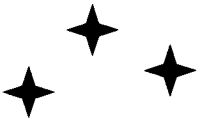

REPORT

MERCOSUR

JULY-DECEMBER 1996

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TABLE OF CONTENTS

P R E S E N T A T I O N

This report represents a new effort of INTAL aimed at promoting understanding and dissemination of the current dynamic process of integration in Latin America and the Caribbean. In this respect, the performance of the Southern Common Market (MERCOSUR), since the signing of the Asuncion Treaty in 1991. has become a leading case for evaluation of its achievements and the challenges expected ahead. Thus, after more than two years since MERCOSUR's Custom Union carne into effect, it was deemed appropriate to make a contribution to the analysis of this exciting integration process.

This MERCOSUR Report launchs a publication series which will analyze the most relevant events and decisions taking place for the consolidation of the common market. The purpose for the publication of this series of reports is to facilitate access of information to a wide number of readers interested in MERCOSUR which comprises the public and private sectors and the community of the subregion as a whole. Likewise, in order to promote MERCOSUR within and beyond the subregion, information dissemination oriented towards the international community will be fostered by the publication of this report in English, Spanish and Portuguese every four months.

Dr. Roberto Bouzas, a well known MERCOSUR analyst, was in charge of the preparation of this report with the technical support of Hernán Soltz, María Luisa Streb, Paula Gosis and Verónica Rapoport under the technical supervision of Mr. Uziel Nogueira in INTAL. The preparation of future reports will be alternated between Dr. Bouzas and Dr. Pedro da Motta Veiga.

We hope this material will be useful to our readers and that it will contribute to the consolidation of the regional integration process encouraging participation of an active and well informed community directly or indirectly involved in the process.

Lastly, we take this opportunity to invite our readers to share their comments or suggestions in order to improve the scope and/or approach of the contents of this publication in the future.

Juan José Taccone
Director

EXECUTIVE SUMMARY

1. Macroeconomic Trends in MERCOSUR

During 1996, the macroeconomy of MERCOSUR member countries was marked by two trends. The first was a n improvement in the behavior of growth and inflation in a context of relative fiscal and externa1 fngility. The second was a reduction of the disparity in the leve1 of economic activity and prices in a context of relative stabilization of real bilateral parities. The greater synchronization of national economic cycles in the largest two economies (in contrast to what occurred in 1991-92 and 1995) raises expect ations that trade tlows will be less intluenced by macroeconomic differences in the immediate future than in the past.

Nevertheless, the macroeconomic situation of the region is far from being strong. A tradition of instability and accumulation of fiscal and externa1 tensions raises the possibility of risks in the future. Moreover, and this notwithstanding the convergence of policies and macroeconomic indicators, the member countries show considerable differences in their exchange and monetary institutionality (reflecting different preferences on policy trade-offs) and in the soundness of the institutions that manage public policy. This is all taking place in a context of increased economic interdependence, especially between the largest two member countries.

Although the intensity of the linkage through trade and investment tlows do not yet seem to be sufficient to create significant macroeconomic interdependent relationships (that are also structurally limited by the differences in the size of the economies), the increase in the trade of goods and the convergence of policies have fostered the perception of common interests between the largest two members. To date, exchange of information and consultation on macroeconomics have been informa1 and linked through personal channels rather than bureaucratic institutional routines. This seems logical given the context of high volatility and uncertainty that characterized the region's macroeconomic performance in the past. Nevertheless, the durability of stabilization processes and convergence in the role of certain policy instruments may set the bases for the development of common interests that will stimulate cooperation to face common dilemmas.

II. Evolution of Trade and Investment in MERCOSUR

Since the implementation of the Treaty of Asunción, intrasubregional trade flows grew rapidly. This dynamism affected both imports and exports, though the effects were more significant in the case of exports. In fact, between 1991 and 1995, the share of intrasubregional exports in total exports almost dou bled, going from 11.1 percent to 20.4 percent. Intrasubregional imports also grew more rapidly than non-MERCOSUR imports but the difference between both rates was less than in the case of exports: as a result, the MERCOSUR suppliers' share of total imports of the region went from 15.9 percent to 1'8.7 percent.

In the first half of 1996, intrasubregional trade continued to grow though at a slower pace than in the preceding year. The partial information available for the first nine months of the year indicates that intrasubregional trade was recovering its earlier dynamism. In fact, intrasubregional exports of Argentina and Brazil (accounting for almost 90 percent of total intrasubregional exports) increased Il .3 percent vis-à-vis the same period in the preceding year (though below the 15.3 percent rate of expansion of total exports). The recovery of economic activity in Argentina and the acceleration of the growth of aggregate demand in Brazil were the principal factors that explain this performance. Should this trend be maintained, the value of intrasubregional trade during 1996 could be close to US$l7 billion.

In quantitative terms, the subregional integration process has not yet had a significant impact on extrasubregional investment flows but significant qualitative effects may be seen in severa1 areas, for example in those sectors in which subsidiaries of transnational enterprises are predominant and where a gradua1 process of rationalization and productive complementarity has developed. "Reorganization

investment" seems to have been more important in the automotive and auto parts, food and beverages, petrochemical, and textile sectors.

Similarly, cooperation and intrasubregional investment flows have become remarkably dynamic, although quantitatively they represent a relatively small amount. A survey to May 1996 identified a total of 3 13 joint Argentine-Brazilian ventures, 60 percent of them linked to the goods sector.

III. Market Access and Conditions of Competition

Effective market access is a pivotal component of a customs union. While MERCOSUR has achieved significant progress in this area, national regulations that limit the free trade of goods still remain in place. The most transparent are tariffs (which still survive in the automatic tariff-reduction *(regimen de adecuación)* and the special treatment granted to the automotive and sugar sectors, but there are also less visible obstacles embodied in nontariff barriers of a border and non-border nature.

Almost two years after the customs union went into effect, most of the State Parties continue to require origin compliance for all products entering from another member country, thus, hindering the free movement of goods. One reason for this procedure is the absence of a definitive consolidated list that includes all the products subject to the MERCOSUR origin system and the rules applicable to each of them. It is therefore essential to finalize the definition of the schedule of products envisaged in the scope of application of that system, ensuring that the schedule does not exclude products that for some reason are not subject to a common trade policy and that therefore generate distortions in the conditions of competition within the subregion.

The number and composition of the consultations channeled through the MERCOSUR Trade Commission, since it started to operate, show that nontariff barriers and measures is an area of frequent differences among the State Parties. Notwithstanding the progress achieved in the area of identifícation, the prevailing asymmetries in national practices make this issue a key topic for guaranteeing effective market access.

The automotive and sugar sectors have been temporarily excluded from intrasubregional free trade and common policies. With respect to sugar, one year after the expiration of the originally established time period, the Common Market Council decided at the Fortaleza meeting to extend until May 31, 1997 the deadline for submitting a proposal on the gradual liberalization of intrasubregional trade for the products of the sector and the neutralization of distortions that may arise from asymmetries among national policies. This decision does not resolve the underlying issue but merely extends the period for treating it, without any substantial addition to the terms of the original decision. The difficulties arising from the lack of harmonization of national policies for the automotive sector have been a recurrent feature in recent years; and they again became evident with the measure announced at the end of 1996 by the Brazilian government offering fiscal incentives and tariff exemptions to automotive assembly plants and related industries that arrange to set up operations in the north, northeast and midwest regions of the country before March 31, 1997. This measure prompted a reaction from the plants located in Argentina that demanded that their government implement some sort of countervailing measure if the Brazilian government did not reverse its position. Negotiations on this case are currently in progress.

Since April 1995, a Technical Committee on Public Policies that Distort Competitiveness has been operating under the umbrella of the MERCOSUR Trade Commission. The objective of this committee is to identify those public policy measures in force in each State Party that may distort the conditions of competition within the region because of their discriminatory nature. The technical committee's proposals should have been submitted to the Trade Commission for its approval before June 30, 1995, but that schedule has not been met. To date, only information on public policies that distort competitiveness has been exchanged, based on which a consolidated list has been prepared. In Fortaleza, it was decided to establish an Ad Hoc group to advise on the treatment of public policies that distort competitiveness. Taking into account the work already done, before 30 June, 1997 this group must review and redefine the criteria,

the procedures, and the scope of the measures originally established, and also ensure that public polices that distort competitiveness are regulated. In practice, very little progress has been made in this area because of the significant asymmetries in public policies existing among the Member countries. Given its potential influence on trade flows and the locations of investment, this topic is a key aspect of the future agenda.

The differences among the member countries were reflected in the discussion of the definition and implementation of the protocol to safeguard competition, the basic guidelines of which were established in 1994. The Fortaleza meeting explicitly set forth the differences related to the inclusion of government aid within the schedule of actions covered by the measures to safeguard competition and to the validity of national laws on antidumping and countervailing duties on intrasubregional trade. The Protocol finally approved by the Common Market Council included an article on government aid in the chapter on temporary measures. In the same chapter, the member countries agree to draw up within a two-year period common rules and mechanisms to regulate State aid that may restrict or distort competifion and affect trade among member countries.

Similarly, ir was decided that until December 31 , 2000, investigations on dumping by a State Party with respect to originating imports of other member countries would be carried out in compliance with national laws. During that period, the member countries would examine the rules and conditions under whicti the topic would be regulated in MERCOSUR.

IV. Common Policies

A customs union requires the implementation of common policies in a certain number of areas. As a minimum, a common externa1 tariff (CET) must be adopted as well as common customs procedures that will ensure that the admission of goods into the expanded market takes place under similar conditions regardless of the point of entry.

MERCOSUR is a customs union in the process of formarion in that the member countries are in transition toward complete enforcement of the CET, still continue to require origin compliance for al1 trade, and have not yet achieved uniformity in the rules and practice of customs procedures.

MERCOSUR member countries continue to collect the CET on extrasubregional imports that enter through another member country. Some justify this practice on the grounds that there is no consolidated list of exempted positions, although this would authorize them to require origin compliance for al1 products but not to collect the CET on an extrasubregional product that has already paid the tariff. In fact, even if a consolidated list existed, member countries could continue to demand origin requirements and the payment of the CET on a non-MERCOSUR product (not subject to the origin regime) that entered through another member country simply because there was no mechanism for assigning customs revenue. Consequently, the central problem would seem to be the absence of mechanisms for assigning customs revenue and the lack of clear rules indicating the procedures to be used where the differential between the national tariff and the CET is to be collected if the product enters through a member country and is subsequently re-exported to another country which includes that product in its exceptions. This point should be explicitly included in the temporary provisions of the customs code that would be in force until all exceptions to the CET as well as other cases of non-common trade policy are eliminated.

It is vitally important to the functioning of the customs union that the common Customs Code and the rules for its application be fully in effect, as well as the implementation of integrated border controls, interconnection of the customs administrations' computer systems, the coordination of the struggle against illicit customs practices, and the adoption of uniform valuation criteria. With respect to customs matters, there is considerable difference between the laws agreed upon and those that have been effectively instituted by the member countries.

At the Fortaleza summit of the Common Market Council, the Common Regulations on the Application of Safeguard Measures on Imports from non-MERCOSUR Countries were approved. Those regulations established the rules for applying safeguard measures, understood to be the measures envisaged in Article XIX of the GATT 1994 and the WTO Safeguard Agreement. During a two-year transition period (l997-98), until the adaptation of their rules, the member countries shall apply their national laws pursuant to the Transitory Provisions of the Common Regulations.

The member countries are also preparing Common Regulations for Consumer Protection. Although the date envisaged for the finalization of these regulations was November 30, 1996, at the Fortaleza meeting five of the twelve chapters relating to specific subjects (consumer, supplier, and so forth), basic rights and protection of the health and safety of the consumer, advertising, and contractual guarantee of goods and services were adopted as resolutions. In any event, the Protocol will enter into force only aftcr all the chapters have been approved and incorporated into the national laws of the member countries. The issues of the supply of goods and services, unfair supply practices, contractual protection. accession contract and temporary location clause are still pending agreement.

V. Harmonization of Policies and "Deepening"

The Mandate of Asunción for the Consolidation of the Southern Common Market, which was approved by a decision of the Common Market Council in December 1995, established a "MERCOSUR Action Program to the Year 2000" which, as it took steps to consolidate and improve the customs union (consolidation of free trade and conditions of intra-MERCOSUR competition, improvement of common trade policy, and legal and institutional development), made "deepening" of the subregional integration process a priority objective including, *inter alia,* the topics of trade in services, investments. govemment procurement, culture, and education, and so forth.

With respect to trade in services, two years after the Mandate of Asunción, little progress has been made. The first meeting of the Ad Hoc group entrusted with the topic was held in September 1995 but the negotiations only gathered momentum since mid- 1996, with the result that to date the framework agreement has not been approved. In order to conclude this agreement, the Common Market Group agreed to instruct the ad hoc group to submit the final text of the framework agreement to the interim Chair by September 30, 1997, and also to submit recommendations for negotiating the Lists of Initial Specific Commitments so that they could be considered by the Common Market Group in December 1997.

In an economic integration process, regulatory divergences become more important because trade flows and the location of investment are boosted when the market becomes less fragmented. Although there has been significant convergence of the regimes regulating investments among the member countries, important differences still remain. In January 1994, the State Parties signed an agreement on the promotion and protection of intrasubregional investments -the Colonia Protocol- which defined general pri nciples and listed the reservations of each member country in relation to national treatment of intrasubregional investments. This protocol is before parliament in all the member countries.

The members also signed a Protocol on the Promotion and Protection of Investments from Third Countries, that established a legal framework to be applied in the treatment of extrasubregional investments. Nevertheless, the member countries reserved the right to promote investments in their territories without establishing any restriction in that regard. This protocol was approved by Argentina and Paraguay, which deposited their respective instruments of ratification in March 1996, whereas the protocol is before the legislature in Brazil and Uruguay.

The problems caused by the differentiated treatment granted by member countries to foreign investors resurfaced when the Brazilian government announced incentives for investments in the automotive sector that set up operations in the north, northeast and mideast regions of the country. This divergence, is reinforced by the fact that the resources available to national governments (and local states) to offer

incentives to (domestic and foreign) investment are quite uneven. It must, however, be borne in mind that the European Union does not yet have a harmonized scheme for treating foreign investments, but merely the possibility of resorting to legislation to safeguard competition when national or regional investment incentives threaten to cause distortions in the expanded market.

Regulations on government procurement may constitute an obstacle to market access if they grant preferential treatment to local suppliers. Moreover, the existence of preferences for supplying the public sector could completely invalidate tariff concessions. These mechanisms have different features in each MERCOSUR country. The current mechanism for supplying the public sector in Argentina is quite open and national treatment is the general rule. In Paraguay, Uruguay and Brazil, there are specific regulations for public works that grant certain preferences to national physical and juridical persons.

Regulations on government procurement ate handled in the Trade Commission's Technical Committee on Public Policies that Distort Competitiveness and in the Ad Hoc Group on Services under the Common Market Group. The Technical Committee shall identify whether these regulations are compatible or incompatible with the operation of a customs union and make proposals, as appropriate, for their harmonization (if they are compatible) or progressive elimination (if they are incompatible). Furthermore, the Ad Hoc Group on Services is also discussing this issue as it prepares a framework agreement on trade in services in MERCOSUR, based on the model of the General Agreement on Trade in Services (GATS), which contains a provision on government procurement. Specifically, GATS established that the contracting of services by the govemment is not subject to most-favored-nation, national treatment, and market access clauses. MERCOSUR member countries have not yet reached consensus in this regard although there is a possibility that this provision will be reformulated.

At the Fortaleza summit in December 1996, two protocols on educational integration were signed. The first established that member countries would recognize degrees awarded by accredited universities in each country, for the sole purpose of pursuing graduate studies (that is, that these degrees would not count as qualification for the practice of a profession). The other protocol, applicable to human resources training at the graduate level, established among its objectives the training and improving of university teaching faculty and researchers in order to bolster and expand postgraduate programs in the region, creating an exchange system among institutions in order to provide human resource training, and establishing common standards and criteria for evaluating advanced degrees.

The member countries also signed a Protocol on Cultural Integration, agreeing to promote cooperation and exchange among their respective cultural institutions and agents.

The institutional structure of MERCOSUR, as defined by the Additional Protocol to the Treaty of Asunción on the Institutional Structure of MERCOSUR (Ouro Preto Protocol), is strictly intergovemmental in nature. An essential component of that design is the dispute settlement mechanism, established by the Brasilia Protocol for the Settlement of Disputes, signed in December 1991 and in force as of April 1993. This mechanism provides for a procedure in stages with separate treatment for disputes among States and for claims by private individuals. The Ouro Preto Protocol, signed in December 1994 and in force as of December 1995, created a new organ (the MERCOSUR Trade Commission) whose functions include the consideration of claims filed by the national sections of the Commission coming from the Member countries or private individuals. An Annex to the Ouro Preto Protocol also established a General Procedure for Claims to the CCM (MERCOSUR Trade Commission) which facilitates claims by private individuals.

VI. Infrastructure

Since the signing of the Treaty of Asunción, intrasubregional exports have tripled, putting pressure on the inadequate transport and communications infrastructure that links the economies of the region. Severa1 physical integration projects have been undertaken to respond to the growing demand for infrastructure. But these efforts barely meet national needs, much less regional demands, which require the formulation of a

physical integration program involving all the member countries. This section examines some of the principal efforts under way in the four member countries in the areas of transport and communications and energy infrastructure.

The requirements for the expansion and improvement of infrastructure represent investment opportunities not only for intergovernmental institutions but also for private operators. At the same time, those demands require coordination among the member countries. Partly for that reason, the Fortaleza summit resolved to create a special committee comprised of official representatives of the five countries of the River Plate Basin (the four members of MERCOSUR and Bolivia). The committee is scheduled to meet by early February 1997 and in five months will prepare a technical proposal to transform the Financia1 Fund for the Development of the River Plate Basin (FONPLATA) into a development and integration financing mechanism with financial, operational, technical and administrative autonomy. One possible way of achieving such autonomy is for the new institution not to rely on national public funds; rather it could be funded on the intemational capital markets and administer resources of intemational financing institutions such as the IDB and the World Bank.

VII. Externa1 Economic Relations

External economic negotiations by MERCOSUR are developing on several fronts simultaneously, namely: a) the multilateral sphere of the World Trade Organization (WTO); b) within ALADI ("pluralization" of the preferences included in bilateral agreements and conclusion of new free trade agreements with other members of the Latin American Integration Association [ALADI]); c) at the hemispheric level (where a process has been instituted aimed at the negotiation of the Free Trade Area of the Americas [FTAA] by the year 2005); and d) the negotiations with the European Union and its member countries, launched with the signing of the Interregional Framework Cooperation Agreement in December 1995. Given the different demands arising from each of these areas of negotiation, the agenda that evolves will cover a wide variety of topics. The increase in the number of interlocutors also poses a heavy load of negotiation and unavoidable demands for consistency.

MERCOSUR has been presented to the World Trade Organization (WTO) as a customs union within the framework of Article XXIV of the GATT 1994. As a result, a special working group was created under the Committee on Regional Agreements with responsibility for examining the compatibility of the preferential agreement with the rules of the multilateral organization; this examination is currently in progress.

The establishment of the customs union on January 1, 1995, should have formally ended the bilateral agreements negotiated with other members of ALADI and replaced them with "plurilateral" preferences. In order to move these renegotiations ahead, the Common Market Group issued two resolutions that establish guidelines for the treatment of the pre-existing preferences *(Patrimonio Histórico)* and for the negotiation of free trade agreements with other members of ALADI. As these renegotiations have taken longer than originally envisaged, the expiration date for the bilateral preferences was extended. In the interim. the preferences with Bolivia were "pluralized" (December 1995) and separare free trade agreements were concluded with Chile (June 1996) and Bolivia (December 1996).

MERCOSUR member countries have also participated in the preparations for the negotiations for the establishment of a Free Trade Area of the Americas (FTAA). In September, 1996, at the first meeting of vice-ministers preparatory to the meeting of ministers of trade slated for Belo Horizonte in 1997, MERCOSUR member countries proposed guidelines for developing those negotiations. These guidelines consist of three stages that would allow gradual progress based on the single undertaking principle and development of a broad and balanced agreement. The first stage (business facilitation) could satisfy the demand for an "early harvest" in such areas as customs documentation, certification of origin, facilitation of goods transport, recognition of sanitary and phytosanitary certificates, publications for the private sector, and so forth. The second stage, which should begin when the working groups complete the tasks assigned to them, covers an undefined series of topics that do not include market access and corresponding disciplines

(sanitary and phytosanitary measures, technical standards, and so forth). The third stage would be "substantive negotiations" which could be developed in phases -first for goods and, subsequently, in areas such as services, government procurement, and so forth.

In December 1995, MERCOSUR and the European Union signed an Interregional Framework Cooperation Agreement. Within this framework, the first meeting of the combined Commissions settled by this agreement took place on June, 1996 when the provisional rules of procedure of that commission were approved, as well as the provisional rules and the guidelines of the Subcommission on Trade. The negotiations between MERCOSUR and the European Union cover a wide range of topics and are currently in the information-gathering stage. Concrete results cannot be expected in the near future because of the lack of precise schedules and timetables in each working group, the breadth of the task, and the contents of the agenda. Nevertheless, the procedures that have been designed place the development of trade and, eventually, trade liberalization between both groups in a high-level

CHAPTER I. MACROECONOMIC TRENDS IN MERCOSUR

During 1996, the macroeconomy of MERCOSUR member countries was marked by two trends. The first was an improvement in the performance of growth and inflation in a context of relative fiscal and external fragility. The second was a reduction of the disparity between the first two variables (growth and inflation) in a context of relative stabilization of real bilateral exchange rate parities.

The greater synchronization of the national economic cycles in the largest two economies (in contrast to what occurred in 1991-92 and 1995) raises expectations that trade flows will be less influenced by macroeconomic differences in the immediate future than in the past. Nevertheless, the underlying situation does not allow us to predict how lasting this trend will be.

A. Macroeconomic Performance

During 1996, regional Gross Domestic Product (GDP) grew at an estimated annual rate of 3.2 percent, much higher than the 1 .1 percent recorded in 1995 (see Table I. 1). This growth may be explained by the recovery of economic activity in Argentina (which contributed about one-third of regional output) and Uruguay, after the deep recession experienced by both economies in 1995. The recovery of the Argentine economy began in the second quarter of 1996, accelerating after the middle of the year. Nevertheless, toward the end of 1996 production levels remained below those recorded before the recession. In the case of Uruguay also, what started as a slow recovery gained momentum after the middle of the year, raising GDP growth rates to double those initially anticipated.

Table I.1
MERCOSUR: Indicators of Macroeconomic Performance

	Share 1991	1991	1992	1993	1994	1995	1996	1997p
Real GDP		**annual growth rate, %**						
Argentina	32.40%	9.5	8.4	5.3	6.7	-4.6	3.5	3.5
Brazil	65.23%	0.1	-1 .1	4.4	5.7	3.9	3.0	3.8
Paraguay	1.05%	2.4	1.6	4.1	2.9	4.5	2.0	3.1
Uruguay	1.90%	3.2	7.8	3.3	6.9	-2.8	5.0	2.5
Total MERCOSUR	100.00%	3.2	2.1	4.7	6.0	1.1	3.2	3.7
Inflation (CPI)		**annual growth rate, %**						
Argentina		84.0	17.5	7.4	3.9	1.6	0.4a	1.7
Brazil		475.8	1149.1	2489.1	929.3	22.0	10.6a	10.0
Paraguay		11 .a	17.8	20.4	la.3	10.5	8.8a	15.0
Uruguay		al.3	59.0	52.9	44.1	35.4	25.5a	1a.0
Total MERCOSUR		338.8	**756.3**	**1627.0**	**608.3**	**15.6**	7.6a	**7.5**
Current account balance		**millions of dollars**						
Argentina		-809	-5,403	-7,047	-9,363	-2,390	-4,200	-6,00C
Brazil		-1,450	6,089	19	-1,153	-1 8,136	-20,300	-26,500
Paraguay		-327	-626	-526	-754	-1,060	-540	-545
Uruguay		42	-9	-244	-439	-359	-535	-343
Total MERCOSUR		-2,544	51	-7,798	-11,709	-21,945	-25,575	-33,388

Note: a, November 1996/November 1995.
Source: The data for the 1991-96 period were taken from ECLAC, Balance *Preliminar* de *la Economía de América Latina y el Caribe*, several issues. The estimates for 1997 are from The Economist *Intelligence* Unit.

Economic activity in Brazil (which contributed some two-thirds of regional GDP) and Paraguay recorded a slight deceleration on an annual basis but maintained positive growth rates for the entire year. In the case of the largest MERCOSUR economy, the deceleration of growth recorded in 1995 was reversed at the end of that year, giving way to a more vigorous recove as mid-1996. The slowdown in the growth rate of the Paraguayan economy, meanwhile, was influenced by such factors as the financial crisis in 1995, the behavior of the economies of Argentina and Brazil, growing restrictions on illegal trade through Ciudad del Este and a restrictive fiscal policy.

The increase in the pace of economic activity in the region was accompanied by a reduction in inflation (measured by consumer price indexes), which reached an estimated annual rate of 7.6 percent at year's end. In fact, during 1996, the rate of price increase was reduced (on average in each country) for the third consecutive year. The reduction of inflation below the international level in a fixed exchange-rate context allowed for a slight improvement in the real exchange rate in Argentina. A more flexible exchange policy permitted a slowdown in the real appreciation of local currency in Brazil and Paraguay and the stabilization of the real exchange rate in Uruguay.

