Intal

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Nº 2

REPORT

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PRESENTATION

The MERCOSUR Report series represents a new effort of INTAL aimed at promoting understanding and dissemination of information about the current dynamic process of integration in Latin America and the Caribbean.

As part of this integrationist trend, the Southern Common Market has become, since the signing of the Asunción Treaty in 1991, a leading case for the evaluation of the achievements and challenges encompassed by this ambitious initiative.

The purpose of INTAL, through the publication of this semiannual series, is to facilitate access of information to a wide number of readers interested in MERCOSUR, which comprises the public and private sectors and the community of the subregion as a whole. Likewise, in order to promote MERCOSUR within and beyond the subregion, information dissemination oriented towards the international community will be fostered through the publication of this report in English, as well as in Portuguese and Spanish, the two official languages of the process.

Report issue number 2 covers the first semester of 1997 and has been prepared by the well known expert Dr. Pedro da Motta Veiga under the technical supervision of Mr. Uziel Nogueira in INTAL.

We hope the material presented today meets the expectations raised by issue number 1. We would like to invite our readers to continue sending their comments and/or suggestions so that improvements can be incorporated in the future scope and focus of the contents of this publication.

Juan José Taccone
Director

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EXECUTIVE SUMMARY

I. Macroeconomic trends in MERCOSUR

In the first half of 1997, MERCOSUR's macroeconomic situation was marked by two trends: first, improved performance in terms of output and inflation rates, in a context of relative fiscal fragility and external vulnerability; and second, convergence in the performance of the different countries, assuring the stability of real bilateral exchange rate parities.

If present trends continue, the region's GDP will grow 4.2% this year, as against 1.5% in 1995 and 3.3% in 1996. The inflation rate—as measured by the consumer price index—will fall from 7.8% in 1996 to 5.4% this year. Economic growth will therefore accelerate gradually while inflation rates fall, and while the development of these two indicators in the different countries of the bloc display converging performances.

Growth with low inflation and performance convergence are occurring against a background of fiscal fragility and external vulnerability. In the fiscal arena, there are indications of a conjunctural improvement in the public accounts of Argentina and Brazil, linked to the increase of levels of activity and, in Brazil's case, to additional factors (levying of a new tax, the CPMF, use of privatization income for debt reduction, etc.).

On the external accounts side, all MERCOSUR countries except Paraguay recorded significant increases in their current account deficits in 1996. For the region as a whole, the current account deficit reached 2.8% of GDP in 1996, a nominal 37% increase relative to 1995. For 1997, a widening of the deficit by 40% over the previous year is estimated, bringing the current account deficit to 3.8% of GDP.

This circumstance indicates that the availability of external financing will in the coming years continue to be an important determinant of growth of the subregion's economies.

The current account deficit of Brazil grew from US$5.2 billion in January-April 1996 to US$10.7 billion in the first third of 1997. Given the possibility of the deterioration of the external accounts as an inertial trajectory of the development of the economy, the government adopted a series of measures gradually to reduce the trade deficit and to stimulate capital inflows.

The stimulus to capital inflows came through an interruption in the fall in domestic interest rates in May, through the elimination of the financial transactions tax (*Imposto sobre Operações Financeiras,* IOF)—on loan transactions abroad—and through the reduction of that tax on fixed income funds and other transactions that involve attracting external resources.

Efforts to cut the trade deficit focused on three areas:

- Broadening export incentives by extending the list of products and sectors benefitting from Proex and by establishing pre-shipment mechanisms in the framework of this program;
- Modifying import financing rules, with regulations imposed under Provisional Measure (*Medida Provisoria*, MP) 1569 and by a complementary measure of the Central Bank to close the loopholes of the MP; and
- An increase of the IOF for credit transactions to individuals, with the expected effects on sales of cars and appliances -imports of which have been growing strongly.

Of the economic policy alternatives, Brazil's strategy for external performance offers the fewest costs for its MERCOSUR partners and would bring the least effects on moves towards the establishment of a customs union. The recourse to strong measures to constrain domestic demand—as yet unaccompanied by any moves towards exchange rate management - would have obvious effects on imports. Eventual exchange devaluations would simply strengthen those effects.

Despite this, the alternative represented by the use of trade policy instruments, on both the import and the export side, and the setting up of sectoral programs of investment support, prompted some significant tensions between Brazil and its partners, as happened when MP 1569 was issued in March 1997.

