REPORT

MERCOSUR

2004 (Second Semester) - 2005 (First Semester)

Integration and Regional Programs Department
Institute for the Integration of Latin America and the Caribbean - INTAL

Inter-American Development Bank
MERCOSUR Report N° 10, February 2006

Intal

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The Subregional Integration Reports series represents an effort by INTAL to promote knowledge and the spread of information about the dynamic process of integration currently underway in Latin America and the Caribbean. As part of this integrationist trend, since the signing of the Treaty of Asunción in 1991, the Southern Common Market has been a test case for assessing the achievements and challenges of this ambitious initiative.

In publishing this annual report, INTAL's aims to facilitate access to information for a broad readership interested in MERCOSUR, from the public and private sectors, and among the subregion's general public. It also seeks to go beyond the interest that MERCOSUR arouses at subregional level by making the Report available to international audience with this version in English, as well as Spanish and Portuguese, the official languages of the process.

Report No. 10 covers the second half of 2004 and the first half of 2005. The document's initial draft was produced by Ricardo Rozemberg, an economist specializing in international economic negotiations, with the collaboration of the economists, Dr. Raúl Ochoa, Marcelo Onesto and Alejo Espora. Paolo Giordano, Cristian Volpe and Mauricio Mesquita, economists from the Integration, Trade & Hemispheric Issues Division have also contributed valuable comments and suggestions in the document's revision stage. INTAL's Director, Ricardo Carciofi, and its Senior Economist in Integration, Uziel Nogueira, were respectively responsible for the coordination of the Report, and for its general and technical editing.

In order to meet the expectations raised by that the publication of previous reports, readers are invited to send their comments and/or suggestions in order to improve the scope or focus of future publications.

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EXECUTIVE SUMMARY

The period between the second half of 2004 and the first half of 2005 can be characterized as a time of convergence in regional macroeconomic trends. The countries of the Southern Common Market (MERCOSUR) saw not only significant economic and trade dynamism in this phase, but also common patterns of fiscal and monetary solvency, similar exchange rates with higher parities than those recorded in the previous decade, positive current account balances, and other factors.

Despite greater coincidence in the regional economic cycle, the period was marked by greater tension in trade, involving partners' public and private actors, especially in Argentina and Brazil. Although bilateral problems concerning intra-MERCOSUR trade of so-called 'sensitive' products have been a common denominator in the bloc's growth throughout its history, they were particularly dynamic during 2004-2005. One of the basic patterns was a tendency toward a more strident defense of internal production on the part of Argentina, a decision framed by the country's aims to 'reindustrialize.' However, growing Brazilian penetration of many products in this market made this goal harder to achieve.

One notable feature of 2004-2005 was Brazil's consolidation as a more productive economy with a higher export capacity, and a relatively lower capacity for import absorption. This internal phenomenon, which ties in with the strong investment flow into transactable sectors of the economy of the largest partner in MERCOSUR after the devaluation of the Brazilian real in January 1999, has had a major impact on production and trade dynamics in the region as a whole. Interestingly, 2004 saw an appreciation of the real against the dollar. This trend became more entrenched in the first part of this year. The phenomenon, which could in principle have boosted imports and curbed Brazilian exports, did not do so in practice, and therefore did nothing to calm other MERCOSUR partners' concerns about trade.

In light of these trends, the convenience of establishing some kind of escape clause in MERCOSUR was discussed, to deal with disruptive situations in intra-MERCOSUR trade. This negotiation has been present in many regional debates, especially since 1999, in different circumstances and under political signs of the MERCOSUR governments. However, in 2004-2005, the Argentinian government was particularly active in defending internal production. Similarly, regarding concern about the distribution of investments in the expanded space, Argentina also supported mechanisms to regulate investment flow in some way, particularly from transnational companies. This could then be distributed better in terms of the bloc's productive configuration.

In terms of the Internal Negotiating Agenda, July 2004-June 2005 was basically framed by the 2004-2006 Work Program. There was the additional potential reform of the Protocol of Ouro Preto, an idea introduced by the Uruguayan Foreign Minister at the Iguazú Summit, which took a great deal of negotiating in 2004, especially by the National Coordinators of the Common Market Group. In the period covered by this report, two major areas reinforcing the integrative process emerged: first, the definition of the first mechanism to eliminate double levying of the Common External Tariff (CET), and second the creation of a MERCOSUR Structural Convergence Fund (MSCF). Both areas are of strategic value in light of the bloc's history. The formation of structural funds, in particular, involved radical change in partners' attitudes to the integration process. The definition reached regarding both measures has not yet been implemented, as rules and complementary regulations still remain to be sanctioned.

An examination of MERCOSUR's external agenda shows some progress in negotiations with countries and/or subregions with similar relative levels of development, and growing difficulties in creating closer ties with more advanced countries. Optimistic forecasts made in late 2003 envisaging the implementation of the Free Trade Area of the Americas (FTAA), and the signing of a MERCOSUR/European Union (EU) Agreement, did not materialize. Given the difficulties in moving forward in negotiations with developed

countries, the questioning of the bloc's external trade policy by business sectors in Brazil was a new and not insignificant phenomenon in the regional scheme of things. The external agenda was thus yet another reason for the increase in regional tensions.

Despite difficulties in North-South relations between mid-2004 and June 2005, there was significant dynamism in South-South negotiations. The MERCOSUR-Andean Community (CAN) Agreement was concluded after many stumbling blocks and various technical difficulties. Negotiations with Mexico also continued, and Fixed Preference Agreements were signed with the Southern African Customs Union (SACU) and India. Talks were begun with Morocco and Egypt over the same kind of trade relationship. And Free Trade Area negotiation proposals were exchanged with the Caribbean Community & Common Market (CARICOM) and Central American Free Trade Association (CAFTA). More generally, trade talks included signing a Framework Agreement with the Gulf Cooperation Council (GCC), the start of a feasibility study on a potential MERCOSUR/Korea trade agreement, a series of meetings with Canada to assess alternatives for rapprochement, and at a very preliminary stage, talks with the *Comunidade de Paises de Lingua Portuguesa* (Community of Portuguese Language Countries), Russia and Pakistan.

A key, albeit bilateral, aspect of the external agenda was Chinese President Hu Jintao's visit to Brazil and Argentina in November 2004. This focused on China's obtaining recognition of its status as a market economy in return for certain advantages of access for MERCOSUR'S products, Chinese commitments to invest in the economies of the Southern Cone, and the definition of these countries as "suitable for tourism" for Chinese citizens. It should be pointed out that in these negotiations there were no consultation or cooperation mechanisms between MERCOSUR Member States.

However, there were intra-MERCOSUR consultations during this period over the crisis in Bolivia's institutions, and over the search for joint alternatives regarding the regional energy supply and the financing of the necessary infrastructure in the medium-to-long term. Here, the Member States' greater political rapprochement with Venezuela –especially in the case of Argentina and Brazil– focused on energy and infrastructure complementarity in the region. Similarly, the creation of the Comunidad Sudamericana de Naciones (CSN: South American Community of Nations) in December 2004 provided a new space for the politico-institutional strengthening of the subcontinent. Thus, at both the quadripartite level, and more generally, on a subcontinental scale through the Iniciativa para la Integración de la Infraestructura Regional Suramericana (IIRSA: Initiative for the Integration of the Regional Infrastructure of South America), integration of the energy sector established itself in this phase as one of the priorities of MERCOSUR's internal and external agendas.

In the context of multilateral negotiations, the activity of the G-20 as a group of emerging countries coordinating their actions to better defend their interests against developed countries, was another space for potential cooperation that was not exempt from disagreement between the region's countries. Indeed, since the G-20 was formed, only three MERCOSUR Member States (Argentina, Brazil and Paraguay) have joined it, with Uruguay remaining on the fringes of the Group and only joining in March 2005. The work program agreed in July 2004 at the level of the World Trade Organization (WTO), with issues essential to agricultural negotiation, stressed the value of joint action. Despite this, progress was slow and the prospects of arriving at the 6th Ministerial Conference in Hong Kong in December, with the issues sufficiently developed to enable substantive progress in multilateral negotiation are uncertain.

Contents

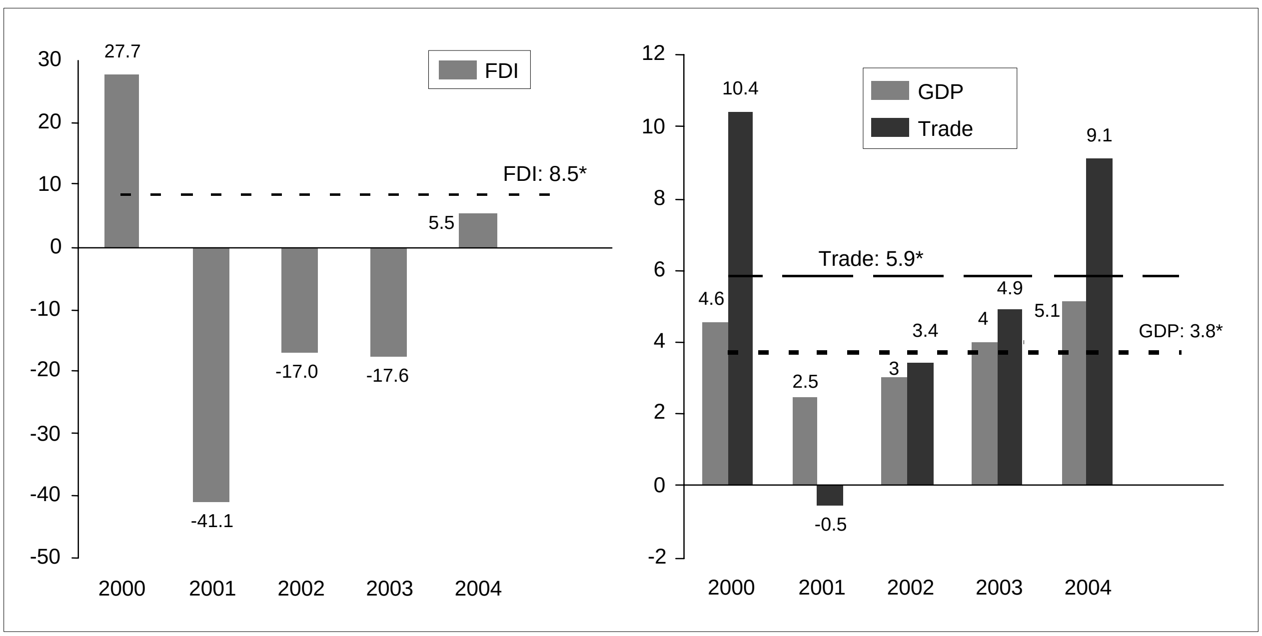
CHAPTER 1. A MACROECONOMIC & TRADE OVERVIEW OF MERCOSUR

A. Trends & Prospects for the World Economy & Latin America

The world economy performed exceptionally during 2004, with the fastest growth rate in the last thirty years. Global economic expansion also continued apace in 2005. Led by this marked dynamism, global trade rose significantly, in terms of both prices and quantities traded. The steady world demand was reflected in the emergence of certain restrictions on capacity, and price rises in basic products, mainly oil. At the same time, a marked rise in external imbalances was also seen in trade between the main global economies. Lastly, there was recovery under the favorable conditions of the world's financial markets, and after falling for three years running, a turnaround was detected in Foreign Direct Investment (FDI), driven mainly by flows directed at emergent economies.

Forecasts for 2005 predict new growth for the world economy, albeit at slightly more moderate than in 2004, with something similar for trade flows. In FDI, the prospects for 2005 are positive, especially for developing countries. In spite of the recent slight worsening of certain risk factors for the world economy, the external context remains highly beneficial to Southern Common Market (MERCOSUR) countries' development, stimulating trade with the rest of the world, economic recovery, and the financing of productive investments.

FIGURE 1
REAL INTERANNUAL VARIATION & AVERAGE GROWTH 1994-2004
Gross Domestic Product (GDP), World Trade in Goods & FDI



Note: * Average annual rate for 1994-2004.

Source: In-house, based on data from IMF, WTO and UNCTAD.

In light of this international prosperity, 2004 saw the highest growth rate in recent years for developing countries, well in excess of high inflow countries. This enabled them to recover a share of global output.

The positive results were largely due to the increase in world trade, steadily rising investment, low real interest rates, and rising international capital flows, especially FDI flows.

In this context, economic activity in Latin America in 2004 was well up on previous years (5.9%). Unlike the last two decades, this expansion affected most countries in the region, with sustained world demand for basic products contributing to the exceptional performance. Low interest rates and high international liquidity also played an important part by providing an abundance of capital. This was conducive to the resurgence of investment and domestic consumption.

As elsewhere in the world economy, the standardization of basic product prices, the increase in international interest rates, and internal inflationary pressure are expected to slow the pace of regional growth during 2005, although this remained at record levels (around 4.3% to 4.5%, and approximately 4% in 2006).

As verified by the Economic Study of Latin America and the Caribbean by the Economic Commission for Latin America and the Caribbean (ECLAC [2005]), should this be the case, the region would be completing "a four-year period of continuous economic expansion, implying a rise in per capita GDP of around 10% between 2003 and 2006."

TABLE 1
REAL GDP GROWTH RATES
2001-2004 & 2005-2006 forecasts

	2001	2002	2003	2004	2005*	2006*
Developing Countries	**4.2**	**4.7**	**6.4**	**7.2**	**6.3**	**6.0**
Latin America & the Caribbean	**0.3**	**-0.8**	**2.0**	**5.9**	**4.3**	**3.7**
Argentina	-4.4	-10.9	8.8	9.0	6.0	3.6
Bolivia	1.7	2.4	2.8	3.6	4.4	4.5
Brazil	1.3	1.9	0.5	4.9	3.7	3.5
Chile	3.4	2.2	3.7	6.1	6.1	5.4
Colombia	1.5	1.9	4.1	4.1	4.0	4.0
Ecuador	5.1	3.4	2.7	6.9	3.9	3.7
Mexico	0.0	0.8	1.4	4.4	3.7	3.3
Paraguay	2.1	0.0	3.8	4.0	2.5	3.0
Peru	0.2	4.9	4.0	4.8	4.5	4.5
Dominican Republic	3.6	4.4	-1.9	2.0	2.5	4.3
Uruguay	-3.4	-11.0	2.2	12.3	5.0	3.5
Venezuela	3.4	-8.9	-7.7	17.9	4.6	3.8
Developing Asia	**5.8**	**6.5**	**8.1**	**8.2**	**7.4**	**7.1**
China	7.5	8.3	9.3	9.5	8.5	8.0
India	4.8	4.4	7.5	7.3	6.7	6.4
Central & Eastern Europe	**0.2**	**4.4**	**4.6**	**6.1**	**4.5**	**4.5**
Russia	5.1	4.7	7.3	7.1	6.0	5.5
Africa	**4.0**	**3.6**	**4.6**	**5.1**	**5.0**	**5.4**

Note: * Forecast.

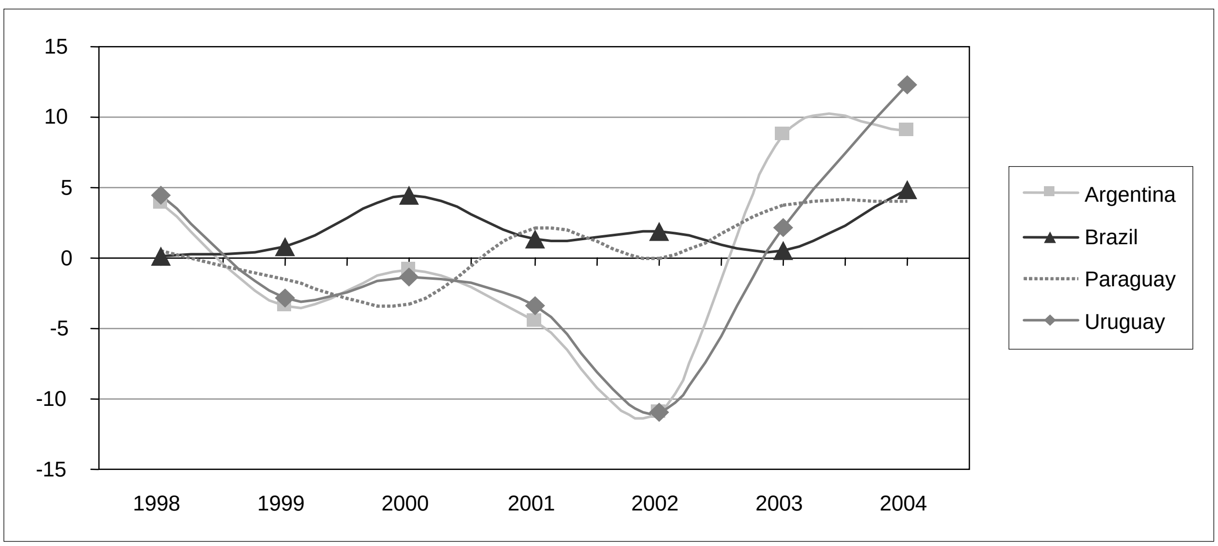
Source: In-house, based on data from IFM, ECLAC and World Bank.

B. Subregional Macroeconomic Conditions

In this exceptional international context, all MERCOSUR members performed outstandingly in macroeconomic terms in 2004, and this carried over into 2005. Almost without exception, the four partners experienced a marked turnaround in economic activity, as well as falling inflation, the maintenance of competitive stable trade rates, and 'twin' current account and primary fiscal balance surpluses. This performance by the main macroeconomic variables reduced the short term chances of a repetition of past external or financial crises. There was also widespread improvement in labor indicators, with rising employment and falling unemployment, though this last variable remains at record levels.

Otherwise, 2005 has resembled 2004. Although MERCOSUR countries display slightly slower growth than the previous period, real rates of GDP variation remain high as compared with the average for recent years. Although, parallel to this, inflation in several members is higher than 2004, the current account surplus continues, and fiscal conditions remain favorable. Lastly, labor market indicators also show fresh, albeit rather slower progress in line with the partial slowing of the expansion of output.

FIGURE 2
GROSS DOMESTIC PRODUCT
Annual rates of variation



Source: In-house, based on data from INDEC, IBGE, INE and Central Bank of Paraguay.

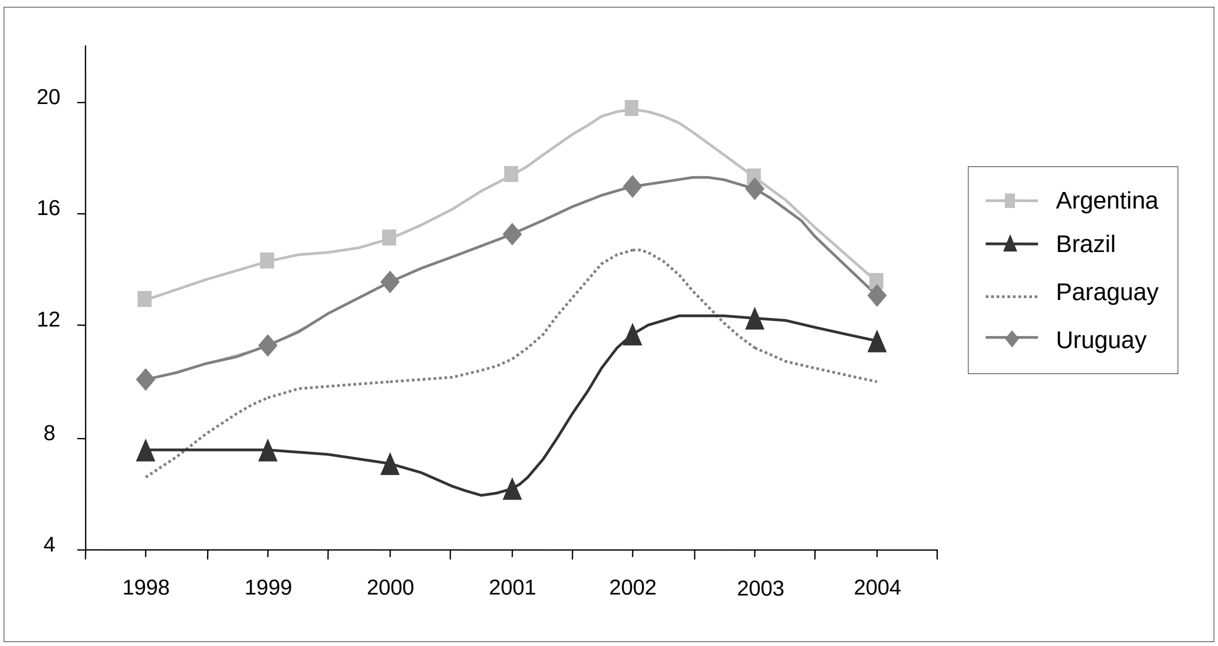
In all cases, the recent high growth occurred in an environment where favorable external conditions and competitive real trade rates fuelled a significant rise in exports. These climbed to record levels in the four countries under analysis. Internal demand was also exceptionally dynamic, driven both by investment and private consumption, which partially recovered from the fall seen over previous years.

In terms of the *external sector*, MERCOSUR countries increased overall exports by 28% in 2004, a record of US$ 135 billion. This increase was due both to rises in quantities sold externally, and in the prices of many raw materials and manufactures traded by the region. This balanced the turnaround displayed by imports for the second year running. These totaled US$ 94 billion, 38% up on 2004.

Including services, the bloc's trade balance showed a surplus of over US$ 40 billion, amounting to US$ 45 billion with the balance of current transfers (US$ 4 billion). In contrast, income balances (including interests and dividends among others) represented a US$ 30 billion net outflow of foreign currencies, resulting in a current account surplus to the order of US$ 15 billion. This figure represents 1.9% of regional GDP, the third year running in which this component of the Balance of Payments was in surplus for the bloc, after a decade of dependence on external financing.

The balance of capital and financial accounts was in deficit by over US$ 14 billion, which is a good indicator that the benign international financial context is not being used by countries in the subregion to borrow; quite the opposite, they are taking advantage of this context to cancel foreign debts. This, plus the current account balance, brought about a slight surplus in the Global Balance of under US$ 0.1 billion. To this were added US$ 8 billion from extraordinary financing sources. The flipside of this was an US$ 8 billion accumulation of reserves, helping to reduce external vulnerability.

FIGURE 3
URBAN UNEMPLOYMENT
Average annual rates (as % of the economically active population)



Source: In-house, based on data from INDEC, IBGE, INE and Central Bank of Paraguay.

At the same time, favorable macroeconomic trends were accompanied by an improvement in *fiscal conditions*. The growth of economic activity and revenue had a positive impact on tax collection, both via the broadening of the taxable base and a greater degree of compliance with tax commitments. This increase in revenue enabled the countries in the subregion to implement an expansionary spending policy, while retaining a record primary surplus. After calculating interest payments on the debt, three of the four partners recorded a deficit in global accounts, albeit substantively lower than previous years.

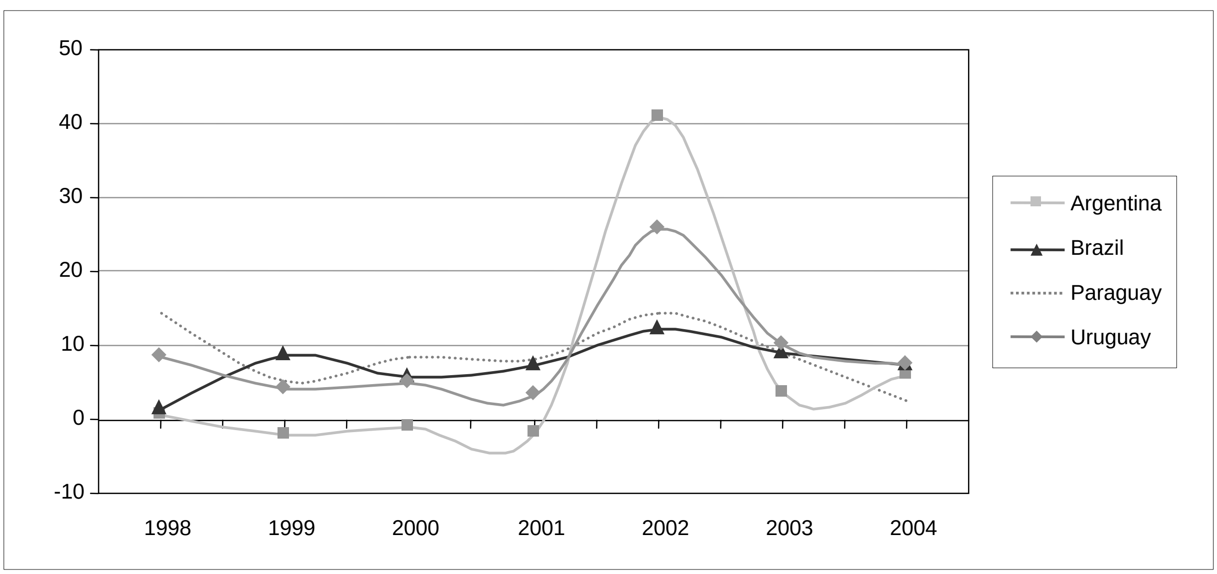
Everything seems to point to the fact that there was a marked determination on the part of officialdom to keep public accounts in order, taking advantage of the favorable climate to avoid, wherever possible, the accruing of new debt, and even to cancel part of their old debt. Similarly, in many cases the fiscal surplus

acts as a monetary anchor, as part of it is used to buy foreign currency, thus lifting pressure on the central banks to intervene in foreign exchanges.
In terms of *prices*, inflation rates in 2004 intensified the falling trend seen in 2003, after the rise experienced in 2002 as a result of the sharp climb in nominal exchange rates in the subregion's countries. Given greater exchange stability, all the partners in 2004 had single digit retail inflation for the second year running, climbing to 7.6% in Brazil and Uruguay, 6.1% in Argentina, and 2.8% in Paraguay. Some prices rose slightly faster in the latter part of 2004 and early 2005, as an accompaniment to the exceptional expansion of economic activity in general, and of internal demand in particular.

In this context, although controlling inflation continues to be the main aim of MERCOSUR members' monetary policy, it should not be forgotten that, over the last year, the central banks had to simultaneously deal with different goals, making their job more complex. The inflow of foreign currency stemming from a rise in exports, and the growing presence of capital in the region, in certain cases brought about greater activity on foreign exchanges to avoid an excessive appreciation of the local currency, which might jeopardize competitiveness and reactivation of production. Greater liquidity generated by the purchase of foreign currency required open market operations (sterilization) in order to reduce inflationary pressure. However, the cycle of the slow rise in interest rates, initiated by the US Federal Reserve in the second half of 2004, led to a gradual rise in domestic rates.

Each country opted for a different combination of instruments among the basic policy options, varying degrees of success in the primary goal to keep internal prices in line. Brazil fought hardest to control inflation, allowing the value of the real to fall, and betting on a contractionary monetary policy. Although in the short term this had negative repercussions on the level of economic activity, it helped to curb prices and inflationary expectations, as well as to meet the Central Bank's annual inflation target for late 2005. At the other extreme, Argentina chose to play a major role on foreign exchanges in order to maintain the parity of the peso, and bring continuity to the swift pace of economic expansion. In spite of its sterilization and fiscal control policies, Argentina did not manage to prevent inflation rising.

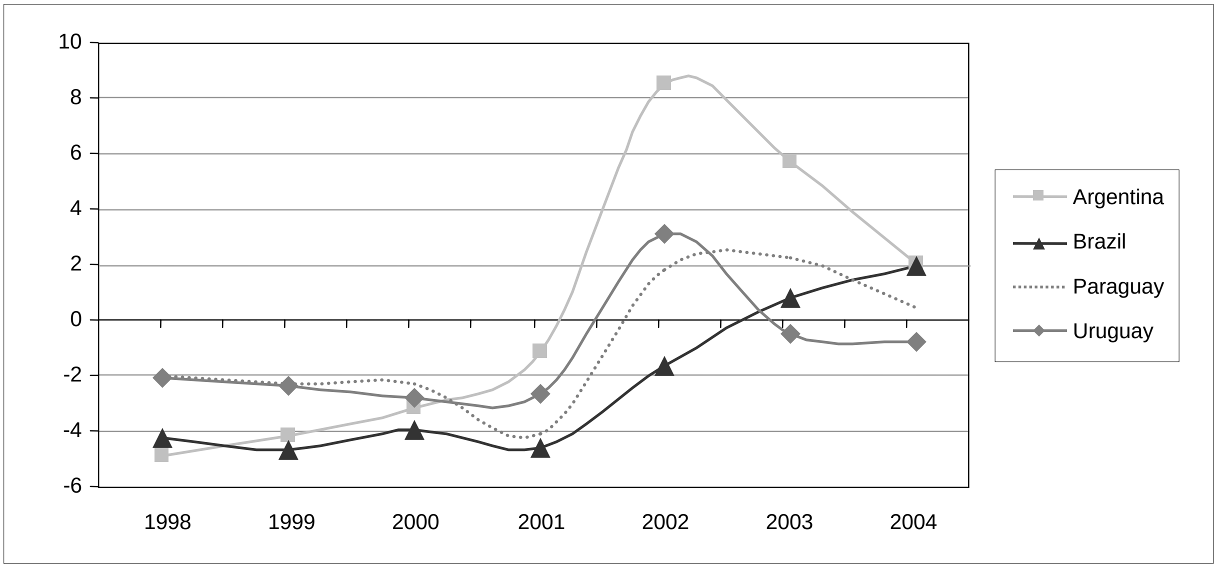
FIGURE 4
CONSUMER PRICES
December-December % Variation



Source: In-house, based on data from INDEC, IBGE, INE and Central Bank of Paraguay.

FIGURE 5
BALANCE OF PAYMENTS CURRENT ACCOUNT BALANCE

% of GDP



Source: In-house, based on data from INDEC, IBGE, INE and Central Bank of Paraguay.

Goaded by economic reactivation, last year's *employment rate* rose in all MERCOSUR Member States, causing a widespread fall in unemployment. The most pronounced cases were Argentina (where unemployment averaged 13.6%) and Uruguay (13.1%), where it fell by nearly four percentage points on average as against 2003, to levels similar to those prior to the recession. Paraguay and Brazil too experienced reductions in unemployment (10% and 11.5% respectively). Despite being less pronounced than the other two partners', they are still appreciably lower.

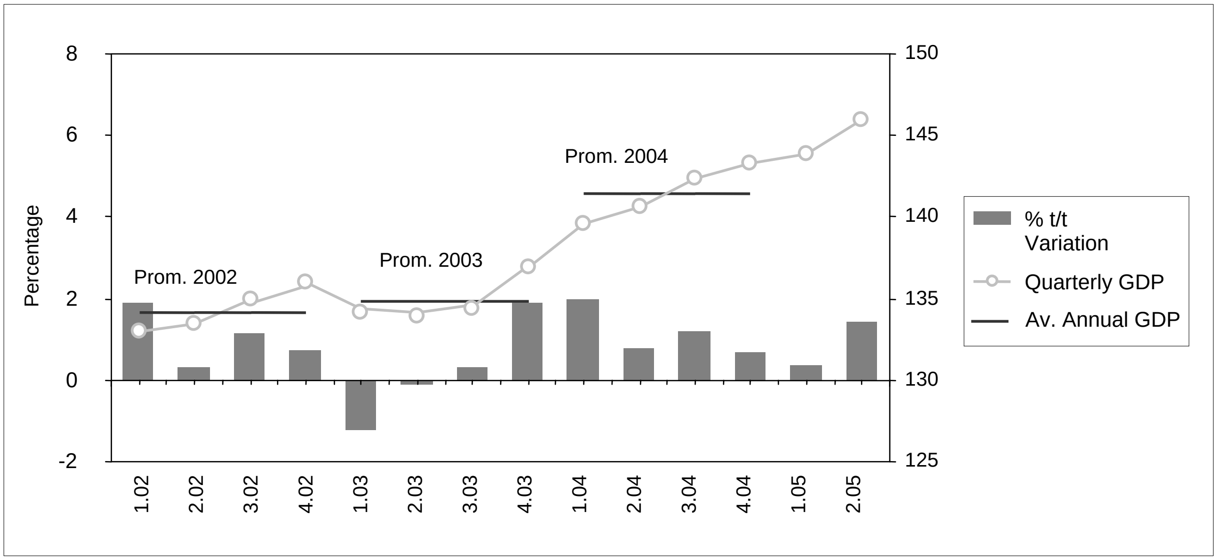
At the start of 2005, all unemployment rates fell significantly compared to early 2004 values, although the rise in employment is now slowing somewhat, reflecting the slower pace of expansion of the regional economy. Likewise, the problem of unemployment continues to be a major one in all four countries, with many jobs created in recent years being informal in nature. This raises the challenge of generating quantitatively more and qualitatively better jobs.

Major Developments & Trends in each Member State

BRAZIL

2004 was a very good year for Brazil From in every way. Taking full advantage of the favorable international context, with a prudent economic policy, the Brazilian economy in 2004 displayed the highest growth of the last decade. This was accompanied by a fall in unemployment, and an improvement in external and fiscal accounts, reflected not only in thriving financial indicators, but also leading the government not to renew its agreement with the International Monetary Fund (IMF), after programs with this organization for six years running.

FIGURE 6
GROSS DOMESTIC PRODUCT
Basic index 1990=100, seasonally adjusted series



Source: In-house, based on data from IBGE.

After virtually zero variation in 2003 (0.5%), Brazil’s GDP ended 2004 with real growth of 4.9%, the highest since 1994. On the supply side, improvement was widespread, unlike the previous year, when the only sector to display an increase of any size had been agriculture.

On the demand side, export volumes in 2004 rose by 18%, even better than 2003 (with a 9% rise), and setting a new record. Domestic demand also reacted positively after the second half, another driving force behind growth. Investment and private consumption thus ended the year significantly up by 10.9% and 4.3% respectively, both variables partially recovering from the fall over the three previous years.

The excellent performance of exports not only helped kickstart the recovery of economic output, but was also responsible for a record trade surplus of over US$ 30 billion. For the second year running, Brazil thus had an unprecedented current account surplus in both absolute terms (US$ 11.7 billion) and percentage of GDP (1.9%), suggesting its external accounts underwent an astonishing transformation in recent years.

While in 1999, even after the real’s maxi-devaluation, and with an almost stagnated economy, the Balance of Payments current account showed a deficit of 4.7% of GDP, the imbalance was slowly reversed, reaching a record surplus last year, the largest in Latin America and the Caribbean in absolute values. Even more striking is the fact that intensification of this reversal in external accounts is not a by-product of shrinking domestic spending, as was initially the case in 2003. The current account surplus is currently given in parallel to the higher growth of recent years in both output and domestic demand.

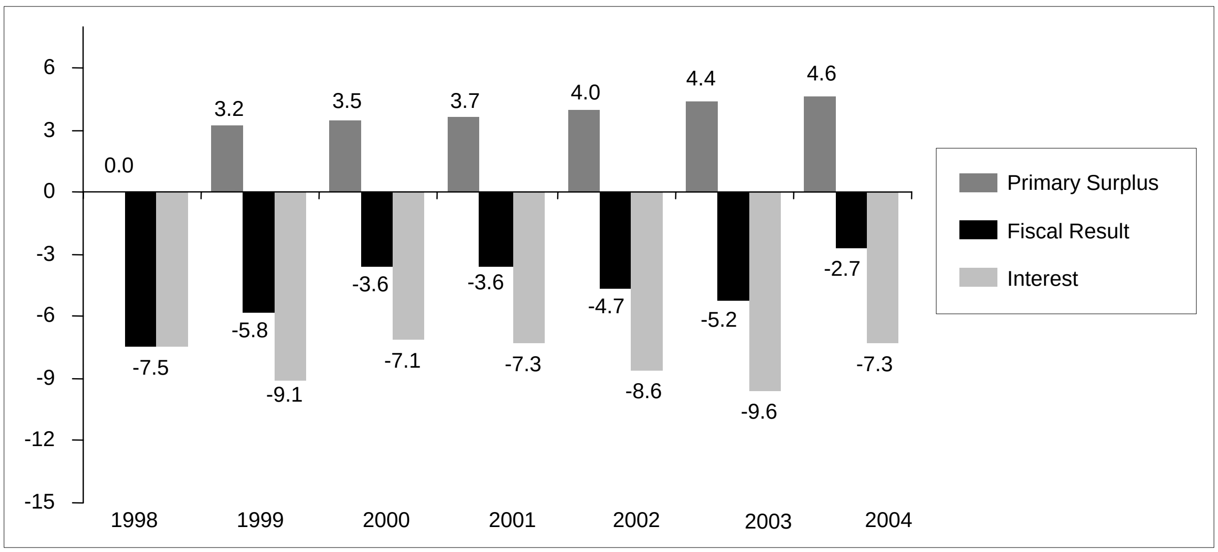
At the same time, the Balance of Payments Capital and Financial Accounts in 2004 amassed a deficit of close on US$ 5 billion, a sign that the benign international context is not being used to secure capital but to cancel foreign debt. With these data, there was a global surplus of around US$ 7 billion, or 1.1% of output.

Last year’s improved economic output translated into higher fiscal collection, enabling the Government not only to comfortably meet the primary surplus agreed with the IMF, but even to ‘double the bet’, and

increase primary saving targets of its own volition from the 4.25% of GDP originally agreed with the IMF to 4.5%. The primary surplus thus rose to 4.6% of GDP (US$ 30 billion), the best result in six years.
At the same time, interest payments represented 7.3% of GDP. Though still high (US$ 48.1 billion), this figure is the lowest for three years (2.3% of GDP down on 2003). Overall, the global fiscal deficit was down 2.5% of GDP, from 5.2% in 2003 to 2.7% in 2004 (US$ 17.7 billion), the lowest in two decades.

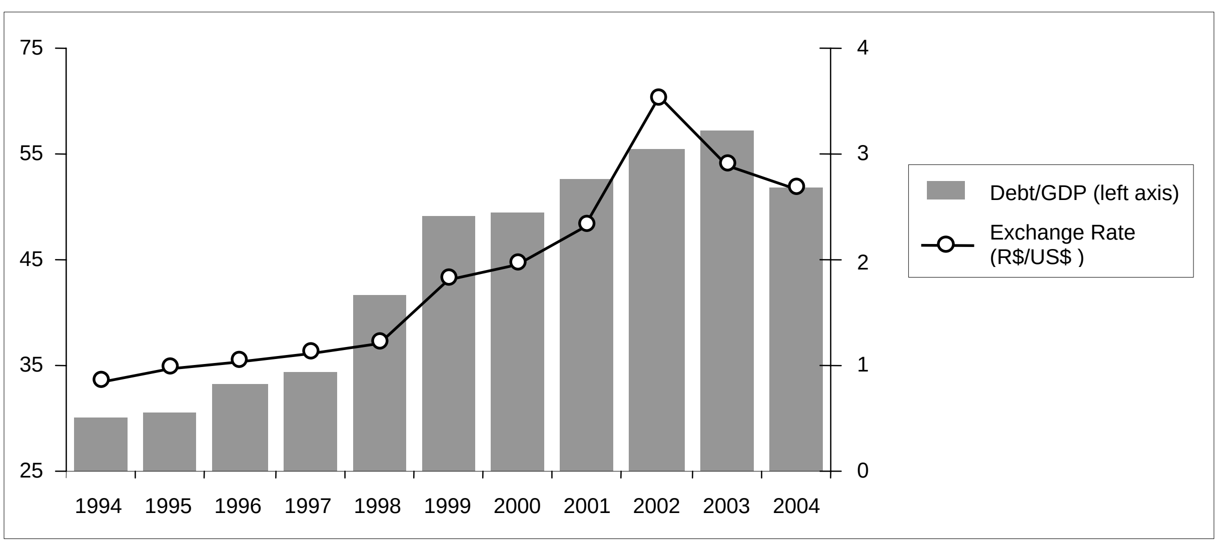
For the first time in 10 years, the rise in primary surplus, added to the lower interest burden, strong growth in nominal GDP, and the appreciation of the exchange rate, generated a significant fall in the ratio between Public Debt and GDP, from 57.2% in 2003 to 51.8% in 2004. The composition of the debt also showed a marked qualitative improvement, with a fall in the share of dollar bonds over the total owed.

FIGURE 7
FISCAL RESULT
% GDP



Source: In-house, based on data from BACEN.

FIGURE 8
NET PUBLIC DEBT & EXCHANGE RATE



Source: In-house, based on data from BACEN.

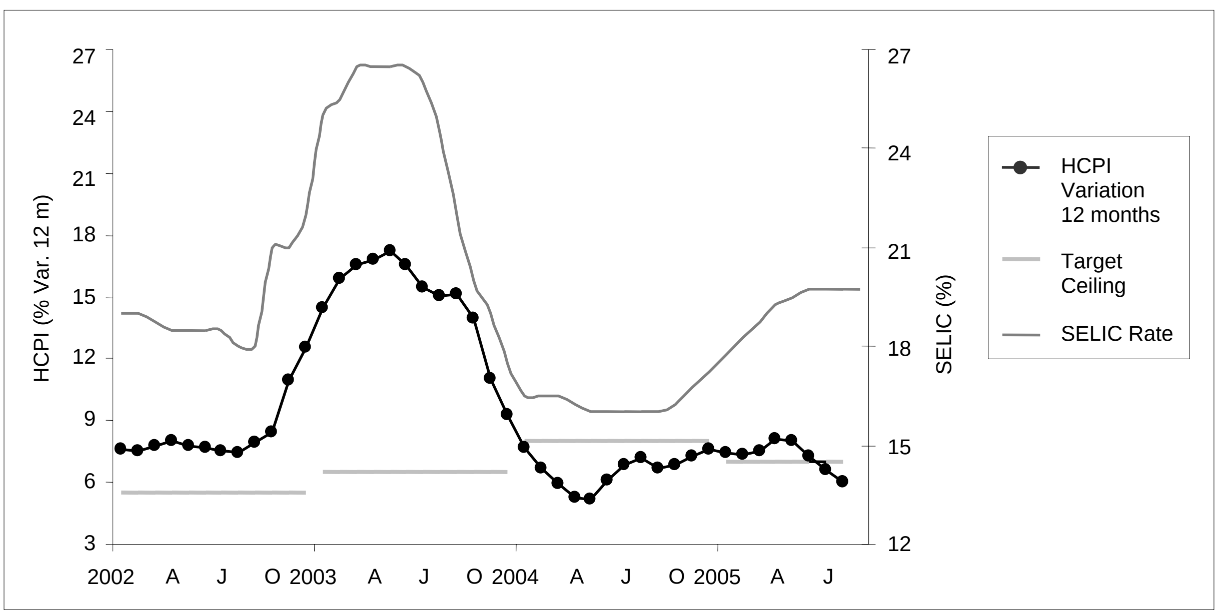
At the end of March 2005, when the IMF program ended, the Brazilian government made the decision not to renew the agreement.[1] Similarly, the correlate of this greater looseness in Brazil's external and fiscal accounts was positive trends in its financial variables. A sharp drop in country risk was recorded last year (by late 2004, this stood at around 400 basic points, the lowest since Luiz Inácio Lula da Silva took office). This was accompanied by a rise in the BOVESPA Index (which had reached record levels) and a persistent appreciation of the real, trends that were consolidated in the first half of 2005.

Economic growth in 2004 had a positive impact on employment, creating about a million and half jobs in the formal market. This pushed unemployment down to 11.5% by end of year, the lowest since 2001, almost a whole percentage point down on the 12.3% 2003 average. This, and the slow but steady upturn in real wages (the first in metropolitan areas in seven years) were responsible for higher private consumption.

