO in 1995 and early 2000.

Table 4 gives an overview of the notified agreements that were in force in early 2000. The bulk of the agreements falls under Article XXIV of the GATT which exempts Free Trade Areas and Customs Unions in the field of goods from the most-favoured-nation principle of GATT Article I provided that certain conditions are fulfilled (i.e. coverage of "substantially all the trade" between member countries and no increase of trade barriers against third countries). The European Union participates in nearly one third of these agreements. The EU is even more prominent in those agreements that fall under the corresponding Article V of the GATS which covers Free Trade Areas and Customs Unions in the field of services. It is, by definition, not involved in the agreements notified under the Enabling Clause by which developing countries are freed from the normal disciplines governing PTAs in the WTO.

The picture displayed in Table 4 is, however, incomplete as only a few of the numerous PTAs involving Mexico are accounted for.[18] The WTO has apparently not (yet) been notified of most of these agreements. The European Union and Mexico are nevertheless both major contributors to the phenomenon which Bhagwati (1995) dubbed the "spaghetti bowl" of preferential trade agreements or the "who is whose" problem that

17 Most of the discontinued PTAs were superseded by redesigned agreements among the same signatories. Out of the total of 214 agreements or enlargements so far notified to the GATT/WTO, 134 are deemed to be currently in force (Source: WTO at http://wto.org).

18 Mexico is listed under Article XXIV (GATT) and Article V (GATS) as a Party to NAFTA and under the Enabling Clause as a member of the Montevideo Treaty, establishing the Latin American Integration Association, and of two further agreements among developing countries, namely the Protocol relating to Trade Negotiations among Developing Countries and the Global System of Trade Preferences.

refers to the growing network of overlapping trade regional and bilateral liberalisation regimes and the concomitant detailed rules of origin to secure their enforcement, and raises the question whether this helps or hinders the further development of a multilateral trading system ("building block" or "stumbling block").

Table 4: Preferential Trade Agreements (PTAs) notified under GATT Article XXIV, GATS Article V and the Enabling Clause, 1958–2000

	Article XXIV	Article V	Enabling Clause
1958 - 1969	3 (1)	1 (1)	1
1970 - 1979	17 (14)	0	3
1980 - 1989	4 (2)	1	5
1990 - 1994	23 (7)	4 (3)	4
1995 - 2000	56 (8)	6 (5)	2
1958 - 2000	103 (32)	12 (9)	15

Source: WTO, own calculations. Notes: Allocation of PTAs, in force early 2000, according to date of entry into force; figures in brackets represent number of PTAs in which the European Community participates.

According to Bhagwati et al. (1998), scepticism regarding Preferential Trade Agreements is allegedly gaining ground in intellectual as well as political quarters. The authors refer *inter alia* to a resolution of the EU Council of Ministers suggesting a "freeze" of the "current architecture" of the EU's trading system and thus a standstill on new PTAs, particularly with "far-away" partners, except when a strong case can be made satisfying several criteria.[19] The EU-Mexico FTA apparently is such a case. The intellectual case against preferential trade essentially relies on the risk of an inter-bloc trade war caused by discrimination, the emergence of a hub-and-spoke pattern of international trade relations involving greater dominance of "peripheral" countries by "core" powers, and a reduced incentive to follow the multilateral route to free trade (Bhagwati and Krueger, 1995).

The sceptical school of thought also asserts that PTAs tend to create endogenous protection, as member countries try to "export" the adjustment costs arising from increased internal competition by raising external trade barriers against non-members, e.g. in the form of anti-dumping duties. An example given to illustrate this possibility is

19 In the Amsterdam European Council conclusions, the EU calls for clarification of the rules for regional trading agreements in the WTO, in order to guarantee the proper functioning of the multilateral trading system. For the criteria to be fulfilled by new preferential agreements see the Council of Ministers report as quoted in footnote 11.

the US accommodating imports from Mexico by reducing imports from Taiwan (using anti-dumping actions against Taiwan), the most efficient non-member supplier, as Mexico starts crowding out inefficient US producers. The increase of non-NAFTA tariffs in Mexico in 1995 (see above) is cited as a case in point to prove the practical relevance of the proposition (Bhagwati et al., 1998, p. 1131).[20]