II. Trade and Investment in MERCOSUR

Two phenomena mark MERCOSUR's consolidation from the perspective of trade flows: the significant growth on intraregional commerce and the sharp reduction in levels of protection towards the rest of the world.

The insufficiencies and vulnerabilities of MERCOSUR appear to be related less to trade diversion -as a result of significant intra-bloc trade preferences - than to the difficulties involved in bringing discipline concerning the member countries' use of instruments that may block the free flow of trade in the region and the goals of the customs union.

In 1996, MERCOSUR's total exports grew by 6.4% while its imports expanded by 9.7%. Intra-regional exports grew by 17.9% last year, below the average for the 1990-95 period (28.4%) and imports grew by 18.5%, also lower that the 1990-95 period (27.8%).

The share of MERCOSUR in the sub-region's total exports climbed from 8.9% in 1990 to 22.6% in 1996, when the growth trend continued. MERCOSUR's share of the bloc's total imports also continued to grow in 1996, reaching 20.15% of the total, against 15.08% in 1990.

For the MERCOSUR countries, 1996 was characterized by three performance patterns as regards trade within the bloc and with the rest of the world:

- Dynamism in intra and extra-MERCOSUR trade, with emphasis on intra-bloc flows -the case of Argentina.
- Significant dynamism in intra-MERCOSUR imports and exports, contrasting with the rates of growth observable in trade with the rest of the world - the case of Brazil, largely on the export side, and of Paraguay on the import side.
- Low dynamism of intra-MERCOSUR trade flows, simultaneous to the significant growth of extra-bloc trade, especially on the export side - the case of Uruguay.

Independently of trends towards a reduction in the growth rate of intra-MERCOSUR commerce (which suggest a growing divergence of trade performances of the members of the group), regional trade remains marked by a notable specialization in manufactured goods. This is particularly the case for the two biggest economies of the sub-region.

Bilateral trade between Argentina and Brazil has recorded substantial growth in recent years, as well as significant changes in its composition. The period of greatest dynamism, from 1990 to 1993, also saw the greatest changes in the structure of bilateral trade.

Analysis of Argentine-Brazilian trade between 1990 and 1996 suggests that, despite the growth of intra-industry commerce between the two countries, bilateral trade flows are still broadly subject to the patterns of specialization prevalent at the beginning of the 1990s, originating in the endowment of "natural" comparative advantages or instituted in the period of import-substitution in the two countries.

Deviations from this rule are centered in sectors where bilateral negotiations or unilateral trade defense initiatives produced some kind of trade administration mechanism (such as in transport material, minerals, oil and fuels, textiles and clothing).

In the area of investment four main, ongoing movements should be noted, not only because of their strategic link to the new regulations but also for their potential to affect the industrial structure of the sub-region and its international competitiveness:

- First, foreign investment in the automotive sector. In recent months Brazil has benefited from the announcement of new investment decisions linked to the federal incentives system, and to the policies of the federal states for attracting investment in the sector.

- Second, foreign investment in the financial services sector, mainly in Argentina, where liberal legislation eliminated a series of restrictions on the activities of foreign capital. In Brazil, similarly, the restructuring of the sector opened opportunities for the entry of new foreign institutions.

- Third, foreign and domestic investment linked to the privatization of public services. In Argentina, a significant part of this process has already occurred. In Brazil the cycle is becoming more active, with the planned sale of more than US$50 billion in shares in state telecommunications and electricity companies during the next three years.

- Fourth, recent investments in the Argentine mining industry. This is a doubly paradigmatic case. It is an example of rapid business reaction to a regulatory environment -established in 1993- that is favorable to investment, including foreign investment. It also reflects the emergence and development of a strongly export-oriented industrial sector, strengthened by the success of the structural reforms undertaken in Argentina, and of efforts to reduce the "Argentine Cost", composed by variables that affect the costing structure of companies performing in the local economy.

In general, the main trends observed in the analysis of flows of productive investment in MERCOSUR suggest strong links between the areas of dynamism and the establishment of horizontal and sectoral regulatory frameworks favorable to new investment.

There has been a significant participation of foreign investment for share acquisitions, which does not in the first instance add supply capacity. Since such investments are mainly targeted at the services sectors, the anticipated benefits are less concerned with an increase in supply than with the improvement of the quality of services and with their effects on the production and export costs of the industrial and agricultural sectors. A final characteristic of foreign and domestic flows to MERCOSUR is their central goal of attending to the demands of the sub-regional market—with the exception of investment in the Argentine mining industry—although in some industrial sectors growth of the exportable supply of goods is possible.

