

EU-Mercosur Trade Relations: Impacts of Exchange Rate Misalignments on Tariffs

Vera Thorstensen, Emerson Marçal
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Abstract

The issue of “trade and exchange rate misalignments” is being discussed at the G20, IMF and WTO, following an initiative by Brazil. The main purpose of this paper is to apply the methodology developed by the authors to exam the impacts of misalignment on tariffs in order to analyse the impacts of misalignments on the trade relations between two customs unions - the EU and Mercosur, as well as to explain how tariff barriers are affected. It is divided into several sections: the first summarises the debate on exchange rates at the WTO; the second explains the methodology used to determine exchange rate misalignments; the third and fourth summarises the methodology applied to calculate the impacts of exchange rate misalignments on the level of tariff protection through an exercise of ‘misalignment tariffication’; the fifth reviews the effects of exchange rate misalignments on tariffs and its consequences for the trade negotiations between the two areas; and the last concludes and suggests a way to move the debate forward in the context of regional arrangements.



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Introduction

After the financial crisis of 2008, persistent misalignments of exchange rates raised the concern of some G20, IMF and WTO members that the issue should not be left out of a multilateral debate. Besides discussion at the G 20 and IMF, Brazil took the initiative to bring the issue to the WTO to analyse the impacts of misalignments on trade. In April 2011, Brazil presented a submission to the Working Group on Trade, Debt and Finance (WGTDF) suggesting a work programme to be initiated by academic research on the relationship between exchange rates and international trade based on a paper to be elaborated by the Secretariat (WT/WGTDF/W/53). In September 2011, Brazil presented to the same Working Group a second proposal on the theme, suggesting the analysis of available tools and trade remedies in the multilateral system that might allow countries to redress the effects of exchange rate misalignments (WT/WGTDF/W/56). The WTO Secretariat presented its Note on a Review of Economic Literature, dated 27 September 2011 (WT/WGTDF/W/57), as mandated by the Working Group. As expected, the conclusions were that a conclusion could not be reached because the Secretariat's work reflected "IMF language", not "WTO language". Although this work presents extensive research, encompassing the effects of exchange rates on economic flows, it did not touch on the issue of the impact of exchange rate misalignments on WTO principles, rules and its instruments: tariffs, antidumping, subsidies, safeguards, rules of origin, GATT Articles I, II, III, XXIV, just to name some of the rules that are certainly affected by exchange rates. In March 2012, a seminar on exchange rates took place at the WTO. The participants at this seminar concluded that exchange rate misalignments can affect trade and that the discussion should continue among WTO and IMF members.

The first research findings on the impact of exchange rate misalignments were published by the authors of this paper in the *Journal of World Trade*.¹ A methodology was developed to estimate how misalignments could affect the level of bound and applied tariffs of Brazil, US and China. It also concluded that tariffs of overvalued countries could be significantly reduced or nullified, and tariffs of undervalued countries could be raised above bound tariffs, affecting their commitments at the WTO. It explored how GATT Articles I and II could be affected.

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¹ See Vera Thorstensen, Emerson Marçal and Lucas Ferraz, "Impacts of Exchange Rates on International Trade Policy Instruments: The Case of Tariffs", *Journal of World Trade*, Vol. 46, No. 3, 2012.

In November 2012, Brazil presented its third proposal, focusing on how the exchange rate was dealt with in the history of the WTO and how trade remedy rules are inadequate to deal with the issue (WT/WGTDF/W/59). Once again, no conclusions could be reached and members agreed to continue the discussions in the WTO, inviting the IMF to be represented in the next meetings.

The objective of this paper is to study the impact of exchange rates misalignments on GATT Article XXIV, on regional arrangements, and to draw some lessons to be applied in the negotiations of a preferential arrangement of two customs unions – between the EU and Mercosur. In summary, one of the most contentious issues is how to neutralise the effects of exchange misalignments on the negotiation of tariffs.

1. EU-Mercosur PTA negotiations

The EU and Mercosur have been negotiating a preferential arrangement since 1995, when a political decision was reached to launch an ambitious trade agreement between two customs unions. Seventeen years later, negotiations are still ongoing. All important aspects of the preferential agreement have been already tabled, but the main obstacles remain the same since the beginning: market access in the EU for agricultural goods from Mercosur and market access in Mercosur for industrial goods from the EU.

After huge efforts in the negotiations from both sides, exporters are eager to reach new markets but domestic producers are worried about the impact of the present economic crisis on their markets.

This paper argues that negotiations should be diverted from the old trade issues of tariffs and tariff quotas, because due to the significant effects of misalignments on tariffs. A better idea should be to concentrate on non-tariff barriers as customs practices, facilitation, rules of origin, TBT, SPS, private standards, competition and investment, that is, on rules to reduce the differences between partners' practices. And only after a solution to neutralise the effects of exchange misalignments on tariffs can be negotiated between the partners or at the WTO should discussions on tariff reductions be resumed.

2. An incomplete debate: To discuss trade without exchange rates in the WTO and exchange rates without trade in the IMF

Since the GATT, the IMF and the World Bank were created in the 1940s, a strict division of functions was established: the GATT would be responsible for international trade regulation and liberalisation, the IMF would maintain the stability of exchange rates and balance of payments, and the World Bank would provide funds for Europe's reconstruction, after World War II. The multilateral trade system was created at that time based on the dollar/gold standard, and even after it was changed to the flexible exchange system in the 1970s, the exchange rate debate remained restricted to the IMF and was not comprehensively discussed either by GATT or WTO rules.

However, the relationship between trade and exchange rates has been briefly explored both by the IMF and the GATT.

In the IMF – Provisions on the intersection between trade and exchange rates and against exchange rate manipulation were clearly set out in Article IV of the IMF's Articles of Agreement:

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries,...

In particular, each member shall: ... (iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; ...

With the end of the gold standard and the advent of the flexible exchange rates system, Article IV was amended in 1977 to adapt the Fund to the new reality of floating exchange rates. In reality, the mandate to monitor members' practices on their exchange rates was never effectively realised. Only after the 2008 financial crisis was the debate raised at the G20 and the mandate was changed, strengthening the surveillance function and amplifying it to include financial stability. On 18 July 2012, a new decision was adopted by the Executive Board of the IMF - Decision on Bilateral and Multilateral Surveillance, establishing new rules.

In the WTO - Provisions related to the relationship between trade and exchange rates were included in the GATT, at the time it was established in 1947. Article XV of the GATT has negotiated rules for exchange arrangements. Article XV.4 states:

Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund.

So far, there are no examples in the WTO of the application of the Article XV.4, due to the fact that no member has ever questioned another member's exchange rate arrangements, as it requires the establishment of a panel as well as time for its members to reach a conclusion. Aside from the difficult matter of how to define the concept of 'frustrated purposes', the main question is whether the WTO has to consult the IMF in such cases.