A more benign view of PTAs is offered by the "domino theory" of regionalism according to which single ("idiosyncratic") incidents of regionalism, such as the completion of the Single Market in Europe in 1992 or the Mexican proposal for an FTA with the US (in the western hemisphere) in 1990, trigger a multiplier effect knocking down bilateral import barriers like a row of dominos (Baldwin, 1993). It is thus the very danger of trade diversion that would cause regionalism to spread further and initial discriminatory import restrictions to be removed in the process. Exporters in third countries would lobby for membership or participation in the regional club in an attempt to secure a level playing field. Enlargement of the bloc would in turn further increase the costs of non-participation and hence prompt a second round of pro-integration or pro-participation political activity, and so forth.

The process gains momentum from a supposed asymmetry in lobbying which is attributable, for instance, to the existence of sunk costs (owing to unrecoverable investments in connection with market entry) and related quasi-rents. Exporters would accordingly fight harder to redress newly-created discrimination in trade than to promote further liberalisation *erga omnes*.[21] Where membership or participation is not feasible, as appears to be the case with NAFTA, the outsiders would turn elsewhere for compensation, i.e. seek new preferential arrangements, as for instance Chile did in the case of MERCOSUR, a move which has apparently also created domino effects of its own. Regionalism or preferentialism, in this perspective, could be a "powerful force for multilateral liberalisation" (Baldwin, 1997, p. 885) by strengthening the power of pro-trade forces, i.e. exporters, while simultaneously weakening that of the key opponents of free trade, i.e. import competitors.

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20 A formal demonstration is given in Bhagwati and Panagariya (1996, pp. 38-41) and Panagariya and Findlay (1996).

21 In this view, further liberalisation might end up in the dissipation of initially rising profits of exporting companies, and hence limit their incentive to lobby for new export opportunities, whereas the same companies, in the event of a profit-reducing discrimination and subsequent reduction in trade, would face a relatively strong inducement to seek compensation and thus to preserve existing business.

The EU has contributed directly to the spread of preferentialism. It has created powerful pressures for inclusion (Lawrence, 1996, p. 77) - witness the periodic expansions of the Community and the emergence of the European Economic Area in 1994; it has led to "responsive" regionalism like that of EFTA (as a primer to inclusion) and possibly also NAFTA as well as - together with NAFTA - that of ASEAN;[22] it has supported regional integration outside Europe, in particular in Latin America; and it is to some extent itself a reaction to regionalism in other parts of the world, such as the western hemisphere, in order to secure market access. The EU-Mexico FTA could accordingly be seen as a response to NAFTA and - by way of anticipation - to the Free Trade Area of the Americas by forcing these regional agreements to open up.[23] The reduction or elimination of potential negative effects for EU exporters of existing or planned FTAs in the western hemisphere is an important motive behind the EU's FTA strategy.

European regionalism also induced other big players such as the US to push for multilateral liberalisation in order to limit the discriminatory consequences. This was most obvious in the early years of the European Community when US exporters successfully sought to redress the harm caused to them by the Common Customs Tariff by inducing the US government to diminish the preference margins through most-favoured-nation tariff cuts agreed in the Kennedy Round of the GATT in the mid-1960s. It is less clear, to what extent the reverse causality holds - namely retardation in the multilateral process pushing regionalism as an alternative route. In this context, Baldwin (1997, p. 865) notes, that the same nations that steered multilateral liberalisation after World War II also drove regional liberalisation. The big regional players are seemingly also big global players.

4. MODEL STRUCTURE

After highlighting essential features of the EU-Mexico FTA treaty and discussing EU and Mexican trade policy as well as the multilateral context, we now focus on the estimation of the trade effects of the agreement. The following ex ante estimates are based on the model developed by Clague (1971, 1972). In the spirit of the "Armington"

22 „NAFTA and EC-1992 together induced ASEAN to initiate AFTA" (Pelkmans and Brenton, 1997, p. 1).