As to price trends, retail inflation in 2004, as measured broadly by the Consumer Price Index (CPI), was 7.6% for December-December, close to the 2.5 percentage point tolerance margin fixed on the 5.5% target fixed by the Central Bank. This was the first year since 2000 (with prices up by 6.0%) that the monetary authority achieved its targets.

Despite inflationary pressure from rapid economic growth, and certain indexation clauses applied to regulated services in the second half of the year, the Central Bank began to pursue a contractionary monetary policy to meet higher inflation levels forecast for 2004, and curb prices and inflationary expectations for 2005. The 2005 target originally set at 4.5% was raised to 5.1%, with a 2.5% tolerance range. As of September 2004, the monetary authority began to put up the SELIC rate. This process lasted nine months, over which the rate rose 375 basic points from 16% to 19.75% (the highest since late 2003).

FIGURE 9
INTERANNUAL % VARIATION IN HCPI, INFLATION TARGETS & SELIC RATE



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[1] IMF assistance to Brazil was particularly important during the 2002political transition, when Luiz Inácio Lula da Silva's election victory prompted concern among investors, while the new administration's continuance of the IMF program played an important part in generating confidence in the market over the Government's prudent policies. At present, the economy's foundations are looking much more solid, while the prospects have also improved. This has led to the government breaking away from the IMF 'umbrella'.

Source: In-house, based on data from IBGE and BACEN.

The results of this price strategy have so far been favorable, with a gradual convergence toward the upper target band. In July the Harmonized Consumer Price Index (HCPI) accumulated an interannual increase of 6.6%, after reaching a peak of 8.07% in April.

The rise in interest rates had a parallel impact on output levels, with decelerating growth. In the fourth quarter of 2004 and the first of 2005, GDP increased by 0.7% and 0.4% per quarter, while in the first part of 2004 it had grown by a quarterly average of 1.3%. Likewise, in the fourth quarter of 2004 and the first of 2005, investment fell twice running, down 2.9% and 3.6% respectively. In this context, according to the survey of expectations carried out periodically by the Central Bank, for 2005 the market consensus anticipates a 3.2% rise in GDP, which is lower than 2004 (although it is still high when compared with the performance of the Brazilian economy during the last ten years, which has averaged yearly growth of 2.5%).

Lastly, in spite of the appreciation of the currency and the recovery of domestic demand, Brazil's trade balance over the year continued to register a major surplus, keeping the external accounts in almost perfect good health. More specifically, over the first six months of 2005, the trade balance climbed to US$ 18 billion (32% above the same period for 2004), while the accumulated result of the twelve months ending in June was positive, standing at US$ 34 billion (exports close on US$ 107 billion, and imports, US$ 72 billion), unprecedented in Brazilian economic history.

ARGENTINA

In 2004 Argentina's GDP registered a 9% rise, the highest in twelve years, marginally even higher than the 8.8% rise seen in 2003. At the same time, during the first six months of 2005, output continued to make steady progress (GDP was 9% up on the previous year) and broke its earlier pre-recession record. From a sectoral viewpoint, the recovery of 2004 was extremely widespread, industry again being mainly responsible for the rise in GDP, followed by trade, construction, and transport and communications services.

As to the spending components, domestic demand played a key role in the progress at aggregate level during 2004 for the second year running, with promising headway also being made in exports in the second half. More specifically, private consumption expanded 9.4% in 2004 (rather more rapidly than the previous year) and Fixed Internal Gross Investment (FIGI) recovered 34.5%, driven both by growing investment in construction, and in machinery and equipment. Thus, after reaching a record .low of 12% of GDP in 2002, investment (measured at current prices) accounted for 21% of GDP by late 2004.

The extreme rapidity of the aggregate output's recovery produced a sustained rise in employment, both formal and informal, extending across virtually all economic activities, particularly the creation of jobs in manufacturing industry, construction and certain services. In this context, the Rate of Employment climbed to historically high levels. This led to a significant fall in the Rate of Unemployment in the fourth quarter of 2004 (even with an increase in labor supply)[2] to 12.1% of the Economically Active Population (EAP). This rate was almost 2.5 percentage points below the end of 2003, representing almost half the maximum reached in May 2002. On recalculating the rates, counting those whose main source of employment is an official employment plan as unemployed, unemployment should have climbed to 16% by late 2004. In the first half of 2005, unemployment stood at around late 2004 levels.

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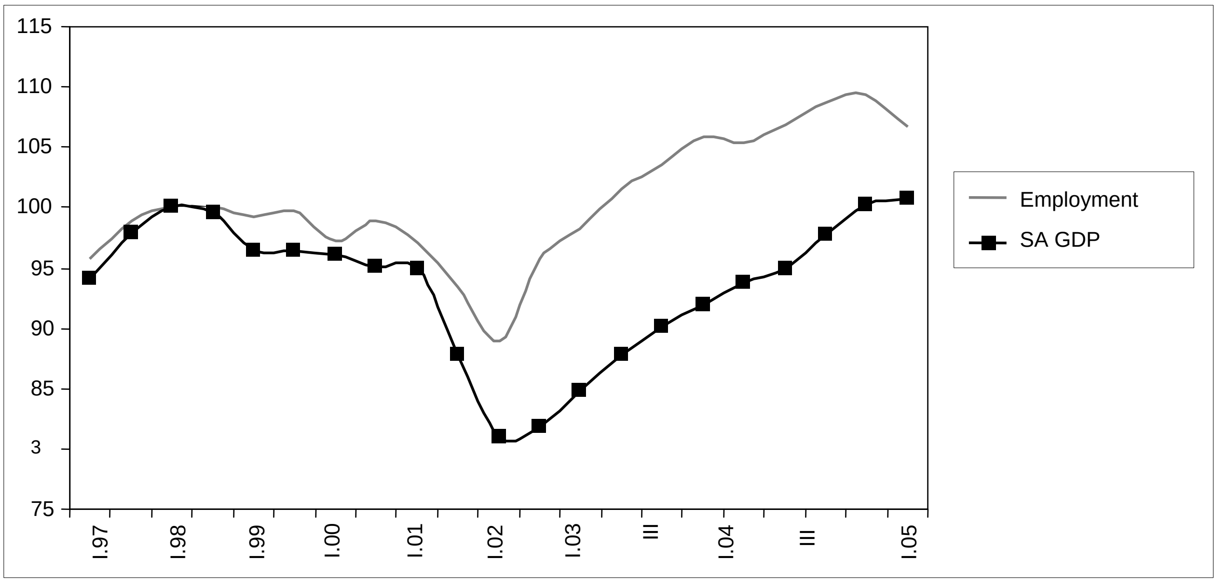
2 Quotient of Economically Active Population & Total Urban Population.

FIGURE 10
GROSS DOMESTIC PRODUCT & URBAN EMPLOYMENT RATE

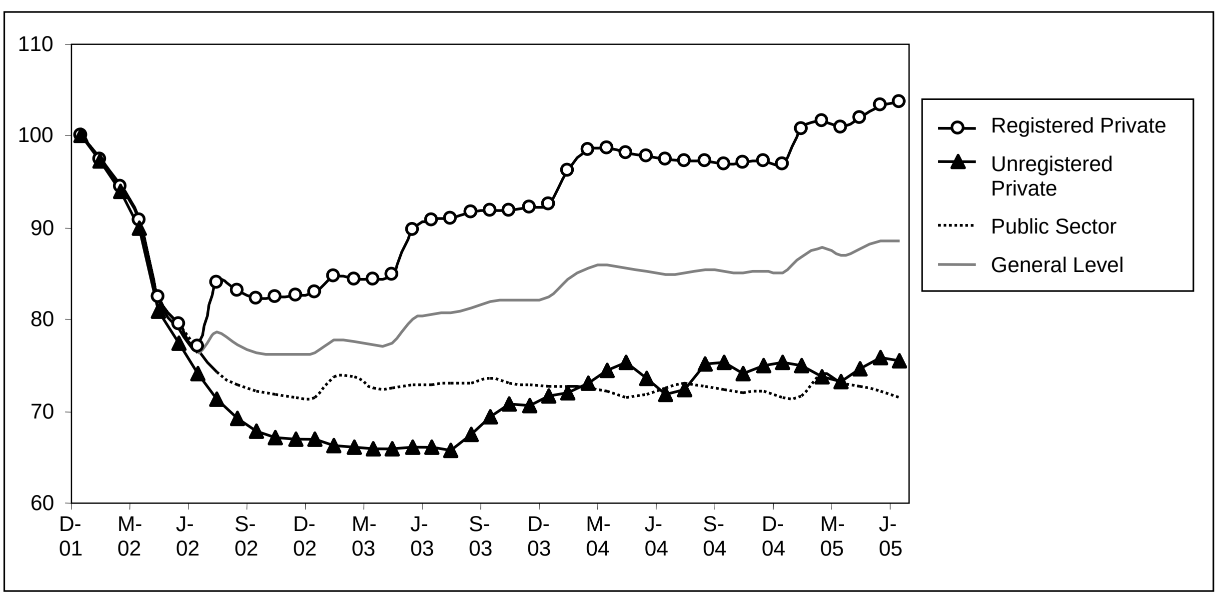
Basic indices 1st half 1998=100, seasonally adjusted series



Source: In-house, based on data from INDEC.

FIGURE 11
REAL WAGES*

Basic indices December 2001=100



Note: * Wages deflected by retail prices.

Source: In-house, based on data from INDEC.

2004 also saw an increase in nominal wages than that registered by retail prices, giving rise to a recomposition of employed earners' purchasing power. Quite apart from the fact that wage rises were driven by government decisions, and the increases were concentrated mainly in the formal private sector (a group that, by early 2005, had recovered pre-devaluation levels of real wages), rises were also detected in the informal private sector. Even so, given the differences between public and private workers, and between private earners themselves (formal or informal), wage discussions came to the fore.

Similarly, the recovery in employment and wages brought about a fall in poverty and homelessness indices. Despite this problem continuing to affect a very high percentage of the population; the poverty index fell in the second half of 2004 to 40%, and the homelessness index to 15%.

December-December retail inflation for 2004 was 6.1%. Although this was above the rate recorded in 2003 (up 3.7%), significant price rises were not detected until early 2005, putting inflation once again at the epicenter of the economic agenda. Specifically, until December 2004 average monthly inflation stood at 0.5%, while between January and March 2005 it increased significantly to over 1% per month.

This rise in inflation was a combination of a wide range of factors: on the one hand, seasonal issues; on the other, a recomposition of relative prices in favor of less transactable goods and services, which had been lagging behind since the end of convertibility. Faced with the pressure of costs, a reduction of idle capacity, and extremely dynamic domestic demand, discreet price adjustments began to be introduced. To this were added rises in certain products (like meat) with a high incidence in the CPI basket. These rises occurred in the context of a simultaneous rise in external and internal demand, which collided with an inflexible supply.

Between the second and third quarter of 2005, inflation slowed as compared to the first three months of the year. Between April and August,[3] average monthly inflation was 0.7%, almost half that of the first quarter (1.3%). This was due to seasonal factors, the contractionary fiscal effect typical of that time of year (coupled with the expiry of income and other taxes), and to a stricter control of monetary policy.

In spite of this partial deceleration, to August 2005, the CPI accumulated a rise of 7.7% over December 2004 (+9.7% interannual), very close to the upper limit of the 8% end of year target set by the monetary authority. This, and the bullish price dynamics typical of the closing stages of the second half, the more expansionary seasonal fiscal policy, and the inflationary pressure anticipated in several economic sectors due to recently agreed wage adjustments, make it very difficult for price variation to reach the upper band of the target in the remainder of 2005, an estimate being that it may reach double figures.

Likewise, wholesale inflation in 2004 rose to 7.9%, significantly up on 2003 (2%). This was driven by price rises in manufactured products and electrical power (up 10%), with primary products remaining relatively stable (up 1.4%) in response to the fall in agricultural products (down 22%). In the first eight months of 2005, the Wholesale Price Index (WPI) rose by 6.3%.

Faced with accelerating inflation, the government opted to keep the nominal exchange rate steady, and to close a series of sectoral price agreements designed to freeze different product values from the basic basket for a given time period. In addition, the rises in certain public services like transport were curbed in exchange for state subsidies.

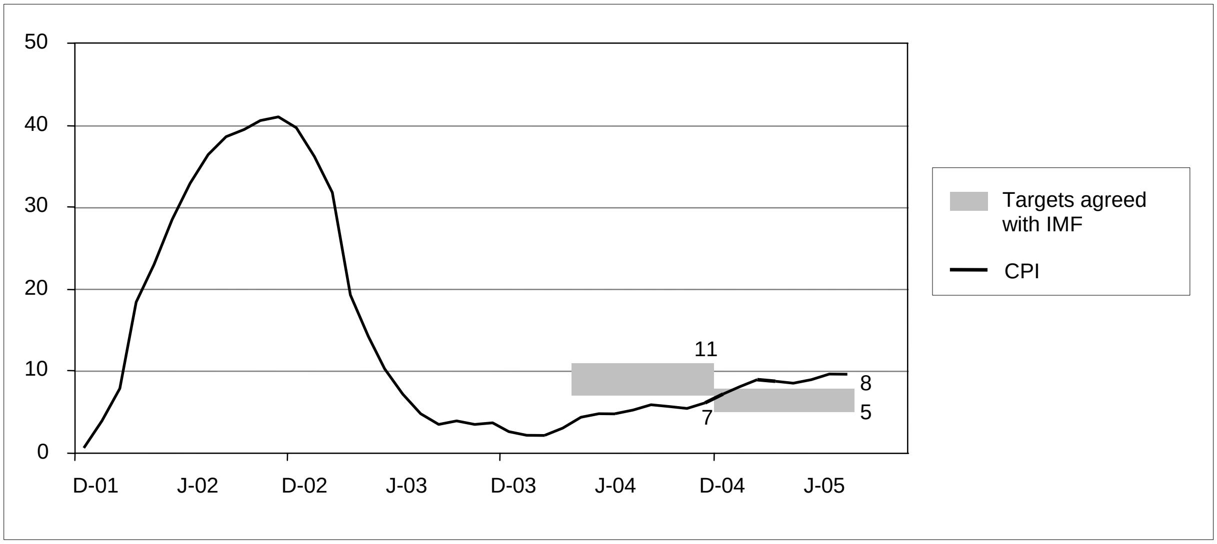
Given the increases thus far recorded by the CPI and WPI, the stability of the nominal exchange rate in practice involved a slight real appreciation, although the competitive exchange rate of the peso over

[3] Latest data.

Argentina’s main trading partners (including MERCOSUR) remained virtually unaltered as result of the nominal upward trend of most currencies of the economies with which Argentina trades.

FIGURE 12
CPI & WPI

Interannual % variation



Source: In-house, based on data from INDEC.

At the fiscal level over 2004, increased output, employment and prices, as well as greater compliance with tax commitments, brought with it a significant 34% rise in national tax collection, well above growth in GDP. This raised the tax burden to a record 22% of GDP. The most dynamic taxes included Value Added Tax (VAT) (which rose by almost 50% last year) and income tax (up 43%). Social security contributions also performed very well, up 30%. The flipside of this increase in revenue was the government's smaller increase in spending to help accumulate a primary surplus of close on 4% of GDP, the highest for decades.

Apart from the fact that the primary surplus easily exceeded agreed IMF targets, the Argentinian government decided to suspend its joint program with this organization because of differences over the scope of so-called 'structural reforms' and the exchange of the public debt. This brought about a suspension of disbursements by the IMF, and led Argentina to make net disbursements for over US$ 2 billion. In the first half of 2005, public finances continued to develop favorably, and, despite some increases in spending, growing revenues shored up the high primary surplus.

In February 2005 the restructuring of the public debt ended in irregularity, reaching a level of agreement of 76%, or US$ 62.318 billion out of a total eligible debt of US$ 81.837 billion. Based on information from the Treasury, the stock of public debt after the exchange rose to US$ 125.283 billion (72% of GDP), a substantively lower figure than prior to restructuring (US$ 191.254 billion, or 124% of GDP). Although the degree of share was high, the treatment of 24% of creditors who did not enter the exchange gave rise to public debate, causing friction between the government and the IMF.

In terms of the external sector, the trade balance of goods in 2004, though down, was once again in surplus, rising to US$ 12 billion, or 8% of GDP. Despite being down on 2003, the current account balance also recorded a surplus, rising to nearly 2% of GDP. This brought a significant inflow of foreign currency, accompanied by an accumulation of reserves due to the official decision to shore up the peso rate.

Argentinian exports rose 16% in 2004, reaching a new record of US$ 34 billion, due to both prices (up 11%) and quantities (up 5%), and was driven mainly by higher external placements of agricultural and industrial manufactures (up 19% and 24% respectively). At the same time, imports (US$ 22 billion) again rose significantly for the second year running (up 62%, after 2003's 54% recovery), stimulated by a significant new turnaround in imports of capital goods and fuel (up 114% and 83% respectively).

Exports again rose in the first half of 2005 (up 13%), while imports continued to make steady progress (up 34%), only 18% below late 1997 levels, before convertibility was abandoned. It is anticipated that this behavior will be repeated in the remainder of 2005, and that, although positive, the 2005 trade and current account surpluses are again likely to adjust to the fall.

With all this in mind, Argentina can be said to have made continued progress over 2004 in the normalization of its economic and financial conditions. The fiscal and current account surpluses provide a cushion against external vulnerability, and make a repeat of the 'train crash' that led to the collapse of convertibility unlikely in the short to medium term. Perhaps one of the main issues remaining for Argentina is the redefinition of the concession frameworks of privatized public services.

URUGUAY

Uruguay's GDP rose 12.3% over 2004, surpassing even the most optimistic expectations. This marked expansion consolidated the incipient improvement seen in 2003, when aggregate output rose by 2%, beginning the exit from the deep recession 1998-2002 (-17.7%). This process of vigorous recovery meant that, by late 2004, the production of goods and services was only 4% below its pre-recession maximum.

The Uruguayan economy continued to make progress in the first quarter of 2005, though rather more slowly. GDP was up 7.1% on the previous year, and in seasonally adjusted terms, was only 0.1% up on the fourth quarter of 2004, a slight slowing in the pace of progress.

On the supply side, last year the rise in GDP was driven by manufacturing industry (which grew by 21.7%), trade, restaurant and hotel output (21.1%), and the agricultural sector (13%). These were responsible for about two thirds of the overall recovery.

In industry, the momentum of both internal and external markets was significant, with a rise in production in all branches of manufacturing. Significant among these were manufacturers of foodstuffs, beverages, tobacco, chemicals and metalware. The favorable performance of the trade, restaurant and hotel sector was influenced by the rise in domestic consumption, the recovery of foreign tourism, and greater domestic demand for leisure activities. Increased agricultural activity was mainly due to the extension of soya, sunflower, wheat and barley crops, while growth in livestock output was due to higher cattle production.

TABLE 2
% VARIATION IN GDP 2004/2003 OF THE PHYSICAL VOLUME INDEX

Activity	% Variation	% Contribution
Manufacturing Industry	21.7	3.7
Trade, Restaurants & Hotels	21.1	2.3
Agriculture	13.0	1.6
Transport & Communications	11.7	1.4
Construction	7.2	0.2
Electricity, Gas & Water	1.2	0.1
Other	7.4	3.0
GDP	*12.3*	*12.3*

Source: Central Bank of Uruguay.

Analyzing the behavior of the components of aggregate demand, last year's recovery of GDP was mainly due to rising internal demand (13.3%), due in turn to an increase in both consumption (11.4%) and Fixed Gross Capital Formation (32%). Moreover, although its role in rising output was somewhat less than the internal market's, external demand was also dynamic, rising 22.7%, according to constant price estimates of national accounts.

As the flipside to the rapid recovery of aggregate output, the 2004 unemployment rate consolidated the downward trend seen in 2003. In the mobile quarter ending in December 2004, unemployment fell to 12.1%, well below the same period the previous year (15.4%). This significant reduction was partially 'obscured' by the fact that to a large extent it was the result of an increase in informal employment (an issue affecting close on 40% of Uruguay's labor force), while by late 2004, 16% of those in employment were underemployed, working fewer hours per week than desired. At the same time, the unemployment rate stopped its downward trend early in 2005, hovering around the 12% mark. This was due to an increase in labor demand similar to the increase in supply, which occurred in a context of the slowing of economic growth.

Besides the increase in output and the fall in unemployment, 2004 saw a reduction in the rate of inflation. Retail prices grew 7.6% last year between December and December, while the wholesale prices of national products rose by 5.1%. Both rates were lower than for 2003 (when the CPI and WPI rose 10.2% and 20.5% respectively), slowing markedly in the final stages of last year. While the CPI rose from 2.5% to 2.9% in the first three quarters of 2004, retail inflation in the fourth quarter was just 0.1%. At the same time, wholesale prices fell in the last three months of the year, 2.7% down on the previous quarter. Among the factors contributing most to these falls are the appreciation of the Uruguayan currency, the backslide in the internal value of meat, and the partial fall in the international oil price.

The favorable trends in domestic prices enabled the 7%-9% target band fixed by the Central Bank of Uruguay to be met, and gave some leeway for flexibility in monetary policy based on the control of monetary aggregates. It also led to a reduction in inflation in 2005, which finally settled in a range of 5.5%-7.5%. To July 2005, the CPI had accumulated an increase of slightly above 3% since the end of 2004, and of 4% over the last twelve months, under the lower band set as an inflation target. At the same time, wholesale prices accumulated a reduction of 0.7% between July 2005 and the end of last year, 5.4% up on August 2004.

In terms of fiscal policy, the nominal increase in revenue from economic reactivation last year enabled the current expenditure of 12% to be expanded, without putting at risk the accumulation of a large primary surplus of close on 4% of GDP. Once the payments of the debt were computed, the global result was down by 2% of GDP. Both primary and global results meant that the quantitative targets agreed with the IMF (a primary surplus of 3.4% of GDP, and a global deficit of 2.9% of GDP) were met comfortably, helping to unblock last November's review of the agreement, a situation occurring despite the delayed implementation of some of the structural reforms laid out in the letter of intent. Among other things, no progress was made in tax system reform, nor in modifying the pensions of the security forces and other groups of workers.

One matter that should not be overlooked is that these highly favorable trends in the main macroeconomic variables took place in the framework of the electoral campaign that put Uruguay's center left party, the Frente Amplio (Broad Front), in government for the first time in its history. The political noise typical of any electoral year made no impact on the economy on this occasion. In fact, after the new government took office, the previous administration's economic policy continued practically unchanged, designed as it was to keep public finances in order, control inflation, and win over new export markets. Perhaps the main difference between the outgoing and incoming authorities lies in the fact that the latter have

given great impetus do a series of social measures, including the launch of an ambitious plan to help the poorest sectors of society.
Looking ahead, the main challenge faced by the new government is probably to create favorable conditions for investment to take off, bearing in mind that the Uruguayan economy continues to present problems in this area. In spite of the strengthening of the gross capital formation since the crisis of 2001-2002, the ratio between investment and GDP at the end of 2004 was 11.4% at current prices, not only very much lower than the 15.2% reached in 1998, but also lower than is necessary to achieve sustained economic growth.

Another important goal to achieve is the consolidation of extra-MERCOSUR positions won by Uruguayan exports. This would help to reduce Uruguay's external vulnerability. In 2004 exports to MERCOSUR made up only a quarter of Uruguay's total exports, having represented more than half this total in 1998. This diversification of destinations came about as a consequence of greater participation in the North American Free Trade Agreement (NAFTA) and the European Union (EU), each of which currently accounts for almost the same percentage of Uruguay's total exports as those destined for MERCOSUR.

PARAGUAY

The rate of growth of Paraguay's GDP in 2004 was 4%, the highest since 1995. This expansion, which is exceptional for the Paraguayan economy, and which consolidates the previous year's growth (3.8%), is largely due to the increase recorded in the fourth quarter of 2004. when output was 12% up on the previous quarter, given the seasonally adjusted series.[4]

From a sectoral viewpoint, the rise in GDP was extremely widespread, not depending solely on progress in the agricultural sector, as happened in 2003. Last year, agriculture developing favorably (driven by higher cotton, wheat, corn, sunflower, manioc and sugar cane production, among other crops), cattle output also performed very well, growing 8%, as a result of improved Paraguayan sanitary standards, which brought expansion of the external markets for these products. Also, after falling for two years running, industrial production showed a considerable recovery (3%) led by higher output from meat processing plants. All services developed positively (5%), especially the rises in basic services and trade.

On the demand side, private consumption was what contributed most to the improvement at the aggregate level, with a rise of 3.5%, similar to GDP. Also significant was the dynamism of public consumption, which recovered 24% after shrinking systematically over the five previous years, while investment rose just 2.7% (well down on the 7% of the previous year), despite the low performance of the construction sector (2%). Lastly, despite a considerable rise, exports' contribution to output growth was more than offset by the contractionary effect generated by the rise in imports.

At the start of 2005, the pace of growth slowed as a result of the negative trends in agriculture and the leveling off of other non-agricultural activities. Given the importance of agriculture in the Paraguayan economy, the drought occurring in the first months of the year made itself felt at aggregate level, along with unfavorable trends in international prices for the country's products. Overall, it is estimated that the growth of Paraguayan GDP in the current year will be under 3%, crowning three consecutive years of increases.

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[4] It is worth noting that the Central Bank of Paraguay has changed the methodology for calculating the series of national accounts, shifting the base year from 1982 to 1994. Were the old methodology to be applied, average growth in 2004 would have been 2.9%, while for 2003 it would have risen to 2.6%.

The rate of urban unemployment fell for the second year running in 2004, from 11.2% in 2003 to 10%, though simultaneous with a rise in underemployment. These unemployment rates are the lowest since 1997, after peaks of unemployment of over 20% between 2001 and 2002.
Inflation in 2004, as measured by the December-December variation of the CPI, was significantly down on 2003 (from 9.3% to 2.8%). This rate was the lowest in 35 years, below the 8% projection (with a 1.5% tolerance band either way) set by the IMF agreement. This marked slowing of inflation can be seen in the drop in the monthly rates of interannual variation, which in the first half of 2003 were around 20%, and in the second around 10%, fluctuating last year between 2% and 5%. In line with the lower inflation of consumer prices, variation in the Producer Price Index (PPI) was 4.7% in 2004 as against 9.3% in 2003.[5]

In the case of the CPI, inflation to July 2005 was 5.6%, after reaching just 2% over the same period the previous year. In this context of partial acceleration of prices rises, it is estimated for the current year that retail inflation will be near the upper target band in the current IMF standby agreement, 6% plus (or minus) a 2% margin of tolerance.

In line with trends in consumer prices, the guarani depreciated 2.9% between December 2003 and December 2004, while keeping the real exchange rate steady at competitive levels. Indeed, it was the trends in the exchange rate against the dollar that in large part enabled the internal prices of consumer goods correlating with this variable to be kept in line, as well as the values of certain basic services. Furthermore, the behavior of the exchange rate helped contain economic agents' inflationary expectations, which up to mid-2003 were closely linked to the dollar rate.

The development of a prudent monetary and exchange policy by the Central Bank proved to be key for price stabilization and the nominal exchange rate. This policy was explicitly mentioned in the IMF standby agreement, and one of its main goals was to attain a level of international reserves of US$ 1.08 billion, a target comfortably achieved. By late 2004, international reserves had climbed to almost US$ 1.17 billion, US$ 0.09 billion above agreed levels, and US$ 0.18 billion up on the previous year, twice the minimum reached by mid-2002, when reserves fell to around US$ 0.5 billion. This accumulation of reserves increased the monetary authority's ability to intervene in foreign exchanges in order to avoid any abrupt shifts in the rate of the guarani that might affect price stability.

Another question to bear in mind is that, in a context of strong economic growth, a fiscal policy designed to strengthen national public finances was implemented over the last year. In 2004 total collection by central government showed a nominal increase of 26%, while spending went up by close on 10%. This brought about an increase in the primary fiscal surplus, which went from 0.4% of GDP in 2003 to 2.7% last year, thus enabling the global result (after calculation of interest payment on the debt) to show a surplus of 1.6% of GDP as against a global deficit of 0.4% of output in 2003.

The fiscal accounts' good performance enabled the targets specified in the IMF agreement to be met, and to a large extent reflects the successful application of a series of conventional reforms with that organization with a view to ordering public administration and increasing the Paraguayan economy's formality. Of the laws and rules that helped increase the efficiency of spending and raise collection it is the Fiscal Adjustment Act of early 2004 that stands out. This law introduces a new tax on personal income, and broadens the taxable base for VAT (with a special lower rate for products of the family basket), as well as adjustments in taxes on private companies. To this is added the reform of the Customs Code, and the introduction of certain changes in the social security system.

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5 Given the trends in prices of components of the retail and wholesale indices, the drop in inflation was strongly influenced by the significant fall in the value of agricultural sector output, offsetting the rise in fuel following the trends in international oil prices.

At the same time, the burden of foreign debt as a percentage of output fell from 44% in 2003 to 36% in 2004, thanks to principal and interest payments, and the increase in nominal GDP. To mid-2005, external public debt continued the downward trend begun last year.
Lastly, where the external sector is concerned, imported goods (42%) grew quicker in 2004 than exports (31%), the former amounting to US$ 2.65 billion, and the latter to US$ 1.63 billion. This brought about a trade deficit of around US$ 1 billion, well up on the previous year (US$ 0.624 billion).

The trade deficit was offset by the balances in services, income and current transfers, producing a current account surplus of US$ 0.03 billion (or 0.4% of GDP), positive for the third year running, though down on both 2003 (2.2% of GDP) and 2002 (1.8% of GDP). If the surplus in the capital account is added to this, the global balance of payments was in surplus by US$ 0.268 billion dollars, enabling international reserves to be accumulated and foreign liabilities to be covered.

In the first half of 2005, the trade balance deteriorated even further due to the rise in imports and the slight drop in exports when compared to the same period the previous year. Thus, the trade balance, which had been in deficit to the tune of US$ 0.286 billion in the first six months of 2004, stood at US$ 0.376 billion, also in deficit, in the same period of the current year. In this context, the 2005 current account balance is forecast to be below that of 2004.

C. Trends in MERCOSUR's External Trade

In a context of expanding world trade in goods, a significant increase in MERCOSUR trade flows was recorded over the last eighteen months. This consolidated the upward trend already seen for the first time in 2003. The most salient event here was the new 'jump' in the bloc's exports, offsetting the strong recovery in imports, and causing an the trade surplus to expand to unprecedented levels for the subregion.

MERCOSUR's total exports in 2004 climbed to a record high of US$ 135 billion, an increase of 28% over the already high levels of 2003, while being in excess of 55% higher than exports in the 2000-2002 period.

At the same time, driven by the marked economic recovery in all the member countries, total external purchases in 2004 reached US$ 95 billion, 38% up on the previous year and 52% higher than 2002, when they fell to the lowest level in the last decade. Unlike exports (which reached a new record high in 2004), imports did not reach the previous 1997 maximum, prior to the currency devaluations by the leading Member States.

Given these data, the 2004 trade balance was in surplus, at the figure record of US$ 41 billion. This was also the fourth year running that global trade exchange was favorable to the bloc, considering that between 1995 and 2000 heavy deficits were recorded in the subregional trade balance.

In terms of 2005, so far the scenario is similar to 2004. In the first half of the year, trade and surplus continued to rise as a result of significant interannual increases in exports (20%), counteracting the rise in imports (24%).

FIGURE 13
MERCOSUR'S EXTERNAL TRADE

Billions of US$

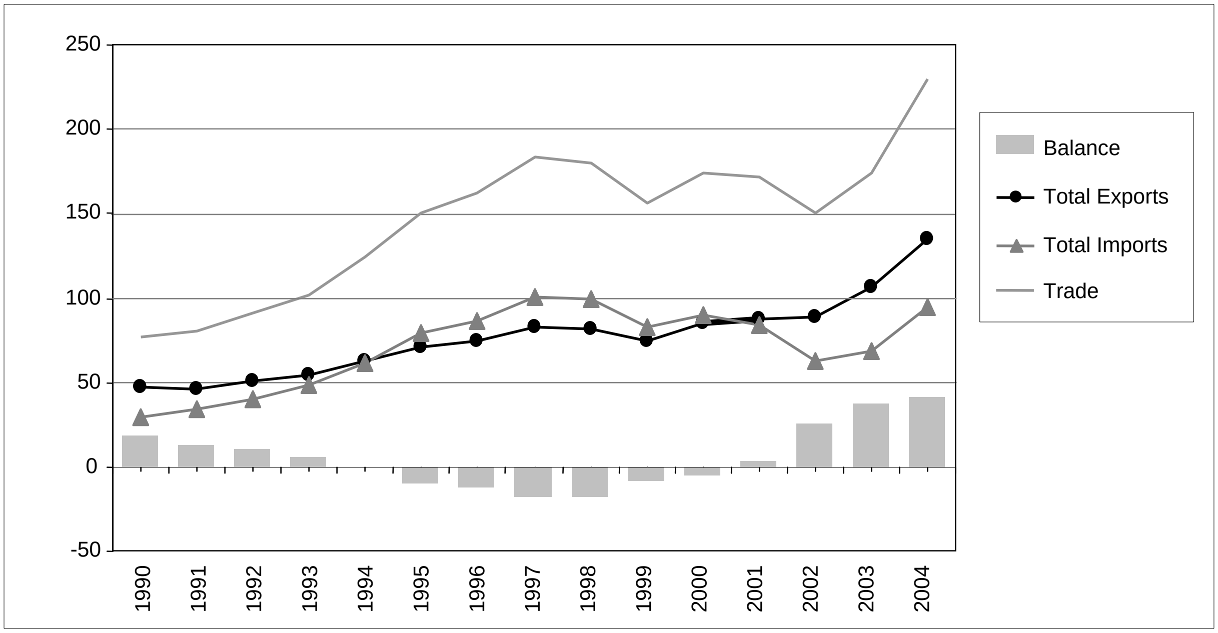


TABLE 3
MERCOSUR'S EXTERNAL TRADE

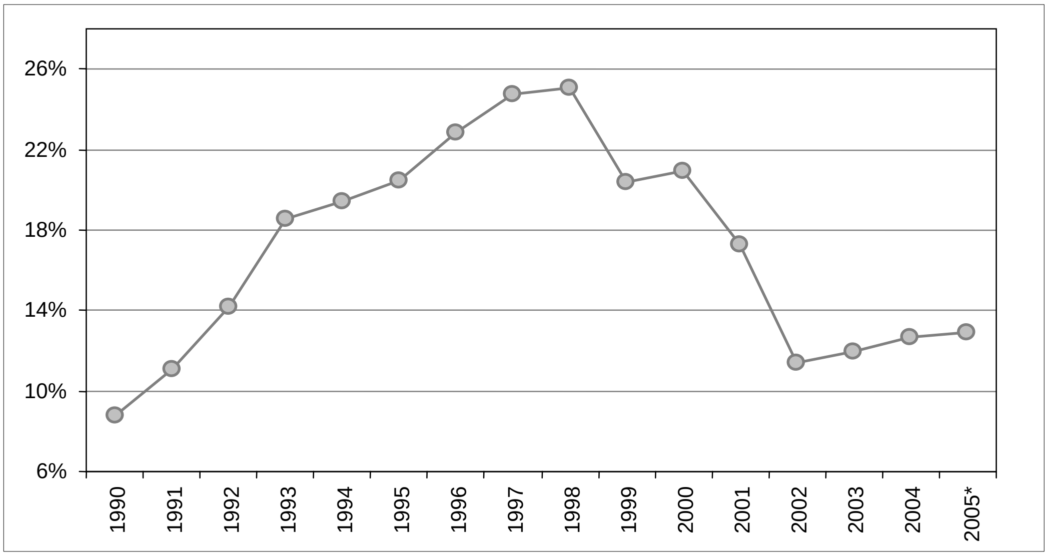
Billions of US$

	Annual Totals			January-June		
	2003	**2004**	**% Variation**	**2004**	**2005**	**% Variation**
Total Exports	106.008	135 .313	28	62.226	74.951	20
Intra-MERCOSUR	12.635	17.192	36	7.894	9.704	23
Extra-MERCOSUR	93.373	118.121	27	54.332	65.247	20
Total Imports	68.693	94.500	38	42.513	52.564	24
Intra-MERCOSUR	13.396	18.064	35	8.101	10.242	26
Extra-MERCOSUR	55.297	76.436	38	34.412	42.322	23
Total Balance	37.315	40.813	9	19.713	22.387	14
Total Trade	174.701	229.813	32	104.739	127.515	22

Source: In-house, based on data from INDEC, SECEX, INE and Central Bank of Paraguay.

Another of the most significant features of trade in goods over the last eighteen months was that intra-MERCOSUR trade made swifter progress than extra-MERCOSUR trade, helping to return the integrated economic area to a leading role. This phenomenon consolidated the tendency from 2003 on, when a slow resurgence in regional trade began to be seen after the return phase (1999-2002).

FIGURE 14
MERCOSUR'S SHARE IN THE BLOC'S TOTAL EXPORTS
Intra-MERCOSUR exports, Total exports (%)



Note: * January-June 2005.

Source: In-house, based on data from INDEC, SECEX, INE, Central Bank of Uruguay and Central Bank of Paraguay.

As of 2002, led by the depreciation and strong economic growth of Argentina first, and then of other partners, the common market has gradually been recovering both its attractiveness as a destination, and its maximum values –though these are still well short of 1997-1998. In 2004 intra-MERCOSUR trade amounted to US$ 17 billion, or 13% of the bloc's total exports.[6] It must be stressed that this phenomenon is particularly important for Brazil, the member for whom MERCOSUR had lost most relative importance in the previous stage (1999-2002).

In both 2004 and the first half of 2005, the trade balance with the rest of the world was broadly speaking in surplus as a consequence of the aforementioned sharp rise in exports that offset the vigorous recovery of imports. Several years on from the traumatic experiences of devaluation, with a stable, competitive real exchange rate, the Member States were able to take full advantage of the world economic and trade boom, expanding exports to unprecedented levels for the subregion. Faced with the widespread parallel growth of its members (the highest for ten years), MERCOSUR imports recovered much of the ground lost after 1997.

[6] After the sharp rise in the common market's total exports (driven largely by rising Brazilian exports), it is hard to imagine, in the short term at least, that MERCOSUR will again represent 25% of its four partners' total exports. For this to happen, total intra-MERCOSUR imports would have to exceed the US$ 33 billion mark, almost twice that of 2004 (US$ 17 billion). This would mean Brazilian products virtually 'flooding' the other three partners' internal markets, or conversely, a drastic redirecting of Argentinian, Uruguayan and Paraguayan exports toward Brazil, either scenario being highly unlikely.

TABLE 4
TRENDS IN MERCOSUR'S EXTRA-MERCOSUR TRADE BALANCE BY ECONOMIC REGION

Billions of US$

	Annual Totals			January-June		
	2003	2004	% Variation	2004	2005 (2)	% Variation
NAFTA	25.256	31.334	24	13.535	16.594	23
EU	24.593	30.024	22	14.270	15.803	11
China, Japan, Korea	11.561	13.303	15	6.724	7.336	9
Chile	5.410	6.460	19	2.965	3.544	20
Rest of South America (1)	*3.800*	*6.000*	*58*	*2.583*	*3.684*	*43*
Rest	*22.752*	*30.998*	*36*	*14.258*	*18.292*	*28*
Total	93.372	118.119	27	54.335	65.253	20

	Annual Totals			January-June		
	2003	2004	% Variation	2004	2005 (2)	% Variation
NAFTA	13.864	17.852	29	8.306	9.603	16
EU	16.365	20.757	27	9.563	11.538	21
China, Japan, Korea	3.908	5.462	40	1.440	4.124	186
Chile	1.213	1.517	25	386	1.094	183
Rest of South America (1)	*1.491*	*2.187*	*47*	*907*	*1.227*	*35*
Rest	*18.456*	*28.660*	*55*	*13.721*	*14.684*	*7*
Total	55.297	76.435	38	34.323	42.270	23

	Annual Totals			January-June		
	2003	2004	Difference	2004	2005 (2)	Difference
NAFTA	11.392	13.482	2.090	5.229	6.991	1.762
EU	8.228	9.267	1.039	4.707	4.265	-442
China, Japan, Korea	7.653	7.841	188	5.284	3.212	-2.072
Chile	4.197	4.943	746	2.579	2.450	-129
Rest of South America (1)	*2.309*	*3.813*	*1.504*	*1.676*	*2.457*	*781*
Rest	*4.296*	*2.338*	*-1.958*	*537*	*3.608*	*3.071*
Total	38.075	41.684	3.609	20.012	22.983	2.971

Notes: (1) Countries' contributions to the variation in total Imports and exports.
(2) Preliminary values.

Source: In-house, based on data from INDEC, SECEX, INE and Central Bank of Paraguay.

Analyzing the trade balance with the large blocs with whom trade is significant, it follows that over the last eighteen months the positive result was general. In spite of this, the surplus was highly concentrated in trade with the most economically developed regions, NAFTA and the United States being of prime importance.

As has been occurring both across the globe and in the subregion for several years now, the United States was again the largest net buyer from MERCOSUR, NAFTA being the bloc with which the biggest trade surplus was obtained. This segment was responsible for a third of the extra-MERCOSUR global balance in 2004 and the first half of 2005 (US$ 13.482 and US$ 6.991 billion, respectively), accounting for close on 60% of the expansion of the aggregate balance in both periods.

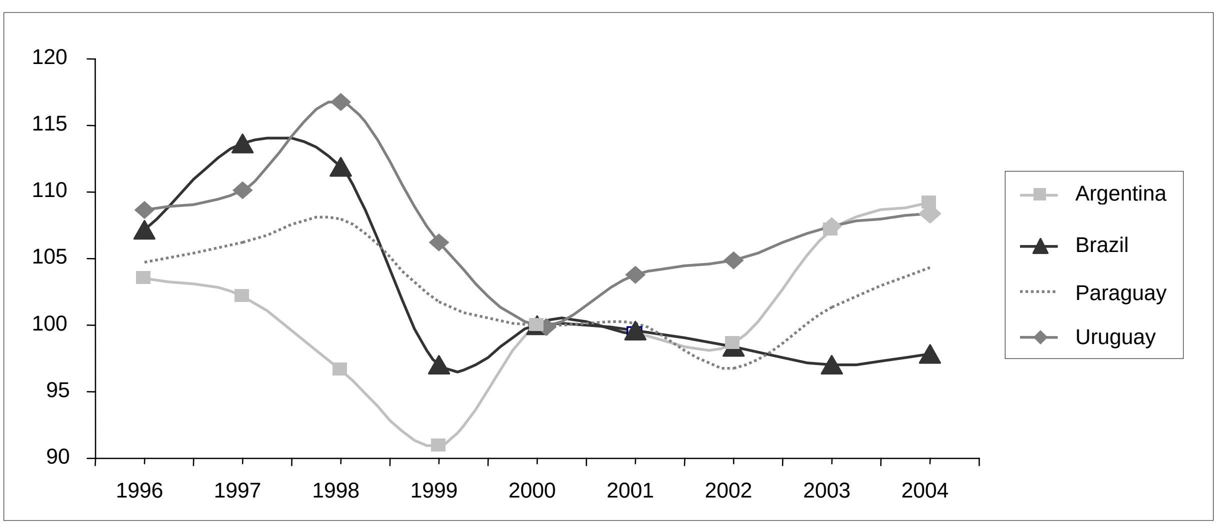
Next in importance was the EU, with 22% of the extra-MERCOSUR surplus. Unlike the NAFTA, however, the positive balance with this bloc, though expanding between 2004 and 2003 (from around US$ 8.2 to US$ 9.2 billion), was down on last year in the first half of 2005 (from around US$ 4.7 to US$ 4.3 billion). This occurred as a consequence of the recent marked slowing of growth in exports to the EU, while imports from the EU continued to rise to high rates.

