THE FIRST, THE FASTEST, THE BEST?

- A Study of Welfare Effects of the EU-Mexico Free Trade Agreement

by

Katarina Goude
Det första, det snabbaste, det bästa? - En studie av välfärdseffekter av frihandelsavtalet mellan EU och Mexiko

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Trade in agricultural products between Mexico and the EU only counts for a small percentage of total trade between them. With the entry into force of the EU-Mexico FTA in 2000, the tariffs on a number of agriculture commodities between the two parties was eliminated or reduced. This will lead to an opening in the trade of agricultural products between the two markets, something that could affect the welfare of the Mexican people positively, if new trade is created. The elimination and reduction of tariffs on agricultural goods could also lead to positive consumption effects as prices on these goods could be lowered. Lower prices on agricultural goods could help a large number of people, especially the poor people of Mexico.

In this thesis, using theories on preferential trade, I aim to examine the effects on the Mexican people due to the elimination of tariffs on agricultural goods between Mexico and the EU consequential to the EU-Mexico Free Trade Agreement. The investigation was carried out for the first two years after integration between the two parties, focusing on agricultural goods in particular. I also aim to determine if there is any group in the Mexican society that has benefited more in terms of welfare as a consequence of the new FTA.

Nyckelord
Keyword
FTA, preferential trade, welfare effects, Mexico, EU, agricultural trade
Språk
Language
Svenska/Swedish
X Engelska/English

Rapporttyp
Report category
Licentiatavhandling
Examensarbete
C-uppsats
X D-uppsats
Ovrig rapport

ISBN

ISRN
Nationalekonomi 2004/2

Serie/titel och serienummer
Title of series, numbering

ISSN

URL för elektronisk version

Datum
Date
2000-01-21

Avdelning, Institution
Division, Department
Ekonomiska institutionen
581 83 LINKÖPING

Titel
Det första, det snabbaste, det bästa? - En studie av välfärds-effekter av frihandelsavtalet mellan EU och Mexiko
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Författare
Katarina Goude

Sammanfattning
Abstract
Jordbrukshandeln mellan Mexiko och EU står för enbart en liten del av den totala handeln dem emellan. I och med undertecknandet av frihandelsavtalet mellan Mexico och EU är 2000, eliminerades eller minskades tallarna på ett antal jordbruksprodukter både i Mexiko och EU. Detta innebar att handeln inom denna sektor öppnades mellan de två marknaderna. Denna öppning i handel skulle kunna leda till handelsutbyten, vilket i sin tur kan leda till ökad välfärd för de mexikanska medborgarna. Borttagning och minskning av tallar på dessa produkter skulle också kunna leda till lägre priser på jordbruksprodukter, vilket också skulle påverka de mexikanska konsumenterna positivt. Lägre priser på jordbruksprodukter skulle i sin tur kunna gynna de fattiga i Mexiko eftersom de flesta jordbruksprodukter är s.k. basvaror.

Syftet med denna uppsats är att, genom att använda teorier om preferential trade och frihandelsområden, undersöka de välfärds-effekter som kan ha uppstått i Mexico som en konsekvens av frihandelsavtalet och borttagandet av tallar på jordbruksprodukter mellan Mexico och EU. Jag har undersökt handel med jordbruksprodukter de två först åren efter undertecknandet av frihandelsavtalet. I en förlängning försöker jag också utröna om det finns någon grupp (e.v. grupper) i det mexikanska samhället som har gynnsats mer än någon annan av frihandelsavtalet och minskningen av tallar på jordbruksprodukter.

Nykterförd
Keyword
FTA, frihandelsavtal, välfärds-effekter, Mexiko, EU, jordbrukshandel
Acknowledgments

Making this investigation and writing the thesis has been interesting as well as intellectually and emotionally challenging. The work was started in a noisy, vibrating Mexico City in February 2003 and ended in calm and snowy Linköping in January 2004. During this year I have had the advantage to receive help and support from various directions.

I would like to thank all the staff of the Swedish Embassy in Mexico for all the support and for the fantastic six months that I spent with you. I will also like to thank the staff at the EU Delegation in Mexico City, who helped me find the adequate information and statistical data for my investigation.

Further, I send my love and thanks to my boyfriend Leobardo Morales Tiburcio for the support and for being my link to Mexico the last six months. Gracias! Last but not least, I thank my parents for supporting and believing in me.
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1. Introduction

This chapter introduces the subject of the thesis through a background description that ends in the problem discussion and an explanation of the purpose of the research, in sections 1.1 through 1.3. In section 1.4, I describe the methodology of the research, which also includes a section on criticism of method and sources. The last section, 1.5, outlines the disposition of the thesis chapter by chapter.

1.1 Background

The European Union-Mexico Free Trade Agreement

“In our relationship, I see marital elements (of course!) of affair, and I see strong, solid friendship.”

These were the words of Pascal Lamy (the EU Trade Commissioner) in his speech before the audience of the Institute of European Integration Studies at Instituto Tecnológico Autónomo de Mexico in 2002. The relationship he is referring to is the new economic and political partnership created through the Free Trade Agreement (FTA) between the European Union and Mexico, which officially entered into force on July 1, 2000.

The negotiation process started in November 1998, and was the conclusive extension of the Global Agreement (Economic Partnership, Political Coordination, and cooperation Agreement) signed in 1997. The negotiations focused on five main areas: market access, customs procedures and rules of origin, public procurement, investment, and institutional issues.

On 24 November 1999, the first free trade negotiations between the European Union and Mexico ended after nine rounds of talks. Pascal Lamy called it “the first, the fastest, and the best”. He explained that it is the first

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Ibid. Access 11/06/2003
transatlantic free trade agreement, the fastest because it only took a year to reach an agreement and the best because, he says, it is the most comprehensive agreement ever negotiated by the EU. Whether it is the best free trade agreement that exists may be argued, however it is fair to say that both parties expect the best outcome possible from it.

The EU-Mexico FTA was signed at the European Council in Lisbon in March 2000 and the tariff dismantling between the two parties, allowing for preferential market access, began on 1 July that same year. Even though the FTA excludes some vulnerable products, as much as 95% of trade between the European Union and Mexico will be liberalized within ten years. Other aspects of the FTA, including trade in services, investments, public procurement, and clauses on intellectual property and competition have also been liberalized and a dispute settlement clause has been set up.

The EU-Mexico FTA covers all trade related matters. As far as industrial products are concerned, the tariff dismantling was concluded in the beginning of 2003, meaning that all industrial exports from Mexico to the EU enter duty free, while the Unions industrial exports are met by a 5% tariff when entering Mexico. For agricultural and fishery products the road of dismantling is a little bit trickier. Around 60% of agricultural trade between the two parties was liberalized before 2003, including products like beer, certain vegetables, and tobacco for EU exports and coffee, avocado and fruit juices for Mexican exports. However, agricultural goods more sensitive to foreign competition will be liberalized within a ten-year period, until 2010.

**Preferential Trade Agreements and Welfare Effects**

According to theories on preferential trade and regional trade agreements, the preferential tariff reduction of an FTA could lead to trade creation, trade diversion and changes in consumption within the Free Trade Area as well as in countries outside the agreement. If the formation of a Free Trade Area is beneficial and leads to an increase in welfare for a member nation, depends

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6 Ibid. Access 11/06/2003
on the strength of the effects of trade creation, trade diversion, and consumption in that particular country. Husted & Melvin (1995) maintain that trade creation leads to positive welfare effects on a partner country if it exceeds the possible trade diversion that might occur. The FTA could also lead to positive consumption effects that could improve welfare because of lowered prices on the traded goods.\(^8\)

The significance and impact of an FTA on a partner country could depend on in which sectors of the economy welfare effects, in form of trade creation, trade diversion, and consumption changes, occur. It seems logic to believe that positive welfare effects, in sectors that are more important for the survival of large number of people, could be more significant for the country as a whole, than if it occurs in a sector with less social importance. Such a sector could for example be the agricultural sector, both when it comes to production and consumption in many countries. This could probably be even more important for a number of developing countries or countries with a high level of poverty and where the agricultural sector employs many poor people.

### 1.2 Problem Discussion

The production of agricultural goods in Mexico counts for s small part of total GDP, around 5% in 2001. Between 1998 and 2001 approximately 20% of the total economically active population in Mexico was engaged in agricultural activities and this large share of people dependent on this sector is a vulnerable group in economic terms.\(^9\) In order to support this vulnerable group, tariffs and other trade protection measures on agricultural products in Mexico have historically been relatively high.\(^10\) Trade in agricultural products between Mexico and the EU only counts for a small percentage of total trade between them. With the entry into force of the new EU-Mexico

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FTA, the tariffs on agriculture commodities between the two parties will be eliminated or reduced.\(^{11}\) This will lead to an opening in the trade of agricultural products between the two markets, something that could affect the welfare of the Mexican people positively, if new trade is created. The elimination and reduction of tariffs on agricultural goods could also lead to positive consumption effects as prices on these goods could be lowered. Lower prices on agricultural goods could help a large number of people, especially the poor people of Mexico.

I am interested in how the EU-Mexico FTA has affected the trade in agricultural goods and the welfare in Mexico so far. I wonder if it is possible to find winners and/or losers among different groups in Mexican society because of the liberalization of agricultural goods between the two parties. In order to find this out I base my investigation on three main questions:

- How may the EU-Mexico FTA be described, examining both the negotiation process and the final settlement?
- Which are the welfare effects in Mexico due to the elimination of tariffs on agricultural goods which follow the EU-Mexico FTA?
- Who are the “winners” and/or “losers” in Mexico in terms of welfare, due to the new FTA and its elimination of tariffs on agricultural trade?

### 1.3 Purpose

My purpose is to describe and analyze certain aspects of the EU-Mexico FTA as well as its section on agricultural goods. Further, I intend to analyze the effects on welfare in Mexico due to the elimination of tariffs on agricultural trade. I also aim to determine if there is any group in society that has benefited more in terms of welfare as a consequence of the new FTA.

1.4 Delimitations

In order to make this thesis comprehensible, I have chosen to delimit it by focusing on the welfare effects of the elimination of tariffs on agricultural goods. Thereby, I look at production and trade of these products. In the definition of agricultural products I include primary crops, processed crops, live animals, primary livestock and processed livestock in accordance with the Food and Agriculture Organization of the United Nations (FAO).

In order to limit the analysis further and make it even more comprehensible, I have decided to focus on two agricultural products, maize and green coffee, i.e. unprocessed coffee beans. Although Mexican trade in maize with the EU is still very small, I chose this product because of its importance for the Mexican agricultural sector and the Mexican people, both for commercial and income reasons as well as for nutritional reasons. Coffee is one of Mexico’s biggest export products destined for the EU. I believe that examining these two products will give me some notion of the trade and production trends in agriculture trade between Mexico and the EU as well as the impact on Mexican society. The reason for choosing these specific products is also that the tariffs of maize and coffee were eliminated directly when the FTA between Mexico and the EU entered into force and this makes it possible to observe the effects already in the year 2000.

In order to see the trends in agricultural trade between Mexico and the EU, I have decided to focus on the two years before integration (1998-1999) and two years after (2000-2001). I chose two years before integration, in order to be able to observe and possible changes that occurred after the year of integration (2000) and compare them to the following year and a half.

When carrying out the analysis of the welfare effects in Mexico of the new FTA, I will focus only on the static analysis using static assumptions. I selected a static analysis before a dynamic analysis, as a dynamic analysis would demand a more extensive investigation than the scope of this thesis.
1.5 Method of Investigation

1.5.1 Classification of Method

For the planning and realization of an investigation, the investigator may classify it in accordance with, for example, the method of analysis of the data compiled, the arrangement of the investigation, the purpose or the data used.\textsuperscript{12}

I have chosen to classify my investigation in accordance with the purpose. Consequently, I classify the thesis as descriptive and explanatory.\textsuperscript{13} In order to reach the purpose, I primarily make a descriptive investigation of the negotiation process and the composition of the agreement both in general as well as for the agricultural sector. Thereafter, I account for statistics on production and trade for agricultural goods in general and maize and coffee (green) in particular. The descriptive part of the investigation is followed by the analytical and explanatory part, which is carried out by applying theories of preferential trade and FTAs on the statistics already presented. This analysis is made in the sector as a whole, also including two agricultural products, maize and coffee (green). From the result of the analysis, I draw conclusions leading me back to the purpose.

1.5.2 Practical Procedure

Because of my internship at the Swedish Embassy in Mexico, I decided that the purpose of this thesis should include the economic relations between Mexico and Europe. The recently signed FTA and its effects on welfare in Mexico was therefore a natural choice for my investigation.

Upon the decision of the purpose, I started collecting information and data during my stay in Mexico. This information and data included statistics on trade and production in Mexico and articles on the economic and political

\textsuperscript{12} Lundahl, Ulf - Skärvad, Per-Hugo (1982), Utredningsmetodik för Samhällsvetare och Ekonomer, p. 58

\textsuperscript{13} Ibid. pp. 60-61
relations between the EU and Mexico from Mexican printed sources and newspapers. Most of the statistics on trade was compiled from on-line databases such as the Food and Agriculture Organization of the United Nations (FAO), EUROSTAT, Bancomext, the Secretary of Economy of Mexico and the Secretary of Agriculture of Mexico.

Thereafter I started to collect literature for the theoretical frame of references of the thesis. The theories used to carry out the investigation were gathered from secondary literature both in Mexico and in Sweden. Some of the background literature for the theoretical frame of references was also found in articles and analyses published on the Internet.

1.5.3 Data Collection

The statistics on production is presented for agricultural products of Mexico in total and for maize and green coffee separately between 1998 and 2001. The data on production was gathered from the FAO Yearbook on production. The data on production of agricultural products is presented in the form of a index showing the trend between 1998 and 2001.

The data presented on trade in agriculture, include total Mexican trade in agricultural products and trade in maize and coffee (green), in total between the years 1998-2001, gathered from the FAO. It also includes trade in agricultural products and especially maize and coffee between Mexico and the EU during the same years, this data gathered from EUROSTAT. These data are presented both looking at the value of exports and imports as well as the quantity traded.

For the analysis, overall trends are more important than particular values. Because of this I have chosen not to change any values of the statistics on trade, even though they sometimes are presented in different currencies.

1.5.4 Criticism of Method and Sources

To make the thesis valid, I have chosen to use only already published theories and tested methods to evaluate the trade and welfare effects of the
EU-Mexico FTA. I believe that the method and the instruments for analysis of the data, used in this thesis, are adequate and valid for an analysis of the trade and welfare effects of the new FTA between the EU and Mexico. However, it is of significance to point out that the theories and methods used in my thesis are not the only alternatives for reaching the purpose. Keeping this in mind, I believe that the methods and theories chosen are valid in order to fit my beliefs and the scope of the thesis.

The material used for the theoretical frame of references has been gathered from literature and other printed sources, treating international trade, trade policy, and regional preferential trade agreements. These theories are applied as well as possible to the case of the EU-Mexico FTA. In my opinion, they are relevant to the study of integration of any sort. Since the theories are well established within the international economics area, I also consider them valid to the study.

The data, statistics and other written material presented in the chapter of empirical findings, can be said to be contemporary, relevant and valid since they are gathered from databases and statistical collections of well established organizations, such as the FAO, EUROSTAT, Bancomext, the Secretary of Economy of Mexico and the Secretary of Agriculture of Mexico. However, it is necessary to point out that although the sources are valid they may give different values on the same variables.