Due to the escalation of exchange rate misalignments, which is responsible for conflict between the US and China, as well as other Asian countries, several experts are examining the issue concerning the exchange rate impacts on the international trade regulatory system, in order to define whether these misalignments could represent a violation of WTO rules. Although many attempts to use trade remedies, such as antidumping and countervailing measures, to offset the exchange effects have been made, the results appear to be legally questionable, since trade remedies were not negotiated or agreed as mechanisms to inhibit the use of exchange rates as unfair trade.

In other words, the issue concerning how exchange rate variations affect trade has never been incorporated to the WTO rules. The only rule on which there is consensus is that the exchange rate is an IMF matter. The problem is that the IMF is an international organisation which does not have an enforcement mechanism such as the WTO's Dispute Settlement Body. It decides the relevant issues through an agreement amongst the most influential parties (those who wield more voting power) in a political way. Unlike the WTO, which decides by consensus, the IMF does not work through negotiation. Also, as noted above, the IMF role as a tight controller of exchange rates has since the 1970s been transformed into a permissible survey of balance of payments.

Since the 1990s, the discussion became more interesting with the work of several economists who started to calculate exchange rate misalignments, developing methodologies to calculate misalignments of exchange rates in relation to some equilibrium rates. There are several models for calculating equilibrium exchange rates: the purchasing power parity, the equilibrium of current account, the equilibrium of assets and liabilities flows, or the exchange rate based on the unit of labour costs.

When reviewing all these studies, it becomes quite evident that the magnitude and the extension in time of these exchange rate misalignments for the main currencies are so

significant that ignoring their effects on trade might undermine the objectives of the whole multilateral system.

Confronting the numbers, one can even ask whether the discussion on manipulation is well placed. Misalignments are presented in almost all currencies. To establish an objective criterion to define manipulation will not be easy. But the main questions are still unanswered: What can be done about trade distortions? How to ensure the efficiency of trade instruments? What about the impact on regional agreements?

The argument that different methodologies for measuring exchange misalignments produce different results can no longer be used to prevent the issue from being discussed. The main target is not to search for an estimate with an absolute degree of precision, but rather to discover limits where misalignments can cause trade distortions. What really matters is to find a threshold at which trade policy instruments become ineffective and the WTO rules might be nullified.

The conclusions are clear: exchange rate misalignments are such an important issue that discussions in the IMF alone are not sufficient. Their effects on trade instruments are so discriminatory that they must also be discussed at the WTO.

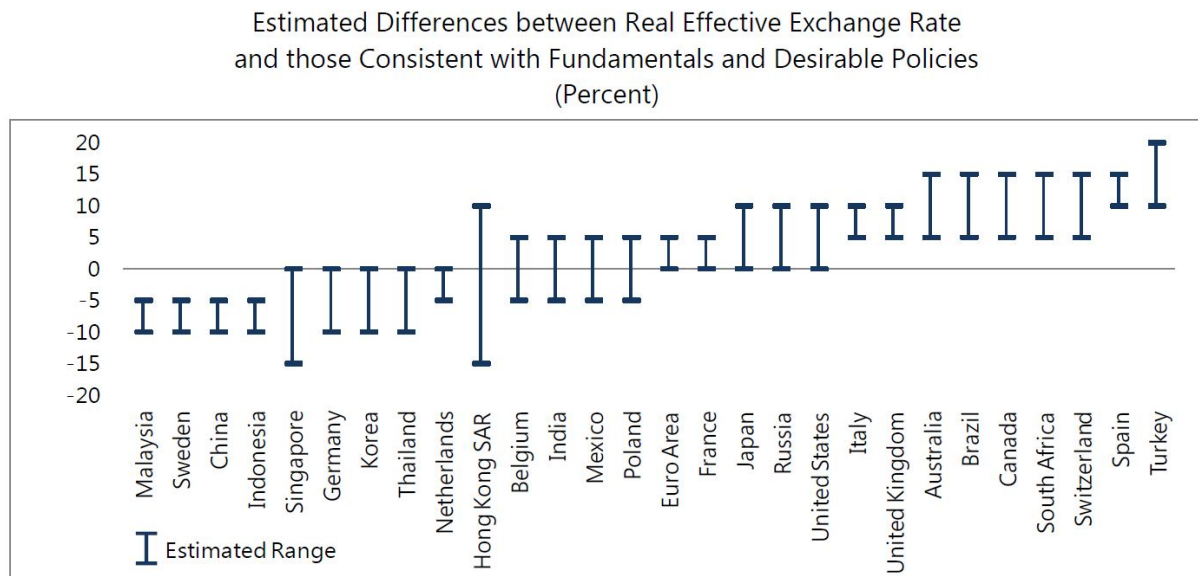
3. Estimating exchange rate misalignments

There are different methodologies for calculating exchange rate misalignments in the literature. The IMF is the most important source of data on misalignments. The Fund presents its estimates in the annual Reports on Article IV for almost every country. Until July 2012, the estimates were carried out by the Consultative Group on Exchange Rates (CGER), using three methodologies: the macroeconomic balance approach, the equilibrium real exchange rate approach and external sustainability (IMF, Research Department, Methodology for CGER Exchange Rate Assessments, 8 November 2006).

On 18 July 2012, a new methodology was modified by the Decision on Bilateral and Multilateral Surveillance. Under the new External Balance Assessment (EBA) methodology, the analysis was broadened from exchange rates to detailed examinations of current accounts, reserves, capital flows and the external balance. Three methods were developed, of which two are based on panel regression: the current account regression approach and the real exchange regression approach. The third is based on a sustainability analysis, a model-free approach where the current account gap is the difference between the level of the projected current account and the current account that would stabilise the net foreign asset at a benchmark level (IMF, Pilot External Sector Report, 2 July 2012, Annex I).

Unlike traditional Article IV surveillance reports published by the Fund, which concentrate on a single country's financial and economic position, this new exercise focuses on global external imbalances, estimating current account targets that better represent the Fund's estimates for selected countries' fundamentals and best policies. The results vary slightly from the averages obtained from each individual Article IV report and are available below.

Figure 1. IMF estimated misalignment – The multilateral approach



Source: IMF staff calculations.