This dissimilar development of trade balances with the most developed regions during the current year (expanding in one case and contracting slightly in the other), was due both to the performance of destination markets (the result of the US economy's greater dynamism –and of NAFTA as a whole– in terms of the European economy), and to the features of MERCOSUR's external supply and demand itself.

Another group with which a high trade surplus was recorded was the common market's neighboring nations. Trade with Chile and the rest of South America in 2004 gave a positive overall balance to the order of US $8.76 billion, contributing US$ 2.25 billion of the US$ 3.609 billion by which the general surplus grew in 2004. This makes it the bloc contributing most to the expansion of the total balance, with a figure similar to that contributed by NAFTA, and twice that of the EU. In addition, trade with the South American region in the first half of 2005 was again significant, the balance in the case of Chile (a State associated to the common market) remaining relatively stable, while the surplus with the rest of South America continued to expand.

Lastly, the result of trade with the major Eastern economies such as China, Japan and Korea rose to almost US$ 7.842 billion in 2004 and US$ 3.212 billion in the first half 2005. This was the only bloc with which the balance of 2004 effectively remained stagnant at 2003 values, while falling markedly in the first half of 2005 to nearly half the value of the previous year. This phenomenon was due to the significant increase in eastern (mainly Chinese) exports to MERCOSUR, which in 2005 were practically triple 2004 levels.

FIGURE 15
TERMS OF TRADE IN GOODS (FOB/FOB)
Basic indices 2000=100



Source: In-house, based on data from ECLAC.

It must also be stressed that MERCOSUR's surplus trade balance occurred in a context of general improvement in the terms of trade of the countries in the bloc. This tended to boost the positive effect of the increase in quantities sold to the rest of the world over the last eighteen months, occurring as a consequence of the rises in international prices of many of the products making up the subregional export basket (that is, agriculture, oil commodities, and certain agricultural and industrial manufactures), driven both by the sustained rise in world demand for primary products (with China playing an important part), and by the emergence of certain restrictions on supply, especially where oil and fuel are concerned.

Trade Trends by Country

When analyzing events within the bloc, it is vital to stress Brazil's importance where the increase in both exports and total imports are concerned. Brazil is a key player in the increase in trade flows and the expansion of the subregion's general balance.

In terms of exports in 2004, MERCOSUR's leading partner was up 32% on 2003's record levels, almost doubling the amounts exported prior to devaluation of the real in 1999. Thus, Brazil was responsible for 80% of the rise in regional exports,[7] followed by Argentina, accounting for 16% of the overall increase with 16% growth. At the same time, Uruguayan and Paraguayan exports increased 33% and 31% respectively, advancing at a similar rate to Brazilian exports. In spite of this, due to their size, both partners together contributed four percentage points to the overall improvement.

In terms of imports, Brazil was responsible for around 60% of last year's total recovery with a 31% rise, while Argentina contributed a third of the increase with a 62% rise (well above the regional average). Uruguay and Paraguay also followed this upward trend with rises of 42% each.

The landscape in the first half of 2005 was similar to 2004, the only exception being Paraguay, whose exports were virtually unchanged from last year (contracting slightly by 2%).

Although the four partners increased their exports and imports over the last eighteen months, they each displayed particularities where their respective trade balances were concerned. Three different scenarios can be identified: on the one hand, there was Brazil, whose exports grew sufficiently to offset the marked rise in imports, bringing about the constant expansion of its record trade surplus; on the other hand, there was Argentina, which showed considerable dynamism in exports, but whose imports once again reached extremely high rates, producing a reduction in the trade gap in Argentina's favor. Lastly, there were Uruguay and Paraguay, the only two cases where imports not only grew faster than exports, but were also slightly higher than them, leading to an increase in the trade deficit. It can be seen then that Brazil was singlehandedly responsible for the increase in the bloc's total surplus in the period analyzed, accounting for 70% of the increase. in the quantities traded

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[7] Although historically Brazil has determined the destination of MERCOSUR's total commerce (essentially because of the size of its economy relative to the other partners), the fact must not be overlooked that the recent exceptional dynamism of its exports (both within the common market, and without) have led the country to extend its leading role still further. In terms of extra-MERCOSUR exports, Brazil has progressively increased its share in recent years from 70% of the total before devaluation of the real in 1999 to 74% in 2004. Where intra-MERCOSUR exports are concerned, while until 2002 Argentina had been responsible for most of these, followed by Brazil, the situation was reversed in 2003 and 2004, with Brazil being responsible for more than half the sales within the block. In addition to Argentina's loss of market share, Brazil's progress in intra-MERCOSUR exports has also been at the expense of Uruguay, while Paraguay slightly increased its share as a result of favorable trends in its exports to MERCOSUR.

TABLE 5
TRENDS IN THE 2004-2005 TRADE BALANCE FOR EACH PARTNER
Billions of US$

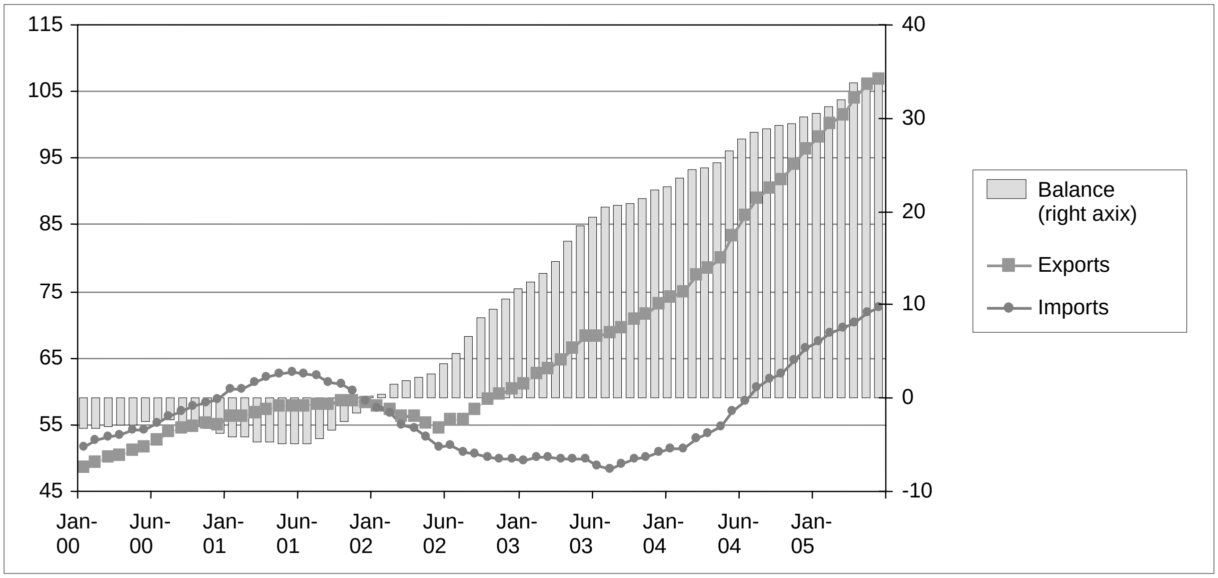
	Exports							
	Annual Totals				January-June			
	2003	2004	% Variation	Contribution	2004	2005	% Variation	Contribution
Argentina	29.484	34.290	16	16%	16.699	18.802	13	17%
Brazil	73.084	96.475	32	80%	43.306	53.677	24	82%
Paraguay	1.242	1.626	31	1%	886	867	-2	0%
Uruguay	2.198	2.922	33	2%	1.335	1.605	20	2%
Total	*106.008*	*135.313*	*28*	*100%*	*62.226*	*74.951*	*20*	*100%*
	Imports							
	Annual Totals				**January-June**			
	2003	**2004**	**% Variation**	**Contribution**	**2004**	**2005**	**% Variation**	**Contribution**
Argentina	13.813	22.320	62	33%	10.080	13.533	34	34%
Brazil	50.824	66.414	31	60%	29.864	35.971	20	61%
Paraguay	1.865	2.652	42	3%	1.172	1.243	6	1%
Uruguay	2.190	3.114	42	4%	1.398	1.817	30	4%
Total	*68.692*	*94.500*	*38*	*100%*	*42.514*	*52.564*	*24*	*100%*
	Balance							
	Annual Totals				**January-June**			
	2003	**2004**	**Difference**		**2004**	**2005**	**Difference**	
Argentina	15.671	11.970	-3.701.0		6.619	5.269	-1.350.0	
Brazil	22.260	30.061	7.801.0		13.442	17.706	4.264.0	
Paraguay	-623	-1.026	-403.0		-286	-376	-90.0	
Uruguay	8	-192	-200.0		-63	-212	-149.0	
Total	*37.316*	*40.813*	*3.497*		*19.712*	*22.387*	*2.675*	

BRAZIL

Brazil registered a significant increase in its trade surplus, from US$ 22.26 billion in 2003 to slightly over US$ 30 billion in 2004. In the first six months of 2005 the trade balance accumulated a surplus of close on US$ 17.7 billion, greatly exceeding the same period last year (US$ 13.442 billion).

As mentioned earlier, the most significant portion of this trade came basically from exports, whose performance in recent years is extremely telling in several ways. Between 1994 and 1998, Brazilian exports fluctuated between US$ 45 and US$ 50 billion annually, later (after the devaluation of January 1999) settling between US$ 55 and US$ 60 billion (2000-2002). After that, there was a steep sustained rise in exports (28% in 2003, 32% in 2004, and 24% in the first half of the current year), with placements of over US$ 100 billion being anticipated for 2005.

FIGURE 16
BRAZIL TRADE BALANCE
Data accumulated over 12 months, Billions of US$



Source: In-house, based on data from SECEX.

Brazil’s increased exports (and trade surplus) over the last eighteen months managed to coexist with a constant appreciation in the rate of exchange, particularly pronounced at the end of 2004 and in the first half of 2005. Thus, in June of this year the nominal exchange rate with the dollar stood at its lowest level since early 2002 (prior to the elections in which the Workers Party, or PT, came to power), while the real exchange rate (adjusted both for retail prices as wholesalers) slipped back to values similar to 1999.

Another item to bear in mind is that, in 2004 and 2005, Brazil’s exports continued to make very good progress, in spite of the solid recovery of its internal market. This differs appreciably from 2003 when, faced with shrinking domestic demand, production not sold locally had to seek an outlet abroad.

At the level of the main items, the turnaround in the exports of manufactured products played a key role, up 34% (accounting for around 60% of the total rise in exports over the period). Leading this segment were the placements of transport material (with a 50% rise, driven partly by the recovery of automobile sales to Argentina), metallurgical products, oils, meat, chemicals, machinery and equipment, and footwear, to name just the main increases of the major products in the export basket.

In order of importance, the variation in manufactures was also accompanied by a marked improvement of exports of basic products, up 35%, (despite this rise being slightly higher than the former group, the segment was responsible for just a third of the growth of Brazilian exports, as its share in the total exported, 30%, is somewhat lower than for industrial products, up 55%). Among the highest exports were soya, oil, minerals and wood.

Imports recovered 30% in 2004, driven mainly by the purchase of raw materials (30% up) as a result of the exceptional growth in domestic production. Also significant were the contributions of fuel and capital goods imports (up 57% and 17% respectively), the variation in fuels being strongly influenced by the price rise in international markets. Last came external purchases of consumer products (24%).

In terms of the overall outlook for 2005, manufactures head the rise in Brazilian exports, while imports continue making progress, led by growing purchases of raw materials, fuels and capital goods.

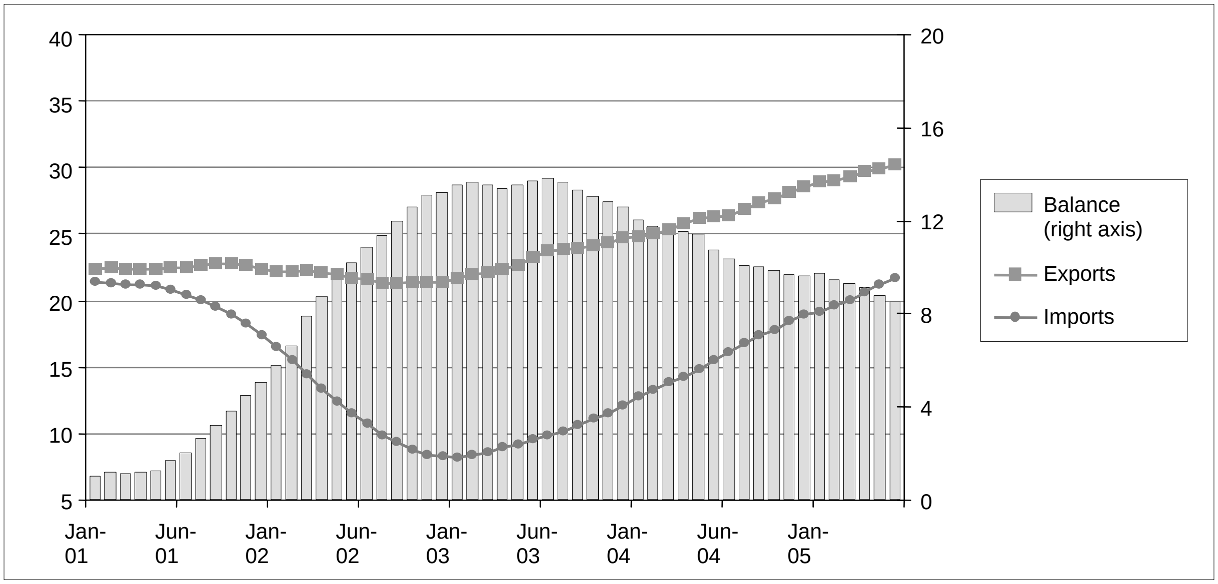
ARGENTINA

Argentinian exports set a new record in 2004, at US$ 34.29 billion, a figure 16% up on the previous year, and 29% up on 2001, the previous maximum in the era of '1-to-1'. Correspondingly, external purchases stood at US$ 22.32 billion, 62% up on 2003, and virtually three times 2002 levels, when Argentina devalued its currency and reached the nadir of the cycle of recession beginning in 1998 (the year when imports totaled US$ 31.4 billion). As imports grew faster than exports, a partial correction was seen in the ample trade surplus that Argentina has been registering for more than four years now. The Argentinian trade balance last year was in surplus of close to US$ 12 billion, down on the two previous years (US$ 16.414 billion in 2002 and US$ 15.671 billion in 2003).

Exports in 2004 were driven by the higher volume of Industrial Manufacturing (IM) placed abroad, and in particular, by the international prices current in the first quarter. Performing especially well were soya and soya based products, which reached extremely high levels between January and April, only to slip back in the second half of the year. The increase in IM exports was driven largely by greater demand in the various different Latin American markets, including common market members. Motor vehicles, chemicals, plastics, electrical material, and paper and cardboard played a prominent part in the increase in industrial shipments.

In terms of imports, the rise was heavily influenced by rising purchases in capital goods and automobiles. Nevertheless, the rise was general, and a significant increase in fuel imports was also detected (alleviating energy problems), as well as in consumer goods, especially durable ones. Regarding the origin of imports, increases were seen from virtually all supplying countries in 2004, particularly from Brazil. This led the positive global balance to coexist with a record intra-MERCOSUR deficit.[8]

FIGURE 17
ARGENTINA'S TRADE BALANCE
Data accumulated over 12 months, Billions of US$



Source: In-house, based on data from INDEC.

8 See the section on 'Trade Relations between Argentina & Brazil' in this Chapter.

By the first half of 2005, the figures for Argentinian foreign trade once again reflected very high levels. Exports totaled US$ 18.8 billion, 13% up on the first half of the previous year, while imports (US$ 13.53 billion) also showed a considerable increase (34%), bringing about a new reduction in the trade surplus, from US$ 6.62 billion between January and June 2004 to US$ 5.27 billion for the same period in 2005.

All the major items contributed to the progress in exports in the first half of the year, albeit with varying degrees of intensity. In dollars, IM and primary products underwent increases of 31% and 15% respectively, with IM rising both in price and quantity. Primary products were driven strongly by quantities (37%) thanks to the record value of agricultural crops. Fuel was up 13% due to the large increases in world market rates, though with falling volumes. Lastly, the Free on Board (FOB) value of Agricultural Manufacturing (AM) expanded just 1% due to the decline in the price of oil-based products in the early part of the year.

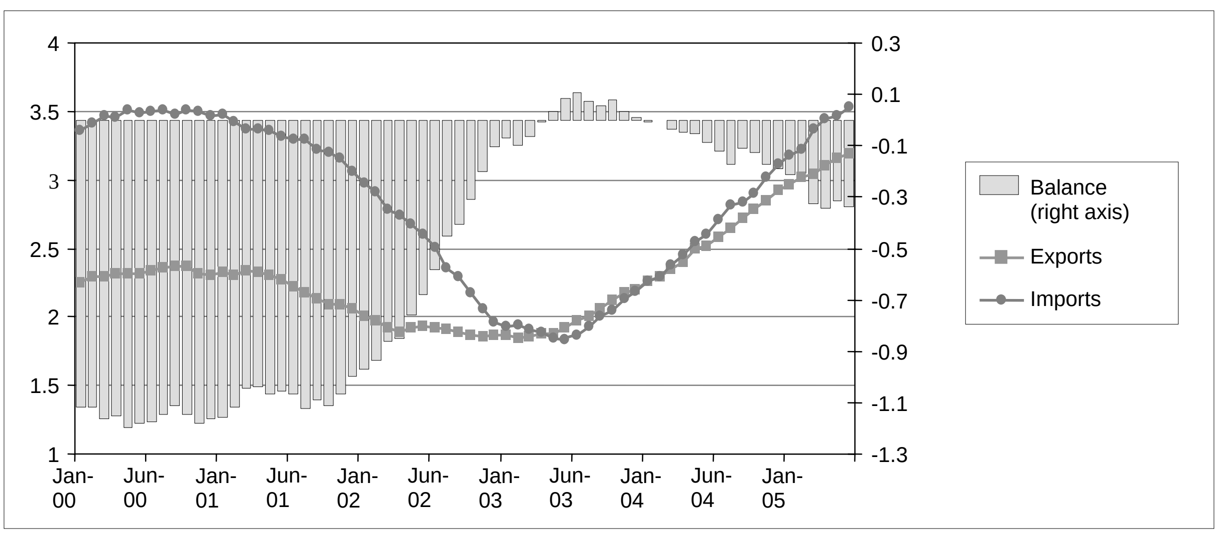
At the same time, the dynamism of imports in the first half of 2005 was to a large extent bound up with greater demand for investment goods, with a 42% rise. Intermediate inputs also saw a significant increase, in a context of sustained rises in internal manufacturing.

URUGUAY

During 2004 exports of goods totaled US$ 2.922 billion, substantially up on the previous year (33%). The rise in exports was driven by the rise in external demand, in export prices, and in the supply of agricultural goods, in the context of a competitive and stable exchange rate.

At the products level, the rise in meat exports was paramount. Standing at 58% in 2004, these exceeded the US$ 0.7 billion mark, a quarter of Uruguay's total exported goods. Exports of leather, agricultural and dairy products also performed well. In terms of destinations, the United States was the most dynamic, and the main buyer, with a 20% share in the total exported (particularly important for meat products, where it accounts for 60% of Uruguay's exports). Likewise, sales to Brazil and Argentina, respectively Uruguay's second and third most important customers, also showed considerable rises.

FIGURE 18
URUGUAY'S TRADE BALANCE
Data accumulated over 12 months, Billions of US$



Source: In-house, based on data from INE and Central Bank of Uruguay.

At the same time, imports of goods in 2004 (US$ 3.114 billion) experienced outstanding growth (42%), in the context of solid internal reactivation and a marked increase in the international prices of several imported products, in particular, oil. The items to rise most were capital and consumer goods, and oil and energy.

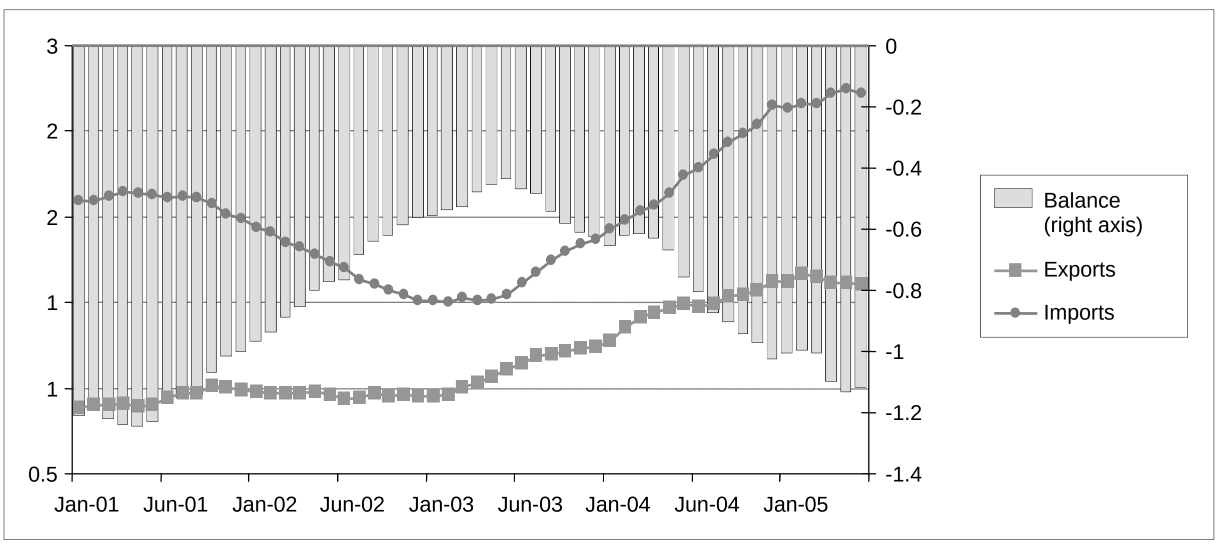
Comparing the quantities of exports and imports, it can be seen that Uruguay in 2004 registered a slight deficit of US$ 0.192 billion, very moderate when compared to the one prior to the crisis of 2001 and 2002. In the first six months of the current year this gap tended to widen, from US$ 0.64 billion between January and June 2004 to US$ 0.213 billion in the same period of 2005.

PARAGUAY

Paraguay's exports came to close on US$ 1.6 billion, an increase of 31%, putting them at record levels. In a highly favorable external context, Paraguayan exports were very dynamic both internally in MERCOSUR (18% up) and externally (50% up). The area most responsible for this progress in exports was AM, with exports of soya-based products (including seeds, flour and oils), meat products, and cotton fiber being of particular importance.

In spite of the outstanding performance of exports, imports also grew markedly, generating an expansion of the (now structural) trade deficit presented by the Paraguayan economy. More specifically, external purchases in 2004 increased 42%, totaling US$ 2.652 billion. This gave a negative result for the trade balance to the order of US$ 1 billion, up on the previous year. The rise in imports was driven mainly by purchases of oil and oil-based products (which, apart from the greater demand, were heavily influenced by international prices rises), and also by the increased acquisition of capital goods.

FIGURE 19
PARAGUAY'S TRADE BALANCE
Data accumulated over 12 months, Billions of US$



Source: In-house, based on data from Central Bank of Paraguay.

Regarding developments in the first half of 2005, the situation closely resembles 2004, with a further rise in imports (6% interannually) accompanied by an expansion of the trade deficit (from US$ 0.286 billion in the January-June 2004 accumulation, to US$ 0.376 million in same period in 2005). The main difference with 2004 lies in the fact that exports remained stagnant (actually shrinking 2% in the first half of 2005) due to a decline in extra-MERCOSUR sales (down 6%).

Trade Relations between Argentina & Brazil

Over the last 18 months, one of the most outstanding developments in terms of foreign trade for MERCOSUR was the trends in trade in goods between Argentina and Brazil, who between them account for more than 90% of intra-MERCOSUR trade. In a context of hale economic recovery and exchange rates aligned to both sides of the border, both countries considerably increased the total flows sold to each other. Brazil in turn considerably enlarged its trade surplus with Argentina, giving rise to a situation that has been unimaginable since the early 1990s, considering that, between 1995 and 2002, the result of bilateral trade strongly favored the smaller of the two partners.

FIGURE 20
TRADE BETWEEN ARGENTINA & BRAZIL
Billions of US$

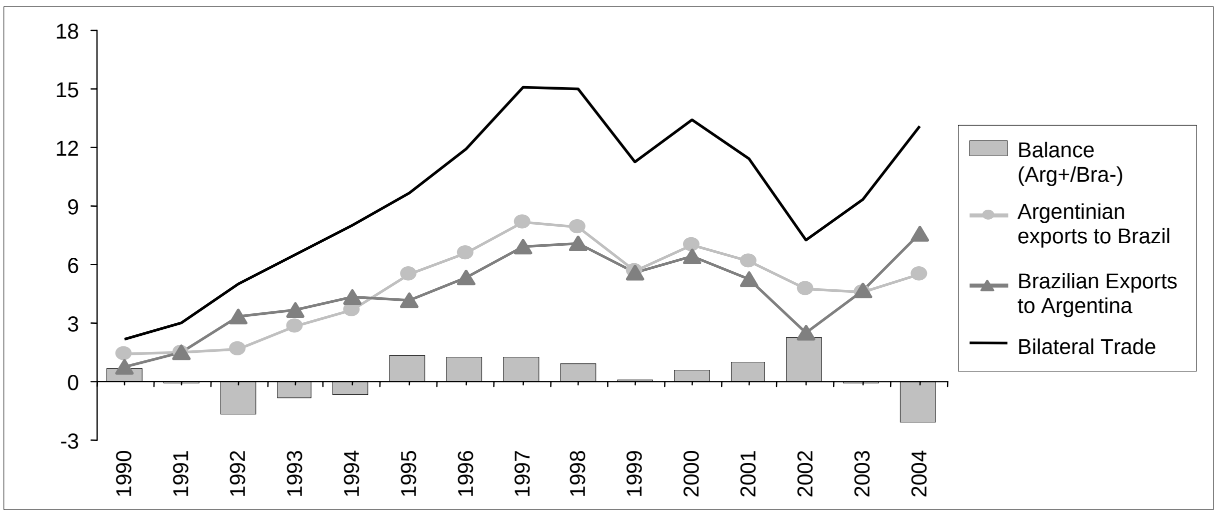


TABLE 6
TRADE BETWEEN ARGENTINA & BRAZIL
Billions of US$

	Annual Totals			January-June		
	2003	**2004**	**% Variation**	**2004**	**2005** (1)	**% Variation**
Total Argentinian Exports	29.480	34.289	16%	16.699	18.802	13%
To Brazil	4.608	5.479	19%	2.564	2.875	12%
To the Rest of the World	24.872	28.810	16%	14.135	15.927	13%
Total Brazilian Exports	73.084	96.475	32%	43.306	53.677	24%
To Argentina	4.701	7.568	61%	3.281	4.549	39%
To the Rest of the World	68.383	88.907	30%	40.025	49.128	23%
Bilateral Balance (Arg+/Bra-)	-93	-2.089	-1.996	-717	-1.674	-957
Bilateral Trade	9.309	13.047	40%	5.845	7.424	27%

Note: (1) Preliminary values.

Source: In-house, based on data from INDEC and SECEX.

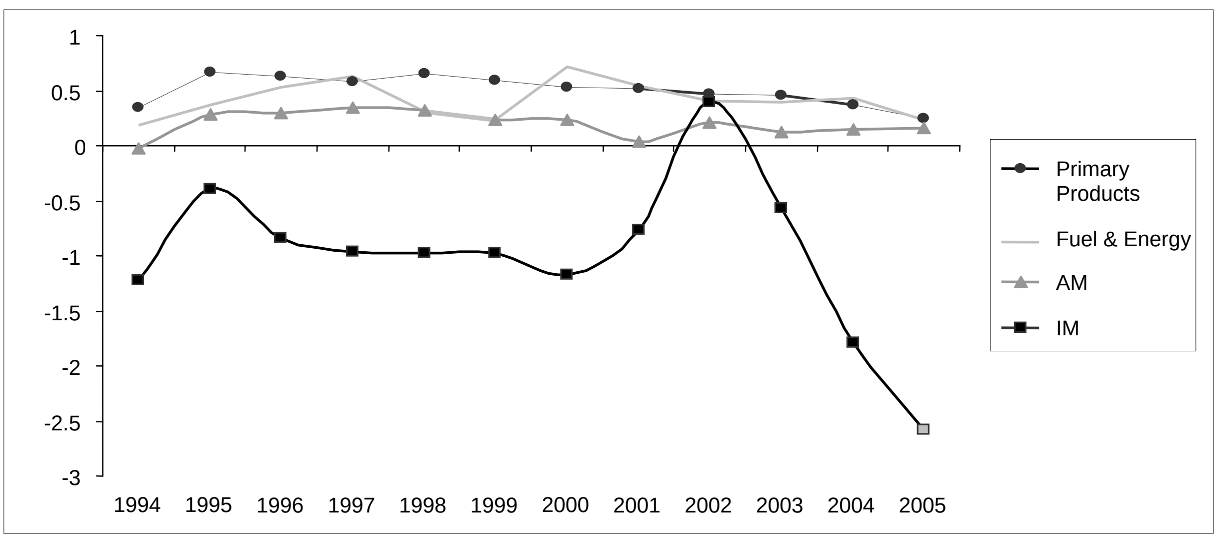
In 2004 the amounts traded between Argentina and Brazil (in dollars) increased 40% over 2003, and rose another 27% in the first half of 2005, compared with the same period in 2004. This made up much of the ground remaining before a return to 1997 values (a peak trade period), after the constant fall up to 2002. At the same time, this progress in trade between the two countries was greater than either's with the rest of the world, leading to the bilateral relationship regaining some of the prominence lost in recent years.

This phenomenon was mainly driven by the pronounced rise in Brazilian sales to Argentina, which grew by 61% and 39% respectively during 2004 and thus far in 2005, faster than total Brazilian exports. Brazilian placements in Argentina too reached record levels in 2005, a fact that takes on particular importance, considering Argentinian imports from other sources are still below the maximum reached in the 1990s. At the same time, exports from Argentina to Brazil also grew emphatically (19% in 2004, and 12% in the first half of 2005), although at rates well below Brazil's, and similar to total Argentinian exports, yet still below the levels applying before the devaluation of the real in 1999.

Due to the unequal performance in bilateral exports, a yawning trade deficit was detected for Argentina in 2004. This began to materialize in 2003, swinging from US$ 0.93 billion to US$ 2.089 billion. Its debit also grew in 2005, at US$ 1.674 billion in the first half, over double the period for 2004 (US$ 0.716 billion).

In terms of sectoral trends in trade from 2003 to the present, Argentina's record trade deficit with Brazil in industrial output rose significantly, while its surplus in other items tended to fall, approaching zero in the first half of 2005. Its general balance thus went from surplus to deficit, with a marked trend to grow.[9]

FIGURE 21
BALANCE OF TRADE BETWEEN ARGENTINA & BRAZIL BY MAIN AREA (ARG+/BRA-)
Accumulation of the first 6 months of each year. Billions of US$



Source: In-house, based on data from INDEC and SECEX.

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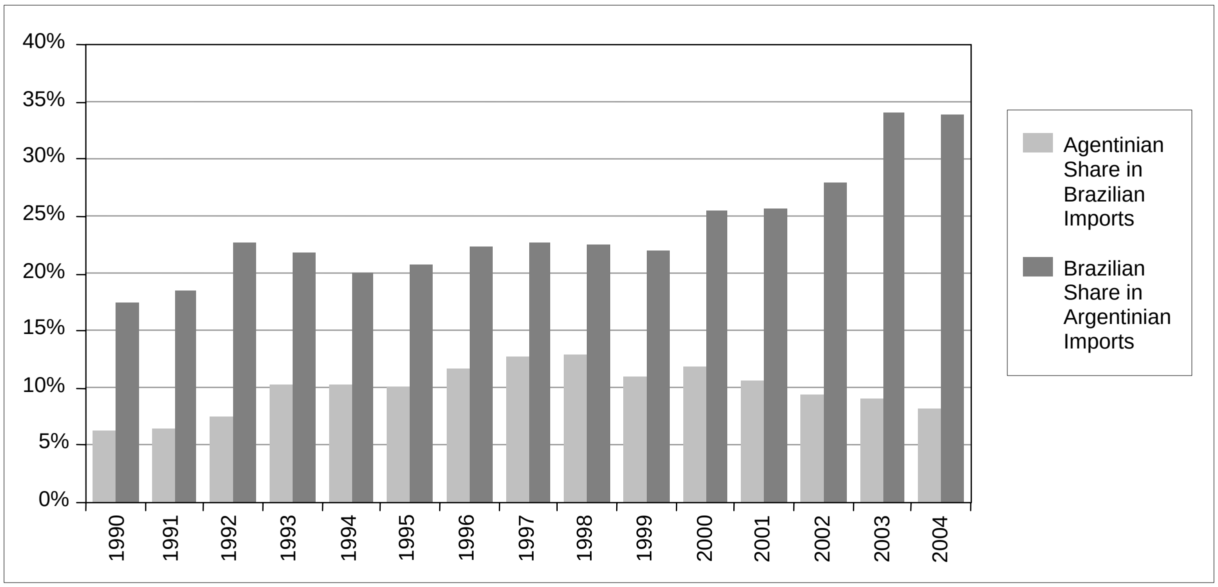
9 Argentina's surplus with Brazil between 1995 and 2002 was maintained on the basis of the trade balance for primary products, fuel, energy, and to a lesser extent, AM. On the other hand, in the case of the IM, the result was extremely favorable for Brazil throughout the period, the only exception being 2002, when Argentinian imports generally collapsed in the economic crisis.

This shift in the trade balance occurred in a context in which Brazil gained ground in Argentinian imports, while Argentina lost ground in Brazilian imports. After reaching a 13% maximum in 1998, Argentina's market share in Brazilian imports fell systematically to a low of 8% in 2004, with extra-MERCOSUR suppliers gaining ground. By contrast, the percentage of Argentina's imports covered by Brazilian products went from 22% in 1998 to 34% in 2004, entrenching the upward trend witnessed since the early 1990s, when in a general context of greater opening, the creation of MERCOSUR prompted partners' trade in goods to rise not just in absolute terms, but also in terms of trade with the rest of the world.

FIGURE 22
SHARE IN PARTNER IMPORTS
% of Total Imports



Source: In-house, based on data from INDEC and SECEX.

Argentinian products' loss of share in Brazilian markets seems to be linked, in part at least, to the development of a process of import substitution in Brazil after the devaluation of the real in 1999. Table 7 shows that total Brazilian imports increased just 7% between 1997/98 and 2004. Due to this the rise in a third of imported items in the reference period could offset the fall experienced by the other two thirds of total imports, made up precisely of products coinciding with much Argentinian export supply to its neighbor in the late 1990s. In other words, the weak performance of Brazilian imports in recent years was essentially focused on the goods most exported by Argentina to Brazil. The products for which Brazil most reduced its imports were motor vehicles and tractors, cotton, diary products, cereals (especially wheat), machinery and equipment, vegetables, oils and fruit.

Overall, total Brazilian imports of the falling items in 2004 came to US$ 6 billion less than in 1998, of which US$ 3.434 billion were purchases from Argentina that were stopped. This figure is one and a half times the result of last year's bilateral trade balance, and clearly shows the importance for MERCOSUR's productive configuration of the import substitution performed in recent years by its largest economy.

TABLE 7
BRAZILIAN IMPORTS (1997/1998-2004)
Billions of US$

	Total Imports				Imports from Argentina				Share in Argentinian Exports		
	1997-1998 Aver.	2004	1997-1998 Share	Absolute Variation	% Var.	Prom. 1997-1998	2004	Absolute Variation	% Var.	% Brazil	% by Heading
General Total	58.786	62.747	100%	3.961	7	8.033	5.572	-2.461	-31	100	30
Falling Items	38.732	32.733	66%	-5.999	-15	6.324	2.890	-3.434	-54	79	31
Rising Items	20.054	30.015	34%	9.961	50	1.709	2.682	973	57	21	28
Main Falling Items											
Cars, autoparts & tractors	5.515	3.154	9%	-2.361	-43	2.460	799	-1.660	-67	31	88
Cotton	737	193	1%	-544	-74	233	11	-222	-95	3	64
Milk & Dairy Products	492	96	1%	-396	-80	225	49	-176	-78	3	56
Cereals	1.410	1.044	2%	-366	-26	982	811	-171	-17	12	32
Machinery & Equipment	10.758	9.323	18%	-1.435	-13	452	284	-168	-37	6	54
Vegetables	397	180	1%	-217	-55	279	129	-150	-54	3	60
Fats & Oils	359	192	1%	-167	-47	141	42	-99	-70	2	6
Fish	401	241	1%	-159	-40	127	50	-77	-61	2	14
Fruit	321	152	1%	-169	-53	149	76	-73	-49	2	28
Other Falling Items	18.343	18.158	31%	-185	-1	1.276	639	-637	-50		

Source: In-house, based on data from INDEC and SECEX.

The growing parallel importance of Brazil as a supplier for Argentina occurred in a context in which total Argentinian imports –probably influenced by the steep fall of 2002– quickly recovered after the devaluation of the peso, with purchases from Brazil being particularly dynamic, and setting a new record. More specifically, while Argentina's total imports in 2004 were 62% up on 2003 (29% below their 1998 high), those from its main partner in MERCOSUR grew 61%, climbing to US$ 7.6 billion (7% above their previous high).

Apart from the issues surrounding higher Brazilian productive supply, and Brazil's aggressive sortie to compete in world markets (from which MERCOSUR was no exception), the new parity of the peso and the real after convertibility was dropped, mirroring that the parity of the dollar and the euro, led to a shift in the origin of Argentinian imports, with Brazil gaining in market share at the expense of the United States and Europe. Regardless of any differences in quality between Brazilian products and American or European ones, Argentina began buying more inputs, capital and consumer goods, and vehicles from Brazil, which at present are far cheaper than in the past, compared to the rest of the world.

TABLE 8
SHARE IN TOTAL ARGENTINIAN IMPORTS BY REGION & BILATERAL RER

%

	Share of Imports			Bilateral RER		
Region	**1998**	**2004**	**% Variation**	**1998**	**2004**	**% Variation**
Brazil	22	34	55	126.9	172.3	36
Rest of Latin America (1)	8	9	13	97.9	136.8	40
Asia (2)	8	9	13	96.7	139.7	44
United States	19	15	-21	90.7	143.4	58
EU	27	18	-33	112.7	188.8	68

Notes: (1) Including Bolivia, Chile, Mexico, Paraguay, Peru, Uruguay and Venezuela.

(2) Including China and Japan.

Source: In-house, based on data from INDEC, BCRA and national sources.

Another matter to be borne in mind is that, though during 2003 many intra-MERCOSUR trade analyses suggested the possible temporary nature of Argentina's slight deficit with Brazil at the time, as the months went by and the situation became more serious, the hypothesis that the change in the direction of trade is due to issues more 'structural' than incidental began to win over more and more supporters. To put it another way, although discussion of the issue is still not closed, there is a series of elements suggesting that the current result of bilateral trade will not be easily reversed, at least in the short term.

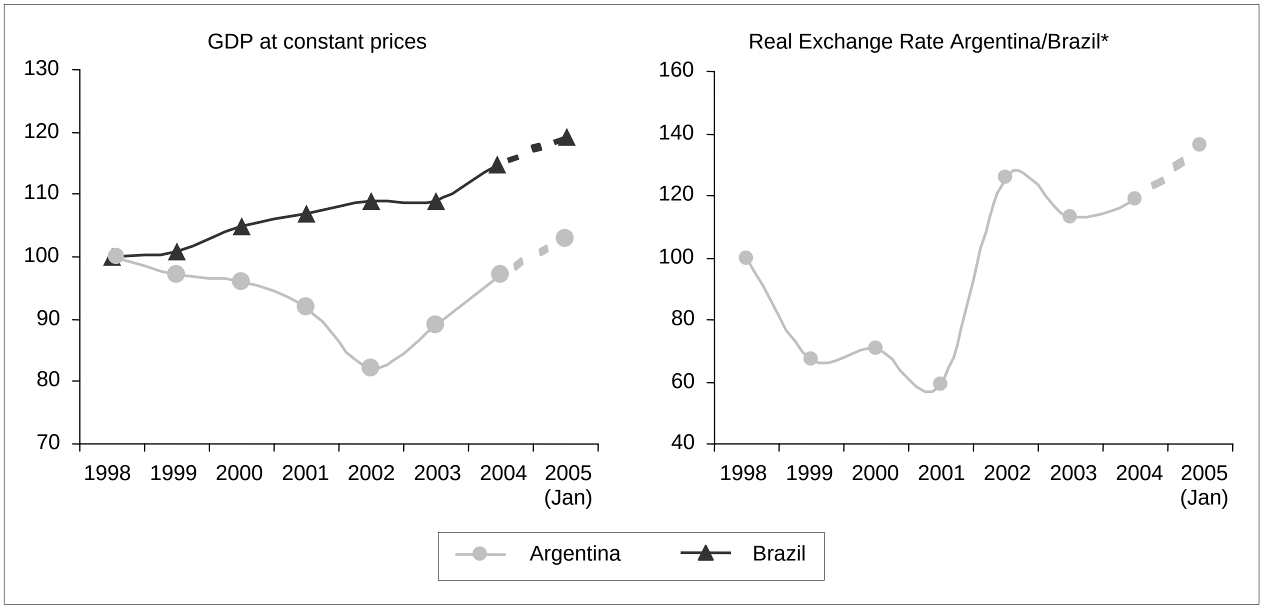
Over the last decade the greater imbalances in bilateral trade occurred in 'out-of-phase' economic cycles; in other words, when there were marked differences in both economies' rates of variation, either because one partner was growing (or shrinking) faster than the other, or because, while one was in recession, the other was reactivating (or at least remaining stable). This happened in 1992 to Brazil's advantage when, faced with the flop of the 'Collor Plan', the country placed part of its excess production in an Argentina expanding rapidly after the successful launch of the Convertibility Plan. It was the turn of the smaller partner to benefit during the 1995 Tequila Crisis, when Argentina increased its exports to Brazil, which at the time was in the throes of the initial stages of the Real Plan, and was less affected by the adverse external factors beleaguering the region, while in 2002 the collapse of Argentinian imports led to a mega-surplus with both Brazil and the rest of the world.

Although both economies are clearly growing during 2004 and 2005, Argentina is doing so much faster than Brazil, which could a priori help to explain the former country's marked deficit with the latter. However, it should not be forgotten that Brazil's recent economic trajectory has been substantively better than Argentina's. Since 1998 (a record year for Argentinian exports to Brazil), Brazilian GDP has grown 15%, while Argentinian output, after severe shrinkage before 2002, currently stands at levels similar to the late 1990s. When comparing the trade balance then favorable to Argentina with the current mega-deficit, it becomes clear that the country's economic recovery can only be responsible for part of the sea change in the result of bilateral trade.

At the same time, both countries' exchange regimes aligned themselves after 2002, with a slight advantage for Argentina when the current bilateral real exchange rate is compared to 2001, or even to the rate prior to devaluation of the real in 1999. The issues associated with current macroeconomic conditions would thus in principle benefit Argentina more than Brazil when accounting for the trade relationship between both partners. And all the indicators point to the fact that there could be other, deeper factors behind the shift seen in the last two years.