The acceleration of growth was accompanied by an increase in the imbalance of the region's external accounts. This behavior was influenced by the development of the largest two economies. In fact, estimates for Brazil for 1996 anticipate a higher trade deficit than that of the preceding year (US$4 billion on an FOB basis) and a negative balance in the current account above US$21 billion (equivalent to more than 3 percent of GDP). During 1996, Argentina's external position also deteriorated, with a current account deficit estimated at around US$4.2 billion. In fact, the economic authorities of both Argentina and Brazil face the difficult task of harmonizing the dynamism of domestic economic activity with control of external accounts, in the framework of a policy regime in which the exchange rate plays a significant role as an anti-inflationary anchor. Although Brazil's exchange mechanism is more flexible than that of Argentina, the possibility of a devaluation seems to be temporarily excluded by both countries, at least for as long as the present conditions of abundant liquidity in the international capital market remain.[1]

Uruguay's current account balance also worsened during 1996, in a context in which exports face problems of competitiveness. Paraguay was the only MERCOSUR State Party whose current account improved during that period, as a result of the slowdown in the growth rate of domestic demand, increasing import restrictions by Brazil on border trade through Ciudad del Este (that reduce imports for re-export), and the good harvest and high international prices of soya.

The region's fiscal situation is also far from being strong (Table I. 1). In Brazil, public sector accounts deteriorated noticeably from 1994, and, since then, the fiscal adjustment process has been very slow. In fact, the difficulty in correcting the fiscal situation has placed pressures on the stabilization program, especially due to the rapid accumulation of domestic debt (the federal domestic public debt grew by 50.8 percent between September 1995 and September 1996). It is expected that once the domestic political issues have been cleared up and reforms pending in Congress passed, the fiscal consolidation process may be accelerated since the actual rate of public debt accumulation does not seem sustainable in the medium term.

One difference between Argentina and Brazil is that in Argentina exports have been increasing rapidly, whereas in Brazil they remained relatively flat in 1996. Notwithstanding the fiscal restrictions, during that year the Brazilian authorities implemented tax and financial measures to boost exports. The response to these measures is an additional factor in evaluating the stability of exchange policy.

Table I.2
MERCOSUR: Economic Policy Indicators

	1991	1992	1993	1994	1995	1996
Public sector deficit	% of GDP					
Argentina (SPNFN)	-1.6	-0.1	1.4	-0.1	-0.4	-2.0a
Brazil (operational SPC)	-0.2	-1.8	-0.7	1.1	-4.8	-4.5a
Paraguay (GC)	0.8	-1.4	-0.7	1.0	-0.3	-0.2a
Uruguay (SPC)	0.0	0.5	-1.5	-3.0	-1.5	-1.5a
MI (end of period)	annual growth rate,			%		
Argentina	148.6	49.0	33.0	8.2	1.7	18.4b
Brazil	429.6	981.9	2018.4	2098.0	31.2	39.7b
Paraguay	32.4	22.5	***16.5***	***31***.1	***28.2***	12.0c
Uruguay	98.4	69.1	57.7	39.4	33.6	35.2b
Nominal interest rate	%					
Argentina	62.0	17.0	11.0	***8.0***	***12.0***	7.0d
Brazil	913.5	1560.2	3293.5	***5175.2***	***52.2***	14.3b
Paraguay	12.0	***10.4***	***10.6***	***11.3***	***10.9***	9.3b
Uruguay	75.2	54.5	39.4	37.0	38.2	28.6b

Notes: SPNFN, Non-financial National Public Sector; operational SPC, operational consolidated public sector; GC, central government; SPC, consolidated public sector; a, Estimate; b, 2nd quarter: c, 1st quarter; d, 3rd quarter.
Sources: ECLAC, ***Balance Preliminar de la*** *Economía* ***de America*** *Latina* ***y*** *el Caribe* , several issues; International Monetary Fund, ***International*** *Financial* ***Statistics,*** several issues.

Argentina's fiscal imbalance (though much less than that of the largest MERCOSUR economy) increased in 1996 as a result of the recession and the consequent fall in tax receipts. Notwithstanding this cyclical factor, Argentina's fiscal fragility seems to have more permanent results such as the effect of the reform of the social security system on government revenue. This has led the authorities to set as a priority the improvement of the fiscal situation as a means of releasing the pressure on the financial markets, reducing risk premium, and improving expectations, eventually promoting expenditure on investment and on consumer durables.

The economies of the other two members do not show a sound fiscal position. In the case of Paraguay, during 1996 the authorities reacted to the fall in fiscal receipts by an aggressive policy of public spending cuts, thus contributing to the slowdown of economic activity registered during the year. Given that the major portion of public sector expenditures comprised current expenditure, the cuts fell largely on public investment. The government of Uruguay has proceeded with its fiscal consolidation policy (reflected in the reduction of the central government deficit), although in the medium term that improvement will depend on the continuity of the state reform process, which is in its initial stage.

In any event, given the present situation of international financial markets, financing fiscal and external imbalances does not seem beyond the reach of the governments of the subregion. In the case of Brazil, the privatization process was recently started and massive capital inflows are expected from abroad in 1997. Nevertheless, there is no certainty that a path of significant fiscal imbalances financed with capital resources is a sustainable option in the medium term. In the case of Argentina, the major share of capital inflows from privatization has already occurred. As a result, financing fiscal and external imbalances should be done through new public sector borrowing (as occurred in 1996) and/or new private portfolio capital inflows from abroad and foreign direct investment.

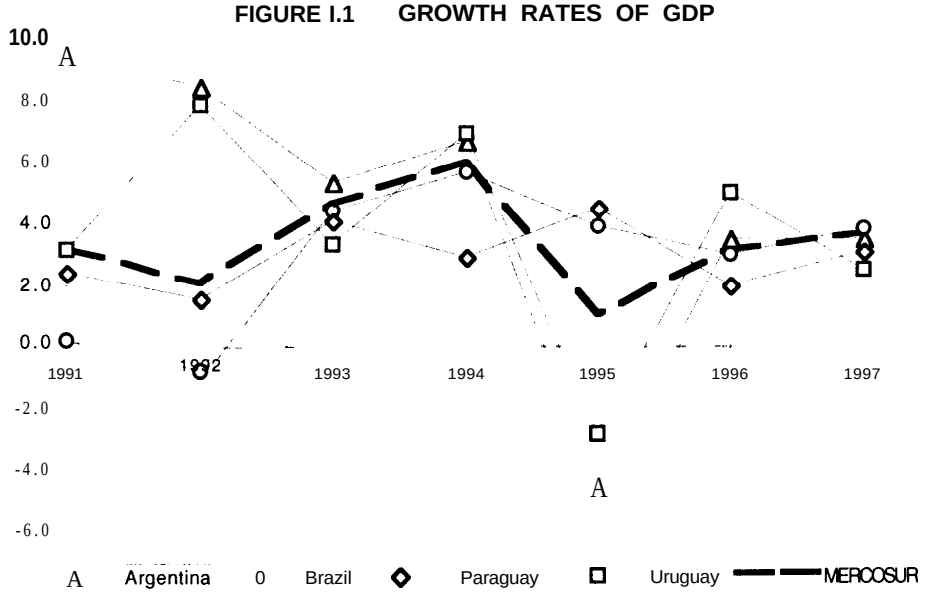
B. Toward Greater Synchronization in the Cycle?

During 1996, regional macroeconomic performance was characterized not only by acceleration of growth and a fall in the inflation rate, but also by a reduction in the differences between the economic performance

of the member countries. That reduction of differences was recorded in relation to the rate of expansion of production and prices (Figures I.1 and I.2) .

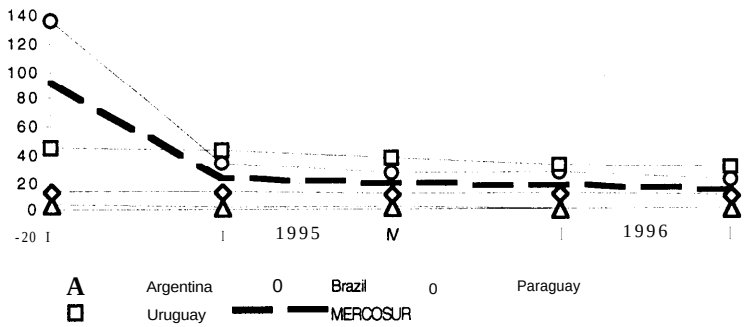
In fact, for the first time since the signing of the Treaty of Asunción, the largest two economies of MERCOSUR seem to have entered a period of synchronization of their national economic cycles. If this trend is consolidated, it will open the possibility that in the near future trade flows will be less influenced by differences in the levels of activity than in other periods in the recent past.

FIGURE I.1 GROWTH RATES OF GDP



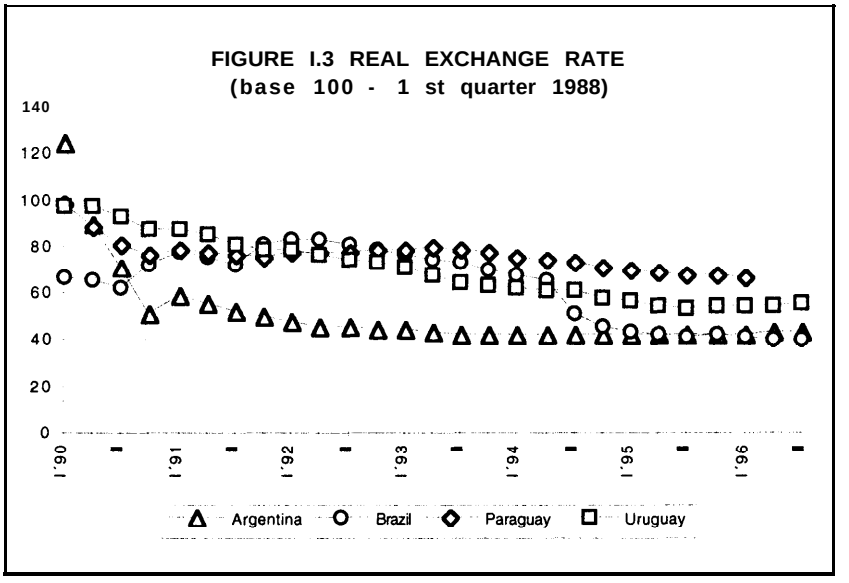
Source: Table 1.1.

FIGURE I.2 INFLATION RATES



Source: Table 1.1.

The volatility of real exchange rates and real bilateral parities also underwent a significant reduction (Figure 1.3). If no unanticipated shocks occur, this trend could last through 1997. As a result, if exchange policies maintain their present orientation (facilitated by abundant availability of external financing), there will be a growing trend for trade flows to be independent of short-term cyclical macroeconomic factors.



Source: Prepared on the basis of data from the Center of International Economy of the Ministry of External Affairs, International Trade and Worship of the Republic of Argentina.

There is broad consensus that policies and macroeconomic performance may be important for the success or failure of an integration process and that some degree of policy coordination is therefore generally required. For this reason, most analysts were originally skeptical about the success of MERCOSUR. Nevertheless, to judge by its effect on trade flows, MERCOSUR has made considerable progress since 1991 in spite of the differences in the performance and in the macroeconomic policies of its member countries and the incipient coordination effort.

There are two explanations for this paradox. One is the relatively low degree of initial interdependence between the largest two member countries, and the other is the presence of exogenous factors that compensated for the disparities in macroeconomic performance during more or less prolongued periods. The abundant availability of external financing during the 1991-94 period (and again in 1996) was an outstanding example.

While convergence in macroeconomic performance (in the sense of fiscal and monetary indicators that exhibit similar trends) may be a necessary condition for taking advantage of all the potential benefits of an integration process in the long term, it is not enough in and of itself. There is also need for macroeconomic discipline.[2] As a matter of fact, in the recent experience of MERCOSUR the convergence of macroeconomic indicators among member countries was the result of internal policy considerations and external restrictions, without policy coordination ever existing in practice. The convergence of the policy priorities of the governments (especially the largest two) and, in particular, the importance assigned to

[2] Hans Genberg and Francisco Nadal Simone, "Regional Integration Agreements and Macroeconomic Discipline, in K. Anderson and R. Blackhurst (eds), Regional integration and the Global System (New York; St Martin's Press, 1993).

stabilization of the price level and the role of exchange policy as an anti-inflationary measure, provided a community of objectives and functions, including a relative stabilization of real bilateral exchange rate parities.

Nevertheless, the macroeconomic situation of the region is far from being strong. A tradition of instability and accumulation of fiscal and external tensions raises the possibility of risks in the future. Moreover, and this notwithstanding the "exogenous" convergence indicated above, the member countries show considerable differences in their exchange and monetary institutionality (reflecting different preferences on policy trade-offs) and in the soundness of the institutions that manage public policy. The context in which this is taking place is one in which macroeconomic interdependence has increased among the member countries, especially between the largest two.

C. Interdependence and Incentives for Coordination

The main vehicle producing that increase in interdependence was the growth of trade in goods.[3] In fact, between 1991 and 1995, intrasubregionai exports as a proportion of GDP increased from 0.86 percent to 1.42 percent (Table 1.3). Although this ratio is still modest in absolute terms, the trend is clear.

Indeed, this aggregate increase includes very disparate national situations. For Paraguay and Uruguay, the heavy trade dependency on the markets of the largest two neighbors is nothing new. In contrast, though to different degrees, this trend is more of a novelty for both Argentina and Brazil. In the case of Argentina in particular, since 1991, the Brazilian market has become the main destination for its exports, with a 26.2 percent share in 1995. On the other hand, since 1992 Argentina has become the second largest market for Brazilian exports, with a 8.7 percent share in 1995.

Table I.3.
Share of Exports to MERCOSUR
as a Percentage of GDP

	1991	1992	1993	1994	1995
Argentina	1,04	1,00	1,43	1,70	2,41
Brazil	0,60	1,09	1,24	1,06	0,88
Paraguay	4,18	3,78	4,16	4,36	5,17
Uruguay	5,58	4,74	4,89	5,50	5,59
Total MERCOSUR	0,86	1,16	1,40	1,39	1,42

Sources. Prepared on the basis of IMF, International Financial Statistics, several issues, and DATAINTAL.

Although the linkage among MERCOSUR members through trade and investment flows do not yet seem sufficiently intense to create significant macroeconomic interdependent relationships (that are also structurally limited by the differences in the size of the economies), the increase in the trade of goods and the convergence of policies have fostered the perception of common interests between the largest two members. At the same time, the risk of "contagion effects" between both countries has increased. Although Argentina appears much more vulnerable to these influences than Brazil by virtue of the relative size of the economies, the potential repercussions of macroeconomic turbulence in Argentina on the Brazilian economy should not be underestimated. In such an event, both countries would share a common interest to promote the development of greater exchange of information and cooperative initiatives in the face of isolated problems. To date, exchange of information and consultation on macroeconomic matters among the governments of

[3] With the exception of the relationship between Argentina and Uruguay, where Uruguay traditionally played the role of off-shore financial market, the linkage across the capital markets among the Member countries of MERCOSUR is still not well developed.

the member countries have been informal and linked through personal channels rather than bureaucratic, institutional routines. This seems logical in view of the context of high volatility and uncertainty that characterized the region's past macroeconomic performance. Nevertheless, the durability of stabilization and convergence in the role of certain policy instruments could establish the bases for the development of common interests that would stimulate cooperation in the face of common dilemmas.

CHAPTER II. EVOLUTION OF TRADE AND INVESTMENT IN MERCOSUR

The principal objective of a preferential trade agreement is to increase the well-being of its members, allowing them to take advantage of the static and dynamic benefits that may result from freer trade and greater market integration. In part, these gains materialize through greater trade and investment flows. Nevertheless, not all increase in trade among members implies an improvement in welfare: indeed, trade diversion (the replacement of more efficient extrasubregional suppliers by intrasubregional suppliers who enjoy preferences) may entail losses. From an international perspective, regional trade agreements have an associated risk: welfare gains of its members may be achieved at the expense of the rest of the world.[4] In such a case, conflict could be fanned and regional agreements could become a threat to an open multilateral trade regime.

In the case of MERCOSUR (as the case in other successful preferential agreements in the past), these concerns have been prompted by the notable increase of intrasubregional trade flows. In fact, during both the transition period (1991-94) as well as the first two years of the customs union, intrasubregional trade linkages expanded rapidly. Nevertheless, an examination of the empirical evidence available does not permit us to conclude that there were significant negative effects on the welfare of either the members or the rest of the world.

A. Trade Flows since the Treaty of Asunción

Since the implementation of the Treaty of Asuncibn, intrasubregional trade flows grew rapidly. This dynamism affected both imports and exports, though the effects were more significant in the case of the latter: between 1991 and 1995, intrasubregional exports grew at an annual rate of 29.6 percent, in comparison to 11.3 percent for total exports (Table II.1). As a result of this difference in export behavior according to market destination, MERCOSUR share of total imports almost doubled, going from 11.1 percent to 20.4 percent (an increase of 83.8 percent).

This behavior was nevertheless not homogenous for all sectors. Intrasubregional exports of the largest two economies (Argentina and Brazil) recorded their highest growth rates: 36 percent and 27.8 percent, respectively. Nevertheless, their exports outside the subregion grew at an annual rate of 9.2 percent and 8.3 percent, respectively, only slightly below the growth rate of total world exports in the 199 l-95 period (9.3 percent).[5] The intrasubregional exports of Paraguay and Uruguay also recorded rapid growth (though less than in the case of Argentina and Brazil), but in a context of contraction (7.2 percent) or slow growth (2.5 percent), respectively, of exports to the rest of the world.

These trends resulted in uneven changes in the weight of the regional market for each partner: Argentina and Brazil experienced greater increases in the regional concentration of their exports, whereas Paraguay and Uruguay did so to a lesser degree. Even so, and consistent with their relative sizes, Paraguay and Uruguay continue to be the economies whose export trade is more oriented toward the subregion. In fact, in 1995 MERCOSUR absorbed 56.8 percent of Paraguay's total exports and 47 percent of Uruguay's.

Intrasubregional imports also grew more rapidly than extrasubregional imports, but the difference between both rates was much less than in the case of exports. In fact, whereas extrasubregional imports grew at an annual rate of 22.7 percent, intrasubregional imports grew at a rate of 28.7 percent (Table II.2). As a result, the share of MERCOSUR suppliers in total imports of the region went from 15.9 percent to 18.7 percent.

[4] The classic example would be through an improvement in the terms of trade made possible by the increase in the strength of the market.

[5] IMF, World Economic Outlook, October 1996 (Washington, D.C., IMF).

Table II.1
MERCOSUR: Evolution of Exports According to Destination, 1991-95
(millions of U.S. dollars and percentages)

	1991	1995	Annual growth rate 1991 /1995
Argentina			
Total	11,975.9	20,962.0	**15.02%**
Exports to MERCOSUR	1,976.8	6,769.3	36.03%
Exports to the rest of the world	9,999.1	14,192.7	9.15%
MERCOSUR share in the total	16.51%	32.29%	95.64%*
Brazil			
Total	31,623.6	46,503.4	10.12%
Exports to MERCOSUR	2,308.6	6,153.4	27.77%
Exports to the rest of the world	29,315.0	40,350.0	8.31%
MERCOSUR share in the total	7.30%	13.23%	81.26%*
Paraguay			
Total	736.9	819.6	2.69%
Exports to MERCOSUR	259.3	465.5	15.75%
Exports to the rest of the world	477.6	354.1	-7.20%
MERCOSUR share in the total	35.19%	56.79%	61.38%'
Uruguay			
Total	1,574.1	2,116.3	7.68%
Exports to MERCOSUR	557.6	995.3	15.59%
Exports to the rest of the world	1,016.5	1,121.1	2.48%
MERCOSUR share in the total	35.42%	47.03%	32.77%*
MERCOSUR			
Total	45,910.6	70,401.4	11.28%
Exports to MERCOSUR	5102.3	14,383.5	29.58%
Exports to the rest of the world	40,808.3	56,017.9	8.24%
MERCOSUR share in the total	11.11%	20.43%	83.84%*
Memorandum:			
World exports (US$ billions)	3.468	4.950	9.3%

Note: *, cumulative variation.
Source: Prepared on the basis of DATAINTAL and IMF.

The relative performance of intrasubregional and extrasubregional imports varied from one country to another, but the differences were less noteworthy than in the case of exports. Imports to Argentina and Brazil from the rest of the world recorded higher growth rates (24.1 percent and 22.9 percent, respectively), in both cases much above the growth rate of world trade. Imports to Paraguay and Uruguay from outside the subregion also surpassed the growth rate of world trade: 16.7 percent and 14.7 percent, respectively.

Likewise, in the four countries extrasubregional imports increased much more rapidly than imports from developing countries.[6] Paraguay and Brazil were the countries that experienced the highest increases in intrasubregional imports and, consequently, the highest increases in the share of the region's suppliers in total imports.

[6] According to the IMF, during the 1991-95 period, imports from developing countries grew at an average rate of 13.7 percent.

Table II.2
MERCOSUR: Evolution of Imports according to Origin, 1991-95
(millions of US dollars and percentages)

	1991	1b95	Annual growth rate 1991/1995
Argentina			
Total	8,274.7	20,067.4	24.79%
Imports from MERCOSUR	1,804.3	4.744.5	27.34%
Imports from the rest of the world	6,470.4	15,322.9	24.05%
MERCOSUR share in the total	21.81%	23.64%	8.43 %*
Brazil			
Total	21,040.9	49,581.6	23.90%
Imports from MERCOSUR	2,268.4	6,820.8	31.68%
Imports from the rest of the world	18,772.5	42,760.8	22.85%
MERCOSUR share in the total	10.78%	13.76%	27.60%*
Paraguay			
Total	1,275.2	2,796.9	21.70%
Imports from MERCOSUR	396.9	1,170.0	31.04%
Imports from the rest of the world	878.3	1,626.9	16.66%
MERCOSUR share in the total	31.12%	41.83%	34.42 %*
Uruguay			
Total	1,549.2	2,865.7	16.62%
Imports from MERCOSUR	654.9	1,320.6	19.17%
Imports from the rest of the world	894.3	1,545.1	14.65%
MERCOSUR share in the total	42.27%	46.08%	9.01%*
MERCOSUR			
Total	32,140.0	75,311.7	23.72%
Imports from MERCOSUR	5,124.5	14,055.9	28.69%
Imports from the rest of the world	27,015.6	61.255.8	22.71%
MERCOSUR share in the total	15.94%	18.66%	17.06%*
Memorandum:			
World exports (US$ billions)	3.468	4.950	9,3%

Note: *, cumulative variation.
Source: Prepared on the basisof DATAINTAL and IMF.

B. Trade Flows in 1996

In the first half of 1996, intrasubregional trade continued to grow though at a slower pace than in the preceding year. Intrasubregional exports reached a value of US$7.7 billion, 2.8 percent above that recorded in the same period of 1995 (Table II.3). The growth rate of intrasubregional exports was less than the growth rate of total exports, which expanded by 6.1 percent during the first half of the year.

The main factor behind this slowdown was the behavior of Argentine exports, which during the first half of 1996 contracted by 1.6 percent vis-a-vis the same period in 1995.[7] Argentina's exports to both Paraguay and Uruguay contracted (21.9 percent and 6.7 percent, respectively), affected by the drop in sales of agri-based manufactures (in the case of Paraguay) and raw materials (in the case of Uruguay). Argentina's exports to Brazil grew slightly (1.3 percent), boosted by fuel sales.

[7] During 1995, Argentina's exports to other Member countries increased almost 41 percent.

During the first half of 1996, Paraguay was the only State Party whose intrasubregional exports grew more rapidly than its total exports. In fact, Paraguay's intrasubregional exports experienced the highest growth rate in the region (46.1 percent), boosted by the sharp increase in sales to Brazil (Paraguay's principal market). This performance meant that during the period January to June 1996, MERCOSUR absorbed almost two-thirds (62.3 percent) of Paraguay's exports, compared to a little more than one half (54 percent) in the corresponding period in 1995.

Table II.3 MERCOSUR:
Growth Rate of Exports, January-June 1996
(percentages)

	Argentina	Brazil	Paraguay	Uruguay
Argentina		13.2	-15.1	-6.8
Brazil	1.3		51.0	2.3
Paraguay	-21.9	-1.5		70.0
Uruguay	-6.7	-20.3	173.2	
MERCOSUR	-1.6	5.3	46.1	1.4
Rest of the world	7.3	7.1	3.4	3.3
Total	4.3	6.9	26.4	2.4

Source: Prepared on the basis of official data of DATAINTAL

Brazil's intrasubregional exports also grew (5.3 percent), though at a slower rate than total exports. The factor responsible for this performance was the increase of sales to Argentina, which grew by 13.2 percent, boosted by the recovery of imports following the end of the recessive situation which prevailed until the first quarter of 1996. Exports of manufactured goods were the most dynamic. This performance allowed for a substantial reduction of Brazil's trade deficit with Argentina. which absorbs 70 percent of Brazil's exports to the subregion.

Uruguay's intrasubregional exports grew by only 1.4 percent. This was the result of the expansion of Uruguay's sales to Brazil, which absorbs more than one-third of Uruguay's total exports. During the first half of 1996, rice, dairy products and meat were the main items responsible for this performance.

The information available for the first nine months of the year indicates that intrasubregional trade was regaining its former dynamism. In fact, intrasubregional exports from Argentina and Brazil (responsible for almost 90 percent of total intrasubregional exports) increased 11.3 percent vis-a-vis the corresponding period in the preceding year, still below the 15.3 percent to which total exports expanded. The recovery of economic activity in Argentina and the acceleration of growth of aggregate demand in Brazil were the main factors explaining this performance. Should this trend be maintained, the value of intrasubregional trade in 1996 could be close to US$17 billion.

C. Investment Flows

Economic integration processes affect both trade and investment flows. In fact, this is one of their most important dynamic effects because direct investment is one of the strategic responses adopted by firms in the face of changes in relative competitiveness -and location advantages. Recent experience indicates that international investment and trade, contrary to what conventional trade theory maintains, are complements rather than substitutes.