Estimates by the FGV Observatory on Exchange Rates

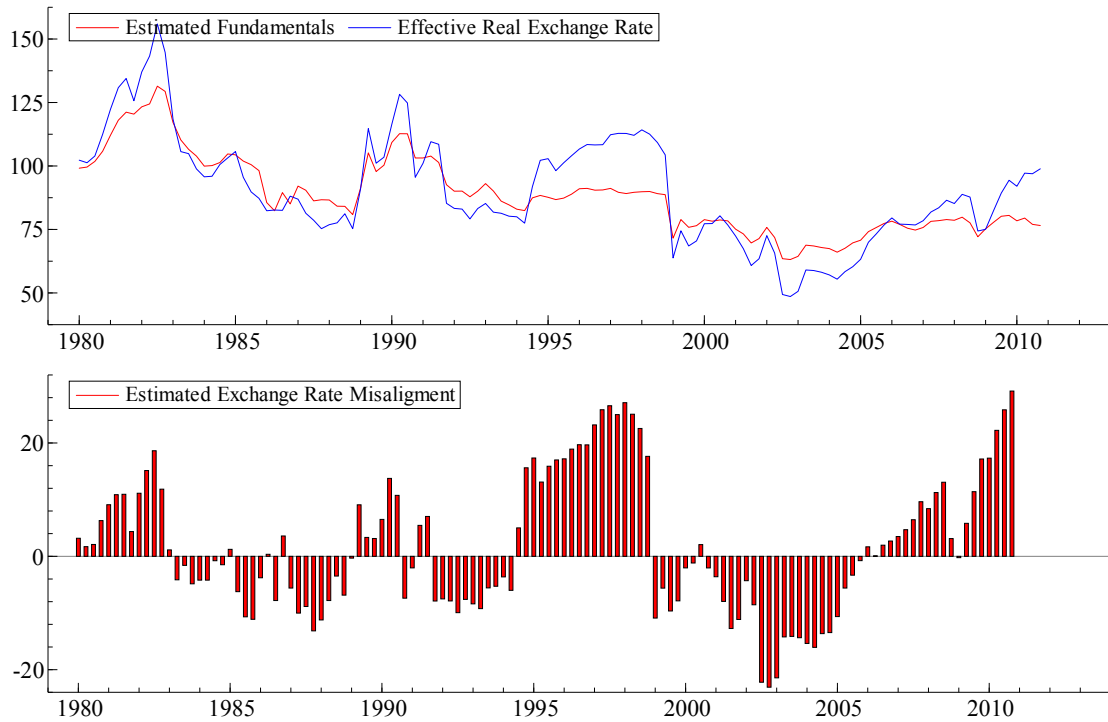
The FGV (Getulio Vargas Foundation) Observatory on Exchange Rates at the São Paulo School of Economics has been calculating exchange rate misalignments since 2009. The Observatory estimates real equilibrium exchange rates that by using an econometric model of co-integration.²

Estimates of exchange rate misalignment are made following the methodology based on the analysis of long-term fundamentals of the real exchange rate using a vector autoregressive model with error connection term as the econometric model. It used as fundamentals the net foreign investment position, terms of trade and an indicator of difference in productivity in the sectors of tradable and non-tradable goods. There is theoretical justification for such choice, and the relationship between the real exchange rate and these variables is empirically validated as shown by Faruquee (1995), Alberola et al. (1999) and Kubota (2009).

Estimates of Brazil, US and China are presented in Figures 2, 3 and 4.

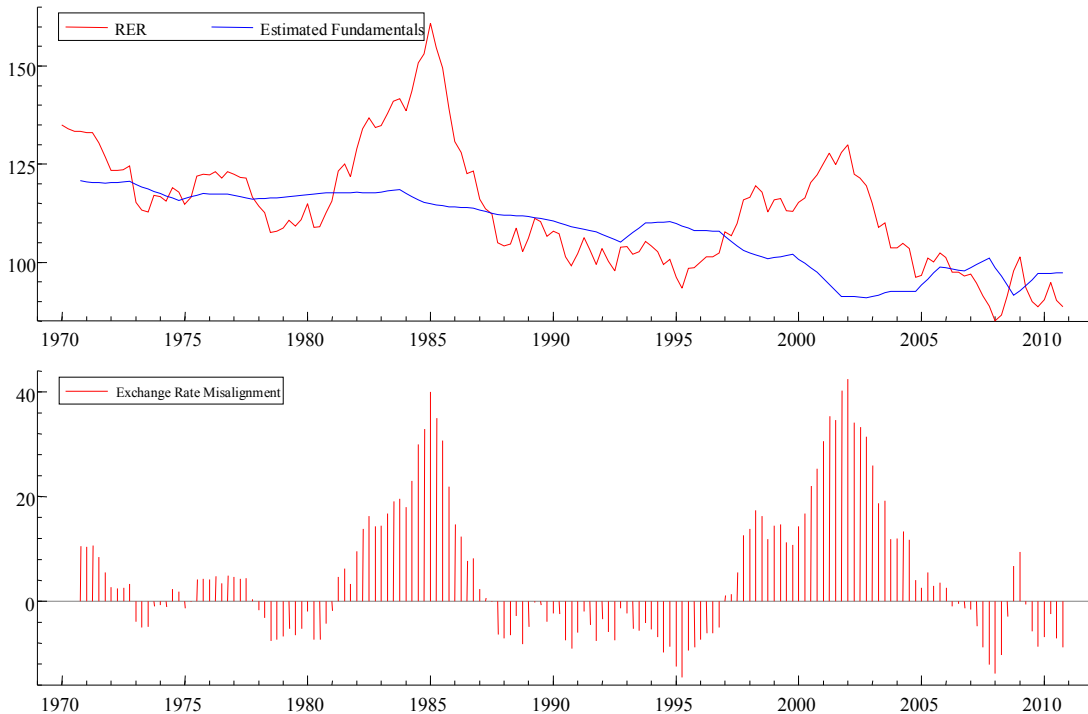
² The methodology is presented in Thorstensen et al., op. cit.

Figure 2. Brazil: Real exchange rate, fundamentals and exchange rate misalignments (quarterly)



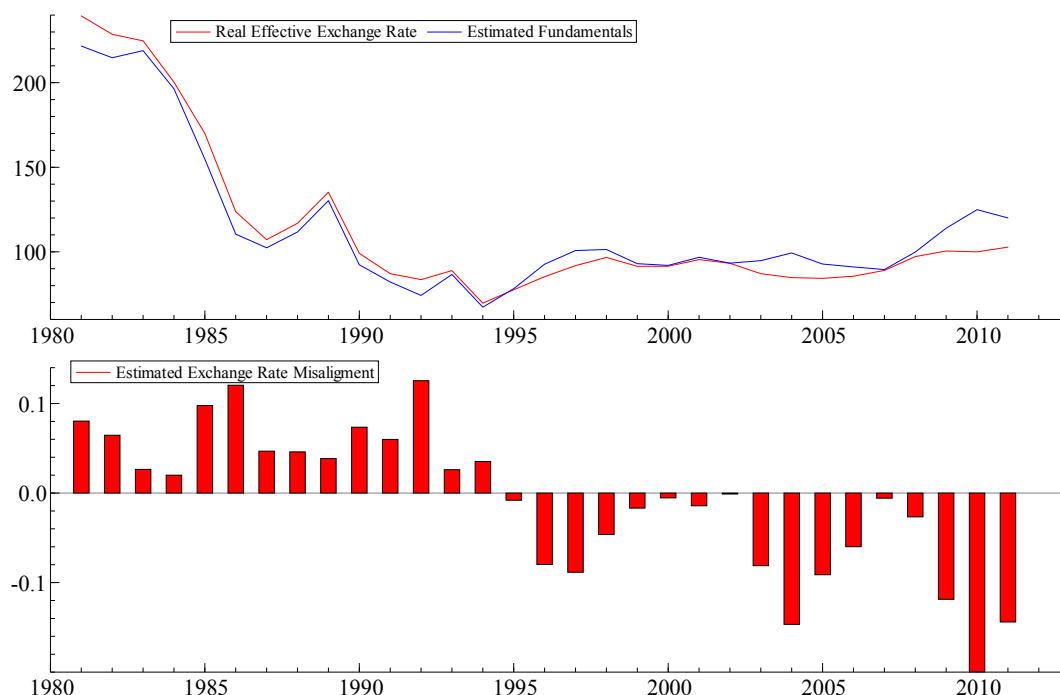
Source: Misalignment estimates – Observatory on Exchange Rates - EESP/FGV (2012).