Lastly, in the case of Argentina, the coexistence of a record global trade surplus and a high and persistent deficit with Brazil led to a proliferation of trade disputes within the common market, with both governments resorting mainly to stopgap solutions. Similarly, a few major trade initiatives recently emerged, albeit without any clear progress in this direction to date.[10]

FIGURE 23
ARGENTINA & BRAZIL: ECONOMIC OUTPUT & EXCHANGE RATE
Basic indices 1998=100



Note: * Real exchange rate deflected by CPI.

Source: In-house, based on data from INDEC, BCRA and IBGE.

D. Trends in FDI in MERCOSUR

Low international interest rates, together with improvements in macroeconomic foundations in different parts of the globe, brought about an increase in financial flows toward emergent markets over the last eighteen months, in particular, the recovery shown by FDI.

After falling for four year running, Latin America and the Caribbean saw FDI rise during 2004, and MERCOSUR countries were no exception. Indeed, FDI inflows to the bloc totaled US$ 22.8 billion, 83% up on 2003, above the average for developing countries. This increase brought about the recovery of foreign investment, with levels similar to 2001, prior to the collapse of 2002 and 2003, though without a return to the values seen in the late 1990s, when the last major privatizations were implemented in the subregion's main economies.

As in the past, during 2004 Brazil and Argentina secured almost all FDI-mode capital inflows in MERCOSUR. These countries respectively monopolized 78% and 18% of last year's total investment flows, close on 3% of their GDPs, higher than Uruguay (2.3%) and Paraguay (1.5%).

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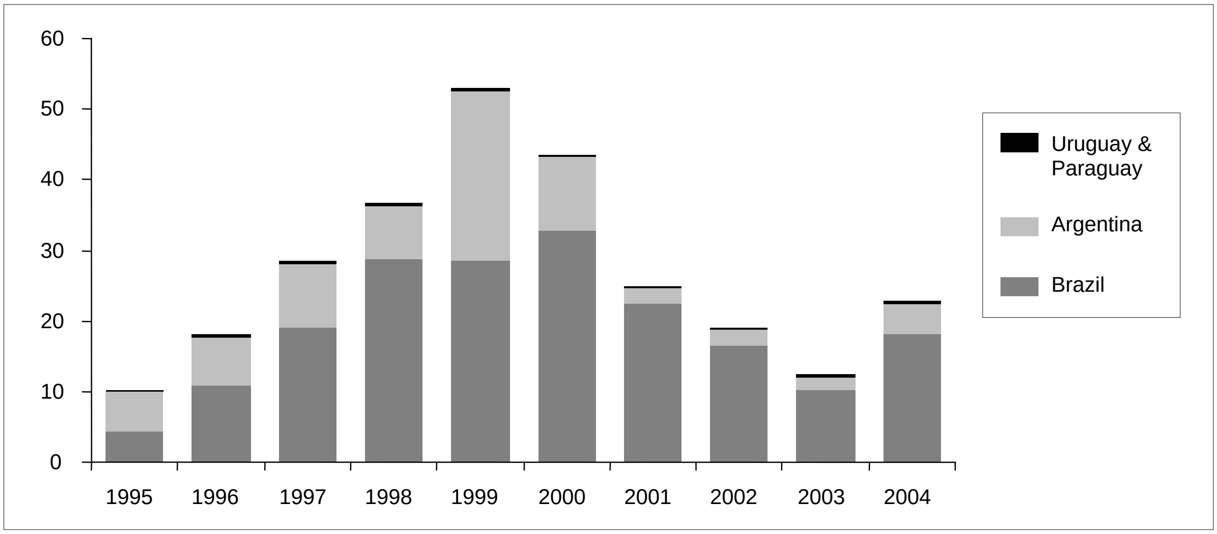
[10] See Chapter 2 and 3 of this Report.

FIGURE 24
INFLOWS BY FDI

Billions of US$



Source: In-house, based on data from ECLAC.

US$ 18.166 billion in FDI came into Brazil in 2004, around 80% up on the previous year. It is also important to underline that last year produced an exceptionally high outflow of direct investment from Brazil abroad, totaling US$ 9.5 billion. This brought net FDI flows to US$ 8.7 billion, down on 1995. This quantum leap in Brazilian FDI to abroad is linked to the process of out-of-borders expansion undertaken by some of the country's leading companies. Several developing economies were targeted by such investments, the FDI flows from Brazil to Argentina associated with mergers and acquisitions by large food and drink, iron and steel, textile and non-metallic mineral companies, being an interesting case in point.

For its part, after two years of strong growth and economic normalization, Argentina experienced a significant increase in FDI inflows in 2004, up to the US$ 4.25 billion mark, over twice the US$ 2 billion average of 2002 and 2003. Although the country is still a long way off pre-crisis values, recent progress bodes extremely well, enabling Argentina to recover a share of total regional FDI. This upward trend is expected to be consolidated over the current year.

Lastly, before the consolidation of macroeconomic stability, Uruguay secured investments of US$ 0.3 billion, which, despite being slightly below 2003, is the second highest value in the last decade. Paraguay too received flows of close to the US$ 0.1 billion mark, the highest in four years.

TABLE 9

		Argentina					Brazil					Paraguay					Uruguay				
		2000	2001	2002	2003	2004	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Activity Level																					
Total GDP	(Billions of US$)	284.2	268.7	101.1	127.5	152.2	602.2	509.8	559.4	506.8	604.0	7.7	6.8	5.6	5.6	6.3	20.1	18.6	12.3	11.3	13.2
Total GDP	(% annual variation)	-0.8	-4.4	-10.9	8.8	9.0	4.4	1.3	1.9	0.5	4.9	-0.4	2.7	-2.3	2.6	2.9	-1.4	-3.4	-11.0	2.2	12.3
National Production	(% annual variation)	-3.8	-7.4	-11.0	16.0	12.0	6.7	1.8	2.8	0.1	8.3	1.0	1.3	-3.2	-1.0	2.0	-2.1	-7.6	-13.9	4.7	21.6
Fixed Gross Domestic Investment	(% current GDP)	16.2	14.2	12.0	15.1	19.2	19.3	20.5	19.6	19.3	18.8	17.5	16.1	15.1	15.6	15.6	13.2	12.4	9.8	8.6	10.0
Unemployment Rate	(%)	15.1	17.4	19.7	17.3	13.6	7.1	6.2	11.7	12.3	11.5	10.0	10.8	14.7	11.2	10.0	13.6	15.3	17.0	16.9	13.1
Prices & Exchange Rate																					
CPI	(% Dec.-Dec. Variation)	-0.7	-1.5	41.0	3.7	6.1	6.7	8.0	12.1	9.1	9.4	8.6	8.4	14.6	9.3	2.8	5.1	3.6	25.9	10.2	76
WPI	(% Dec.-Dec. Variation)	2.4	-5.3	118.0	2.0	7.9	12.1	11.9	35.4	6.3	14.7	10.4	8.6	36.8	9.3	4.7	9.5	3.8	64.6	20.5	5.1
Nominal Trade Rate	(% Dec.-Dec. Variation)	--	--	249.0	-15.2	0.3	6.5	20.3	53.5	-19.3	-7.1	6.9	31.3	49.4	-14.5	2.5	7.4	13.0	93.1	7.4	-9.1
Real Trade Rate	1997=100	83	78	188	167	170	141	167	177	176	174	107	110	114	120	115	92	93	108	139	140
Terms of Trade	1997=100	98	97	97	106	107	88	88	87	85	86	94	94	91	95	98	91	94	95	97	98
Public Sector																					
Total Public Sector Result	(% of GDP)	-2.4	-3.2	-1.5	0.5	2.6	-3.6	-3.6	-4.7	-5.2	-2.7	-4.6	-1.2	-3.2	-0.4	1.6	-3.5	-4.5	-4.9	-4.6	2.0
Primary Public Sector Result	(% of GDP)	1.0	0.5	0.7	2.3	3.9	3.5	3.7	4.0	4.4	4.6	n.d.	n.d.	n.d.	0.7	2.7	-1.3	-1.2	0.3	2.9	3.9
External Sector																					
Exports	(% Annual Variation)	12.9	1.0	-4.5	16.0	16.3	14.7	5.7	3.7	21.1	32.0	17.4	13.9	-4.0	30.6	30.9	2.8	-10.5	-9.8	19.4	32.9
Imports	(% Annual Variation)	-0.9	-19.6	-55.7	53.6	61.6	13.5	-0.4	-15.0	2.0	30.7	18.9	-3.0	-24.1	23.5	42.2	3.3	-11.7	-35.8	11.5	42.2
Exports	(Billions of US$)	26.3	26.6	25.4	29.5	34.3	55.1	58.2	60.4	73.1	96.5	0.9	1.0	1.0	1.2	1.6	2.3	2.0	1.8	2.2	2.9
Imports	(Billions of US$)	25.3	20.3	9.0	13.8	22.3	58.8	58.6	49.8	50.8	66.4	2.1	2.0	1.5	1.9	2.7	3.5	3.1	2.0	2.2	3.1
Trade Balance	(Billions of US$)	1.1	6.3	16.4	15.7	12.0	-3.7	-0.4	10.5	22.3	30.1	-1.2	-1.0	-0.6	-0.6	-1.0	-1.2	-1.0	-0.1	0.0	-0.2
Current Account	(Billions of US$)	-9.0	-3.3	8.7	7.7	3.3	-24.2	-23.2	-7.6	4.2	11.6	-0.2	-0.3	0.1	0.1	0.0	-0.6	-0.5	0.4	-0.1	-0.1
Current Account	(% GDP)	-3.2	-1.2	8.6	6.0	2.2	-4.0	-4.5	-1.7	0.8	1.9	-2.1	-3.9	1.5	2.4	0.3	-2.8	-2.7	3.1	-0.5	-0.8
Gross FDI	(Billions of US$)	10.4	2.2	2.1	1.9	4.3	32.8	22.5	16.6	10.1	18.2	0.1	0.1	0.0	0.0	0.1	0.3	0.3	0.2	0.4	0.3
Total Gross External Debt	(Billions of US$; end per.)	155.0	166.3	156.7	164.9	170.8	236.2	226.1	227.7	235.4	220.2	2.2	2.2	2.3	2.5	2.4	8.9	8.9	10.5	11.0	11.6
Reserves	(Billions of US$; end per.)	26.9	14.9	10.5	14.1	19.6	33.0	35.9	37.8	49.3	52.9	0.8	0.7	0.6	1.0	1.2	2.6	3.0	0.8	2.1	2.5

Contents

CHAPTER 2. THE ASYMMETRIES DEBATE

The second half of 2004 and the first half of 2005 can be described as one of convergence in the macroeconomic performance of MERCOSUR countries. Among other things, as described in Chapter 1, the bloc experienced significant economic and trade dynamism, common patterns of fiscal and monetary solvency, similar exchange regimes, higher parities than the previous decade, and positive current account balances. Given higher growth, the political authorities expressed their will to speed up integration.[11]

Despite higher coincidence in the economic cycle at regional level, this stage was paradoxically marked by an increase in tensions between different public and private actors from the partner countries, especially in Argentina and Brazil. Indeed, during much of the period under analysis, regional negotiations were dominated by the reemergence of multiple sectoral conflicts, and of debate over the suitability of establishing some kind of escape clause in MERCOSUR to tackle any disruptive situations in intra-MERCOSUR trade. This negotiation has been present in regional debates in different forms and under different political colors among MERCOSUR Member States, particularly since 1999 (see INTAL [2003]). Similarly, concern over the distribution of investments in the larger space motivated the Argentinian government at this stage to seek negotiating alternatives designed to somehow regulate an investment flow –particularly for transnational companies– that could be distributed more in line with the composition of MERCOSUR's production.

This chapter provides information about the various different aspects of asymmetries between the bloc's members, issues which have had an impact on trade negotiations.

A. The Debate over Asymmetries & the Origins of Sectoral Conflicts

Since the beginning of the integration process, MERCOSUR countries have exhibited pronounced 'structural' or 'natural' asymmetries to do with quantitative and qualitative differences in the development of their economies, and unevenly endowed resources, among other factors. There are also 'artificial' asymmetries to do with various different economic policy outlines, promotion mechanisms, and so on.[12] Yet the Treaty of Asunción provides for no differences between the partners, the four Member States having the same rights and obligations (it differed in this from previous Latin American integration agreements, where the principle of special differentiated treatment was recognized for the smallest economies). The only flexibility in the Treaty of Asunción is to do with the pace of Uruguay and Paraguay's trade liberalization, who have been given an extra year to meet the timeframe for regional opening, and a higher number of exceptions to the program.

At the same time, although the Treaty provided for the coordination of macroeconomic policies and the elimination of tariff and of other types of barriers, it placed little emphasis on the treatment of structural and policy differences between countries. Despite this, the Las Leñas Timetable was signed by mid-1992,

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[11] The IDB's 2005 Regional Programming Document for MERCOSUR states that "the presidents of the bloc's member countries have clearly stated their desire to give new impetus to the regional integration process. The partners' macroeconomic situation also seems in principle to offer a much more suitable framework for future regional coordination (...) than over the last five years."

[12] 'Artificial' asymmetries stem essentially from the public policy decisions implemented by the governments themselves. These decisions are transmitted to the various different markets via two main implements: tax and subsidy structure, and regulatory frameworks. State intervention can thus become a cause of inequalities and imbalances in regional competition. In other words, to the extent that they have very different effects on the prices and quantities indicated by the markets, countries' economic policies can be the source of serious distortions in the conditions of competition, by not guaranteeing access under equal conditions (symmetry of opportunity), for all the participants in the expanded market. Asymmetries in the integration process are also usually classified as 'structural' and 'policy-based' (Bouzas [2005]).

providing a harmonization and coordination agenda for the four States' various internal policies, and including the definition of common policies and disciplines in various different areas. The Timetable was to 'order' MERCOSUR technical studies during the transition period, up to the formation of the Customs Union (1992-1994).

However, progress in terms of policy harmonization and the construction of common activities during much of the 1990s has been thin on the ground. Similarly, a lack of mechanisms to manage 'structural' differences continued to characterize the process, despite the almost permanent demands for them, especially from the smaller economies.

Related to this, the events and corollaries of the meeting of the Common Market Council (CMC) of mid-2004 in a way marked the mood and dynamics of the negotiations that would characterize much of the bilateral relations between Argentina and Brazil –as well as the MERCOSUR negotiations– between July 2004 and June 2005. Indeed, while Presidents Kirchner and Lula da Silva were restating their joint commitment to their nations' industrial development at Iguazú, the Argentinian government was simultaneously applying bilateral trade restrictions for the first time since the demise of convertibility.[13]

This phenomenon was largely accounted for by the return of growth to the region, hinted at in 2003 and confirmed in 2004, which demonstrated the productive changes brewing within MERCOSUR in previous years. In this respect, although in the short term the Brazilian devaluation of January 1999 had not been reflected in widespread trade imbalances, it did upset the profile of investment and production decisions in MERCOSUR. Foreign investors thus tended to concentrate their activities on the largest partner, which, together with national investors' operations in the different Member States, resulted in an accentuation of natural asymmetries. The new process of economic growth in the region made explicit this 'expansion' of structural productive differences in MERCOSUR countries –and the complementary role of artificial asymmetries– and generated tensions in different productive sectors.

In the face of criticism emphasizing the accumulation of serious bilateral trade deficits with Brazil throughout last year, Argentina's American Integration and MERCOSUR Undersecretary, Eduardo Sigal, tried to address the issue in perspective: "while between 1980 and 1994 Argentina had twelve years of deficit and three of surplus as compared to Brazil's accumulated debit of US$ 4.270 billion, after the start-up of MERCOSUR activity between 1995 and 2003, our country had seven years of surplus and just two of deficit, with a favorable accumulated balance of US$ 8.515 billion" (Clarín 08/26/04). Hernán Lacunza of the Centro de Economía Internacional (Center for International Economics) held that "the temporary balances of a specific year depend on the state of a country's economic cycle. In this case, the deficit came in the framework of high growth for Argentina with a rise in imports from a very low minimum." However, Bernardo Kosacoff of ECLAC held a different position, claiming that "Argentina has basically sold Brazil energy, foodstuffs and automobiles up till now, items in which Brazil could be self-sufficient in the near future. What will we sell the Brazilians then?" (The Economist 07/12/04).

B. From Debate to Proposals: Negotiating Trade & Investment 'Management' Initiatives

When Brazil started proposing different kinds of initiatives to be concluded at the December Summit, designed to 'relaunch' MERCOSUR (on the basis of a reform of the Protocol of Ouro Preto, incorporating

[13] The measures and trade conflicts voiced in this period are described and analyzed in detail in Chapter 3.

advances in such institutional aspects as regulation of the Commission of Permanent MERCOSUR Representatives, implementation of the Regional Parliament), Minister Roberto Lavagna was on an important visit to his neighbor in early September. The Argentinian Secretary met with President Lula da Silva in Brasilia, and with Casa Civil (Civil House) head, José Dirceu, and the Ministers for the Treasury, Development and Foreign Relations. In these meetings he presented three instrument projects: a competitive adaptation clause, a safeguard mechanism for disruptive macroeconomic conditions in one or other of the Member States, and a draft code of good practice for transnational companies in the region.

1) Temporary Safeguard Mechanism for Strong Macroeconomic Asymmetry Conditions

This instrument provided for the application of safeguard measures, in the face of serious disturbance in the macroeconomic conditions of one of the Member States, in the event of a significant increase in exports from that country to another partner or partners. More specifically, this proposal advocated the application of tariff contingents (quotas) on imports from a partner country, in the event of a substantive increase in purchasing a certain product that damaged or threatened to damage domestic production, for macroeconomic reasons (strong disturbances in the bilateral exchange rate or out-of-phase economic cycles).

Finally, and unlike other trade protection mechanisms (like antidumping or compensation rights), this microeconomic instrument (for specific products) was conceived with macroeconomic causes in mind. The rationale behind the imposition of this ‘additional’ requirement was that, once customs unification had been achieved, the disturbances in macro variables (given a lack of coordination) are fundamental engines of abrupt shifts in trade flows. In this sense, Roberto Lavagna’s proposal seemed to lean towards offsetting –at least in part– the lack of macroeconomic coordination among Member Countries. Therefore, the validity of this mechanism could only be justified insofar as progress was made toward some kind of explicit or implicit coordination in this area.

2) Competitive Adaptation Clause

The proposal involved imposing safeguards for cases of sensitive increases in imports in a given sector that might damage or threaten national production, without having to rely on the existence –and proof– of macroeconomic disturbances. Under this proposal, it would be sufficient for sensitive increases in imports originating in a member country and any relevant damage to take place, whatever their cause.

Many of the conflicts and/or tensions generated at regional level effectively seem to be microeconomics related: the relative differences in certain sectors’ competitiveness, the existence of different incentive mechanisms on either side of borders, shifts in the configurations of markets, and so on. Because of this, the Argentinian government supplemented its proposal with the presentation of this sectoral instrument. This measure, which would only be resorted to in cases where agreement between both countries’ private sectors could not be reached, would be temporary and would consist of establishing a quota for import preferences (zero tariff), and the application of the extra-MERCOSUR import tariff for imports exceeding the quota.

The application of this instrument would also be subject to a program of competitive adaptation for the activities benefiting, with a view to promoting sectoral readjustments for competitive conditions in the region, a program in which all parties involved should participate, since the causes of sectoral problems might not always be related to a business’s relative competitiveness (whereas they are related to the existence of differentiated subsidies, among other matters).

3) Code of Good Business Practice

Whereas the two previous proposals were directly trade related, the code of good practices aimed, in one way or another, to discipline the stimulus to invest, and to generate a voluntary framework to promote responsible business behavior in aspects as varied and significant as the environment, the fight against corruption, fiscal responsibility, technology transfer, and consumer protection, among others. The proposal was based partly on the Organisation for Economic Cooperation & Development (OECD)'s multinational company guidelines. Certain articles placing emphasis on the behavior of transnational companies were also included. Such companies were urged to be located evenly across the expanded market, with the application of geographical decentralization criteria for production.

Lavagna was thus seeking to influence the short term negotiating agenda, which had to a great extent been distinguished by the possibility of making progress toward a second Ouro Preto Protocol driven by Brazil. According to the Argentinian minister: "In our relationship with Brazil we want what hasn't been realized up to now to be realized, but until such time as it happens, specific instruments for MERCOSUR to function properly will have to set in motion" (Ámbito Financiero 11/03/04). He was suggesting that the proposed mechanisms were not replacing the necessary macroeconomic coordination and the reduction in the asymmetries of incentives, but were helping to mitigate the lack of progress in these areas. In addition, Lavagna stated at a press conference that "MERCOSUR's problem is not the institutions, but the lack of economic instruments to ensure that integration is intra-industry, and that it unifies the value chains." The Argentinian government thus began to warn its Brazilian counterpart as to the difficulties any future proposal approving a second Ouro Preto Protocol could face at the December meeting, should it not include the proposed trade and investment 'management' measures.

Negotiation of these mechanisms continued on December 10, when a Brazilian mission led by Deputy Foreign Minister, Samuel Pinheiro Guimaraes, arrived in Buenos Aires. The mission conveyed a negative reply to Argentina's request to institute a safeguard mechanism to protect industrial sectors affected by trade flows. The Brazilian mission argued that "Argentinian industry's situation last July[14] was one thing; now it is another. There has been recovery in the Argentinian economy and the trade balance between the two countries" (Marco Aurelio García, La Nación 12/10/04). As was expected, the bilateral meeting finished with nothing more than the signing of a joint press release stating that, while bilateral talks on the subject were still underway, the protection measures imposed by Argentina on Brazilian imports would remain in force.[15] By that time, Brazil's ambition to sign a second Ouro Preto Agreement at the end-of-year presidential summit had been shelved.

The debate over safeguards, though not on the Agenda of the Ouro Preto Summit in December 2004, did come up at various times in the meeting, and the political statements about the need for a more developed, harmonic region were repeated. However, no consensus emerged over the instruments to achieve this end. For Foreign Minister, Celso Amorim, safeguards were no solution; instead "we have to admit that there is a problem. I cannot see Argentina giving up a degree of industrialization. Nor can anyone in Brazil" (El Cronista, 12/17/04). President Lula da Silva stated that "an Argentina with no industry is not psychologically possible, politically possible or economically viable" (El Cronista 12/17/04). On January 25, 2005, an Argentinian delegation headed by Ministers Chiaradia and Dumont was received in Rio de Janeiro by their counterparts, Deputy Foreign Minister Pinheiro Guimaraes and Minister Marcio Fortes, to pick up the discussions of the proposals outlined by Minister Lavagna. On this occasion, Brazil presented three alternative instruments: (a) a proposal to set up a Commission for

[14] The approximate date these mechanisms began to be discussed.

[15] See Chapter 3, paragraph 3, describing the protection measures application mechanism.

Trade Expansion and Promotion of Productive Integration, (b) a proposal for a temporary bilateral trade management mechanism, and (c) a proposal linked to the need to balance incentives and define a common policy to attract investment to the region.

a) *The* C*ommission for Trade Expansion and the Promotion of Productive Integration*: the Brazilian proposal involved a formalization of the preexisting Argentina/Brazil Bilateral Trade Monitoring Committee (chaired by the respective Industry Ministers) with certain innovations. Among these was the inclusion of a new authority at the level of the two countries' Deputy Foreign Ministers, who would be responsible for analyzing the Committee's results. The proposal also suggested that the Commission would be responsible for raising recommendations in order to implement measures designed to achieve the balanced expansion of bilateral trade and the progressive productive integration of the economies.

b) *The Temporary Bilateral Trade Management Mechanism*: this proposal considered several of the issues included in the competitive adaptation clause proposed by Argentina. It incorporated, among other things, the idea of tool to temporarily restrict the flow of certain goods in bilateral trade, the need to prove the existence of damage or threat of damage, and the maintenance of preferences.

Furthermore, like the Argentinian sectoral proposal, it suggested that the instrument should not provide for macroeconomic triggers. However, the proposal moved forward in additional issues, such as the demand for the decision-making process of the application of the mechanism to be shared. At the same time, the Brazilian mechanism included the need to establish an explicit commitment to structural adjustment from the sector benefiting from the measure, a subject that, despite being contained in the Argentinian proposal, was in this case limited only to the sector's weaknesses (leaving aside, for example, the existence of financial asymmetries and fiscal incentives, among other things).

In the Brazilian proposal both the design, and the follow-up and control of the structural adjustment program would be both countries' responsibility. Finally, Brazil made the start-up of this instrument a condition for the elimination of the other intra-MERCOSUR trade protection mechanisms (antidumping measures and compensation rights), and for the establishment of some kind of 'peace clause' regarding various other measures potentially affecting the flow of trade.

c) *The Mechanism to Balance Incentives and Define a Common Policy to Attract Investment*: the Brazilian proposal tried to generate a simplified alternative to the code of good practice presented by Argentina. In this sense, and bearing in mind that part of the code was taken from the OECD's Transnational Company Guidelines, the Brazilian government proposed working together on the different components of the document, thus implicitly disregarding the Argentinian proposal, and reaffirming the currency of the OECD document, while promoting cooperation.

In any event, to accommodate Argentina's concern regarding the balanced distribution of investments, Brazil proposed a joint declaration which recognized the need for the application of policies designed to reduce asymmetries and stimulate integration of the productive chains of the various productive sectors. The joint declaration would urge transnational companies to help achieve MERCOSUR's central goal (the balanced development of Member States) in terms of planning their investments in the expanded market, while recognizing the fundamental importance that the region's governments place on FDI to develop their economies.

A week before the mid-2005 Asunción Summit, Paraguay renewed its efforts to bring nuances and additional content to the proposals. As part of the Agenda, and in line with Argentina's stance, Paraguay put forward a proposal later formalized at the meeting of the Common Market Group (CMG) to create a mechanism to be applied by the Member States in the event of extraordinary rises in imports from another partner country, caused by any sudden disturbances in one of the main macroeconomic variables. The

Draft Decision drawn up by Paraguay laid down that a Member State could apply an import tariff on a specific product (a) when the regional supplier's share exceeded 25% of the total imports of this good, and (b) when import flows rose by more than 10% over the previous two years. In any event, the fact that this import flow damages or threatens to damage the good's domestic production was established as a condition.

Finally, the temporary and exceptional nature of the instrument's application was outlined in the proposal, with a twelve-month deadline for any future measures, only deferrable for a further twelve months. This instrument was in line with one proposed in due course by Argentina, in the sense that it presented strong macro imbalances for the implementation of the import flow restriction measure as a 'trigger'. It should however be pointed out that, at the time of the Paraguayan draft presentation, the Argentinian proposal with this 'trigger' was virtually dead in the water. The merely trade mechanism was all that was left on the negotiating agenda. Despite the wealth of proposals and statements exchanged throughout the period, no consensus was reached over any of the mechanisms proposed by Argentina (nor their Brazilian or Paraguayan alternatives), either at the bilateral Argentina/Brazil level, or in the quadripartite sphere of MERCOSUR.

C. Convergences & Divergences in the Business & Government View

The MERCOSUR Business Council was set up in October 2004 to promote dialogue between Argentinian and Brazilian businessmen, as well as to consolidate integration, to establish or strengthen productive chains, and to support governments in the design of common development and negotiation strategies in international economic and trade forums. In a context of growing tensions in the bilateral sphere, the creation of the Council sought to contribute to the positive debate of ideas. In this regard, Foreign Minister, Celso Amorim, taking part in his first meeting in São Paulo, claimed that "instead of discussing whether we have 50% or 60% of the Argentinian market in refrigerators, we have to make a MERCOSUR refrigerator that will compete in world markets." Foreign Minister, Rafael Bielsa too said that "the problems of the last few months are a very small part of overall trade between our two countries. There is no problem with 80% of trade" (Clarín, 10/15/04). Official sources from both countries also emphasized that the problems were being properly processed by the Bilateral Trade Monitoring Committee, with voluntary agreements between the respective private sectors witnessing a high degree of compliance.

The second meeting of the business coalition was held in Buenos Aires on November 24. In an opinion article in La Nación newspaper of 11/23/04, the Brazilian Foreign Minister, Celso Amorim, gave a foretaste of the proposal he would be making to both countries' businessmen: to agree a work agenda with six basic headings: (1) the promotion of joint ventures, (2) financial mechanisms for integrating value chains, (3) government procurement, (4) the development of joint research, (5) joint participation in business events, and (6) extra-regional trade negotiations and joint trade promotion. According to Amorim "the business coalition has this challenge ahead of it: to take a quantum leap in the quality of the business vision of the integration process so as to ensure that MERCOSUR consolidates itself as a model for generating competitiveness and efficiency, and income distribution." Amorim's Argentinian counterpart, Foreign Minister Bielsa, however, understood that the work agenda had to move forward along the lines of the proposals expressed by Lavagna on his visit to Brazil.

During the meeting, representatives of Brazilian firms stressed drawing up a positive agenda that included joint trade promotion in third countries, the formation of joint ventures, the coordination of common and third party negotiating positions, the facilitation of the *Banco Nacional de Desenvolvimento Econômico e Social* (BNDES: The Brazilian Development Bank) and the *Banco de Inversión y Trade Exterior* (BICE: Foreign Trade and Investment Bank) lines for joint ventures. In this respect, they referred to the opportunities for investment in the bilateral environment at a time when the productive capacity of both countries was witnessing high levels of use. Argentinian businessmen, on the other hand, emphasized the need to arrive at satisfactory solutions to the problems in trade between the two countries and the dissimilar policies for attracting investment and promoting productive activity.

In other words, both countries' private sector representatives agreed with the positions of their respective governments, but could find no common parameters to make mutually satisfactory agreements possible. Apart from agreeing the date for a new meeting, the holding of the First Business Forum for MERCOSUR and associate countries, in parallel to the end-of-year meeting of the Common Market Council (CMC) in Brazil.

Regarding the business perceptions of the integrative process, Ricardo Markwald (2005) holds that "the current assessment of MERCOSUR in Brazil shows a clear imbalance between expectations, perceptions and facts. Indeed, the crisis in MERCOSUR persists in spite of the region's greater convergence in macroeconomic policy, and in the supposed political affinities between the governments of its main partners. Nevertheless, such exaggeratedly negative perceptions are neither justified nor backed up by facts. The balance, mainly from the viewpoint of Brazil's private sector, is much more favorable than the one that is preached. Even so, it is difficult to imagine any more significant progress in MERCOSUR without a solution to its main challenge: the partners' perception that the project of regional integration contributes little to its countries' international insertion."

On the subject of bilateral conflicts, a 2005 report from Brazil's *Confederação Nacional da Indústria* (CNI: National Industry Confederation) questioned the real influence of Argentinian trade barriers on Brazil's productive sector. The report stated that "the trade conflicts between the bloc's two main partners are spread across six sectors, in which the share of Brazilian sales has grown constantly. Between 1997 and 1999, Brazil had 44.9% of the Argentinian market in the sectors of paper, footwear, steel, ceramic products, electrical appliances and textiles. This share grew 68% between 2001 and 2003, and to 79.3% in the first half of 2004." In other words, the CNI survey confirmed the existence of a certain specialization in Brazilian exports in the conflictive products, whose share in Argentinian imports doubled Brazil's average share in total Argentinian imports.

While a business agreement was being tied up in the dairy sector, and commitments to such as cotton fabrics, acrylics and toweling were being renewed, the number and variety of products affected grew daily. Included on the agenda were goods such as gas cylinders, batteries, wood, and so on, despite many private agreements recording high levels of compliance.[16]

[16] See the follow-up and assessment of private agreements in Chapter 3 of this Report.

Contents

CHAPTER 3. AN APPROACH TO THE MAIN SECTORAL ISSUES IN ARGENTINIAN/BRAZILIAN TRADE

Although the bilateral issues surrounding intra-MERCOSUR trade of so-called 'sensitive' products have been a common denominator of growth in the bloc throughout its history, they were particularly dynamic over 2004-2005. One of the basic patterns in this respect has been the tendency toward a more vigorous defense of internal production by the Argentinian government, a decision taken in the framework of the goal to 'reindustrialize' the country. This political decision faced the constraint of growing Brazilian penetration in numerous industrial products in this market over the analyzed period.[17]

The higher sales from Brazil to Argentina during this stage took place in a context of pronounced expansion of total Brazilian world exports, and of growing 'diversion' of Argentinian imports to the advantage of Brazilian suppliers and to the detriment of third countries' suppliers (to do, among other factors, with relative advantages in exchange parities). For numerous products Brazilian sales to Argentina exceeded the highs reached in convertibility, a trend viewed by the Argentinian public and private sectors as threatening the goal of reconstructing their industrial network.

In this context, the authorities in Brasilia demonstrated understanding of the needs of their Buenos Aires counterparts. And from this understanding emerged the Bilateral Trade Commission between Argentina and Brazil in October 2003, a forum designed to analyze the evolution of bilateral trade and make recommendations.[18] In practice, the Commission has acted as a kind of antechamber for the adoption of one trade restriction or another, mostly at the request of Argentina. The mechanism has, in general, been the same. First, governments move to reach private agreement and, if unsuccessful, the Argentinian government decides whether to apply (or simply threaten to apply) some kind of paratariff restriction (non-automatic licensing, safeguards, antidumping, etc). In some cases, the private Brazilian representatives decide to be more flexible in their approach toward such measures in order to reach an agreement that – broadly speaking– takes the form of a voluntary restriction on exports on the part of Brazilian businessmen (the Argentinian measure being suspended or suppressed).

This mechanism, which made its debut a few months after the creation of the Commission with the textiles case, became a kind of bilateral gymnastics of foregone conclusions. More and more sectors were thus incorporated in the 'monitoring' list, and in every case, private representatives were involved in the negotiation. In parallel, the Argentinian government continued throughout this stage to nurture the idea of finding some escape clause that would allow it to channel the relief measures for the problems generated by competition between partners, as described in Chapter 2.

Although at other times in MERCOSUR (especially after devaluation of the real in 1999) attempts were made to strike private agreements, the strike rate was low. In general, the chances of achieving positive results (in reaching agreements or in observing their compliance) depended directly on how concentrated supply in the regional space was: the smaller the number of parties in play, the greater the chances of monitoring the agreement, and the smaller the likelihood of getting something out of non-compliance.

In the 'new wave' of agreements, certain circumstances have varied, thus explaining the greater degree of success and observance of the agreements. On the one hand, unlike what happened in 1999, the Argentinian market recorded vigorous growth at this stage. This allowed both parts to negotiate the split of these 'earnings', while on previous occasions, the negotiation developed in a context of a 'zero sum game' where earnings by one party determined the losses of the other. The new agreements were thus designed to allow Argentinian production to increase parallel to the (regulated) increase of Brazilian sales.

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[17] Albeit not exclusively. The period's main sectoral conflicts have had a marked bilateral Argentinian/Brazilian slant, which has greatly influenced the approach of this chapter.

[18] The MERCOSUR Trade Commission also operates within the block, but with different scope and functions.

Another factor that undoubtedly made an impact is the greater degree of political empathy between the governments of Brasilia and Buenos Aires. Apart from certain disagreements blown out of proportion by the media (see Chapter 2 for more details), a positive attitude toward finding appropriate solutions and not marring the spirit of MERCOSUR agreements has been witnessed from both governments in the course of these negotiations, and since the creation of the Bilateral Monitoring Commission.

One of the most frequent arguments used to minimize the importance of intra-MERCOSUR trade conflicts has been the insignificant percentage of trade involved in such conflicts. Although this reasoning does have a quantitative basis in fact (automotive trade aside, the trade in sectors in conflict during 2004 was 7% of total bilateral trade), it is nevertheless worth underlining that its importance is really qualitative, with the proviso that such conflicts often tend to alter the general conditions of trade.

It should be pointed out that the list of cases dealt with in this chapter does not claim to be exhaustive, but is limited to the main sectors.[19] First came what might be termed ‘general cases’: those conflicts and/or tensions involving exports from Brazil to Argentina. Second, the reverse is described, Argentinian exports to Brazil (including the case of rice, which also affects Uruguayan exports). Last, two ‘special’ topics are dealt with: the possible renegotiation of MERCOSUR’s Common Automotive Policy, and the conflict between Argentina and Uruguay surrounding the former’s industrial development policy.

TABLE 10
CONFLICTIVE SECTORS IN BILATERAL TRADE
2004 Data, Billions of US$

Brazilian Exports to Argentina	**Billions of US$**	**% of total**
Agricultural Machinery	0.3455	4.7
Footwear	0.1078	1.5
LHAs	0.1071	1.5
Yarns & Cotton Fabrics	0.00953	1.3
Synthetic & Artificial Fibers & Yarns	0.00937	1.3
Towels, Sheets & Blankets	0.00217	0.3
Subtotal 1	*0.7712*	*10.5*
Vehicles & Autoparts	2.0349	27.6
Subtotal 2	*2.8061*	*38.1*
Total Brazilian Exports to Argentina	**7,373.2**	**100.0**
Argentinian Exports to Brazil	**Billions of US$**	**% of total**
Rice	0.0071	1.3
Flour & Premixes	0.00417	0.7
Wine	0.00199	0.4
Subtotal	*0.1326*	*2.4*
Total Argentinian Exports to Brazil	**5.5696**	**100.0**

Source: Aliceweb (MDIC).

[19] The issues linked to the sugar sector are not included, for example. Although this sector is considered ‘sensitive’ from the outset of the integrating process, it has seen no new developments during the period under analysis.

A. Argentina's 'Sensitive' Sectors

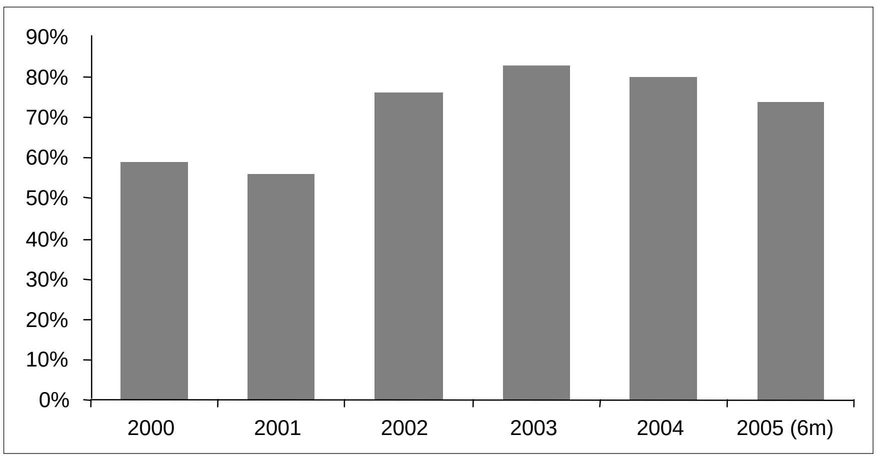
Large Household Appliances (*LHAs*)

GENERAL HEADINGS

This product world is made up of large household durables. Despite Brazil's status as a major supplier in the 1990s, it is after 2000 that its market share and Argentinian imports display a significant jump.

After the collapse immediately following Argentinian devaluation, Brazil's export flow of such products toward its partner country showed a vigorous recovery. Brazilian supply not only grew in absolute terms, but its market share in Argentina also rose sharply, on the back of favorable trade diversion. With lower purchasing power in dollars, Argentina's demand shifted toward Brazilian output, with lower prices in terms of supply from industrialized countries. In certain areas, Brazilian supply totally dominated, enabling Argentina to reoccupy a major position as a destination for Brazilian exports of such products.

FIGURE 25
BRAZILIAN LHA EXPORTS TO ARGENTINA
Value & Market Share (%)



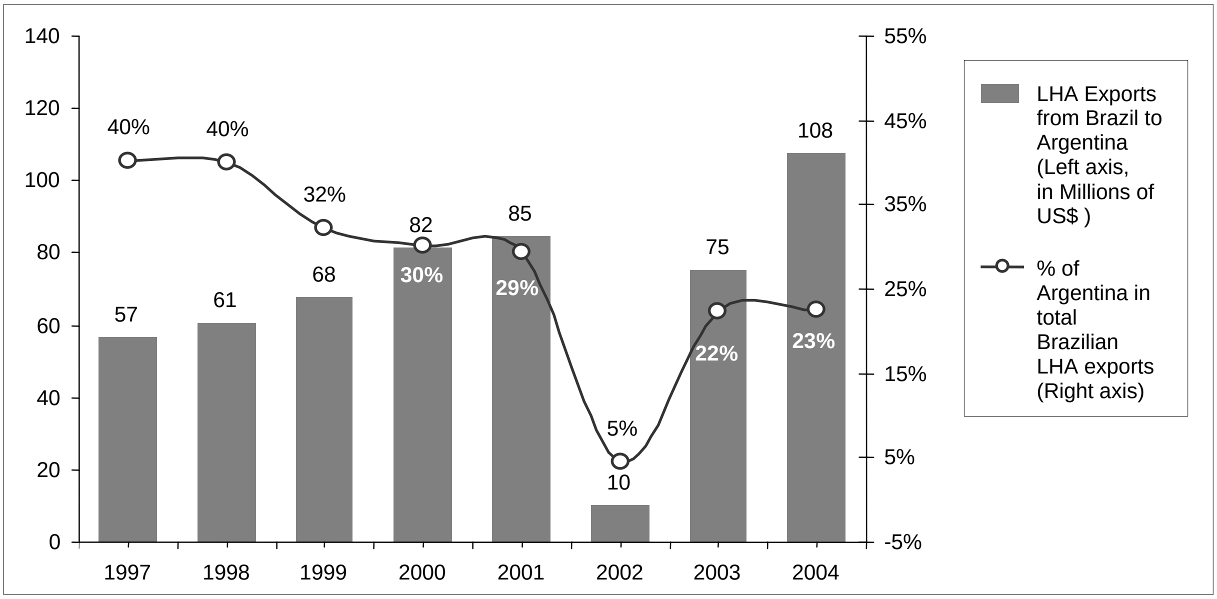
Source: INDEC.

All branches in the sector exhibit serious asymmetry to one extent or another in terms of productive structure in both Brazil and Argentina. Although this was a fact of life during the 1990s, the Argentinian crisis in 2001 and Brazilian growth in recent years widened the gap. During 1999-2003, Brazil virtually monopolized investment, achieving a supply ready to meet regional demand, with the strong productive presence main global players in the sector (Centro de Estudios para la Producción 2004).

On the other hand, the economic crisis in Argentina conditioned the withdrawal of the few transnationals producing locally. These decided to supply the Argentinian market from their plants in Brazil. The remaining production fell to companies with Argentinian capital, or to other countries in the region of a smaller scale and with less technological know-how than their Brazilian counterparts. These differences were felt in bilateral trade, and enabled Brazilian production to further penetrate the Argentinian market.[20]

[20] A particularly relevant case was Whirlpool's withdrawal from Argentina, which strongly affected bilateral trade flows for these products, especially in refrigerators.

FIGURE 26
BRAZILIAN LHA EXPORTS TO ARGENTINA
Value & Share



Source: Aliceweb (MDIC).

Under these conditions, the Argentinian government estimated in late 2003 that the tangible recovery being registered in its market in the volume of sales may risk falling totally into the hands of Brazilian supply, without being translated into a recovery of local production. This risk, it was argued, put the brakes on any investments to be made in Argentina, and thwarted any chance of reducing asymmetries.