In order to make the thesis reliable, I try to present information and data in a comprehensible manner in order for the reader to form a clear opinion of the subject. I have also chosen to limit the data to these reliable and internationally approved sources. As I mentioned in delimitations, the years observed spans from 1998 to 2001. This means that the data and statistics used for the analysis reflect two years before and after integration between Mexico and the EU. Examining only two years before the entering into force of the FTA may seem too short of a time to be able to observe any relevant trends. However, I chose to limit the statistical material after the scope of the thesis as well as after the supply of reliable data. Further, the reason for

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limiting the data to two years after integration is that the most recent and reliable data spans up to 2001.

Using a large amount of Internet sources for investigation purposes could be criticized, since there exist a number of incorrect and non-reliable web-sites. The choice of using an extensive amount of internet sources for this investigation is that many organizations such as the European Community, the FAO etc. use their official web sites to display official documents. I have tried to keep to these official web sites in order to present data as reliable as possible.

In order to make the thesis available to more readers and more useful in my coming career, I decided to write it in another language than Swedish. In order to increase the reliability of the thesis, I chose to write it in English, since my skills in the English written language are good enough to make it clear and comprehensible.

1.6 Disposition of the Thesis

I will look upon this thesis as a circle, where I strive forward from the introductory chapter and the purpose to the conclusion in the last chapter where I tie the knot with the purpose. I start by introducing the problem and the purpose through a background discussion. The Introduction ends in a presentation of the delimitations and the method of the study.

In the second chapter, the Theoretical Frame of References, I present the theories that are used for the analysis of the FTA and its effects on welfare. These include theories on trade policy and preferential trade agreements.

The Empirical Findings (Chapter 3) consists of two separate parts. The fist part describes the EU-Mexico FTA, including the negotiation process and the actual settlement as well as it touches themes such as economic and political dimensions of the agreement. In the second part of this chapter, I include a brief description of the Mexican agricultural sector as a whole and also short descriptions of the maize and coffee sectors. Thereafter, I account for production and trade statistics in general as well as between Mexico and
the EU, for both the agricultural sector and for coffee and maize in particular.

In the Analysis, presented in chapter 4, I apply my empirical findings to theories presented in chapter 2. Here I analyze some aspects of the FTA as well as the possible welfare effects of the FTA of the elimination of tariffs on agricultural goods between Mexico and the EU. The chapter ends with an analysis of how the Mexicans are affected, including some thought on how to solve the problems encountered in the analysis.

In the fifth chapter, I summarize my analysis and conclude the trends to be able to answer the problem questions posted in the Introduction and fulfill the purpose of the thesis. I end the chapter by giving some of my own reflections of the area studied and speculate over further investigations that could be made in the same area.
2. Theoretical Frame of References

This chapter contains the theories, which I will use as a base for the analysis of the trade and welfare effects in Mexico of the EU-Mexico FTA. I will start out by explaining the basics of theories on trade policy, including the cases of free trade and protectionism. These theories on international trade and trade policy will be treated as background theories in order to understand the theories on regional preferential trade agreement and integration, such as a Free Trade Area, which will be used more thoroughly in the analysis of this thesis. The part of this chapter, discussing preferential trade agreements, includes theories on the effects on welfare of different groups in a society, focusing on the countries within the Free Trade Area in particular.

2.1 International Trade and Trade Policy

Foreign trade has been the concern of many economists, starting with the thoughts of Adam Smith in his *An Inquiry into the Nature and Causes of the Wealth of Nations* in 1776. Later David Ricardo developed a basic theory of the gains from trade, which during the past few hundred years, have been refined and changed by different economists in many different ways.

Is trade advantageous? Well, what we can see is that international trade flows of almost all commodities have increased over hundreds of years. The most spectacular increase has been seen since the end of the Second World War. In today’s world, governments all over the world have to face the new scenario of globalization and the questions that arise consequently. Which trade policies should they pursue to gain from trade without jeopardizing the development of their industries and the welfare of its people? They have various options of policies to choose from, but to get a better understanding of what these governments are faced with, one has to look at the two

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extremes of the different trade policies. In this case, free trade and protectionism.³

2.1.1 The Case of Free Trade

Free trade allows all countries to specialize in the production of the commodity in which they have comparative advantage. This leads to efficiency and elimination of distortions in both consumption and production, which are normally present when trade is protected against foreign competition. Free trade allows for maximization of production so that each consumer could consume more goods than in a world without trade. It could also contribute to that the domestic industry benefit from economies of scale due to the access to the world market, which lead to elimination of inefficient domestic firms and the introduction of technology and know-how. Free trade may also have political reasons. Free trade is a good policy in practice and it could discourage the interest groups that lobby for protectionism. In this sense, free trade contributes to gains for an economy that engages in this type of trade policy. One may conclude that it is possible for free trade to improve the living standards of everyone in the world, although this is not always the case.⁴

2.1.2 The Case of Protectionism

Protection could be justified by policy makers for many reasons. The most commonly used reasons are of economic nature, even though protection against trade also may be applied on other grounds, such as national security issues, protection of vulnerable groups in society, to defend certain interest group with political influence etc. Let us start by looking at the economic reasons.

**Economic Reasons for Protection**

As I mentioned earlier, trade restrictions can be used to protect industries on the domestic market that are too new and/or too weak to face the

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⁴ Ibid. pp. 723-724
international competition, a so called infant industry. This is the oldest valid argument to protect against trade and has been or is used by many countries in the process of economic development. There are many reasons for protecting an industry during its infant stage, for example, to take advantage of economies of scale, existence of high start up cost, managerial and technological development etc.\(^5\)

Trade restriction can also be used to alter terms of trade in favor of countries that exports a large amount of the world’s supply or constitutes a large part of the world’s demand. If you restrict the supply of this particular product, the price of this product will go up relative to the price of other products, which will turn the terms of trade in favor of the country that supplies that particular product.\(^6\)

Another justified reason to protect its industry is to countervail unfair trading practices, such as export subsidies or dumping. Dumping occurs when a company exports a product at a price lower than the price it normally charges on its own home market. Under these circumstances, the government of the affected country counters the practices by levying so called antidumping duties. The government could also protect their industries against market failure, which allows them to function although the market do not function or do not even exist.\(^7\)

**Non-economic Reasons for Protection**

There are not solely economic reasons behind protection. Although the comparative advantage theory dictates that specialization is most favorable, governments may decide, for social reasons, to protect a diverse economy in order to be less vulnerable to fluctuations in world trade and prices. It has also been said that in order to protect the country using an experienced army and navy, it is important to protect industries that provide equipment and knowledge for this purpose. Another significant non-economic reason behind a protectionist trade policy is to protect and favor certain groups in society.\(^8\) In most developed countries, societies have decided to protect

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\(^6\) Ibid. p. 725  
\(^7\) Ibid. p. 725  
\(^8\) Ibid. pp. 724-725
farmers and the agricultural sector for political and social reasons. In some societies, industrial and labor groups also put pressure on politicians to protect industries that probably would not benefit as much from free trade. Labor groups may argue that the government should protect an industry that employs a large number of unskilled workers and in that way improve the wages of these workers.9

Although these arguments, both economic and non-economic, seem to be reasonable in many circumstances, it is also important to criticize it. The arguments against protectionism of this sort and for these reason, are of course the arguments supporting free trade, which I mentioned above in section 2.1.1

**Fallacious Arguments**

It is however important to remember that the reasons for engaging protective measures have been much criticized. The reasons stated above are usually seen to be valid arguments for protection but there are other fallacious arguments used in some cases. One of these arguments is patriotism, that it is patriotic to imposed tariff barriers as it protects the domestically produced products. This argument is most usually used as a marketing stunt. Another fallacious argument of protectionism is that it creates and preserves jobs in the country. However, even if protection favors particular industries, it ignores the effects in other markets. Protection is more likely to redistribute jobs than create them. Yet, another erroneous reason for protection is that it supposedly preserves the home market as it prevents money flowing out of the country. This could be seen as a false argument, since goods must pay for goods and money that flows out comes back to pay for the country's exports.10

**Instruments to Restrict Trade**

A government can use different instruments to restrict its imports and protect the country’s domestic production of goods and services. Tariffs directly raise the price of an imported good. A tariff is a charge levied upon an imported product from a particular country, essentially to make the product more expensive in the market of the importing country, which will

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discourage consumers from buying that particular product. The domestic producers benefit from this treatment but on the expense of domestic consumers that have to purchase the product to a higher price. The extra amount they pay for the product goes to the domestic producers and the tariff on the product still imported goes to the government as a revenue.\textsuperscript{11}

\textbf{Figure 2.1 - Effects of a Tariff}

![Graph of a Tariff](image)

Model elaborated from Lipsey-Courant (1996).\textsuperscript{12}

Figure 2.1 depicts the effects of a tariff as an instrument of protection. As the tariff is levied, the price of the particular good rises from $P_W$ (world market prices) to $P_D$ (domestic market price), which is the full amount of the tariff. Consumption is reduced from $q_1$ to $q_2$, while domestic production increases from $q_0$ to $q_3$. As a consequence, the revenues of the domestic producer increases because of the higher domestic prices paid by the domestic consumers. The production revenue is therefore the same as the loss of the foreign producers, which formally supplied the good, and the

\textsuperscript{12} Ibid. p. 729
consumers of the country. The tariff will be revenue for the government paid by the consumers.\textsuperscript{13}

Another type of protection is the import quota. The import quota means that the importing country sets a maximum of how much of a product it wants to import each year, which obviously reduces the quantity imported directly. Another way of restricting quantity imported is to agree on a so-called voluntary export restriction or VER. This agreement means that the exporting country voluntarily restrict the amount of a product exported to another country.\textsuperscript{14}

In the following section, I dig deeper into the issue of trade policy, focusing on preferential trade agreements and their effect on welfare.

\section*{2.2 Preferential Trade Agreements and Economic Integration}

Since World War II, measures have been taken to reduce the use of tariffs and non-tariff barriers on trade between countries of the world. As a consequence, many multilateral and regional agreements have been agreed upon, in order to get closer to global free trade.\textsuperscript{15} Below, I give a short explanation to some regional preferential trade agreements and then focus on a description of a Free Trade Area, the type recently established between the EU and Mexico, and further look at its effects on trade and welfare.

\subsection*{2.2.1 Different Types of Regional Agreements}

Tariffs and other protectionist measures are still used in almost all countries of the world. In order to come to terms with this situation, a number of agreements have been, or are on the verge to be, signed in order to reduce

\begin{footnotesize}
\begin{enumerate}
\item Ibid. pp. 729-730
\item Husted, Steven - Melvin, Michael (1995), \textit{International Economics}. p. 252
\end{enumerate}
\end{footnotesize}
these tariffs and non-tariff barriers on a regional basis. There are three standard forms of regional economic integration. These are:

- Free Trade Area
- Customs Union (CU)
- Common Market

As will be seen, a Free Trade Area is the least comprehensive agreement of them all, meaning that it allows for free trade between normally a few countries while these countries still apply their own tariff policy towards other countries. A Customs Union (CU) is characterized by free trade between member nations and a common customs policy with the rest of the world. A Common Market is a CU with free movement of labor and capital.

From now on, I look further into the significance of a Free Trade Area and its effects on welfare, using theories on trade creation, trade diversion (production effects) and consumption effects and their determinants. The theories used are later applied for a so-called static analysis of welfare effects, excluding dynamic effects of economic growth such as technological progress and allocation of investments. It is also important to mention that the theories used in the following section are mainly theories on CUs and their effects on welfare within and outside the union. However, Balassa claims that the effects are very similar for a CU and an FTA. Therefore, I have chosen to use these theories when examining the EU-Mexico FTA. In order to look specifically at the Free Trade Area, I devote the last section of this chapter looking specifically at problems of this type of economic integration.

### 2.2.2 Free Trade Area and the Effects on Welfare

Free Trade Areas are increasingly applied as a way to reduce tariffs between countries where gains from free trade could be extensive. Today there exist many such agreements while new ones are close to being negotiated and

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17 Ibid. p. 737
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entered into force. The first important free trade agreement was established by a group of European countries that did not want to join the European Common Market (today known as the EU). This free trade area is called the European Free Trade Association (EFTA). Another fairly new free trade pact is the North American Free Trade Agreement (NAFTA), which was signed in 1993 between the USA, Canada and Mexico. In Chapter 3, the new FTA between the EU and Mexico will be described in more depth.\(^\text{18}\)

The effects on welfare, created through the forming a Free Trade Area, depend on the size of production effects and the consumption effects.\(^\text{19}\) In order to better understand the implications of an FTA, I now introduce and explain the terms trade creation, trade diversion (production effects) and their determinants and later the consumption effects and its determinants. Further I use these explanations to demonstrate their joint effect on welfare, using a fictitious example based on some simplifying static assumptions. In the discussion, I assume that no factor movements take place and I disregard the dynamic effects of integration.

**Production Effects - Trade Creation and Trade Diversion**

As a Free Trade Area combines free trade between member states while it is keeping tariff protection towards the rest of the world, it is hard to find good theories to explain the phenomena. Earlier it was said that integration, such as a Free Trade Area or a Customs Union, automatically led to increased welfare globally. However, in 1950 the Canadian economist, Jacob Viner, introduced the theory of trade creation and trade diversion in his book *The CU Issue*.\(^\text{20}\) This theory will briefly be described below. While looking at the production effects, I will disregard any change in consumption pattern. The consumption effects will be added at a later stage.

Simply enough, **trade creation** occurs when the producers of a member nation decide to export to a nation because of the preferential elimination of tariffs instead of to the country with which it traded before the elimination.

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\(^\text{19}\) Balassa, Bela (1965), *The Theory of Economic Integration*. p. 23

The preferential tariff elimination leads to specialization and, consequently, new international trade is created.\textsuperscript{21} Let us make an example:\textsuperscript{22}

Assume that there do not exist any marketing or transport costs that affect the production costs and that there exist only three geographical regions in the world: Country A, B and C. All production factors are fully employed and the demand for a certain product is inelastic in terms of prices, meaning that the same amount of the product is demanded despite price changes on the market. An explanation for trade creation could be done by an easy table looking at the production costs and the prices of, for example, cellular phones. (See Table 2.1).