23 For instance, raising (unbound) tariffs on non-NAFTA imports, as practised by Mexico during the 1995 peso crisis (see above), would no longer be possible vis-à-vis the EU.

assumption[24], this model assumes product differentiation among supplying countries. More specifically, domestically produced and imported goods are considered to be imperfect substitutes in use. This assumption seems reasonable, since the vast majority of EU-Mexico trade consists of manufactured goods and tariff rates for typical homogeneous products like raw materials or mineral fuels are either zero or very low.

Clague's model is based on the normal assumptions of partial equilibrium analysis, such as iso-elastic import-demand functions, no repercussions of changing trade flows on exchange rates or incomes, and, in its restricted version, infinite supply elasticities. The latter assumption, frequently applied in models of international trade, seems reasonable for large countries like the European Union, but might be of some cause for concern in the case of Mexico. The Mexican elasticity of supply is likely to be less than infinite. Within the analysis of the trade effects of the FTA, however, we can assume horizontal supply curves for Mexico for two reasons. First, as shown above, the share of Mexican exports to the EU as a percentage of total Mexican exports is rather small. Second, EU tariff rates on Mexican imports are, on aggregate, relatively low by world standards, reflecting the low overall level of the Common Customs Tariff and, in addition, reduced or zero tariff rates granted to Mexico under the Generalised System of Preferences. For these two reasons, the expected trade effects of the FTA on total Mexican exports are likely to be small and the assumption of horizontal Mexican supply curves seems appropriate.

To analyse the different trade effects of the FTA, let us consider a particular commodity category (M), such as shoes. The consumer wishes to maximize his utility

$$U = f\ (M_1, M_2, M_3), \tag{1}$$

where M_1 and M_2 denote imports of shoes from preferred and non-preferred countries; and M_3 represents domestically produced shoes. The consumer allocates expenditure among the three sub-categories M_i subject to his budget constraint

$$Y_s = P_1M_1 + P_2M_2 + P_3M_3, \tag{2}$$

24 See Armington (1969).

where Y_s refers to the share of total income spent on shoes and P_i stands for the prices of different shoes.

Consider now the impact of a tariff (t) elimination only on preferred imports M1. If the supply elasticities are infinite, then the price of the beneficiaries' imports P_1 changes by

$$\frac{dp_1}{p_1} = \frac{\Delta t}{1+t}. \tag{3}$$

To measure the degree of substitution among the M_i, we use the Allen partial elasticity of substitution (σ).[25] Therefore we can express the change in preferred imports that replaces domestic production, or trade creation (TC), as follows:[26]

$$dM_1 = TC = M_1\, h_3\, \sigma_{31} \frac{\Delta t}{1+t}, \tag{4}$$

where h_3 refers to the share of M_3 in the consumption of shoes and σ_{31} to the elasticity of substitution between preferred imports and domestic production. The chain reaction comes in two stages: first the tariff is eliminated only on M_1 and P_1 falls, and then the consumer substitutes M_1 against M_3, and M_3 declines.

Likewise, trade diversion (TD) is defined as the replacement of non-preferred with preferred imports:

$$dM_2 = TD = M_2\, h_1\, \sigma_{21} \frac{\Delta t}{1+t}, \tag{5}$$

where h_1 refers to the share of M_1 in the consumption of shoes and σ_{21} to the elasticity of substitution between preferred and non-preferred imports. The total trade expansion of M_1 is therefore equal to the sum of trade creation and trade diversion.

25 See Allen (1962).

26 See Clague (1971, 1972) for details. Income effects are neglected, since these would be extremely small.

As can be seen from (4) and (5), estimation of TC and TD in the differentiated product model requires estimates of the partial elasticities of substitution between preferred imports and domestic production as well as between preferred and non-preferred imports. Empirical estimates for σ_{31} and σ_{21} at the disaggregated level, however, are limited. As an alternative to σ_{31} we can use ε_m, which refers to the price elasticity of total import demand, since estimates for ε_m are available in the literature[27], and rewrite (4) as follows:

$$TC = M_1 |\varepsilon_m| \frac{\Delta t}{1 + t}. \tag{6}$$

Thus, we implicitly assume that the substitutability between beneficiaries' imports and domestic production is equal to the substitutability between total imports and domestic production.