Therefore, after months of fruitless negotiations in the framework of the Bilateral Trade Monitoring Commission, the Buenos Aires government announced, in July 2004, the imposition of various import restrictions for these types of products. For so-called ‘white line’ products (stoves, refrigerators and washing machines) it was decided to adopt a non-automatic licensing regime,[21/22] while a 21% tariff was implemented for televisions as a safeguard in the framework of CMC Decision No. 8/94 regulating intra-MERCOSUR trade in goods from free zones and special customs areas.

There follow details of the agreements reached in each case.

- *Gas Stoves*

Upon the announcement of the imminent imposition of non-automatic licensing by Argentina, private negotiations speeded up, becoming the first sector where an agreement was concluded. This meant that, ultimately, no such measure ended up effectively being applied.

Argentinian imports of gas stoves have risen since the 1990s. However, the share of foreign products inside the Argentinian market remained lower than average in electrical household appliances, not rising above 25% (of which 45% was from Brazil). After Argentina’s devaluation, this 25% of the market was

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21 A measure adopted in the framework of the WTO’s Agreement on Import Licensing Procedures.

22 If the measure had been applied to all imports, Brazilian supply would have been the most affected given its dominance in Argentinian imports in these items.

occupied totally by Brazil. Even so, the flow of sales from Brazil to Argentina did not recover the values reached just before convertibility was dropped.

The private agreement limited exports from Brazil to Argentina during 2004 to 90,000 units, roughly 6% up on 2003 values. For the first half of 2005 a quota was set at 47,500 units. The low impact of the Argentinian market on Brazilian stove exports (less than 10%) was a facilitating factor when agreeing the market split. Although imports over 2004 were above what was stipulated in the agreement, this was offset during the current year according to what was previously agreed.

- *Refrigerators*

In terms of LHAs, the refrigerator sector is where structural asymmetries between Brazil and Argentina are accentuated. In 2002 Whirlpool decided to supply the Argentinian market from Brazil. The withdrawal from Argentina of the only multinational with an industrial base was decisive for the subsector's bilateral trade, and impacted the development of regional trade in refrigerators, causing a marked break in Argentina's sectoral value chain (Manson [2005]).

Brazil, however, consolidated its position as a world center for producing and exporting refrigerators through the operations of the sector's major world players. Brazilian refrigerator exports have thus risen steeply in recent years. With the diversification of Brazilian export destinations, Argentina gradually lost its importance for Brazil, though it is still the largest market, absorbing almost a third of total exports.

Similarly, the Brazilian share in Argentinian imports has been growing over the years and became almost total after devaluation of the peso, supplying 65% of this product's internal market in Argentina during 2004. In other words, on the plus side, Whirlpool's exit from Argentina, and its intention to preserve market share by manufacturing its products in the neighboring country, pushed imports from Brazil up ten times higher between 2002 and 2003, tripling the figures for 2001.

The road to agreement was fraught with difficulties. Although a temporary private agreement was quickly reached by July 2004 –without non-automatic licensing even being implemented– the final agreement would have to wait until bilateral verification of the real scale of the Argentinian market. In the interim there was no lack of friction from an incipient diversion of Argentinian imports from other countries like Chile and Mexico, homes to the capital of two of the four Argentinian household refrigerator producers.

Reached in November 2004, and valid until 12/31/05, the agreement provides for a voluntary limitation on Brazilian exports. This brings the Brazilian quota in the Argentinian market in 2005 down from 65% to 50%. Given prospective growth for the Argentinian market, Brazilian shipments are 7% up on 2004.

Nevertheless, the percentage of the market allocated to Brazilian products is flexible, in that, if imports from third origins exceed 3% of the Argentinian market, the share allocated to Brazil would be increased by the same amount as the excess. This measure was adopted to stop trade diversion maneuvers harming Brazilian refrigerators' competitiveness in the Argentinian market. In terms of the degree of general compliance with the private agreement, though there were some excesses in imports from Brazil, these were partially offset by surpluses in extra-MERCOSUR imports.

- *Washing Machines*

Washing machine production was the only subsector where non-automatic licensing was effectively applied due to the initial failure of private negotiations. The difficulties in reaching an understanding were largely due to the extreme importance of the Argentinian market in Brazilian exports of this product. In these terms, any potential limitation would have a major impact on Brazilian production programs. This is especially true considering that products made in Brazil targeting the Argentinian market, could not easily be retargeted to the Brazilian market due to design differences (horizontal rather than vertical drums).

Brazil's share in Argentinian washing machine imports to 2001 was always below 40%. However, as of 2002, this market share rose to above 70%, aided by an antidumping measure applied by Argentina on suppliers' from Italy and Spain.

The application of non-automatic licensing effectively paralyzed trade flow between August and October.[23] Import companies later began to cope with the restrictive measures' complex bureaucratic mechanism, and recovered their volume of sales. Only by late March 2005 did companies close an agreement. This provides for a 'voluntary' restriction on exports of 180,000 units per year by Brazil (an average of 15,000 per month), well below levels prior to implementation of the restriction. Despite the agreement, and unlike other cases, automatic licensing is still in place to control possible trade diversion.

- *Television Sets*

Unlike 'white line' products, over which hung the threat of non-automatic licensing, the restrictive measure adopted by Argentina in this sector involved setting up a safeguard under CMC Decision 8/94.[24] A temporary tariff of 21% on television sets from the Manaos Free Zone was thus adopted in July 2004.

Though Brazilian television sets gained ground in Argentina, their share was lower than other electrical appliances. In the best year, 2004, Brazilian imports accounted for 20% of Argentina's television market.

Though, in both Argentina and Brazil, television set production is rooted in special customs areas (Ushuaia and Manaos), there is a major difference in the features of each industrial installation. As with refrigerators, the major global players in the sector are resident in Brazil, whereas in Argentina the bulk of production is in the hands of Argentinian firms or under license for transnational company brands.

Toward the temporary measure's expiry in January 2005, and threatened with the application of a more rigorous definitive measure, businessmen from both parties came to an agreement. The agreement adopted the legal nature of a definitive measure in the ongoing safeguards process. It provides for a safeguard consisting of a quantitative restriction of around 100,000 units by 2005, a quota of 9% of the 2005 Argentinian market by 2006, and 10% of the 2006 Argentinian market by 2007. 2005 shipments would thus be half those recorded in 2004 (close on 8% of the Argentinian market).

The measure is clearly more restrictive than for other household appliances, with a sharp reduction in Brazilian placements in Argentina, and smaller market quotas. This may be to do with the restriction's different institutional structure as a safeguard, there being voluntary agreements in other subsectors.[25]

TEXTILE PRODUCTS

This sector was the first to reach a 'private' agreement under the ægis of the Bilateral Monitoring Commission, and was also the first in which the Argentinian government applied its strategy of imposing a paratariff restriction (as a lever for the private agreement based on the voluntary limitation of Brazilian exports to Argentina). The negotiations begun during the second half of 2003, were fruitless early on, but

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[23] According to sources in the sector, a stock of 40,000 washing machines was accumulated in Argentinian customs over the period, equivalent to more than three months' imports.

[24] Article 3 of this Decision states: "Safeguards may be applied under the legal regime of the General Agreement on Tariffs &Trade (GATT) when imports originating in free trade zones, free industrial zones, export processing zones, and special customs areas involve an unexpected increase in imports that will damage or threaten to damage the importing country." This constitutes an exception to the general ban on applying safeguards to intra-MERCOSUR trade.

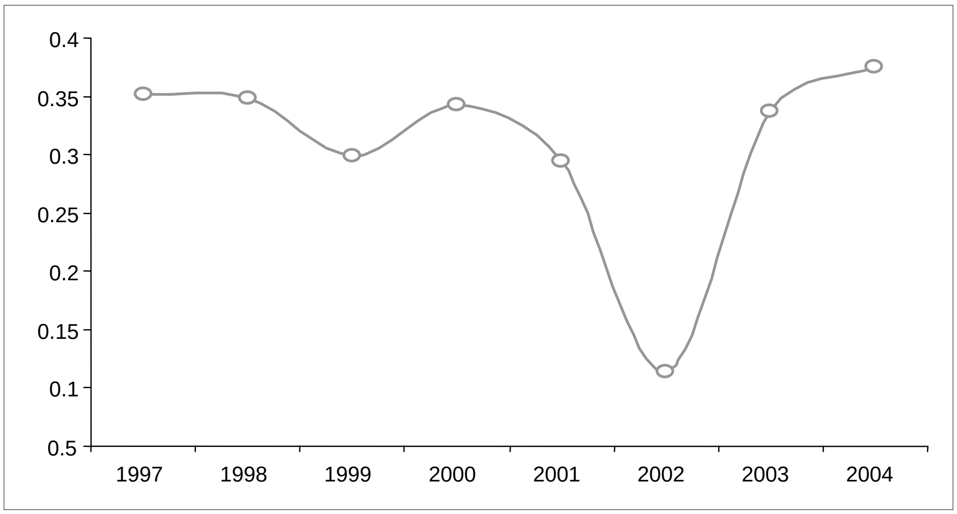
[25] This stricter approach toward Brazilian output succeeded in diverting trade to the benefit of third suppliers. So far 2005 has seen a marked diversion of Argentinian imports to the benefit of China and to the detriment of Brazil.

there was a breakthrough when the Buenos Aires authorities decided to introduce non-automatic import licensing on a group of products (cotton fabrics, yarns and synthetic fibers, and synthetic carpets).

The first ‘by-product’ of this restriction was the agreement over denim, and later on agreements on other cotton fabrics for shirts, and on acrylic yarns. From March 2004, as private agreements were concluded, licenses were eliminated for all the products where they had been introduced,[26] the exception being carpets, a sector where agreement was reached only in June 2004.

FIGURE 27
BRAZILIAN TEXTILE EXPORTS TO ARGENTINA

Billions of US$



Source: Aliceweb (MDIC).

Taking Argentina’s total textile imports (both raw materials, and garments and creations), Brazil’s share in them can be seen to be growing. Although the various protective measures adopted by the Argentinian authorities to the detriment of other supplier countries (especially in Asia) have played a part in this, the change in the composition of Argentinian textile imports after devaluation in early 2002 has undoubtedly weighed heavily. In broad terms, from then on, textile imports take up a larger share of intermediate products (raw materials like yarns and fabrics) at the expense of end products (garments and creations).[27] The change was beneficial for Brazil, as their shipments to Argentina were characterized (even before Argentina’s devaluation) by a high content of raw materials (60% of Brazilian textile exports).

As a result, the range of products ‘monitored’ has grown steadily in recent months. Others have been added to the original products, like other cotton fabrics and cotton yarn. Following proceeding, it is hoped to extend the agreements to these items, which would cover virtually all textile raw material commodities.

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[26] In the case of denim and shirt fabrics, the restriction took the form of a quota, whereas in acrylic yarns the arrangement was based on establishing a minimum price. The agreements were valid throughout 2004, although the agreement for denim was extended to 2005. The agreements were generally complied with.

[27] This shift in make-up is due, on the one hand, to a shift in relative prices in Argentina, due in turn to lower labor costs (the ‘price effect’), benefiting clothing manufacture, and aware of the high labor component of the cost structure of these products. Likewise, there was an ‘inflow effect’ determined by the expansion in demand from the reactivation of clothes manufacturing in Argentina, which in turn determines larger orders of yarns and fabrics, resulting in higher imports of such products, given the low idle capacity of spinning and knitting in Argentina.

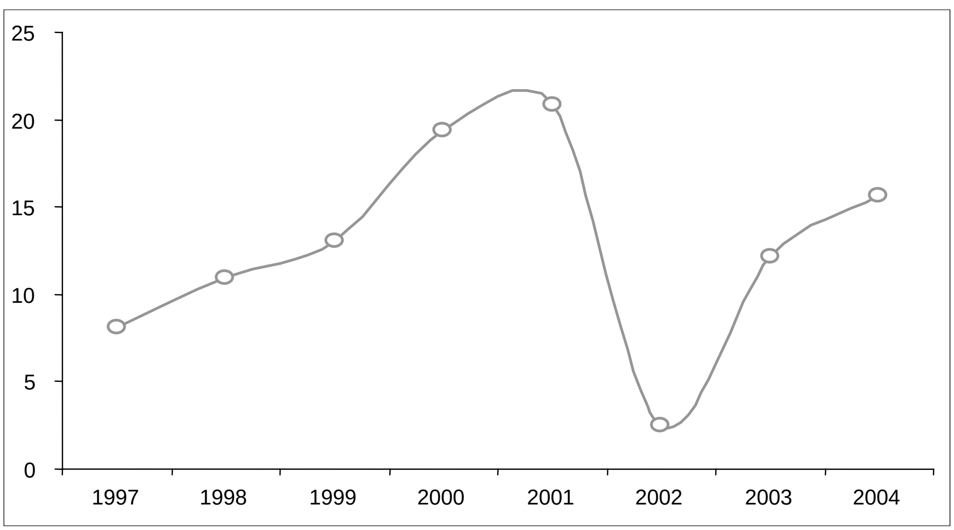
FOOTWEAR

Footwear production features recurrently on the list of 'conflicting' sectors in the bilateral relationship due to the existence of serious structural asymmetries between Brazilian and Argentinian production. While in Argentina production is mostly in the hands of very small companies, Brazil is the world's third largest footwear producer, and its production is by much larger firms with greater exporting experience.[28]

In addition to these structural elements, there was the bankruptcy of Argentina's largest sports footwear producer (the only footwear segment where large companies operate in Argentina). This made it impossible to continue the company's local foreign brand footwear production. In these circumstances, the parent company of the world brand decided to start supplying the Argentinian market from Brazil.

In spite of this factor, the aggregate volume of Brazilian footwear exports to Argentina in 2004 was 25 % down on 2001 (a record year, when Brazilian exports to Argentina totaled 21 million pairs). The fall could have been even bigger, if it had not been for the 90% increase in textile footwear exports, a high incidence category in the sport footwear group. In other words, it can be seen that, while in non-sport footwear, the amounts imported are well below the ones recorded in 2001, the serious imbalance is related to sport footwear (with imports easily exceeding 2001's levels).

FIGURE 28
BRAZILIAN FOOTWEAR EXPORTS TO ARGENTINA
Millions of pairs



Source: Aliceweb (MDIC).

In this respect, the key element of the Argentinian negotiating position would seem to come from the strong contraction in production levels during the 1990s, and in the view of Argentina's footwear companies, was to do with strong external, mainly Brazilian competition. Given Argentinian producers'

[28] Brazil is a worldwide exporter of footwear. Argentina's share as a destination for Brazilian footwear exports in 2004 was 5.6%.

desire to regain the production volumes of the 1980s,[29] footwear trade began to be studied at the Bilateral Trade Monitoring Commission. Early in 2004, an agreement was thus reached limiting Brazilian exports to about 12 to 13 million pairs (the figure for 2003 had been 12 million).

Despite the agreement, the situation did not ease after blatant non-compliance with the agreement. By late 2004, Brazilian exports had totaled about 15.7 million pairs. The large number of actors playing in the footwear market makes it difficult to enforce these types of agreements, unlike more concentrated sectors like paper or yarns and cotton fabrics. In 1999 a similar agreement in the footwear sector failed due to this.

This factor raised the requirements of Argentinian producers when renewing the agreement. In the first months of 2005, they demanded that Brazilian exports be limited to 10 million pairs. Lastly, in May, faced with the recurring threat by Argentinian authorities to introduce non-automatic import licensing, a two-year agreement was reached, limiting Brazilian exports to Argentina in 2005 to 12.9 million pairs.

AGRICULTURAL MACHINERY

Given the two countries are the largest agricultural producers in the region, there is a major productive chain in Brazil and Argentina to supply the machinery and tools needs of the rural sector. Yet there are also major asymmetries, wider than is desirable in terms of the two countries' agricultural output. As in other sectors, Brazilian production has markedly upped its share in Argentina's agricultural machinery.

During the 1990s, production in this sector in Argentina registered a trend toward growth, hand in hand with agricultural profitability generated by rising international grain prices. But the trend snapped in 1997. From then on, demand dropped sharply due to the fall in agricultural prices and producers' rising debts. Similarly, the imported supply (mostly from Brazil) began to gain ground in the internal market.

At the same time, the rapid spread of direct sowing[30] affected the sector's development. Although this change in the function of agricultural production favored competitive conditions for seeder manufacturers (which, thanks to the new methods, had a 'natural' protection from imported supply, designed for traditional productive methods), it had negative repercussions on the already overly depressed demand for tractors, given the new technology's lower tilling requirements (Bragachini *et al.* [2000]).[31]

Meanwhile, the Brazilian market focused on the sector's main international companies, whose production supplied internal demand and the Argentinian market, among other destinations.[32] By contrast, by the late 1990s, Argentina's agricultural machinery sector was basically made up of small and medium companies mainly supplying the internal market, and a single large multinational with a productive base –operating not as a storage facility, but as a manufacturer of engines and parts. The major production rifts were seen in the tractor and harvester subsectors, while in other machinery (especially seeders) the specificities of Argentinian demand –on the increase due to direct sowing– ensured their survival (Bragachini *et al.* [2000]).

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[29] According to Alberto Sellaro, President of the *Cámara de la Industria del Calzado* (CIC: Footwear Industry Chamber), "the Argentinian position is not only to limit Brazilian footwear imports; our goal is to go back to producing the kind of quantities we were producing in Argentina in the late 1980s" (El Cronista 05/18/05, p. 8).

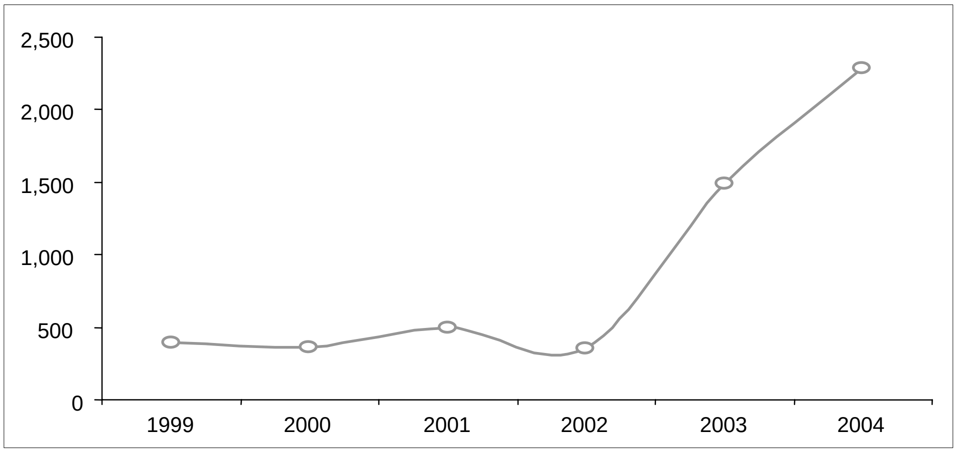
[30] Direct sowing is a method of cultivation that eliminates tilling. It has the advantage of reducing soil deterioration, and reduces production costs, including lower expenditure on diesel oil and less use of tilling machinery (tractors, plows, etc.).

[31] Another crucial factor is the increasing separation between land property and the agents running agricultural operations (the 'contractors'). Demand was thus concentrated, acquiring fewer, but more technologically advanced units, and favoring penetration by imported products (Chudnovsky-Castaño [2003]).

[32] Argentina was the destination for just 23% of Brazilian tractor exports during 2004. Among other destinations was the United States, which absorbed 17% of Brazilian tractor exports. This gives a precise idea of the competitive level of Brazilian supply in this sector, exporting 26% of its production.

After convertibility, Argentinian agriculture markedly increased its profitability. The 'pesification' of bank debts substantively improved producers' assets, and demand for rural machinery began to revive. In addition, grains rates soon recovered, especially with the soya boom of late 2003 and early 2004. With no debts and very significant profitability, Argentinian agriculture set about renewing its aging machine stock. Between 2002 and 2004 harvester sales rose 340%, while tractors rose 420% in the same period.

FIGURE 29
BRAZILIAN HARVESTER EXPORTS TO ARGENTINA
In units



Source: INDEC and AFAT.

As almost a 'natural' result of the critical condition of Argentinian tractor and seeder production since the 1990s (production of the former had virtually disappeared), the increased demand for this type of products was covered by the supply of Brazilian-based multinationals.[33] In parallel, Argentinian producers in the sector were working at full capacity and with a backlog of orders that exceeded their production capacity, generating prolonged delays in deliveries. Despite these problems, Argentinian tractor and seeder production between 2002 and 2004 grew by over 200% in both cases.[34]

This almost ideal situation (a growth market with expansion of production and imports) looked as if it would be interrupted in 2005 as a logical result of the fall in international grain prices, and the rapid renewal of the machine stock of years immediately prior to this. Forecasts point to a 20% reduction in overall sales for 2005, although this may eventually be smaller, given the recent reversal in the downward trend in rates. In spite of falling demand, local producers' sales have not been so affected, and have gained ground in their market share.

Nevertheless, at these first signs of 'cooling' of internal sales, complaints have been heard from local producers about the 'excessive' presence of Brazilian output in Argentina's agricultural machinery market.[35] It comes as no surprise that the loudest complaints are from tractor manufacturers, perhaps the

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[33] Between 2002 and 2004, imports from Brazil absorbed 84% of the increase in Argentinian demand for tractors. The percentage stands at 75% for harvesters.

[34] For harvesters this meant a return to the normal values of the 1990s. However, for tractors the productive level of 2004 represents just 21% of average production for 1990-1997.

[35] Fears are growing over the fall in sales recorded in the Brazilian market (down 35% to July). This may push up exports targeting Argentina.

sector with the most weaknesses compared with its Brazilian counterpart. One factor to bear in mind is that trade in tractors, seeders, and other self-propelled machinery are governed by MERCOSUR's Common Automotive Policy (CAP). Therefore, any resolution over the bulk of the world of agricultural machinery will depend upon how the future of the CAP is defined. Despite the concern of Argentinian companies, restrictive measures were not adopted in this segment.

B. Brazil's 'Sensitive' Sectors

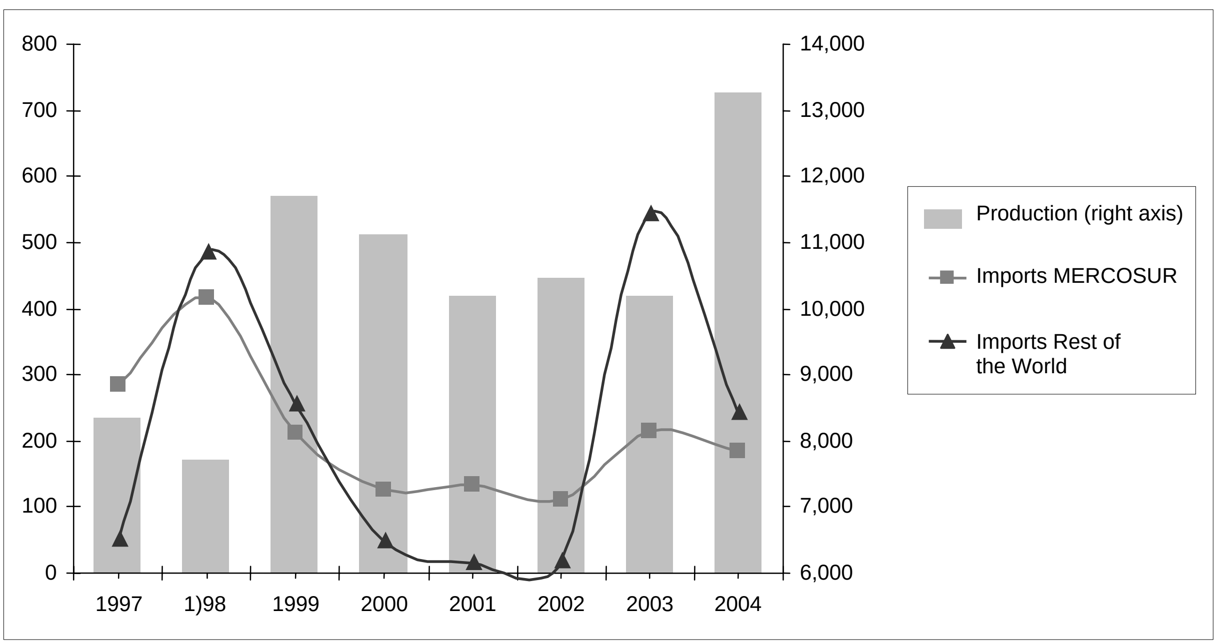
This section covers the events surrounding three sectors displaying a degree of 'sensitivity' from the Brazilian perspective. They are characterized by being composed of agro-food chains, although only in one (wine) are there any clearly perceptible productive asymmetries (in favor of Argentina).

Rice

By mid-2004, rice producers from southern Brazil had begun to protest about rice imports from Uruguay and Argentina, claiming that these shipments were behind the depression in rice prices in the Brazilian market. These claims reached their pitch in October the same year, when roads were blocked to prevent foreign rice entering Brazilian territory. Sporadic protests went on throughout the first half of 2005.

Brazil consumes about 12 million tonnes of rice per year. As this demand usually exceeds internal production, it has to turn to imports to make up the difference. Nevertheless, over the last few years there has been an upward trend in Brazilian production, which has allowed Brazil to increase its degree of self-sufficiency. Over recent years, imports from MERCOSUR neighbors have represented around 6% of the Brazilian market's total supply of rice, a percentage that appears too small to influence rice prices.

FIGURE 30
BRAZILIAN RICE PRODUCTION & IMPORTS
In thousands of tons



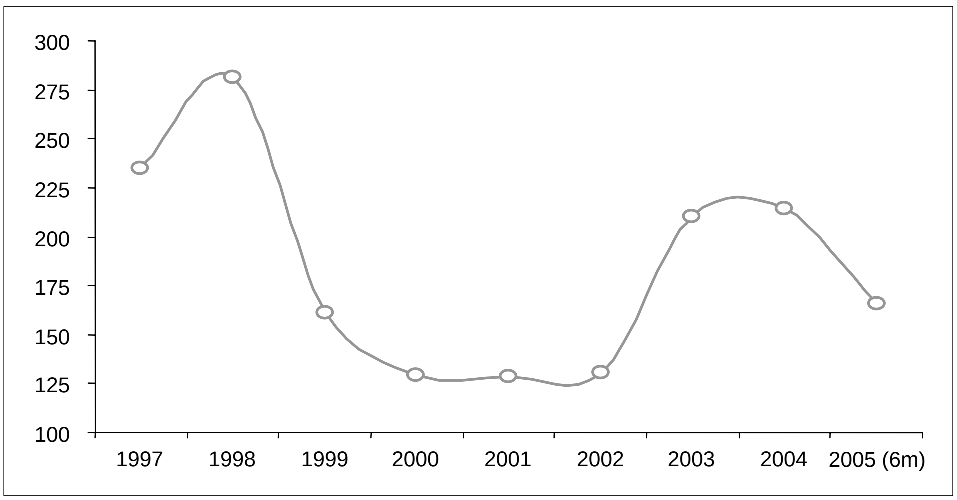
Source: Aliceweb (MDIC) and Brazilian Ministry of Agriculture.

There is an additional factor which minimizes the relationship between the fall in prices in Brazil to the inflow of Uruguayan and Argentinian rice. By observing the various components of Brazil's total rice supply (Brazilian production, imports from MERCOSUR, and imports from other points of origins), in recent years, the 1998 and 2003 imports highs can be seen to coincide with the low of internal production.

But, unlike 1998, most imports in 2003 were extra-regional in origin, aided by a temporary reduction in the Common External Tariff (CET) for rice. Extra-regional imports thus more than compensated in the end for the fall in production, and generated an increase in stock. This problem worsened the following year, with the sharp rise in Brazilian production. The pressure of greater production and the stocks accumulated by extra-MERCOSUR imports over the previous year were the fundamental reasons for the slight downward trend in the current price. It is worth underlining the fact that, despite the obstacles to trade flow caused by the producers' protests, the Brazilian government has so far not adopted any restrictive measures on Uruguayan or Argentinian rice.

FIGURE 31
RICE PRICES IN RIO GRANDE DO SUL

US$ per tonne



Source: IPEA.

Wine

In mid-2004, Brazilian grape growers and wine producers began expressing their concern about rising wine imports from Argentina, claiming that these were essentially low price products, precisely the segment targeted by most of Brazilian production.

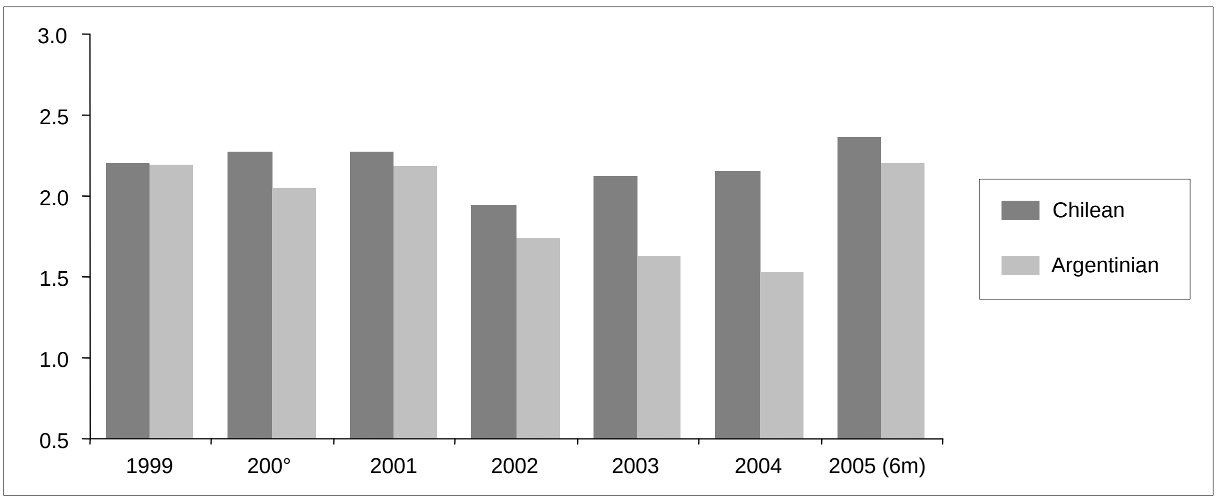
Unlike the automotive or LHA sectors, the asymmetries are to Argentina's advantage in wine production. Indeed, Argentina is the world's fifth largest producer of wines with an annual production of 1.2 billion liters, and a domestic consumption of 30 liters per year per head of population. The wine industry is highly developed, with vineyards located in optimal geographical regions for vine growing, and operations of the major world players in the area, attracting serious investment in recent years.

By contrast, in Brazil annual production barely reaches the 230 million liter mark, with a relatively small per capita consumption of no more than 3 liters per year –which, besides, shows no signs of growth. Vine plantations in Brazil are located mainly in the states of Rio Grande do Sul and Minas Gerais, with vineyards characterized by low scales of production.

In spite of the large volume of its production, Argentina's grape growers and wine producers have basically always been characterized by targeting domestic consumption. Export growth began during the 1990s, coinciding with major investments in the sector, with the participation of global players. After the end of convertibility, this export process took on even greater momentum. It is precisely over these last two years that Argentinian wine expanded vigorously into the Brazilian market.

This significant growth meant that, between 2002 and 2004, the Argentinian share in Brazilian wine imports virtually doubled, becoming Brazil's main supplier by 2004, a place occupied by Italy in the 1990s, and more recently by Chile. Although a certain downward trend was seen in the average price of Argentinian wines exported to Brazil up to 2004, their price is not far off Chilean shipments to Brazil.

FIGURE 32
BRAZILIAN WINE IMPORTS
Average prices, US$ per liter



Source: Aliceweb (MDIC).

After two meetings held between May and June 2005 (in which private and official representatives of both parties took part) an agreement was reached. This established a minimum price of US$ 8 per 12 750cc bottle box (approximately US$ 0.9 per liter), and includes commitments to initiate joint campaigns to promote wine consumption in Brazil, and to take steps to reduce wine smuggling in the region.

Wheat Flour

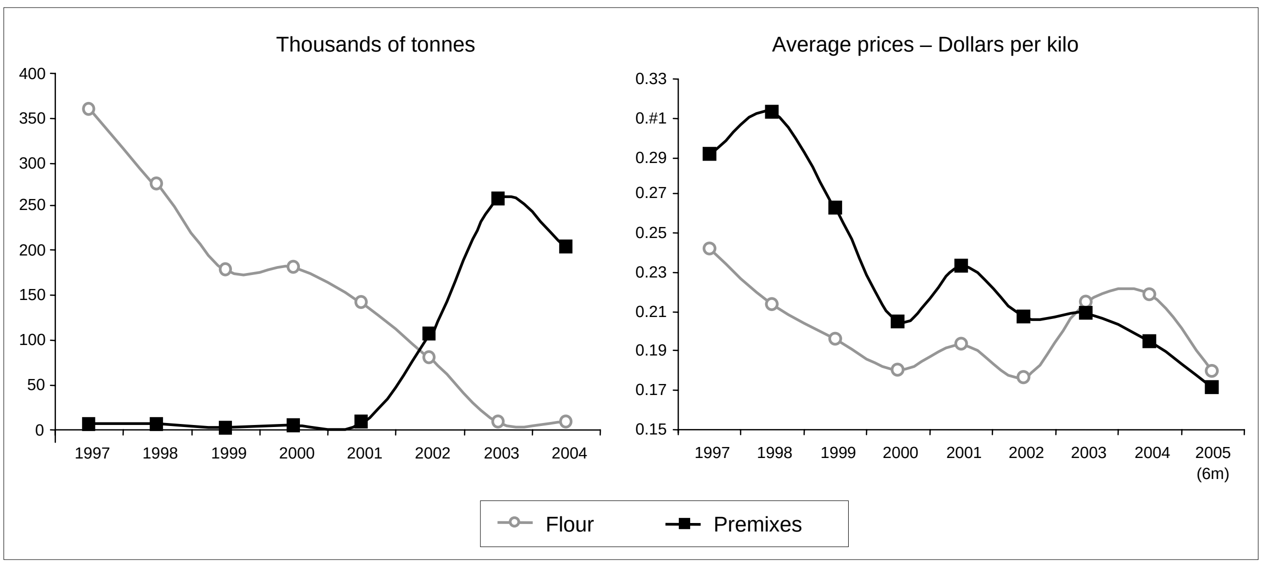
This conflict is a long running one, and is bound up with the existence of different rates of export tax in Argentina, and the effects this has within a productive chain. In the first months of the crisis after the end of convertibility, the Argentinian government decided to put in place a system of export taxes ('withholdings') to increase tax collection, and as a way of moderating the effects of devaluation on prices in the internal exportable products market. Although general rates of 5% and 10% ad valorem were established for manufacturing products and primary products respectively, certain exceptions were envisaged, on which were applied higher rates of up to 20%. Among these were wheat and wheat flour.

As early as the second half of 2002, the Brazilian milling industry began complaining that the system of export taxes applied in Argentina was pushing up the price of raw materials (wheat), and creating a hidden subsidy on the export of premixes[36] (a product on which in Argentina the general 5% rate was applied from the tax on exports manufacturers).

Although the application of a tax in Argentina can barely affect the price of a commodity like wheat (determined by international markets), comments about distortions are relevant: due to the rate differential, Argentinian mills buy wheat at 20% below the export price, while for premixes exports the price received is only 5% below the export price, thus generating a margin of extra profitability for local milling output, compared with foreign producers (in this case, Brazil).

The foreign trade figures speak volumes, and confirm that Argentinian mills made the most of this window of opportunity, quickly substituting flour exports with premixes in order to take advantage of the extra margin created by the differential in withholdings. Nevertheless, premix exports barely replace previous flour shipments, without creating a clear trend for growth in total exports. It is worth stressing that the volume of Argentinian flour or premix imports represents around 4% of these products' sales in the Brazilian flour market.

FIGURE 33
ARGENTINIAN FLOUR & PREMIX EXPORTS



Source: Aliceweb (MDIC).

Another repeated claim by Brazilian millers was the absence of rules regulating the composition of premixes. According to them, this situation was being exploited by Argentinian millers, whom they accused of selling the simple mixture of salt and ordinary flour as a 'premix'. The fact that the average prices of Argentinian premix exports to Brazil were below those for flour during 2003 and 2004 would support the Brazilian argument.

Finally, in June 2005, Brazil's Government decided to regulate wheat flour marketing through new parameters and controls, though this action is not felt to affect shipment of Argentinian premixes to Brazil.

36 'Premixes' are a product derived from flour, with aggregates that allow them to be processed without any aggregates other than water (Viteri & Ghezán [2002]).

C. Special Topics

The Possible Reform of he MERCOSUR Common Automotive Policy

After the conclusion of negotiations between Argentina and Brazil on the *Política Automotriz Común del MERCOSUR* (PACM: MERCOSUR Common Automotive Policy) in March 2000, a transitional regime with regulated trade was established, extending to December 31, 2005, after which date free trade would be adopted.

The administration system of intra-MERCOSUR trade current during the transition provided for balanced trade under free trade conditions, while a growing margin of (potential) imbalance (or *flex*) was stipulated.[37] Similarly, a CET was set for the range of products included under the PACM (with ascending or descending timeframes, accordingly), a minimum subregional content was set for parts and pieces (including 'superlocal' content in Argentina's favor),[38] and limits were placed on support and sectoral promotion measures. After Paraguay and Uruguay's incorporation in the agreement, the protocol of the MERCOSUR Common Automotive Policy was formalized before the Latin America Integration Association (LAIA) in October 2001.

Demands for reformation of the PACM by Argentina began to be heard in 2001. Despite this, formal negotiations started up again in 2002, once Argentina's devaluation had helped ease bilateral conflicts between the regional bloc's two largest members–temporarily, at least. The debate on this topic was thus inserted in the process that came to be called "cleaning the negotiating table."

From Argentina's perspective, the main (almost the sole) point of interest was expanding the flex. The goal was to increase the margin of the flex, and thus loosen what was seen as a 'straightjacket' on Argentinian automotive exports to Brazil, and thus, leaven, if only partially, the serious depression in sales in the Argentinian market.[39]

The renegotiation was concluded by mid-2002. In return for agreeing an expansion of the flex, amendments were specified in response to Brazilian aspirations such as a reduction of the scope of Argentinian 'superlocal' content, which would be applied only to automobiles and light utility vehicles, with a descending timeframe. Likewise, for the balanced trade calculation, neither trade in chassis nor self-propelled machinery (another old chestnut of Brazil's, as the trade balance in these products is generally in the country's favor) would be taken into consideration.

Another distinctive aspect of this agreement that would have a good deal of relevance for future developments, was the inclusion of a clause to promote specialization from warehouses on both sides of the border, aiming at getting them to produce different platforms, and by this indirect route, to prevent excessive concentration of the autoparts industry in just one country. This formalized something reflected in practice: the smaller scale of the Argentinian automotive industrial facilities favored the manufacture of medium sized vehicles –usually with shorter production series. By contrast, the larger scale of Brazilian production facilitated the production of 'long' series for cars with smaller cylinder capacities.

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[37] This rule aimed to give more flexibility to the need to level out the automotive trade. It originally established that the maximum diversion of imbalance might be 3% of the volume of the total trade for the sector in 2000, reaching 10% in 2003. After the renegotiation of the PACM agreed in 2003, the margins of diversion permitted were extended, beginning with a maximum of 33.3% for that year, which would be extended to 45% in 2005.

[38] The original PACM text stated that Argentina could demand a 30% minimum national content for light vehicles, and 25% for trucks. The 2003 amendment reduced this to 20%, scheduled to fall to 5% in 2005, the last year of the special clause's application.

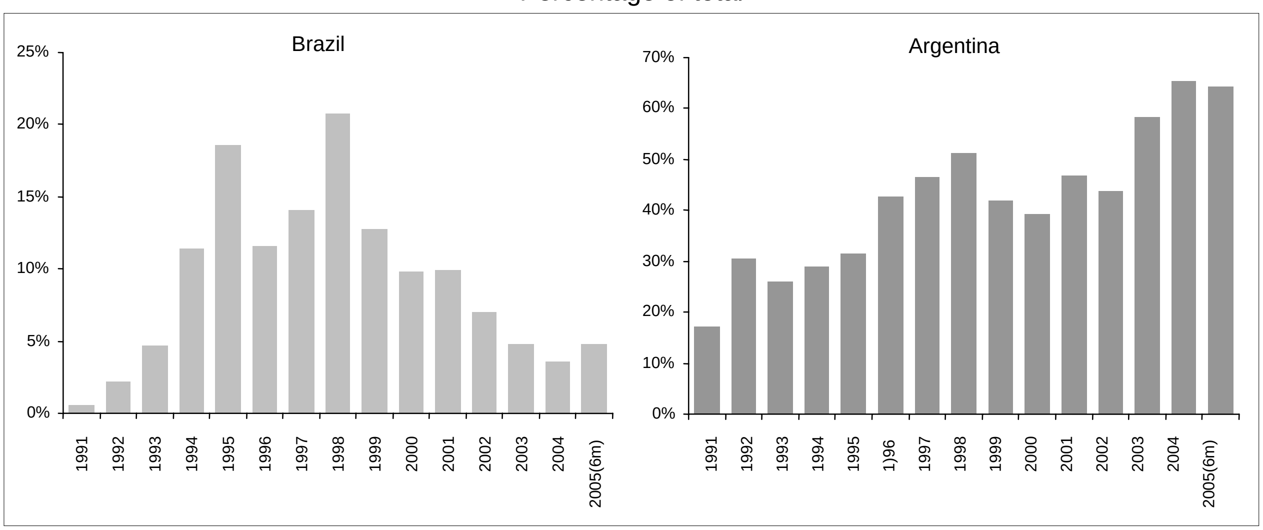
[39] This view was to a great extent paradoxical, as introduction of the compensation regime had been an Argentinian demand since the start of the PACM negotiation in the late 1990s.

Nevertheless, the later trends in bilateral automotive trade did not by any means live up to expectations. The problems arising from the crisis deepened: the market loss suffered by Argentinian automobiles in Brazil increased, and Brazilian supply absorbed a more and more significant share of an Argentinian market on the road to recovery. Brazilian motor vehicles thus came to occupy 56% of total sales in the Argentinian market, a figure that rose to 62% in 2004.

From a longer term perspective, the decline in Argentinian sales to Brazil had already begun in 1999, after the end of the Real Plan. Imports went from a peak of more than 220,000 units in 1998 to around 100,000 in 1999. This level remained fairly steady until 2001, but fell again during 2002. Since then, Argentinian sales in its partner country's market have remained stationary at around 40,000 units, 80% down on 1998. It is important to stress that this decline did not stem from Argentinian supply's relative loss of position against third origin automobiles. Indeed, the Argentinian share in Brazilian imports remained at record levels, around 60%-70% of the total.

In other words, the cause of the decline in Argentina's automotive sales to Brazil was very strong total automotive import substitution. The imported share (from all origins) has been falling steadily since 1998, from a market share of 20% in that year to 3.6% in 2004.[40/41] And, since 2002, an extremely significant parallel increase has occurred in the share of Brazilian cars in the Argentinian automotive market. Since then, the imported supply in the Argentinian market has to all intents and purposes been Brazilian.

FIGURE 34
SHARE OF AUTOMOBILE IMPORTS IN THE LOCAL MARKET
Percentage of total



Source: ANFAVEA (Brazil) and ADEFA (Argentina).

Several factors have had a bearing on these trends. These include the marked disparity in investment in Brazil's favor after the depreciation of the real in 1999. This situation was consolidated with the results of

[40] One of the most notable factors in the reduction of Argentina's presence in the Brazilian automotive market is the waning of the range of models exported. Just four models accounted for 90% of Argentinian shipments during 2004.