Figure 3. US: Real exchange rate, fundamentals and exchange rate misalignments (annually)



Source: Misalignment estimates – Observatory on Exchange Rates - EESP/FGV (2012).

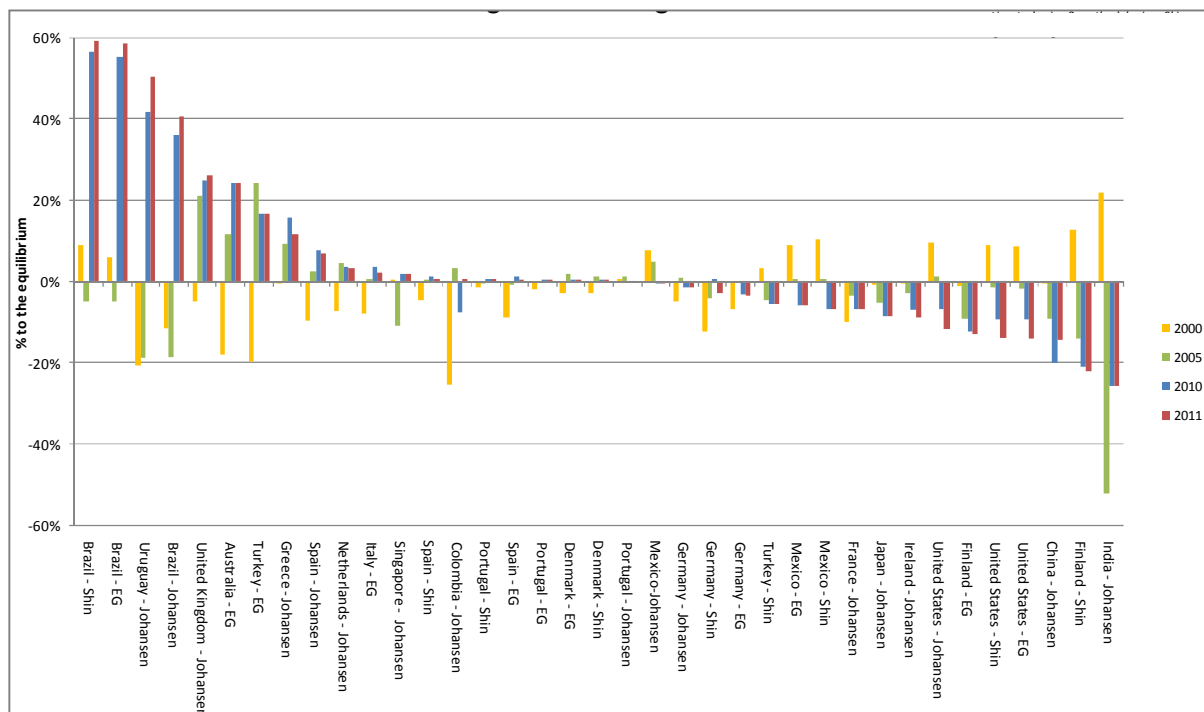
Figure 4. China: Real exchange rate, fundamentals and exchange rate misalignments (1980-2010)



Source: Misalignment estimates – Observatory on Exchange Rates - EESP/FGV (2012).

In order to allow for some degree of comparability, some selected countries estimates for different years: 2000, 2005, 2010 and 2011.

Figure 5. Selected countries: Exchange rate misalignments (2000, 2005, 2010 and 2011)

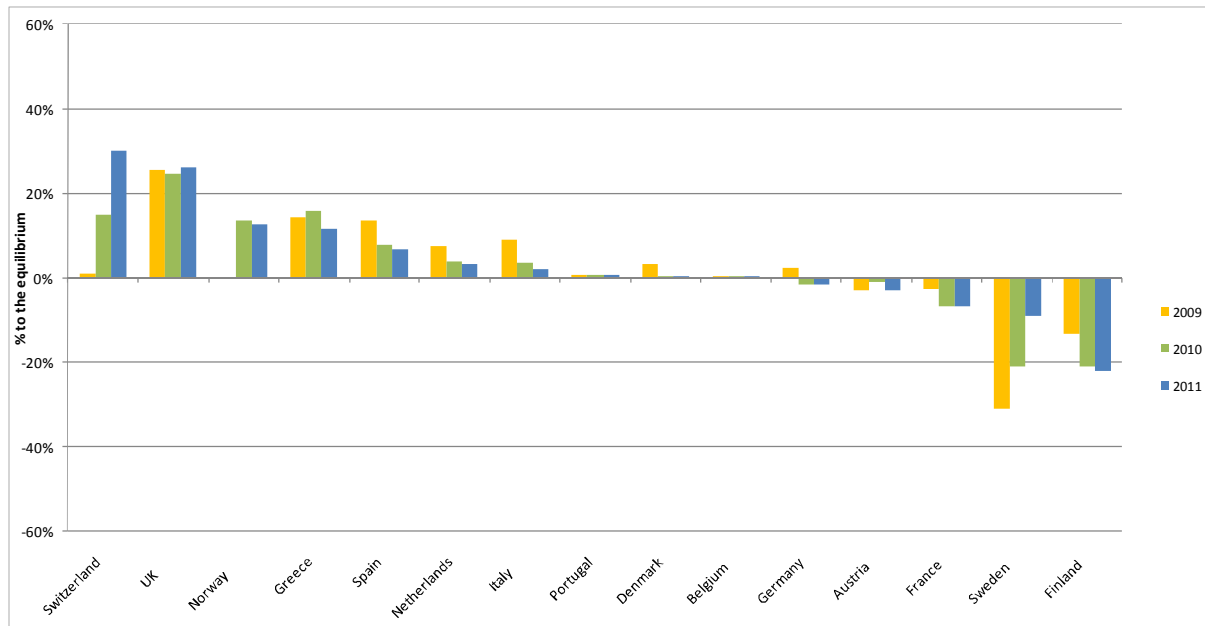


Source: Misalignment estimates – Observatory on Exchange Rates - EESP/FGV (2012).

For more recent years, exchange rate misalignments were also estimated for some European countries. It is interesting to note that the UK and Norway, which do not belong to the

eurozone, are overvalued. On the other hand, Finland (eurozone) and Sweden (outside the eurozone) are undervalued.