For σ_{21} we apply the aggregated estimations of Faber and Siegers (1990), who estimated EU elasticities of substitution between imports from various developing countries of origin. In the case of Mexico we use the empirical estimates made by Hickman and Lau (1973) for developing countries with a similar resource endowment and import structure as Mexico. Even though these estimates are almost 30 years old, they are the only ones available. Consequently, we have to keep in mind that our estimations of trade creation and diversion contain possible biases, since tying the value of σ_{31} to the parameter ε_m and the procedure for obtaining the value of σ_{21} have to be regarded as a simplifying assumption.

5. EMPIRICAL RESULTS

Before we present the results of the projection of the trade effects of the free trade agreement, let us first have a look at the methodology and the data used. The analysis has been carried out at the 3-digit level of the Standard International Trade Classification (SITC)[28], tariff rates and domestic production were taken from the free trade treaty (EC Commission, 2000) and the OECD Stan Database for Industrial Analysis (OECD, 1998), respectively. Furthermore, the conversion of key nontariff

27 See Faber and Siegers (1990) for the EU and Almon (1990) for Mexico.

28 The trade data were optained from the OECD database on international trade (OECD, 1997).

barriers, in particular in the agricultural sector, into specific tariffs as part of the FTA accord enables us to convert nontariff barriers into ad valorem tariff rates.

To simplify the calculation, only those commodity categories are included whose import value exceeds one million US-$. With this cut-off point, the analysis still covers 99.4% of total EU imports from Mexico and 99.8% of total Mexican imports from the EU in 1997. Another simplification refers to the timing of trade liberalisation as stipulated in the agreement. Under the terms of the FTA, tariffs and tariff-rate quotas will be reduced or eliminated within a period of 5 years for the most part, although a few import-sensitive goods are either excluded or tariffs for theses products will be phased out over ten years. In our analysis, however, we have focused on the final stage of trade barrier elimination, instead of calculating the effects at each stage.

Let us now have a look at the projections of the FTA's impact on trade. As can be seen from Table 5, total EU imports from Mexico increase by roughly $210 million or 4.9%.[29] Trade creation and trade diversion are both in the range of $105 million. EU gains in Mexico, on the other hand, are much higher with respect to both absolute and relative trade effects: total Mexican imports from the EU are projected to rise by some $2.5 billion or 28.9%, with trade creation accounting for twice the value of trade diversion (see Table 6). The disproportionate EU gains are clearly due to considerably higher Mexican tariff rates, as Mexico already enjoyed privileged access to EU markets due to the Generalised System of Preferences. In addition, the higher estimated elasticities of substitution between preferred and non-preferred imports (σ_{21}), underlying the projections, as well as those between preferred imports and domestic production (σ_{31} or ε_m) indicate a greater degree of competition among exports to Mexico.

Among EU exports to Mexico, Italy will be most affected by the FTA with total trade gains of 35.3% (EU average: 28.9%). This is clearly due to above-average Mexican trade barriers in particular categories where Italian exporters dominate EU exports to Mexico. French, Spanish, and German exports to Mexico are estimated to rise by 29.6%, 29.3%, and 29.0%, respectively, whereas the corresponding figure for Great Britain amounts to 26.2%.

29 As has been mentioned before, partial equilibrium analysis is best used to identify those disaggregated commodities that will be particularly affected by the FTA. Nevertheless, we also present the aggregated trade effects to give some impressions about the order of magnitude.

Table 5: Trade Effects of the FTA in the EU, Sized as a Share of Total Imports from Mexico