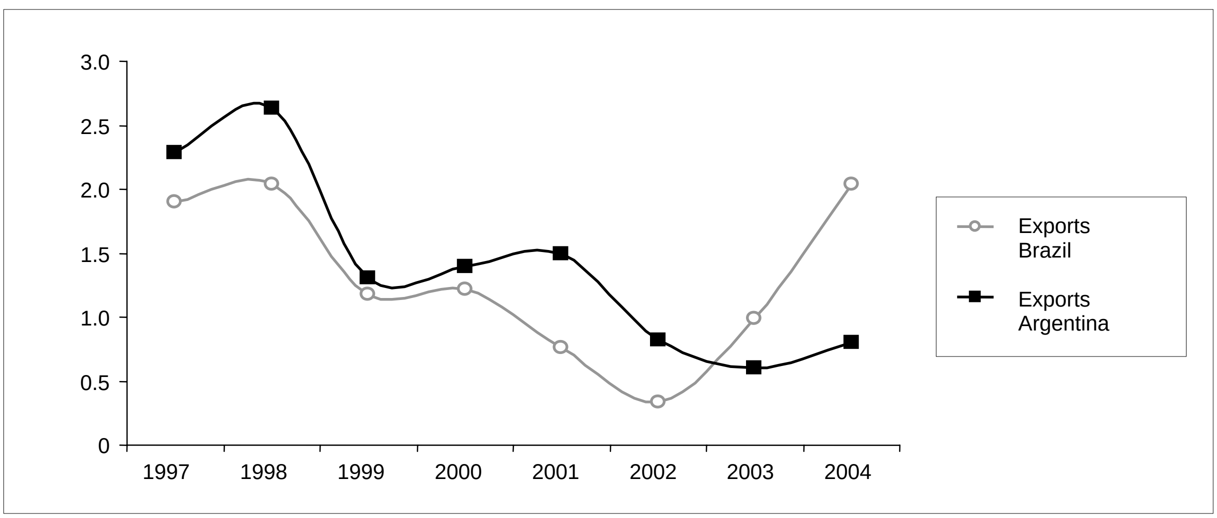
[41] The decline of Brazil's purchases has meant that Mexico has become Argentina's main automotive export market. Paradoxically, despite the sharp rise in Brazilian shipments to Argentina, Mexico is also the main market for Brazilian automobile exports.

the negotiation of the PACM in 2000, which brought certainty over the existence of free trade in the region in the medium term, and with the debacle over the Argentinian automotive market due to the recession and the eventual collapse of convertibility. This marked imbalance in investment flows (and the subsequent extreme scarcity of new platforms for Argentinian plants) brought about a relative aging of Argentinian automotive supply, thus jeopardizing its insertion in the Brazilian market (ABECEB [2004]).

The stagnation affecting the Brazilian automotive market from 1997 also meant low use of installed capacity in Brazilian warehouses, as the new investments were planned on projections based on a market of over 2 million units, while the reality since 2000 has been one of sales stagnating around the 1.6 million mark. This excess capacity meant that companies with warehouses in both countries decided to supply the Argentinian market from their Brazilian plants, and to defer all new investment in Argentina until the existing idle capacity in the Brazilian plants had been eliminated. These 'supply' conditions in Brazil were complemented with shifts in Argentinian demand which, after the sharp fall in average income –as measured in dollars– brought about by the devaluation of 2002, tended toward the purchase of smaller models, thus favoring Brazilian supply (relatively specialized in these types of automobiles).

These market conditions, and the poor investment prospects for Argentinian warehouses, meant that the Buenos Aires government began to hint at the need for a new 'review' of the PACM, in a context marked by growing bilateral sectoral friction caused by the pressure of Brazilian exports, and by the Argentinian decision to 'reindustrialize' its economy.[42]

FIGURE 35
ARGENTINA/BRAZIL AUTOMOTIVE TRADE
In billions of US$



Source: Aliceweb (MDIC).

Faced with this decision, President Kirchner announced in early September 2004 that the schedule for the PACM, setting the start of free trade at 2006, would not be met. From then on the automotive regime

[42] Although new models have been launched, starting in 2004, and others are at the pre-launch stage, relative competitiveness has not varied greatly, due to the fact that conditions of relative obsolescence persist in Argentina's automotive supply (ABECEB [2005]). This view is supported by the fact that a great deal of the recovery in Argentinian car sales over the first half of 2005 is explained by exports of a new model, whose production began early this year.

entered into kind of a stand-by state, where it continues to function but without being sure how it will develop beyond January 1, 2006. Under the circumstances, no formal negotiations were held at government level during the first half of 2005. There were only informal consultations between warehouses and governments in each country.[43]

In negotiations between firms it was agreed to put back the start of free trade until 2008. Although the Argentinian government's initial reaction was favorable, it later switched its position, negating the possibility of a solution via simple postponement, and hinting that the renegotiation of the PACM should go deeper. On the Brazilian government side, there were signs of willingness to renegotiate, although under the circumstances it was decided to postpone this until the second half of 2005.[44]

The only thing agreed is for the renegotiation to be bilateral, at least in the early stages. In terms of the features of any future regime, it must be pointed out that the simple postponement of free trade via a temporary expansion of the flex will not guarantee a modification of the current situation. The asymmetries that led to a fresh postponement of free trade were consolidated in a context of compliance with the guidelines of the flex (SICA 2005).[45]

The Uruguayan Claim over the Industrial Development Regime in Argentina

In February 2002, Uruguay lodged a formal complaint against Argentina with the MERCOSUR Trade Commission in connection with the industrial development regime applied in the provinces of Catamarca, La Rioja, San Luis and San Juan. This regime has a system of tax exemption including exemption from VAT for a fifteen year period. Although the award of new benefits for industrial projects was suspended in 1989, companies whose projects had already been approved –but not implemented– retained the right to enjoy the benefits of the regime for investments up to December 31, 1992, a term later extended to December 31, 1997.[46] In 1996, the Argentinian government decided to expand the regime, allowing companies benefiting to receive up to 21% of the FOB value of exported products in VAT refunds.

According to the Uruguayan stance, this regime contains provisions that involve tax discrimination, restriction on access, and export incentives. Specifically, Uruguay questioned whether the regime discriminates against its suppliers of inputs, as the VAT exemption included in it encourages Argentinian manufacturers to supply Argentinian companies. At the same time, in the Uruguayan view, the regime affects Uruguayan products similar to those of Argentinian producers based in the zones promoted, since Uruguayan manufacturers are affected in terms of competition in both the Argentinian market (Argentinian producers being exempted from VAT) and other markets (receiving export subsidies).

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[43] During the first half of 2005, measures have begun to be adopted to promote investment in the automotive sector. These include the award of subsidies to autopart import substitution for projects with new platforms.

[44] In the interim, the Argentinian government introduced a local incentive regime for the use of local autoparts in projects related to new platforms, and the manufacture of engines and distribution sets. These incentives could cause renewed conflict according to the previsions of PACM Article 16 as modified by the 31st protocol of ECA 14: "automotive products manufactured under any investments made, with projects approved after the entry into force of the current Agreement, and receiving promotional, sectoral and/or regional incentives and/or support, in the Parties, be it from National Governments and their centralized or decentralized entities, from Provinces, Departments or States, or from Municipalities, will be considered as extra-MERCOSUR goods and will not therefore enjoy any tariff preference whatever in trade with the other Party."

[45] The only excesses occurred during the PACM's early years, and were due to a surplus of Argentinian exports, not the opposite.

[46] Projects implemented after that date would only enjoy the benefits for an eight-year term.

According to this analysis, the Argentinian industrial development regime violates provisions of the Treaty of Asunción and CMC Decision 10/94 by establishing VAT linked tax benefits that constitute non-tariff restrictions and tax discriminations against imported products.

After not achieving a satisfactory outcome to the conflict in the processes of the MERCOSUR Trade Commission (CCM) and the CMG by mid-January 2003, the Uruguayan government decided to formally present the case before the MERCOSUR Arbitration Tribunal.

Parallel to the Uruguayan claim, Argentina questioned Uruguay's imposition of specific duties on imports of certain products (including many promoted by the questioned regime), thus violating the provisions of the Treaty of Asunción. Negotiations were held in the framework of the Protocol of Brasilia, and the controversy was then considered by the CMG. No solution being arrived at, Argentina was authorized to request that an Arbitration Tribunal be assembled.

In March 2003, as a result of a meeting between the two countries' Economy Ministers and Deputy Foreign Ministers, the controversy was suspended de facto. The parties reached an agreement by which Uruguay would not take the controversy over industrial development any further, and Argentina would not press the issue of specific duties. After this, and as part of a bilateral negotiation designed to prevent the case formally entering the Sistema de Solución de Diferencias del MERCOSUR (SSDM: MERCOSUR Dispute Settlement System), in late 2003 the Argentinian government dropped the extension of the regime to export operations (the main object of the Uruguayan claim).

In February 2004. Uruguay stated that Argentina's amendment of the rule only dealt with one of its claims, leaving unresolved the issues surrounding the less advantageous conditions Uruguayan products encounter when competing with Argentinian products on Argentinian territory, as well as supplying inputs.

In this regard, Argentina's stance claimed that the provision had eliminated the main Uruguayan claim, and that the other two did not yet have a MERCOSUR rule regulating them. Argentina therefore moved that there was a lack of formal arguments for Uruguay to continue the controversy in the framework of the SSDM, or for it to maintain Specific Tariffs 'mirroring' the Argentinian measure. In January 2005, Uruguay decided to reopen the process, as a result of which steps were taken to constitute the Arbitration Tribunal, a process which, for various reasons, has not reached its conclusion to date.

Contents

CHAPTER 4. THE MERCOSUR 2004-2005 INTERNAL AGENDA

MERCOSUR's internal agenda between July 2004 and June 2005 was to all intents and purposes framed by the 2004-2006 Work Program (CMC Decision 26/03).[47] In addition, there was the possible reform of the Protocol of Ouro Preto, an idea introduced by the Uruguayan Foreign Minister at the Iguazú Summit in July 2004, demanding much negotiating during 2004, particularly from National CMG Coordinators.[48]

After half the term stipulated in the Work Program had been completed, the balance shows some progress in the bloc's consolidation. As mentioned later in this chapter, decisions were adopted that solved pending problems and consolidated integration. Nevertheless, they are still not great enough for MERCOSUR to play a strategic role in its partners' development policies. Proof of this is that at the Asunción Summit in July 2005 it was decided "to prioritize aspects inherent to MERCOSUR's internal agenda," including issues that ensure more effective participation from civil society in the integration process and macroeconomic policy coordination. This reflected the political decision to attempt to change the negotiating trend in the immediate future, regarding the excessive attention the agenda of conflicts and external relations had taken up during the period analyzed in this report.

A. Main Trends in the Internal Agenda

There follows a description of the main events in MERCOSUR's consolidation and intensification agenda between July 2004 and June 2005, mainly concerning the negotiation of future institutional reform, various matters to do with the CET, the handling of asymmetries, progress in services trade liberalization, and the signing of the Protocol of Public Procurement, among other things.

In this grouping, the period's main results are the decision to progress toward eliminating the double levying of the CET for goods not originating from the customs union, the constitution of a *Fondo para la Convergencia Estructural del MERCOSUR* (MERCOSUR Structural Convergence Fund), progress toward liberalizing the movement of physical persons via the adoption of the Agreement for the facilitation of business activities in MERCOSUR, and the adoption and regulation of the Protocol of Public Procurement.

Possible Reform of the Protocol of Ouro Preto

One of the central foci of negotiations during the second half of 2004 was the debate at the Iguazú Summit on the possible institutional reform of MERCOSUR. The reference on this matter was the Council Minutes, stating that "the delegations raised the possibility of identifying any points of the Protocol of Ouro Preto (POP) that may require a revision in terms of MERCOSUR's recent institutional progress."

In this framework, an Ad Hoc High Level Group was set up, in which two major issues were presented: (a) strictly institutional ones, and (b) economic and trade ones. Each topic area was treated fairly independently, and showed very dissimilar trends.

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[47] Besides dealing with traditional economic and trade subjects like improving the CET, customs matters, trade and competition defense, productive integration, incentive disciplines, and macroeconomic coordination, the Program includes institutional matters like the MERCOSUR Parliament, institutional strengthening, and the incorporation of provisions. For its part, the social area includes the participation of civil society, and human rights, among other issues. There is also a 'new integration agenda' to address such areas as cooperation in science and technology, and physical and energy integration.

[48] Over the six-month period, there was a series of Informal Coordinator Meetings. This way of working has been routine since early 2004.

Institutional topics appeared easy to adopt, as this was basically just a case of reflecting in a single instrument any amendments introduced over the years through more minor rules (generally Common Market Council Decisions and/or Common Market Group Resolutions). These included the Permanent Review Tribunal created by the Protocol of Olivos, the Commission of Permanent MERCOSUR Representatives (CRPM), the role of the Forum for Political Consultation & Coordination (FCCP), the operation of the Common Market Council (CMC), the CMG and the MERCOSUR Trade Commission (CCM), how to make the future creation of the MERCOSUR Parliament (PM) compatible (as mooted in the 2004-2006 Work Program), the functions and powers of the Economic and Social Consultative Forum (FCES), the role of the MERCOSUR Secretariat (SM), and the issue of the incorporation of MERCOSUR Rules in national legislation. However, the apparent consensus glimpsed early on gradually evaporated as questions of detail were entered into for each point.

The economic and trade issues, on the other hand, were driven basically by Argentina, and centered upon the ratification of programmatic commitments in the Treaty of Asunción, and the introduction of future intra-MERCOSUR trade measures, or codes for managing investments. In practice it was not possible to make progress over an in-depth analysis of these proposals during the second half of 2004.

Box 1
POP 2 & Member States' Expectations

The arduous negotiating process of the POP's future reform revealed the partners' various different expectations. Stimulated by the potential *symbolic* burden of signing a review of the POP (ten years after its conclusion, and in the same city), Brazil limited its approach to crystallizing the current institutional situation. In parallel, it demonstrated some specific interest in increasing the powers of the MERCOSUR Secretariat, and in limiting proposals linked to the Forum for Political Consultation & Coordination and the Commission of Permanent MERCOSUR Representatives.

Argentina saw an opportunity to include its request for safeguards on intra-MERCOSUR trade in the Protocol, as well as other topics on the internal agenda, which had been incorporate programmatically in the Treaty of Asunción without any specific progress being achieved over the years. In Argentina's view, it made no sense to go to the trouble of reforming of the Protocol (which was then to be submitted to the Congresses) only to seal and order institutions that were already operating in an instrument.

Paraguay centered its strategy on consolidating and increasing the responsibility of the Permanent Review Tribunal and its Secretariat, based in Asunción, as well as on other questions related to receiving more favorable treatment as relatively the least developed country, including the question of the Structural Funds, whose constitution at the time had not still been resolved. Where the Argentinian proposals of non-institutional topics were concerned, Paraguay was generally well disposed to their inclusion in any future reform.

Lastly, Uruguay took up a similar stance to Brazil in terms of the range of topics to be addressed. It was also rather concerned about questions relating to the Permanent Review Tribunal and its Secretariat, lest the allocation of more responsibilities for the MERCOSUR Secretariat in Montevideo be limited through such bodies. At the same time, Uruguay viewed the Argentinian proposal on safeguards with some suspicion, given the possibility that this mechanism may affect its exports to partners.

With the date of the Ouro Preto Summit approaching, and lacking the necessary minimum consensus over both issues, negotiation was clearly not sufficiently well advanced to anticipate the signing of a POP 2. Under these circumstances, the Brazilian Pro Tempore Presidency informally brought up the possibility of the Summit being used to convene an immediate Diplomatic Conference with a view to concluding the draft of the new instrument during 2005.

Yet paradoxically, despite all the efforts made over POP 2, and the expectations generated in connection with the process, no mention was made of future institutional reform at the 2004 Ouro Preto Summit, and the issue gradually evaporated to the point of virtually disappearing from the internal negotiating agenda. Nevertheless, it has clearly remained a latent issue that can be addressed less urgently.

Box 2
The Vicissitudes of the POP 2 Negotiation

Negotiating the Institutional Package

The *Forum for Political Consultation & Coordination*: while Argentina was well-disposed to granting a decision-making role, and allowing Associate States greater active participation in this area, the other partners (mainly Brazil) wanted it to retain its current status as a consultative forum and for Associate States to go on being invited.

The *Commission of Permanent MERCOSUR Representatives*: doubts were raised about the suitability of consolidating the Commission's existence in an international instrument, fully aware that it owes its existence primarily to the political need of one of the Member States, rather than to any in-depth debate over the benefits of having such a body.

The *MERCOSUR Secretariat*: Brazil and Uruguay agreed to grant the Secretariat greater powers, and even for it to answer directly to the Council and be responsible for all technical cooperation projects. Argentina, however, felt that the process of restructuring to form a technical secretariat had just been concluded, and preferred to have more time to analyze the suitability of new responsibilities.

MERCOSUR Rules: a variety of options were presented, and there was no clarity over whether MERCOSUR should advance in the direction of the direct application of provisions or not.

The *Decision-Making System*: Argentina wanted to include a provision allowing the CMC to establish a decision-making system other than that by consensus.

Other topics dealt with were to do with the powers of the current decision-making bodies, the issue of the budget, the MERCOSUR's legal sources, and the participation of Associate States.

The 'Non-Negotiation' of the Economy/Trade Package

The economic and trade proposals put forward by Argentina reaffirmed certain commitments already assumed in the Treaty of Asunción. In this sense, it proposed a ratification the need to take steps to guarantee the free circulation of goods, services and productive factors in order to consolidate the Customs Union. To these ends, the partners were to bring into effect a MERCOSUR Customs Code to consolidate the CET, and adopt the principle of mutual recognition of goods to be traded.

In addition to this, Argentina included the commitment to implement sustainable financing schemes to encourage regional competitiveness and structural convergence, as well as strengthening institutional structure and consolidating integration. It also provided for the adoption of a Physical Infrastructure Works Plan and the constitution of a Production Commission.

A special point referred to the need to ensure equal conditions for competition in the region via the establishment of common disciplines in terms of incentives and investments, and via the promotion of integration and complementation of its productive sectors. With this in mind, the States should formulate a 'Code of Conduct' for international companies operating in the region. Argentina thus sought to put on the MERCOSUR agenda an issue it was pressing in its bilateral agenda with Brazil.

At the same time, Argentina also proposed adopting the commitment to designing instruments to protect Member States' national production, as a result of rising imports from other partners, and protecting national economies from any heavy macroeconomic turbulence. The proposal suggested that, as long as such instruments had not been agreed, partners could apply temporary mechanisms to avoid structural impact on intra-industrial development. In short, Argentina used euphemisms in the draft to introduce the possibility of applying safeguards on intra-MERCOSUR trade, as described in Chapter 2.

The CET

The existence of a common trade policy is one of the fundamental features of all customs unions. Such a policy's basic instrument is a current CET, although obviously it is not the only requirement. Other elements are necessary, such as uniformly applied special import regimes, a single trade defense policy, and the granting by all partners of equal tariff preferences to third parties, among other matters.

In terms of the tariff, a pragmatic approach can be discerned in the history of MERCOSUR regarding the goal of applying a common rate for imports from extra-MERCOSUR. In this sense, even when the CET was defined across virtually the whole tariff board in 1994 (excepting the automotive and sugar sectors), there have been many mechanisms allowing partners to apply numerous diversions of the levy established at community level.

Salient examples include convergence schedules for capital goods and information technology and telecommunications goods, temporary increases of the CET, waivers granted to various countries, the permanence of special national import regimes –particularly draw back and temporary admission–, and bilateral preferences granted by Member States.

With the exception of the last point, which looks as if it is correcting itself as the agreements signed by MERCOSUR with the other LAIA countries are improved,[49] a snapshot of the current diversions in the application of the CET can be described on the basis of a set of Decisions adopted by the CMC in December 2003. Indeed, on that occasion, the Council put back the finalization of the CET to 2011 (abandoning the 2006 date in advance, as provided for in the Relaunch Package) through CMC Decisions 31/03 (CET), 32/03 (Special Import Regimes), 33/03 (Information Technology & Telecommunications Goods), and 34/03 (Capital Goods).

[49] See Chapter 5 of this Report.

Box 3
The CET & the Decisions of December 2003

CMC Decision 31/03, CET

Through this measure it was decided:

- to extend the list of 100 articles exempt from the CET per Member State, provided for in CMC Decision 68/00, to December 31, 2005.
- to allow Paraguay and Uruguay to respectively retain 150 and 125 additional exempt articles until 2010.
- to extend Paraguay's entitlement to maintain the 399 exceptions detailed in Decision 7/94 until 2010.

CMC Decision 32/03, Special Import Regimes

Through this measure it was decided:

- to authorize Paraguay to retain its raw materials regime up until December 31, 2010, for a reduced list of tariff items to be determined before December 31, 2005, which Paraguay may import at 2%.
- to extend the opportunity for partners to use draw back and temporary admission regimes for intra-MERCOSUR trade until December, 31, 2010.
- to authorize Paraguay and Uruguay to apply a rate of 2% up until December 31, 2010, for a list of items from such inputs to be determined by each Member State before December 31 2005, provided these countries do not use draw back and temporary admission in importing extra-MERCOSUR agricultural inputs.

CMC Decision 33/03, Information Technology & Telecommunications Goods

This measure approved the following:

- to continue monitoring information technology and telecommunications goods (ITTG) in order to maintain the competitiveness of Member States' economies.
- to negotiate a Common Regime for Information Technology & Telecommunications Goods in the framework of the CCM, to be approved by the CMG before December 31 2005.
- to authorize Paraguay and Uruguay to apply a 2% tariff up to December 31, 2010, for extra-MERCOSUR ITTG imports.
- to define an ITTG list before March 31 2004, for which Member States may apply a tariff of 0% up until December 31, 2005, subject to quadripartite consultation.

CMC Decision 34/03, Capital Goods

This Decision established:

- The Common Regime for Capital Goods Produced outside the Subregion that will come into effect on January 1, 2006.[50]

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[50] It must be remembered that the entry into force of the Common Regime for Capital Goods Produced outside the Subregion (BK) overlaps with the deadline of the waiver allowing the Member States to apply a 0% tariff for the import of BK.

- to extend capital goods import regimes current in Member States, up until December 31, 2005, including any unilateral measures authorized by CMC Decision 2/03, Exceptional Tariff Measures, which allowed a reduced CET to applied on extra-MERCOSUR capital goods imported by Argentina, Paraguay and Uruguay.
- to authorize Paraguay and Uruguay to apply a 2% tariff on extra-MERCOSUR imports of capital goods, with the exception of those included in the common regime as from their entry into force, which will have a 0% tariff.
- to establish a commitment to continue monitoring the situation of capital goods with a view to maintaining the competitiveness of Member States' economies.

Besides these measures, the 2004-2006 Work Program (CMC Decision 26/03) also provided for other CET-related tasks:

i) making progress in the elimination of double levying and finding a solution to the issue of customs revenue distribution;

ii) identifying high-priority sectors for the establishment of common special import regimes;

iii) carrying out the mandate of the High Level Group in the sense of examining the consistency and dispersion of the CET's current structure, and assessing the eventual reduction in protection levels and tariff dispersion in Capital Goods, and Information Technology and Telecommunications chains occurring or not in MERCOSUR.

The main breakthroughs for this mandate in the three areas over the second half of 2004 and first half of 2005 are presented below.

i) Double Levying of the CET

The issue of avoiding double levying of the CET for goods circulating in the customs union came onto the MERCOSUR agenda driven by external demand. Indeed, it was in the framework of the MERCOSUR/EU negotiation that the EU laid down the condition that the Association Agreement being negotiated was to guarantee single payment of the tariff on goods circulating within MERCOSUR.

This demand was less ambitious than free circulation,[51] but still represented a great challenge for the South American bloc. Indeed, only goods originating in MERCOSUR (complying with the rules of origin regime) could circulate freely within the customs union.[52] The rest of the goods not complying with the MERCOSUR rules of origin (either because, once produced, they did not meet the regime's requirements, or because they had been imported from outside MERCOSUR) had to pay the CET again when crossing another national border within the union.

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[51] The concept of free circulation involves not only non-payment of the tariff in intra-MERCOSUR trade for all kinds of merchandise, but also other measures affecting imports such as internal taxation, compliance with sanitary and technical measures.

[52] Trade Commission Directive 3/04 was approved with this in mind. This Directive provided that MERCOSUR goods shipped for consumption in a Member State could be exported to the other Member States –even to the State of origin– without missing out on preferential treatment or its original nature, albeit with certain limitations. At the same time, the MERCOSUR Rules of Origin Regime (CMC Decision 1/04) laid down that, to establish whether a good for which preferential tariff treatment has been requested is original, its production in the territory of one or more Member States by one or more producers has to be taken into account, as if it had been made in the territory of this Member State. This regime was regulated by CCM Directive 4/04.

In this respect, the 2004-2006 Work Program had established that "in the first half of 2004 a mechanism proposal be designed to eliminate the double levying of the CET and resolve the issue of customs revenue distribution." To do this, technical studies by the MERCOSUR Secretariat, and negotiations at the Commission of Trade and the CMG were carried out.

Box 4
Double Levying & the Technical Alternatives Identified

The MERCOSUR Secretariat presented three alternatives concerning the circulation of goods within the expanded space, avoiding the double levying of the CET:

1) A first scenario, applicable solely to extra-MERCOSUR goods. This involved returning the amount paid in import duty on goods that, having entered through a Member State, were reexported to another MERCOSUR partner.

2) A second scenario, applicable to goods complying with the common trade policy. These commodities would be treated as originating in MERCOSUR, and would be issued with a certificate at customs in the Member State through which they had entered, enabling them to circulate within the customs union.

3) A third long term scenario involved setting up a single customs territory, and required the definition of additional trade policy instruments (a common customs code, common special import regimes, common trade defense, the elimination of intra-regional trade promotion policies, the elimination of intra-regional trade defense policies, and a common competition defense policy).

On the issue of customs revenue distribution, three alternatives were identified:

- The levying of extra-MERCOSUR goods at the final destination, compatible with scenario 1.

- The establishment of a transition period in which any changes in the circulation deriving from modifications to the rules of double levying provided in scenario 2 would be monitored, or any subsequent modifications to customs revenue appropriation. During this period, the creation of a fund was to be implemented, guaranteeing the offsetting of any negative effects in the country or countries potentially threatened by a decrease in collection (basically, landlocked Paraguay).

- The creation in the medium term of an institutional structure to manage the common revenue generated by scenarios 2 and 3, allocating it according to a given approach (either transfer to each partner, or financing a common MERCOSUR policy).

The main difficulties lay with the position of Paraguay, a country seeking to make headway in issues relating to customs union improvements, before addressing the double levying of the CET. In actual fact, their main concern seemed to be bound up with the need to guarantee a minimum customs revenue, while import duties represent approximately 18% of Paraguay's total tax revenue.[53]

CMC Decision 54/04, The Elimination of the Double Levying of the CET and Customs Revenue Distribution, was passed in December 2004. This measure established the general principle that goods imported from third countries by a MERCOSUR Member State, and complying with the common tariff

[53] Import duties for Argentina represent 3% of the total collected, 2% for Brazil, and 5% for Uruguay (Villela & Barreix [2004]).

policy,[54] would be treated as MERCOSUR goods, in terms of both circulation within the bloc, and their incorporation in productive processes.[55]

This Decision set a precedent which would come into effect by December 31, 2005, at the latest, when it would be applied to goods imported from third countries to which a CET of 0% would apply in all Member States. It would also apply to those goods to which, in quadripartite and simultaneous fashion, partners applied 100% of tariff preference in the framework of agreements signed by MERCOSUR.[56] To these ends, the CCM was urged to regulate the issue, and to define a positive list of goods that would meet these conditions.

Likewise, the measure provided that, no later than 2008, Member States should approve and bring into effect the MERCOSUR Customs Code, the on-line interconnection of customs administration information technology systems, and a mechanism for distributing customs revenue, with a view to extending such treatment to the rest of the tariff range.

ii) *Common Special Import Regimes*

In 2000, the Member States committed to completely eliminating all special unilateral import customs regimes on January 1, 2006, involving the total or partial suspension of customs duties on the temporary or permanent importation of goods, and whose goal is not the improvement and subsequent reexportation of the resulting goods for third countries, excepting special customs areas (CMC Decision 69/00).

In this context, the idea was that regimes to be kept on were to be the object of a common discipline. The Common Regime for the import of capital goods not produced in the subregion was thus approved (CMC Decision 34/03), the negotiation of a common regime for ITTGs was stipulated by December 2005 (CMC Decision 33/03), a Common Import Regime for goods destined for Scientific and Technological Research was approved (CMC Decision 36/03), and special disciplines in the ITTG sectors were defined for Paraguay and Uruguay, and in agricultural products and the import of raw materials for Paraguay (CMC Decisions 32, 33 & 34/03). This was in addition to the use of draw back and temporary admission for the intra-MERCOSUR trade being extended until December 2010 (CMC Decision 32/03).

In parallel, the 2004-2006 Work Program provided that high-priority sectors be identified for the establishment of common special import regimes. On the basis of this mandate, the Trade Commission has been working on the issue, aiming to define a common list of Capital Goods not produced in the subregion (as contemplated in the approved Common Regime), and on the analysis of proposals relating to new common regimes for ITTGs, goods for health and education, and a common naval industry regime.[57]

At the same time, the CCM is also analyzing other kinds of special national import regimes, rescinding of which as of January 2006 does not seem feasible, but about which a specific decision will have to be taken.

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[54] Under this Decision, payment of the CET is understood as "compliance with the common tariff policy" in the case of definite imports or, where appropriate, of the tariff resulting from applying the same tariff preference on the CET by all MERCOSUR Member States in trade agreements signed with third countries, or common measures resulting from applying trade defense instruments.

[55] It must again be stressed that this treatment goes beyond the simple goal of avoiding multiple payments of the tariff for those goods imported by a partner that are circulating in the customs union, since granting treatment as originating means that goods are calculated on the percentage of regional content stipulated by the MERCOSUR Rules of Origin Regime.

[56] As long as they originally come from the country or group of countries the preference is granted to.

[57] Apart from these works, Argentina announced its intention at the CMG meeting last October to prorogue the waiver for BK for five years (without bringing the common regime into effect), and the national CET exceptions lists for two years.

Examples of this type of situation include regimes for the import of goods for states of emergency and catastrophe, goods for diplomatic staff, postal deliveries with no commercial value, and commercial samples.

iii) *The High Level Group*

The 2004-2006 Work Program ratified the need to comply with the mandate of CMC Decision 5/01, creating the High Level Group for the CET, and gave it the mandate of assessing the consistency and dispersion of the CET, and the possible reduction in levels of protection and tariff dispersion in Capital Goods chains, Information Technology and Telecommunications, produced or not produced in MERCOSUR Member States. Other than this mandate, the forum held no meetings during the second half of 2004 and the first half of 2005.

Structural Funds

The origin of the approach to Structural Funds in MERCOSUR goes back to February 2003, when Paraguay presented a document to its partners analyzing the country's situation in the framework of the integration process, as well as a series of projects whose exclusive beneficiary was Paraguay, and which considered such matters as the temporary application of intra-MERCOSUR tariffs, the flexible application of the CET in bringing down the purchase price of extra-MERCOSUR capital goods and inputs, the application of a more flexible rules of origin regime, support in external negotiations, and the allocation of funds to reverse structural problems in the Paraguayan economy.

In short, Paraguay was requesting differential treatment in MERCOSUR justified by its need to achieve higher levels of development. The Paraguayan proposals signified a sea change in MERCOSUR's operational logic. Indeed, MERCOSUR had in the past adopted pragmatic measures of special and differentiated treatment, characterized by the granting of longer deadlines for compliance with common obligations, and by greater flexibility in the application of certain commitments for the smaller countries, although, in the medium and long term, the rules were the same for all partners.

In this context, it was feared that the 2003 Paraguayan proposals would damage the bloc's cohesion, establishing unilateralities running counter to the goal of building a common market.

However, at the Summit the same year, the CMC did approve several measures linked with special treatment. Among these were CMC Decision 27/03, ordering that studies be carried out in 2004 to establish Structural Funds in MERCOSUR designed to raise competitiveness in the smaller partners and the less developed regions[58] (a commitment also appearing in the 2004-2006 Work Program).

Six months later at the Iguazú Summit, CMC Decision 19/04 on Structural Convergence In MERCOSUR & Financing the Integration Process was approved. Negotiated on the basis of a proposal by the CRPM,[59] this Decision created a High Level Group (GAN) to identify initiatives and programs to promote competitiveness in partner countries –particularly the smaller economies– and structural convergence, and proposed formulas for its funding (as well as the operation and strengthening of MERCOSUR's institutional structure).

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[58] At the same time, the Council defined other measures reflecting special treatment for Paraguay, such as one providing that MERCOSUR would push for differentiated treatment for Paraguay in all external negotiations with third parties and country groupings, in accordance with its status as a smaller economy with no maritime access (CMC Decision 28/03). A more flexible Rules of Origin Regime for Paraguay (CMC Decision 29/03), lists of additional exceptions, also effective for Uruguay (CMC Decision 31/03) and special import regimes for agricultural raw materials and inputs (CMC Decision 32/03).

[59] The CRPM played a key role in the negotiation process of the Structural Funds.

On this last point, it was the CRPM that proposed that the funds were also targeted at financing MERCOSUR's institutional structure. It thus tried to comply with another Decision (CMC Decision 15/03) fixing the mandate to propose mechanisms for the financing of the Commission's Presidency, though it should be borne in mind that, temporarily, such financing at present devolves on the Member State holding the Presidency.

Paraguay and Uruguay, for their part, stated emphatically that the negotiation should focus on the destination of the funds, while Argentina and, to a lesser extent, Brazil preferred to start negotiations about the origins of such funds.

One of the central issues was the mechanism for establishing the make-up of such a fund. Argentina first insisted that it should come from revenue with a specific destination (for example, a rate on imports, an increase in the CET, etc.), as against the alternative of budget resources, which were subject to the national distributive conflicts of each Member State. The amount mentioned was approximately US$ 0.8 billion (at the suggestion of the CRPM), 10% of which would be targeted at institutions.

At the Ouro Preto Summit, there were hopes of approving a series of outlines for the composition of the Fund, agreed by the GAN. However, some delegations raised the need for greater internal analysis, particularly in connection with financing the institutional structure. Lastly, the less ambitious Decision 45/04 was approved, which merely established the Fund and noted the GAN's efforts, instructing it to continue in the same vein.

The GAN continued to work in the first half of 2005, and CMC Decision 18/05 was eventually approved at the 28th Council. This created the Fondo para la Convergencia Estructural del MERCOSUR (FOCEM: MERCOSUR Fund for Structural Convergence) with an annual budget of US$ 0.1 billion, progressively building up over a three year period (50% during the first year for pilot projects, 75% the second year, and 100% as of the third year).

The FOCEM's aim will be to finance programs to promote structural convergence, develop competitiveness, promote social cohesion –particularly in the smaller economies and less developed regions– and "to support the operation of the institutional structure and the strengthening of the integration process." Here the measure clearly states that any programs linked to this objective "will set about improving MERCOSUR's institutional structure and future development. Once the project objectives have been achieved, any resultant structures or activities will be financed by the Member States in equal parts."

Its composition will take into account each country's GDP, with 70% being contributed by Brazil, 27% by Argentina, 2% by Uruguay and 1% by Paraguay. 48% will be distributed to projects presented by Paraguay, 32% to Uruguayan projects, 10% to Argentinian projects, and 10% projects from Brazil. Contributions from third countries or institutions and international organizations may also be received, under Article 9 of Decision 18/05, which reads: "The FOCEM will be able to receive contributions coming from third countries, institutions or international organizations for project development." In any event, given these percentages, Brazil and Argentina will be the major contributors, and Paraguay and Uruguay the major beneficiaries.

The Decision also provided that beneficiary Member States will contribute to any projects financed with FOCEM funds, representing at least 15% of each project's total cost. Projects will be presented to the CRPM, and a technical authority of the MERCOSUR Secretariat will be responsible for assessment and follow-up.

Lastly, it was stipulated that the GAN present a FOCEM Regulation Project by November 30, 2005. A central issue to be decided will be the question of the decision-making mechanism. Clearly, in a financial-style mechanism with differential contributions from the partners, the rule of consensus may not be the most acceptable for all partners.

Trade in Services

In 1997, the Member States signed the Protocol of Montevideo on trade in services, an instrument establishing the objective of total liberalization of trade in services in MERCOSUR over a 10 year period, through annual Negotiation Rounds, broadening the initial 1998 commitments by each of the Member States. The Protocol provided that each member immediately and unconditionally grant Most Favored Nation (MFN) status to the other partners' service providers, national treatment and market access benefits being limited to the sectors and benefit types defined in national lists of specific commitments to be negotiated annually.

Although the Protocol and its lists of initial commitments are not currently in force,[60] the annual rounds of talks stipulated in it have been developing. A positive list approach was taken. These positive lists were designed in the early stages to increase transparency and consolidate the status quo of the restrictions on MERCOSUR trade in services, with a gradual specification of the features of these access restrictions.

The 5th Round of Negotiations on Specific Commitments in the area of services was called in December 2003. The results were to be submitted to the CMC at the end of 2004. In terms of sectors, audiovisual services, advertising, telecommunications and financial services were defined as high-priority. Regarding the elimination of limitations, a survey of the Services Group concluded that there were few restrictions based on Executive Powers' rules of competence. Their elimination or reduction therefore demanded a firm hand from governments in presenting bills to their respective Congresses.

In this context, the 5th Round of the Services Group focused on the restrictions on the movement of persons providing services (known as Mode 4) via the harmonization of the categories used in the lists of commitments. It was agreed to adopt the following categories: (a) business persons, (b) intracorporate transfers, and (c) foreign company representatives. Argentina, Brazil and Uruguay also agreed to include a fourth category in their lists, namely, professionals and specialized technicians.

The Round was approved by CMC Decision 29/04 in late 2004, transferring Mode 4 horizontal commitments to the new classification. The lists were also improved by incorporating the elements offered by MERCOSUR in the EU negotiations (in this area new commitments from Argentina and Brazil in the sector of financial services were particularly significant) and the changes in Member States' legislation (which, in some cases, involved the introduction of new limits).

On that same occasion, the 6th Round of Negotiation was launched (CMG Resolution 33/05) to be held during 2005, with the aim of making progress in the liberalization/elimination of restrictions, and wrap up the process of consolidating the status quo and explaining any 'non-consolidated' entries for all sectors, and all modes of service provision. The Services Group was also instructed to submit harmonization proposals to the CMG for regulatory frameworks and horizontal and/or sectoral commitments.

Business Facilitation

Aside from the negotiation Rounds on specific commitments, the 20004-2006 Work Program dealt with other Mode 4 service provision related issues. Specifically in terms of business facilitation, it stipulated a need to "identify (...) the necessary instruments to facilitate the location and development of business activities in MERCOSUR in establishing companies, business visas, harmonization of sums demanded from investors, and the setting up of MERCOSUR companies."

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[60] Brazil's Executive Power currently has to promulgate this for it to come into effect there, and in Argentina and Uruguay (the three countries that have internalized the Protocol).

In this context, CMC Decision 32/04, Agreement for the Facilitation of Business Activities in MERCOSUR, was approved in December 2004. This measure, not yet in effect, reduces the obstacles for the establishment of businessmen from the Member States. In this sense, the Agreement will enable temporary or permanent residence permits to be granted immediately to investors, board members, administrators, managers and legal representatives, and the amount demanded from investors to process their residence permits to be reduced to US$ 30,000. The measure also authorizes persons to direct and/or administrate companies, as well as providing the opportunity to represent the company in law.

Box 5
Progress in the Liberalization of the Movement of Physical Person (Mode 4)

- The Agreement for the Creation of the MERCOSUR Visa (CMC Decision 16/03) created a harmonized, uniform procedure in the area of migration and work authorization, and facilitated the procedures for service providers from Member States who apply for entry to provide services temporarily in the territory of a Member State, under work contract in the Member States entered.

- The Mechanism for Temporary Professional Practice (CMC Decision 25/03) provided directives to conclude Framework Agreements for Reciprocal Recognition between Professional Entities, and for disciplines to be devised for the granting of temporary licenses, setting minimum criteria and mechanisms, providing for the existence of quadripartite organizations in each profession or group of professions, enabling the incorporation of entities from each profession in the relevant Framework Agreement, and finally, establishing a dispute settlement mechanism.

It should be pointed out that both instruments are undergoing internalization for entry into force.

Government Procurement

In December 2003 the CMC approved the Protocol of MERCOSUR Government Procurement with CMC Decision 40/03. The objective of this instrument was to gradually extend non-discriminatory treatment in procurements made by public entities to the suppliers and providers established in the Member States, and to the goods, services and public works originating there.

Later amendments demanded a redesign of the instrument, which was approved in December 2004 by CMC Decision 27/04 (rescinding the earlier CMC Decision 40/03). The Protocol is applied to the procurement undertaken by the entities at every level of government, federal and subfederal, for the acquisition of goods and services (including public works) via any contractual method, without prejudice to the reserves that Member States established in the Protocol itself. The instrument also listed the entities mentioned in the Protocol, the goods, services and public works, and the thresholds below which application is not obligatory.

Discrimination will be eliminated gradually through positive and negative lists, and the setting of new thresholds. These elements may be modified through negotiations held every two years, or on application by one or more partners. It is interesting to note that the lists and thresholds provide for differentiation between countries, considering the asymmetries existing within the bloc. This undoubtedly constituted a very pragmatic approach to the treatment of regional disparities.

Regarding reserves, Argentina and Brazil exempted subfederal entities. Paraguay, for its part, was freed from its obligation to grant Argentina and Brazil access to its government purchasing market (until the opening of the markets of state and provincial governments bordering on Paraguay).

Regarding the ‘negative lists of goods’, government purchases of which are excluded from the Protocol, there is a general list for Argentina, Brazil has not presented restrictions in its supply of goods, Paraguay is committed to negotiating it, and Uruguay presented separate lists for Argentinian and Brazilian goods, and has committed itself to negotiating one for Paraguayan goods.

Annex 5 established the thresholds as follows:

Country	Currency	Goods & Services	Works
Argentina	US$	150,000	
Brazil	US$	75,000	3,000,000
Paraguay	US$	200,000	
Uruguay	US$	200,000	

Among the exceptions to National Treatment (additional to the negative lists) Argentina was allowed to apply such Treatment after a five year period, during which the preference received by national suppliers will decrease against Brazil on the one hand, and Paraguay and Uruguay on the other. Thus, in Year 1 of the Protocol, Argentina may award the contract to the national offerer when the difference between theirs and a Brazilian supplier’s proposal is no higher than 5%, or 4% if the supplier is from Paraguay or Uruguay. This difference is reduced to zero by Year 6.

At the same time, Paraguay and Uruguay reserved the power to apply this type of preference to their national offerers without setting any limits in terms of the amount of the difference or the time. Lastly, the Protocol also contains disciplines in the areas of contract values, rules of origin, rejection of benefits, compensations and technical cooperation, among others.

Similarly, in line with the provisions of the 2004-2006 Work Program the regulation of the Protocol was negotiated, being approved by CMC Decision 55 of December 2004. It should be pointed out that both instruments (Protocol and Regulation) are scheduled to come into effect with the approval of two or more Member States, a situation that has not yet occurred.