\textbf{Table 2.1 Trade Creation and Trade Diversion}

<table>
<thead>
<tr>
<th></th>
<th>Country A</th>
<th>Country B</th>
<th>Country C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production cost (EURO)</td>
<td>100</td>
<td>70</td>
<td>60</td>
</tr>
<tr>
<td>Price (100% tariff before integration)</td>
<td>100</td>
<td>140</td>
<td>120</td>
</tr>
<tr>
<td>Price (100% tariff after integration)</td>
<td>100</td>
<td>70</td>
<td>120</td>
</tr>
<tr>
<td>Price (50% tariff before integration)</td>
<td>100</td>
<td>105</td>
<td>90</td>
</tr>
<tr>
<td>Price (50% tariff after integration)</td>
<td>100</td>
<td>70</td>
<td>90</td>
</tr>
</tbody>
</table>

\textit{Source: Own elaboration, inspired by Husted & Melvin (1995).}\textsuperscript{23}

The production cost of a cellular phone in Country A is 100 EURO. If Country A initially levies an import duty on cellular phones of 100\%, there do not exist any imports of cellular phone since it is much cheaper to buy it domestically (100 EURO). However, now Country A and Country B form a Free Trade Area and eliminate their tariffs on cellular phones between each other, as Country A keeps its tariff of 100\% on cellular phones made in Country C. This will result in trade creation within the Free Trade Area because Country A decides to buy their cellular phones from Country B since it is much cheaper; it costs 70 EURO instead of 100 EURO. This

\textsuperscript{22} Example inspired by Husted, Steven - Melvin, Michael (1995), \textit{International Economics}. pp.253-255
\textsuperscript{23} Husted, Steven - Melvin, Michael (1995), \textit{International Economics}. pp.253-255
means that inefficient domestic production is substituted for more efficiently produced imports, creating trade.\(^{24}\)

**Trade diversion**, on the other hand, occurs when exporters, as suppliers, from a country outside the Free Trade Area, are replaced by exporters of another member nation (i.e. within the Free Trade Area).\(^{25}\) In order to explain the trade diversion phenomenon, I have to modify the assumptions in Table 2.1 above. Assume that Country A levies a 50% duty on imported cellular phones before integration. In this case, Country A would buy their phones from Country C since it provides Country A with the cheapest on the market (90 EURO). When tariffs are lifted between Country A and Country B it turns out to be cheaper for Country A to buy phones from Country B, although the industry actually is less efficient in Country B than in Country C. If we look at this phenomenon globally, one may conclude that trade diversion is an inefficient use of resources. However, in a national perspective, trade diversion may lead to some benefits. As the integration between the member countries gives the producers of the Free Trade Area advantages over producers from other parts of the world, it leads to an increase in production within the area.\(^{26}\)

Up to this point, trade creation and trade diversion have been looked upon in the case of constant cost, where market price is equal to production cost of the lowest-cost producer. Under the assumption of increasing costs, market price is determined by international demand and supply of a commodity. The elasticity of supply is no longer infinite and a country where marginal cost equals the market price at a point where output exceeds demand in the home country will export the commodity. Consequently, the higher the domestic elasticity of supply, the larger the positive production effects due to larger reduction of domestic production.\(^{27}\)

**Determinants of production effects**
Under static assumptions, there are certain factors that determine the extent of the production effects of an FTA. In this investigation I deal with four

\(^{24}\) Balassa, Bela (1965), *The Theory of Economic Integration*. p. 27
\(^{26}\) Balassa, Bela (1965), *The Theory of Economic Integration*. p. 27
\(^{27}\) Ibid. p. 27
determinants to the welfare effects of an FTA: (1) complementarity and competitiveness, including the difference in production costs, (2) the size of the Free Trade Area, (3) the distance between member nations and (4) the height of tariffs before integration.\textsuperscript{28}

\textit{Complementarity and competitiveness}
Economies are complementary if they show differences in the production costs for most commodities. In terms of trade creation and trade diversion, this could mean that complementarity is beneficial if the member nations produce about the same commodities before integration and harmful if only one of the countries produced a certain commodity before integration, meaning that the established FTA would exclude a foreign low-cost producer. The complementarity argument has to be modified when increasing cost are introduced in the model. In this case, the cost curves of the countries involved will determine production and trade.\textsuperscript{29}

Competitiveness on the other hand is defined as the degree of overlapping of the commodities produced. According to Viner, competitiveness means that member countries produce the same kind of products before integration. If the Free Trade Area consists of competitive nations, the differences in production costs will increase the possible gains from trade. However, the more complementary the member nations are the larger the negative production effects will be.\textsuperscript{30}

\textit{Size of the Free Trade Area}
Among others, Viner and Meade argued that, \textit{ceteris paribus}, the larger the countries that establish an FTA, the greater the potential of improving internal division of labor, reducing the possibility of negative trade diversion. Other economists criticize this point of view and argue that when an economic area is extended, trade policies would probably be modified towards larger extent of protectionism. However, if one accepts this view that a greater economic area increases the benefits, volume of production

\textsuperscript{28} Balassa, Bela (1965), \textit{The Theory of Economic Integration}. p. 29
\textsuperscript{29} Ibid. p. 30
\textsuperscript{30} Ibid. pp. 31-35
would be an appropriate measurement for this. The most appropriate measurement will therefore be gross national product (GNP).\textsuperscript{31}

\textit{Distance between member nations}

It has been said that an FTA will have beneficial effects if the member nations are able to increase the economic flows that are disturbed by national boundaries. If one includes the non-economic factors to this, the advantages of being close to its partner countries are (1) the distance to be traversed is shorter (2) taste are more likely to be similar, and (3) countries close to each other may have a common history and interests and have an easier time to agree on different policies. Another advantage of closeness is lower transportation costs although this also could depend on efficiency of infrastructure, maritime fleets and customs procedures.\textsuperscript{32}

The distance between partners has been measured in different ways. Balassa mentions two particular ways, the geographical distance and the economic distance. The measurement of geographical distance is quite straightforward (e.g. distance in kilometers) but the economic distance can be measured in different ways. The most common is, according to Beckerman (in Balassa, 1965) the markup between the f.o.b. average value of exports of a specific good and the c.i.f. average value of imports of the same good. This would give a rough indication of the cost of the economic distance.\textsuperscript{33}

\textit{Height of tariffs}

The last factor that influences the effects on welfare is the level of tariffs that was levied between the member countries before the FTA. The higher the tariff mounted before the FTA, the larger the positive effects on welfare when the Free Trade Area has been formed. It is however important to remember that the higher the tariff on those goods that most likely will lead to trade diversion, the higher the trade diversion and the lower the positive effects on welfare. In a CU, the lower the tariff levels of the union towards the outside world, the larger the positive production effects. However, since the members of a Free Trade Area keep their individual tariffs towards third countries, the mentioned effect will not be present in this stage of

\textsuperscript{31} Balassa, Bela (1965), \textit{The Theory of Economic Integration}. pp. 35-39
\textsuperscript{32} Ibid. p. 39
\textsuperscript{33} Ibid. pp. 39-44
integration. This problem will be discussed in the last section of this chapter. The possible measurement of the height of tariffs is the unweighted average of ad valorem\textsuperscript{34} tariffs. This measurement will measure the effectiveness of the tariffs applied.\textsuperscript{35}

**Consumption effects**

According to Viner’s model, trade creation has positive effects on world welfare while trade diversion has a negative effect on welfare. However, to make the model a little bit more realistic, I have to introduce yet another concept to the model, the effect on consumption, i.e. when commodities no longer are assumed to be consumed at fixed proportions. In order to continue accordingly, I have to look at the price elasticity of demand.

Price elasticity of demand can be explained by the following equation, *ceteris paribus*:

\[
E_d = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in price}}
\]

The relative elasticity of a product is determined by different factors; such as the availability of substitutes of the product (more substitutes, more elastic demand), if the product is a luxury item (more luxurious, more elastic demand), if the purchase of the product consume a large portion of the consumer’s budget (large portion, more elastic demand) and time (in the long-run demand tends to be more elastic).\textsuperscript{36}

At this point I do not follow the assumption that demand is inelastic to price. If demand is elastic, the price reduction that occurs as a consequence of integration will lead to more consumption. If the creation of a Free Trade

\textsuperscript{34} Ad valorem means after value, i.e. the tariff is set as a proportion of the production value of the imported good (Dickson, H. – Luukkainen, P.A. – Sandelin, B. (1992), *Termer i Nationalekonomi – innebörd och sammanhang*. p. 13.)

\textsuperscript{35} Balassa, Bela (1965), *The Theory of Economic Integration*. pp. 44-49

\textsuperscript{36} Lipsey, Richard G. - Courant, Paul N. (1996), *Economics*. p. 91
Area has led to trade diversion, it is fair to say that the consumption effect could equilibrate the loss from trade diversion and consequently lead to an increase in welfare. One may say that the larger the amount of trade with member nations compared to trade with non-member nations, the larger the positive consumption effects within the Free Trade Area. As the FTA alters the relative prices because of a sloping demand curve, one should also expect this to lead to some sort of substitution of products, from expensive to cheaper products. This would probably increase the imports from the FTA member and decrease the imports from the outside world and the consumption of domestically produced goods. This phenomenon is usually called the substitution effect in consumption. Information of existing trade relations between the member countries would provide an indication of the consumption effects of the FTA.37

**Determinants of consumption effects**

The determinants of the production effects on welfare of a Free Trade Area are also relevant when examining the consumption effects. For example, the higher the initial tariff rates before integration, the greater the creation of trade and consumer satisfaction because of lowered market prices. Also in terms of complementarity and competitiveness, it can be said that the more competitive production structure of the member nations, the greater the trade creation and the positive consumption effects. However, if the member countries are complementary in production structure this leads to less reduction of imports from countries outside of the Free Trade Area and consequently to negative consumption effects within the Free Trade Area. The distance between the partners, as far as culture and taste are concerned, could also determine the effect on consumption. The more similar the culture and taste the more likely the increase in competition that will benefit the consumers.38

In conclusion, all, things being equal, an FTA is likely to have greater positive effects on welfare if the members have a competitive production structure, differences in production costs of commodities produced before integration, the larger the size of the Free Trade Area is, the shorter the

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37 Balassa, Bela (1965), *The Theory of Economic Integration*. pp. 57-58
38 Ibid. pp. 60-61
distance between member nations and the higher the tariff level before integration.

**Interaction between Production and Consumption Effects**

Although I have separated the production effects and consumption effects in my explanation above, it should not be interpreted as if there does not exist any interaction between the two. I now present a model of preferential trade liberalization that shows the effects on welfare as a consequence of trade creation, trade diversion, and altered consumption patterns. Let me continue with the example of trade in cellular phones between three geographical areas; Country A, Country B and Country C.39

![Figure 2.2 – Joint Effects of an FTA](image)

Model elaborated from Husted & Melvin (1995).40

In Figure 2.2 above, I illustrate the effects of the phenomena trade creation, trade diversion and the consumption effects. In this model I have made some adjustments of the numbers presented in Table 2.1, introducing elastic

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demand in the model. I have also chosen to only display the effects in the import country, in order not to confuse the reader.

In autarky, a cellular phone would cost 100 EURO in Country A. Although there does not exist any trade with Country A, Country B is willing to export its phones for 40 EURO and Country C, the low-cost producer, wants to export its phones at a price of 30 EURO. Lines $S_B$ and $S_C$ denote the export supply curves of cellular phones when Country A opens up to free trade. Assume now, that Country A levies a tariff on cellular phones of 100% in order to double the price of imported cellular phones. Under these circumstances, Country B phones now cost 80 EURO and Country C phones are sold at a price of 60 EURO (the curves $S_B + \text{tariff}$ and $S_C + \text{tariff}$). At this point Country A would import cellular phones from Country C, since it is much cheaper buying them there than anywhere else. However, suppose that Country A negotiate an FTA with Country B, which means that the cellular phones coming from Country B will be free from tariffs. At the same time, tariffs on cellular phones coming from Country C stay the same as before ($S_C + \text{tariff}$). At this point, it is more profitable to import the phones from Country B, at the price of 40 EURO, and consumers pay a lower price for imports, leading to an expansion in trade from AB to CD. This is an example of trade creation and a positive consumption effect. However, at the same time it is evidence of trade diversion. There is a shift in trade source from Country C, the country that produces phones to less cost, to Country B. The trade diversion could be seen, as Country A no longer imports cellular phones from the country that has comparative advantage in producing exactly this product.

If the formation of a Free Trade Area is beneficial and leads to an increase in welfare for a member nation, depends on the strength of the effects of trade creation, trade diversion and the consumption effect. If we look at Figure 2.2, the first impact of the formation of a Free Trade Area between Country A and Country B is that consumers benefit as prices go down from 60 EURO to 40 EURO. This leads to a rise in consumer surplus with the areas $\mathcal{E} (a + b + c + d)$, producer surplus fall by area $\mathcal{E} (a)$ as the domestic producer lose market shares, and tariff revenue falls by areas $\mathcal{E} (c + e)$. The impact of welfare in Country A, from these effects, nets out to be $\mathcal{E} (b + d) - \mathcal{E} e$. The loss in producer surplus (area a) and part of the loss in tariff revenue (area c)
accrue to consumers in Country A as they pay less for the cellular phones. However, the other part of the lost tariff revenue is the cost of the trade diversion, as consumers have to pay more for the phones from Country B within the Free Trade Area than they would do if they bought them from Country C without tariffs.\textsuperscript{41}

Although there is some loss connected to the formation of the Free Trade Area, the overall effect is positive in a member nation if trade expands more than it diverts. However, this could not be guaranteed just by looking at the diagram in Figure 2.2. As for the other countries, Country B benefits on the export side because it now has access to the market in Country A, which before integration was almost impossible. However, if Country A is a high-cost producer, Country B could lose on lowering its tariff on Country A goods. At the same time, Country C loses since their producers sell less to the Country A market. Because of the ambiguity of gains and losses in Country A and Country B and the obvious loss of Country C, it is hard to predict the real worldwide effects of an FTA, and these analyses are often based on speculative predictions.\textsuperscript{42}

**Problems of Free Trade Areas**

In a Free Trade Area, each member has the right to set its own tariffs and other protective measures towards third countries. This situation is accompanied by various problems such as deflection of trade, investment, and production.\textsuperscript{43}

A Free Trade Area could be used by countries outside the FTA in a way that they could export to countries of the FTA via the member nation with the lowest tariff. This would even out the tariff level within the union to the lowest tariff level, creating deflection of trade. This situation goes against the principle that an FTA member has the right to set his own tariffs, even though it could diminish trade-diverting effects for countries outside of the Free Trade Area. An FTA could also cause the production structure to be less economic. Industries, which produce commodities with material mainly made in foreign countries, would move to the country with the lowest tariff.

\textsuperscript{42} Ibid. p. 254-255
\textsuperscript{43} Balassa, Bela (1965), *The Theory of Economic Integration*. p. 70
level. The reallocation of resources could disturb the pattern of production, as it follows the level of tariffs instead of comparative advantage of the member countries. The last problem of an FTA is the deflection of investment. Even in this case, investment fund would be moved to the member with the lowest level of tariffs.\textsuperscript{44}

In order to come to terms with these problems, countries may use various methods. The most common method is the percentage rule for the determination of origin, i.e. determining rules of origin. The calculation of rules of origin is based on the value added of every product, and products with a determined percentage of value added inside the Free Trade Area, will be traded without duty. The member nations should decide on rules of origin that maximizes the gains within the Free Trade Area. Some problems arise in the application of rules of origin. The difference in accounting procedures may cause different calculations of rules of origin, a product or material could consist of different percentages of value added changes in world market prices of raw material could alter the value added, it could give producers the incentive to raise prices, and the procedure of calculation demand expensive administration.\textsuperscript{45}

Considering the problem of an FTA, a CU could be seen as superior from an economic perspective. However, from a trade policy perspective, the members of an FTA with liberal tariff policies will be encourage to lower their individual tariff levels against the outside world in order to avoid trade deflection. This could have positive effects on world welfare as a whole.\textsuperscript{46}

\textsuperscript{44} Balassa, Bela (1965), \textit{The Theory of Economic Integration}. pp. 70-75
\textsuperscript{45} Ibid. pp. 70-75
\textsuperscript{46} Ibid. p. 78
3. Empirical Findings

In this chapter, I primarily describe the EU-Mexico Free Trade Agreement, focusing on trade in agricultural goods, starting with the negotiation process and continuing with the content of the actual agreement, including a brief description of the elimination schedule on tariffs on goods in general and agricultural goods in particular. The first part will also include a brief description of the political and social dimension of the agreement. The second part of the chapter starts with a description of the Mexican agricultural sector, followed by a presentation of the statistical data that will be used in the analysis of the welfare effects of tariff elimination of agricultural goods. The section on agricultural production and trade also include information and statistical data on maize and coffee.