Figure 6. Exchange rate misalignments for selected European countries

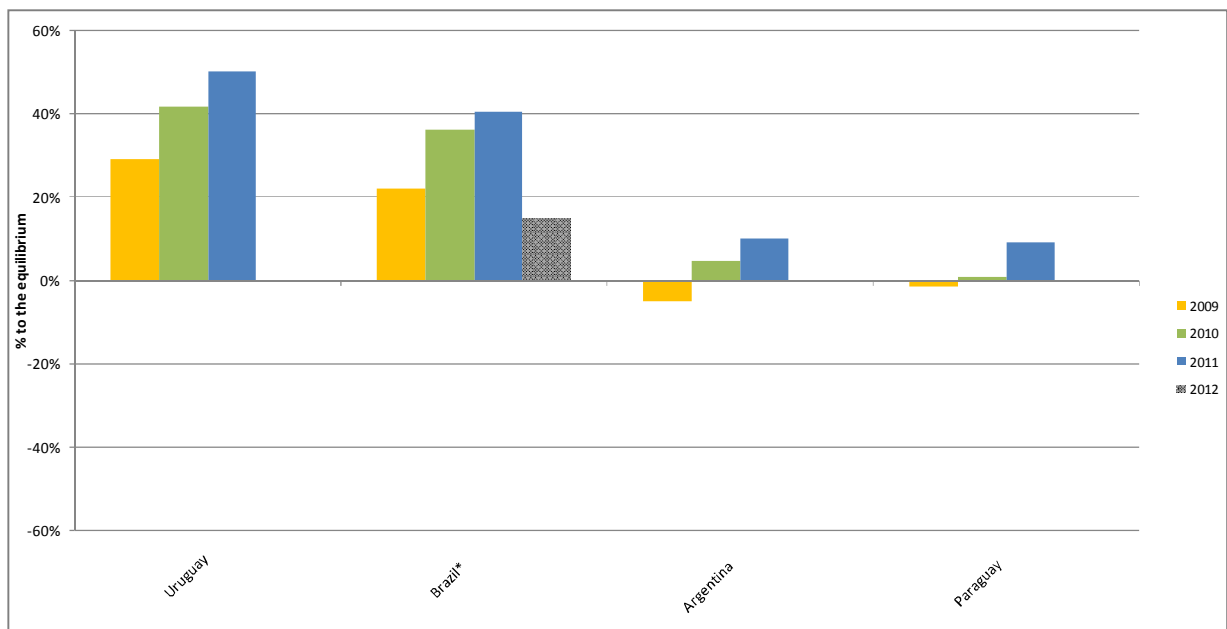


Note: Swiss 2011 misalignment estimate at its highest peak of overvaluation before CB intervention.

Source: Misalignment estimates - Observatory on Exchange Rates - EESP/FGV (2012).

For Mercosur, in 2011, all four countries were overvalued.

Figure 7. Exchange rate misalignments - Mercosur members



Note: Brazilian 2012 misalignment is estimated considering real effective exchange rate appreciation after Brazilian CB intervention.

Source: Misalignment estimates - Observatory on Exchange Rates - EESP/FGV (2012).

4. Examining the effects of exchange rate misalignments on bound and applied tariffs

In order to evaluate the impact of exchange rate misalignment on tariff levels, a methodology was developed aiming to convert misalignments on tariffs and adjusting bound and applied tariff levels to their full impact. This is achieved with a formula that allows the tariffication of misalignments, following the tradition of the GATT/WTO negotiations. The details of the methodology are presented in Thorstensen et al.³

Having the estimates of misalignments and a methodology to transform them into tariffs, the next step is to exam the effects of these adjusted tariffs on the tariff rates notified to the WTO. The effects of exchange rate misalignments on either bound and applied tariffs can be analyzed through each country tariff profile.

Tariffs are GATT's historical instrument for trade protection and one of the main negotiating subjects included in multilateral rounds. In the cases of preferential agreements, it is the core of the negotiations, since GATT determines that duties and other restrictive regulations should be eliminated with respect to substantially all the trade partners (GATT Article XXIV-8).

The concepts of tariff and tariffication are the core of the GATT/WTO logic. Estimates of *ad valorem* equivalent rates of several duties expressed on a monetary basis, such as specific rate duties, can be obtained and are published by the WTO Secretariat. As demonstrated in the preceding section, exchange rate misalignments can also be tariffied through the calculation of a tariff equivalent. Just like tariffs, the effect of the exchange rate can be transferred to imported and exported goods' prices.

The tariff profile of each WTO member can be shown by a figure showing tariff averages for each chapter of the Harmonized Commodity Description and Coding System - HS (97 chapters), which includes: foodstuff, mineral, textiles, machines, electronics, vehicles and aircraft, amongst others.

4.1 Impacts of exchange rate misalignments on tariffs levels

With the tariffication of exchange rate misalignments, some simulations can then be developed based on the estimates of these misalignments and its tariff equivalents, or, in other words, with the tariffication of exchange rates.

It is important to emphasise that this exercise is not searching for the precise value of the exchange rate misalignments, but the threshold beyond which trade policy instruments and rules can be undermined. Negotiators, with these numbers at hand, could figure out how to neutralise the effects of exchange rate misalignments on trade and to regain the effectiveness of their tariffs and other GATT/WTO rules.

The values of tariffs used in this paper were obtained in the WTO database (*Tariff Analysis Online*) and dated from 2011-12. Mercosur countries have 100% *ad valorem* tariffs, but the Common External Tariff of Mercosur (TEC) is not completely uniform since each member presents its own list of exceptions: Brazil and Argentina have 200 products, and Paraguay and Uruguay 300 products, all at HS 8 digits level.

The EU tariff profile includes *ad valorem* as well as specific tariffs. In this exercise, the EU tariff profile is portrayed at HS 2 digits, including only available *ad valorem* simple averages (no specific tariffs or AVE - *ad valorem* estimates were used), in the same manner as published by WTO database.

³ See Thorstensen et al., op. cit.