III. Consolidation and Deepening of the Customs Union

Greater inter-dependence prompted by the growth of trade and investment, as well as the convergence of economic performances among the countries of MERCOSUR, are key points on the integration agenda. The aim is to maximize the benefits of intra-regional liberalization and to distribute its costs in a manner acceptable to the member countries, while respecting the guidelines of "open regionalism".

The prospects for consolidating and deepening the MERCOSUR customs union are related to four macro-issues:

- market access for the members and the existing conditions of competition in the sub-region;
- the establishment of common policies in a certain number of priority areas for the operation of the customs union;
- policy harmonization and the adoption of measures for deepening the customs union, whose overall agenda was defined in 1995 by the Common Market Council in the "MERCOSUR Action Program to 2000"; and
- the expansion and improvement of the sub-region's transport communications and energy infrastructure.

In the first half of 1997, three questions dominated the MERCOSUR negotiations on market access and the conditions of competition; these mostly concerned bilateral relations between Argentina and Brazil:

- Discussions on Brazil's automotive regime and its effects on flows of foreign investment to the sub-region.

Despite Argentine demands, and in view of the scant importance that Brazil gave to the issue, discussions on the prevailing automotive regimes have not advanced recently and the sectoral negotiations have focused on Argentine demands for an increase in its quota to export vehicles to Brazil up to 1999.

- intra-MERCOSUR sectoral non-tariff measures and restrictions, whose accumulation and lack of resolution provokes tensions in the integration process;
- "horizontal" restrictions on access to the Brazilian market, in light of the external imbalances of the country's economy. The concerns aroused by Provisional Measure 1569 last March, which reduced the period for financing imports into the country, mobilized businessmen and negotiators from the other MERCOSUR countries and added to the two other questions concerning market access and competition conditions.

In the area of common policies, the anxieties about the efficiency and transparency of MERCOSUR's trade policy were revealed in three areas of negotiation during the first half of the year:

- special import regimes: while the scope of the results of the negotiations in this field has been limited, Paraguay Presidential Decree 16146 was issued on 27 February, reducing to zero up to 1 January 1999 the proportional duties on imports of inputs and raw materials by industrial and agricultural firms whose production programs are supported by the government. According to Paraguayan authorities this Decree only represents a balancing to the incentive mechanisms granted by the other MERCOSUR member countries to industrial competitivity.

- customs matters: The lack of adequate infrastructure and of harmonized norms continue to impede the adoption of integrated border controls. At the Asunción meeting in June, there was discussion of the possibility of establishing a Common Customs Fund as a mechanism for assigning among the members the resources generated by the levying of the CET by any of the countries. This would avoid the CET being levied on the same product by more than one country, and the demand for the certificate of origin for all products. The technical proposal for creating the Fund has not been completed, and work on it continues under the direction of the Central Banks of the sub-region.

- regulations on unfair practices and safeguards: in December 1996, after adoption of the Common Regulation on the Application of Safeguards by Non-Member Countries of MERCOSUR, Technical Committee Nº 6 of the Common Market Council began a project to establish the functions of the Committee of Commercial Defense and Safeguards.

The MERCOSUR Action Program to 2000, adopted by the Common Market Group in December 1995, established among other things the deepening of the customs union as a goal of the integration process. Trade in services, investment, the environment and labor issues, among others, were put on the agenda. As yet, however, they have received little attention from the national governments.

The issue of deepening the customs union has reacquired its primacy. The Rio de Janeiro Declaration affirms that MERCOSUR's strategy must move through deepening "towards its final objective"—that is, the establishment of the common market. The matter was addressed again in the presidential declaration that emerged from the MERCOSUR summit in Asuncion last June. Both declarations highlight services and government procurement as priority areas for deepening, to which the Declaration of Asunción added the issue of public policies that distort competition in MERCOSUR.

On the other hand, the decision of the MERCOSUR governments (plus Bolivia) to transform FONPLATA into a MERCOSUR Development Bank, as announced in March 1997, strengthens the agenda of deepening and may add a new dimension to the integration process: that of projects and initiatives that are fundamentally sub-regional in conception.