In the particular case of MERCOSUR, the reduction of market fragmentation has begun to have a significant impact on the business strategies of the private sector. In fact, since the start of the integration process it has effected both intrasubregional and extrasubregional investment flows. Trade liberalization and rapid growth of trade have begun to have qualitative effects on business strategies in the subregion, whether through representation, distribution or productive complementarity agreements, the formation of joint ventures, the acquisition of shares in the capital of established enterprises, the opening of subsidiaries or, to a lesser degree, "strategic alliances".

I. Foreign Direct Investment in MERCOSUR

Between 1991 and 1995, MERCOSUR countries absorbed 30.3 percent of the FDI of Latin America and the Caribbean, to reach a record US$9.16 billion in 1995.[8] During this period, the share of Brazil as a recipient of FDI fell (vis-a-vis the preceding five-year period), whereas Argentina, Paraguay and Uruguay experienced an increase. In 1995, FDI flows to the smallest two economies more than doubled the records at the start of the decade. Nevertheless, since 1994, Brazil resumed its leadership position as a recipient of FDI in the subregion.

Even in the absence of definitive estimates for 1996, forecasts of FDI growth for the present year reach 35 percent, especially as a result of the high investments directed to Brazil (US$18.1 billion according to private estimates). In part, this increase is due to the privatization process initiated with the National Divestment Program launched at the beginning of the decade.

After the sale of state enterprises in the fertilizer and iron and steel sectors (already concluded), and chemicals and petrochemicals (in progress), the present stage is oriented toward the privatization of energy (controlled by Electrobras), roads, and infrastructure. The privatization of the oil and communications sectors is pending legislation, notwithstanding that the 1995 reforms to the 1988 Constitution established the bases for the dismantling of state monopolies in these areas.

Privatization and the behavior of domestic demand have been the main factors attracting FDI flows to the larger economies. In comparison, to date the integration process seems to have had only a minor impact.[9]

In terms of'quantity, the subregional integration process has not had a significant impact on investment flows; sizeable qualitative effects may, however, be observed in several areas, [10] for example in those sectors in which subsidiaries of transnational corporations predominate and where a gradual rationalization and productive complementarity process has developed. In fact, the so-called reorganization investment seems to have been more significant in the automotive and auto parts, food and beverages, petrochemicals, and textile sectors.[11] As the process of removing nontariff restrictions deepens, incentives to productive reorganization will be more intense.

The outlook of integration of the regional market of transport equipment, incentives of sectoral promotion regimes, bilateral agreements in existence since the mid-1980s, and the possibility of productive

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[8] UNCTAD/IMF, World Investment Report: Investment, Trade and International Policy Arrangements (New York, 1996).

[9] Although there are no exhaustive works for the entire region, this is the conclusion reached by a work that examined the experience of FDI to Argentina during the 1990-94 period. See D. Chudnovsky, Los limites de la apertura (Buenos Aires: CENIT-Alianza Editorial, 1966), Chap. 111. This conclusion may be extended to Brazil, where the size of the economy relativizes the role of the regional market as an incentive to investment.

[10] For a more detailed analysis, see R. Bouzas, *Integración* economica e inversion extranjera: la experiencia reciente de la Argentina y Brasil, in F. De la Balze (ed.), Argentina y *Brasil. Enfrentando el Siglo* XXI (Buenos Aires: Ed. Manantial, 1995).

[11] Four types of incentives to FDI have been identified that are associated with the static and dynamic effects of integration, namely: a) "defensive" investment to replace imports (the reply to "trade diversion" produced by preferential liberalization); b) "reorganization" investment (resulting from the effects of "trade creation" produced by economic integration; c) "rationalization" investment (derived from the reduction in production costs produced by the dynamic effects of integration; and d) "offensive" investment to replace imports (result of the acceleration of growth and the increase in market size). See United Nations, From the Common Market to EC92 (New York, 1993).

complementarity have already been seized by a number of established enterprises and others that have set up operations or have recently announced that they will set up operations (See Table 11.4). Among the former are the cases of Ford and Volkswagen (enterprises that have made new investments in Brazil and, to a lesser extent, in Argentina) or FIAT, General Motors and Toyota which, being established or developing productive activities directly in a single country, have located in the neighboring country. Firms not established or operating under licenses have also made or announced direct investments in the region, as in the case of Chrysler, Peugeot, Renault or Asia Motors. The total amount of investments announced in Argentina and Brazil through the year 2000 in the automotive sector is close to US$18 billion, a significant amount by any standard. In Paraguay, an investment plan of Toyota was approved for the construction of an auto parts and truck assembly plant; and there is also an investment project of the Korean firm Daewoo.

The increase in the variety of products offered and in the production and organization techniques that is taking place in the region starting with the new investments by transnational enterprises in the automotive sector will presumably have favorable effects on the economies. At any rate, it is still premature to state how far this reorganization process will allow the subregion's automotive industry to become an international actor or, simply, to allow it to operate more efficiently within the framework of the protection that the customs union will offer. In this respect, the new investments have not been directed only to the automotive assembly sector but also to the auto parts sector. Recent examples of these operations include the acquisition of an important local producer of exhaust pipes by Tannieco; the investments by the Italian autoparts firm Magnetti Marelli SA. in Argentina; and the acquisition of the Brazilian auto parts maker Metal Leve by Cofab and the German Mahle.

Table II.4
Investments Made or Announced in the Automotive Sector of Argentina and Brazil (1995-2000)
(millions of US$)

	Argentina	Brazil
Renault	500*	1.000**
General Motors	350**	2,600
Fiat	600 ***	1,000
Ford	1,000	2,500
Volkswagen	280	2,300
Peugeot	500 ****	250
Chrysler	165*	350*
Hyundai	not established	1,000
Mercedes Benz	100	500
Audi	nd	nd
Honda	not established	600
Toyota	150*	500
Iveco	125	not established
Scania	100	nd
Asia Motors	not established	500*
Mitsubishi	not established	150
ESTIMATED TOTAL	3,900	13,250

* Renault produces in Argentina througha licensee (CIADEA) in which it is a minority shareholder.
**New establishments.
*** Until1996 Fiat produced in Argentina through a licensee (SEVEL) in which it was a minority shareholder.
.**** Peugeot produces in Argentina through a licensee (SEVEL) in which it is a minority shareholder.
nd no data.
Source: Based on press and private sector information.

The food industry, especially in Argentina, has also received a significant increase in foreign direct investment, mainly through the acquisition of existing enterprises. Examples of such operations were the acquisitions by RJR Nabisco, Seagram, Heinz, and Cadbury Schweppes. The wine sector received a significant flow of foreign investments during 1996, as in the case of *Bodegas y Viñedos Santa Am* (one of the four most important wineries in Argentina), 65 percent of whose block of shares was acquired by Santa Carolina of the Chilean group Larrain. Although there is still no evidence that these investments are mainly aimed at exports, the establishment of foreign enterprises in sectors in which there are evident comparative advantages may be the prelude to greater trade and specialization. Examples more directly linked to the regional integration process are the establishment in Argentina in 1996 of two international manufacturers of frozen french fries, McCain Foods and Farm Fries, aimed at exporting tariff-free to Brazil. Investments in the dairy industry in Uruguay are also worth mentioning.

The petrochemical sector has also attracted the interest of foreign investors. In 1995, Dow Chemical (number one world producer of polyethylene) set up operations in Argentina and acquired an existing plant in order to supply ethane (derived from natural gas) to the Brazilian market more cheaply than that produced from gasoline in Brazil. The investments announced for the sector to the end of the century amount to US$2 billion in Argentina and US$6 billion in Brazil. The principal ventures in Argentina are linked to supplying the Brazilian market, as in the case of the Megaproject to produce ethane and the expansion of the cracker plant at Bahia Blanca to produce ethylene. The principal partners of the first project are the Argentine enterprise YPF, Petrobrás, and Dow Chemical. [12]

2. Intrasubregional Investments

Although cooperation and intrasubregional investment flows represent a relatively low amount quantitatively, they have acquired remarkable dynamism. Indeed they started from a very modest base but the intensity of flows in recent years has been substantial. A survey to May 1996 identified a total of 3 13 joint Argentine-Brazilian ventures, 60 percent of which were linked to the goods sector (Table II.5). According to the same source, 44 percent of the total has a direct productive impact. If these results are compared with a similar survey at the end of 1992, it will be seen that the total number of ventures has more than tripled in a little over three years. Notable among the sectors in which cooperation was established ate food and beverages (13 percent), automotive and auto parts (13 percent), banks (9 percent), telecommunications (5 percent), press and communications (4 percent), chemicals (4 percent), construc tion (4 percent), franchising (4 percent), and agricultural machines (4 percent).

It is interesting to note that the acquisition of blocks of shares or the establishment of subsidiaries do not constitute the most frequent linking mechanisms. On the contrary, there are other modalities such as the establishment of joint ventures, the opening of representation offices, complementarity and cooperation agreements, or, simply, representation agreements. Table II.5 presents a (non-exhaustive) list of the main business initiatives identified up to May 1996.

The lack of systematized information on intrasubregional foreign investment is an obstacle to a complete, reliable, and up-to-date quantitative analysis. Nevertheless, the data collected by the Central Bank of Brazil afford a partial picture of the recent evolution of the stock of investments.[13] Up to June 1995, the stock of Brazilian investments accumulated in the other three MERCOSUR member countries reached US$349 million. [14] This was almost double the US$180 million recorded in 1991. [15]

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[12] The investments programmed in Brazil are aimed at the construction of two new plants (in Paulina and Rio de Janeiro) and the expansion of the plant at Triunfo (Rio Grande do Sul).

[13] For an explanation of the limits to this information, the reader may consult ECLAC, *Directorio sobre Inversión Extranjera* en America *Latina y el Caribe* 7993: *Marco Legal e Información Estadística* (ECLAC: Santiago, Chile, *1993).*

[14] This sum excludes portfolio investments, except in Uruguay.

[15] According to the same source, in the first half of 1995 the flow of investments from Brazil to the other three Member countries of MERCOSUR reached US$63 million, in comparison to US$9.4 million for all of 1991. The flow of investments from the other Member countries to Brazil went from US$2.5 million to US$51 million.

Table II.5
Argentine-Brazilian Joint Ventures

Type of venture	October 1992	November 1994	May 1996
WITH TRADE IMPACT	**32**	**37**	**46**
Trade agreements	13	18	21
Distribution agreements	14	7	9
Offices/tradings	5	12	16
WITH PRODUCTIVE IMPACT	**43**	**92**	139
New plants	5	23	36
Joint ventures	3	15	23
Joint ventures-new plants	6	9	17
Acquisition of enterprises	5	17	22
Share holding	0	3	6
Productive complementarity	20	17	22
Exchange of technology	4	3	5
Regionalization	0	5	**8**
SERVICES	24	86	**128**
Agreements, operations or complementarity	nd	21	**30**
Share holding	nd	9	12
Joint venture	nd	14	20
Exemption	nd	10	14
Representations	nd	2	6
Subsidiaries	nd	14	22
Acquisitions	nd	3	7
Consortia to bid on public works	nd	a	11
Others	nd	5	6
TOTAL	99	215	313

Source: Embassy of Argentina in Brazil.

Up to mid-1995, Argentina had been the recipient of 75 percent of those investments (that is, US$262 million), concentrated in industry (59 percent) and in the services sector (37 percent). The main industries receiving the Brazilian investments were: automotive and auto parts (43 percent), metallurgy (18 percent), food and beverages (9 percent), electronic, electrical and communications material (9 percent), and chemicals (8 percent). Investments in the services sector were basically in banks (50 percent), insurance companies and trust companies (21 percent), and other finance institutions (26 percent).

Brazil's investment in Paraguay and Uruguay represented the remaining 25 percent, a rather larger proportion than the share of the smaller economies in other regional indicators such as GDP or the value of trade. In fact, up to June 1995 Paraguay had received investments of US$49 million from Brazil, 92 percent of which was earmarked for the services sector (banks, finance institutions, and trust companies). Brazilian investments in Uruguay were more diversified. Of a total of US$39 million, only 37 percent was allocated to the services sector (banks, real estate, and import/export operations).

At the same time, the stock of investments of Argentina, Paraguay and Uruguay in Brazil amounted to US$473 million, 36 percent above Brazil's investments in the other member countries; and of the total investment in Brazil, 73 percent was from Argentina. It is worth noting the outstanding increase in the stock of Argentine investments in Brazil in recent years, that went from US$36 million in 1991 to US$347 million in June 1995. This growth is mainly reflected in investments in the industrial sector (investments that up to June 1995 represented 89 percent of the total), concentrated in the food and beverages sector (78 percent), textiles (14 percent) and chemicals (5 percent). Whereas Brazilian investments in the services sector in Argentina enjoy a relatively important share, the converse is not true. Only 8 percent of Argentine investments in Brazil were concentrated in that sector at mid- 1995. This uneven performance is partially explained by the asymmetry in the terms of access to the sector in Brazil. During the last year, this question acquired public visibility after some Argentine banks tried to establish branches in Brazil.

Up to mid- 1995, the stock of Paraguayan and Uruguayan investments in Brazil amounted to US$11 million and US$115 million, respectively. In both cases the principal target sector was services (banks in the case of Paraguay, and banks, import/export trade, and real estate in the case of Uruguay). Of the Uruguayan investments, 36 percent were directed to industry (US$42 million), specifically to the chemical (25 percent), wood (22 percent), textile (18 percent), tobacco (9 percent), mechanical (9 percent), and food (8 percent) sectors. In 1991, Uruguay's stock of investment in Brazil was only US$53 million.

In comparison with other sectors, the public utility services (transport and infrastructure) mobilizes minimal amounts of investment in the four countries.

CHAPTER III. MARKET ACCESS AND CONDITIONS OF COMPETITION

Effective market access is a central feature of a customs union. While MERCOSUR has made major progress in this area, national regulations that limit free trade in goods still remain in place. The most obvious are tariffs (which still survive in the "automatic tariff reduction regime") and the special treatment granted to the automotive and sugar sectors. Less visible obstacles remain embodied in non-tariff restrictions of a border and non-border nature. But free access to the market also requires suitable mechanisms for regulating conditions of competition in the extended market and avoiding "unfair" trading practices, or at least assuring that measures to defend against them (mainly the application of antidumping and countervailing duties) do not tilt toward protection.

A. Automatic Tariff Reduction Regime

As a transitory procedure, the "automatic tariff reduction regime" exempts from duty-free treatment trade in a series of sensitive products included in specific national lists. The objective of this regime is to enable those sectors to adapt to the new competitive conditions within a defined time period (until December 31, 1998, for Argentina and Brazil and one year later for Paraguay and Uruguay). Convergence toward free trade within the region is taking place through a scheduled linear automatic tariff reduction starting from the respective total nominal tariffs in effect on August 1994, with an initial margin of preference granted by the member countries.[16]

The products eligible to be part of the "automatic tariff reduction regime" were those remaining on the national exception lists on December 3 1, 1994, and those that had been indicated in the protection clauses envisioned in the Treaty of Asunción.[17] For the products affected by safeguards a tariff- free quota, had to be established to benefit a trade volume no less than the one in effect when the measure went into effect. Paraguay and Uruguay were the countries that included the largest number of goods in the "automatic tariff reduction regime" because their national exception lists were the most extensive at the close of the transition period established by the Treaty of Asunción (Table III. 1).

During the period when the "automatic tariff reduction regime" was in effect, the member countries retained the power to withdraw and reintroduce products on their respective lists, and also to increase and reestablish the quotas set for products previously subject to safeguard clauses. Likewise, the member countries were authorized to move to the treatment envisioned in the tariff reduction timeline ahead of schedule. All these decisions may be adopted unilaterally.

Thus far the timeline for tariff reduction of the "automatic tariff reduction regime" has been met smoothly. On January 1, 1997, the margin of tariff preference over what it was initially rose 50 percent for Argentina and Brazil and 25 percent for Paraguay and Uruguay. The increase in the margin of preference for the products included in the "automatic tariff reduction regime" has prompted pressure on the part of some producer sectors, especially in Argentina. These pressures are expected to increase as the schedule for lifting tariffs moves further along at the end of 1997 and 1998.[18]

[16] The initial preference was applied as of January 1, 1995 to Argentina and Brazil and a year later to Paraguay and Uruguay. For Argentina, the total nominal tariff included the statistical tax.

[17] Contrary to the exception lists in the transition period (in which the number of products benefitting was to be reduced, not the level of protection), in the "automatic tariff reduction regime" the protection remaining over the total schedule of goods included gradually declines over a four-year period (five years in the case of Paraguay and Uruguay).

[18] The difficulties felt by some sectors currently benefitting from the "automatic tariff reduction regime" seem to be one of the reasons for Argentina's interest in establishing a safeguard mechanism for trade within the zone, as was expressed at the Fortaleza meeting (see section IV.C).

Table III. 1
MERCOSUR: Exceptions to Intra-Zone Free Trade

	Argentina	Brazil	Paraguay	Uruguay
Automatic tariff reduction regime				
Number of tariff positions	212	29	432	958
Products	Steel products, textiles and footwear, paper and cardboard, lumber, tires, sugar, appliances, orange juice, instant coffee and furniture	Textile products, rubber manufactures, wine, and peach preserves.	Textiles and footwear, food, paper and cardboard, leather, pharmaceutical products, steel, furniture, machinery and equipment, soap, glass manufactures, plastic, cement.	Textiles and footwear, machinery and equipment, steel products, food, pharmaceutical products, chemicals, plastics, paper and cardboard, glass manufactures, stones and ceramics, furniture, toys, lumber.
Free trade starting	1-1-1999	1-1-1999	1-1-2000	1-1-2000
Automobile and automotive parts				
Number of tariff positions	undefined			
Transition regime	A technical committee within the CCM must prepare a proposal for a common automobile regime before December 31, 1997, and it is to be in effect starting in 2000			
Free trade starting	1-1-2000	1-1-2000	1-1-2000	1-1-2000
Sugar sector				
Number of tariff positions	4	4	4	4
Agreement	An Ad hoc Group is charged with preparing an automatic tariff reduction regime for intra-regional free trade. Until the regime has been approved for the sugar sectors, the countries may maintain their total nominal tariffs for intra-zone trade. The time period for presenting the proposal was extended to May 31, 1997.			
Free trade starting	1-1-2001	1-1-2001	1-1-2001	1-1-2001

Source: Prepared on the basis of *Decisiones 5/94, 19/94, 24/94, 29/94 and 16/96, Resolución 48/94* and corresponding annexes.

At the proper time it was established that the "automatic tariff reduction regime" lists would be registered with ALADI before December 3 1, 1994, after they had been considered and approved by the Common Market Group (GMC). The "MERCOSUR Action Program to the Year 2000" (approved in December 1995) emphasized this objective as an essential element for consolidating and improving the customs union. Thus far, however, almost two years after the regime began to operate, this task has not yet been fulfilled. The reasons are certain disagreements between the member countries over the eligibility of certain goods and the treatment for products benefitting from the safeguard clause, questions that have been under consideration under the consultation procedure of the MERCOSUR Trade Commission (CCM - *Comisión de Comercio del MERCOSUR).*

The eligibility problems result from the imperfect equivalence between the nomenclature used for drawing up the exception lists of the Treaty of Asunción (NALADI) and that of MERCOSUR (NCM). [19] The same thing has occurred with goods not eligible for inclusion in the "automatic tariff reduction regime" as those whose import is prohibited (in the case of Paraguay) or were benefitted by GAIT safeguards (such as some kinds of paper in the case of Argentina). In this latter case, Uruguay is in the process of formally opening a dispute in accordance with the procedure established by the Brasilia Protocol .

[19] When the two sections of NALADI were merged into one of NCM, there were cases in which protection was extended to a previously unprotected item, making it necessary in some cases to clarify the scope of the restriction by means of technical notes.

B. Rules of Origin

When a customs union is still being formed, trade within the region must be partially subject to rules of origin. However, arrangements must be made to ensure that those rules meet their objective of avoiding the deflection of trade flows without constituting trade barriers within the region. The scope of the rules of origin to be applied in MERCOSUR extends to the following goods:

- Goods excepted from the CET when they are exports going to one or more member countries which have the product among the exceptions with a rate higher than that of the respective CET (descending convergence) or are exports made by one or more member countries which have the product among their exceptions with a rate lower than that of the respective CET (ascending convergence).
- Products with more than 40 percent of their FOB value in imported materials excluded from the CET.
- Products for which there is a differentiated trade policy (automotive, sugar, textiles, antidumping or countervailing duties applied to third countries, special import regimes, etc.).
- Exceptional cases determined by the CCM.

The general rule of origin combines the change of tariff classification and a requirement of a 60 percent regional value added (when there is no change in the tariff classification).[20] Nevertheless, many of the products excluded from the CET (like those in the computer and telecommunications industry) and others, such as chemicals and steel, have specific requirements.[22]

In the case of operations carried out under the bilateral agreements between Argentina and Uruguay (CAUCE) and Brazil and Uruguay (PEC) the rules of origin established in those agreements (50 percent regional content) remain mandatory until the year 2001. Likewise, during the transition, Paraguay benefits from preferential treatment because a requirement of only 50 percent regional content will be demanded for the products included in its list of exceptions to the CET until January 1, 2001. As of that year and until the year 2006, the MERCOSUR general list will be in effect.[21]

Almost two years after the customs union was launched, most member countries continue to demand origin requirements to all products entering from another member country, thereby impeding the free flow of goods. One reason for this procedure is that there is still not available a final consolidated list including the products subject to the MERCOSUR rules of origin and the requirements applicable to each of them.

Hence it is absolutely necessary to conclude the tasks of defining the complete list of products included in the scope of application of that regime, assuring that the list does not omit products that for some reason are not subject to a common trade policy and might thereby cause distortions in the conditions of competition within the subregion.

At Fortaleza, the Common Market Council (CMC) approved a decision that includes an initial list prepared by the CCM with the products subject to MERCOSUR rules of origin and their respective requirements. Members may require that products not included on the list comply with MERCOSUR rules of origin until January 1, 1999, (that deadline will be reviewed during 1998), which means that certification may generally continue to be required. Prior to that date, the survey of the various special import regimes in effect in the countries should be completed so that MERCOSUR rules of origin can be applied to the products included

[20] It may be that one group of products will be required to fulfill both criteria (change of tariff classification and over 60 percent regional content) but the corresponding list has not yet been approved.

[21] In exceptional cases when the specific requirements cannot be met due to the occurrence of circumstantial problems of supply, availability, technical specifications, delivery period, and price, materials not originating in the region may be used. Doing so requires the intervention of the authorized agencies and the competent government authority.

[22] In the event of a sudden increase of exports of the products exempted from the CET for Paraguay entailing damage or the threat of grave damage, the affected country may adopt duly justified safeguards until the year 2001. This is the only case in which it is permitted to apply protection to trade within the region.

in them. The CCM must draw up a work program before April 30, 1977, making it possible to finish the list of products subject to MERCOSUR rules of origin and the requirements applicable in each case.[23]

C. Non-tariff Restrictions and Measures

In late 1994, a series of non-tariff restrictions (NTRs) and non-tariff measures (NTMs) implemented by the member countries was identified and parameters were set for eliminating and harmonizing them, respectively. The CCM was charged with assuring compliance with this process through Technical Committee 8 (TC 8) on "Non-tariff Restrictions and Measures", which was not only to keep up to date the lists of existing restrictions and measures but also to identify new ones. Subsequently in 1995 it was decided that some of the Working Subgroups and Technical Committees were to monitor NTRs and NTMs in the areas of their competence and to bring matters to TC 8.

In the annexes of Decision 3/94 there are 224 non-tariff restrictions and measures on imports and 51 on exports identified by the member countries. The country that identified the largest number of cases was Brazil (33.5 percent of the total). Almost two-thirds of the total of NTRs and NTMs identified are those of the Agricultural Policy (40 percent) and Technical Standards (24 percent) subgroups. In 80 percent of the cases the NTMs were subject to harmonization.

As of October 1995, most (70 percent) of the NTRs and NTMs identified were still in effect. To these had been added 51 new measures awaiting harmonization or elimination. It was basically the Technical Standards Subgroup that had the task of analyzing them. Even though few advances had been made, 43 percent of the NTRs and NTMs that fell to the Agricultural Policy Subgroup had been eliminated, harmonized, or justified.

As of June 1996, the situation had not changed substantially. The reason was that at the Fortaleza meeting the GMC charged the Working Subgroups and the Technical Committees with keeping as their priority task the treatment of the NTRs and NTMs, and set July 31, 1997, as the final deadline for setting the date when the restrictions and measures listed could be eliminated or harmonized.[24]

In September 1996, Brazil made a methodological proposal in TC 8 for classifying the measures and restrictions identified. The proposal is that they be grouped into two categories: a) measures justified by GATT/WTO and b) non-tariff measures strictly speaking. The former would not necessarily be the object of negotiation within the region (although nothing would prevent them from being harmonized). They include 16 categories related to the protection of health, the environment, public morality, arms control and nuclear materials, combating unfair practices, etc.

The restrictions in turn would be subject to negotiation among the member countries. Classification into one category or the other of the measures and restrictions identified will be a very difficult task, as reflected in the consultations held in the CCM and the differences that have arisen among the member countries on similar matters (see, for example, section III.F).

Previously, a significant proportion of consultations held in the CCM have had to do with identifying NTRs and NTMs. From their inception (in 1995) to October 1996, Argentina was the country making the largest

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[23] In August 1996, the CCM had approved the instructions for the application of the MERCOSUR rules of origin to be utilized by customs administrations and the agencies empowered to issue certificates of origin, and they went into effect on November 1, 1996. Until the new list of agencies authorized to issue certificates of origin goes into effect, certificates issued by agencies registered with ALADI are valid. As of July 1, 1997, the customs administrations must use solely the consolidated list of agencies authorized for monitoring the issuance of certificates of origin.