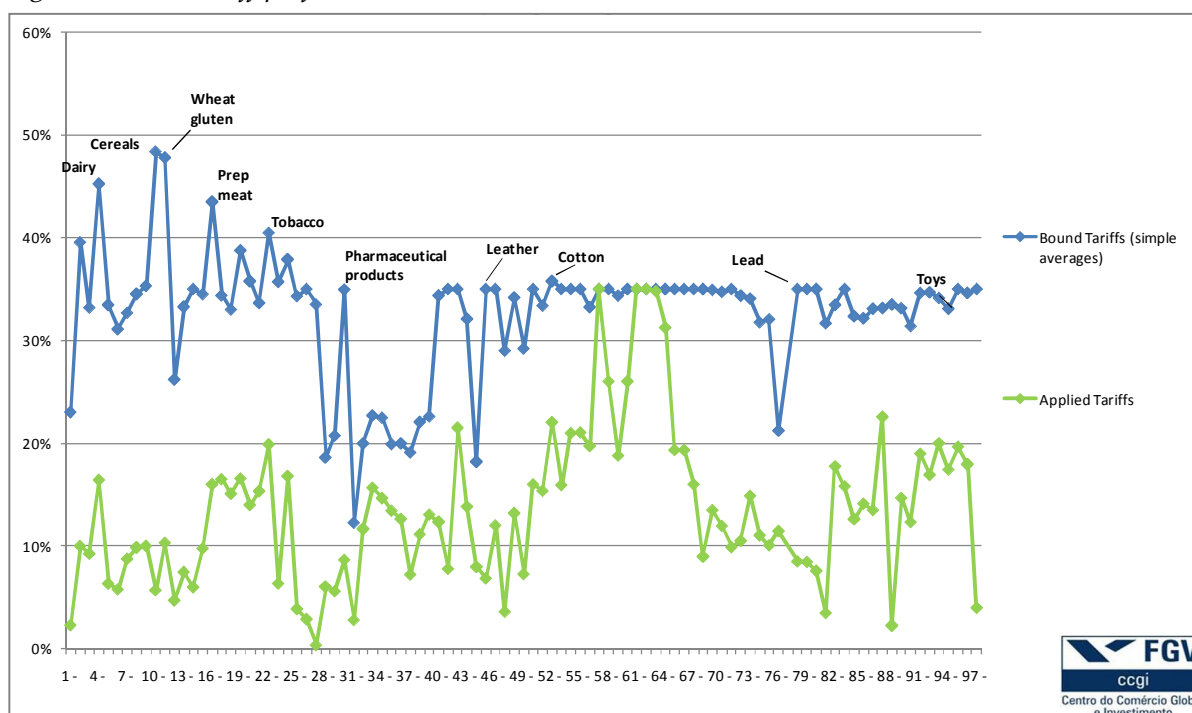
The following simulations present a comparison of bound tariffs, applied tariffs and adjusted tariffs (after the tariffication exercise), measuring tariffs as a simple average at HS 2 digits. For exchange rate misalignments, this paper uses approximated values calculated by the FGV - Observatory.

Simulations

i) Brazil's tariff profile

- Brazil's tariff profile is presented here in HS 2-digit simple averages with its 97 chapters.
- Bound tariffs vary from 16% to 50%.
- Applied tariffs vary from 0.5% to 35%

Figure 8. Brazil tariff profile



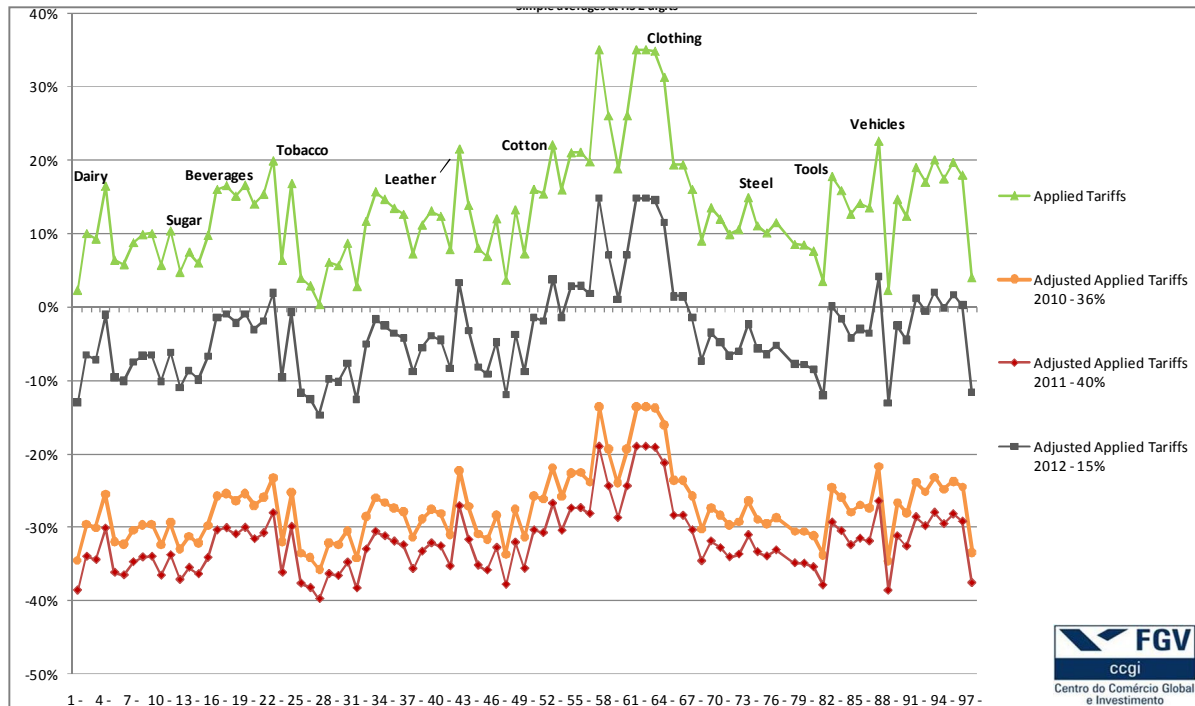
Sources: Tariffs - WTO (2011) / Misalignment estimates - Observatory on Exchange Rates - EESP/FGV (2012).

Introducing the exercise of exchange rate misalignment tariffication, three profiles can be presented for Brazil:

- 2010: -36% overvaluation
 - Brazil's average applied tariffs, which currently vary from 0.5% to +35%, due to exchange rate overvaluation, were varying from -36% to -14%. As a consequence, all adjusted tariffs are negative, meaning that Brazil has no tariff protection, offering a stimulus to imports instead.
- 2011: -40% overvaluation
 - Brazil's average applied tariffs, which currently vary from 0.5% to +35%, due to exchange rate overvaluation, were varying from -40% to -19%. More than in 2010, all adjusted tariffs are negative, meaning that Brazil has no tariff protection, offering yet a bigger stimulus to imports.
- July 2012: -15% overvaluation

- Brazil's average applied tariffs, which currently vary from 0.5% to +35%, due to exchange rate overvaluation, vary presently from -15% to +15%. For this level of misalignment, only products classified between chapters 49 to 63, mainly textiles and apparel, still present positive degrees of protection.

Figure 9. Brazil tariff profile and adjusted tariffs: Effects of Brazil exchange rate overvaluation (2010-12)



Note: Simple averages at HS 2 digits.

Sources: Tariffs - WTO (2012) / Misalignment estimates - Observatory on Exchange Rates - EESP/FGV (2012).