Despite the political directive to deepen the customs union, the June meetings of the Common Market Group and the Common Market Council showed that some difficulties persist for reaching consensus among the member countries, as to how the directive should be put into effect. While Argentine negotiators argue for the adoption of a common investment policy, Brazil defended a series of priorities concerning the bloc's "pending agenda": negotiating the common automotive regime by the end of the year; meeting the deadlines to reduce to zero the tariffs on the products in the automatic tariff reduction regime, discussing the special import regimes; and adopting common rules on consumer protection.

IV External Economic Relations

The FTAA dominated MERCOSUR's external agenda in the first half of 1997. The governments and business associations of MERCOSUR put great efforts and much of their negotiating capacity into the February meeting of vice-ministers in Recife (and in Rio de Janeiro in April), and the trade ministerial and the III Business Forum in Belo Horizonte during May.

FTAA negotiations create a significant incentive for the MERCOSUR countries to negotiate intra-bloc agreements on consolidating and deepening the customs union, as building blocks in the hemisphere-wide negotiations.

In the framework of the Latin American Integration Association (LAIA), negotiations with Mexico, the Andean Group and, more recently, Peru, are encouraging the multilateralization of the preferences granted in the bilateral agreements and, in the latter two cases, the conclusion of free trade accords.

The Bolivian and Chilean presidents attended the Asunción summit in June, where President Frei—backed by his Bolivian counterpart—argued for a more effective Chilean participation in intra MERCOSUR discussions. Among other things, the aim would be to establish common negotiating positions in both sides' foreign relations, and especially in the FTAA context. He also argued that MERCOSUR should be endowed with institutional mechanisms for resolving disputes between its members, and which would also embrace Bolivia and Chile.

In political terms, the strengthening of Chile's relations with MERCOSUR is highly significant, underpinned by a substantial increase in Chilean exports to and investment in MERCOSUR. Chile's international credibility is a notable asset for MERCOSUR in its external negotiations, particularly in the FTAA framework. Chile's experience of negotiating free trade agreements—most recently with Canada—could also bring added value to MERCOSUR's internal and external dynamic. Moreover, as a recent IDB document indicates, "in view of the progress made in the reform process and the opening up of the Chilean economy, and the country's experience of modern regulatory systems, an institutional framework that allows a fluid integration between Chile and MERCOSUR might support the future development of the integration process".(Periodic Note, Integration, Trade and Hemispheric Issues Division. [1996]).

CHAPTER I. MACROECONOMIC TRENDS IN MERCOSUR

A. Growth and Low Inflation: Performance Convergence and Structural Fragilities

Two trends continued to mark macroeconomic conditions in MERCOSUR in the first half of 1997. The first was an improvement in the performance of growth and inflation in a context of relative fiscal fragility and external vulnerability. The second was a convergence of the performance of the four member countries, thereby ensuring the stability of real bilateral exchange rate parities.

Data for the early months of the year suggest that these trends will prevail throughout 1997, although the possibility can not be discounted that Brazil might adopt measures to constrain credit or to boost interest rates in order to address the economy's growing external deficit. In such a case, Brazilian growth would slow, which may in turn affect the overall performance of MERCOSUR to some degree.

TABLE I.1
MERCOSUR: MACROECONOMIC INDICATORS

Evolution of real GDP

Country	% of GDP MERCOSUR/95	1995	1996	1997(*)
Argentina	27.4	- 4.6	4.4	5.2
Brazil	70.0	3.9	2.9	3.8
Paraguay	0.9	4.5	1.5	2.5
Uruguay	1.7	- 2.8	4.9	3.8
MERCOSUR	100.0	1.5	3.3	4.2

* Estimates of the Economist Intelligence Unit for Argentina, Paraguay and Uruguay. Estimated average from eight banks and consulting agencies summarized by the BNDES for Brazil.

Inflation rates (IPC %)

Country	1995	1996	1997(*)
Argentina	1.6	0.1	0.1
Brazil	22.0	10.4	7.1
Paraguay	10.5	8.2	10.7
Uruguay	35.4	24.3	18.3
MERCOSUR	15.6	7.8	5.4

* Estimates of the Economist Intelligence Unit for Argentina, Paraguay and Uruguay and average of estimates from twelve banks and consulting agencies summarized by the BNDES for Brazil.

Current Account Balance (US$ millions)

Country	1995	1996	1997(*)
Argentina	- 2,390	- 4,013	- 6,924
Brazil	- 18,136	- 24,347	- 33,100
Paraguay	- 1,060	- 540	- 745
Uruguay	- 359	- 535	- 468
MERCOSUR	- 21,575	- 29,435	- 41,237

* Estimates of the Economic Intelligence Unit for Argentina, Paraguay and Uruguay. Summary of estimates from eight banks and consulting agencies for Brazil (BNDES).