3.1 The EU-Mexico Free Trade Agreement

The Free Trade Agreement (FTA) between Europe and Mexico officially entered into force on 1 July 2000 and meant the start of a new phase in the relations between the EU and Mexico. The FTA covers all trade-related matters, which were included in the Economic Partnership, Political Coordination, and Cooperation Agreement signed by the EU and Mexico in 1997. The new FTA was signed at the European Council in March and the tariff dismantling began on 1 July in 2000, giving European and Mexican exporters preferential access to their respective markets.¹

3.1.1 The Negotiation Process

The EU-Mexico FTA was concluded in twelve and a half months, a fairly quick negotiation process compared to, for example, the North American Free Trade Agreement (NAFTA) which took over 18 months to conclude.²

In his speech before the Institute of European Integration Studies in Mexico 2002, the EU Trade commissioner, Pascal Lamy, proclaimed the EU-Mexico

The EU-Mexico FTA negotiation process consisted of nine rounds of talks, which were held between 9 November 1998 and 24 November 1999, changing venue between Brussels and Mexico City. The talks were focused on five main areas: market access, customs procedures and rules of origin, public procurement, investment, and institutional issues such as dispute settlement, competition and countervailing measures.\(^5\)

During the first three rounds, the two parties exchanged draft proposals on the agreement and in the Third Round, they exchanged lists of proposals of tariff dismantling and rules of origin. It was not until the Fourth Round that the negotiators faced some problems. The hang up concerned the so-called “NAFTA parity for duty-free trade in industrial goods”, which meant that the EU wanted to liberate its industrial trade to Mexico the same year as that NAFTA would come to complete liberalization (2003). Therefore, the EU proposed to liberalize 93% of its total trade in goods in two stages: 82% at once and the rest in 2003. Mexico responded by proposing a more moderate change with a longer timetable, starting out by immediately liberalizing 42.5%, adding 6% of the goods to be liberalized in 2003, and the rest to be liberalized during six years to follow. Mexico feared that the liberalization of industrial goods with the USA, Canada, and the EU at the same time would harm their small-and medium-sized enterprises (SMEs) and bring about extensive social costs.\(^6\)

\(^{6}\) Ibid.
Because of Mexico’s refusal to accept the EU’s proposal, the EU negotiators threatened to stop the negotiations. This led to yet another proposal from the Mexican negotiators in May 1999, just before the start of the Fifth Round of negotiations. This fresh proposal offered a 60% elimination of tariffs on EU industrial goods immediately and the rest to be liberalized in stages until 2007. The new proposal put new life to the negotiations. From here on the negotiations entered into its most difficult phase. The most controversial talks were focused on very sensitive issues such as rules of origin, market access and payments. The issue of rules of origin, meaning the criteria used to define where a product is made, had to be dealt with care and an agreement was not met until the last rounds of negotiations. The reason for this is that the determination of rules of origin is an essential part of trade rules and helps to avoid a number of policies that discriminate between exporting countries such as quotas, preferential tariffs, anti-dumping actions, countervailing measures, and more.7

The negotiations ended on 24 November 1999 after a number of extraordinary meetings and on that afternoon that same day, the two parties announced a conclusion of the talks and declared the new FTA to be an unprecedented pact between them.8

3.1.2 The Agreement on Trade in Goods

The FTA between the EU and Mexico is unique for various reasons. It is the first FTA that the EU has negotiated with a Latin American country and the FTA builds a free trade bridge between the EU and a NAFTA member nation. It is also a very thorough and ambitious agreement, and conditional on factors such as human rights.9

The agreement on trade in goods, and consequently issues linked with trade in goods, was settled through the Decision No 2/2000 of the EC-Mexico

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8 Ibid.
9 Ibid.
Joint Council of 23 March 2000. The general objectives of this decision, Article 1, Title 1 General Provisions (see Annex 1), are stated as follows:

(a) the progressive and reciprocal liberalization of trade in goods, in conformity with Article XXIV of GATT 1994;
(b) opening the agreed government procurement markets of the Parties;
(c) establishing a cooperation mechanism in the field of competition;
(d) setting up a consultation mechanism in respect to intellectual property matters; and
(e) establishing a dispute settlement mechanism.

According to Title II, Free Movement of Goods, the objective of the EU and Mexico is to “(...) establish a Free Trade Area over a transitional period lasting a maximum of 10 years starting from the entry into force of this Decision” (Article 2, No 2/2000 of the EC-Mexico Joint Council of 23 March 2000). This means that customs duties on imports have to be eliminated on goods originating from the territory of the two parties, after the qualification of rules of origin. The agreement also means that all customs duties on exported goods from one party to another also shall be eliminated. Further, the agreement states that it is not allowed for the parties to introduce new customs duties on imports or exports. In the agreement, a customs duty is defined as “(...) any duty or charge of any kind imposed in connection with the importation or exportation of a good, including any form of surtax or surcharge in connection with such importation or exportation” (Article 3, Point 8).

Looking at the trade in goods, the new FTA will liberalize over 96% of EU-Mexico trade by 2007. From the year of the entering into force of the FTA, 82% of Mexico’s industrial export entered duty free into the EU market and around 50% of European exports, which entered into Mexico, were not levied with duties. The industrial goods that were immediately liberalized in 2000 include, were among others products, engines, telephones (cellular and public), TV and radio parts and medical equipment. In the beginning of 2003, when all industrialized goods were totally liberalized within NAFTA, all Mexican industrial goods entered freely without duties into the EU. The

EU exports destined for Mexico, not yet liberalized, were only levied with a maximum tariff of 5%. The remaining around 50% of EU exports of industrial goods will be liberalized in 2005 or later in 2007, depending on each particular sector and industry. When rules of origin of industrial goods are concerned, the agreement secure that EU regulations on this matter will be used for most industrial goods with the exception of some sectors such as automobiles and clothing.

As for trade in agricultural goods between the two parties, 62% will be liberalized directly, but some sensitive products will gradually be liberalized over the ten-year period, exactly as the Decision 2/2000 stated (see Appendix 1, Article 2, No 2/2000 of the EC-Mexico Joint Council of 23 March 2000). The tariff elimination schedule on agricultural goods is rather complex in its composition, stating every stage of reduction and elimination of tariffs taking place during the ten-year period. Preferential access will immediately be granted for EU exports on particular products such as beer, fruits, vegetables, tobacco and liquors and spirits (Category 1 of the elimination schedule of the Mexico). Tariffs on wine were at first reduced five percentage points, from 20% to 15%, but were totally liberalized in the beginning of year 2003. Other products such as some types of meat and lacteous products are to be reduced during a longer time span.

Mexican agriculture benefited immediate preferential access to the EU of products such as coffee, fruit, and fruit juices, avocado, cut flowers etc (Category 1 of the Elimination schedule of the European Community). Their more sensitive products, including different types of cereal will not be liberalized until the year 2010. In the agreement, it is also stated that 99% of trade (by volume) in fish goods was liberalized. For agricultural and fishery goods the rules of origin according to EU regulations are applied.

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13 Ibid.  
Making a short summary of the elimination and reduction on tariffs within the agreement, I may conclude that:

- 100% of trade in industrial goods will be liberalized (by 01-01-2003 on the EU side and 01-01-2007 on the Mexican side)
- 80% of EU imports of agricultural goods will be liberalized by 2010, for Mexican imports of agricultural goods, only 42% by the same year.
- By 2010 100% of EU imports and 89% of Mexico’s imports of fishery products will be liberalized.

3.1.3 Economic and Commercial Dimension of the FTA in Goods – a prognosis

According to a number of analysts of the EU-Mexico FTA, the new FTA will bring some positive effects to both parties, as it will most probably increase trade between EU and Mexico significantly. According to Instituto de Relaciones Europeo-Latinoamericana (IRELA), only the first year after the FTA entered into force, EU exports increased by about 30% and imports by about 50%. IRELA predicts that the FTA could double EU-Mexican trade within five years, which seems to be a quiet realistic figure since most of the bilateral trade was liberalized in 2003.

According to the same analysts, it is also possible that it is the Mexican imports from the EU that will increase the most in short term, both for industrial and agricultural goods. However, they predict that Mexican export will react more slowly than EU exports, because of Mexican enterprises being less internationalized than European ones, making it harder for them to battle the international competition. Consequently, there is a risk that Mexico’s trade deficit with the EU will increase the first years of the FTA.

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but in the medium term the trade balance will be improved and in the long term, the deficit will probably disappear. Analysts have predicted a significant growth in trade, since the average tariff on imports applied by the EU and Mexico before the FTA was relatively high, mounting to around 12%. Also the FTA will make it possible for Mexico to increase its trade with some EU countries with which Mexico has had almost no trade relations earlier. The increase in trade will hopefully also result in an improvement of welfare, most especially in underdeveloped areas in Mexico.\textsuperscript{19}

However, IRELA believes that it is probable that there will not be any significant change in diversification of Mexico’s trade because of the new FTA. Although trade with the EU increase it will not change the country’s dependency on trade with the USA. Around 75-80% of Mexico's trade will still be destined to its closest neighbor in the north. For agricultural products, trade with the EU will also have less importance than the existing trade in agricultural goods with the USA.\textsuperscript{20}

3.1.4 Political and Social Dimension

The EU-Mexico FTA is not only an agreement that deals with purely economic issues but has also a very important political dimension. Since it is the first FTA between the EU and a Latin-American country, it gives Europe access to a continent that is and has been very affected by U.S. domination. It is likely that political and institutional links will multiply between the two parties and their politicians and other functionaries have highlighted the importance to increase talks and discussions in issues of common interest such as democracy, human rights, drug policies etc.

By the entry into force of the FTA, the governments of the two parties also decided to create and maintain an open dialogue with European and Mexican civil society for the exchange of information and views on the agreement.


\textsuperscript{20} Ibid.
They have decided to open a forum where representatives from trade unions, political parties, private sector, non-governmental organizations (NGOs) etc. get together to discuss advantages and disadvantages of the new FTA. The First Forum "EU-Mexico Civil Society Dialogue" was held on 26 November 2002 in Brussels, in order to exchange points of view on the implementation of the Global Agreement, and to strengthen the participation of the civil society from both parties in the political, economic and cooperation relations between Mexico and the European Union. The forum was attended by about 200 representatives of Mexican and European organizations such as NGOs, academic communities, business communities, regional offices, EU institutions, trade unions, media and other civil society organizations. The forum was organized through working groups for each major theme (political, economic & commercial and cooperation), which together came up with a number of proposals in order to improve the current FTA. The political working group focused on human rights and democratic issues and the proposals were mainly aiming at changes to be made in Mexico in terms of democratization. Within the economic and commercial area, the working group proposed several committees to be created in order to smooth the differences between Mexico and the EU. Mexico has also been anxious to extend the talks on agricultural trade both with their new partners of the EU and with other countries within the World Trade Organization (WTO). The new political closeness to the EU due to the FTA might help Mexico to reach out to their colleagues in the EU in order to get an understanding of the difficulties in the agricultural sector in Mexico and other developing countries in Latin America.

22 Ibid. Access 11/06/2003
3.2 **Mexican Agriculture - Production and Trade**

### 3.2.1 The Mexican Agricultural Sector

**General Data**

The topography and the climatic conditions of Mexico limit the cultivable land to around 22 million hectares, which represent approximately 11% of the whole country. The Mexican climate is very diverse, ranging from dry desert like conditions to very humid climate in the rainforests. As a consequence of the diversity in climatic conditions, the Mexican territory is very apt for different kind of agricultural activities. The Mexican agricultural sector is characterized by the irregularities in production methods. There exist big companies and ranches with many resources, modern technology, and high productivity while the majority of the farmers have low yields, rudimentary technology, and reduced land to cultivate.²⁴

The productivity in the sector is generally low and its contribution to GDP is scarce. The share in GDP was around 5.5% in the year 2000, a decrease from the first half of the 1990’s when its share in GDP was approximately one percentage point higher at average. The decrease in share of GDP of the agricultural sector, and the primary sector as a whole, is probably due to increasing industrialization in the country and hence decreasing investments in the agricultural sector.²⁵

With the new economic policy of development through exportation, subventions to the agricultural sector have been reduced or eliminated, which has caused a number of structural problems in the sector. Such problems are; low technology level of cultivated areas, difficulties to take advantage of economies of scale, non-qualified work force, high transaction

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²⁵ Ibid. Access 03/12/2003
costs and low competitiveness in producing agricultural products.26

The Mexican agriculture is very diverse, as it comprises products from tropical zones to temperate zones and is very dependent on the amount of rainfalls. Mexico produces approximately 437 different agricultural products of great commercial importance27 Nevertheless, it is possible to point out six principle products: maize (sweet corn), beans, wheat, cane sugar, coffee, and sorghum. The two first are the base of the alimentation of the Mexican people and around 3/4 of total cultivated land is dedicated to the cultivation of these two products. Wheat and sugar is also generalized consumer foodstuff and sorghum is primarily used for cattle food. Coffee on the other hand is Mexico's biggest agricultural export product.28

Statistically, about 18 % of the economically active population is engaged in agricultural activities (including seasonal work).29 However, only a small part of the total rural population (approximately 9 million people of 24 million in 2000) is counted as economically active and wage earning.30 The majority of the rest of the rural population is informally active in agricultural activities, usually working on their own small and unprofitable farms. The states with the largest share of rural population are Oaxaca, Chiapas and Hidalgo, states that are characterized for their importance of the production of primary goods. The density of rural population is depicted in Figure 3.1.

27 Ibid. Access 02/12/2003
28 Ibid. Access 02/12/2003
The most extensive poverty is found in the rural areas among farmers or people employed in the agricultural sector. According to the Mexican Secretary of Agriculture, SAGRAPA, the employment growth in the agricultural sector of most Latin American countries is negative. Even though, the rural poverty in Mexico has improved, around 55% the Mexican population considered extremely poor was located in rural areas in 1998. Approximately 60% of the rural poor are limited farmers with small assets. According to United Nations Development Programme, which measures the human development in different countries, using the Human Development Index (HDI), Mexico is classified as a country with medium development. Further, they have established that the Southern regions of

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33 The Human Development Index (HDI) has three basic dimensions for its measurement: longevity, knowledge and access to resources. As indicators of each dimension life expectancy at birth, literacy and school enrollment rates, and per capita Gross Domestic Product (GDP) are used.
Mexico, i.e. for example Chiapas and Oaxaca are the least developed. As I mentioned earlier, these Southern states have the highest percentage of rural population and the livelihood depend on farming and other agricultural activities. This means that many of the states, which have a lot of rural population, living on small farms with small assets, are ranked much lower than the Mexican average when development is concerned.

**Production of Agricultural Products, 1998-2001**

Mexican production in agricultural products in total increased from 1998 to 2001, according to the statistics of the Food and Agriculture Organization of the United Nations. This is demonstrated through index calculations using the years 1989-1991 as base years, these years representing 100. The up-going trend in agricultural production between the 1998 and 2001 is depicted in Table 3.1 below.