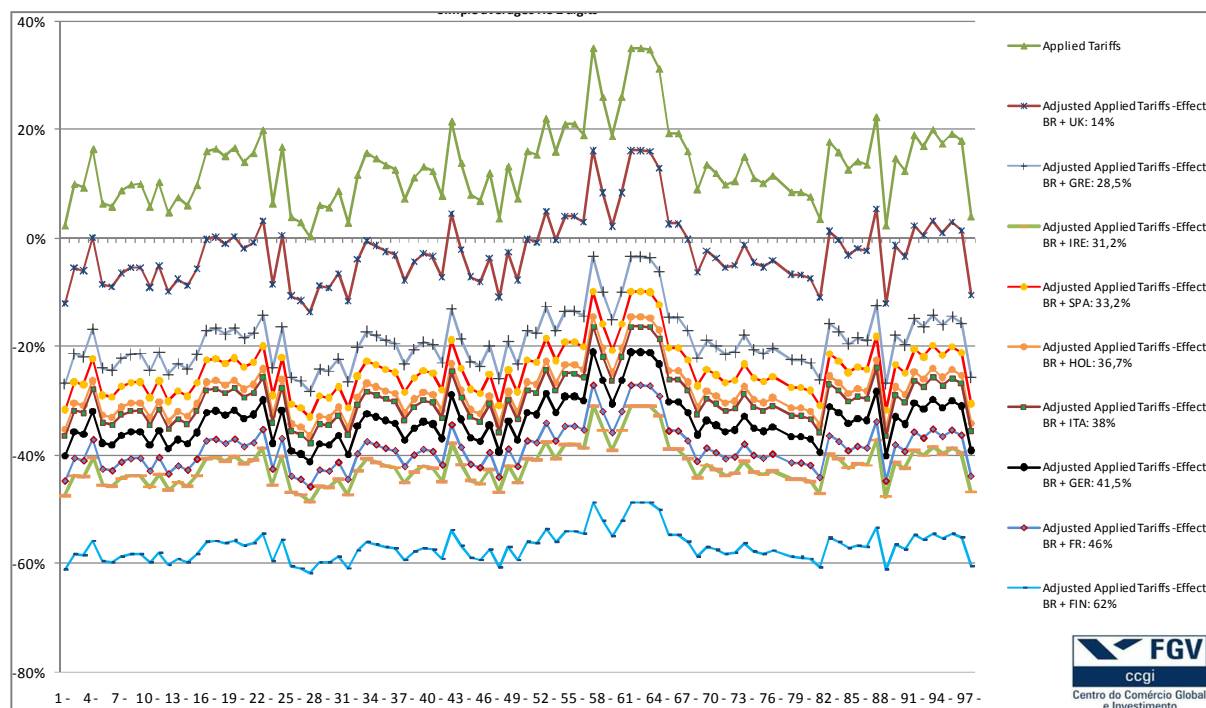
ii) Brazil's market access for some European countries

Following the tariff profile of Brazil, one can examine the market access granted for products from different European origins, each adjusted to their own exchange rate misalignment added to the Brazilian exchange rate overvaluation.

For 2011, the consequences are:

- Brazil's average applied tariffs, which currently vary from 0.5% to +35%, vary considerably due to European exchange rate misalignments.
- The only case that includes some positive values is the UK, mainly for textiles and apparel. For other products, Brazil's tariffs will be nullified.
- For some other European countries, Brazil's tariff will vary from -62% to -3.5%. As a consequence, all adjusted tariffs are negative, meaning that Brazil has no tariff protection. The most interesting case is Finland, where Brazil's adjusted tariffs vary from -62% to -49%.

Figure 10. Brazilian market access for selected European countries (2011)



Note: Simple averages at HS 2 digits.

Sources: Tariffs - WTO (2012) / Misalignment estimates - Observatory on Exchange Rates - EESP/FGV (2012).

iii) EU market access

The same simulation can be made for the EU.

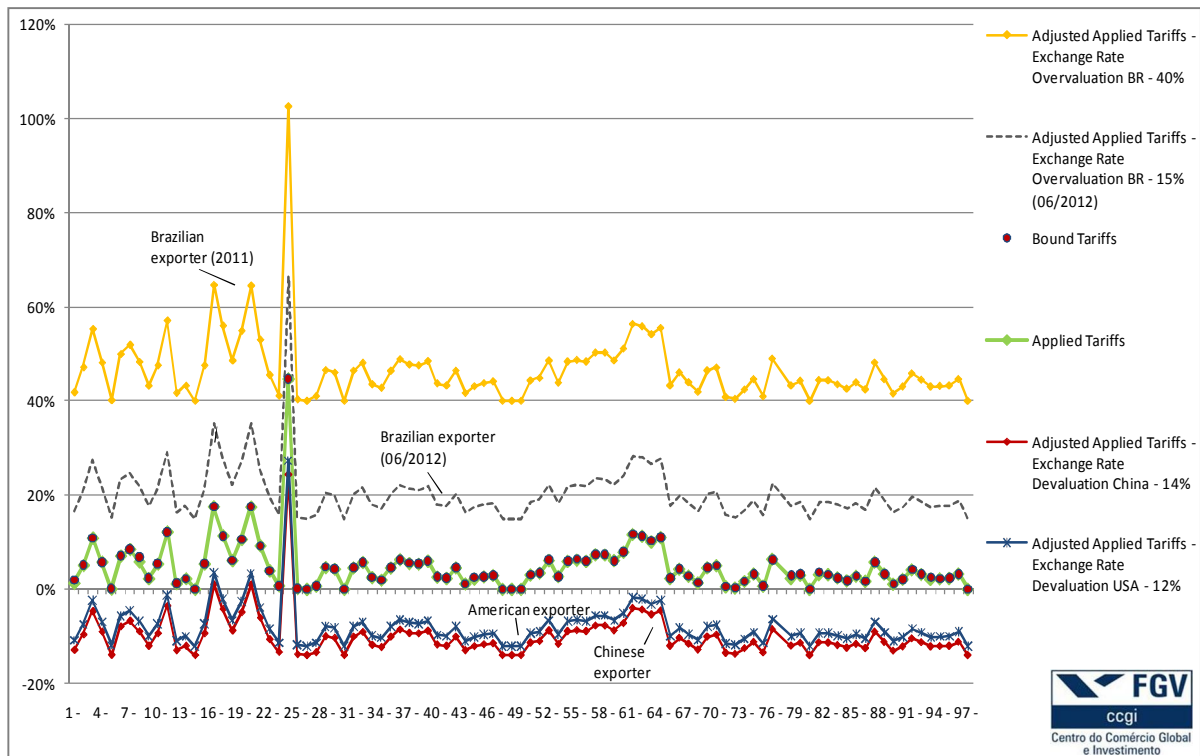
The EU's bound and applied rates have average values that vary from 0% to +18%, with a notable exception for Chapter 24 for which the tariff rate average reaches 45% (tobacco).

Assuming the euro exchange rate is in equilibrium, the access granted to the EU market will vary depending on the misalignment of other countries:

- For Brazil, the EU adjusted tariffs varied, in 2011 (40% overvaluation), from +40% to +65% (excluding Chapter 24); and for July 2012, they vary from +15% to +35%.
- For China, the EU adjusted tariffs will vary from -14% to +1%.
- For the US, the EU adjusted tariffs will vary from -12% to +3.5%.

As a consequence, the EU tariff profile, when adjusted by exchange rate misalignments, due to the overvaluation of Brazil, will be higher than the bound rate notified to the WTO. For China and the US, on the other hand, due to both countries' exchange rate undervaluations, the EU tariff profile will be negative, representing no protection to the EU market and better access by the US and China compared to Brazil.

Figure 11. Selected countries' adjusted access to the EU market



Note: Simple averages at HS 2 digits – Exchange rate misalignments for 2011-12.