[24] In addition the Communications, Financial Matters, Transportation and Infrastructure, and Energy subgroups and the Automotive Sector Technical Committee were asked to inform TC 8 of the list of NTRs and NTMs in their area of competence, in accordance with the provisions of Res. 32/95.

number of consultations (64.2 percent of the total) and most were aimed at Brazil (53 percent) (Table 111.2). As can be seen, most of the consultations were concentrated around these two countries, which is not surprising given the value of the trade involved.

Table III.2
Number of Consultations presented in the CCM 1995/OCTOBER 1996
(percentage)

COUNTRY OF ORIGIN OF **CONSULTATIONS**		COUNTRY **AT WHICH CONSULTATIONS ARE AIMED**				
		ARGENTINA	BRAZIL	URUGUAY	PARAGUAY	TOTAL
ARGENTINA	64.2	-	68.8	20.3	10.9	100.0
BRAZIL	16.7	69.4	-	22.2	8.3	100.0
URUGUAY	9.8	47.6	47.6	-	4.8	100.0
PARAGUAY	9.3	40.0	45.0	15.0	-	100.0
TOTAL	100.0	20.0	53.0	18.1	8.8	100.0
Number of consultations	215	43	114	39	19	215

Source: Prepared on the basis of Consolidation of Consultation's Arranged, XVII Meeting of CCM.

A review of the nature of the consultations awaiting solution can shed some light on the main NTRs and NTMs that have occupied the attention of the member countries. It should be emphasized that the consultations that have been delayed over a longer time period may bring to light areas where the conflict has been more diffkult to resolve. As of October 31, 1996, there remained 15 consultations of the 128 presented in 1995, most of them (all but two) initiated by Argentina.

Approximately half (seven consultations) are concentrated on matters related to phytosanitary matters and technical standards applied by Brazil (in the agriculture and food and beverage sectors) and by Uruguay (in the food sector). Four consultations were claims on discriminatory tax treatment on the part of Brazil (in the fishing and alcoholic beverages sectors) and Uruguay (in the alcoholic beverages sector and in trade and supplying of services in general). Another pending consultation had to do with the petroleum sector (also of Argentina and Brazil), motivated by the denial of import permits for paraffin.[25] The two consultations aimed at Argentina had to do with whether it was legitimate for that country to include a particular product in the final automatic tariff reduction regime.

The consultations began in 1996 and awaiting the ruling as of October 31 of that year together amounted to a total of 39 (50 percent of the total). Forty-four percent of them were directed at Brazil, 28 percent at Uruguay, 23 percent at Argentina, and the remainder at Paraguay. A third of the consultations pending had to do with public policies such as discriminatory tax practices. The main addressees of these pending consultations were Brazil and Uruguay and the sectors affected were wheat, beer, cigarettes, brake shoes, and motorcycles.

Seven of the consultations pending were connected to tariff matters and compliance with the timeline for lifting the automatic tariff reduction regime. In these areas the complaints were aimed primarily at Argentina and revolved around tariff treatment of products such as cow leather, rolled steel, gunpowder, and munitions. Seven other consultations had to do with pre-import permits, five of which had to do with the denial of import permits and the requirement of cash payment for various products (mozzarella cheese, zinc, self-adhesive labels, tinting materials, and glass) on the part of Brazil.[26] These issues will probably become

[25] The lack of reciprocity in access to the market for petroleum and petroleum products among MERCOSUR member countries has become a recurring theme, and the dispute extends to the realm of investments.

[26] Brazil has demanded import permits for all these products. This NTR is identified on the corresponding list and is expected to be eliminated. The demand for cash payment is applied to selected products as a requirement for issuing import permits. Complaints have been made about the change in the scope and the list of positions included in this latter mechanism.

less frequent after the SISCOMEX system is implemented and import permits are eliminated by Brazil starting in January 1997.

Only four of the pending consultations have been over technical standards or phytosanitary barriers applied by Argentina and Brazil. All other pending consultations involved impediments due to administrative procedures, quantitative restrictions, and antidumping. This last consultation has to do with a request to revise and update the antidumping investigations initiated between 1991 and 1996 in Argentina against a number of Brazilian products.[27]

In short, as the number and composition of consultations channeled through the CCM demonstrates, NTRs and NTMs are areas in which differences often arise between member countries. Despite the progress made in identifying issues, the prevailing imbalances that exist in national practices will continue to make this matter a key issue for assuring real access to markets.

D. Special Sectors

The automotive and sugar sectors have been temporarily excluded from free trade within the region and from common policies, primarily because of the severe inequalities in the government regulations in both sectors, especially between Argentina and Brazil. A technical committee (for the automotive sector) under the CCM and an ad hoc group (for the sugar sector) within the Common Market Group, are charged with preparing a proposal to decontrol trade within the region in both sectors, eliminate the domestic incentives that distort competitiveness, and propose a transition mechanism until a common regime is attained.

1. Sugar Sector

The sugar sector will be excluded from free trade within the region and common policies until the year 200 1; an ad hoc group to prepare a proposal for an automatic tariff reduction regime and common pol icies has been created. This group will also analyze the alternatives for neutralizing the distortions flowing from uneven national policies in this sector. Until the common regime is approved, the countries may maintain their total nominal tariffs for trade inside and outside the region.

According to the original mandate, that proposal ought to have been presented to the GMC before November 1, 1995. However, differences between the parties prevented the mandate from being met. The center of the dispute lies in the differences between Argentina and Brazil over how to make inclusion of the sugar sector in commitments to liberalize trade within the zone compatible with the national imbalances that exist over supply and pricing policies.

At the Fortaleza meeting, a year after the established deadline had passed, the CMC decided to grant an extension to May 3 l, 1997, for presenting a proposal envisioning gradual liberalization for products in the sugar sector and neutralizing the distortions that may arise from imbalances between national policies. This decision does not resolve the underlying issue, but merely extends the deadline for dealing with the matter, without adding anything substantial to the original terms of the decision.

2. Automotive Sector

In December 1994, the member countries assumed a commitment to draw up a proposal for a common automotive regime prior to December 31, 1997, and it was to be adopted as of January 1, 2000. That

[27] Argentina has made intensive use of its antidumping legislation against imports from Brazil. In September, 1996, there were 28 cases of antidumping investigations initiated by Argentina that involved products originating from Brazil.

proposal was to contain three basic elements: complete liberalization of trade within the region, a CET, and no national incentives that would distort competitiveness in the subregion.[28]

In addition, the member countries revised the bilateral agreements (between Argentina and Brazil, and between Uruguay and those two countries) in order to improve market access conditions as of January 1, 1995. In the agreement between Argentina and Brazil, Argentina considered Brazilian auto parts as national for the purpose of compliance with the national content requirement of the domestic auto regime, provided those exports were compensated with exports elsewhere.[29] Argentine exports of auto parts to Brazil were multiplied by 1.2 in order to offset auto parts imported from that country. Brazil in turn regarded Argentine auto parts as national for purposes of complying with the national content requirement envisioned for the "people's car" program underway at that time. Likewise, Argentine vehicles that met the requirements demanded by the "people's car" regime were regarded as national in Brazil. In addition, free trade in vehicles, trucks, and buses was established between plants (without quotas and with zero tariff). Although Brazil accepted the automotive regime until December 31, 1999, Argentina did the same with the "people's car" regime and other regulations having to do with the Brazilian automotive sector until the end of 1996.

In mid-1995, the Brazilian government devised a new program of sectoral incentives (through provisional measure 1024) whose main objectives were to reverse the growing deficit in the trade balance and to attract foreign investment to this sector.[30] The regime included a system of import quotas, preferential tariffs for the importation of raw materials, inputs, parts, and capital goods by automotive and related companies, and performance requirements (countervailing exchange mechanism). Assembly plants set up in Brazil were authorized to import vehicles with a 50 percent tariff preference.

The reaction that this initiative provoked among other MERCOSUR member countries, particularly Argentina, culminated in the decision by the Brazilian government to exclude trade within the region from the quota regime. In early 1996, an effort was made to resolve the conflict around the automotive sector with the negotiation and prior drafting of a common transition regime (similar to the previously existing Argentine regime) to be in effect until 1999.[31] Free trade in vehicles between the two countries was maintained, subject to the performance requirements established by the national regimes (imports should be compensated with exports to anywhere), and both countries mutually recognized that the regimes were to be in effect until December 3 1, 1999." Free trade in auto parts was established (zero tariff and no quotas) for those originating in the subregion, which were to be regarded as being of the importing country for purposes of calculating the mean index of nationalization of finished vehicles, provided they had been compensated with exports to any destination.

Both countries also agreed to establish two quotas without compensation, one for assembly plants located in only one of the countries and the other in acknowledgment of the bilateral trade deficit accumulated by Argentina between 1991 and 1994. The size of the first quota has not yet been agreed upon, although according to conversations held between the two parties (at the government and the private sector levels) it would be 60,000 vehicles a year for Argentina and 20,000 vehicles a year for Brazil. This segment of trade without compensation is especially beneficial to the Argentine assembly plants of Sevel and Ciadea, which

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[28] In addition, there was to be provision for the regime for importing parts for assembly plants and auto parts dealers, the regime for importing vehicles, indices of regional content, rules for protecting the environment and consumer safety, and a procedure for the transition from national regimes to the common regime, including harmonization of the existing promotion mechanisms.

[29] In the event that imports of Brazilian auto parts were not compensated with exports elsewhere, they would be regarded as imported for purpose of compliance with the national content requirement.

[30] Moreover, in February of that year the Brazilian government had raised the tariff for importing automobiles from 20 percent to 32 percent, and a month later raised it to 70 percent.

[31] This agreement replaced the bilateral agreement signed at the Ouro Preto summit in December 1994.

[32] The average indices of nationalization of finished vehicles and auto parts are set by the different national legislation. In both Argentina and Brazil, a 60 percent national content is required, although the manner of measuring that index differs.

do not have operations in Brazil.[33] The other quota would enable Argentina to export 85,000 vehicles to the Brazilian market free of any compensation up to December 31, 1998, although the distribution between assembly plants remains to be defined.

The problems posed by the fact that national policies for the automotive sector have not been harmonized was once again made evident with the measure announced by the Brazilian government in late 1996, whereby it offered tax incentives and tariff privileges to automobile assembly plants and related industries that make arrangements to locate in the north, northeast and midwest of the country before March 31, 1997 (investments of auto parts makers have an additional year). According to newspaper articles, the Korean companies Hyundai and Asia Motors and the Czech company Skoda plan to use those incentives to set up operations in Brazil. Until December 31, 1999, companies in the automotive and related sectors can benefit from reductions on tariffs (100 percent for import of machines and equipment, 90 percent for raw materials and auto parts, and 50 percent for finished vehicles) and duties (exemption from the Tax on Manufactured Goods -IPI- for the purchase of machines and equipment and a 45 percent reduction for raw materials and auto parts, and an income tax exemption for profits).[34] In addition, they will not be obliged to comply with national content requirement at least for a five-year period. Some of these benefits could be extended until the year 2010 at the discretion of the executive branch of government.

This measure prompted a reaction on the part of assembly plants located in Argentina, that urged their government to implement some kind of countervailing measure in the event that the government of Brazil did not change directions.[35] The Argentine government is considering what strategy to follow in the next negotiations which are expected to take place in early 1997. One of the main drawbacks to these measures is that the benefits could extend beyond the proposed date when the common automotive regime is to go into effect (January 1, 2000).

E. Export Incentives

Like the NTMs and NTRs and national policies toward the automotive sector, the issue of export incentives has recently become increasingly prominent. One of the reasons has been the increase in the divergence in practice between the two largest members; while the Argentine government has been forced to cut some current benefits for budgetary reasons, the Brazilian government has announced new stimulus measures in the areas of export financing and taxes.

The MERCOSUR member states have agreed not to use export incentives within the area with the exception of export financing, rebates or exemption from indirect taxes, and special customs regimes, which may be applied with certain restrictions.[36]

The accord establishes that for trade within the region the members may grant long term financing only for exports of capital goods and under conditions and rates compatible with international practice. Nevertheless, there are disagreements over how these agreements are to be interpreted. Official lines of credit that benefit other exports are justified by Brazil on the grounds that these measures ought to be considered as an imbalance of a credit nature that can be negotiated within the technical committee charged with government

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[33] All the plants installed in Brazil also have operations in Argentina, with the exception of Volvo.

[34] These investments would also be exempt from the additional tax for modernizing the Merchant Marine and the tax on exchange operations to pay for imports.

[35] One proposal is to apply current tariffs for trade outside the zone to Brazilian vehicles coming from the states favored with tariff and tax reductions.

[36] The member countries may use export incentives toward third countries, while respecting commitments assumed vis-a-vis GATT/WTO: they must refrain from using exchange rate incentives; they may grant credits for promoting and financing exports when they are granted with time periods and interest rates compatible with those internationally accepted in equivalent operations; they may exempt or reimburse (totally or partially) indirect taxes paid by exporters and may use draw back and temporary admission procedures.

policies that distort competitiveness.[37/38] The other MERCOSUR countries also have lines of official financing for export, although of lesser magnitude.[39]

With regard to fiscal incentives, the two largest members have also moved further apart in recent years. In August 1996, the Argentine government ordered the elimination of drawbacks for exports within the area (which were in effect only for capital goods and products included on the automatic tariff reduction regime lists of the other members) and their reduction to a maximum of 10 percent for exports outside the region. Likewise, it was decided to suspend the industrial specialization regime, by which import licenses were granted with preferential tariffs in return for export commitments. The Argentine private sector contrasted these decisions with the policy of refunding indirect taxes included in exports, such as the IPI (Taxes on Industrialized Products) and the ICMS (Tax on the Circulation of Goods) practiced in Brazil.[40] However, the agreements in effect in MERCOSUR allow the refund of indirect taxes for intra-regional trade in accordance with multilateral norms and until tax policy is harmonized.[40]

Special customs regimes such as drawback and temporary admission may be used in intraregional trade solely for inputs, parts used in manufacturing goods that are exempt from the CET, or those products whose inputs excluded from the CET are over 40 percent of the FOB value of the final product, which entail the application of rules of origin.[42] The objective of this limitation is to assure that the benefits from these rules will not be extended to suppliers from third countries. Nevertheless, the member countries have applied these rules extensively.[43] At the Fortaleza meeting, this situation was reaffirmed when it was decided that not until January 1, 1999, will the limitations on the use of such rules envisioned in the agreement on export incentives be applied.[44] It may be noted that the Chile-MERCOSUR Economic Complementarity Agreement authorized the use of drawback benefits and temporary admission for products falling under the trade liberalization program for a five-year period.

In addition, with regard to special customs regimes, it was established that the CCM would be responsible for analyzing the scope and limitations of their use in intraregional trade and for proposing the adjustments that might be necessary to preserve the protection provided by the CET. These issues have recently begun to

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[37] Since July, 1996, the BNDES has a Manufactured Goods Export Support Program, which has a US$1 billion fund and benefits the footwear, apparel, auto parts, furniture, manufactures of ornamental stones, ceramic finishing, electric appliances, tools, and plastic goods sectors.

[38] Tension over this issue may rise if plans go forward to improve credit conditions for Brazilian exporters. The BNDES proposes to cut the interest rate and raise the limit in the amount of loans in the Manufactured Goods Export Support Program. Moreover, the financing period for Finamex (credits for exports of capital goods) also operated by the bank could be extended from the current eight years to twelve years.

[39] In Argentina the main mechanism for export financing is operated by the Banco de *Inversión* y Comercio Exterior (BICE), which basically offers financing for export of capital goods. Other public and private banks also have lines of financing for exports. In Uruguay, there is no official mechanism for financing exports, but the Central Bank establishes certain regulations defining the upper limits for the interest rates that banks may charge. In Paraguay, the Banco *Nacional* de *Fomento* is the official institution that finances exports, but it has not been used very much, nor has the rest of the banking system developed significant lines of financing for exports.

[40] A bill completely exempting exports from the ICMS was recently passed.

[41] That work of harmonizing tax measures has begun within the technical committee on public policies that distort competitiveness, although progress is very slow given the reluctance of the member countries to give up degrees of freedom in this area. In principle, the parties agreed to begin by harmonizing taxes that may cause distortions in regional competition, especially indirect taxes. New problems arose with the decision of the Brazilian government to establish an additional drawback so as to restore the PIS-Pasep and COFINS taxes paid by exporters in the production cycle. The return is made through a credit on the IPI, and some argue that these taxes do not fit in the category of direct taxes (but rather of social contributions) and hence that they may not be rebated for exports within the region.

[42] Products negotiated in the framework of the PEC and the CAUCE may continue to use special drawback and temporary admission customs rules.

[43] In February 1995, Argentina limited the use of special customs rules to products exempted from the CET, but three months later it temporarily suspended the application of this measure until the other countries take the same step and assure equal treatment for all MERCOSUR exporters.

[44] It would be useful to remember that the Chile-MERCOSUR Economic ComplementationAgeement authorized the use of the draw back benefits and the temporary admission of products benefited from the trade liberalization program for a five year period.

be considered in the CCM with a concentration on aspects such as the identification of the goods for which benefits may be granted, the determination of whether the goods exempt from the CET are so from the standpoint of the importer or of the exporter, and the analysis of the impact of applying these regimes to the automatic tariff reduction regime. These tasks ought to be complemented with the review of the special customs regimes in effect in the member countries, in order to reduce the imbalances that may exist between the respective mechanisms (for example, in the area of deadlines).

At the Fortaleza meeting in December 1996, the GMC decided to set up an ad hoc group (under Working Subgroup 7 - Industry) specifically to examine the situation of trade policy applied to the leather sector. By April 30, 1997, this group must conclude a proposal for treating the leather and related manufacturing sector in trade within the zone and outside it, with a view to neutralizing national policies affecting competitiveness. The leather issue had been submitted by the CCM to the GMC in November, in response to questions raised about the tax that Argentina applies to leather and wet blue exports in order to stimulate local processing.

F. Public Policies that Distort Competitiveness

A Technical Committee on Public Policies that Distort Competitiveness has been operating within the CCM since April 1995. Its objective is to identify those public policy measures in effect in each member country that by their discriminatory nature may distort conditions of competition within the region.

Once identified, the measures must be classified according to the following categories: a) measures that entail exceptions to MERCOSUR common trade regime; b) tax-related measures; c) measures of a credit nature; d) measures connected to the regime for government procurement; and e) other measures. On the basis of this classification, the TC should identify which measures are compatible or incompatible with the operation of the customs union, bearing in mind criteria of economic efficiency, the general objectives of MERCOSUR, and multilateral provisions. Those measures that are compatible must be harmonized (whether by an overall adjustment of the current norms or by maintaining them with the proper justification), while measures that are incompatible must be gradually eliminated.

Originally, proposals from the TC were to have been submitted to the CCM for its approval before June 30, 1995, but the complexity of the activities and the varying positions of the member countries made it impossible to meet that deadline. Thus far information has been exchanged on the public policies that distort competitiveness and based on that information a consolidated list has been drawn up. In these efforts differences have arisen between the countries about the scope of the measures that should be included on the agenda. Likewise, discussion was initiated around possible criteria to be used for harmonizing or eliminating the measures identified.

At Fortaleza, the CMC instructed the GMC to set up an *ad-hoc* group to provide advice on dealing with public policies that distort competitiveness. Keeping in mind the work already performed, by June 30, 1997, this group must revise and in any case redefine the criteria, procedures, and scope of the measures originally established, and also assure that discipline is applied to public policies that distort competitiveness. In practice, there has been very little progress in this area due to the significant imbalances in public policies existing between the member countries. Given its potential influence on trade flows and the placement of investment, this topic is a key aspect of the future agenda.

G. Protocol to Safeguard Competition

The basic guidelines for safeguarding competition were agreed upon by means of Decision 21/94. In discussions held in Technical Committee 5 to Safeguard Competition major divergences in the internal systems of the countries were exposed. While Argentina and Brazil already have laws on the matter, neither

Paraguay nor Uruguay has such legislation. Likewise, while there are no substantial differences with regard to the scope of application and to the classification of behavior prohibited in Argentine and Brazilian legislation, the legislation in the former is concerned solely with anti-competitive behavior while in the latter it also includes norms on the control of mergers and acquisitions. There are also differences over the makeup of the agencies for compliance, and over procedures and sanctions.

In October 1996, the presidents of the National Commission to Safeguard Competition in Argentina and the Administrative Economic Defense Council of Brazil signed a Letter of Intent to establish a program of cooperation between the two countries for safeguarding competition. They further agreed to provide Paraguay and Uruguay with assistance for developing legal mechanisms and creating institutions to safeguard competition.

The Protocol to Safeguard Competition is intended to be a tool for protection against unfair practices and for analyzing mergers and acquisitions within MERCOSUR more effectively. The document contains specific rules on practices that restrict competition and a chapter on anti-trust. The two enforcement agencies are the MERCOSUR Trade Commission and the Committee to Safeguard Competition. The c hapter on procedures mentions the Protocol of Brasilia for the Settlement of Disputes as a final level of appeal in the event that consensus is not reached.

While there was agreement on most items, at the November 1996 meeting of TC 5 the governments of Argentina, Paraguay, and Uruguay judged that it was necessary to include in the Protocol to Safeguard Competition a chapter on government aid to companies, since it causes distortions in conditions of competition in the region. Brazil rejected this stance on the grounds that the "State aid" is not a topic envisioned in Dec. 21/94 and that it must be dealt with by Technical Committee 4 on Public Policies that Distort Competitiveness.

At the GMC meeting in Fortaleza, Argentina made approval of the Protocol contingent on the inclusion of an article on government assistance and on maintaining in effect national legislation on anti-dumping and countervailing duties to intra-regional trade, until approval is given to Chapter 1 (anti-dumping measures) of the Common Regulations on Unfair Practices by Third Countries, which would also apply to intra-MERCOSUR trade. The Argentine proposal revised the agreement of the member countries (Res. 129194) to replace anti-dumping legislation within the internal market with legislation to safeguard competition.

The argument for replacing one piece of legislation with another is that in a single market there are no differences between export prices and domestic prices, and in any case, it is predatory price policies that antidumping policies must combat, and for that purpose the appropriate tool is a legislation to safeguard competition. For Argentina that argument would be valid only after the customs union was firmly established, but in the meantime antidumping legislation would have to be used. The positions taken by the largest two MERCOSUR member countries reflects the intensity with which this mechanism has been used by both of them and the nature of their public policies to provide incentives to the private sector.

The protocol was finally approved by the CMC (Dec. 18/96) with the incorporation of an article on government aid in the chapter on transitory measures. There, the member countries agree to draw up within a two-year period common standards and procedures to discipline assistance from the government that might restrict or distort competition and affect trade between member countries. Likewise, it was established that until December 31, 2000, investigation of dumping made by a member country into imports from other members would be carried out in accordance with national laws. During that period the countries will examine the standards and conditions in which the matter will be governed in MERCOSUR.

CHAPTER IV. COMMON POLICIES

A customs union presupposes the implementation of common policies in a certain number of areas. At a minimum, a customs union must adopt a common external tariff **(CET)** and common customs procedures to assure that the admission of goods into the expanded market takes place under similar conditions regardless of point of entry. MERCOSUR is a customs union in formation, in that the Member countries are in transition toward having a CET fully in effect; they still continue to require origin compliance for all trade, and they have not yet reached normative and practical uniformity on customs procedures.

A. Common External Tariff

The main instrument of common trade policy formally in effect in MERCOSUR is the CET which is applied to imports coming from outside the region. The CET agreed upon includes eleven tariff levels between 0 percent and 20 percent, with an average tariff of 11.3 percent. The CET has been in effect on almost 88 percent of all tariffs since January 1, 1995. The remaining 12 percent belongs to the sectors temporarily excluded (sugar and automobiles), the sectors of capital goods, computer, and telecommunications sectors, and to the products included in the national exception lists. The agreement on the CET envisions a maximum tariff rate of 14 percent for capital goods -which is due to go into effect in the year 2001- and an upper limit of 16 percent for telecommunications and computer products--which is due to go into effect in 2006.[45] In the case of capital goods, for Uruguay and Paraguay the convergence period will be extended to January 1, 2006. Convergence will take place in annual tranches moving upward or downward according to the initial national tariff.

The national exception lists include up to 300 products (399 for Paraguay) excepted from the CET (Table IV. 1). These exceptions will be in effect until December 3 1, 2000, except for Paraguay which may maintain its list until 2006.[46] Convergence toward the CET is to be gradual, linear, and automatic, moving upward or downward according to a schedule, just as in the capital goods, computer, and telecommunications sectors. The member countries may hasten the process of convergence toward the CET, although it will be irreversible, unlike the automatic tariff reduction regime.

The agreement on the CET also establishes that all imports from special customs zones, export processing zones, or free trade zones must pay the CET or the national tariff (if the product is excepted from the CET). Between Argentina and Brazil there is an exception until the year 2013 for products manufactured in the special customs zones of Tierra del Fuego (Argentina) and Manaus (Brazil).

In practice, most MERCOSUR countries continue to collect the CET on imports from outside the region entering through another member country. Some justify this practice on the grounds that there is no consolidated list with the positions excepted, although that would authorize them to require rules of origin for all products but not to collect the CET on an extra-regional product that already paid it.

In fact, even if a consolidated list existed, the member countries would be able to continue demanding rules of origin and payment of the CET on a product from outside the region not subject to the origin rules entering through another member country simply because there was no procedure for assigning customs revenue. This practice is expressly authorized for goods meeting certain conditions by the Transitory Provisions on the rules to be applied on clearing customs approved by CMC Decree 16/94. Technical Committee 2 of the CCM is currently discussing the scope of that authorization, in view of the fact that there

[45] Within TC 1 of the CCM, a discussion is taking place on tariff treatment for goods not produced in MERCOSUR that belong to the capital goods, computers, and telecommunications sectors. These goods would have a zero tariff and a list common to the four countries.