SITC	Product	Trade creation in $ '000	%[1)]	Trade diversion in $ '000	%[2)]	Total trade effects in $ '000	%[1)]
012	Other meat and edible meat offal	4,223	37.9%	1,108	0.05%	5,331	47.9%
842	Women's clothing, of textile fabrics	319	9.5%	746	0.01%	1,065	31.6%
841	Men's clothing of textile fabrics	1,613	9.4%	3,788	0.04%	5,402	31.4%
059	Fruit juices and vegetable juices	577	18.5%	358	0.02%	936	29.9%
062	Sugar confectionery	3,057	26.3%	407	0.28%	3,464	29.8%
843	Men's or boys' underwear, nightwear	245	9.4%	502	0.03%	747	28.7%
845	Articles of apparel, of textile fabrics	878	8.9%	1,899	0.01%	2,777	28.2%
844	Women's or girls' underwear, nightwear	175	9.4%	349	0.01%	524	28.1%
658	Made-up articles, of textile materials	230	8.0%	499	0.02%	728	25.5%
058	Fruits, preserved, and fruit preparations	916	14.7%	520	0.03%	1,437	23.0%
121	Tobacco, unmanufactured; tobacco refuse	2,495	14.1%	1,464	0.06%	3,960	22.4%
846	Clothing accessories or textile fabrics	484	7.5%	899	0.05%	1,382	21.6%
851	Footwear	1,810	6.3%	4,227	0.05%	6,037	21.0%
652	Cotton fabrics, woven	2,033	7.0%	3,770	0.16%	5,803	19.9%
653	Fabrics, woven, of man-made fabrics	261	7.1%	463	0.02%	724	19.8%
655	Knitted or crocheted fabrics	255	7.5%	383	0.05%	638	18.9%
056	Vegetables, roots, tubers	278	13.9%	83	0.01%	361	18.0%
034	Fish, fresh (live or dead), chilled or frozen	3,474	9.9%	2,343	0.05%	5,817	16.6%
054	Vegetables fresh, chilled or frozen	5,481	11.8%	1,634	0.07%	7,116	15.4%
894	Baby carriages, toys, games	752	2.9%	3,088	0.03%	3,840	14.8%
848	Articles of apparel and clothing accessories	234	4.2%	572	0.02%	806	14.6%
057	Fruit and nuts (excluding oil nuts)	5,216	8.4%	3,376	0.04%	8,592	13.8%
512	Alcohols, phenols, phenol-alcohols	226	4.3%	459	0.02%	685	13.1%
514	Nitrogen-function compounds	696	4.2%	1,435	0.05%	2,132	13.0%
515	Organo-inorganic, heterocyclic compounds	574	3.8%	1,337	0.02%	1,911	12.6%
657	Special yarns, special textile fabrics	814	5.4%	1,040	0.07%	1,854	12.2%
098	Edible products and preparations	375	9.5%	64	0.01%	439	11.2%
611	Leather	409	2.8%	1,202	0.05%	1,611	11.0%
651	Textile yarn	500	4.2%	792	0.02%	1,292	10.9%
782	Motor vehicles for the transport of goods	138	7.0%	77	0.00%	215	10.8%
513	Carboxylic acids	5,971	3.8%	10,754	0.50%	16,725	10.6%
266	Synthetic fibres suitable for spinning	584	4.6%	745	0.17%	1,329	10.4%
532	Dyeing and tanning extracts	390	5.6%	333	0.28%	723	10.4%
714	Engines and motors, non-electric	406	3.0%	992	0.01%	1,399	10.3%
112	Alcoholic beverages	5,528	8.8%	852	0.04%	6,380	10.1%
	Subtotal (35 categories)	51,619		52,563		104,183	
	Total (313 categories)	106,717	2.5%	105,546	0.02%	212,263	4.9%
	Share	48.4%		49.8%		49.1%	

Source: Own calculations. [1)]of EU imports from Mexico, [2)]of non-preferred imports.

Table 6: Trade Effects of the FTA in Mexico, Sized as a Share of Total Imports from the EU