If present trends continue, the sub-region's GDP will grow by 4.2% this year, against 1.5% in 1995 and 3.3% in 1996. The inflation rate—as measured by the consumer price index—will fall from 7.8% in 1996 to 5.4% this year (Table I.1). Economic growth will therefore accelerate gradually while inflation rates fall.

The development of these two indicators in the countries of the bloc reflects the fact that performances are converging. In 1995 the extremes of GDP growth were -4.6% and 4.5%. In 1996 this gap closed to1.5% and 4.9%. It is expected to close further in 1997, to between 2.5% and 5.2%. Inflation rates reveal an even sharper tendency towards convergence: the extremes recorded in 1995 (1.6% and 35.4%) have gradually closed and estimates for 1997 suggest a gap between 0.1% and 18.3%.

This dual convergence is notable in MERCOSUR's two biggest economies: the GDP growth rate differential has fallen from 8.5% in 1995 to 1.4% in the estimates for 1997. The inflation rate differential has dropped from 20.4% in 1995 to 7% in the 1997 estimates. Since bilateral exchange rate parity remained stable despite the two countries' different exchange rate regimes, the impact of macroeconomic divergences on bilateral trade flows was negligible in the first half of 1997.

In the first quarter industrial growth reached 7.2% in Argentina and 5.3% in Brazil in comparison to the same period of the previous year. Growth of industrial GDP was impelled, especially in Argentina and Brazil, by the expansion of the consumer durables sectors as they benefited from the supply of greater credit to consumers. In Argentina, automobile production grew almost 50% in the first quarter of 1997, against the same period of 1996. In Brazil, production of durables in January 1997 was 24.5% greater than in January 1996, while total industrial output grew by 6.7%.[1] In March 1997 the consumer durables sectors grew by 7.6% in comparison to March 1996. Output of basic and intermediate goods grew in both countries during the first months of 1997 at a rate higher than that for industry. This phenomenon has been particularly intense in Argentina where, in the first quarter, steel output grew by 14% over the same period of 1996, cement output by 28%, and aluminium production by 39%.

Growth with low inflation and performance convergence are occurring against a background of fiscal fragility and external vulnerability. Argentina's public deficit was equivalent to 2% of GDP in 1996; it reached 1.35 billion pesos in the first quarter of 1997 and should fall to 1.7% of GDP over the course of the year. The growth of output boosted the tax revenue by almost 10% in the first quarter, while government spending increased moderately. At the end of 1996 public debt was equivalent to about 32% of GDP, with a marked concentration (50%) in maturities in the next four years.

In Brazil, fiscal performance has sharply improved in nominal and operational terms, since the middle of last year. In 1996 the operational deficit stood at 3.9% of GDP, against 4.8% the previous year. In the first four months of 1997, this fell to 3.3% of GDP. The growth of the tax revenue sprang largely from the growth of the economy, from the levying of the Provisional Contribution on Financial Transactions (*Contribucão Provisoria sobre Movimentos Financeiros*, CPMF) and an increase in operational revenue from state companies. On the spending side, the federal government decided not to increase the salaries of public officials in 1997, to cut R$3.2 billion in planned spending from the budget and to send to Congress a constitutional amendment extending the Fiscal Stabilization Fund, FEF, to December 1999. It was initially to be in force until June 1997.

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[1] In both countries, the dynamism of the demand for durables also translated into import growth: in Brazil, by 67% in January 1997 over January 1996; and in Argentina by 32% in the first two months over January-February 1996.

These measures, coupled to the use of some of the revenue derived from privatization to reduce the domestic debt in negotiable securities, appear to have been sufficient to halt the tendency towards fiscal deterioration observable since 1994. But they are insufficient to affect decisively the determinants of public debt growth, equivalent to 34.5% of GDP at the end of 1996.

The delay in approving constitutional amendments for the administrative reform of the state and the revision of the social security system are hampering the start of a process of fiscal consolidation that might ensure medium-term consistency between the results of the public accounts and the goal of stabilization. In this context the government may advance its fiscal control policy via measures "in the margin" which at least avoid a worsening of expectations concerning the public accounts.