[46] The positions included in the automatic tariff-reduction regime that entail exceptions to the CET have to converge toward the agreed upon CET by January 1, 1999, for Argentina and Brazil, and one year later for Paraguay and Uruguay.

is no uniform criterion for collecting the CET on imports from outside the region that enter through a member country and are then reexported to another.[47]

The central problem would therefore seem to be the lack of mechanisms for assigning customs collection and the lack of clear rules indicating what procedures are to be used in the event that the differential between the national tariff and the CET must be collected if the product enters through a member country and is then reexported to another country which has it as excepted off the top. This point must be included in the transitory provisions of the customs code, which would be in effect until all exceptions to the CET and other instances of non-common trade policy are eliminated.

Moreover, other exceptions to the CET remain in effect besides those originally agreed upon, and their permanence extends the scope of the application of the rules of origin, impeding the free circulation of goods (although in any case the origin compliance is being required for all products) and causes distortions in competition between the member countries through differences in the structure of effective protection. The more noteworthy of these are:

The mechanism established in June 1996 whereby the CCM can approve tariff reductions in case of supply problems up to a maximum of 20 products per country for up to one year.[48] The four member countries have used this procedure for a small number of products and Brazil is the country that has included most products. This system is more restrictive than the previous ones because it allows a smaller number of exceptions to the CET with the additional demand that a quantitative limit to making use of the benefit, be set.[49] But it is also more flexible because it does not need to be ratified by the GMC, nor does it authorize the other member countries to go along with the tariff reduction for the products included by one of them. In June the GMC, by way of exception, also authorized Brazil to include in its exceptions to the CET some 18 tariff items with rates higher than the CET ranging from 22 percent to 56 percent. This measure was requested by that government in the context of the protectionist pressures prompted by the worsening trade deficit in 1996.

Applicability of bilateral preferential agreements with other ALADI countries.[50]

Special import rules. [51] In June 1996, a Special Committee was created within the CCM charged with analyzing and identifying the products benefitted in order to evaluate whether they needed to be incorporated into the consolidated list of products subject to the MERCOSUR origin rules.

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[47] Strictly speaking, a mechanism should be designed for those products that are subject to the application of rules of origin and that enter a member country from outside the region and then go to another member country that does not have it as an exception to the CET, in which case the latter should charge the differential between the national tariff and the CET.

[48] These products may be replaced or renewed at the end of each half year. The rate applied to imports from outside the region may not be less than 2 percent (in exceptional cases the CCM may authorize rates of zero percent). They shall be subject to rules of origin and moreover it may be possible that, at the request of some CCM member country, rules of origin may be established for goods produced therefrom where the inputs considered in the measures are over 40 percent of the FOB value of the final product.

[49] The new mechanism replaced the Dallari list and the system for guaranteeing supply of raw materials and inputs, both established in early 1995. The Dallari list (which allowed 150 further exceptions to the CET to deal with supply bottlenecks) authorized the Brazilian government to modify the list and rates of up to 75 tariff items every three months. The other member countries were authorized to accept the tariff reduction in order to preserve equal conditions for competing in the region. The Dallari list was gradually reduced until it included some 10 products in the April-June 1996 period. The guarantee system made it possible that when facing problems of regional supply of raw materials and inputs, the four member countries could adopt tariff reductions (maintaining a regional preference margin) for up to 50 items. These measures had to be previously evaluated and approved by the CCM and ratified by the GMC. The other member countries could adhere to the tariff reduction while the measure was in effect. At that time, it was established that this procedure would be in effect until April 28, 1996, but it was extended for another year. Before expiring, it was replaced by the procedure established in June 1996.

[50] It should be emphasized that products traded in the framework of these agreements are subject to less demanding rules of origin than in MERCOSUR.

[51] Like the rules for importing goods going into turnkey plants (Argentina), on fiscal incentives for national and foreign capital investments (Paraguay), on industrial promotion (Uruguay), and the tariff exemption for importing sporting goods (Brazil).

The textile sector is a special case. In late 1994. a Technical Committee was created within the CCM to analyze whether it would be advantageous to adopt a common external policy for the sector, and if so, to define it. Meanwhile the member countries were authorized to apply measures toward imports from out side the region (without thereby entailing the inclusion of new exceptions to the CET) and they assumed the commitment not to charge specific duties on trade in textiles from outside the region.[52]

Before June 30, 1995, the TC was to bring to the CCM a report on trade in textile products and its effects on the region, along with the recommendations that it considered necessary and trade policy actions that MERCOSUR ought to adopt, bearing in mind the entry into effect of the WTO agreements.

The differences between the member countries over conditions of competitiveness and the impact of trade flows from outside the region on their respective textile sectors hindered the efforts of the TC. Nevertheless, the differentiated policies in some cases also affect trade within the region. Therefore, in September 1996 the CCM redefined the working agenda of the TC in the textile sector.[53] The guidelines established are not very precise and deadlines for meeting them have not been set. While the issue of a common trade policy was included, eliminating the remaining barriers affecting trade within the region is the priority.

A conflict arose between Brazil and other MERCOSUR members in mid-1996 over the measure announced by the Brazilian government whereby it was cutting the time period for textile financing and import from 180 to 30 days as a requirement for issuing import permits. In the end the Brazilian government eliminated the requirement for the import originating of textile goods produced in MERCOSUR.[54]

[52] The member countries have included a number of textile and footwear products in the lists of automatic tariff reduction regime and exceptions to the CET.

[53] The technical committee must: a) list legal documents of extra-regional trade policy in order to harmonize them in the long run and analyze their repercussions within the region; b) monitor the evolution of the flows of trade inside and outside the region, in an effort to guarantee the efficacy of the trade policy tools used by the member countries; c) monitor and promote the removal of obstacles to trade flows of textiles and apparel within the region; and d) develop regulations aimed at standardizing technical norms on MERCOSUR trade in textile products and apparel.

[54] A problem was also posed with Argentina a few months ago when officials decided to require labeling and certification of origin for imports of certain footwear and textile products, thereby in some cases affecting remittances from other member countries.

Table IV.1
MERCOSUR: Exceptions to the Common Trade Policy

	Argentina	Brazil	Paraguay	Uruguay
Capital goods				
Tariff positions	approx. 1100	approx. 1100	approx. 1100	approx. 1100
Maximum CET	14%	14%	14%	14%
Convergence	1-1-2001	1-1-2001	1-1-2006	1-1-2006
Computers & telecom				
Tariff positions	approx. 400	approx. 400	approx. 400	approx. 400
Maximum CET	16%	16%	16%	16%
Convergence				
National lists				
Tariff position*	300 / (206)	300 /(0)	399 / (288)	300 / (362)
Products**	Chemical products (R/F), Precision instruments (R/F) Mach. & equip. (F), Steel products (R/F) Textiles & footwear (R/F) Paper (F), Food products (R/F), Furniture (F), Toys (F)/ Plastic (F), Rubber (R/F), Lumber (F), Transportation Mat. (F).	Machinery & equip. (F), Chemicals (R/F), Transportation (F), Textiles (R) and footwear (F), Paper & cardboard (R), Petroleum products (F), Leather and furs (R), Foods (R/F).	Chemical Products, Machinery & Equipment, Steel, Textiles & Footwear, Foods, Pharmaceutical products, Toys, Plastics & rubber, Paper & cardboard, Glass & ceramic manufactures.	Chemical products (R), Plastics and rubber (R), Steel products (R/F), Textiles (R), Pharmaceutical products (R), Machinery & equipment (R), Paper & cardboard (R/F), Leather and furs (R).
Sugar	Common trade policy by 2001			
Automotive	Common trade policy by 2000			

. * The exceptions to the CET resulting from the automatic tariff reduction regime do not count for purposes of the limit established (indicated in parenthesis). These positions must converge to the agreed upon CET in 1999for Argentina and Brazil, and a year later for Paraguay and UruguayThe number of positions included is the maximum allowed.

. ** R: Rising tariff convergence/ F: Falling tariff convergence. All of Paraguay's excepted products have rising convergence.

Source: Prepared on the basis of *Decisions 7/94,19/94, 29/94 and 16/96, Resoluciones 48/94 and 124/94* and exemption national lists.

B. Customs Matters

It is vitally important for the functioning of the customs union that the Customs Code agreed upon between the member countries (Decision 25/94) be fully in effect. It is also necessary to conclude its rules of application, implement integrated border controls, interconnect the information systems of the customs administrations, coordinate the struggle against customs crimes, and complete the uniform adoption of customs evaluation criteria. In the following pages the current situation with regard to each of the topics is presented, revealing that many questions still remain pending, including those having to do with the adoption of standards. Indeed, in the area of customs matters, there is a significant divergence between the mass of standards agreed upon and those that have really been adopted by the member countries.

With regard to the Customs Code, as of October 1996 the only country that had ratified it was Paraguay (with Law No. 621/95). In Argentina it was being studied by the executive branch, while in Brazil it had been approved by the Chamber of Deputies and was being analyzed by the Federal Senate. In Uruguay it had recently been brought before the Chamber of Deputies.

With regard to border controls, the Recife Agreement stated that Integrated Controls were to be applied on borders between member countries.[55] This agreement was incorporated into the legislation of almost all the countries (except Paraguay, where it is being implemented). The four countries approved a list of sixteen border points with integrated controls (Res. 8/94) and agreed on administrative regulations of the coordinating agencies in the area of integrated control.[56] As of October 1996, the only country that had incorporated the provisions into its legislation was Argentina, while Uruguay had done so with the first resolution (which was being implemented in Paraguay) as had Brazil with the second.

As of September 1996, the greatest advances in implementing integrated checkpoints had been made between Argentina and Uruguay and between Argentina and Paraguay, especially with regard to integrated checking of local and tourism travel and freight transported by truck (but not by railway). The only progress made on integrated checkpoints between Brazil and another member country is that of the Santana do Livramento/Rivera border point, where monitoring of freight transportation by truck is already in operation (Table IV.2). The reasons given for the slow progress in implementing integrated border controls, at least for Brazil and Argentina, are the existence of unequal standards in the border control agencies between the countries and inadequate infrastructure at customs points. That is the case with Paso de los Libres/Uruguayana and Puerto Iguazú/Foz de Iguazú, the two access points between both member countries.

Paso de los Libres/Uruguayana is one of the border points with integrated control agreed upon in Res. 8/94 and it is the most important access point of Argentine exports (as measured by value) into the Brazilian market and the main exit for Brazilian exports (in value) to Argentina. According to that resolution, the integrated control at this border crossing ought to function as follows: local and tourism traffic is checked by officials of the two countries at the entry point to the Paso de los Libres bridge and freight transported in truck and by railway will be checked at both entry points. The general criterion for customs checking is that it be performed in the recipient country.[57] In this instance, it is claimed that the inadequate infrastructure at Paso de los Libres (in addition to the fact that both countries have not passed legislation) is a hindrance to launching the integrated control program.

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[55] Integrated control points are understood to mean areas where the competent officials of adjoining countries use compatible procedures for verifying compliance with the legal and administrative requirements for the entry and exit of persons and goods, simultaneously if possible.

[56] There are two border points for Argentina and Brazil, two for Argentina and Paraguay, three for Argentina and Uruguay, three for Brazil and Paraguay, and six for Brazil and Uruguay. Sixteen integrated controls are envisioned for local and tourism traffic, another sixteen for freight carried by truck, and three for freight carried by railway.

[57] This means that all procedures having to do with Brazilian expats to Argentina shall be carried out at the "Freight Control Terminal" in Paso de los Libres and those connected with Argentine exports to Brazil will be checked at the Border Customs Station in Uruguayana.

At the Puerto Iguazú/Foz de Iguazú border crossing there is now an Integrated Control system located at the Brazilian entry to the bridge, where officials from both countries work. Res. 8/94 intended that integrated checking of local and tourism traffic and vehicle freight be performed at both entry points. Again the absence of infrastructure and lack of common rules is hindering the establishment of integrated controls.

Table IV.2
Number of Controls Implemented and Not Implemented According to Countries involved
(September 1996)

COUNTRIES	LOCAL AND TOURIST TRAFFIC		LOADS CARRIED			
			BY TRUCK		BY TRAIN	
	YES	NO	YES	NO	YES	NO
ARGENTINA-BRAZIL		2		2		1
ARGENTINA-PARAGUAY	1		2			1
ARGENTINA-URUGUAY	3	1	2	1		1
BRAZIL-PARAGUAY		3		3		
BRAZIL-URUGUAY		6	1	5		
TOTAL	4	12	5	11		3

Source: Prepared on the basis of Document 3/96 of the Working Subgroup on Customs Matters.

Some of the problems presented as a result of lack of coordination between customs at the same border point are differing schedules and duplication of activities at each of the posts, making procedures lengthy and therefore increasing operating costs.

The value at customs of imported goods is the basis for the application of the Common External Tariff (CET) and any other non-tariff charge established by specific common provisions. It shall be monitored selectively in accordance with the rules to be applied to customs clearance. All four countries already have legislation responding to Decisions 16/94 on customs clearance and 17/94 on customs appraisal of goods. Nevertheless, legislation on general guidelines for such decisions has not yet been drawn up in Brazil and Paraguay. At the Fortaleza meeting, the Technical Committee on Customs Matters was enjoined to continue to move forward with the tasks of implementing a uniform system for applying appraisal criteria.[58]

Likewise, information systems are not sufficiently developed to allow them to be interconnected nor is there agreement on the content of the information that will be exchanged between customs of the members.

By Resolution 125/94 agreement was also reached on rules on customs crimes and penalties. They have not yet been incorporated into national legislation.

C. Regulations on Unfair Practices and Safeguards

Technical Committee 6 on Unfair Practices and Safeguards has been devoted to drawing up draft proposals, one on unfair practices (dumping and subsidies) and another on measures for safeguards against third countries, along the lines of the WTO Agreements. The deadline for presenting both regulations to the CCM has been repeatedly postponed; the current deadline is July 30, 1997. The successive extensions have been justified on the grounds of the technical complexity of the tasks and on the interpretation and harmonization of texts prepared in different languages. The drafting of the regulations on dumping is in its final stages.

[58] The magnitude of the tasks remaining in the customs area has made this area a key issue for technical cooperation. In this regard, in June 1996 the first Meeting of General Customs Directors of the European Union and MERCOSUR was held in Recife within the MERCOSUR/UE Program for Cooperation and Technical Assistance. Customs representatives from Chile and Bolivia also attended. The member countries expressed their interest in receiving technical assistance on the following issues: economic customs regimes (as integration mechanisms, free trade zones, and customs warehouses, comparison of UE and MERCOSUR regulations), computerization and customs procedures, and the struggle against illegal trade and drug traffic.

The Common Regulations on the Application of Safeguard Measures to Imports from non-MERCOSUR Member Countries was debated at the Fortaleza summit of the GMC. Argentina would only give its approval on the condition that the other member countries accept a study on an exceptional procedure for applying safeguards within the region. In the end, the Argentine position did not obtain consensus and the Protocol was approved by the CMC as Decision 17/96.

The Common Regulations establish the rules for applying safeguard measures understood as the measures envisioned in Article XIX of GATT 1994 and the WTO Safeguards Agreement. MERCOSUR may adopt a safeguard measure for a product as a single entity (if rising imports of a product harm or threaten to gravely harm the domestic production of the subregion) or in the name of one of its member countries. The safeguard measures shall be applied to all imported products no matter where they come from. Textiles are excluded and are to be governed by the WTO Textiles and Apparel Agreement.

The Trade Protection and Safeguards Committee is to be the entity that will evaluate whether there is damage or threat of grave damage or not. The CCM will make decisions on initiating investigations and adopting safeguard measures. The interim chair will inform the WTO Safeguards Committee of any decision on the use of safeguard measures.

The safeguard measure will be applied as an increase on the import tax. In the event that quantitative restrictions are used, they may not reduce the volume of imports to levels lower than the average of the most recent three representative years. The maximum period for applying the measure is four years, with the possibility of extension. The application period of a measure may not exceed eight years. In very urgent situations provisional safeguard measures may be applied for a period of no more than two hundred days.

During a two-year period (1997-98) until the rules of the member countries have been adjusted, they shall apply their national legislation on the matter in accordance with the Transitory Provisions of the Common Regulations.

D. Protocol on Consumer Protection

Through Resolution 126/94, the Consumer Protection Committee was charged with continuing work aimed at drawing up a draft Common Consumer Protection Regulations. The aim is to define the frame work that will guarantee consumer rights within the subregion, without thereby posing unnecessary obstacles to trade.

Consumer Protection is a recent branch of law. Since the beginning of the decade, Brazil has had a Consumer Protection Code and it has a hundred consumer protection agencies that provide legal assistance in this domain. While the date envisioned for finalizing the Common Regulations was November 30, 1996 (according to Dir. 23/95), at the Fortaleza meeting five of the chapters on specific issues (consumer, supplier, etc.), basic rights and the protection of the health and safety of the consumer, advertising and contractual guarantee of goods and services were approved as resolutions. In any event, the Protocol will go into effect only after all the chapters have been approved and they are incorporated into the national law of the member countries. Still pending are the issues of supply of goods and services, abusive supply practices, contractual protection, accession contract, and temporary location clause.

Once the member countries agree upon the entirety of the Common Consumer Protection Regulations, the Santa Maria Protocol on International Jurisdiction for Consumption Relations, approved last December by the CMC (Dec. 10/96), will go into effect. This protocol sets up the international jurisdiction for the area of consumer relations between providers of goods and services and consumers. When it goes into effect, consumers who suffer harm for any reason (for example, by the sale of defective products) may sue any company in the region in courts in their own cities.

CHAPTER V. HARMONIZATION OF POLICIES AND "DEEPENING"

The Mandate of Asunción for the Consolidation of the Southern Common Market approved by CMC decision in December 1995 established a "MERCOSUR Action Program to the Year 2000," which as it took steps to consolidate and improve the customs union (consolidation of free trade and conditions of competition within MERCOSUR, improvement of common trade policy, and legal and institutional development) likewise made the "deepening" of the subregional integration process a prime objective. In that document, "deepening" was identified with issues such as progress toward the common market, externa1 relations, and other dimensions of integration (environment; labor relations, employment and social security; culture; health; education; science and technology; intellectual property; police coopera tion and migration). Some of these topics are treated in this section with special attention given to progress made since approval of the mandate.

A. Labor Issues

As the customs union takes firm hold, divergences between nations in the area of labor legislation will become more prominent and important. Harmonization is one possible path toward dealing with it, but it is not necessarily the only option open. A key question lies precisely in identifying which aspects of the respective bodies of labor law need harmonization and which can be left in the realm of competence between different institutions and regulatory principles. A pre requisite for doing so is more thorough knowledge of the national legislation from a comparative standpoint. inasmuch as there has been little progress in this area even though it has been five years since the signing of the Treaty of Asunción. This is one of the tasks specified in the Priority Negotiating Guidelines prepared by Technical Subgroup 10 on Labor, Employment, and Social Security Issues approved in October 1996 by the GMC (Res. 115/96).

Although the Negotiating Guidelines are extensive, none of the tasks envisioned have time periods of over two years.[59] The issues are grouped under three commissions: a) labor relations, b) employment, migration. professional qualification and training, and c) health, safety, work inspection, and social security. The basis for the Negotiating Guidelines that were approved is Recommendation 1/96 presented to the GMC by Technical Subgroup 10. This recommendation included among the Subgroup's tasks the evaluation and observance of the consensual list of IL0 conventions and other intemational agreements, and continued study of the "MERCOSUR Charter of Fundamental Rights in the Area of Labor", which have not been included in the Negotiating Guidelines. This was due to opposition on thc part of Argentina, which believcd that it was first necessary to "analyze the social dimension of the integration process and the various altematives for its institutional formulation". This task was what was finally added to the Negotiating Guidelines of Technical Subgroup 10 at the Fortaleza meeting as Res. 153/96.

The ratification of the ILO agreements and the drafting of a MERCOSUR social charter are initiatives that labor unions have been following with special interest, and they reflect the fear that there could be episodes of "social dumping" due to disparities in labor regulations. The purpose of the common social charter would be to lay down similar foundations in the realm of labor (with regard to hiring, remuneration for time worked, health and safety protections, vacations, Christmas bonus, etc.) and coordination among labor organizations.

[59] The tasks entrusted are comparative analysis of legal institutions and collective relations agreed upon by the member countries, the study of labor costs in specific areas of the economy, harmonization of health, safety, and labor environment, coordination of monitoring procedures in the area of work inspection, creation of a system of occupational certification valid for the four countries, monitoring the impact of the integration process on employment, and incorporation of the issue of labor migration in sectoral analyses of employment.

In MERCOSUR countries, the labor movement has gradually begun to take an active part in the integration process. The CCSCS (Coordinating Body of Labor Federations of the Southern Cone -*Coordinadora de Centrales Sindicales del Cono Sur),* which emerged a decade ago, had gone into obscurity until 1991 when it reemerged seeking to coordinate the strategies of the region's labor organizations. This body links the labor federations of the four MERCOSUR countries, as well as Bolivia and Chile. The first manifestation of the coordinated labor movement of the countries of the region occurred in December, when the CCSCS decided to observe the Intemational Day of Struggle for the Labor Rights of MERCOSUR Workers. The demonstration was held at the same time as the Fortaleza summit and consisted of marches in some cities of the region.

The labor union members delivered to the MERCOSUR Joint Parliamentary Commission a document with four demands: a) approval of the charter of workers' rights; b) creation of procedures for carrying out collective bargaining in MERCOSUR; c) definition of a policy to promote employment by creating funds to support productive reconversion and professional retraining; and d) more room for organized sectors of society (such as NGOs) in the groups decision-making processes.

The labor federations intend to have more demonstrations in 1997. The CCSCS is organizing a simultaneous labor stoppage across the subregion in March 1997. In May it will take advantage of the Third Encounter of the Americas in Belo Horizonte to reiterate its claims.

On the business side, the new dimension in labor relations took shape through the formation of the MERCOSUR Industrial Council. The only permanent body in the process in which both employers and workers participate is the Economic and Social Consultative Forum, which channels the concerns of both sectors about the labor and economic policies adopted.

Before the Fortaleza summit meeting, provisions were made for dealing with a Draft Multilateral Social Security Agreement, that sought to guarantee to workers who migrate from one member country to another social security coverage and to reconcile the time of contribution, without modifying the characteristics of each country's system. The draft agreement included benefits for old age, disability, and death, as well as both government and private retirement, and included public health benefits. This draft was withdrawn from the agenda of the summit because the Argentine government, which supported it, nonetheless thought that its possible fiscal impact demanded a deeper analysis.

B. Trade in Services

The Treaty of Asunción established free trade in services, but this commitment was not accompanied by any specific timeline. Only with the Mandate of Asunción (Action Program to the Year 2000) approved in December 1995 was it determined that in the new phase of deepening the integration process, progress should be made toward liberalizing trade in services. The process began with approval of a framework agreement based on the GATS [General Agreement on Trade in Services]. The subgroup on services was to finish preparing the protocol by September 1996 and to present recommendations for negotiating the Lists of Initial Specific Commitments. However, two years after the Mandate of Asunción, not much progress has been made: although the first meeting of the group was held in September 1995, negotiations only began to move after mid-1996. The upshot is that thus far the Framework Agreement has not been approved.

The draft of the Framework Protocol on Trade in Services comprises four parts: scope of application and definitions, general obligations and disciplines, specific commitments, and liberalization schedule. Following the GATS guidelines, the draft broadly defines trade in services, identifying four ways in which they are provided. Among the more important general provisions are the granting of most favored nation treatment to providers of services from any other member country, regulation of monopolies, and of exclusive providers of services to assure that MFN treatment is observed, the establishment of safeguard

measures in conformity with what is agreed upon in the WTO, free flow of capital among the member countries, authorization to apply restrictions to trade in services in order to protect the balance of payments, and the exception made for govemment procurement of services intended for official purposes, to which MFN treatment is not to be applied, national treatment, and market access commitments.

With regard to specific commitments, the framework protocol establishes that each member will grant national treatment to services in the sectors included in the liberalization program. The article on market access establishes that in those sectors where specific commitments are contracted, the member countries may not maintain nor adopt limitations on the number or amount of service operations. The protocol establishes that the liberalization program is to be carried out over ten years (as of the date on which the Framework Agreement goes into effect). Annual rounds of negotiation will enable new sectors of services to be brought into the liberalization program, and to reduce or eliminate measures affecting trade in services. Each country shall draw up a list with the sectors in which it will assume specific commitments. It is also established that three years after the list of commitments assumed goes into effect, a member may modify it, provided that it negotiates compensation with any other member country that may feel affected.

The countries have expressed reservations about severa1 of the provisions in the Framework Agreement, especially with regard to the ability to maintain measures that might be incompatible with MFN treatment, and the relationship between negotiation of the liberalization of certain areas of services and the simultaneous establishment of the disciplines necessary to assure that certain interna1 regulations do not hinder trade in services, the commitment not to impose restrictions on capital transfers except when there are very serious externa1 financing or balance-of-payment problems, the exclusion of contracting of services by the govemment of MFN commitments, national treatment, and market access, and the non-inclusion of measures that limit inputs intended for the supply of services among the prohibitions to the adoption of limits on the total number of service operations or the sum total of services produced.

In order to finalize matters pending on the Framework Agreement, the GMC decided to instruct the Ad Hoc Group on Services to submit the final text of the Framework Agreement to the interim chair by September 30, 1997, and to submit recommendations for negotiating the Lists of Initial Specific Commi tments so that they could be considered by the GMC in December 1997.