SITC	Product	Trade creation in $ '000	Trade creation in %[1)]	Trade diversion in $ '000	Trade diversion in %[2)]	Total Trade effects in $ '000	Total Trade effects in %[1)]
761	Television receivers	644	30.7%	699	0.27%	1,343	63.9%
762	Radio broadcast receivers	851	30.2%	925	0.19%	1,776	63.1%
711	Steam or other vapour generating boilers	611	30.4%	640	2.41%	1,251	62.1%
061	Sugar, molasses and honey	686	57.6%	29	0.02%	715	60.1%
763	Sound recorders of reproducers	345	28.3%	377	0.09%	722	59.2%
813	Lighting fixtures and fittings	1,643	30.5%	1,451	1.05%	3,093	57.5%
764	Telecommunication equipment	91,353	25.6%	87,827	2.72%	179,181	50.3%
697	Household equipment of base metal	5,117	32.4%	2,643	4.06%	7,760	49.1%
752	Automatic data processing machines	14,031	29.8%	8,287	0.53%	22,318	47.4%
716	Rotating electric plant	21,086	24.4%	19,516	1.10%	40,602	47.0%
775	Household type equipment	11,097	30.2%	5,945	2.03%	17,042	46.4%
745	Other non-electrical machinery, tools	35,748	25.9%	26,360	5.01%	62,108	45.1%
751	Office machines	3,551	28.6%	2,006	0.77%	5,557	44.8%
843	Men's or boys' underwear, nightwear	564	33.7%	184	0.14%	748	44.6%
845	Articles of apparel, of textile fabrics	4,876	32.8%	1,631	0.18%	6,507	43.8%
846	Clothing accessories or textile fabrics	2,155	32.5%	732	0.12%	2,887	43.5%
844	Women's or girls' underwear, nightwear	959	32.5%	325	0.14%	1,284	43.5%
893	Articles, n.e.s. of plastics	23,750	29.4%	11,274	0.32%	35,023	43.3%
712	Steam turbines and other vapour turbines	2,742	23.5%	2,311	6.63%	5,053	43.3%
696	Cutlery	1,233	30.2%	531	0.96%	1,764	43.2%
773	Equipment for distributing electricity	15,537	22.1%	14,726	0.50%	30,264	43.0%
895	Office and stationery supplies	4,560	22.7%	4,053	1.28%	8,613	42.8%
785	Motorcycles and cycles	877	29.1%	411	0.47%	1,288	42.7%
733	Machine tools for working metal	20,748	28.8%	9,702	4.21%	30,450	42.2%
831	Travel goods, handbags	1,366	33.3%	354	0.44%	1,721	42.0%
658	Made-up articles, of textile materials	602	31.7%	189	0.17%	791	41.6%
841	Men's or boys' clothing	6,763	30.8%	2,367	0.37%	9,131	41.6%
891	Arms and ammunition	2,163	29.1%	930	5.68%	3,093	41.5%
898	Musical instruments	5,810	24.9%	3,850	0.73%	9,660	41.3%
771	Electric power machinery & parts thereof	8,333	24.3%	5,867	0.47%	14,200	41.3%
695	Tools for use in the hand or in machines	23,911	26.8%	12,606	3.08%	36,517	41.0%
842	Women's or girls' clothing	6,578	30.2%	2,349	0.39%	8,928	40.9%
778	Electrical machinery and apparatus	30,297	21.6%	26,683	0.80%	56,979	40.6%
692	Metal containers for storage or transport	2,672	25.5%	1,573	1.36%	4,245	40.5%
691	Structure of iron, steel or aluminium	1,687	28.2%	723	0.95%	2,410	40.2%
	Subtotal (35 categories)	354,947		260,075		615,022	
	Total (313 categories)	1,706,537	19.4%	831,329	0.9%	2,537,866	28.9%
	Share	20.8%		31.3%		24.2%	

Source: Own calculations. [1)]of Mexican imports from the EU, [2)]of non-preferred imports.

Looking beyond the overall trade effects, there are considerable differences at the product level in both Mexico and the EU. Mexico will benefit in the fields of agricultural and semi-finished products in particular. More specifically, as shown in Table 5, of the leading 35 commodities affected in the EU and sized as a share of the respective total imports from Mexico, all but 9 are food and live animals (SITC 0), organic chemicals (51), textiles (65), and apparel and clothing (84). These key commodity groups show above-average total trade gains in the range of 10% to 48%. Projected trade increases are largely due to high protection levels for individual commodities.

European exporters, on the other hand, will see above-average gains in Mexico in finished products (see Table 6). These include metal manufactures (69), machinery and transport equipment (7), and miscellaneous manufactured articles (8) with total trade increases up to 64%. Trade gains in these product categories arise from high Mexican tariff rates, high ratios of imports to domestic production and keen competition from other exporters to Mexico for individual commodities.