<table>
<thead>
<tr>
<th>Table 3.1 - Total Production of Agricultural Products</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total production index, agriculture, value (PIN) Net Pin base 89-91</td>
</tr>
<tr>
<td>1998</td>
</tr>
<tr>
<td>122,7</td>
</tr>
</tbody>
</table>


During the years stated in Table 3.1, agricultural production in Mexico stood for around 5-6 % of GDP.

**General Trade Policies for Agricultural Products in Mexico**

In order to look at the significance of the new FTA for Mexico when liberalization of agricultural goods is concerned, it is important to appreciate the general trade policies for agricultural goods that Mexico engages.

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During many years of the last century, Mexico engaged in protective trade policies following the so-called Import Substitution Industrialization (ISI) strategy. The agriculture was protected by high tariffs and other protective measures. During the last decades, this trend has shifted and Mexico has gone from being an economy based on agricultural production to an industrial nation. Mexico has concluded, as I mentioned earlier, 31 preferential trade agreements all over the world. This shows the intention of Mexican trade strategy to diversify its trade relations to avoid commercial dependency to the United States of America. However, Mexico is not willing to lose the trade status that NAFTA brings them. Mexico is also known to have been one of the first trade reformers in Latin America, seeing trade reform as a way of promoting economic growth and welfare. As a consequence of these reforms, the production and trade of the agricultural sector have become smaller compared to the industrial production and trade.37

**Total Trade in Agricultural Products, 1998-2001**

Approximately 17 years after the initiation of trade liberalization of Mexican agricultural goods, the international trade of these products reflects the structural changes of the Mexican economy. Most of all, it could be noted that Mexico has exploited its comparative advantages and specialized in product groups such as vegetables, fruits, fishery products and coffee.38

Total trade in Mexican agricultural products between 1998 and 2001 increased both when exports and imports were concerned. In 1998, the total exports had a value of approximately 6.8 billion U.S. dollars and until 2001 it had risen to a value of 7.6 billion (see Table 3.2).

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Table 3.2 – Total Trade in Agricultural Products (value)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total exports,</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>agricultural products,</td>
<td>6863292</td>
<td>6989469</td>
<td>7619352</td>
<td>7631154</td>
</tr>
<tr>
<td>value (1000 U.S.$)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total imports,</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>agricultural products,</td>
<td>8493918</td>
<td>8752287</td>
<td>9560992</td>
<td>10830164</td>
</tr>
<tr>
<td>value (1000 U.S.$)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>-1630626</td>
<td>-1762818</td>
<td>-1941640</td>
<td>-3199010</td>
</tr>
</tbody>
</table>

Source: FAO Statistical Database in Agriculture (2003). \(^{39}\)

In order to further depict the trend in trade, I plot the data in Table 3.2 in a diagram, showing both Mexican exports and imports of agricultural products between 1998 and 2001.

**Figure 3.2 - Total Trade in Agricultural Products (value)**

Source: FAO Statistical Database in Agriculture (2003). \(^{40}\)

Total imports of agricultural products of Mexico increased faster than its exports these years, from a value of approximately 8.5 billion U.S. dollars in 1998 to a value of 10.8 billion U.S. dollars in 2001. Although trade in


\(^{40}\) Ibid. Access 02/12/2003
agricultural trade has increased between 1998 and 2001, the trade deficit for agricultural products has increased as well, from a deficit of around 1.6 billion U.S. dollars in 1998 to 3.2 billion U.S. dollars in 2001. Hence, the deficit had almost doubled in three years.

**Trade in Agricultural Products with the EU, 1998-2001**

The share of agricultural trade between Mexico and the EU has decreased during the 1990’s, along with the liberalization of trade within NAFTA. However, the EU is still Mexico’s second largest trading partner when agricultural products are concerned. In the year 2001, 5.7 % of Mexico agricultural exports were destined to the EU and the same year, 6.4 % of Mexico’s total agricultural imports came from the EU. Approximately 62 % of trade in agricultural goods between Mexico and the EU was liberalized directly in 2000, while both parties will liberalize other more sensitive products during a ten-year period.

According to the data from EUROSTAT, depicted in Tables 4.3 and 4.4 below, the value of Mexican exports to the EU has been fluctuating around 330 million ECU during the four-year period, with a minor slump in 1999 when they went slightly below 300 million. The agricultural imports from the EU experienced an increase of approximately 166 million ECU from 1999 to the year 2000. Despite the increasing trend from 1998 to 2000, the value of agricultural imports decreased in 2001.

Looking at trade in agricultural goods in terms of quantity (Table 3.4), one may observe a decreasing trend both when exports as well as imports are concerned between 1999 and 2001. The downward trend is especially apparent when examining exports. The different trends in value and quantity could be a consequence of increased export and import prices after the year 2000.

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Table 3.3 – Mexican Trade in Agricultural Products with the EU (value)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mex-EU, exports, agricultural products, value (1000ECU)</td>
<td>344023</td>
<td>290859</td>
<td>331013</td>
<td>331847</td>
</tr>
<tr>
<td>Mex-EU, imports, agricultural products, value (1000ECU)</td>
<td>242503</td>
<td>279412</td>
<td>445287</td>
<td>334763</td>
</tr>
<tr>
<td>Balance</td>
<td>101520</td>
<td>11447</td>
<td>-114274</td>
<td>-2916</td>
</tr>
</tbody>
</table>

Source: EUROSTAT (1998-2001).\(^{43}\)

Table 3.4 – Mexican Trade in Agricultural Products with the EU (quantity)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mex-EU, exports, agricultural products, quantity (metric tons)</td>
<td>339356</td>
<td>321197</td>
<td>270982</td>
<td>245511</td>
</tr>
<tr>
<td>Mex-EU, imports, agricultural products, quantity (metric tons)</td>
<td>221228</td>
<td>305036</td>
<td>279829</td>
<td>221061</td>
</tr>
<tr>
<td>Balance</td>
<td>118128</td>
<td>16161</td>
<td>-8847</td>
<td>24450</td>
</tr>
</tbody>
</table>

Source: EUROSTAT (1998-2001).\(^{44}\)

It is also interesting to point out that Mexico’s trade balance with the EU in agricultural products reached a deficit in 2000, which means that Mexico imported more agricultural products from the EU than what it exported.

3.2.2 Maize in Mexico – Production and Trade

Mexicans have cultivated maize (sweet corn) for almost 10,000 years. As was mentioned earlier, maize is together with beans the most important aliment in Mexico. Its importance could be compared to the importance of the potato in the northern parts of Europe. The flour of maize is used for many typical Mexican dishes and the government considers it an important aliment and includes subventions for maize in the support programs in rural areas. It has been calculated that approximately 15 million people in Mexico


\(^{44}\) Ibid.
depend on the cultivation of maize and the majority of the Mexican population is dependent on it for nutrition.\textsuperscript{45}

Mexico produces more than 3500 different varieties of maize and each hectare cultivated with maize in Mexico yields about 2 tons. In 2001, approximately 7.3 million hectares of cultivated land was dedicated to the cultivation of maize, which is the biggest area dedicated to a crop in Mexico. Since the middle of the 1990’s the prices of maize have plummeted by more than 70 \%. This is probably due to the liberalization of trade with the United States, resulting in the entrance into Mexico of enormous amounts of cheap maize from the north. Consequently, the small Mexican maize farmers are unable to compete under these conditions.\textsuperscript{46}

Maize is primarily produced in Jalisco, Mexico and Jinalóa located in the South West and Western parts of Mexico (see Figure 3.3).

\textbf{Figure 3.3 - Principal Maize Producing States}

\begin{minipage}{\textwidth}
\begin{tabular}{|c|c|}
\hline
Jalisco & 13.4\% \\
Mexico & 11.1\% \\
Sinaloa & 10.6\% \\
Chiapas & 8.8\% \\
Michoacan & 6.3\% \\
Veracruz & 5.7\% \\
Puebla & 5.7\% \\
Guatemala & 4.5\% \\
\hline
\end{tabular}
\end{minipage}

Source: INEGI (2001)

\textsuperscript{45} Oxfam International (2003), \textit{Dumping Without Borders: How U.S. agricultural policies are destroying the livelihoods of Mexican corn farmers}. No.50
\textsuperscript{46} Ibid.
Production of Maize, 1998-2001
For the production of Maize between the years 1998 and 2001, one may observe a down-going trend between 1998 and year 2000 and a significant increase between 2000 and 2001 (see Table 3.5). From 1998 to 1999 production fell with approximately 784,300 metric tons and from 1999 to 2000 with around 149,476 metric tons. The increase in production between 2000 and 2001 was of the magnitude of 2,586,400 metric tons.

Table 3.5 - Mexican Production of Maize (quantity)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total production, maize, quantity (metric tons)</td>
<td>18454710</td>
<td>17706376</td>
<td>17556900</td>
<td>20134300</td>
</tr>
</tbody>
</table>


The trend in Mexican Maize production is depicted in Figure 3.4 below.

Figure 3.4 – Total Production of Maize, 1998-2001 (quantity)


48 Ibid. Access 02/12/2003
Total Trade in Maize, 1998-2001
The tables below (Table 3.6 and 3.7) show Mexican total trade of maize between the years 1998 and 2001. From these tables it can be concluded that imports were kept on a high and fairly constant level during the four years observed, with a small reduction in 2000, while exports fluctuated significantly both when it comes to the quantity in metric tons and the value in U.S. dollars. Especially between 1999 and 2000, Mexican exports decreased from a value of 7.8 million U.S. dollars to approximately 950,000 U.S. dollars.

Table 3.6 – Mexican Total Trade in Maize (value)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total exports, maize, value (1000 U.S.$)</th>
<th>Total imports, maize, value (1000 U.S.$)</th>
<th>Balance, maize, value (1000 U.S.$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>35210</td>
<td>621134</td>
<td>-585924</td>
</tr>
<tr>
<td>1999</td>
<td>7866</td>
<td>648192</td>
<td>-640326</td>
</tr>
<tr>
<td>2000</td>
<td>947</td>
<td>548264</td>
<td>-547317</td>
</tr>
<tr>
<td>2001</td>
<td>3812</td>
<td>648697</td>
<td>-644885</td>
</tr>
</tbody>
</table>


Table 3.7 - Mexican Trade in Maize (quantity)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total exports, maize, quantity (metric tons)</th>
<th>Total imports, maize, quantity (metric tons)</th>
<th>Balance, maize, quantity (metric tons)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>231204</td>
<td>5211863</td>
<td>-4980659</td>
</tr>
<tr>
<td>1999</td>
<td>17749</td>
<td>5545811</td>
<td>-5528062</td>
</tr>
<tr>
<td>2000</td>
<td>2551</td>
<td>5347618</td>
<td>-5345067</td>
</tr>
<tr>
<td>2001</td>
<td>11233</td>
<td>6174028</td>
<td>-6162795</td>
</tr>
</tbody>
</table>


Trade in Maize with the EU, 1998-2001
Mexico’s biggest trading partner in maize is the United States. The liberalization of trade within NAFTA has lead to an enormous inflow of maize from the U.S. to Mexico. The EU does not export any maize to Mexico, despite dismantling of tariffs in 2000. The export of maize from

50 Ibid. Access 02/12/2003
Mexico to the EU between 1998 and 2001 was of little significance both when it comes to value and quantity (less than 0.1% of total exports). The small trade in maize between Mexico and the EU makes it difficult to observe any clear and conclusive trends. However, a slump in Mexican maize exports may be observed in 1999 as well as an increase in export prices in 2000.

Table 3.8 – Mexican Trade in Maize with the EU (value)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mex-EU, exports, value (1000ECU)</td>
<td>50</td>
<td>8</td>
<td>43</td>
<td>55</td>
</tr>
<tr>
<td>Mex-EU, imports, value (1000ECU)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Balance</td>
<td>50</td>
<td>8</td>
<td>43</td>
<td>55</td>
</tr>
</tbody>
</table>


Table 3.9 – Mexican Trade in Maize with the EU (quantity)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mex-EU, exports, quantity (metric tons)</td>
<td>48</td>
<td>4</td>
<td>10</td>
<td>12</td>
</tr>
<tr>
<td>Mex-EU, imports, quantity (metric tons)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Balance</td>
<td>48</td>
<td>4</td>
<td>10</td>
<td>12</td>
</tr>
</tbody>
</table>


3.2.3 Coffee in Mexico – Production and Trade

Mexico is the world's fifth producer of coffee and its exports have historically played an important role in external sales of the agricultural sector. During the prime years, it reached 27% of total international sales of agricultural goods. However, due to the fall in international market price of coffee, its participation in the total sales was reduced in the 1990’s and in the beginning of the 21st century.

52 Ibid.
Coffee is of great importance to Mexico, both economically and socially. Approximately 3 million people are dependent on the production of coffee, which means that for almost 4600 communities in Mexico, coffee is the principal source of income. Approximately 92% of the Mexican coffee producers have less than 5 hectares available for coffee production and have no access to economic or technical assistance. For many of the small coffee producers it is impossible to produce high-quality coffee and to process the coffee, and as a result, they obtain low prices for their coffee.\(^\text{54}\)

The Mexican exports of coffee have in the past ten years been directed more toward the United States than other parts of the world. This could be due to a less competitive market and less fastidious consumers.\(^\text{55}\) The elimination of the tariff on coffee between Mexico and the EU might change this around.

Coffee is primarily produced in Chiapas, Veracruz, Oaxaca and Puebla (see Figure 3.5).

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\(^54\) http://www.vinculando.org/mercado/cafe/. Access 04/12/2003
\(^55\) Ibid. Access 04/12/2003
Production of Coffee, 1998-2001
Table 3.10 shows the change in production of green coffee between the years 1998 and 2001. Although production for all four years is more or less constant\(^{56}\), it may be observed that from 1999 to 2000, coffee production rose significantly compared to the previous year, which can be seen as a recovery from a slump in 1999 to similar amounts as produced in 1998.

Table 3.10 - Mexican Production of Coffee (green) (metric tons)

<table>
<thead>
<tr>
<th>Year</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total production, coffee (green), quantity (metric tons)</td>
<td>277372</td>
<td>202119</td>
<td>338170</td>
<td>302996</td>
</tr>
</tbody>
</table>

Source: FAO Statistical Database (2003).\(^{57}\)

The diagram in Figure 3.6 shows the development in Mexican coffee production during the four years that were investigated.

Figures 3.6 – Mexican Coffee (green) Production in Metric Tons

Source: FAO Statistical Database in Agriculture (2003).\(^{58}\)


\(^{57}\) Ibid. Access 02/12/2003

\(^{58}\) Ibid. Access 02/12/2003
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**Total Trade in Coffee, 1998-2001**
Coffee is one of Mexico’s biggest export products. Most of the exports go to the United States and the countries of the EU. In the statistics of the FAO, Mexican coffee exports fell in value between 1998 and 2001, from 700 million U.S. dollars to around 240 million U.S. dollars. Judging from the more moderate and changing export quantity, the fall in export value is a consequence of a fall in world market prices of coffee. Import of coffee to Mexico are relatively small. Despite this, one may observe a significant decrease in both import value and import quantity in 2000. The trends in total coffee trade are found in Tables 3.11 and 3.12 below.