Sources: Tariffs – WTO (2012) / Misalignment estimates – Observatory on Exchange Rates - EESP/FGV (2012).

In conclusion, the co-existence of two kinds of exchange rate misalignments, one of overvaluation and the other of devaluation, when substantial and sustained for extended periods of time, represent a serious distortion for many international trade policies. This observation is especially true for tariff policy, which is one of the core trade instruments not only at the WTO but for all preferential trade agreements.

5. Final conclusions

For seven decades, the discussion on exchange rate misalignments was monopolised by the IMF. But as shown in the preceding pages, the IMF lost its function as supervisor of exchange rates in the 1970s with the end of the dollar/gold standard. After the reforms of 1997 and 2007, exchange rate misalignments returned secondarily to become the focus of the Fund, and only in 2012, with a new mandate from the G20, a decision was reached for the Secretariat to start examining the impact of members' exchange rate policies on other members' economic stability, through new bilateral and multilateral surveillance mechanisms. It is too early to see the results, but the prospects do not seem particularly promising as an instrument of trade. The discussions are to be treated as confidential between the Fund and each member, and even after the multilateral surveillance finds a member practicing currency manipulation, the decisions of the Board are not mandatory. The IMF has no political leverage to bring a member into conformity, as in the WTO.

As a consequence, even after the IMF reforms, the impact of misalignments on trade instruments was not addressed. Tariffs are a good example to highlight. Tariffs are still an important international trade policy instrument for many WTO members, representing the single instrument allowed for market protection in accordance with WTO rules. For decades,

negotiations on tariffs were the main objective of the GATT rounds. For preferential trade agreements, tariffs are still the main topic of negotiations.

This paper presents clear evidence of the effects of exchange-rate misalignments on tariffs, as follows:

- For countries with overvalued exchange rates, depending on the level of such appreciation, their bound and applied tariffs can be nullified and become negative, implying that the country is granting a stimulus to imports and waiving the tariff protection level negotiated within the WTO.
- For countries with undervalued exchange rates, depending on the level of such depreciation, their bound and applied tariffs can be increased in greater proportions than the exchange rate. For countries with a small difference between applied and bound tariffs, any depreciation may imply that applied tariffs surpass the limits negotiated within the WTO, violating GATT Article II, establishing that no member can apply tariffs bigger than the bound tariffs.
- Considering bilateral misalignments, even GATT Article I – non-discrimination among nations – can be affected because the tariffs between every pair of countries will vary under the effects of their exchange rates, which may result in different levels of protection vis-à-vis third countries, in violation of the Most Favour Nation (MFN) treatment obligation.
- Considering preferential trade agreements, exchange rate misalignments can affect the general incidence of tariffs to third countries when compared to tariffs prior to the formation of these agreements. Moreover, these misalignments are undermining the elimination of tariffs among parties. Both rules were determined by GATT Article XXIV. Finally, rules of origin, when based on value added, will also be affected, distorting the rules negotiated by parties to have access to the preferential market, adding additional degrees of uncertainty to the institutions.

One can raise some questions concerning the main impasse facing the WTO at the present time. Examining the reasons behind the blockage of the Doha round of negotiations and analysing the demands of some developed members such as the US and the EU related to the concessions from emerging countries, one can question the real level of market access offered by these countries, given that their exchange rate policies might even nullify all their offers in the negotiations. The level of market access granted by members that practice long-term exchange rate devaluations can be called into doubt and one can question the real level of concessions or tariff cuts offered in the last few years of negotiations.

Against the reality of exchange rate misalignments, it is no longer acceptable to allow the continuation of the present situation. It is time to start negotiating a mechanism to neutralise exchange rate effects on tariffs, which, when effectively applied, would allow the maintenance of the level of market access previously established.

Some proposals have already been presented by experts. Bergsten & Gagnon (2012) from the Petersen Institute use the concept of currency manipulation to offer a methodology to identify 20 countries that are undervaluing their currencies due to large foreign reserves and other foreign assets. In retaliation for these currency activities, they propose that the US should take four sets of actions: i) undertake countervailing currency intervention against countries with convertible currencies by buying amounts of their currencies equal to the amount of dollars they are buying themselves, to neutralise the impact on exchange rates; ii) tax the earnings on, or restrict further purchases of, dollar assets acquired by intervening countries with inconvertible currencies to penalise them for building up these positions; iii) treat manipulated exchange rates as export subsidies for purposes of levying countervailing

import duties and iv) bring a case against the manipulators in the WTO that would authorise more wide-ranging trade retaliation.⁴

Lima-Campos & Gaviria (2012) from the College of Law at American University analyse undervaluation as a case of export subsidies and propose a pure WTO remedy – the initiation of countervailing measures. They argue that the effects of undervaluation are different by product and by sector, suggesting a full investigation of each case.⁵

6. Suggestions for the EU–Mercosur negotiations

Considering the analysis above on the effects of exchange rate misalignments on tariffs and their importance on the bi-regional negotiations between the EU and Mercosur, some suggestions can be made.

First, after almost two decades of negotiations between the parties, one can agree that the reduction or elimination of tariff barriers is still an important issue blocking the achievement of a final result. Second, the economic crisis of 2008 and the consequent euro crises are reducing economic growth to levels near depression. This scenario is forcing governments to use trade as a means to bring economic activities to higher levels.

In the case of goods, agricultural and non-agricultural ones, competitiveness is affected by exchange rates, interest rates and infrastructure costs. In Mercosur, after many years with overvalued exchange rates, imports from different sources have significantly increased. The same can be said for some European countries. As a result, there is no political support from industries in Mercosur to advance negotiations or from agricultural producers in Europe.

Exchange rate misalignments are one of the main uncertainties behind the negotiations. There are ways to help unblock the impasse, however, as suggested below

- Negotiate an exchange rate misalignment clause or special safeguard between the parties, either by countries or by regions. There are many examples of bilateral and sectoral safeguards in the EU agreements.
- Negotiate who will be in charge of the calculations of misalignments – the IMF, the European Commission or the Mercosur Secretariat.
- Negotiate a band of fluctuation of bilateral misalignments and a period for the misalignment. A possibility is a band from +15% to -15% and a period of six months. Each time two countries approach the limit, their governments could start monitoring imports and identifying products causing concern to parties.
- Negotiate thresholds to establish triggers to the safeguard based on import growth.
- Negotiate safeguards based on tariff quotas for agricultural goods and tariffs for non-agricultural goods for a limited period of time, until misalignments are reduced.

The alternative would be to wait for either the WTO or the IMF to start negotiations and reach a practical solution on exchange rates and trade.

⁴ F Bergsten and J. Gagnon, “Currency Manipulation, the US Economy, and the Global Economic Order”, Policy Brief 12-25, Peterson Institute for International Economics, Washington, D.C., December 2012.

⁵ A Lima-Campos and J. Gaviria, “A Case for Misaligned Currencies as Countervailable Subsidies”, *Journal of World Trade* 46, Issue 5, 2012.

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