Formulating an agreement on services and commitments to liberalization for this sector has become important for some member countries because of the imbalances existing in the area of market access. One case that drew public attention in 1996 had to do with financia1 services. Regulations in Brazil limit the number of foreign banks that may be established in the country, while in Argentina the regulations on establishing banks are very liberal. This difference became evident as a result of problems that Argentine banks encountered in setting up operations in Brazil. While branches of Brazilian banks like the Itaú and Bamerindus had set up operations in Argentina, the Banco Rio, the Banco Francés and the Banco de Galicia have been waiting for some time for permission from the Central Bank of Brazil to operate with their own branch offices there. The problem lies in the fact that the federal law on banks in Brazil requires that foreign banks be associated with a local financia1 institution in order to operate on the local market. To resolve the problem, the Banco de Galicia formed a partnership with the Barclays Bank, and acquired 23 percent of the bankshares of the Banco de Crédito Nacional Barclays de Brasil, which initially operated as an investment bank but this year was authorized to function as a multiple service bank.

C. Treatment of Foreign Direct Investment

In an economic integration process, divergences in regulatory matters become more important because when the market becomes less fragmented trade flows and placement of investment are energized. Even though investment regulation patterns have converged significantly between MERCOSUR members, there are still major divergences between them. Almost al1 restrictions on foreign investment have been removed in Argentina and Paraguay. The Brazilian rules on foreign investment still retain some limitations but the

process of constitutional reform (the regulations for which are still being drawn up) have made it possible to make progress in the opening of certain sectors to foreign capital. In Uruguay the parliament is discussing the need to approve a new foreign investment law to reflect the overa11 context because in practice the restrictions imposed by current legislation are not effective.

While the regulatory framework in effect in Argentina does not place restrictions on the participation of foreign capital in any sector of economic activity, there are specific pieces of legislation that currently restrict its access in certain cases, for example, real estate in border regions.[60] In Brazil, a series of constitutional amendments were approved in 1995, allowing for greater participation of foreign capital in sectors where restrictions were formerly in place. However, in a number of cases the extent of the reform will depend more on the regulations to implement the constitutional changes than on the constitutional reform itself, and those are still pending.[61]

In Paraguay, Law 117/91 on Investments establishes national treatment for foreign investors. No previous permission is required except for foreign investors who wish to take advantage of the benefits of the fiscal incentives regime for investment of national and foreign capital as provided by Law 60/90. This requirement is also valid for national investors. The foreign investment regime does not place any restric tions on national treatment, although there would be certain restrictions resulting from particular or sec toral legislation, for example, for participation in public works. Nor are there restrictions on the profit remittance or capital repatriation. It should be noted that restrictio ns are placed on the participation of capital in sectors now under state monopoly, such as ANTELCO (telecommunications) and ANDE (electric power).

Law 14179/74 in effect in Uruguay establishes an optional set of regulations for foreign investors that guarantees remittance of profits and repatriation of capital under certain conditions. Prior authorization is

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[60] The former restrictions on the participation of foreign capital in the areas of the media and uranium mining were removed in practice with the signing of the Bilateral Treaty with the United States, in which Argentina does not reserve the right to maintain exceptions to national treatment in these sectors. Inasmuch as the bilateral agreements signed by Argentina include a most-favored-nation clause, the concessions granted to the United States extend in practice to other countries. A law that would open the way to the participation of foreign capital in nuclear power generation is pending approval in the parliament. Actually, the current legislation restricts the participation of private capital, whether national or foreign, by reserving this activity solely to the state. Law 24,498 on Mining put nuclear materials (uranium) on a par with other minerals, thereby nullifying the previously existing restriction on its exploration and commercialization.

[61] Law 4131162 (amended by Law 4390/64) which regulates foreign direct investment in Brazil requires that foreign investment be registered at the Central Bank of Brazil. The registration certificate protects the rights to repatriate capital and remit dividends outside the country. By virtue of Article 176 of the Federal Constitution only Brazilians and Brazilian companies with national capital could be allowed to explore for and market mining and hydraulic power resources. With the modification introduced, the state may grant concessions to Brazilians and companies set up under local legislation whose headquarters and management are located in Brazil. However, there are restrictions for border regions and indigenous lands. A change has been introduced into gas distribution allowing private companies to be granted concessions for this service, although regulations have not yet been drawn up. Previously this activity was reserved to the state.

- Article 178 of the Federal Constitution formerly stipulated that only Brazilian ships could transport goods by navigating along the coast and inland. Through a constitutíonal amendment it became possible for foreign vessels to participate, although specific regulations will be required to establish the conditions. In addition, provisions on the requirements of the nationality of the owner, captain, and crew were eliminated. In October 1995, the Executive Power sent a bill to Congress but it has not yet been passed. The bill envisions some restrictions on the participation of foreign vessels in coastal and inland shipping of goods and certain restrictions on the nationality of the crew.
- The constitutional amendment to Article 177 relaxed the state monopoly in the fossil fuel area. Exploration, marketing, and production of petroleum, natural gas, and other liquid fossil fuels, the refining of national and foreign petroleum, and its export and import, along with that of petroleum products, and the transport of crude oil on ships or by oil pipeline, were all state monopolies. The amendment does not completely eliminate the state monopoly in the area of fossil fuels but it relaxes it inasmuch as it allows private sector participation. However, specific legislation must be passed that will make provision for assuring the supply of petroleum products, contracting conditions, and the structure and powers of the agency to regulate the state monopoly. Currently, the Congress is considering a bill sent by the Executive Power. The restrictions in effect in the fossil fuel sector have led to a number of complaints by Argentines in the oil business over the difficulties they face in gaining access to the Brazilian market for petroleum products, particularly lubricants.
- Exclusive control over telecommunications services by the state (or by companies in which the state holds a controlling interest) was lessened through a constitutional amendment to Article 21. The state may develop these services directly or indirectly; regulations on concessions, authorizations, or licenses, the organization of services, the creation of a regulating body, and other institutional aspects are to be determined later. At the end of 1995, the Executive Power sent to the Congress a set of bills for regulating telecommunications services -the bills on cellular phone service and policy for the use of satellite were passed in the Chamber of Deputies in May 1996, but have not yet been voted upon in the Senate.

required for taking advantage of the regulations. In some sectors foreign investors must obtain express authorization from the executive power with reasons given.[62] There are also state monopolies, such as ANCAP in the oil sector.

In January 1994, the MERCOSUR members signed an agreement on the promotion and protection of investments within the region -the Protocol of Colonia- by which they agreed to grant investors in the region most favored nation status or to treat them as national investors. This protocol, which is now before the parliaments in al1 member countries, represents nothing more than the sanction of national policies which are open to foreign capital on non-discriminatory bases in Argentina, Paraguay, and to a lesser extent, Uruguay. That protocol prohibited the use of performance requirements, and expropriation (except for reasons of public interest and with payment of prómpt, adequate and effective compensation) and prohibited restrictions on the repatriation of capital and remittances of profits in convertible currency. Nevertheless, the member countries have reserved the right to retain exceptions to treating investments within the region as national for an unspecified period of time.[63]

The member countries also signed a Protocol on the Promotion and Protection of Investments from Third Countries which establishes a common legal framework to be applied to the treatment of investments from outside the region. While general principles for minimum performance in the treatment of invest ments from outside the region were defined (especially in the areas of expropriation, transfers, and settlement of disputes which formalized in a regional agreement commitments already made in bilateral agreements), the members reserved the right to promote investments in their territory and did not set any restriction in this regard. This protocol was approved in Argentina and Paraguay, which deposited their instruments of ratification in March 1996, while in Brazil and Uruguay it is making its way through the legislative process.

The problems posed by differentiated treatment of foreign investors by member countries resurfaced when the Brazilian govemment announced incentives for investments in the automotive sector to set up operations in the north, northeast, and midwest areas of the country. This divergence is made al1 the greater by the fact that the resources available to national governments (and local states) to offer incentives for (national and foreign) investment are very uneven. However, it should be pointed out that the European Union does not yet have an harmonized system for treating foreign investment, but merely the possibility of utilizing legislation to safeguard competition when national or regional incentives for investment threaten to cause distortions in the expanded market (see Section III. G).

D. Regulations on Government Procurement

Regulations on government procurement may constitute an obstacle to market access if they grant preferential treatment to local suppliers. Moreover, the existence of preferences for supplying governments could completely cancel out tariff concessions, as was the case for a long time among the countries of the European Union for certain goods (for example, trade in telecommunications equipment).

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[62] At one time, what made this regime attractive to companies was that it assured profit remittance and capital repatriation, albeit under certain conditions. Inasmuch as currently the general regime does not set limits, the benefits and restrictions established by Law 14179/74 have no effect.

[63] Among Argentina3 exceptions are real estate in border areas, air transport, naval industry, nuclear power generation, uranium mining, insurance, and fishing. Brazil's list of exceptions is more extensive, and includes exploration and development of minerals, utilization of hydraulic power, health care, radio broadcasting services and other telecommunications services, purchase or lease of rural property; participation in the financia1 intermediation, insurance, securities, and capitalization system; construction, real estate, and coastal and inland navigation. Moreover, Brazil reserved the right to retain the exception envisioned in its Constitution with regard to government procurement (subsequently amended by the 1995 reform). Both Argentina and Brazil reserved their right to continue demanding performance requirements in the automotive sector. Paraguay included in its list real estate in border areas; mass media; air, sea, and land transportation; electricity, gas, water, and telephone service; exploitation of fossil fuels and strategic minerals; import and refining of petroleum products, and postal service. The sectors excepted by Uruguay are electricity; fossil fuels, basic petrochemicals; atomic energy; development of strategic minerals; financia1 intermediation; railways; telecommunications; radio broadcasting, press, and visual media.

These procedures have different features in each of the MERCOSUR countries. The current procedure for government supply in Argentina is quite open and national treatment is the general rule. In Paraguay, Uruguay, and Brazil there are specific regulations for public works that grant certain preferences to national individuals and legal entities.[64]

The regulations on government procurement in Brazil were changed by a constitutional amendment in August 1995. Article 171 of the Federal Constitution established the distinction between a Brazilian company and a Brazilian company with national capital, and allowed the latter to receive certain benefits through specific legislation and preferential treatment in govemment procurement of goods and services. This article was eliminated by a constitutional amendment, and hence the distinction between national and foreign companies disappeared. Nevertheless, the preferential treatment mandated in Article 170 for small Brazilian companies with national capital was retained, although, with the elimination of the distinction between a Brazilian enterprise and a Brazilian enterprise with national capital, this benefit is in effect for enterprises established under local legislation that have their headquarters and management in Brazil. In any case, a restriction remains in place inasmuch as small companies are required to have a presence, and they are able to enjoy favorable treatment in purchases made by the state.

Other regulations goveming purchases of some large Brazilian state-owned companies, such as Telebrás and Petrobrás, state that supply is preferably to be provided by national producers. At least in the case of Petrobrás, preferential treatment for local suppliers could be continued if the bill to regulate the constitu tional amendment relaxing the state monopoly of fossil fuels is passed. The bill states that Petrobrás shall enjoy flexibility for its purchases and contracting, and that current legislation on public bidding need not be observed. Moreover, this firm will have priority in the public bidding processes in which it partic ipates, when other companies offer equal conditions.

Decree-laws 666/69, 687/69, and 1143/70 make it mandatory that imports by govemment agencies or enterprises be transported in Brazilian flag vessels. Although the effectiveness of these regulations will probably decline with the process of privatization and opening to foreign capital, a broader agreement to allow regional suppliers access to govemment procurement would be desirable (for example, by eliminating the presence requirement). Nevertheless, in this instance the conditions that must be met by the ben eficiaries need to be defined.

Regulations on govemment procurement are handled in the CCM Technical Committee on Public Pol icies that Distort Competitiveness and in the Ad Hoc Group on Services, which is under the GMC. The Technical Committee must determine whether these rules are compatible or not with the operation of the customs union and depending on each case, propose that they be harmonized (if they are compatible) or gradually eliminated (if they are incompatible).

Moreover, the Ad Hoc Group on Services is also now discussing this issue, as it prepares a framework agreement on trade in services based on the GATS model, which contains provision on govemment procurement. Specifically, GATS establishes that govemment procurement of services is not subject to most-favored-nation, national treatment, and market access clauses. The MERCOSUR countries have not yet reached a consensus on this matter, although this situation may change.

In view of the importance of the issue, at the last meeting of the GMC, held in Fortaleza, Argentina pre sented a proposal to create an Ad Hoc Group on Govemment Procurement whose mandate would be to draw up a MERCOSUR protocol in this area to deal with market access and harmonization of procedures.

[64] Law 1045/83 of Paraguay places restrictions on foreign companies that seek to participate in public works. The law establishes that any public work must be executed by Paraguayan professionals or companies; in those cases where foreign companies must be hired, they must be in partnership with local companies, and their share may not exceed a certain limit set by law. In Uruguay, Laws 15903/87 and 16170/90 are in effect, and they grant preferences in government procurement for public works to those goods and services entailing the greatest use of national labor and products. In order to participate in international bidding for public works in Brazil, fa-eign companies must be associated with national companies.

E. Environment

The issue of the environment was mentioned marginally in the introduction to the Treaty of Asunción. Two years later, on the occasion of the Presidential Summit at Las Leñas, the Specialized Meeting on the Environment (REMA -*Reunión Especializada* ***de Medio Ambiente)*** was created with the hope that it would be the kick-off point for developing a common environmental agenda. It was REMA's task to analyze each member country's environmental legislation and offer suggestions on how to harmonize environmental protection and how to eliminate NTRs applied for environmental reasons. After a year of work, however, REMA only managed to issue eleven Basic Directives encompassing a wide variety of topics, the most salient of which were the harmonization of environmental legislation among the various members, sustainable use of natural resources, inclusion of environmental cost as part of total cost, adoption of non-polluting technologies, adoption of common environmental criteria in intemational economic negotiations, monitoring of activities that could have an environmental impact on shared ecosystems, and institutional strengthening through information exchange.

In 1995, environmental officials in the four countries met for the first time in Taranco, Uruguay. At that meeting it was decided that the main objective to be reached in 1996 was the harmonization of environmental regulations. Another point of emphasis was the importance of closely following the negotiations on ISO-14,000 to verify the possible effects on the intemational competitiveness of the area's exports. Despite these ambitious objectives the most notable practica1 consequence of the Taranco meeting was that REMA became part of the Common Market Group structure as a technical subgroup (Technical Subgroup 6 "Environment"). SGT 6 defined seven priority tasks with their respective time periods, namely: i) analyzing NTRs connected to environmental matters and preparing a proposal to harmonize or eliminate them; ii) encouraging studies to evaluate the environmental cost and make it part of total production cost so as to allow for equitable conditions of environmental protection and competitiveness; iii) encouraging implementation of proposals in the area of the environment that were presented by the Working Subgroups at the end of the transition period, having to do with needs, requirements, and sectoral costs (energy, agriculture, industry); iv) monitoring the process of preparing the ISO-14,000 standards, and analyzing the possible impacts of their application on the competitiveness of the subregion's exports; v) drafting a legal document that would take national legal provisions as a reference point and seek to optimize levels of environmental quality by effectively applying the legal procedures in each of the member countries; vi) designing and launching an environmental information system; and vii) defining and formalizing a MERCOSUR Green Sea1 system.

Despite (or because of) the ambitious goals that the subgroup set for itself, progress has been slow and there have been few concrete accomplishments. At the subgroup meetings held in 1996, a procedure for examining and resolving non-tariff measures and restrictions was established and 18 measures were ex amined (13 were considered to be environmentally justified, one was partially justified, and the remai ning four are still being analyzed). Work was begun on the tasks related to the matters of competitiveness and the environment, and they were initially expected to be concluded by December 1997. With regard to monitoring, the process of drawing up the ISO-14,000 standards, the different tasks were begun and there was one specific experience of the member countries being involved in the negotiation process for the ISO-TC-207. With regard to preparing a legal document (whose original deadline was October 1996), progress was made on drafting a single text which considers the environmental standards in effect in the countries and seeks to optimize levels of environmental quality and to move forward on harmonization. With regard to implementing an Environmental Information System, the Ad Hoc Working Group was set up within SGT 6, and it prepared a proposal for taking the actions needed to establish such a system, including a timeline for work. Finally, it was agreed to move forward gradually toward a Green Seal, beginning with a process of analysis and identification of national products that could receive a MERCOSUR Environmental Seal, and drawing up a list of such products to be used as a pilot project for certification.

F. Cultural and Educational Issues

Among the topics dealing with the overall dimension of integration mentioned in the Mandate of Asunción for the Consolidation of MERCOSUR, were those having to do with culture and education. With regard to cultural matters, it stated that encouragement should be given to the spread of the artistic expressions, values, and ways of life of the peoples of the member countries by preparing programs and projects to improve the promotion of cultural expressions and knowledge of history in order to preserve and protect the cultural heritage, encourage cultural exchanges, and support artistic creation . On educa tional issues, it stated that the various levels should be made compatible, opportunities for joint training of personnel should be established, plans for teaching the official MERCOSUR languages should be set up, national information systems should be inter-connected, and academic degrees should be recognized.

At the Fortaleza summit in December 1996, two protocols on educational integration were signed. The first establishes that the members will recognize university degrees issued by the accredited universities in each country, solely for pursuing postgraduate studies (that is, these degrees will not constitute qualification for working as a professional). Entry of students from other member countries will be govemed by the same admission requirements as those applied by institutions of higher leaming to students of the country. Each member country agrees to let the others know which universities or institutes of higher learning are to be recognized as falling within this Protocol.

The second protocol, which has to do with postgraduate leve1 human resource training, includes among its objectives training and upgrading university professors and researchers in order to bolster and extend advanced degree programs in the region, creating an exchange system among institutions in order to encourage training of human resources, and establishing common standards and criteria for evaluating advanced degrees. In order to attain these objectives the countries will support cooperation between research and teaching groups working together in areas of regional interest, with emphasis on doctoral leve1 training; efforts to harmonize the existing advanced degree programs in the region; and the establishment of specialization courses in areas regarded as strategic for the development of the region. It also esta blishes the creation of an Ad Hoc Regional Technical Commission on Advanced Degrees for overall planning and monitoring of actions flowing from this agreement.

The members also signed a Protocol on Cultural Integration, agreeing to promote cooperation and ex change between their respective institutions and performers in the cultural realm. This action goes beyond stimulating co-production of artistic events and strives to encourage joint training of human resources in the area of culture, research into common historic and cultural matters, and cooperation between institutions responsible for preserving the historic and cultural heritage. Each country also agreed to protect within its own territory the intellectual property rights of works created in other member countries and to facilitate the entry of material intended for use in cultural projects and transit of people involved in them. The presumption is that once these commitments have been implemented, they will make it possible to improve the circulation of artistic expressions which thus far remained subject to a number of restrictions in customs procedures.

G. Institutional Design

As defined by the additional protocol to the Treaty of Asunción on the Mercosur Institutional Structure (Protocol of Ouro Preto), the institutional structure is strictly intergovemmental in nature (see Appendix). The maximum authority is the Common Market Council (CMC), composed of the ministers of foreign relations and economy (or their equivalent), and it is the agency responsible for guiding the integration process politically. Under it is the Common Market Group (GMC), which is MERCOSUR executive agency made up of official representatives of each of the members. The MERCOSUR Trade Commission (CCM) is the agency responsible for applying and monitoring the common trade policy instruments agreed upon, and it is also made up of representatives from each member country. Under the Trade Commission in

turn are ten Technical Committees which deal with different issues. Linked to the Common Market Group are also the Economic and Social Consultative Forum (made up of representatives of economic and social sectors), the Joint Parliamentary Commission, the Administrative Secretariat, and the Specialized Areas which work on structural matters (Ad Hoc groups, Specialized Meetings, and Working Subgroups).

An essential component of the institutional design of an integration agreement is the procedure for resolving disputes. In MERCOSUR, the mechanism in place is constituted by the Protocol of Brasilia for the Settlement of Disputes, signed in December 1991, which went into effect in April 1993, thirty days after the formal registration of the third instrument of ratification. The process established in the Brasilia Protocol establishes a mechanism in stages with separate treatment for disputes between govemments and for claims by individuals.

Govemments that have a dispute first make use of direct negotiation (within 15 days), and may then (in the event that there is no agreement) go to the GMC, which shall have 30 days to make recommendations (after consulting with experts). If no agreement is reached, authorization is given for arbitration through an Ad Hoc tribunal which shall issue a binding decision which shall be final and shall not be subject to appeal. Claims of private parties (individuals or legal entities) can be handled through the conflict resolution system only when there is a failure to comply with legal or administrative (within the country) requirements but not over violations of the Treaty of Asunción or agreements flowing from there. The Protocol of Brasilia envisioned that private parties might present their claim through the national section of the GMC and established procedures for handling disputes.

The Protocol of Ouro Preto signed in December 1994 and in effect since December 1995, created a new body (the CCM) whose functions include handling claims filed by the national sections of the CCM coming from member countries or claims of private parties. An Annex to the Protocol of Ouro Preto also established a General Procedure for Claims to the CCM that makes it easier for private parties to pursue their claims. The national section of the CCM is responsible for presenting the problem to the intergovemmental CCM, which, in the event that it fails to reach a decision, must bring the matter before a Technical Committee (which has 30 days to issue a ruling). After the ruling has been issued, the CCM makes a final decision, except when there is no consensus within it, in which case the matter is taken before the GMC which shall resolve it within 30 days. If there is no consensus, the petitioner may invoke the procedure established in the Brasilia Protocol. After having exhausted al1 procedures, Uruguay has announced that it will invoke the procedure established in the Brasilia Protocol in a dispute that has risen with Argentina over inclusion by that country of goods in the automatic tariff reduction regime. At this stage of the formation of the customs union, increasing attention is being paid to the desirability of creating a special tribunal to give shape to legislation for the economic community; some member countries have called for it, but there is nevertheless no consensus on this matter.

The Protocol of Ouro Preto of December 1994 established that the MERCOSUR Administrative Secretariat (SAM -*Secretaría Administrativa del MERCOSUR*) headquartered in the city of Montevideo is to be responsible for providing services to other bodies in the group. SAM's functions include serving as the official archive for the documentation of the integration process, Publishing and distribut ing the regula tions adopted within it, organizing the logistics of the meetings of MERCOSUR bodies, and performing the tasks that the CMC, GMC, and CCM may request of it. Likewise, it must prepare its draft budget for the approval of the GMC. SAM shall be headed by a Director who must be elected by GMC and appointed by CMC with a two-year mandate.

At the Fortaleza meeting, in compliance with the Ouro Preto decision, the CMC approved the agreement between MERCOSUR and the govemment of Uruguay for SAM operation to be headquartered there. The agreement sets forth the immunities and tax exemptions of the Secretariat, its communication facilities, and the prerogatives of its officials and employees. The Director for the 1997-98 period was also appointed at that meeting. As of January 1, 1997, SAM is operating with its own budget which was approved by GMC in June 1996.

CHAPTER VI. INFRASTRUCTURE

Since the signing of the Treaty of Asunción, intrasubregional exports have tripled, putting pressure on the inadequate transportation and communications infrastructure that links. the economies of the subregion. Various physical integration projects have been undertaken to respond to the growing demand for infrastructure. But these efforts barely meet national needs, much less the subregional demand, which requires development of a physical integration program involving all the subregional partners. This section reviews some of the principal efforts under way in the areas of transportation and communications and energy infrastructure.

The requirements in terms of expanding and improving infrastructure represent investment opportunities not only for intergovernmental institutions but also for private operators. At the same time, those demands require coordination among the countries. In part as a result of this, it was resolved at the Fortaleza meeting to create a special committee comprised of official representatives from the five countries of the River Plate basin (the four members of MERCOSUR plus Bolivia). The committee will meet no later than the beginning of February 1997 and in five months will develop a technical proposal to transform the Financia1 Fund for the Development of the River Plate basin (FONPLATA) into a development and integration financing mechanism that will enjoy financial, operational, technical and administrative autonomy. One possible way to achieve such autonomy would be for the new institution to use very little public funding from the nations involved; rather it could be funded through intemational capital markets and administer resources from international financia1 institutions such as the Inter-Ameritan Development Bank and the World Bank.

A. Transportation and Communications Infrastructure

Roads constitute one of the most used means of transportation for intraregional commerce. This system of interconnected roads has developed as a natural extension of national road systems. Evidence of the fragility of the system was seen when Zárate-Brazo Largo highway complex was temporarily closed because of maintenance problems. As a result, trucks transporting cargo between Argentina, Brazil and Uruguay had to make detours covering hundreds of kilometers and use special ferry barges to cross the Paraná River.

To the road system is added the rail system. Even though there are no modern and efficient rail systems in the region, this mode of transport is nevertheless being used with increasing frequency. Between 1991 and 1995, rail cargo from Brazil to Argentina increased fivefold.

In terms of river transport, the Paraguay-Paraná waterway will enable merchandise to be transported between specific cities and facilitate access to ocean ports for overseas trade. Along with the Paraná-Tieté Waterway, this could become the hub of a multimodal transport system.

1. Bridges, Roads and Highways

Argentina-Brazil: The Santo Tomé-San Borja bridge will be the junction for the Transcontinental Road Network that will link the Chilean ports of Iquique and Antofagasta on the Pacific with the Brazilian port of Río Grande on the Atlantic. Work has begun under the direction of a consortium that obtained the concession for 25 years after winning the contract in public bidding in 1995. The project will be financed by the consortium and by the Argentine and Brazilian governments and will operate under a toll system. At the end of 1995, the countries agreed to establish an integrated border control point at the bridge that will absorb part of the operations of Paso de los Libres/Uruguayana.