**Table 3.11 – Mexican Total Trade in Coffee (value)**

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total exports, coffee (green), value (1000 U.S.$)</td>
<td>700305</td>
<td>622846</td>
<td>651700</td>
<td>241746</td>
</tr>
<tr>
<td>Total imports, coffee (green), value (1000 U.S.$)</td>
<td>16787</td>
<td>13105</td>
<td>5948</td>
<td>11089</td>
</tr>
<tr>
<td>Balance</td>
<td>683518</td>
<td>609741</td>
<td>645752</td>
<td>230657</td>
</tr>
</tbody>
</table>


**Table 3.12 – Mexican Total Trade in Coffee (quantity)**

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total exports, coffee (green), quantity (metric tons)</td>
<td>189650</td>
<td>238144</td>
<td>280059</td>
<td>162145</td>
</tr>
<tr>
<td>Total imports, coffee (green), quantity (metric tons)</td>
<td>9002</td>
<td>8083</td>
<td>5067</td>
<td>17708</td>
</tr>
<tr>
<td>Balance</td>
<td>180648</td>
<td>230061</td>
<td>274992</td>
<td>144437</td>
</tr>
</tbody>
</table>


**Trade in Coffee with the EU, 1998-2001**
Between 10 % and 20 % of Mexico’s total exports of coffee are destined for the EU. The quantity traded and the value of exports and imports of coffee, between the two parties between the years 1998 and 2001 is shown in the

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59 Conclusion drawn by comparing the value of coffee trade with the quantity traded.
61 Ibid. Access 02/12/2003
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A Study of Welfare Effects of the EU-Mexico Free Trade Agreement

Tables 3.13 and 3.14. The value of exports is fluctuating between 1998 and 2001, as well as the quantity exported. However, one may observe a significant increase in 2000, even though it fell again in 2001. The fluctuating trade pattern could reflect the instability in market prices in coffee.62

It can be observed that Mexico imports a small amount of coffee from the EU, which of course is due to small production of coffee in the European countries. Consequently, Mexico’s trade balance in coffee with the EU is in convincing surplus. Despite this, it is possible to see an upward-going trend in coffee imports from the EU, both in value and in quantity during the four years observed.

Table 3.13 – Mexican Trade in Coffee with the EU (value)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mex-EU, exports coffee (green), value (1000ECU)</td>
<td>81912</td>
<td>57292</td>
<td>85803</td>
<td>62890</td>
</tr>
<tr>
<td>Mex-EU, imports coffee (green), value (1000ECU)</td>
<td>100</td>
<td>135</td>
<td>318</td>
<td>352</td>
</tr>
<tr>
<td>Balance</td>
<td>81812</td>
<td>57157</td>
<td>85485</td>
<td>62538</td>
</tr>
</tbody>
</table>


Table 3.14 – Mexican Trade in Coffee with the EU (quantity)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mex-EU, exports coffee (green), quantity (metric tons)</td>
<td>25058</td>
<td>24006</td>
<td>34434</td>
<td>32168</td>
</tr>
<tr>
<td>Mex-EU, imports coffee (green), quantity (metric tons)</td>
<td>11</td>
<td>11</td>
<td>23</td>
<td>29</td>
</tr>
<tr>
<td>Balance</td>
<td>25047</td>
<td>23995</td>
<td>34411</td>
<td>32139</td>
</tr>
</tbody>
</table>


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63 Ibid.
64 Ibid.
4. Analysis

This chapter is dedicated to analyze the negotiation process and formation of the EU-Mexico FTA as well as the welfare effects due to liberalization of agricultural trade. In order to analyze the welfare effects of the EU-Mexico FTA when agricultural products are concerned, I use the data presented in Chapter 3, and apply it to the theories on preferential trade agreements presented in Chapter 2. In the last section of this chapter, I analyze the welfare effects, focusing on the Mexican people.

4.1 The Free Trade Agreement and the Relationship between Mexico and the EU

The new EU-Mexico Free Trade Agreement is a continuation of the relations between Mexico and the European Union, which during the last decades has been enforced. The talks started formally in 1995 and in 1997 the parties signed the Economic Partnership, Political Coordination, and Cooperation Agreement. The new FTA entered into force on 1 July 2000 and although an FTA is the least comprehensive of all stages of integration, the FTA between Mexico and the EU can be described as relatively comprehensive in its composition. One could see the EU-Mexico FTA as a role model for future relations between the two continents, as it is the first FTA negotiated between the EU and a Latin American country and as it comprises many different areas, both of political and economic nature. The FTA not only signifies better economic integration, but also a political integration that could be advantageous principally to Mexico, which may increase its influence on the developed countries in Europe.

The negotiation process and the formation of the FTA, bear witness to slight asymmetries in power between the two parties. European negotiators threatened to close down the negotiation when Mexican negotiators refused to agree upon a fast liberalization of industrial goods that would begin already in 2003. The EU member’s justification for this drastic liberalization of industrial goods was the so-called “NAFTA parity for duty-free trade in industrial goods”. The EU wanted to liberalize its industrial trade with
Mexico the same year as that NAFTA would come to complete total liberalization. Mexico feared that liberalization of industrial goods with the USA, Canada, and the EU simultaneously, would harm domestic enterprises and lead to social costs and hence, proposed a more moderate elimination schedule. However, the threat to close down the negotiations resulted in a compromise from the Mexican side and it appears as if Mexico could not afford the negotiations to fail neither that the FTA would be postponed. On the other hand, it seems as if the EU and its negotiators could afford to put pressure on the Mexicans and risk a break down of the negotiations. This situation reveals some asymmetry between the two parties.

The composition of the FTA also shows some of the asymmetry in power, even though it appears that there do exist an understanding for the economic asymmetry between the two parties, Mexico being the least powerful in this aspect. The necessity for Mexico to continue to protect sensitive products is taken into account in the agreement as well as a longer time span for the dismantling of tariffs on both industrial as well as agricultural goods. However, the relatively fast liberalization might still hurt small and medium sized producers in Mexico, especially now, after trade liberalization with the rest of North America. Further, looking at the rules of origin applied within the Free Trade Area, it is stated in the agreement that for the most part the rules of origin according to EU regulations are to be applied. The rules of origin are important in order to be able to avoid discriminatory trade policies between countries such as preferential tariffs, anti-dumping actions, countervailing measures etc. The use of European regulations to determine the rule of origin could affect Mexico negatively. There might arise a number of problems due to difference in accounting and calculation of the rules of origins. This could lead to an increase in prices as the administrative costs might increase. High level of bureaucracy and consequently high costs, may in turn affect the European exporters negatively as well, as they are the ones that probably have to pay for these costs.

The forum, “EU-Mexico Civil Society Dialogue”, which was formed for the European and Mexican civil society to vent there opinions on the FTA and its progress, is an attempt to actually improve and equalizing the asymmetries that exist between the two parties of the FTA. The next civil society forum, i.e. the Second Forum, is planned to be held in the beginning
of 2004\(^1\), which gives proof of continued ambitions to make the FTA more equal in terms of political power, economic and commercial relations and cooperation.

Further, it is possible to observe an indirect effect of the FTA. When EU exports enter into Mexico without duties, it also means that the exports enter freely into the NAFTA area. This could lead to European producers of goods and services, exporting their products to Mexico, taking advantage of the low tariffs, changing the content to fit NAFTA rules of origin, and selling it to the United States and Canada. Consequently, European producers avoid the tariffs and other protectionist measures that their products would meet entering directly through American and Canadian customs. If, and in that case, how this indirect entry into the United States and Canada may be used by European producers and exporters, is yet to be observed. At the same time, there is no guarantee that American and Canadian exporters will not use the same method in order for their products to reach the EU more easily. This scenario could lead to inefficiency by evening out the tariff levels within the EU-Mexico Free Trade Area and also between the two Free Trade Areas, which could lead to deflection in trade between the two continents. The future will tell if this will lead to changes in the economic and commercial relations between, for example, the EU and the United States.

### 4.2 The FTA, Trade in Agriculture and Welfare Effects

#### 4.2.1 Mexican Trade Policy and Agricultural Trade

Historically, Mexico has protected its industrial and agricultural sector by a policy well established in Latin America, the so-called Import Substitution Industrialization (ISI). This trade strategy was based upon the ideas of protecting domestic production by limiting imports and creating some kind of self-sufficiency within the country. Under this policy, the Mexican agricultural sector was protected with high tariffs and other non-tariff

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measures, normally because this sector had been too weak to face international trade, which is a well-known and accepted argument for protectionism.

With negotiations and formation of no less than 31 FTAs, Mexico shows ambition to liberalize its trade and hence be able to enjoy the possible gains from free trade, for example by increasing the capacity of the domestic industry. Consequently, Mexican agriculture has been exposed to the international competition and in many cases the Mexican farmers have not been able to fight it. The EU-Mexico FTA is yet another attempt to liberalize trade using preferential elimination of tariffs. In the following section, I try to assess the welfare effects of the elimination of tariffs on agricultural goods of the EU-Mexico FTA, including the cases of maize and coffee.

4.2.2 Welfare Effects due to the EU-Mexico FTA

The effects on welfare created through the formation of an FTA, depend on the size of production effects and the consumption effects. In this section I will look at the production effects and consumption effects as well as the interaction between these two as a consequence of the formation of the EU-Mexico FTA and the following liberalization of agricultural goods, which started in 2000.

**Production effects**

I start by observing the production effects, i.e. trade creation and trade diversion, in agriculture. Trade creation occurs when the producers of a member nation decide to export to a particular nation because of the preferential elimination of tariffs. The preferential tariff elimination leads to specialization within the FTA and trade is created.

The EU-Mexico FTA entered into force in July 2000 and 62% of the tariffs on agricultural goods were lifted. Theories on preferential trade agreements suggest that the elimination of tariffs between Mexico and the EU should lower prices of Mexican agricultural goods in the EU relatively to the rest of the world and vice versa and consequently trade could be created within the Free Trade Area. According to EUROSTAT, the value of Mexican trade in
agricultural goods (both exports and imports) with the EU increased slightly in 2000 compared to the previous two years. This increasing trend in trade value may also be observed for Mexican production and total trade of agricultural goods during these years. However, compared to 1998 and 1999, the traded quantity of agricultural goods between Mexico and the EU experienced a slight decrease in 2000 and 2001. This development in trade means that prices on agricultural products increased rather than decreased after the formation of the FTA, contradicting the theory of the effects of preferential trade, and that no trade in agricultural goods was created within the Free Trade Area during the first two years of integration. The data rather suggests that trade was reduced. There are no signs of trade in agricultural goods produced inefficiently in Mexico being replaced by more efficiently produced goods from the EU. The increase in value of agricultural goods traded between Mexico and the EU probably is the result of an increase in market prices of these products on an international level and it seems as if the price level was not significantly affected by the elimination of tariffs between Mexico and the EU. This trend of rising prices on an international level is supported by the increase in value of production and total trade in agricultural products during the two years after integration.

As trade in agricultural products was reduced within the FTA, Mexicans that produce agricultural goods inefficiently was not eliminated through competition from the EU and consequently, the increase in income due to higher prices on agricultural goods probably benefited these Mexican producers. At the same time, even though the value of exports increased because of higher prices on Mexican exports, and hence the income of the Mexican producers of agricultural products exported to the EU, these producers lost market shares in the European market. If this inefficiency in agricultural production continues within the FTA, there will be no clear sustainable effects on the welfare in Mexico as a whole in the future and this could mean that the FTA has lost its commercial purpose.

Trade diversion could benefit Mexico, or any country entering into an FTA, if it leads to increased production within the country. However, if the new FTA has led to any trade diversion is hard to tell. Since the quantity traded decreased in the year 2000 and 2001, there appears to be no evidence of trade diversion within the Free Trade Area. Mexican agricultural products
have not been directed especially to the European market despite elimination of tariffs and vice versa. Even when trade diversion is concerned, it is probably too early to find evidence of Mexico redirecting its agricultural trade to the EU instead of to another trading partner. Maybe in a couple of years, after 2003 when more products have been liberalized, it might be possible to better observe if trade diversion has occurred. Reality is clearly more complicated than the three-country example, which I presented in Chapter 2. In order to examine if the FTA has lead to trade diversion, it is necessary to compare the changes in trade with the EU, due to the FTA, with another country with which Mexico trade their agricultural products and with which it does not have a preferential trade agreement. Since Mexico has entered into 31 preferential trade agreements, it is difficult to find such as a country and the analysis of trade diversion gets more complicated.

Extending the analysis of the production effects further, I now turn to the development in trade of maize and coffee between Mexico and the EU. When maize is concerned, trade with the EU is very small and it is difficult to make any significant conclusions of the production effects. Mexico does not import any maize from the EU and this did not change in 2000 and 2001, despite elimination of the tariffs. The value of the maize exports increased in 2000 compared to the two years prior to integration even though the values were relatively small. However, despite an increase in the quantity of maize exported to the EU, it did not rise as much as the export value, suggesting an increase in price of Mexican maize traded with the EU. Once again it contradicts the theory of preferential trade, which suggests that prices will be reduced when tariffs are eliminated. The small amount of trade created, which could be an effect of the elimination of the tariffs on maize, and the increase in income because of higher prices, could lead to increased welfare for Mexican maize producers. Nevertheless, it is important to point out that trade in maize between Mexico and the EU is still very small and that, even though some trade has been created, the welfare of Mexican maize producers rather depend on domestic production and trade with the United States.

Even in the case of maize it is difficult to conclude that the elimination of tariffs led to any trade diversion. Despite the fact that Mexico increased its maize exports to the EU, the increase was probably too small to say that they
were redirected from another trading partner to the EU. In conclusion, it is fair to say that trade created in maize did not affect the welfare in any significant level between Mexico and possible trade diversion did probably not create any significant negative effects on the Mexican agricultural sector as a whole.

Despite down-going trend in international coffee prices since the end of the 1990’s international, Mexican production of coffee as well as total exports and exports to the EU of coffee, (both value and quantity) increased in the year 2000. However, the increase in exports could be viewed as a recovery to the trade levels observed in 1998, which were interrupted by a slump in production and trade in coffee in 1999. However, it is important to note that despite the increase in production and exports (both total and to the EU) in 2000, exports fell again in the year 2001. The higher increase in the value of coffee exports compared to exported quantity, suggest that the price on coffee increased as well, showing an equal development as maize exports and agricultural goods in general.

Accordingly, the data on coffee, presented in Chapter 3, it is difficult to conclude that the increase in trade (exports and imports), both in value and quantity in 2000, really was trade creation since there is great fluctuation in the data for the four years studied. It is also difficult to observe any trade diversion in coffee. However, it is not possible to rule out that trade in coffee was created between Mexico and the EU and that trade could have been diverted towards the EU because of elimination of the tariff on coffee between them. This could be supported by comparing the trend in trade between Mexico and the EU with production and total trade of coffee. During the four years observed, the production and total trade decreased significantly, which was not really the case for trade in coffee between Mexico and the EU. Further, exports of coffee to the EU is large enough (10-20 % of total trade) to believe that trade creation and trade diversion of coffee within the Free Trade Area, would affect the welfare of the Mexican coffee producers positively. Europeans drink a lot of coffee but the European production of the product is relatively small compared to Mexico. Hence, by lifting the tariffs on coffee, the large European market was opened to the Mexican producers, and they could enjoy the specialization within the Free Trade Area, which would increase their production.
However, even in this case, data from more than two years after the formation of the FTA, would hopefully give a clearer picture of the production effects on coffee.