Progress in Other Internal Agenda Issues

INTRA-MERCOSUR CUSTOMS PROCEDURES

In November 2004 the CMG approved CMG Resolution 34/04, by which it provides for the development of a mechanism designed to simplify customs procedures for commercial operators from Member States who meet certain requirements (minimum experience in the activity and as importer and/or exporter, a minimum number of intra-regional operations, etc.).

The proposed mechanism will include procedures designed to move sanitary controls, and technical regulations and their equivalents for exports by authorized operators, away from borders (either because authorization of the exporting country’s facilities by the importing country is already underway, or because the products are protected by mutual recognition agreements between the certifying bodies). Similarly, the necessary means must be put in place for the effective implementation of electronic control of customs traffic and electronic data exchange for export customs procedures to be combined with the relevant import data.

Over the first half of 2005, the Commission has been deliberating the issue, especially the methodology and procedure for qualification as an authorized operator, as well as the range of intra-MERCOSUR customs procedures to be simplified and harmonized. However, progress in this work is related to the definitions of the MERCOSUR Customs Code still pending, which are the territory of the CMG.

Facilitation Mechanism For Intra-MERCOSUR Trade

With CMG Resolution 21/05 in June**,** the CMG established a mechanism enabling an urgent solution to specific problems of market access due especially to non-tariff restrictions via the adoption of trade facilitation measures.

These particular situations will be studied on a case-by-case basis by the Trade Commission's National Coordinators under the following conditions: (a) a commodity originates in MERCOSUR, (b) the commodity is being held in the territory of a Member State, (c) the situation stems from action or measures adopted by a Member State, (d) the actions or measures questioned are not the object of an ongoing dispute between the parties involved, or any legal action.

The Integration of Productive Processes

To facilitate the integration of regional productive chains, CMC Decision 3/05 (approved during the 28th Meeting of the CMC) created a regime enabling the integration of productive processes undertaken in different Member States using material from third countries. The goods benefited by this regime may be targeted at the Member State's internal market where the productive process was concluded, exported to another MERCOSUR Member State, or exported outside MERCOSUR.

Companies wishing to make use of the benefits of this regime will present a project to the competent authority of each Member State. This will then be analyzed and approved by the CCM.

Facilitation Measures for Imports Of Paraguayan Products

A mandate had been included in the 2004-2006 Work Program to identify cooperation measures and information regarding technical or administrative measures with a view to facilitating Paraguayan exports to the region's markets.

Paraguay only presented a proposal in June 2005, on the basis of which CMC Decision 04/05 was drafted. In accordance with the ruling, Paraguay committed itself to establishing an information system known as the *ventanilla única del exportador* or 'single exporter window', by which the Paraguayan State will make data on exporters, producers, products and establishments available to the partners' Customs Administrations as from January 2006.

Via this procedure, Paraguay will guarantee the traceability of products from production stage to export, and eliminate the opportunities for customs fraud and crime. In short, this constitutes an effort by Paraguay to make trade operations more transparent. For their part, the partners will instruct their Customs Administrations to implement any technical or administrative measures necessary to carry out the consultation, with a view to facilitating trade in Paraguayan products to the region's markets.

MERCOSUR Foot-and-Mouth Disease Programs

After an initiative from the CRPM, CMC Decision 8/05 was approved. By this it was decided to coordinate policies and action to combat foot-and-mouth fever in the region. The Meeting of MERCOSUR Agriculture Ministers was enjoined to devise a Draft Plan with the CRPM, to be presented in October 2005, and containing the definition of the Plan's scope, contents and terms of implementation, a timeframe for the adoption of any harmonized measures felt necessary by Member States to make viable the implementation of the Action Program, identifying technical bodies responsible for the task in each country, the specific prevention measures to be complied with by participating partners and Associate States, sanitary surveillance systems to provide information on the development of conditions in participating Member and Associates States, the indication of the national authorities responsible for implementing the MERCOSUR Foot-and-Mouth-Free Action Program, and the identification and assessment of possible sources of technical and financial cooperation that may be used in the MERCOSUR Foot-and-Mouth-Free Action Program.

THE MERCOSUR PARLIAMENT

The presidents of the MERCOSUR partner countries in 2003 agreed on the need to establish a MERCOSUR Parliament, and entrusted the drafting of the Constitutive Protocol to the Combined Parliamentary Commission (CPC).[61]

At the Iguazú Summit, the CPC presented a draft proposal for the Constitutive Protocol. At the same time, the CMC approved CMC Decision 49/04, which brought continuity to the creation of the institution, stipulating that it will be set up by December 31, 2006, and investing the Combined Parliamentary Commission with the status of a preparatory commission to take any steps necessary.

The CPC created a High Level Technical Group that has been working on a draft Constitutive Protocol for the MERCOSUR Parliament (PM). The document anticipates that the PM would be made up of representatives elected by universal, direct, secret ballots, according to each State's legislation, with the possibility of reelection. An analysis would be made of a composition of 31 parliamentarians from Argentina, 36 from Brazil, 16 from Paraguay and 16 from Uruguay, with a four-year mandate, although Paraguay would be willing to accept an egalitarian composition of 16 representatives per Member State.

The main powers of the PM would be to oversee the observance of MERCOSUR rules, and the continuation of democratic regimes in the Member States; to establish mechanisms enabling it to receive, examine and process claims and complaints on any matter relating to acts or omissions by MERCOSUR bodies; to issue statements, reports, recommendations and rulings on matters linked to the process (particularly on rules being drafted and international negotiations); to propose draft measures for consideration by the CMC; to issue non-binding opinion on the appointment of the Director of the MERCOSUR Secretariat and the President of the CRPM; to draw up a budget, and inform the CMC of its execution; to approve MERCOSUR's general budget and accounts.

Any decision-making would be by simple majority, absolute majority, ordinary majority (two thirds of current members from at least three States), and special majority (three-quarters of current members, in turn, representing the simple majority of those present from all States) depending on the issue. In principle, an ordinary majority would be demanded, unless otherwise stipulated, even though one partner is proposing that decisions be taken by consensus.

The PM will be able to issue rulings, draft measures, preliminary draft measures, statements, recommendations, reports and resolutions. Different criteria were analyzed for budget contributions, either according to participation or in terms of national and regional GDP.

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[61] This instruction was included in the 2004-2005 Work Program as follows: "to consider (...) the CPC's proposal over the establishment of a MERCOSUR Parliament in accordance with the application made by the presidents of MERCOSUR Member States, considering the Interinstitutional Agreement signed by the CMC and the CPC as a first stage."

B. Prospects for the Internal Agenda

MERCOSUR is still going through a period of some skepticism over its ability to coordinate the partners' internal agendas and external agendas, characterized respectively by the need to facilitate sustainable growth and the attempt to achieve active, intelligent international insertion.

A brief summary of the specific results reached in the areas of consolidation and intensification between July 2004 and June 2005 should address two major issues: Double Levying of the CET, and Structural Funds, both of which were the object of important strategic Decisions. The composition of Structural Funds, in particular, involved a radical shift in attitudes –and responsibility– from each partner in terms of the integration process.

However, to date, both rules express commitments, and though their direction is a positive one, they have no practical effects. Negotiation of the respective regulations is currently underway. The result of these negotiations, along with the procedures implemented by each Member State to bring these disciplines into effect, will be the true barometers of political commitment to integration.

But in the perception of MERCOSUR, other topics will also be of influence: issues such as the way in which certain issues currently the object of bilateral talks are eventually dealt with (particularly the issue of intra-MERCOSUR trade measures), compliance –or non-compliance– with the December 2005 deadline set for the entry into force of various CET related disciplines,[62] as well as the partners' efforts regarding the Work Program 2004-2006.[63]

In this context, the results of the latest MERCOSUR Summit, held in Asunción in June 2005, stress the need to focus on the consolidation and strengthening of the integration process.[64/65] It now remains to wait and see how this will be put into operation.[66]

In short, the current challenge facing MERCOSUR involves removing the ambiguity of recent years between words and deeds. One hopeful sign is a certain headway being made in two areas that used to be at the focal points of partners' debates and dissatisfactions: one, is the issue of asymmetries; the other, the impact on intra-MERCOSUR trade of the lack of macroeconomic coordination. The resolution of these focal points would bring a more pro-integrationist attitude from Member States, which is reflected not only in the non-adoption of anti-MERCOSUR measures, but which also allows progress to be made in improving the customs union, work on issues like the validity of a CET, trade and competition defense, industrial specialization and complementation, and the like.

On the downside, the debate and definitions necessary to bring about this (necessary) change of direction in the integration process are not being seen at CMC or CMG meetings. Should such change not be achieved, the most likely scenario in the integrative process over the next few years is status quo in the area of regulation and business, but a status quo increasingly insignificant from the viewpoint of both national policy and international positioning (like other previous integration initiatives in the region).

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[62] The expiry of the list of 100 national exceptions, the culmination of the waiver for BK, the ITTG import regime, the definition of the list of Paraguay's agricultural inputs, etc.

[63] The 2004-2006 Program's degree of compliance is not so important as partners' commitment and determination to carry it through.

[64] It may be assumed that it did this to counterbalance the packed international agenda that demanded so many resources in recent years.

[65] The CMC emphasized three broad objectives: (a) to intensify steps to consolidate MERCOSUR's internal agenda; (b) to identify formulas to ensure more effective participation by civil society in the integration process, and (c) to coordinate macroeconomic policy. It also emphasized the drive that had to be undertaken to promote productive complementation between Member States.

[66] What is not in doubt is that real national political conditions do not at present seem to be helping partners to focus much attention on their international agenda. However, MERCOSUR should clearly be seen as a part of Member States' internal agenda.

Contents

CHAPTER 5. TRENDS IN THE MERCOSUR 2004-2005 EXTERNAL AGENDA[67]

A. An Overview of the Agenda

A run through of the MERCOSUR External Agenda for the second half of 2004 and the first half of 2005 shows some progress in negotiations with countries and/or subregions of similar levels of development, as well as a good dose of 'frustration' in approaching the developed world. The optimistic spirit of late 2003 seems to be very much a thing of the past. Then, from both the academic and business worlds, and from policy makers themselves, 2005 was analyzed as a post-negotiation scenario, referring to the idea that, as the respective agenda negotiators forecast, the Free Trade Area of the Americas (FTAA), the Agreement with the EU and, possibly, the Doha Round would already be a reality by that date.

In this respect, although the chances of 'closing' some kind of FTAA agreement seemed to be evaporating in early 2004, the MERCOSUR-EU negotiation kept up optimism over reaching an agreement until shortly before the pullout of the European negotiating team (toward the end of this year).

In this context of 'distance' in North-South relationships, between mid-2004 and the first six months of 2005, significant dynamism was seen in South-South negotiations. The MERCOSUR/Andean Community (CAN) agreement was closed after many stumbling blocks and various technical difficulties. Though its economic/trade impact may not be overwhelming, it nevertheless constitutes tangible progress in the rapprochement of both integrative operations. Negotiations with Mexico also continued, and Fixed Preference Agreements were signed with the Southern African Customs Union (SACU) and India, talks were begun with Morocco and Egypt in order to progress in the same kind of trade links, and proposals to negotiate Free Trade Areas were exchanged with the Caribbean Community (CARICOM) and the Central American Free Trade Association (CAFTA).[68] More generally, trade talks in this period included the signing of a Framework Agreement with the Gulf Cooperation Council (GCC), the start of a feasibility study on a potential MERCOSUR-Korea trade agreement, a succession of meetings with Canada to assess different alternatives for rapprochement, and –in the very early stages– talks with the Comunidade de Paises de Lingua Portuguesa (Community of Portuguese Language Countries), Russia and Pakistan.

A key, albeit bilateral, aspect of the External Agenda was Chinese President Hu Jintao's visit to Brazil and Argentina in November 2004. This focused on China's obtaining recognition of its status as a market economy in return for certain advantages of access for MERCOSUR'S products, Chinese commitments to invest in the economies of the Southern Cone, and the definition of these countries as "suitable for tourism" for Chinese citizens. It should be pointed out that in these negotiations there were no consultation or cooperation mechanisms between MERCOSUR Member States.

However, there were intra-MERCOSUR consultations during this period over the crisis in Bolivia's institutions, and over the search for joint alternatives regarding the regional energy supply and the financing of the necessary infrastructure in the medium-to-long term. Here, the Member States' greater political rapprochement with Venezuela –especially in the case of Argentina and Brazil– focused on energy and infrastructure complementarity in the region. Similarly, the creation of the Comunidad Sudamericana de Naciones (CSN: South American Community of Nations) in December 2004 provided a new space for the politico-institutional strengthening of the subcontinent.

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67 An overview of some of the main events on the External Agenda, dealt with here in depth, appeared in Chapter 2.

68 The CAFTA is known in Spanish as the *Secretaría de Integración de Centroamérica*, or SIECA. It comprises five countries: Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.

In the context of multilateral negotiations, the activity of the G-20 as a group of emerging countries coordinating their actions to better defend their interests against developed countries, was another space for potential cooperation that was not exempt from disagreement between the region's countries. Indeed, since the G-20 was formed, only three MERCOSUR Member States (Argentina, Brazil and Paraguay) have joined it, with Uruguay remaining on the fringes of the Group and only joining in March 2005. The work program agreed in July 2004 at the level of the World Trade Organization (WTO), with issues essential to agricultural negotiation, stressed the value of joint action. Despite this, progress was slow and the prospects of arriving at the 6th Ministerial Conference in Hong Kong in December, with the issues sufficiently developed to enable substantive progress in multilateral negotiation are uncertain.

The institutional importance of the WTO for developing countries was reflected at this stage in the favorable rulings obtained at the start of 2005 in Brazil's demands on the United States (for export subsidies and internal supports for their cotton producers), and on the EU (for export subsidies on beet sugar).

B. FTAA Negotiations

Toward the start of 2004 it was clear that the two-tier format agreed at the meeting of FTAA Trade Ministers held the previous year in Miami, would be inadequate in facilitating the consensus necessary to meet the deadline of January 2005 for the start of hemispheric integration. Thus, another attempt again failed to channel continental negotiations by defining basic common rules for the 34 thirty countries, and additional rules and/or treatment of sensitive bilateral or multilateral issues. This 'LAIAcización' of the FTAA process[69] was set in train to move toward concluding the Agreement.

Although there were the beginnings of consensus where the group set of rights and obligations would prioritize goods and services market access negotiations with disciplines relating to access, though 'minimal' in all other negotiating areas, the disagreements over the degree of ambition of the access negotiation and the scope of certain other disciplines (services, intellectual property, agriculture) prevented an agreement being reached. In contrast to the stagnation of the FTAA, the United States continued its offensive in the region with bilateral and/or subregional negotiations, a strategy MERCOSUR countries were not invited to take part in.[70] After the Agreement with Chile, the United States closed the agreement first with the CAFTA and the Dominican Republic, and intensified negotiations on free trade treaties with Panama and some CAN countries (Colombia, Ecuador and Peru) with successive rounds of talks. In these cases, it was established that the Agreements should be implemented as of 2006. However, the lack of definition in specific major issues in these negotiations, and the difficulties faced in Washington over ratification of the United States Congress's Free Trade Treaty with Central America and the Dominican Republic,[71] raise doubts about the realistic chances of these agreements being concluded within the preestablished timescale.

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[69] It refers to the way negotiations are defined in the LAIA, with basic rules for all parties, and bilateral agreements allow the some relationships to be consolidated (voluntarily).

[70] Regarding the negotiations with the United States, Regis Arslanian, Director of the Itamaraty Department of International Relations, stated that "the Brazilian government had, on two occasions, formally approached the United States over the start of bilateral negotiations with the MERCOSUR, but got no response" (Valor Económico 07/05/05).

[71] The DR-CAFTA was passed by the Senate in early July 2005, but met with serious resistance in the other Chamber, with democratic and republican legislators insisting upon the imposition of restrictions on Chinese imports being dealt with before ratifying the agreement. It was finally approved by a minimum difference of two votes at the end of the month.

Box 6
The United States/Dominican Republic/CAFTA Agreement
(US/DR/CAFTA)

The US/DR/CAFTA Agreement was signed by the United States, five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua), and the Dominican Republic. For the Central American countries, the agreement was an instrument to consolidate –and perpetuate– the trade preferences granted (unilaterally) by the United States in the early 1990s, later extended in 2000 by the Caribbean Basin Initiative, and expiring in 2006. For the US authorities, the Agreement was a kind of model for signing other trade agreements (a ‘cutting-edge trade agreement’). Its main features are presented below.

1. Agricultural Liberalization (Costa Rica)
The US Market: it opens with different linear tariff timeframes depending on the sensitivity of goods, at 0, 5 and 10 years. Products entering with a quota under free trade conditions, and others with no quota but subject to tariff payment, appear in special categories. 98.3% of Costa Rica’s current exports enter duty free; 1.7% (sugar, sugar-based products, dairy products and beef) will continue with a quota. For beef, the initial quota is 10,300 tons, with a yearly 5% increase. Tariffs on tobacco and cotton are reduced to 15 years. The sugar quota is doubled, despite which the total benefits of the six countries is equivalent to 1.2% of US sugar production.

The Costa Rican Market: opens at 0, 5, 10, 12, 15 and 20 years depending on the good. Only two products are not subject to a reduced tariff: potatoes and onions, which are with a quota. There are quotas from 12 to 20 years, and in some cases, periods of grace prior to the start of tariff reduction. 68.5% of current imports from the United States have entered at 0% since the Treaty was signed, 5% at 5 years, 3.7% at 10 years, 6.2% at 12 years, 8.6% at 15 years and 8.0% at 20 years. At the 20 year mark are milk, butter, cheese, rice, ice creams, and milk based drinks.

The Agreement provides a specific Safeguard Clause for agricultural products during trade liberalization.

2. The Liberalization of Industrial Goods
US Market: the opening for the entire range is immediate, except for sports footwear and canned tuna. Costa Rican Market: the whole range opens at 0, 5 and 10 years. 13.3% of positions are subject to tariff reduction in 10 years.

3. Rules of Origin: specific rules are defined in textiles, where it is provided that raw materials must be from the area, even for Mexico and Canada. The regional content rule holds for a wide range of industrial products, fixed in a range from 35% to 45% accordingly. For automotive products the net content rule applies.

Services: it provides for the liberalization of services, with periods of grace, as well as the adaptation of current legislation regarding insurance, transport and financial services.

Intellectual property: the United States imposed the criterion of broadening the scope of the WTO Agreement on Intellectual Property, extending the deadline on patents beyond 20 years, eliminating the possibility of using compulsory licenses to import medications for reasons of public health, etc.

Investments: it restricts the possibility of governments regulating Foreign Direct Investments with instruments like performance clauses, technology transfers, and controls on the movement of capital. In the event of any dispute, the investor may appeal to international tribunals.

Toward the end of 2004, after President Bush's reelection, the United States Trade Representative (USTR) contacted the Brazilian Foreign Ministry. From this, the mandate emerged for the two co-presidents on the Negotiations Committee (Brazil and the United States) to begin working again on the flexible FTAA approved in November 2003. However, no progress in this direction was seen during the first half of 2005.

With the deadline established for the conclusion of the negotiations (January 2005) already up, the negotiating process could be restarted in the event of progress being made in the Doha Round's agricultural negotiation. Depending on the results, the FTAA talks may once again pick up speed.

C. MERCOSUR/EU Negotiations

At the turn of 2003 and 2004, the MERCOSUR/EU Agreement appeared the most likely to be concluded under the deadlines and conditions provided, considering it contained matters not only on the economy and trade, but also on cooperation and political association. This, among other factors, was reflected in the coincidence of a multipolar view of the world, and in the road of regionalism as a means to the best international insertion for the countries.

Similarly, a possible agreement with the EU met with little resistance among parliamentary political parties in the Southern Cone countries, and even union organizations brought up few conflictive issues, unlike the FTAA, and/or a potential direct bilateral United States/MERCOSUR association.

There was speculation in MERCOSUR that the EU would have great incentive to reach some type of Biregional Agreement by the end of 2004, bearing in mind:

1. the change in the membership of the European Commission envisaged for the end of year;
2. the possibility of the Europeans wishing to overtake the United States in negotiating dynamics with the region, given the FTAA impasse;
3. the interest in the region shown by the EU, expressed in the agreement with Chile;
4. the coincidence of interests and geopolitical visions among the leaders of both areas.

In this context, the then European Commissioner, Pascal Lamy, pointed out that "indeed the EU's profound motivation in this agreement has always been geopolitical; it is not just a trade agreement: it is political, economic and trade related." Regarding the idea that the EU wanted to provide a counterbalance to US influence in the region, however, he stated: "I never felt there was a race between the FTAA and the EU/MERCOSUR Agreement. We do not have the same goals: the FTAA is trade related and that is all there is to it. In MERCOSUR there is a tendency to want to play to achieve better conditions for one member or another. I can understand that, but it is not our problem."

In the framework of Biregional negotiations, over the second half of 2004 the EU presented certain specific improvements in access quotas in meat, cereals, ethanol and other products, and 50% reductions in the tariffs on processed agricultural products. The offers on quotas were divided into two phases: the first, in force up to the signing of the agreement, and the second, subsequent to the close of the Doha Round. Nevertheless, the levels offered fell a long way short of MERCOSUR's expectations.

TABLE 11
QUOTAS OFFERED BY THE EU BY PRODUCT & DIFFERENCE WITH THAT REQUESTED BY MERCOSUR

Product	No. of positions	MERCOSUR Request*	Total EU Supply	Offered Quota 1st Phase			Quota Value**
				Tonnes	Euros per tonne	Millions of Euros	Millions of Euros
Fresh & Frozen Beef	11	350,000	100,000	60,000	3.8	227.73	187.86
Poultry & Fresh Poultry Offcuts	83	250,000	75,000	45,000	2	90.78	39.02
Powdered Milk	31	50,000	13,000	6,500	1.9	12.36	3.44
Butter & Milk Fats	8	20,000	4,000	2,000	1.8	3.57	2.92
Cheeses & Curds	37	60,000	20,000	10,000	5.8	58.08	11.92
Garlic	1	20,000	10,000	6,000	1.1	6.71	7.52
Wheat & Wheat Blends	1	4,600,000	200,000	120,000	0.1	14.93	10.68
Corn & Sorghum	7	700,000	700,000	400,000	0.1	53.10	27.82
Rice	24	300,000	40,000	26,000	0.5	13.79	10.03
Pigmeat	19	80,000	11,000	6,000	3.1	18.52	4.37
Bananas	1	60,000	30,000	30,000	0.6	18.83	19.28
Ethanol	2	3,000,000	1,000,000	600,000	0.6	344.30	67.82

Notes: * Request for both phases.
** Estimated at 10 years for first phase.
Source: *http://www.abeceb.com*.

In this context, both blocs made various efforts between May and September 2004 to bring their positions closer, but the result was negative. There was even a last minute backtracking in concessions from the EU –and MERCOSUR too–. This reflected the fact that interest in closing the agreement before the end of October had been gradually waning.

Indeed, analysis of the offers shows that the EU had promised to slightly increase certain quotas such as beef in July, only to return to May's figures in September. Something similar is seen when analyzing the positions included with an immediate reduction in tariffs: in this last offer fewer products were listed, producing a shortfall in the offer for 16% of European imports from MERCOSUR (source *http://www.abeceb.com*). September's offer was also more limited in services, investments and government procurement than May's.

MERCOSUR's September offer of goods increased to over 90% of trade, and included a Brazilian proposal for Government Procurement; yet at the same time, it put back opening of the automotive sector –substantively– from 10 to 18 years. Likewise, certain promises to broaden services and investments were not kept in this proposal.

ANALYSIS OF MERCOSUR & EU OFFERS

MERCOSUR's last offer of goods included an immediate tariff reduction on 12% of tariff positions, while it envisaged taking free trade to three and eight years at close on 30% more items of the Nomenclature. Thus, over eight years, close on 40% of European products would enter MERCOSUR under free trade conditions, as shown in the following table.

TABLE 12
MERCOSUR'S LAST OFFER OF GOODS

Category	September 2004 No. of Positions	September 2004 MERCOSUR Share (%)
A (immediate)	1,168	12.0
B (3 years)	1,760	18.1
C (8 years)	1,077	11.1
D (10 years + 1 grace)	1,889	19.4
E (10 years + 2 grace)	2,784	28.6
F (quota + 18 years)	46	0.5
Fixed Preference 20% & 50%	185	1.9
Unscheduled	821	8.4
Totals	9,730	100.0

Source: *http://www.abeceb.com*.

The EU's September proposal to MERCOSUR, on the other hand, left out only 435 positions of the 10,427 total. It included 9,652 items in baskets A, B, C and D, among which were processed agricultural products (for which it requested reciprocity in MERCOSUR's offer). Lastly, it offered fixed preferences of 20% and 50% for 340 mainly agricultural positions, as well as quotas.

TABLE 13
EU PROPOSAL TO MERCOSUR

Category	No. NC	Share (%)
A	3,526	34
B	2,449	23
C	2,079	20
D	1,310	13
Processed Agricultural Products (reciprocal)	288	3
Total Liberalization	9,652	93
Preference - 20%	43	0
Preference - 50%	56	1
Quotas	241	2
Total Preference & Quotas	340	3
Total not Included	435	4
General Total	10,427	100

Source: *http://www.abeceb.com*.

In terms of trade, the EU offer of goods reduced tariffs immediately on 58% of MERCOSUR exports (which had already been liberalized as a result of previous multilateral negotiations), 35% at ten years, 1.1% through fixed preferences, and 5% through quotas (in the latter two it included many agricultural products and foodstuffs).

The MERCOSUR proposal, for its part, offered to immediately liberalize 11% of European imports, 61.3% at 10 years, with preferences and quotas for close on 18% of the remainder. Unlike the European offer, the MERCOSUR proposal left out close on 10% of imports from the EU.

TABLE 14
MERCOSUR PROPOSAL

	European Union					MERCOSUR				
	No. of Positions	**UE Imports** (A) **Millions of euros**	**% Share of Imports**	**MFN (%)** (B)	**Tariff to 10 years (%)**	**No. of Positions**	**MSC (C) Millions of US$**	**% Share of Imports**	**CET (%)** (B)	**Tariff to 10 years (%)**
0%	2,169	11,804.96	58.3	0.0	0.0	655	2,545.60	11.1	0.0	0.0
Tariff Reduction in 10 years	7,483	7,156.55	35.3	6.8	0.0	8,023	14,051.21	61.3	10.9	0.0
20% Preference	43	215.38	1.1	30.0	24.0	64	747.81	3.3	15.0	12. 0
50% Preference	56	3.23	0.0	35.5	17.8	121	2,211.73	9.6	15.9	8.0
Quota	241	1,029.23	5.1	40.9	40.9	46	1,102.89	4.8	34.7	27.7
Excluded	435	53.54	0.3	28.0	28.0	821	2,275.69	9.9	15.6	15.6
Total	10,427	20,262.88	100.0	7.3	2.3	9,730	22,934.92	100.0	10.8	1.6

Notes: (A) EU imports 15 from MERCOSUR between 1999 and 2001 in millions of euros.
(B) Base rate for tariff reduction. The ad valorem equivalents were calculated for the EU.
(C) MERCOSUR imports from the EU between 1998 and 2000 in millions of US$.

Source: *http://www.abeceb.com*.

In addition to issues of access in goods, there were differences in services (particularly maritime, financial and telecommunications), investments, government procurement, geographical indications and intellectual property, as well as rules of origin, where the EU was quite inflexible in its proposal, arguing that their own rules prevailed in the agreements already signed.

In short, analysis of this long drawn out, fruitless negotiation process shows that:

- although the EU made clear on several occasions its will to present an ambitious agricultural offer, this never took shape on the negotiating table;
- the special and differentiated treatment by the EU requested by MERCOSUR was not borne in mind, significantly blocking any progress toward an agreement;
- there were clearly intra-MERCOSUR problems in drawing up the offers of goods, but the argument put forward by Brazilian business entities that Argentina was a barrier to a more complete proposal contrasts with the difficulties over drawing up proposals in services, investments and government procurement by Brazil, which were and still are of great interest to the EU;

- MERCOSUR may have erred on the short side in resources for these negotiations. There was no special negotiating group devoted to it, nor did it have back-up technical assessment. The External Agenda is growing, and the countries are in the fray with the same resources;
- the difficulties in progress in the Doha Round in general, and in the area of agriculture in particular, brought about a more cautious and defensive stance from the Europeans in biregional negotiations.

In the view of international relations analyst, Professor Félix Peña, there might be substantive methodological causes to explain the non-signing of the agreement. Substantive causes would include the agreement's loss of significance with the entry of ten new countries to the EU, a loss of incentive to negotiate after the stagnation of the FTAA, the profound asymmetries in development, and the perception of MERCOSUR as not very credible, particularly visible in coordination difficulties regarding the negotiating agenda. In terms of methodology, there is the divergence of negotiations with the EU over multilateral negotiation and the FTAA, the discontinuities and fragmentation in the was negotiations are conducted, especially on the MERCOSUR side, and lastly, a certain operational disconnection between the political and strategic vision, particularly in the EU, a phenomenon witnessed in negotiations and reflected in the last summits before closing in Lisbon. (La Nación 10/26/04).

D. Negotiations in the WTO & the Role of the G-20

Although MERCOSUR does not act as bloc in the WTO, there has been greater interaction between its component countries since the failure of Cancún in 2003, and with the creation of the G-20 (when, in August that year, 16 countries disclosed a proposal about types in agriculture).[72] It is worth remembering the effect that agricultural discussions have been, and still are, a fundamental barrier to the conclusion of trade agreements with developed countries, both in the FTAA and the EU, and therefore, dealing with it at multilateral level takes on extraordinary importance for our countries as efficient producers and exporters of agricultural and agroindustrial products.

Indeed, the G-20 emerged as a reaction to the proposal on agriculture, presented jointly by the United States and the EU prior to the Cancún meeting, and viewed by the developing countries as unsatisfactory. The G-20 also actively intervened in the negotiation of Strategic Products and Special Safeguard Mechanisms, as well as the cotton negotiations which advocated the total and urgent elimination of subsidies.

The emergence of this new coalition represented a sea change for the Cairns group (of which twelve G-20 countries were members), as the new movement was only made up of developing countries. Not always compatible interests nevertheless cohabited in the Group –and still do. The group brings together efficient agricultural producer and exporter countries with producers and importers of these products (with high rural populations and, therefore, defenders of the protection of certain crops).

For many analysts, this divergence of interests is the germ of the coalition's failure after Cancún. This did not happen, however, though the Group is not exempt from difficulties and differences in objectives in various respects. The G-20 has thus become an undisputed actor in the Round's negotiations insofar as:

1. it includes the main emerging powers;
2. it represents 70% of agricultural production, and more than half the world population;
3. it is a coalition with proactive proposals;
4. it has demonstrated the ability to draw up technically sustained proposals.

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72 The original 16 countries were South Africa, Argentina, Brazil, Bolivia, Chile, China, the Philippines, India, Mexico, Paraguay, Thailand, Colombia, Costa Rica, Ecuador, Guatemala, and Peru. A few days later Cuba, Egypt, Pakistan, Venezuela and El Salvador joined. Later Indonesia, Nigeria, Tanzania came in, and Zimbawe, and six countries negotiating bilateral agreements with the United States (Colombia, Costa Rica, Ecuador, Guatemala, Peru and El Salvador) withdrew. Uruguay joined in March 2005.

The participation of countries with opposed interests within the G-20 has in practice been visible in specific negotiating proposals, in terms of both market access and internal support measures since, although to much lesser degree than the mature economies, some emerging economies also subsidized and protected. Where there is full agreement in the G-20, is over the elimination of export subsidies.

The post-Cancun impasse over agricultural negotiations apparently ended in July 2004 with the approval of a new work program for 2004-2005, in which the G-20 had a significant hand. The program expressed a commitment to eliminate export subsidies, but did not set any dates. The United States agreed to bring down (and eventually eliminate) the components of subsidies for its credit, guarantees and insurance programs, and reached consensus over regulating the operation of state trading companies.

In terms of production grants, a mechanism was agreed to reduce all subsidies (save for the supposedly less inequitable ones), and changes were agreed in the various classifications of different support measures, in order to make negotiations more transparent. In market access, the work program set the goal of reducing all tariffs –mainly the highest– but it was not possible to reach agreement over how to reduce tariff progressivity (higher tariff rates at greater added value). It also established a whole array of exceptions (special sensitive products and an agricultural safeguard mechanism).

The G-20's decisive role in moving talks forward was reaffirmed in May 2005 in the definition of the formula for conversion of the specific tariffs into their ad valorem equivalents.[73/74]

The importance of the multilateral negotiation for MERCOSUR countries has meant that Brazil outlined a resolution project at the Extraordinary Meeting of the CMG in December 2004, aiming at coordinating positions in the WTO through the creation of an Ad Hoc Consultation and Coordination Group on market access. The advances in the Round's negotiation –particularly on the agricultural issue– will here be vital in increasing the bloc's chances of success in negotiations with mature economies.

Box 7
Brazilian Demands over Agricultural Subsidies in the WTO

Brazil's actions in the WTO against the abuse of export subsidies and internal support measures in the United States and the EU was welcomed in the first half 2005. Indeed, on March 21, the Dispute Settlement Body adopted the reports of the Appeal Body and the panel for the Brazilian demand against US cotton subsidies, requesting they be eliminated as of July 1.[75] Initiated in 2002, this action is of great importance given the size of the subsidies, over and above what is laid down in the Agreements on Agriculture and Subsidies approved in the GATT/WTO, and is proof of how they have affected international prices –downward–, causing flagrant harm to other countries' producers.

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73 The 'small table' of the central coordinating authority for agricultural negotiation (NG5) has, since 2004, comprised the United States, the EU, Australia, Brazil and India.

74 In Public Citizen's view, Brazil and India have been coopted by the PDs, and the G-20 proposals of July 2004 enable the United States and the EU to resolve a substantial part of the internal support and access to their markets in return for the elimination of export subsidies (no date). Additionally, they have committed to making progress in industrial goods and other matters of interest to developed countries (Enfoque en el Sur Global August 2004).

75 The United States has applied for an extension to eliminate any subsidies and internal supports considered incompatible with the agreements. In the event of non-compliance, Brazil could apply retaliatory measures of around US$ 3 billion annually, which could become effective by retaining bonus payments, copyright and patents.

Similarly, on April 28, the Appeal Body issued its report on demands by Australia, Brazil and Thailand over subsidies on the EU's beet sugar exports. It was proved that the EU has granted subsidies for a volume in tonnes very much higher than the figures fixed in the Agricultural Agreement, thus affecting the international market for this product, and displacing other producers. These actions are significant for MERCOSUR countries, as they involve valid precedents for making other demands which, despite taking time and money, may represent an alternative for the progressive dismantlement of the agricultural policies of developed countries.[76]

Nonetheless, expectations over these negotiations are not high. The outgoing Director General of the WTO, Panitchpakdi Supachai, draws attention to the lack of momentum in the talks, and warns about the situation leading up to the Ministerial Conference in Hong Kong in late 2005. He recognizes that, although there have been advances in the discussion of two of the mainstays of agricultural policy, these are still slow and complicate progress in other topics.

In this light, what can be expected from the Doha Round? There are at least three scenarios:

Scenario 1 (the most likely): there would be an agreement on agriculture, setting a deadline for export subsidies, some progress –albeit far from the G-20's expectations– in terms of market access (due to the tenacious defensive stance of the EU), and less favorable still, in internal support (on which the United States focuses its strategy with support from the EU). Under this hypothesis, agreements in access liberalization for industrial goods would also be limited, and it would be the same for offers in services.

Scenario 2 (less likely but possible): the Round ends in 2006 on schedule, with no agreements, and therefore, the multilateral system would be locked in crisis for a long time to come.

Scenario 3 (almost totally out of the question): a sea change in the stances of the EU and the United States, facilitating widespread agricultural liberalization in the three mainstays, with widely favorable effects on other matters in the Round.

E. South-South Negotiations & the Global System of Trade Preferences: An Attempt at Revitalization

The agreement on the Global System of Trade Preferences (GSTP), signed in 1989 in the framework of the UNCTAD, aimed to strengthen economic and trade relationships between developing countries via the granting of widespread trade preferences.[77] In spite of enormous efforts to inject life into it, the GSTP has made little progress, being influenced, on the one hand, by shifts in world power (the agreement precedes the collapse of the Soviet bloc) and the burden of multilateral negotiations, and on the other, the features of the agreement itself, as concessions benefit all countries, whether participating in the talks or not.

On the other hand, the concessions' entry into force often lacked effectiveness due to the existence of bureaucratic barriers and the absence of a framework relating to accompanying disciplines. After the failure of Cancún 2003, and taking advantage of the relationship with the G-20 coalition and its

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[76] Analysis of the results of the research into cotton subsidies provides data that shed light on other products in a similar situation. (Revista CEP No. 49).

[77] The original agreement included Argentina, Brazil, India and Rumania.

connections with other less advanced countries, Brazil advocated fresh negotiations in the framework of the GSTP, as well as the incorporation of China, in order to consolidate South-South relations.

The 11th UNCTAD Conference, held in San Pablo in June 2004, was used by the body's then General Secretariat, the Brazilian, Rubens Ricúpero, with his government's support and the active participation of Argentina's Minister Lavagna, to relaunch the issue at the international level. Currently, 48 countries belong to the GSTP, and this number is expected to at least double over the new Negotiation Round (the third), which began in November 2004, and is expected to last two years.

F. The MERCOSUR/CAN Agreement: A Biregional Agreement, or an Accumulation of Bilateral Agreements?

At the start of 2005, Economic Complementation Agreement No. 59 came into force, by which MERCOSUR countries and three CAN countries (Colombia, Ecuador and Venezuela) undertake to progressively reduce tariffs on reciprocal trade until a Free Trade Area is achieved. MERCOSUR thus has three new Associate States, a category similar to Bolivia and Chile. For its part, Economic Complementation Agreement No. 58, establishing the beginnings of a Free Trade Area between Peru and MERCOSUR, did not come into effect simultaneously with ECA 59. but is to do so in the near future.

The conclusion of these negotiations is a positive sign for MERCOSUR, because it closes a long drawn out negotiation with countless stumbling blocks, and because these are the first Free Trade Area agreements that the bloc has signed with third countries for almost eight years. From a political standpoint, the agreements lay the foundations for the formation of the Comunidad Sudamericana de Naciones (CSN: South American Community of Nations), since MERCOSUR, and now its six associate states, represent a strong core in the new grouping.

From the economic standpoint, the clinching of the Free Trade Area between MERCOSUR and the CAN creates a market of 350 million inhabitants, and covers a broad space for cooperation in infrastructure and investment. For MERCOSUR, the incorporation of the new associate states involves expanding the market by 100 million inhabitants, who import close on US$ 40 billion annually.

These agreements with the Andean countries replace previous bilateral agreements in the framework of the LAIA for a limited number of products. The new agreements, with linear and automatic tariff timeframes (at 10 years, and 15 for sensitive products) will take almost all items in the tariff range to 100% preference.

However, the format adopted by ECA 59 highlights the difficulties seen by the parties in reaching agreement, and hampers economic and trade impact analysis for the different countries. Indeed, although the agreement is Biregional, and possesses certain common rules and disciplines for all countries, the annexes where the respective commitments are stated explicitly are bilateral (in other words, for each MERCOSUR country with each of the three CAN members). Thus, for example, the trade liberalization programs, and specific rules of origin differ and are complex in interpretation.

According to some analysts, the clear intention to close the agreement has meant that the likes of Brazil granted numerous concessions with no reciprocity, or that the number of positions liberalized after 10 years for Argentina and Brazil is far from the percentage range necessary to be considered a Free Trade Area in WTO terms. Similarly, in many cases temporary rules of origin were established for different products, leaving it up to the Agreement's Administrative Commission to (later) establish specific rules. Equally, in terms of comparative analysis, the agreements with Chile and Bolivia were claimed to be more balanced, technically more coherent, and therefore, to have greater impact in effective trade liberalization (Markwald [2005]).

Box 8
Venezuela: A Special Case

Over 2004-2005, the political, economic and trade relationship between MERCOSUR (especially Argentina and Brazil) and Venezuela has grown significantly, the Biregional Agreement with the CAN aside. In 2004, Venezuela signed energy and industrial complementation agreements with Argentina, by which it provided Argentina with fuel oil to replace the winter shortfall in gas, favored the import of agroindustrial products and capital goods for the Venezuelan agricultural sector, contracted the construction of oil tankers in Argentinian shipyards, and entered into partnership with the state controlled company, Energía Argentina SA (ENARSA), through Petróleos De Venezuela SA (PDVSA).[78/79]

In the case of Brazil, agreements were signed between Petrobrás and PDVSA for joint exploration and exploitation in Venezuela. Agreements to undertake infrastructure works were also signed between both countries, such as the Cumaná/Puerto La Cruz highway, the extension of the Caracas metro, irrigation works, and the provision of vessels for oil transport.

In 2005, Venezuela upped its involvement in MERCOSUR, acquiring US$ 500 million worth of bonds of the Argentinian debt, and putting forward a proposal to the region's governments to create a South American oil company, Petrosur, with the goal of developing strategic regional planning in the use of the oil and gas resources, and greater international presence. The initiative to set up a South American Bank and a Regional Guarantee Fund, proposed by President Chávez at various meetings with the Argentinian and Brazilian presidents, might also be mentioned.

G. The Formation of the CSN

The South American Community of Nations was created on December 9, 2004, in Cuzco, Peru. It consisted of MERCOSUR member countries and the CAN, plus Chile, Guyana and Surinam. South American integration thus had a new agenda for subregional rapprochement in the style of the Latin America Free Trade Association (LAFTA) of the 1960s, and the LAIA of the early 1980s, albeit with a more political look.

This initiative effectively emerged from a major drive by the Brazilian government (which, since the early days of MERCOSUR, had been toiling for progress in a Latin American Free Trade Area as a step prior to the FTAA), the commitment and action of the President of the Committee of Permanent MERCOSUR Representatives, Eduardo Duhalde, the favorable stance of the CAN countries, and the enthusiasm of the Venezuelan government. The CSN can become an effective vehicle for the consolidation of physical integration and regional infrastructure –in the field of energy, for example–, and can bring together the region's supply capacities to supply different countries.

No less importantly, it can also form a significant institutional critical mass to tackle democratically and legally –and try to resolve– any serious conflicts, such as those currently being suffered by Bolivia and Ecuador, or the historical territorial conflict between Chile and Bolivia. In the much longer term, is the

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[78] The agreement with the Río Santiago Shipyards involves the hiring of oil tankers, and lasts 36 months. The enforcement of the ENARSA/PDVSA agreement began with the purchase of certain service stations.

[79] Argentinian exports to this destination went from US$ 0.136 billion in 2003 to US$ 0.426 billion in 2004, with important purchasing in dairy products, medicines, meat, edible oils, tractors, chassis and bus, while Brazil exports went up from US$ 0.604 to US$ 1.463 billion in the same period.

bloc's newfound relevance as a promoter of economic and trade integration. In this context, it was established that the Ministers of Foreign Relations would be responsible for drawing up proposals (to be presented to Heads of Government) with the courses of action to be followed.

Box 9
The South American Gas Pipeline

In the 1960s and 1970s, Latin America depended almost exclusively on oil, except Argentina, which built a major network of gas pipelines supplying virtually all parts of the country. Brazil then began to buy Bolivian gas after building the Santa Cruz/São Paulo/Porto Alegre gas pipeline. In an attempt to become the supply center for the Southern Cone at the time, before the emergence of Bolivia as the great competitor in gas provision, Argentina raced to build four gas pipelines to Chile.