Argentina and Uruguay: The Buenos Aires-Colonia bridge at present in the prequalification phase. It would have an extension of 42 km and an expected investment of US$1 billion. Once built, the bridge

will be part of the high velocity road corridor between Buenos Aires and São Paulo.

Brazil and Paraguay: Construction of the Foz de Iguazú-Presidente Franco bridge over the Paraná River has been put up for bidding.

Argentina, Brazil and Uruguay: The Buenos-Aires-Montevideo-Rio de Janeiro road network is in the feasibility study phase. Extension of the work will cover 3,000 km, require expansion and rehabilitation of existing sections, operate under a private concession mechanism, and require investments estimated at US$1.5 billion.

Argentina: The Victoria-Rosario road and bridge involves an 80 km link that will complete a new connection between the Atlantic and the Pacific, as well as connect central and midwest Argentina with southern Brazil. The project, which will begin in 1997, will require $400 million.

Uruguay: It will cost an estimated $100 million to rehabilitate and reinforce bridges in the country's interior to enable them to sustain the cargo now in circulation. The project is in the preliminary study phase.

2. Waterways

Argentina, Bolivia, Brazil, Paraguay and Uruguay: The Paraguay-Paraná waterway extends from southern Brazil to the port of Nueva Palmira (Uruguay). It represents a potentially significant transportation corridor. Currently, however, its use is limited because of a lack of signaling and insufficient depth. The *Comité Intergubernamental de la Hidrovía* (which includes the four MERCOSUR countries and Bolivia), created in 1990, is preparing two studies on this issue with the support of the IDB and UNDP: one on the engineering and technical and economic viability of improving navigation conditions on the Paraguay-Paraná waterway, and the other on the potential environmental impact of the development of that waterway.

Brazil: The Tieté-Paraná waterway is an infrastructure project in Brazil with important repercussions for MERCOSUR. It would require US$45 million to finish the Jupía lock at the confluence of the Tieté and Paraná Rivers. Jupía would facilitate navigability to Itaipú, on the border of Brazil and Paraguay, which has no navigation canal and interrupts the continuity of the Paraná River. A connection would link the conlluence of the Paraná and Paraguay Rivers with the Argentine section of the Paraguay-Paraná waterway. The Tieté-Paraná waterway could serve as a connection with the ports of Arica and Antofagasta in Chile, since cargo could be transported to the Pacific by rail from the Paraná River in Argentina.

3. Railroads

Argentina, Brazil and Uruguay: Along the Buenos Aires-Sao Paulo axis there are projects to a) rehabilitate the Buenos Aires-Sao Paulo railroad; b) rehabilitate the Rivera-Montevideo and Fray Bentos railroad; and c) build a high-speed railway between General Luz and Pelotas. Estimated cost of these projects is US$400 million.

4. Telecommunications

Strong growth of intraregional commerce has put considerable pressure on the telecommunications sector, particularly telephone systems, whose quality varies greatly from country to country. In Argentina, the sector has been completely privatized and has attracted significant investments that have modernized the telephone system.[65] In the other member countries, however, the sector is in the hands of the State, so

[65] In 1996, the telecommunications sector received 30 percent of foreign direct investment flows into Argentina, more than any other sector, accordi ng to ***Fundación Invertir.***

investments have lagged. For the moment, the sector in Brazil is the only one with possibilities of being privatized. Paraguay has the most deficient system, which has prompted increasing use of other modes of communication there.

The increase in intraregional connections raised the demand for more rapid and economical communications services. As a result four operators created the *Proyecto Sintonía* in June 1996 (Telintar in Argentina, Embratel in Brazil, Ante1 in Uruguay, and CTC Mundo in Chile). This service, run by businesses established in the subregion, is based on the use of the fiber-optic cable Uniser, which transmits digital voice signals, as well as images and data, among the four countries involved. The cable will be extended to Bolivia, taking advantage of the gas line that will be built between Bolivia and Brazil.

B. Energy Infrastructure [66]

Diverse energy infrastructure projects are being planned to interconnect gas and electricity systems in the subregion. Transport and distribution of natural gas is seen as a potentially dynamic activity in MERCOSUR, particularly given the predominant role of natural gas in energy consumption in Brazil. Because the principal energy source in the subregion is hydroelectric power, interconnection of gas and electricity implies importation of large volumes of liquid gas from the producing countries (particularly Argentina and Bolivia). The River Plate basin, one of the world's richest in terms of natural gas resources, is shared by the four countries. A significant portion of hydroelectric projects on the Paraná and Uruguay Rivers are in border areas, which means that their execution requires cooperative projects among the countries.

1. Gas Interconnection

- **Argentina and Brazil:** At the end of 1994, the firms YPF of Argentina and Petrobrás of Brazil signed an Agreement of Understanding to study joint business opportunities in the petroleum and gas sectors. A study on the import of. natural gas for Brazil envisions construction of a gas pipeline between northeast Argentina and São Paulo. The 2,600 km pipeline would cost an estimated US$2.2 billion. To make construction of the pipeline economically viable, new gas reserves are currently being identified in Aguarague in the Argentine province of Salta. The consortium examining this prospect was formed by YPF, Ampolex Argentina, Tecpetrol, Petrobrás, Compañia General de Combustibles, and Ledesma. YPF and Bridas are carrying out a similar identification process in Acambuco (along with two other enterprises, Apco and Northwest, which have a minority participation in the consortium).
- **Argentina and Brazil:** At the beginning of 1996, the governments of Argentina and Brazil signed a Protocol of Intent for Cooperation and Energy Interconnection. Among the projects under consideration is the exportation of natural gas (2 million m^3 daily) from Entre Ríos to Uruguayana, where a thermal power plant will be built by the private sector. Participants in the agreement are the Argentine companies YPF and Transportadora del Gas del Norte and the Brazilian firms Petrobrás, Electrobrás, and the State Electric Energy Company of Río Grande do Sul. The gas line will require an investment of US$120 million at a total project cost of US$240 million. Details of the agreement (price of gas, conditions under which it will be provided, and the time period involved) were to be defined at the end of 1996, and the works should be finalized in 1998.
- **Argentina and Uruguay:** There is a project to build a 265 km gas pipeline between Paraná and Fray Bentos. The estimated investment is US$200 million. Another project would build a gas pipeline from the Argentine coast toward Santa Lucía, at an estimated investment of US$400 million. Both gas pipelines could be extended to Montevideo, and in the case of the latter, even to southern Brazil.

[66] INTAL has recently published a report on energy integration in the Southern Cone, which includes a survey of the various projects being studied in the subregion.

2. *Electricity Interconnection*

Argentina and Brazil: The Protocol of Intent for Cooperation and Energy Interconnection signed by Argentina and Brazil at the beginning of 1996 included among its possible projects two involving the supply of electric energy from Argentina to Brazil: a) a hydroelectric power plant in Garabí on the Uruguay River, with installed capacity of 1,800 MW and generating capacity of 6,1OO GWh per annum, and a required investment of US$1.8 billion (to be concessioned); and b) the interconnection of electricity systems through construction of a frequency conversion station in Garabí[69] with an initial capacity of 450 MW (later to be increased to 900 MW), and an expected investment of US$220 million.[68] Other projects on the Uruguay River currently in the prefeasibility study phase are a) the Roncardor power station, with installed capacity of 2,700 MW and a generating capacity of 9,300 GWh per annum, and a required investment of US$3.2 billion; and b) the San Pedro power station, with installed capacity of 750 MW, generating capacity of 3,700 GWh per annum, and an estimated investment requirement of US$1.95 billion.

Argentina and Paraguay: There are three projects on the Paraná River: a) the Yacyretá-Apipé complex, with installed capacity of 3,200 MW, generating capacity of 20,300 GWh per annum, and an estimated investment of US$7.5 billion (only a portion of the turbines are in operation, and bidding is pending to transfer operations and maintenance to the private sector); b) construction of the Corpus Christi power station, with installed capacity of 4,600 MW, generating capacity of 20,000 GWh per annum, and an estimated investment of US$3.7 billion (construction and operation will be run by the private sector under a concession modality for public works); and c) construction of the Itatí-Itacorá power station, a hydroelectric facility that complements Yacyretá, with installed capacity of 1,700 MW, generating capacity of 11,300 GWh per annum, and an estimated investment requirement of US$2.4 billion (project is in the pipeline).

Argentina, Brazil and Paraguay: An electricity interconnection project between the Itaipú (operated between Brazil and Paraguay), Corpus and Yacyretá power stations would increase the security of the supply of electricity for the energy markets. The investment requirement is US$150 million.

Argentina and Uruguay: Construction of the Salto Grande compensatory power station on the Uruguay River, with installed capacity of 400 MW and generating capacity of 2,000 GWh per annum (project is in the pipeline).

Brazil and Uruguay: Interconnections between Candiota and San Carlos[69] (with an investment of US$145 million) and between Rivera and Livramento (US$35 million). Since Uruguay is interconnected with Argentina through the Salto Grande station, interconnection with Brazil will facilitate the exchange of energy among the three countries.

C. Agreements in the Transportation and Communications Sector

Agreement on Multimodal Transport: Brazil has been the first MERCOSUR member country to implement the issue of certificates for multimodal transport (which combines ground, rail, river and maritime travel) between the four countries. The first authorizations were given in September 1996. Under this system, a single operator takes al1 the steps -the consolidation of cargo and delivery through a system of door-to-door delivery- without regard to the mode of transport used. The operator contracts the vessels, trains and trucks, as required. Cargo is sealed at its place of origin and opened only at its final destination, reducing layover time. Uruguay already incorporated the agreement in its domestic legislation and is in the process of implementing it. The respective Congresses of Argentina and Paraguay are debating laws that would put the agreement into effect.

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[67] Argentina uses 50 Hz and Brazil 60 Hz.

[68] A conversion plant already exists in Paso de los Libres/Uruguayana, which was used for the first time at the end of 1995. This plant, which has a much smaller capacity (50 MW), represents the first energy integration facility between Argentina and Brazil.

[69] Uruguay, like Argentina, uses 50 Hz.

- **Agreement on Subregional Air Services:** Along with Chile and Bolivia, the members of MERCOSUR signed an agreement on Subregional Air Services in Fortaleza that will regulate passenger, freight and mail services that are not covered by bilateral agreements already in effect. The concession of rights to businesses that want to develop new routes will be handled by the member countries. It was agreed that the frequency of air services and the equipment to be used should be sufficient to meet the needs of potential levels of traffic. Aeronautics authorities from each country involved will be responsible for avoiding excess capacity that is not in accordance with potential traffic levels, or which could be considered anti-commercial practices.[70] Until now, only the airports of the principal cities in each country have been permitted to be used for intemational flights. Under the agreement, other airports will also be used, opening up connections with cities on national borders as well as those in the interior of the countries.[71] The agreement will require the construction, modemization and expansion of airports.

[70] Increases in specials offered by regional airlines and in the frequency of flights can lead to an excessive number of available seats, and unfair competition by some companies that set prices below cost.

[71] There are 48 airports in Brazil, but until now only four have been used for international flights. A similar situation prevails in countries.

CHAPTER VII. EXTERNAL ECONOMIC RELATIONS

Externa1 economic negotiations by MERCOSUR are being developed on severa1 fronts simultaneously, including a) the multilateral sphere of the World Trade Organization (WTO); b) within the Latin American Integration Association (ALADI), pluralizing the preferences included in bilateral agreements and concluding new free trade agreements with other ALADI members; c) at the hemispheric leve1 (which has been put in place pending negotiation of the Free Trade Area of the Americas by the year 2005); and d) with the European Union and its member countries, launched with the signing of the Interregional Framework Agreement on Cooperation in December 1995. In addition to these four areas, other contacts have been developed with selected regional interlocutors such as the Australia-New Zealand Free Trade Agreement.

Given the different demands of each of these areas of negotiation, the agenda that evolves will involve a wide variety of themes. The increase in the number of interlocutor-s implies considerable negotiation and an unavoidable need for consistency.

A. The Multilateral Sphere: The World Trade Organization

MERCOSUR has been presented to the WTO as a Customs Union within the framework of Article XXIV of GATT-1994. As a result, a special working group was created under the Commitee on Regional Agreements to examine the compatibility of the preferencial agreement with the rules of the multilateral organization. To respond to the demands of this examination, the Common Market Group (GMC) established an Ad Hoc MERCOSUR-WTO group to prepare for the participation of regional representatives in meetings of the working group, the first of which was held in October 1995 and the second in September 1996, both in Geneva. The third meeting is scheduled for March or April of 1997.

In the two meetings, the member countries developed a response to the questionnaire prepared by other WTO countries. A recurring theme in the work of the ad hoc group was development of a negotiating position and a possible compensation offer for cases when other WTO member countries make claims because the consolidated WTO tariffs are lower than the CET. Given that most of these types of cases involve Paraguay and the volume of implied trade is reduced, compensation should not present major difficulties. To comply with the rules established in Article XXIV:6 of the GATT-1994, MERCOSUR should also present information related to such cases to the WTO.

Another area of concern to the member countries in their relation with WTO is the definition and analysis 01 concessions received and offered under the Global System of Trade Preferences (GSTP) among developing countries; the second round of negotiations concluded in December 1996.

The WTO ministerial meeting in Singapore in December 1996 represented a new opportunity to advance a common vision of the development process and a shared agenda in terms of certain key themes related to the multilateral trade system.

To address the need for consistency, the GMC had resolved the issue of policy coordi nat ion arnong the member countries, with an eye toward scheduled meetings on the Free Trade Area of the Americas (FTA A) and of the WTO. As it is known, distinctive positions have prevailed among the member countries with respect to certain topics of the multilateral agenda. Such discrepancies have been reflected in the intensity and orientation with which those topics were treated in the past (for example, liberalization of agricultura1 trade, service sectors, and governnent procurement systems, etc.).

Nevertheless, during the ministerial meeting in Singapore, the members reiterated a shared commitment to again take up negotiations to improve access to agricultura1 markets, address the question of ties between regionalism and the multilateral trade system, and approach the question of labor standards, among other issues. Given the features of their trading pattern, the countries of MERCOSUR share a common interest in

a multilateral trade system characterized by effective disciplines, which has been reflected by the participation of some of the countries in recently-created bodies (such as the Dispute Resolution Group or the Trade Committee and the Environment).

B. The Interregional Sphere: the Latin American Integration Association

MERCOSUR is an active participant in intra-ALADI trade relations. In fact, during 1995 MERCOSUR countries contributed 64.4 percent of total exports of the South American members of ALADI, and one-third of total exports of al1 Latin America and Caribbean countries. Intra-MERCOSUR exports represented 60.3 percent of intrasubregional exports of the South American members of ALADI and 35.6 percent of total intrasubregional exports of al1 Latin American and Caribbean countries. This makes MERCOSUR a relevant player in the series of preferential trade agreements among the economies of the region.

The establishment of the Customs Union on January l, 1995 should have resulted in the formal expiration of bilateral preferences negotiated with other ALADI members and their replacement with "plurilateral" preferences. To move those renegotiations ahead, the GMC issued two resolutions that establish guidelines for the treatment of preexisting trade preferences (Patrimonio Histórico) and for the negotiation of free trade agreements with other ALADI members. The renegotiations took longer than initially expected, however, so the expiration period for the bilateral preferences was extended. In the interim, preferences with Bolivia were "plurilateralized" (December 1995) and free trade agreements were concluded with Chile (June 1996) and Bolivia (December 1996). Negotiations at various levels and degrees of intensity were also carried out with the other ALADI countries.

To date, MERCOSUR and Mexico have held four meetings to address the situation that developed as a result of the non-extension of the preferences conceded by Mexico to the other members of NAFTA, applying the principles of the Interpretive Protocol of Article 44 of the Treaty of Montevideo. Three of the four meetings were held in 1995 and t he fourth in August 1996. As a result, both sides agreed to extend the bilateral trade agreements already in effect and to continue meetings to reach a new agreement. The August 1996 meeting concluded with a commitment to initiate negotiations for a new agreement to replace al1 existing bilateral and regional agreements within the framework of ALADI. Delegations from Mexico and MERCOSUR concluded that the agreement a) will be transitory and essentially commercial, and will replace agreements under ALADI; b) will cover products subject to preexisting trade preferences as well as other products of interest to participating countries (with product-by-product concessions under the principle of reciprocity, although for reasons of sensitivity certain products could be excluded from these criteria); and c) will define compensation under the Interpretive Protocol of Article 44 of the Treaty of Montevideo, and it will be treated as an integral part of the general package of negotiations.

The final act of the meeting also specified that the new agreement will consider levels of preference that will be defined during the negotiating process, although an agreement was not reached on a definition regarding adoption of residual tariffs (as Mexico proposes) or percentage preferential tariffs (as MERCOSUR has enjoyed in al1 of its agreements). In November 1996, negotiators also exchanged proposals on the regulatory portion of the agreement. In the meantime, current trade agreements were extended until September 30, 1997. One obstacle to the multilateralization of existing bilateral preferences is that the bilateral accord between Uruguay and Mexico includes a high proportion of concessions in the tariff schedule.

Negotiations with members of the Andean Group progressed more slowly than others because of difliculties in defining the format of the agreement. The MERCOSUR countries also determined that renegotiations of preexisting trade preferences neither served the group's interest nor established the foundation for future development of a free trade agreement. It was decided, therefore, to extend the negotiations and to leave the bilateral agreements in effect until September 30, 1997, with the expectation of evaluating in June of that year the possibility of again extending them until December 31, 1997.

It has already been agreed that the format of the negotiations will be between groups and that a first phase will likely concentrate on defining regulations on trade of goods (schedule for tariff reduction, rules of origin, dispute settlement, safeguards, customs valuation, etc.) Other areas of interest, such as trade in services, transportation and others, will be put off until later. It is expected that there will be three categories of goods: a) those covered under preexisting trade preferences: tariffs will be reduced during an eight-year period at the agreed-upon margin of preference (except for goods on the list of sensitive products); b) new products (which will have a minimum margin of preference of 40 percent); and c) the list of sensitive goods. The format of the agreement will probably continue to follow the guidelines of previous agreements with MERCOSUR. The differences in the positions of both groups will revolve around the tariff reduction schedule, initial margins of preference, extent of the coverage of the agreement, treatment of agricultura1 products, differential treatment, duty-free zones, and mechanisms for customs valuation.

1. Free Trade Agreement between MERCOSUR and Chile

After two years of negotiations, MERCOSUR finalized a free trade agreement with Chile in June 1996. The agreement carne into effect on October 1 of the same year in the form of an Economic Complementarity Agreement (ACE). For MERCOSUR, the agreement with Chile is important not only for potential trade, but also because it serves as a precedent for future negotiations with other ALADI members. The agreement with Chile was, in essence, MERCOSUR's first free trade pact with third countries. Even though the Treaty of Asunción in 199 1 had left the door open for the inclusion of Chile into MERCOSUR, Chile preferred to negotiate a free trade pact, which finally carne to pass with the signing of the June 1996 agreement.

The different negotiating postures of Chile and MERCOSUR were evident from the first round of negotiations in September 1994 and affected such diverse areas as the coverage of the agreement; the approach to tariff reduction; treatment of goods subject to preexisting trade preferences, new products, sensitive products, and exceptions; treatment of the Regional Tariff Preference (PAR); nontariff restrictions; and the criteria to be applied to nonregional negotiations and to modifications of the general tariff. Until March 1996, negotiations were particularly difficult regarding the composition of the lists of goods, and the products considered exceptions and periods applicable to them.

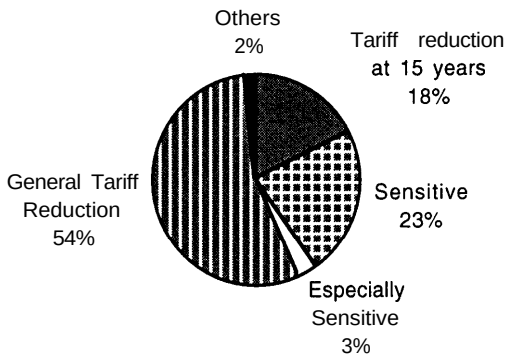
The Economic Complementarity Agreement signed in June 1996 included a trade liberalization program that establishes progressive and automatic reductions of existing tariffs for third countries. An eight-year General Tariff Reduction program was established, beginning with an initial preference of 40 percent; a 10-year list of sensitive products that begins with a fixed reduction of 30 percent for three years and across-the-board reductions as of the fourth year; a three-year grace period for a list of especially sensitive products, during which time complete tariffs will be maintained, followed by across-the-board tariff reductions between the fourth and the tenth years; a list of highly sensitive products for which tariff reductions will begin only in the tenth year and continue until the 15th (with the exception of sugar, for which reductions will begin in the l l th year and end in the 16th); and finally, in the case of wheat and wheat flour, tariffs will be completely removed in the eighteenth year, according to a methodology to be defined in the eighth year of the agreement. Preexisting trade preferences for nonsensitive goods were multilateralized and reduced to eight years from the highest prevailing preference, conforming to the Ad Hoc list. -Maintaining or increasing preferences, or in some cases establishing preferential quotas, for goods subject to preexisting trade preferences but now included on the lists of sensitive, especially sensitive and highly sensitive goods, was negotiated bilaterally or multilaterally on a case-by-case basis.

The agreement prohibited the establishment of new taxes, duties or rates above those existing at the time of the signing; arranged the identification, "stand still" and progressive dismantling of existing nontariff restrictions (NTRs); and excluded preferential treatment of goods from duty-free zones. The agreement also established general rules of origin based on a change of tariff position together with a requirement of 60 percent of the FOB value of the regional content and specific requirements for certain products.

In terms of unfair trade practices, applicability of national legislation was established consistent with GATT/WTO accords. The agreement also put into place safeguard measures as of January 1, 1997, and an arbitration procedure to resolve disputes, as of the fourth year of the agreement. In terms of customs valuation, the agreement follows the relevant WTO code and, in terms of the price bands applied by Chile, agreed not to include new products, modify mechanisms, or apply them in a way that impedes market access. The parties agreed to respect commitments made within the WTO framework regarding export subsidies and the exchange of lists of existing incentives in each case. It was also established that national drawback or temporary import rules would be compatible with the usufruct of preferences derived from the agreement only up to and including the fith year of the agreement. A framework for liberalization of trade in services was also established (in the broad definition adopted in the GATS), although no commitments were made regarding the period or sequence, and a commission was created to administer and evaluate the agreement. The question of the most-favored nation clause (which is of divergent importance) was finally settled, establishing shorter periods for notification of new agreements and concession negotiations and compensation than those established in the Interpretative Protocol of Article 44 of the Treaty of Montevideo. The dispute-settlement mechanism will render a decision in the event that negotiations fail. The Economic Complementarity Agreement between Chile and MERCOSUR also included a Physical Integration Protocol, which reaffirmed investment commitments by Chile and Argentina to improve border points.

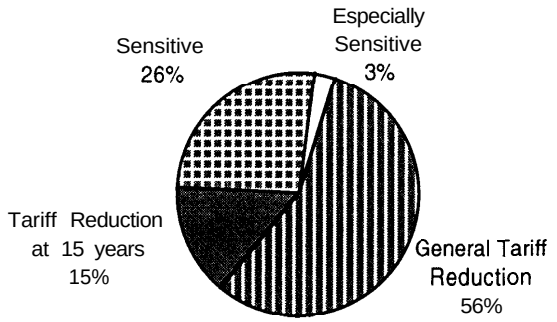
Figures VII.1 and VII.2 show the tariff situation following the accord for 100 principal products exported by MERCOSUR to Chile, and by Chile to MERCOSUR in 1995, respectively. As can be observed, more than half of the traded products are included on the general tariff reduction list.

FIGURE VII.1 MERCOSUR: TARIFFS OF THE 100 PRINCIPAL PRODUCTS EXPORTED TO CHILE (1995)



Source: Ministry of Foreign Relations, Chile.

FIGURE VII.2
CHILE: TARIFFS OF THE 100 PRINCIPAL PRODUCTS EXPORTED TO MERCOSUR (1995)



Source: Ministry of Foreign Relations, Chile.

If the universe being considered is total MERCOSUR exports to Chile in 1995, 62 percent of the value was included in the general tariff reduction category, 22 percent in sensitive goods with 15 years or more of reduction, 14 percent in sensitive products, and 2 percent in especially sensitive products. Sectors with the largest proportion of the value of exports included on the lists with 15-year periods or more are foods and beverages (76 percent), agriculture, fruit, forestry and fishing (35.9 percent), and metal, electronics, transport and other products (32 percent). Regarding Chilean exports to MERCOSUR, 67 percent of the export value in 1995 was included on the general tariff reduction list, 20 percent on the sensitive product list, 10 percent in sensitive products with 15 years or more of tariff reductions, and 2 percent, especially sensitive. Sectors with the largest number of products on lists with periods of tariff reductions of 15 years or more are agriculture, fruit, forestry and fishing (43 percent), foods and beverages (21 percent), and metal, electronics, transport, and other products (20.5 percent).

The first meeting of the Administrative Commission of the Chile-MERCOSUR complementarity agreement was held in October 1996, at which time the rules of Procedure of the Commission were approved. The areas to be dealt with and supervised by the Commission included a) putting in place safeguard measures before January 1, 1997; b) designating eight national experts and eight experts from third countries during the first three months of the agreement to participate in the second stage of the dispute-settlement process; c) exchanging and revising pertinent regulations regarding technical and phytosanitary standards, during the first six-month period; d) defining specific rules of origin for computer and telecommunications products, during the first six-month period; e) identifying and analyzing existing export incentives, during the first 12-month period; f) negotiating and agreeing on arbitration procedures prior to the fourth year of the agreement; and g) evaluating and proposing a system for the treatment of the automotive sector, prior to the fourth year.