Hence, the results of the analysis of production effects on Mexican maize and coffee, contradicts the results of the agricultural sector as a whole, as trade could have been created and diverted in these sectors, even though to a very small extent. However, the results of maize and coffee are very ambiguous and no decisive conclusion can be made of the effects on the Mexican producers of these products. The contradiction in development could depend on the lack of sufficient data material but also on the fact that these two products probably do not, in the case of trade with the EU, represent the Mexican agricultural sector as well as I believed they would.

Further, it could also be too early to draw any clear conclusions from the analysis of the data presented in Chapter 3, since it is difficult to see any trends, only looking at two years before and after integration. It is possible that the results become less ambiguous as the FTA grows older and more agricultural goods are liberalized, hence increasing the statistical data material available.

**Determinants of production effects**

Even though it seems to be too early to make any certain conclusions of the welfare effects in Mexico due to the elimination of tariffs on agricultural goods, I would like to speculate around the determinants of these effects on production and welfare, or rather the lack of them.

Firstly, I want to point out the importance of the elasticity of supply of agricultural goods when interpreting the results of the elimination of tariffs on agricultural goods. The supply for agricultural goods in general is often characterized as inelastic in the short-run. This is because the production factors needed for production of farm products, such as land, labor and machinery, are very inflexible for other uses. This inelasticity of supply, which means that the supply does not change in significant levels when price is altered, could in this case contribute to the fact that production was not

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affected and trade not created by the tariff elimination on agricultural products as a consequence of the FTA. This inelasticity of supply probably affects the results and gains from trade in these products for all traders of agricultural goods.

Looking further on the determinants of the results of the analysis of production effects, there are, according to Balassa (as I mentioned in 2.2.2), some determinants for the production effects, which are more important than others. These are complementarity and competitiveness, size of the FTA, the distance between the members of the FTA and the height of tariffs before integration.

The fact that the FTA includes many nations\(^3\) could increase the probability for competitiveness within the Free Trade Area, as there might be a higher chance for overlapping in the production of agricultural products. However, cultural and climatic differences between Mexico and the EU could contribute to less overlapping when agricultural products are concerned and hence to less competition. This could be the reason for the production inefficiency within the Free Trade Area, which may be observed, and that trade in agricultural products is not created as it would if the FTA had led to more competition. However, without competition, Mexican farmers can keep on producing agricultural goods inefficiently, something that could help these farmers in the short-run but does not help the development of Mexico in the long-run. It is also fair to believe that the structure of production and the production costs of the agricultural sector differ between Mexico and the EU. This difference in production structure and production costs, together with the lack of competition between the two parties, could lead to small effects on production within the Free Trade Area and trade is neither created nor diverted.

GNP wise both the EU and Mexico are large, even though the GNP of the EU members is far greater than that of Mexico. Nevertheless, it seems that size have had little effect on trade and especially trade in agricultural goods between the two parties. In my opinion it is too early to see any clear positive effects on production and consumption of the FTA as a consequence of the size of the FTA members. In the future, allowing for economic growth

\(^3\) At the time of the formation of the FTA the EU consisted of 15 member nations.
in both in Mexico and in the EU, as well as the expansion of the EU in a couple of years, the size could probably improve the results of the FTA.

The next determinant, distance between member nations, is very interesting when analyzing the EU-Mexico FTA. One could not neglect the fact that the two parties are separated by an ocean, which makes fast access to commodities difficult and the transport cost are probably relatively high. This is certainly true for agricultural products, which in most cases are sensitive when it comes to long-distance transportation. The high costs of transportation would probably affect trade between the two parties. Furthermore, there are differences in culture and tastes between Mexico and Europe, which could mean differences in demand for agricultural products and could also affect negotiations between importers and exporters. This could be a reason for the relatively small changes in trade. However, today these cultural differences are diminishing and are becoming less and less important as the world is “globalized”. This trend together with high ambitions of smoothing out differences, the two parties might possibly reduce the cultural distance in the future, making up for the obvious geographical distance, and hopefully improving the production effects within the Free Trade Area and eventually the welfare effects in Mexico. The “Civil Society Dialogue”-forum could be of help in improving this scenario, as it was created for the purpose of discussing differences and in order to understand each other.

The average tariff on imports applied by the EU and Mexico before the FTA was relatively high, mounting to around 12%. The sensitive character of the agricultural sector in both Mexico and the EU probably contributed to these elevated levels. A number of agricultural products, such as coffee and many fruits and vegetables, were totally liberalized in 2000 but despite this liberalization, prices of traded agricultural goods between the two parties were not reduced and trade was not created. Hence, the elimination of some of the high tariffs, levied before integration, do not seem to have affected production of agricultural goods in Mexico. However, in the course of the elimination of tariffs in agriculture, during the seven years that remain until

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almost total liberalization, the effects might be more apparent. However, this is still to be discovered.

**Consumption effects**

The possible consumption effects depend on the elasticity of demand for agricultural products. The demand for agricultural goods is normally price inelastic, i.e. a change in price on agricultural goods would not affect the quantity demanded significantly. The relative inelastic demand for agricultural goods as a whole is mainly due to lack of substitutes. Agricultural products are necessary for survival and cannot be substituted for cars or shoes. Agricultural products are seldom luxury items, as many industrial goods, which also show that the demand for agricultural products is relatively inelastic. Hence, the probable price reduction that occurs as a consequence of integration would probably not lead to a clear increase in consumption of agricultural goods.

When examining trade in agricultural goods between Mexico and the EU, one may observe a slight increase in the value of imports of agricultural products from the EU to Mexico in 2000, compared to the two years before the formation of the FTA. Nevertheless, as I mentioned earlier, the quantity of agricultural goods imported from the EU decreased during the years 2000 and 2001, suggesting a rise in prices of the imported agricultural goods. Simultaneously, the inelastic demand for agricultural goods, would cause a moderate reaction to the increase in prices, i.e. similar amounts of the products would be demanded despite the rise in prices. Consequently, the contradictory results of a rise in prices on agricultural goods imported from the EU, despite the elimination of tariffs, together with the inelastic demand for agricultural products, would affect the Mexican consumers of these products negatively. If these agricultural products are consumed by a lot of Mexicans, including those with small assets, the effects on consumption and, consequently the welfare of the consumer, could be devastating. On the other hand, if a small and relatively rich share of the Mexican population mainly consumes the products, the overall effects would be moderate. When discussing the determinants of the production effects, I mentioned that the agricultural products imported from the EU are probably complementary to what is produced in Mexico. Consequently, I believe that a lot of agricultural

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products imported from the EU, are probably not necessary for survival. The lack of imports of maize, which is a crop important for the survival of many Mexicans, could give some evidence to this statement. If this is the case, the negative effects on welfare of the Mexican people, could be more moderate than what the increase in import prices suggests.

As the imported quantity of agricultural products was reduced and as prices of the imported goods rose, it is probably fair to conclude that there has not been any significant substitution in consumption, i.e. Mexican consumers exchanging their consumption of domestically produced agricultural goods or agricultural goods imported from other countries, for products imported from the EU. Substitution in consumption does not occur, even though the amount of European agricultural goods liberalized in the year 2000 was larger than the amount of Mexican agricultural goods liberalized.

Do the cases of maize and coffee give similar results when consumption effects are concerned? Well, when examining the consumption effects on maize and coffee, I have to look at the price elasticity of demand even for these products. Maize is very important to the Mexican people, i.e. a fundamental product and necessary for survival. There are no clear substitutes to maize in Mexico, since potatoes and other grains are cultivated scarcely both due to the climate and the cultural habits. For this reason, demand for maize is probably relatively inelastic in Mexico compared to other products. However, according to EUROSTAT, trade in maize between Mexico and the EU is very small. Mexico does not import any maize from the EU and this did not change despite elimination of tariffs in 2000 and 2001. Therefore, it is both impossible to observe any effects on consumption of imported agricultural goods due to the FTA and to analyze the effects on the welfare of Mexican consumers of maize.

Coffee also lacks substitutes and the most evident substitute today is tea. In many countries, especially developed countries, coffee is not a luxury product and stand for a small proportion of the consumer’s total budget. Consequently, the demand for coffee, just as for agricultural products as a whole and maize, is relatively inelastic. Compared to people in the countries of the EU, Mexicans consume relatively little coffee. The domestic consumption of coffee in Mexico is about 700 grams per capita and year,
compared to consumption in Sweden of 11 kilos per capita and year. Mexico’s total imports of coffee are small and they are even smaller from the EU. However, the data presented in chapter 3, suggest that Mexican imports of European coffee increased, both in value and quantity after integration, which could be a sign of Mexican consumers switched the consumption pattern towards the EU, i.e. there was probably a substitution in consumption. However, the relatively higher increase in value compared to quantity, suggest an increase in import prices. Consequently, there were probably negative effects on the welfare of the Mexicans consuming the European coffee. Nevertheless, the share of the Mexican population consuming expensive European coffee is probably small and would probably not significantly affect the welfare of Mexicans in general.

Unfortunately, the case of maize did not confirm the results of the consumption effects due to the elimination of tariffs on agricultural goods in general, because of the lack of imports of maize from the EU. Coffee, on the other hand, gave some hints of the contradicting trend of increased import prices in Mexico after integration, and that it affects the welfare of Mexican consumers negatively. However, the cases of maize and coffee show very ambiguous results also when analyzing the consumption effects and are of little guidance for me to confirm my results on the agricultural sector as a whole.

As for the case of production effects, two years after integration is probably too soon to be able rely on the results of the effects on consumption presented above. In a couple of years and with more agricultural products being liberalized, the data might give other results for the welfare effects on the Mexican people.

**Determinants of consumption effects**

The inelasticity of demand for agricultural products is probably the reasons behind these relatively negative effects on consumption. Further, despite high tariffs on average before integration, the elimination of tariffs in 2000 did not cause a reduction in prices of the imported agricultural goods, as the theories suggest, and consumption was affected negatively. The lack of

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6 http://www.vinculando.org/mercado/cafe/. Access 04/12/2003
connectiveness in agricultural production and also differences in tastes and culture, as I mentioned when discussing the determinants of production effects, could also have contributed to the lack of trade creation and consequently the reduction in price, which would have benefited Mexican consumers.

Summary of the welfare effects and their interaction
The observed welfare effects on Mexico for the first two years of the FTA are ambiguous in many ways, depending on the few years that have gone after the formation of the FTA and consequently the small data material used. However, with some help from the model in Figure 2.3 (p. 26), I try to summarize the welfare effects, which I have encountered in my analysis as well as depict the interaction between these effects. I have decided to exclude the cases of maize and coffee from this summary, as the ambiguous results that they present seem to confuse rather than contribute to the understanding of my analysis.

The effects on welfare depend on the strengths of the production effects and the consumption effects. According to Figure 2.3, if the demand for agricultural goods is elastic and if the FTA and the elimination of tariffs on agricultural goods have led to a reduction in prices of the agricultural goods and trade is created. Because of lower prices, consumer surplus rises and hence the welfare of the consumers is improved. The lower prices on imports of agricultural goods eliminate inefficient domestic production and producer surplus in the importing country is reduced.

However, this scenario is not true for what has happened in Mexico after entering into the FTA with the EU. Despite elimination of tariffs on a number of agricultural goods, it turns out that prices on traded agricultural goods have increased and that trade in agricultural goods has rather been reduced than created. What are the consequences of this? Well, the rise in prices has reduced trade of agricultural goods between Mexico and the EU. Examining only Mexico, the increase in prices has meant a reduction of consumer surplus and the surplus lost has accrued to the domestic producers and the producer surplus (the opposite of what I displayed in section in explaining Figure 2.3). The producers of agricultural goods in the EU, which export their products to Mexico, have lost market shares in Mexico, which in
turn accrue to Mexican producers. However, since the same scenario is displayed in the EU, the Mexican producers that export agricultural goods to the EU have also lost market shares in the European market, leading to a loss in benefit for these producers. However, the increase in export prices as can be seen from the increase in value of exports, paid by the consumers in the EU for the products still imported by the EU members might compensate some for this loss in market shares. Furthermore, as the demand for agricultural products is inelastic as well as the supply of agricultural products, the increase in prices of these has probably not affected the production, consumption and trade as much as if the demand and supply were more elastic. This could moderate the negative welfare effects seen in Mexico after the year 2000. However, since 62% of the tariffs on agricultural goods were eliminated or reduced in 2000, Mexico also lost tariff revenue at the same time as prices rose, accentuating the negative welfare effects on Mexico in general.

By examining the development in trade and trade prices of agricultural goods between Mexico and the EU after integration in the year 2000, it could be possible that the increase in the import prices, and hence the reduction in trade, is not only a consequence of the formation of the FTA and the elimination of tariffs between the two parties. The fact is that tariffs on certain agricultural products were lifted and this should have resulted in a reduction in price for these products traded between Mexico and the EU. The rise in prices of the traded agricultural goods and the following effects observed on consumption and production appears to have been caused by events taking place on the international market, independent of the formation of the FTA and the elimination of tariffs. It seems as if the new FTA and its effects is still too small in the “big picture”, and although it bears witness of ambitions of gains from free trade, it is still not able to influence the developments in prices set in the world market. However, one may interpret the elimination of tariffs on agricultural goods between Mexico and the EU, as working in the opposite direction as the rising prices. Consequently, without the elimination of tariffs, the prices on agricultural goods that Mexico and the EU faced in 2000 could have been much higher and the effects could have been more severe. This is however difficult to assess from the data presented in Chapter 3.
Nevertheless, the overall effects of the first two years of integration appear to be mostly negative in both Mexico and the EU. The consumers face higher prices, which reduces their welfare. Although the producer surplus rises because of the rise in prices and the exporters of agricultural products enjoy a higher income for their exported goods, the reduced trade within the Free Trade Area, bears witness to inefficiency in production within the Free Trade Area and if the FTA cannot alter this situation, it is probable that the overall negative effects on welfare will continue in the future. The consumers and producers of the EU are faced with the same problem as Mexico. However, because of higher prices on agricultural imports from the EU, the income of the European farmers is higher than the income of Mexican farmers that export agricultural products to the EU. If the inefficiency within the Free Trade Area continues, the difference in income from trade may accentuate the economic and commercial asymmetries between Mexico and the EU. In the case that the FTA is unable to alter the situation apparent in agricultural trade between Mexico and the EU, the intentions of the formation of the FTA could be discussed. Was it formed to serve the interest of some influential interest groups instead of all groups in society? Are the ambitions of the FTA to take advantage of the gains from free trade in all sectors? Will the Mexican farmers be able to influence the process and the outcome of the FTA in a way that could benefit them in the future? These questions will not be answered in this thesis but they are interesting to have in mind when analyzing the effects of the FTA.

### 4.3 Welfare effects and the Mexican People

In this section, I examine how the FTA and the elimination of tariffs on agricultural goods affect the people of Mexico, using the results from the above analysis.