Looking at trade effects in absolute terms, a similar picture emerges. With only 35 out of a total of 313 categories, we can explain almost 50% of total trade effects in the EU in absolute terms, which strengthens the impression that these are the categories that will be affected most. In Mexico, however, trade effects in absolute terms are more scattered: the above-mentioned 35 categories make up only 24% of total trade effects.

Trade creation and diversion are roughly equal in the EU (some $105 million), while in Mexico the trade created ($1.7 billion) clearly dominates the trade diverted ($830 million), as can be seen from Tables 5 and 6. From an economic perspective, trade creation is welfare improving, as consumers substitute lower cost beneficiary imports for domestically produced goods. Trade diversion, however, will reduce welfare as a more efficient source of imports will be displaced by a higher cost producer.

But which are the countries that will “loose” markets shares? While trade diversion in the EU is relatively small and widely dispersed, in the case of Mexico it is concentrated on the United States, Japan, and Canada, since these are the leading exporters to Mexico in the particularly affected categories. US exports to Mexico will decrease by $685 million or 0.8%, whereas Japanese and Canadian exporters see their exports decline by $28 million (1.1%) and $12 million (0.9%), respectively. In the case of the United

States and Canada, the projected reductions in exports have to be seen as an erosion of NAFTA members' preferences and will offset some of their trade gains since NAFTA came into force in 1994.

6. CONCLUDING REMARKS

Regionalism or preferentialism is a major element of European as well as Mexican trade policy. Moreover, it goes beyond economics into the area of politics such as foreign policy in the case of the EU and domestic policy in the Mexican case. EU and Mexican preferential trade policies have apparently caused no serious harm to third countries thus far and are rather unlikely to do so in future. The bilateral EU-Mexico FTA seems to be no exception to this. It strengthens economic links across the Atlantic and adds an inter-regional dimension to regional integration processes on both sides, which may by and large make them more compatible with multilateral trade liberalisation.

Since the EU-Mexico FTA discriminates in favour of the member countries, beneficiary imports will not only displace domestic production but also imports from non-member countries. The estimation of the trade effects has been carried out within a partial equilibrium framework and the results can be summarised as follows: First, considerable trade effects can be expected in a narrow range of products - agricultural and semi-finished products in the case of Mexico and finished products like machinery and transport equipment for the EU; second, the EU is likely to gain much more than Mexico; third, trade creation clearly dominates trade diversion; and, fourth, the United States in particular will see its trade diverted in Mexico in absolute terms.

As a result of using a static partial equilibrium model to estimate trade effects, we have neglected potential positive dynamic effects in our analysis. Positive income effects, due to explored economies of scale in an expanded market, for instance, will accelerate growth rates in member countries. Besides the fact that this will increase EU and Mexican gains from the FTA, accelerating growth rates will also lead to a rise in overall import demand. This could offset some or all of trade diverting effects on non-member countries.

In addition, investment diversion might occur, as stimulation of inward foreign direct investment follows from the removal of investment barriers and from trade liberalisation alike. This occurs because the latter allows the import of intermediate

products without paying duties. Growing export-oriented foreign direct investment by European companies in Mexico could in turn switch exports to the US from European locations to Mexican plants of EU subsidiaries. Such unexpected trade diversion at the final-product stage would, however, at least to some extent and constrained by the rules of origin applying in NAFTA, be offset by trade creation at the intermediate-product stage.

In many cases, exports of European affiliates within Mexico would also come in addition to, rather than at the expense of, respective sales of their parent or sister companies in Europe. Particularly in industries such as automobiles and machinery, Mexico could become increasingly important for European firms wishing to break into the US market. Conversely, US firms could use the EU-Mexico FTA to relocate European-bound exports from domestic to Mexican sources or increase exports to Europe via subsidiaries producing in Mexico. To sum up, whereas the EU will profit from trade creation for the most part, Mexico, as a point of entry to the World's two biggest trading blocs, will improve its position as a location for foreign direct investment.

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