Uruguay's 1996 fiscal deficit, equivalent to 1.9% of GDP, comes from increases both in terms of spending (+5%) and of revenues (+6%) against 1995. In Paraguay, public spending cuts were accompanied by a fall in fiscal revenue, with effects on levels of economic activity.

Nominal interest rates fell in 1996 in all MERCOSUR countries (Table I.2) and continued to fall in the first half of 1997, especially in Argentina and Brazil. In May 1997, Brazil's Central Bank interrupted the gradual reduction of the base interest rate and kept it unchanged at 1.58% in June. This was interpreted as a reaction to signs of excess demand in the economy, and as an incentive to foreign investment in a context of deterioration in the current account balance.

TABLE I.2
NOMINAL INTEREST RATES IN THE MERCOSUR COUNTRIES
(in percentages)

Country/Year	1995	1996
Argentina	11.9	7.4
Brazil	51.9	26.4
Paraguay	21.2	15.9
Uruguay	38.2	26.6

Source: IMF - International Financial Statistics. Data from Paraguay and Uruguay from 1996, referred to the average of 1996 third trimester.

On the external accounts side, all MERCOSUR countries except Paraguay recorded significant increases in their current account deficits in 1996 (Table I.1). This was particularly notable in Argentina and Brazil, and the trend continued into 1997 as a result of the trade deficits— particularly significant in Brazil's case—and the factors service account deficit.

At the end of 1996 MERCOSUR's international reserves (Table I.3) were enough to finance the bloc's current account deficit for 32 months. In the Argentine case this ratio was approximately 55 months and in the case of Brazil it was, throughout 1996, about 29 months. Since then the ratio has been reduced in Brazil as reserves have fallen slightly and as the deficit has grown. It has increased from 3.3% of GDP at the end of 1996 to 3.9% in April 1997. At the end of April the ratio was about 24 months.

TABLE I.3
INTERNATIONAL RESERVES IN THE MERCOSUR COUNTRIES
December - 1996

Country	in millions of US$	reserves/current account deficit 96	reserves/monthly imports (96 mean)
Argentina	18,396	4.58	9.32
Brazil	58,738	2.41	13.23
Paraguay	882	1.63	3.99
Uruguay	1,344	2.87	5.32
MERCOSUR	79,360	2.70	11.52

Source: IMF - International Financial Statistics.

For the region as a whole, the current account deficit reached 2.8% of GDP in 1996, growing by a nominal 37% in comparison to 1995. It is estimated to grow by 40% in 1997, bringing the current account deficit to 3.8% of GDP. This circumstance indicates that in the coming years the availability of external financing will continue to be an important determinant of growth of the sub-region's economies.

The ongoing transition in those economies is intense, not only because of the commercial and financial "decompression" that accompanied external liberalization and the return of domestic credit to the consumer, but also because of the efforts at modernization undertaken by deregulated and/or privatized public industries and services. Additionally, the foreign currency remittances for provision of services have tended to become stronger as service markets have been deregulated and as revenues have increased from tourism, dividend payments, royalties, etc.

These are short-term effects. Boosting export capacity, coupled to a new cycle of investment, is a slower process. This suggests, especially in the case of Brazil, that external restrictions on growth will continue for some years. This seems to have motivated the government to adopt active policies in the areas of foreign trade and industry, in order to accelerate the period of business response to the new context. In Argentina, the growth of investment in the mining industry exemplifies a dynamic that can unblock a situation of unstable balance.

Hence, in the short term, only the prospect of a significant increase in US interest rates (an unlikely scenario) threaten the Argentine and Brazilian strategy for financing their current account deficits with foreign capital, which may prompt some decline in the expectations of foreign investors.

In general terms, the data for the first months of 1997 suggest that Argentina and Brazil will continue to be significant targets of foreign investment. According to World Bank data, the two countries together received about US$ 26 billion in private foreign capital in 1996, equivalent to around 10.7% of the total received by emerging countries. In the same year, the two countries accounted for 49.3% of the portfolios of the main emerging market variable income funds, with the issuing of publicly-circulated Argentine and Brazilian bonds and notes reaching US$13.4 and US$13.0 billion respectively.