One month after its first meeting, the commission held a special meeting at which it a) examined possible ways to establish channels of communication so that the productive sectors could present recommendations to the Administrative Commission; b) looked at the status of interna1 conversations within MERCOSUR regarding trade in services and its treatment in certain agreements of Chile with other ALADI countries; c) extended until March 31, 1997 the period to agree on safeguard measures, given that a common text has already been prepared that identified differences; and d) initiated an exchange of ideas regarding specific

rules of origin for the information and telecommunications sectors, which must be decided upon prior to March 31, 1997. The special meeting in November 1996 also represented an opportunity to voice the two initial conflicts regarding trade practices by one of the members of the agreement. While Chile requested confirmation of Brazilian arrangements that limit the financing period for imports (particularly for the textiles and graphics sectors) and that establish minimum import prices (in the same sectors), the MERCOSUR members expressed their concem through a first instance ruling questioning competence of authorities overseeing MERCOSUR beef exports to Chile.

2. *Free Trade Agreement between MERCOSUR and Bolivia*

At the Presidential summit in Fortaleza in December 1996, MERCOSUR and Bolivia signed an Economic Complementarity Agreement that will go into effect on April 1, 1997 and includes a Trade Liberalization Program that will gradually and automatically liberalize mutual trade. The new agreement replaces ACE.34 of December 1995, through which unified concessions were granted and received by each of the MERCOSUR countries and Bolivia. Bolivia was authorized by the members of the Andean Group to negotiate individually. The products included in ACE.34 will be incorporated into the new agreement with tariffs reduced by between 30 and 80 percent and ultimately eliminated over a 10-year period. Tariffs on products that enjoy preferences of more than 80 percent in ACE.34 will be eliminated in accordance with the new agreement.

As in the case of the pact with Chile, the agreement with Bolivia includes different categories of sensitive products, for some of which total reduction of tariffs will be over 10 years, but leaving lesser margins of preference and freezing certain levels for a varying number of years. Reduction of tariffs for one group of goods will be postponed until January 2005 and will reach a margin of preference of 100 percent in 15 years. Tariffs on products that correspond to sugar products and oilseeds will be eliminated within 18 years after the initiation of the agreement.

According to the Trade Liberalization Program, nearly 95 percent of al1 tariffs -which involves over 80 percent of trade- will be eliminated before the 10th year. For the remainder of goods, tariffs will disappear in a maximum of 18 years. The agreement includes regulatory aspects tied to nontariff restrictions. rules of origin, safeguard measures, and dispute-settlement mechanisms. The agreement creates a commission to administer these aspects, as well as a Business Assessment Committee made up of leading business organizations.

Bolivia has a significant leve1 of economic ties with MERCOSUR, even though this market has decreased in importance for Bolivian exports in recent years (particularly as a result of the drop in natural gas sales to Argentina). In 1995, 13.9 percent of Bolivian exports went to MERCOSUR (as opposed to nearly one-fifth that went to Andean Pact countries), whereas the MERCOSUR countries accounted for 28.2 percent of Bolivian imports (in comparison to 4.2 percent of Andean Pact imports).

One of the main obstacles to increasing economic ties between MERCOSUR and Bolivia is the lack of adequate transportation infrastructure. There is still no operable, weather-proof connection by road between Bolivia and Brazil or Paraguay, and the connections with Argentina are precarious. Rail connections (traditionally important) require considerable investments to be modernized. If al1 of these were done, Bolivia could provide an important ground link between western Brazil and the ports of the Pacific (especially Arica, to which a road has just been completed).

Trade with Bolivia is not significant in global terms for MERCOSUR, but the agreement represents an important step in the direction of having a series of South American free trade agreements tied to the customs union. Bolivia also has the potential to become an important supplier of natural gas to the urban centers of Brazil.

C. The Hemisphere: Negotiations on the FTAA[72]

Relations with the principal hemispheric market are of singular importance for MERCOSUR. In June 199 1, the member countries signed a Trade and Investment Agreement with the United States (known as the "4 + 1 agreement") that established a Consultative Council and a wide negotiation agenda. The council held severa1 meetings during its initial years, but without significant progress.

Since December 1994, the trade agenda of the "4 + 1 agreement" has in practice been overshadowed by the hemispheric negotiations launched by the Presidential Summit of the Americas. The first annual meeting of trade ministers held in Denver in mid-1995 established seven working groups, whose objectives were to compile information and formulate recommendations for the ministerial meeting in Cartagena in March 1996. Four new working groups were created at the Cartagena meeting, as well as another group for the meeting in Belo Horizonte, Brazil in 1997. At the Cartagena meeting, vice ministers were instructed to examine the different approaches to building the FTAA and to formulate recommendations as well as evaluate how and when to initiate FTAA negotiations. Commitments were reiterated to conclude the negotiations no later than the year 2005 and to achieve concrete advances toward that objective before the end of this century.

There is no doubt that the speed and progress of hemispheric integration will depend to a great degree on the initiative and commitment of the United States. At the same time, it is equally clear that the hemispheric process would have difficulty advancing without the constructive and dynamic participation of MERCOSUR. Some of the divergences voiced at the Cartagena meeting included treatment of environmental and labor rights issues, the emphasis on building the FTAA and the periods needed to obtain results, and relations between the FTAA and the WTO.

A priority of the United States has been to incorporate environmental and labor rights issues into the FTAA agenda. Even though the Cartagena declaration includes both themes in the FTAA process more explicitly than before, treatment of each one is different in order to maintain consistency with each one's respective treatment by the WTO. While the creation of an environmental study group was linked to the results of a ministerial meeting of the WTO in Singapore, the labor issue was left to the ministers of labor, who were asked only to keep their colleagues in the trade area informed.

The ministerial debate at the Cartagena meeting showed that there are different positions regarding the best path to build the FTAA, as well as the time periods needed to initiate negotiations and get results. In this area, MERCOSUR has supported the approach of uniting existing subregional agreements, although it has not explicitly spelled out how to go about doing that. The members have also insisted on assuring solid, consensual and sustainable progress rather than giving priority to obtaining quick results (early harvest). The nature of the commitments of the FTAA vis-à-vis those of the WTO has also been subject of substantive discussion. The members of MERCOSUR have supported high standards for the FTAA, but not necessarily standards stricter than those of the WTO (WTO-plus). One area where this issue specifically carne up was in terms of government procurement.

The MERCOSUR members carry out their participation in the FTAA process through coordination within the framework of the MERCOSUR-FTAA Ad Hoc Externa1 Relations Group, which in al1 cases holds prior coordination meetings. The MERCOSUR members have warned of the need to make a subregional negotiating effort in areas where there is still no common position, and have reserved the right to act individually in cases where the other members have been given prior notice.

In the first of the vice-ministerial meetings (in Florianópolis in September 1996) prior to the ministerial meeting in Belo Horizonte, MERCOSUR proposed guidelines to develop negotiations on the FTAA. The guidelines outlined three stages that would allow for gradual progress based on the single undertaking

[72] Through the Tripartite Committee, the IDB, the OAS and ECLAC are supporting the working groups of the FTAA in the information gathering stage covering diverse areas under analysis.

principle and the development of a broad and balanced accord. The first stage (business facilitation) could satisfy the demand for an "early harvest" in areas such as customs documentation, certification of origin, facilitating transport of goods, recognizing sanitary and phytosanitary certificates, and developing publications for the private sector. The second stage should begin as soon as the tasks assigned to the working groups have been concluded and should cover a series of undefined themes, not to include market access and corresponding disciplines (sanitary and phytosanitary measures, technical standards, etc.). The third stage would be one of substantial and step-by-step negotiations on goods and later in such areas as services, government procurement, etc. Even without having received reactions to this proposal, it is expected that it will require a significant leve1 of precision, particularly the activities of the second stage. In terms of areas of immediate action, the GMC resolved at its December meeting to define a MERCOSUR proposal to present at the next meeting of each working group.

D. Negotiations with the European Union

The first meeting of the European Union-MERCOSUR Mixed Commission, which was established by the December 1995 agreement, was held in June 1996 in Brussels. Provisional rules of procedure of the commission were approved, along with similar rules and guidelines for the Subcommission on Trade, also created in December 1995.

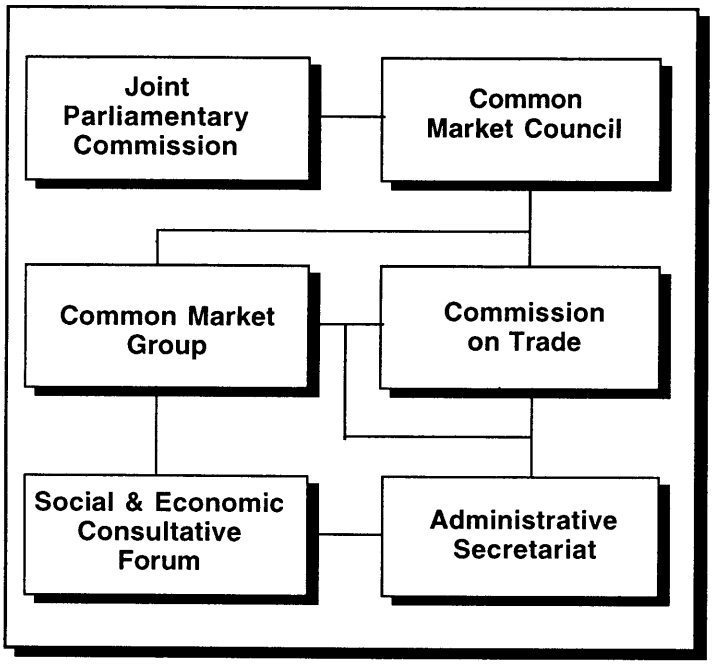
The function of the Mixed Commission will be to stimulate trade relations, exchange opinions on questions of mutual interest regarding eventual trade liberalization and cooperation, present proposals, and evaluate proposals and reports of the Subcommission on Trade. The Mixed Commission will be made up of representatives of the members of the Council and the European Commission as well as representatives from the GMC of MERCOSUR. The commission will also serve as a consulting mechanism if so requested by one of the parties involved.

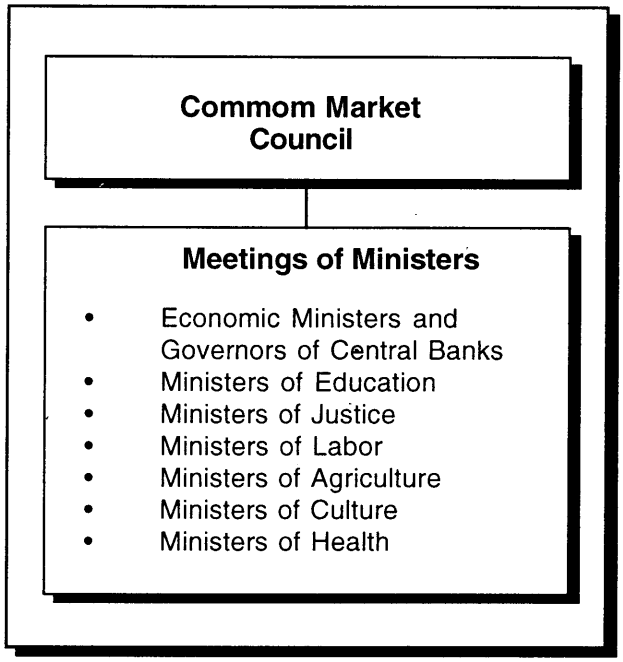
The Subcommission on Trade will assure compliance with the trade objectives stipulated in the interregional framework agreement and will prepare the work for subsequent trade liberalization. Meetings will be held twice a year, although special meetings may be held as required. The subcommission will include three working groups (Goods, Services, and Trade Disciplines). Guidelines established by the Mixed Commission for the subcommission include promoting the increase and diversification of trade, preparing for the eventual liberalization and reciprocity of trade, and creating conditions that favor establishment of interregional associations, taking into account the sensitivity of certain products and the need to conform to WTO rules. The subcommission will also serve as a consulting mechanism for specific themes.

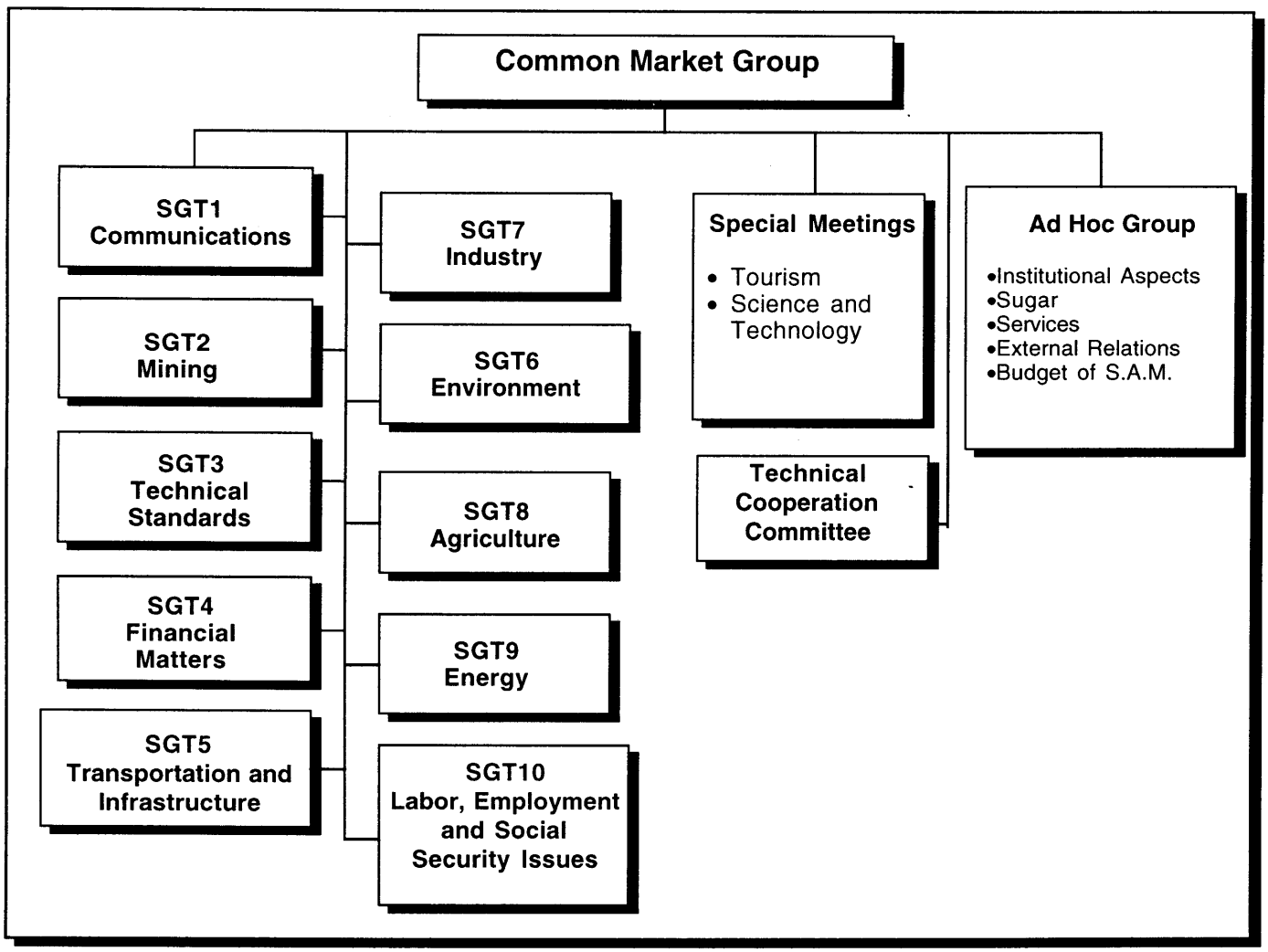
At its first meeting in Belo Horizonte in November 1996, the subcommission defined guidelines for the three working groups and procedures for trade consultations. The working group on goods will analyze current trade, identify sensitive products and priorities of the members, and suggest actions to increase and diversify trade. However, no timetables or specific commitments were defined. The working group on services, for its part, spelled out a broad but unspecific program of activities, including definition of a methodology to analyze trade and services flows among the members, analysis of those flows, and identification of sensitive and priority sectors. The trade discipline and guidelines working group will analyze a wide variety of issues in this area (customs nomenclature, sanitary standards, rules of origin, safeguard measures, policies on competition, etc.), explore possibilities of negotiating mutual recognition agreements, identify priority or sensitive areas, and exchange information on measures adopted in these areas. Guidelines were established for trade consultations, which, contrary to the original wishes of MERCOSUR, will probably be extended to the bilateral sphere.

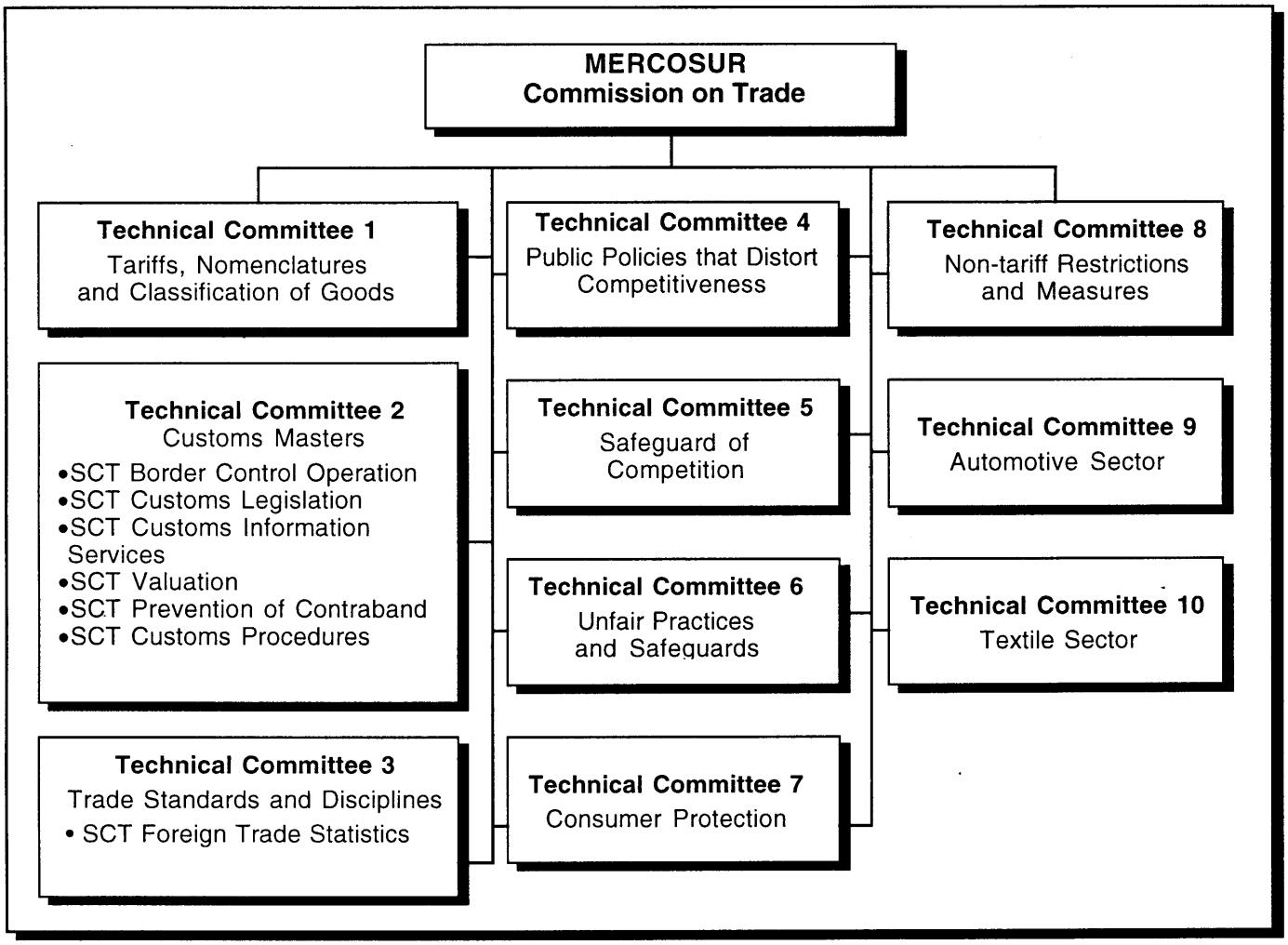
The aforementioned makes clear that negotiations between MERCOSUR and the European Union cover a wide range of areas and are in an information gathering phase. Concrete results cannot be expected in the near future because of the lack of specific programs and timetables on the part of the working groups, the breadth of the task, and the contents of the agenda. Nevertheless, the procedures that have been designed put development of trade and, eventually, trade liberalization between both partiesjn a high-leve1 context.

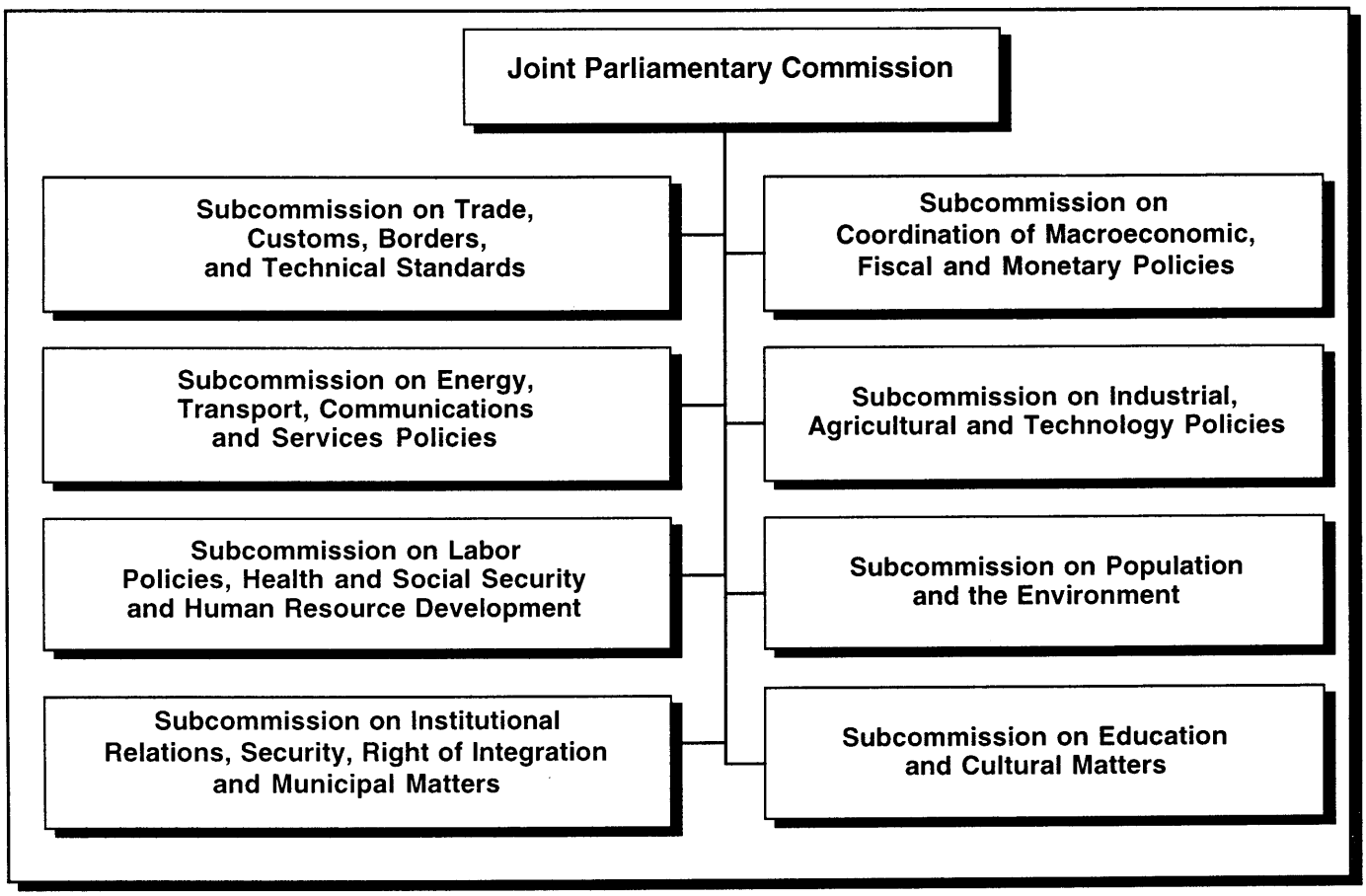
ANNEX
INSTITUTIONAL STRUCTURE OF MERCOSUR








MERCOSUR
Commission on Trade
Technical Committee 1
Tariffs, Nomenclatures and Classification of Goods
Technical Committee 2
Customs Masters
•SCT Border Control Operation
•SCT Customs Legislation
•SCT Customs Information Services
•SCT Valuation
•SCT Prevention of Contraband
•SCT Customs Procedures
Technical Committee 3
Trade Standards and Disciplines
• SCT Foreign Trade Statistics
Technical Committee 4
Public Policies that Distort Competitiveness
Technical Committee 5
Safeguard of Competition
Technical Committee 6
Unfair Practices and Safeguards
Technical Committee 7
Consumer Protection
Technical Committee 8
Non-tariff Restrictions and Measures
Technical Committee 9
Automotive Sector
Technical Committee 10
Textile Sector


Joint Parliamentary Commission
Subcommission on Trade, Customs, Borders, and Technical Standards
Subcommission on Energy, Transport, Communications and Services Policies
Subcommission on Labor Policies, Health and Social Security and Human Resource Development
Subcommission on Institutional Relations, Security, Right of Integration and Municipal Matters
Subcommission on Coordination of Macroeconomic, Fiscal and Monetary Policies
Subcommission on Industrial, Agricultural and Technology Policies
Subcommission on Population and the Environment
Subcommission on Education and Cultural Matters