Historical issues aside, the danger of an energy shortage has in recent times become a recurrent theme in South America, as a result of a degree of rationing in Brazil, the reduction of supplies in Argentina, and the threat of interruptions in natural gas exports due to Bolivia's political crisis. According to The Economist Intelligence Unit "the problems highlight the need for a substantive flow of investments in the region's energy sector, and for better energy integration strategies." The ECLAC believes that an investment of US$ 20 billion is required over the next five year period to prevent an energy shortage in the Southern Cone countries.

The agreement to achieve South American energy integration, signed at the last MERCOSUR summit in Asunción, revolves around the potential of Peru's Camisea natural gasfield, exploitation of which began in August 2004. According to technical studies, it has a lifespan of 33 years, according to detected reserves of about 250 billion m^3, and probable additional reserves of a little over 190 thousand million m^3.

The so-called 'energy ring' will transport between 30 and 35 million m^3 of natural gas per day from the Camisea fields in Peru to Chile via a 1,600 kilometer gas pipeline connecting Pisco with the Chilean port of Tocopilla. Most of the Peruvian natural gas will be directed at Argentina, Uruguay and Brazil via improved existing pipelines, and a new conduit that will connect Uruguayana on the southern border of Brazil, Argentina and Porto Alegre.

"The idea is to connect the ring of the Southern Cone with the north of South America to form Southern Cone energy. The 'energy ring' is extremely important because these are steps toward covering the energy needs of the countries of the Southern Cone in the immediate future or medium term." (Hugo Chávez 07/20/05)

This greater regional cooperation demonstrates that the South American countries are increasingly considering energy as a development factor, and placing their state owned companies at the service of expanding the regional energy business (Oxford Analytica 03/05). The IDB will contribute to the project's financing, considered by former president, Iglesias, as "a landmark in the history of the South American integration." This body is already financing the work of a consultancy firm that will draw up the legal framework document to be discussed by the region's competent Ministers.

"The project involves countries with different legislations and practices. Therefore, to be able to make it viable they have the requirement that a legal framework be in place to guarantee their investments. This report must be ready soon if the region's public (and possibly private) sectors are to push ahead with their calculations and finish the network by 2007" (Jorge Rodríguez, La Nación de Chile 07/05).

H. MERCOSUR/China Negotiations & Bilateral Dialogues

As a result of President Kirchner's visit to China at the end of June 2004, the MERCOSUR/China Link Group was set up to follow up and execute cooperation projects between the parties, facilitate communication of important issues on the negotiating agenda, and assess the possibilities of an agreement between MERCOSUR and China. To this end, the CMG applied to the MERCOSUR Secretariat to carry out a study on trade flows between the parties, and a report on barriers to trade as the basis for a later assessment of any future agreement. Despite progress in the area from MERCOSUR, it has not yet been decided who will perform the joint study, or what form it will take. Unrelated to the dialogue with MERCOSUR, President Hu Jintao of China visited Brazil and Argentina in late 2004, when specific cooperation bilateral agreements were reached, with minimal or zero coordination between partners.

The China/Brazil Agreements

During President Hu Jintao's visit to Brazil, a Memorandum of Understanding was signed on cooperation in trade and investment, and a Protocol on conditions to be met for the entry of boneless beef between the Ministry of Agriculture and the General Administration for Quality Control.

The Memorandum recognized China's status as a market economy, which in any investigation into unfair practices for imports from China would mean the internal Chinese market price would be taken as a reference. Also, the Memorandum mentioned an interest in joint ventures between companies from both parties and measures to facilitate trade in coke for the iron and steel industry. On the first issue, it underlined the particular importance of the joint venture in regional aviation.[80] On this point, the Chinese government committed to encouraging Chinese companies to buy the first ten aircraft manufactured in 2005. Finally, Brazil obtained Chinese government authorization to receive Chinese tourists.

The Brazilian government's recognition of China as a market economy was not welcomed by Brazil's business community, which had warned the authorities prior to negotiations about the possible effects of such a decision on the industrial sector in connection with the application of antidumping rights. Nevertheless, after approving China's status as a market economy, the Brazilian government passed two decrees designed to address the new situation: first, to regulate potential safeguards on Chinese products in general (according to the China's access agreement to the WTO); and second, specifically to manage trade in textile products.[81]

The China/Argentina Agreements

The first article of the Memorandum of Understanding signed between the two countries on November 17 includes Argentina's recognition of China as a market economy, but is more explicit than the Brazilian one, stating the decision not to apply any discriminatory treatment to imports from China. The agreement also includes a kind of quantitative target for Argentinian exports to China increase over current levels (US$ 2.6 billion) to at least US$ 4 billion over five years. Similarly, it establishes the will to cooperate in a variety of areas of interest: infrastructure (including passenger transport), housing, energy, agriculture, basic industries, telecommunications and mining, with the Chinese government committing to encourage

[80] It is the first joint trade venture between both countries, and involves the Brazilian aeronautical company, EMBRAER, and the Chinese aviation company, AVIC.

[81] The general safeguard may be applied until 2013. The second one (on textiles) may be applied only until December 31, 2008, and can only be renewed by agreement with China. In this event, the measurement may be applied when Chinese exports exceed the flow of the previous twelve months by 7.5% without signs of damage.

its financial institutions to grant credit support to their companies with approved feasibility plans to be executed in Argentina.

Also, it is agreed to move forward in cooperation over regulation and sanitary inspection for the entry of animal and vegetable products. Lastly, consensus was reached over starting the operation of Work Groups on Railroad Activities and the Study of Bilateral Economic and Trade Complementation. Argentina also obtained Chinese government authorization to receive tourists, and to export beef and poultry to China.

As in Brazil, the Agreement with China and, particular, the recognition of its status as a market economy was strongly criticized by businessmen –especially industrialists. In answer to this concern, and like its neighbor, the Argentinian government passed two instruments to administrate the new relationship. These consisted of the regulation of a general safeguard and a specific one for the textile sector.

I. The MERCOSUR/India Agreement: Progress in Fixed Preferences

Under the umbrella of the Framework Agreement signed in 2003, MERCOSUR and India signed a Fixed Preference Agreement in New Delhi on March 19, 2005, as a first step toward a future Free Trade Area. The agreement consists of five annexes containing the lists of products benefiting, their rules of origin, a safeguards regime, and a dispute settlement mechanism. The agreement is at present undergoing parliamentary approval by the MERCOSUR countries, an official estimate being that the process could be concluded by the end of 2005.

The agreement involves the granting of preferences in 450 positions for each party, fluctuating between 10% and 100% depending on the products (there are quotas in some cases). Most of the preferences for entry into India were established in around the 10%-20% mark, almost all of them intermediate inputs, and very few under headings 1 to 24. The list includes wool, leather, ham, chemicals, apples, pears, oil based products, steel piping, chinaware, gearboxes, and furniture.

It should be borne in mind here that, despite having undertaken a trade liberalization process, India is still a closed country, especially where agriculture and textiles are concerned, which are of particular interest to MERCOSUR. In this sense, the bloc's trade with India is relatively low at just 0.9% of total MERCOSUR exports, although over the last five years significant dynamism has been observed. For its part, the bloc agreed to also lower import tariffs for Indian products by between 10% and 100%, in such articles as chemical products, pharmaceuticals, handtools, compressor pumps, textile machinery, and electrical appliances.

J. The MERCOSUR/SACU Agreement

On December 16, 2004, the Preferential Trade Agreement was signed by the two blocs in Belo Horizonte, and progress was made in drafting the respective annexes (Safeguards, Dispute Settlement, Rules of Origin, and Product Lists). The granting of fixed preferences (from 10% to 100%) were accordingly agreed for close on 1,000 products for each contracting party. By mid-2005 there remained pending the closure of certain annexes, moving forward a customs cooperation agreement, the treatment of free zones, and the definition of certain specific requirements of origin. There is also an additional list of preference applications by the SACU and MERCOSUR.

Analysis of the products negotiated augurs well for MERCOSUR in terms of various industrial manufactures' entry into the African market, especially where the metallurgical, furniture, instrumental, toys and capital goods sectors are concerned. When it becomes operational, the agreement will have a beneficial impact on trade flows between both regions, as a high degree of complementation exists between them. Indeed, between 2000 and 2004, there has been a significant quantitative leap in bilateral trade: MERCOSUR exports to the SACU have tripled, and this meant raising the status of this region as a trade partner, as it has come to represent 1.2% of total MERCOSUR sales.

K. MERCOSUR/Canada Negotiations: Beyond the FTAA

In the framework of the Understanding on Cooperation in Matters of Trade and Investments signed by MERCOSUR and Canada in 1998, and after various bilateral meetings between Brazil and Canada in 2004, Canada accepted MERCOSUR's proposal to move talks forward to intensify the trade and investment relationship between the parties. Indeed, after the meeting between President Lula da Silva and Prime Minister Paul Martín in November 2004, Canada and MERCOSUR decided to push forward in talks toward greater reciprocal opening in goods, services and investments.

As a result, during the first half of 2005, two meetings between MERCOSUR countries and Canada were held, one in Ottawa in early February, and another in Asunción in mid-May. While at the first meeting, Canada expressed reservations about taking the step from talks to negotiating a Trade Agreement outside the FTAA framework, on the second occasion the same country expressed doubts about the continuation of the FTAA process –not only due to the total lack of any progress, but also to the indefinite postponement of the meeting of co-presidency representatives. As a result, Canada pointed out that it would propose alternatives to its highest authorities in order to obtain a mandate that would allow progress in negotiations with MERCOSUR, outside trends in the FTAA.

The negotiation with Canada is interesting because, among other things, trade is still on a small scale (1% of total MERCOSUR trade), but has high growth potential. Nor does Canada pursue intellectual property proposals such as those expounded by the United States (TRIPs-Plus), and which were one of the obstacles to the FTAA. Finally, in both Argentina and Brazil, the search for an Agreement with Canada is well looked on by the industrial and agricultural sectors. Where these sectors are concerned, Canada maintains high tariff barriers, but does not subsidize exports or grant supports for its producers, at least not in quantities comparable with the EU or the United States.

L. MERCOSUR/Mexico Negotiations: Between the Bilateral & the Free Trade Area

In mid-2002, MERCOSUR and Mexico signed ECA 54 in the framework of the LAIA, by which the parties committed to making headway in the creation of a Free Trade Area, and agreed that, for the duration of the negotiation, any preexisting bilateral agreements between Mexico and each of MERCOSUR countries would form part of the ECA 54 'umbrella'.

Since 2003, there has been a political rapprochement from Mexico with the region, coinciding with a much stronger economic/trade relationship, especially with Argentina and Brazil.[82] In April 2004, the Mexican Foreign Minister thus applied to be incorporated as a full partner in MERCOSUR, a proposal that was reformulated by the bloc, which offered Mexico entry as an associate member.

At the Iguazú meeting in July 2004, with President Fox present, Mexico was accepted as an associate member after the finalization of a free trade agreement between the two parties. The conditions and format of this agreement began to be assessed from that time on. In May 2005 the first technical meeting was

[82] Trade with Mexico has expanded greatly in recent years, increasing the bloc's exports by 110% on 2000. 3.8% of MERCOSUR exports are destined for Mexico.

held, aiming at broad agreement with no exclusions, while taking into account sensitive positions and special, differentiated treatment for Paraguay. This would be done on the basis of goods, services and investments, not therefore including government procurement or intellectual property. It should be pointed out here that Mexico's position in the negotiation –as well as in others past and present– is to move toward broad agreements, and as a precedent for this, it has the agreement signed with one of the MERCOSUR countries (Uruguay). This agreement in effect provides for liberalization in services, and more ambitious investment than has so far been offered by MERCOSUR in its external negotiations.

M. MERCOSUR/Russia Relations: Starting with the Political

Dialogue between MERCOSUR and the Russian Federation has been taking place within MERCOSUR's Forum for Political Consultation and Coordination (FCCP). The first meeting was held on the occasion of the extraordinary meeting of the Forum in Buenos Aires in April 2004, while a second version was held in Moscow in June 2005. The FCCP has not tackled economic cooperation issues, as it does not intervene in matters of MERCOSUR trade policy, a responsibility that falls exclusively to the CMG and CMC.

In addition to this Forum, between May 17 and 20, 2005, the President of the Commission of Permanent MERCOSUR Representatives, Eduardo Duhalde, visited the Russian Federation, and held meetings with the Russian Minister for Foreign Affairs, Sergei Lavrov, in order to develop relations between the two parties. The meeting included significant agreement regarding the central problems on the international agenda, and it was agreed to expand bilateral cooperation in the area of the United Nations Organization (UNO) and other international organizations.

The Russian Foreign Ministry also made an official statement to the effect that "avenues of trade, economic and investment cooperation have been explored, with the possibility of taking place in the immediate future. Talks designed to increase bilateral economic cooperation have foregrounded such sectors as oil, natural gas, electrical energy, transport infrastructure, new technologies, medicine, the pharmaceutical industry, and the agroindustrial complex."

The MERCOSUR delegation that accompanied Dr. Duhalde, was made up of businessmen from the biotechnological, information technology and pharmaceutical industries, as well as representatives of the Brazilian and Argentinian Foreign Ministries. It held meetings with the Russian Federation's Chamber of Trade and Industry, agreeing to hold a business forum and specialist meetings in 2006 to explore the prospects of more intense cooperation between the two parties.

Finally, at this stage, there was an official visit by Argentinian Vice-President, Daniel Scioli, who presided over the third meeting of the Argentinian/Russian Business Council in Moscow, which highlighted the possible expansion of trade and investment. This consensus came about just months after Russia signed a series of cooperation agreements on economic, scientific, cultural and technological matters with Brazil.

N. MERCOSUR/Korea: Making a Start with a Feasibility Study

Korea and MERCOSUR have, since 1997, had a consultation and information mechanism in place similar to those effective in Japan and China. Five High Level Meetings have been held. In October 2004, on Korean President Roh Moo-Hyun's visit to Brasilia, an agreement was signed to carry out a feasibility study of the economic/trade impact of a possible Korea/MERCOSUR Free Trade Area.

This study's terms of reference were established in May 2005. It will include a general equilibrium analysis, and a partial equilibrium analysis, plus the use of trade indicators, to determine impacts of trade flows at the level of productive sectors, and a survey of measures affecting trade.

O. Other Negotiations

a) MERCOSUR/Egypt

At the Iguazú Summit in mid-2004, a Framework Agreement was signed for negotiation between the parties. This provides for the formation of a Free Trade Area, subject to the signing of a Fixed Preference Agreement.

b) MERCOSUR/Morocco

In late November 2004, with Morocco, MERCOSUR signed the same kind of framework agreement as its existing one with India, SACU and Egypt, the idea being to move toward some kind of preferential trade agreement.

c) MERCOSUR/Israel

After repeated proposals by Israel to start negotiations to form a Free Trade Area, MERCOSUR formalized the opening of talks by mid-2005, beginning with a proposal for a Framework Agreement.

d) MERCOSUR/Pakistan

Pakistan has expressed an interest in negotiating a trade preference agreement with MERCOSUR on various occasions, as a first step toward negotiating a free trade treaty. MERCOSUR decided to open negotiations at the CMG meeting in June 2005.

e) MERCOSUR/Gulf Cooperation Council (GCC)

In 2004, the countries forming the GCC (Saudia Arabia, Bahrain, the United Arab Emirates, Kuwait, Oman and Qatar) proposed the signing of a framework agreement with a view to negotiating a Free Trade Area. This Framework Agreement for Economic Cooperation was signed in May 2005 at the Summit of Heads of State and Government of South America and Arab Countries. The Agreement sets out the initial negotiation of a trade agreement, later progressing to a free trade agreement.

f) Other Talks

Over the last year, MERCOSUR began talks with Japan, the countries of Closer Economic Relations (CER), namely Australia and New Zealand, the Sistema de Integración Centroamericano (SICA: Central American Integration System), CARICOM (consisting of a number of small countries among which are Trinidad & Tobago, Jamaica, Guyana and Surinam), and with the Comunidade de Paises de Lingua Portuguesa (Community of Portuguese Language Countries).

CHAPTER 6. INFRASTRUCTURE & REGIONAL PHYSICAL INTEGRATION

The inclusion of matters of physical integration on the MERCOSUR agenda as one of the main driving forces behind sustained development in the region is a recognition of its strategic importance in partners' economic and social growth. This is how the bloc's supreme authorities approached it at the various different meetings, and it is central to the objectives and debates surrounding South American integration.

At the 28th Meeting of the Common Market Council, held in Asunción on June 18 and 19, 2005, the presidents of the MERCOSUR Member States expressed their political will for the decisions and tasks performed in the context of the Initiative for the Integration of Regional Infrastructure in South America (*Iniciativa para la Integración de la Infraestructura Regional Suramericana* - IIRSA) to advance more rapidly, with a view to effectively integrating the region's countries. They advocated the creation of financing mechanisms to encourage the development of the region's infrastructure, and expressed the most resolute support for the development of the Central Bioceanic Corridor, involving Argentina, Bolivia, Brazil, Chile, Paraguay and Uruguay. Finally, they stressed their desire for the continued progress of physical and energy interconnection projects in the subcontinent, embracing all the region's countries, while bearing in mind specific existing energy sources, and prioritizing the neediest areas.

Integration action for the energy sector in MERCOSUR's ambit has been one of the priorities for the governments of Member States over the last year. Various different events have been organized to focus on joint planning and coordination by regional agencies to strengthen cooperation in supporting sustainable projects, as well as improving the use of natural resources.

Activities have been identified at regional level whose agendas will focus on areas such as identifying new financial instruments for the energy sector, devising a regional strategic plan, the sustainable development of Bolivian gas, regional technological cooperation, and the strengthening of the Regulating Agencies.

Similarly, the Energy Ministers and Government Representatives of MERCOSUR, Chile, the Andean Community (*Comunidad Andina de Naciones* - CAN), Surinam and Guyana recognized in Caracas at the end of September 2005 that, in spite of breakthroughs in the sector, and the region's development potential, serious challenges exist where energy provision is concerned. To meet this challenge, it was agreed to intensify the Petroamérica initiative, designed to achieve comprehensive South American energy integration.

Meanwhile, in matters to do with developing transport and communications infrastructure, the breakthroughs made in this last period related to processes of land transport (roads and bridges, border crossings, and improved port facilities), and Information Technology & Communications (ITC), both sectors strongly linked with the development of IIRSA.

At the MERCOSUR level, the works prioritized by governments on IIRSA's Agreed Implementation Agenda can be singled out. These include the widening of Route 14 between Argentina and Brazil (the 'MERCOSUR Road') with an estimated investment of US$ 0.27 billion, the adaptation of the Rio Branco/Montevideo/Colonia Corridor between Uruguay and Brazil estimated at US$ 0.09 billion, the construction of the Yaguarón/Rio Branco Bridge between Brazil and Uruguay at US$ 0.012 billion, the Palhoca/Osorio Widening, the 'MERCOSUR Highway' between Brazil, Argentina and Uruguay with an estimated investment of US$ 0.283 billion, the Los Andes/Mendoza Railroad Project between Argentina and Chile estimated at US$ 0.224 billion, and the Northwest Gas Pipeline between Argentina and Bolivia estimated at US$ 1 billion. São Paulo's Railroad Ring with an investment of up to US$ 0.3 billion is also worth mentioning.

Still on the subject of MERCOSUR's physical infrastructure integration, the progress of the Border Crossings Pilot Program, comprising the borders crossings at Cristo Redentor, FrayBentos/Puerto Unzué, Ciudad del Este/Foz do Iguazú.
In the framework of the Pilot Program,[83] specific works are being performed, such as diagnosing each crossing's different conditions, particularities and critical factors, technical/institutional meetings required for the execution of projects, conceptual designs, preparation of final bilateral agreements for the implementation of the new models of each crossing and the preparation of the documentation required for the technical cooperation management.

The Pilot Program supports the MERCOSUR government authorities in bilateral negotiations to reach agreements on matters institutional, legal, regulatory, operational, and relating to investment, assessment and control mechanism, indicator and measurement systems, immediate solution proposals, integrated rules and procedures, the proposal to create or strengthen the Binational Consultative Council, and the schedules for activities.

A. IIRSA

As mentioned earlier, MERCOSUR countries have been participating in IIRSA, since MERCOSUR's creation in August 2000. This organization aims to undertake joint action to push forward the process of political, social and economic integration in the southern part of the continent, including the modernization of regional infrastructure, and specific measures to stimulate the integration and development of isolated subregions. The initiative's goal is thus to promote the development of transport, energy and telecommunications infrastructure with a regional vision, to achieve the physical integration of the twelve South American countries and a model of equal and sustainable territorial development.

In operative terms, IIRSA contemplates coordination mechanisms and information exchange between Governments, the region's three multilateral financial institutions (IDB, CAF and FONPLATA), the private sector and civil society to achieve its proposed objectives.

IIRSA's work is organized on three levels:

1. The *Executive Steering Committee* (ESC): made up of senior representatives appointed by South American Governments. The ESC has a Presidency and two Vice-Presidencies;

2. *Executive Technical Groups* (ETGs): made up of officials and experts appointed by South American Governments. The Executive Technical Groups are to be constituted for each hub of integration and development, and for each of the sectoral integration processes approved by the ESC;

3. The *Technical Coordinating Committee* (TCC): made up of IDB, CAF and FONPLATA representatives who coordinate the technical support to be provided to high-priority areas established by the ESC and for the ETGs. The TCC has a permanent Secretariat at the headquarters of the Institute for the Integration of Latin America & the Caribbean (IDB/INTAL) in Buenos Aires.

Additionally, the Initiative in each country has been structured around the National Coordinators, who are responsible for coordinating the participation of the different Ministries and government organizations

[83] A program by sectorized border crossings financed jointly by the IDB and the *Fondo Financiero para el Desarrollo de la Cuenca del Plata* (FONPLATA: Financial Fund for Development of the River Plate Basin). The *Corporación Andina de Fomento* (CAF: Andean Development Corporation) is also participating in the Pilot Program, financing the Cúcuta/San Antonio border crossing between Colombia and Venezuela.

involved in IIRSA, and potentially, of any other relevant sectors of society (private sector, provincial governments, academia, NGOs, etc.).

In accordance with its presidential mandate, IIRSA bases its activities on seven basic principles:

1. Open Regionalism: South America is conceived as a fully integrated geoeconomic space, for which internal trade barriers and bottlenecks in the infrastructure and regulation and operation systems driving regional productive activities have to be reduced. While trade opening facilitates identification of globally competitive productive sectors, the vision of South America as a single economy allows the benefits of intra- and extra-regional trade to be better retained and distributed.

2. Integration & Development Hubs: The South American environment is organized around multinational sectors that concentrate current and potential trade flows, in which it is sought to establish a minimum common quality standard for transport, energy and telecommunications infrastructure services to support the specific productive activities of each Integration and Development Hub. The provision of these services seeks to develop business and productive chains with economies of scale along the hubs, whether for the region's domestic consumption, or for export to global markets. This classification of the South American space will facilitate access to areas with productive but currently underemployed potential, due to the shortfall in the provision of transport, energy or telecommunications services.

3. Economic, Social, Environmental & Politico-Institutional Sustainability: the integration of South America should be achieved by respecting the following four elements: (i) economic sustainability, provided by efficiency and competitiveness in productive processes; (ii) social sustainability, provided by the visible impact of economic growth on the population's general living standard; (iii) environmental sustainability, involving the rational use of natural resources, and the conservation of ecological assets; and (iv) politico-institutional sustainability, creating the conditions for the various public and private social agents to contribute to the process of development and integration.

4. Growth in the Added Value of Production: regional development and integration should not simply exist to produce more than in the past; instead it should be a process of constant improvement in the quality and productivity of goods and services (via the innovation and production of knowledge). As part of the process of regional integration, our economies should reorientate themselves to form productive chains in sectors of high global competitiveness, capitalizing on the various comparative advantages of the region's countries, and strengthening the complementation of their economies in order to generate added value in production.

5. Information Technologies: the intensive use of modern information and communications technologies totally transforms the concepts of distance and space, overcoming geographical and operative barriers within the region, and bringing the South American economy closer to the major driving forces of the world economy. The spread and intensive use of such technologies supports a transformation not only of the region's productive systems, but of the workings of society in general, including educational systems, the provision of public services, and the organization of civil society itself.

6. Regulatory Convergence: as part of the requirements to make investments in regional infrastructure viable, the political will of governments is necessary to promote and facilitate dialogue between the countries' regulatory and planning authorities in order to achieve compatibility between the rules governing the performance of private initiative in the region.

7. Public/Private Coordination: the development challenges facing the region raise the need for shared coordination and leadership between government and the private business sector, including both the promotion of public/private strategic associations to finance investment projects, and consultation and cooperation to develop an appropriate regulatory environment for the significant participation of the private sector in regional development and integration initiatives. The conception of development as a shared responsibility of government and business encourages the design of innovative formulas for the financing, execution and operation of 'structuring' projects, sharing risks and benefits.

In this context nine basic lines of actions were defined:

1. To design an integral vision of infrastructure.
2. To develop the projects within a strategic planning framework, on the basis of the identification of integration and regional development hubs.
3. To modernize and update the national regulatory and institutional systems governing the use of infrastructure.
4. To harmonize the policies, plans and regulatory and institutional frameworks between the States.
5. To place value on projects' environmental and social dimensions.
6. To improve the living standard and opportunities of the integration hubs' populations.
7. To incorporate participation and consultation mechanisms.
8. To develop regional mechanisms for project programming, execution and management.
9. To structure financial schemes adapted to the risk configuration of each project.

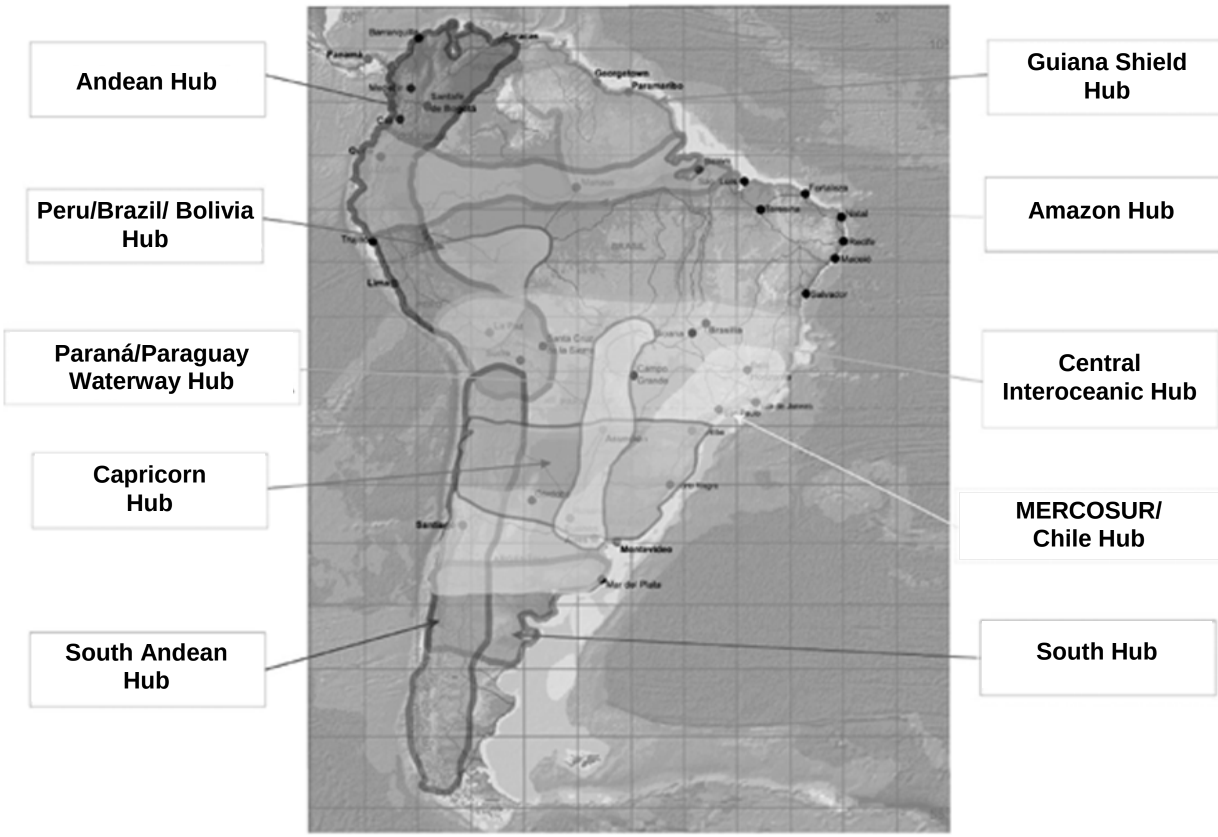
This effort includes the search for innovative solutions between the Governments and multilateral financial organizations promoting the incorporation of private capital.

B. Achievements

IIRSA has consolidated its position as a central authority for the construction of a common agenda of physical integration measures and projects. In its first four years, it has concentrated its efforts on three main areas of action:

1. Designing a Strategic Vision for South American Physical Integration: a vision is sought that is shared by the twelve countries, in which basic principles are agreed in order to guarantee the region's sustained economic growth, with physical integration being conceived as a necessary condition for development, bound up with significant transformations in four other key dimensions: competitiveness, social quality, environmental quality, and institutional quality.

2. Integration & Development Hubs (*IDHs*): the countries have defined ten IDHs linking up the South American continent. The aim is to identify the physical infrastructure requirements for each IDH on the basis of its economic, social and environmental qualities in order to stimulate development.



3. Sectoral Integration Processes (*SIPs*): these strive to modernize and update the national regulatory systems governing the use of infrastructure, and promote the harmonization of policies, plans and legal and institutional frameworks between countries.

With these ends in mind, the Initiative developed regional diagnostic studies, and presented short, medium and long term lines of action to the countries for the following processes:

- Information & Communications Technologies
- Air Transport Operating Systems
- Border Crossing Facilitation
- Maritime Transport Operating Systems
- Energy Integration
- Multimodal Transport Operating Systems
- Financing Instruments

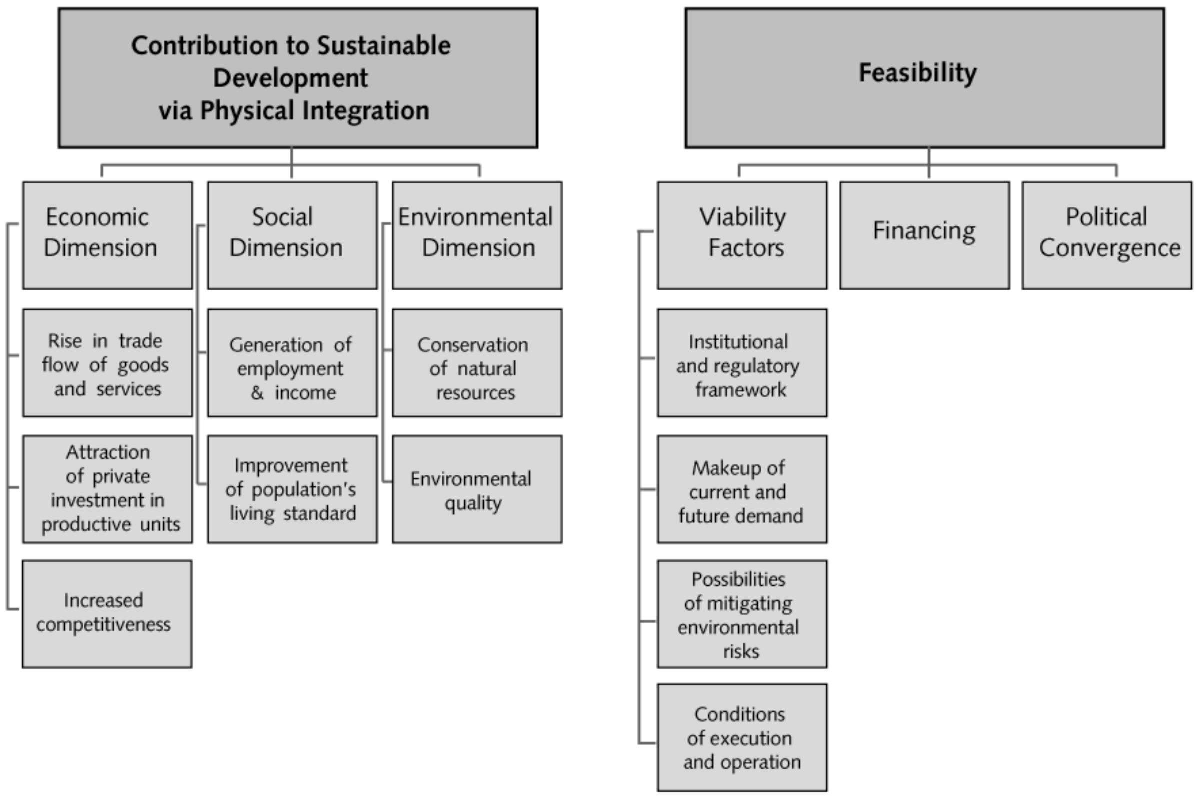
Territorial Planning

Territorial planning verified three basic stages:

1. In the first stage, the grouping of projects within each IDH was developed on the concept of synergies,[84] and identified forty groupings, their anchor projects[85] and functions.

2. The second stage involved defining a structure of factors that consolidate the attributes of each group of projects, in terms of impact on development and feasibility of implementation.

3. Two strategic analytical dimensions were defined by the TCC and the National Coordinators: (a) Impact on sustainable development in its economic, social and environmental dimensions; and (b) Feasibility of implementation deriving from technical viability, capacity to access financing from a variety of sources, and political convergence. The structure of factors applied to the assessment of the groupings is presented below:



At the third stage, assessment of the groupings was developed over three ETG meetings, a process which distinguished two features:

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[84] The grouping process is based on the possibility of exploiting the positive externalities of a set of investments that can generate greater benefits than the sum of the individual component projects' effects (synergies). These investments can be conceptually classified as *Vertical Synergies* (the grouping occurs by virtue of input/output relationships in a functional systemic chain) and *Horizontal Synergies* (the use of common resources or by ease of implementation).

[85] The anchor project is what gives meaning to the group's formation, and makes synergies viable. In other words, it must have catalytic/synergetic power to justify a group being formed in its environment. It is not necessarily the most important project, but has been identified as the 0bottleneck' or 'missing link' in the infrastructure network, preventing benefits being gained from the combined effects of the group.

- *Qualitative*: based on the convergence of expert opinions on the prospective impact of the implementation of the groupings;
- *Hierarchical*: attempting to identify such impacts in a comparative framework for the groups, which will enable a relative order to be established.

In this framework, the governments have drawn up a portfolio, at present containing 335 transport, energy and telecommunications infrastructure projects, representing an estimated investment of US$ 37.47 billion.[86]

TABLE 15
TRANSPORT, ENERGY & TELECOMMUNICATIONS INFRASTRUCTURE PROJECTS & INVESTMENT

Integration & Development Hub	No. of Groups	No. of Projects	Estimated Investment (millions of US$)
Amazon	6	44	2,000
Andes	11	74	5,000
Guiana Shield	4	32	370
Peru/Brazil/Bolivia	3	18	11,600
Central Interoceanic	5	44	3,300
Capricorn	4	34	2,000
South	2	21	1,100
MERCOSUR/Chile	5	68	12,100
Total	40	335	37,470

Achievements for July 2004-July 2005

2005-2010 AGREED IMPLEMENTATION AGENDA (AIA)

At the 6th IIRSA ESC Meeting in Lima on November 23-24, 2004, the countries defined a group of 31 high-priority projects for implementation in the 2005-2010 administration, representing alternatively financed investments of US$ 4.316 billion. The amounts estimated for MERCOSUR countries total an investment of US$ 0.955 billion. Likewise, projects with one or more Member States reach the US$ 3.064 billion mark. The aim is to generate a new stage in the Initiative, and to speed up the achievement of specific results in high impact continental physical integration projects.

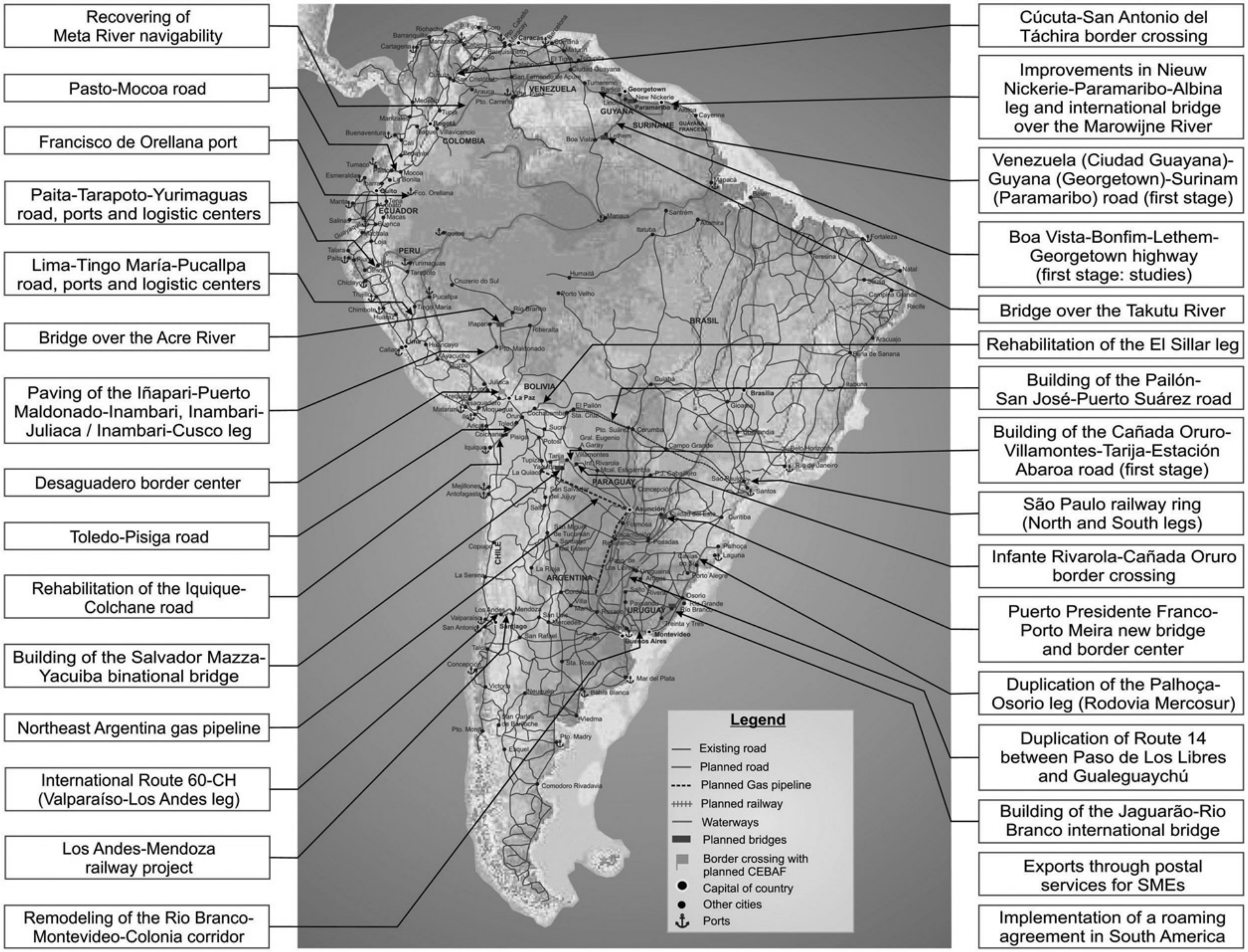
86 A draft portfolio for the Hubs of the Paraguay/Paraná Waterway and of the Southern Trans-Andean Railroad has been drawn up.

TABLE 16
STRATEGIC PROJECTS FOR INTEGRATION & DEVELOPMENT HUBS AND SECTORAL INFORMATION & COMMUNICATIONS TECHNOLOGIES PROCESSES

No.	Projects	Hub	Millions of US$	Countries
1	Widening of Route 14	MERCOSUR/Chile	270	AR (BR)
2	Adaptation of Rio Branco/Montevideo/Colonia Corridor	MERCOSUR/Chile	90	UR (BR)
3	Construction of Yaguarón/Rio Branco Bridge	MERCOSUR/Chile	12	BR/UR
4	Palhoça/Osorio (MERCOSUR Highway) Widening	MERCOSUR/Chile	283	BR (AR/UR)
5	Andes/Mendoza Railroad Project	MERCOSUR/Chile	224	AR/CH
6	Route 60 Valparaíso/Los Andes Concession	MERCOSUR/Chile	165	CH (AR)
7	Northeeast Gas Pipeline	MERCOSUR/Chile	1,000	AR (BO)
8	Construction of Salvador Mazza/Yacuiba Bridge	Capricornio	10	AR-BO
9	New Presidente Franco/Porto Meira Bridge	Capricornio	55	PR-BR
10	Construction of Pailón/Puerto Suárez Highway	Interoceanic	245	BO-BR
11	São Paulo Railroad Ring	Interoceanic	300	BR
12	Cañada Oruro/Infante Rivarola Border Crossing	Interoceanic	1	BO-PR
13	Construction of Cañada Oruro/Villamontes/Tarija/Estación Abaroa Highway (1st stage: Villamontes/Cañada Oruro)	Interoceanic	60	BO (PR)
14	Toledo/Pisiga Highway	Interoceanic	75	BO-CH
15	Restoration of Colchane/Iquique Highway	Interoceanic	20	BO-CH
16	Restoration of El Sillar Stretch	Interoceanic	30	BO (BR-CH-PE)
17	Desaguadero Border Center	Andes	5	BO-PE
18	Cúcuta/San Antonio del Táchira Border Crossing	Andes	2	CO/VE
19	Recovery of Navigability of the River Meta	Andes	12	CO/VE
20	Pasto/Mocoa Highway	Amazon	71	CO
21	Paita/Yurimaguas Highway, Huallaga Waterway, Paita, Yurimaguas and Iquitos Ports and Logistical Centers	Amazon	248	PE (BR)
22	Lima/Tingo María/Pucallpa Highway, Pucallpa Portsand Logistical Center, and modernization of El Callao Port (1st stage)	Amazon	296	PE (BR)
23	Francisco de Orellana Port	Amazon	20	EC
24	Paving of Iñapari/Puerto Maldonado/Inambari, Inambari/Juliaca/Inambari/Cusc	Peru/Brazil/Bolivia	700	PE/BR
25	Bridge over the River Acre	Peru/Brazil/Bolivia	10	BR/PE
26	Boa Vista/Bonfim/Lethem/Georgetown Highway (1st stage: feasibility and environmental studies)	Guiana Shield	2	GY/BR
27	Bridge over the River Itakutu	Guiana Shield	18	GY/BR
28	Venezuela (Ciudad Guayana)/Guyana (Georgetown)/Surinam (Paramaribo) Highway (1st stage: feasibility studies)	Guiana Shield	2	VE/GY/SU
29	Improvements to Nieuw Nickerie/Paramaribo/Albina and International Bridge over the River Marowijna	Guiana Shield	90	SU/GY
30	Mail Exporting for PYMES	ITCs	-	All
31	Implementation of Roaming Agreement in South America	ITCs	-	All
	Subtotal projects MERCOSUR countries only		*955*	
	Subtotal projects with one or more MERCOSUR countries		*3,064*	
	Total		**4,316**	

Source: IIRSA Secretariat.

The following map shows the geographical location of the selected Projects:



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