It appears as if EU-Mexico FTA has not been strong enough to have any significant effect on the consumption and production of agricultural goods in Mexico since its formation in 2000. The welfare effects observed probably also depend on other exogenous events taking place; events that have raised prices on agricultural goods traded between Mexico and the EU and affected Mexican consumers negatively. The increase in prices on agricultural goods
could harm many people in Mexico. Mexico, as many other Latin American
countries, is still considered a developing country (country with medium
development according to UNDP) and development in rural areas lags
behind. The poor people of Mexico, both in urban and rural areas, depend on
the prices of agricultural products and foods, as the majority of their budget
is spent in the purchase of these products. In this case, higher prices could
cause a hard blow to those with already low income or no income at all.
However, it is important to examine the nature of the products imported at
higher prices. As the cases of maize and coffee suggest, the agricultural
products imported from the EU are probably not necessary for survival and
appear to be more specialized products, such as European coffee. If this is
the case, it is probably a relatively small and probably fairly wealthy share
of the Mexican people that consumes these products and the negative effects
on welfare in general, because of the increase in prices of these products,
will be less severe. Nevertheless, the development in both domestic
production and total trade suggests that prices for agricultural products have
risen in general and this most certainly affect the Mexican consumers
negatively.

The quantity of agricultural goods traded between Mexico and the EU was
reduced in 2000, despite the first round of elimination of tariffs. Hence, no
trade was created, which shows inefficiency in agricultural production
within the Free Trade Area and that Mexico has not experience the gains
from free trade, which should be the consequence of the elimination of
tariffs. However, because of higher prices the producer surplus in Mexico
rose and the value of trade in these products increased, which probably
means an increase in revenue for both Mexican and European producers. If
this increase in revenue reaches the actual producer depends on the structure
of the Mexican agricultural sector. For example, if there are intermediaries
to whom the domestic farmers primarily have to sell their products in order
to be able to export them, the mentioned revenue might not reach the
original producer. This scenario is common in countries where there is an
abundance of farmers with small assets who are unable to export the
products themselves. The majority of the Mexican farmers are such poor
farmers and hence, there is a risk that the revenue for the higher prices on
their exported goods does not reach them.
As I have concluded before, the EU-Mexico FTA appears to lack the power to alter the situation of high prices on agricultural goods. If the inefficiency in production of agricultural goods within the Free Trade Area continues, the FTA loses its meaning commercially and the sustainable positive effects will not present themselves. For the moment, the Mexican producers might enjoy some positive welfare effects due to higher prices but in the long–run, the country as a whole will suffer from it.

Nevertheless, if in the future, when more tariffs on agricultural goods have been eliminated between Mexico and the EU and the FTA leads to trade creation, lowered prices and production efficiency, the government of Mexico has to take care of the consequences. When discussing the determinants of the production and consumption effects, I mentioned that the agricultural goods produced in Mexico and the EU is probably not overlapping to a great extent, which lower competition between them. However, if the FTA means lower prices in the future it is possible that this competition will rise. More competition will eliminate the producers of agricultural goods that produce inefficiently. In Mexico this will mean problems for a lot of poor farmers. The ambitions of the Mexican government to open up trade to many countries, including the EU, must be followed by a strategy that combines free trade and liberalization with rural development. Today the rural areas in Mexico lag behind in development. The states with the largest number of people active in agricultural activities have an HDI much lower than the country average, and a large share of their population is extremely poor. Simultaneously, the agricultural sector in many, if not all, countries of the world suffer from something called the “farm problem”. The farm problem is the joint problem of the long-run tendency for incomes in the agricultural sector to be lower than in urban industrial sectors and the fluctuation in prices from year to year, which also lead to variability in incomes for farmer and other agricultural workers. The low incomes compared to other areas are due to technological and laborsaving advances, which have led to a higher supply than demand. Along with this employment in the sector has decreased. Further, fluctuations in farm prices often depend of factors that are beyond the control of the farmer such as floods and droughts, which affect the output. In order for the Mexican government to help its poor farmers survive and

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develop, despite the “farm problem” and the increased competition due to liberalization, it has to formulate policies that will be able to handle this.
5. Conclusions

In this chapter, I link my analysis to the purpose of the thesis by answering the three main questions. The chapter ends with a section where I discuss some reflections that appeared when working with this thesis and suggest alternative investigation within the area of the EU-Mexico FTA and other similar preferential trade agreements.

5.1 The EU-Mexico FTA and its Future

The FTA between Mexico and the EU can be described as relatively comprehensive in its composition, compared to other FTAs in the world, despite its short negotiation process. It includes five main areas: market access, customs procedures and rules of origin, public procurement, investment, and institutional issues and covers all trade-related matters that were established in the Global Agreement in 1997. It is the first FTA concluded between the EU and a Latin American country and could be considered as a role model for future FTAs concluded between the two continents. The FTA is an ambitious agreement, both economically and politically, as it does not solely include economic and commercial issues but also political relations and human rights issues and ambitions of participation of the civil society. By the formation of the FTA, the two parties have improved their possibilities to influence each other both economically and politically and this could lead to a deepening of the relationship already established.

In my investigation, I have chosen to analyze some particular aspects of the FTA, which in my opinion are significant for the comprehension of the relationship between Mexico and the EU. One of these aspects is the asymmetry between the two parties. Examining the negotiation process and the formation of the FTA, as well as the commercial statistics treated in this thesis, it is possible to observe slight asymmetries in both political and economic power between the two parties, Mexico being the weaker of the two. The negotiation process bear witness to some asymmetry in power, as the Mexican negotiators had to compromise when the European negotiators threatened to break off the negotiations. It appears that Mexico could not
afford losing the opportunity of forming an FTA with the EU and miss out on the positive political and economic effects it could bring. The choice of using EU regulations when rules of origin are concerned is also proof of some asymmetry in power. Using EU regulations for the determination of the origin of a product or a material could lead to accounting problems in Mexico followed by increased administration costs. Interchange of ideas on a political level, in so-called Joint Committees, together with the “The Civil Society Dialogue” can be seen as an attempt to help smoothing differences and asymmetries between the two parties of the FTA. The smoothing of differences seems to be important for both parties to enjoy the gains from the FTA, both when commercial and political relations are concerned.

In my analysis, I displayed yet another aspect, a probable indirect effect of the FTA, which could lead to problems in the relationship between the two parties of EU-Mexico FTA. The fact that the EU-Mexico FTA gives the EU access to a NAFTA member, might result in a situation where the European producers use the free entry of their products into Mexico, in order to convert their products in accordance with NAFTA rules of origin and further enter their products into the United States or Canada. This could lead to deflection in trade between the continents and inefficiency since the tariff levels between the two economic blocks could be evened out. On the other hand, the United States and Canada could also take advantage of this situation in a similar fashion and the future will tell if this is going to affect and change the existing trade patterns between the EU and NAFTA as a whole.

5.2 The EU-Mexico FTA and Welfare Effects

One of the principal purposes of forming a FTA is probably the gains from free trade that could be enjoyed by the country. Since the entering into force of the EU-Mexico FTA, according to my analysis, the effects on Mexican welfare from the elimination of tariffs on agricultural goods due to the FTA are ambiguous. The EU is Mexico’s second largest trading partner when agricultural goods are concerned but agricultural trade between the two is still small and it appears as if the FTA and the elimination of tariffs still is not able to influence the prices set on the international market. Hence, the
welfare effects that I encountered in my analysis are probably not only the
results of the FTA but also the effects of external events. Nevertheless, I still
account for and summarize these effects on welfare.

Due to a rise in prices of agricultural goods traded between Mexico and the
EU, trade in these products decreased after the year 2000. The rise in prices
of agricultural imports to Mexico from the EU, along with a possible
inelastic demand for agricultural goods, has had negative effects on
consumption and consumer surplus in Mexico has decreased. Increased
prices has probably led to a rise in producer surplus in Mexico and domestic
production has increased, while it has led to inefficiency within the Free
Trade Area and trade has been reduced rather than created. However, the
effect on production could have been moderate because of the normally
inelastic supply of agricultural goods. Even though prices of the agricultural
goods exported from Mexico to the EU also rose after integration according
to EUROSTAT, which might have led to an increase in income of the
Mexican producers that exports agricultural goods to the EU, these
producers have also lost market shares in the European market. This shows
that the specialization that should be taking place within the Free Trade Area
has not occurred yet within the agricultural sector. Neither has there been
any sign of Mexico redirecting its trade in agricultural goods towards the EU
and vice versa, hence there has not been any trade diversion within the Free
Trade Area after integration, despite elimination of tariffs on agricultural
goods. Simultaneously with the increase in prices of the agricultural goods
traded between the two parties, Mexico has lost the revenue it received
before from the tariffs levied upon EU imports.

In conclusion, despite an increase in producer surplus in Mexico and
probably domestic production of agricultural goods, the overall effects on
welfare after the year 2000, appear to be mostly negative. Differences in
production structure and costs as well as the economic and cultural distance
between the two partners, could have contributed to these negative effects on
welfare in general. However, the effects on welfare found in this
investigation are probably not solely the result of the formation of the FTA
but also the result of exogenous occurrences.
Chapter 5: The EU-Mexico FTA – Winners and Losers

I chose to examine two products, maize and coffee, as examples that hopefully could clarify the effects on the agricultural sector as a whole. Nevertheless, the development in trade in these sectors, after integration with the EU, has not given me much of guidance. Maize trade between Mexico and the EU is still too small to make any clear conclusion of the effects and it is hard to tell if the increase in trade in coffee (exports and imports), both in value and quantity in 2000, really was trade creation or simply just a recovery to equal levels as before integration. If trade was created it would probably benefit Mexican producers with increased exports of coffee. In general, consumers in Mexico would not be particularly affected by the elimination of tariffs on coffee, since imports of coffee from the EU is still very small. Unfortunately, because of the ambiguity of the results on maize and coffee, I chose to exclude them from the final summary of welfare effects in Mexico.

According to a number of analysts of the EU-Mexico FTA, the new FTA will bring some positive effects in the long run, despite the overall negative effects on welfare since the formation of the FTA in 2000. Instituto de Relaciones Europeo-Latinoamericana (IRELA) predicts that it will most probably increase trade between EU and Mexico significantly, that EU-Mexican trade actually could double within five years.¹ IRELA believes that in the medium term the trade balance will be improved and in the long term, Mexico’s trade deficit with the EU will probably disappear.² This could mean that in the medium and long run, Mexico will enjoy positive welfare effects as a consequence of the FTA with EU. Well, time will show!

5.3 The EU-Mexico FTA – Winners and Losers

Part of my purpose of this thesis was to find out if there were any groups in Mexican society that had benefited more from the FTA during the first two years after integration with the EU. Although my results of the welfare effects on Mexico are ambiguous and it is probably too early to be able to

² Ibid.
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make any certain conclusions of both production effects and consumption effects, I may conclude that it appears as if the effects found in my analysis are not only consequences of the elimination of tariffs on agricultural goods due to the FTA. However, I will try to speculate over who are the winners and losers the two years after integration with the EU and who might be winners and losers in the future if the purpose of the FTA is fulfilled.

From the formation of the FTA and until the end of 2001, the Mexican consumers are the obvious losers. Higher prices on domestically produced agricultural goods as well as of imported agricultural goods, including products from the EU, have most probably affected consumers negatively and especially the poor people living in both urban and rural areas. The expenditure on food and hence agricultural products of the poor Mexican people is large compared to their total income and a rise in prices would, in some cases, jeopardize the survival of these people. Looking further on the value of production and total trade in agricultural products, which also rose during the two years after integration, the negative effects on Mexican consumers are confirmed. Reduction of tariff revenue due to the formation of the FTA, could also affect the Mexican people and consumers negatively if this revenue is used as means for, for example, development programs or other support programs for the poor. However, this is just a speculation.

Mexican producers of agricultural goods may be seen as winners for the moment. High prices of imported goods have increased their production and their revenue. But they are losing market shares in the EU and if the trend continues, inefficiency in production and lack of specialization within the Free Trade Area might result in the commercial intentions of the FTA with the EU losing its purpose. Nevertheless, as I mentioned before, if the FTA leads to more competition in agricultural production within the Free Trade Area (as the theories on preferential trade suggest) and more trade is created between Mexico and the EU, the Mexican farmers could be outmaneuvered and become the losers of the preferential agreement. To prevent this from happening, the free trade strategy needs to be followed by complementary policies to support rural development in Mexico.

In the investigation and prognosis carried out by IRELA, it is concluded that during the first year after integration Mexican imports rose by 30 % and
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Mexican exports by 50%. In my analysis, I found a reduction in trade in agricultural products the first two years after integration and I therefore interpret the increase in trade belonging to the industrial sector. It is possible that the industrial sector has benefited from the elimination of tariffs and could be the big winner of the FTA so far. Nevertheless, since the purpose of the thesis was to look exclusively at the agricultural sector, I have no data to support this claim.

5.4 Reflections and Further Investigations

During the process of writing this thesis, to me a number of questions surfaced around the actual intentions behind the formation of the EU-Mexico FTA and the relevancy of the FTA for the Mexican people. The formation of an FTA is principally a political decision, decided far from the minds of the ordinary Mexican, going to work, taking care of its children or simply trying to find a way to survive. What lies behind the liberalization strategy conducted by Mexico the last decades? Is the strategy to liberalize trade beneficial for the majority of the Mexican people? Do the poor Mexican farmers really have an understanding of the effects of an FTA? Do the know how to influence politicians in this matter? Do they actually have the power to influence or are they only pawns in the game?

The democratization process that was started in Mexico in the 1980’s was accompanied by the liberalization of the economy and consequently also a liberalization of its trade. It is possible that the new reforms and policies were realized upon conditions put on Mexico by financers such as the United States and the International Monetary Fund (IMF), which contributed in helping Mexico to overcome the economic crises the country experienced in the 1980’s and 1990’s. Since then, many Mexicans have benefited from new political rights and new economic opportunities. However, in my opinion, the political decisions to liberalize trade with 31 different partners has been made very far from many Mexicans and especially far from the farmers living in the remote underdeveloped areas of Mexico. Their knowledge about the effects of free trade is probably limited as well as their power to influence it, even though the will and ambitions of many Mexicans, to improve their every-day lives, are very high. The lack of power to
influence politicians in their decision breeds ignorance among people. As a consequence, political decisions become irrelevant to them.

As many poor people all over the world, the Mexican farmers are deeply affected by globalisation. Faced with competition from countries with highly modernized and efficient agricultural production, these farmers have a hard time surviving on their coffee, tomato, banana or maize plantation. What they probably do know about globalisation is that they suffer from it. Many of these farmers, mainly from the underdeveloped southern states, move into the ever-growing mega city of Mexico City, hoping to find a living or they try to cross the border into the United States. If they are lucky not to get caught or killed while crossing the border, these farmers meet even more difficulties as illegal immigrants in the United States. However, in many cases it is worth the effort to escape the hardships in Mexico. For them survival is relevant.

I believe that when examining the welfare effects in Mexico of the EU-Mexico FTA, or of any FTA that Mexico has entered into, it is always important to keep this in mind. It is important to keep the reality near at hand when diving into the world of economics with constructed models and theories often difficult to apply on reality. However, I believe that the dive is a step closer to understanding reality, even though the dive could be done with another technique and from another height than what I have chosen to do it. It could be done again in a couple of years, using more data, other sectors or by examining yet another FTA. It could also be done from the perspective of the public choice theory, trying to find the underlying intentions of the formation of the FTA or any other FTA for that matter. Well, no matter how we dive or what kind of water we dive into, I believe it is important to dive as it takes us one step closer to understand the world and the economics behind it.
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