In 1997 there has been more improvement in Argentina's and Brazil's risk rating. In the case of Argentina,[2] some major companies and private banks managed to be reclassified at levels above the sovereign ceilings"

[2] In Uruguay, Standard & Poor's also raised the rating of the long-term, foreign denominated public debt of local companies.

established by country risk, attaining Standard and Poor's "investment grade" status. In the case of Brazil, the resources recently secured by BNDES and the sale abroad of Brazilian company stock suggest that the risk premiums paid by Brazilian companies will be reduced and the periods of maturity will be extended. Brazil's more recent issue of US$ 3 billion in 20-year bonds points to the same conclusion.

B. Brazil's External Disequilibrium

Brazil's current account deficit grew from US$5.2 billion in January-April 1996 to US$10.7 billion in the same period of 1997. Trade was almost balanced in the first four months of 1996, recording a deficit of barely US$254 million (0.86% of the trade flow in the period). In the same period of 1997 this climbed to a deficit of US$4 billion, or 10.6% of the trade flow. While exports grew by scarcely 4.3%, imports increased by more than 30% in the period.[3]

Simultaneous to the performance of trade, the increase of foreign travel expenses, dividend payments, and technology transfer put pressure on the Brazil's current account balance, raising doubts about the sustainability of exchange rate policy. In April and May, concern with this issue increased when the Central Bank made known the results of the external accounts for April, in which the country's loss of international reserves was clear.

Faced with the possibility of the deterioration of the external accounts as an inertial trajectory of the development of the economy, the government adopted a series of measures gradually to reduce the trade deficit and encourage capital inflows.

An incentive to investment was provided by interrupting the fall in domestic interest rates in May, by eliminating the financial transactions tax (*Imposto sobre Operações Financeiras,* IOF) on loan transactions abroad, and by reducing this tax on fixed income funds and other transactions that involve attracting foreign revenue.

These measures are necessarily moderate, since efforts to attract capital have significant trade-offs with other goals of stabilization: interest rate increases would boost the fiscal cost and capital inflows would put pressure on the exchange rate, reducing export competitiveness further. Moreover, a surge of short-term capital would eliminate one of the positive results of 1996 in the area of the external accounts: the improvement in the quality of Brazilian reserves, linked to the extension of the periods of foreign investment in the country.

Efforts to cut the trade deficit focused on three areas:

- Broadening export incentives by extending the list of products and sectors benefitting from Proex and by establishing a pre-shipment mechanism in the framework of this program;
- Modifying import financing rules, with regulations imposed under Provisional Measure (*Medida Provisoria,* MP) 1569 and by a complementary measure of the Central Bank to close the loopholes of the MP; and

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3 In May 1997 Brazil's trade deficit was US$271 million, far lower than that of the preceding months and reflected seasonal factors (completion of the soya harvest). However, it is possible that the reduction in import values over the previous month reflects the "suitability" of the rhythm of import growth.

◆ An increase in the IOF for credit transactions to individuals, with the expected effects on sales of cars and appliances -imports of which have been growing strongly.

These measures were also moderate. Exchange rate policy was maintained despite the fact that, at some points in the first half of the year, the market rate came close to the upper limit of the band of fluctuation. Modifications of exchange rate policy, in the sense of allowing a faster devaluation of the real, would reduce Brazil's attractiveness as a target of foreign investment and would maintain upward pressure on domestic interest rates, with negative fiscal effects. Moreover, devaluation would quickly translate into inflation unless preceded by measures to constrain demand.

In light of the significant trade-offs among the instruments of economic policy (Table I.4), the government seems to have opted to keep the current account deficit under control by recourse to moderate measures that might attenuate the growth of the trade deficits. Given the costs originating in significant increases in domestic interest rates, additional measures to decelerate domestic demand would tend to focus on restricting credit, while the growth of foreign investment inflows would give credibility to the government's's strategy.

TABLE I.4
MATRIX OF OBJECTIVES AND INSTRUMENTS OF ECONOMIC POLICY

	Public debt interest	**Rate of exchange devaluation**	**Level of aggregate demand**
Inflation rate	—	**Negative** devaluation legitimates price rises	—
Current Account Deficit	—	**Positive** devaluation boosts the competitiveness of Brazilian goods	**Negative** an increase in the level of aggregate demand increases imports and lowers exports
International Reserves	**Positive** interest rate increase attracts foreign capital	**Negative** devaluation reduces the interest rate in dollars	—
Public Debt/ GDP	**Negative** rise in interest increases the public deficit	—	—

Source: Amadeo, E. & Camargo, J.M. - "Os desafios da politica economica, in *Gazeta Mercantil*, 19 May 1997.

In fact, inflows of foreign capital reached US$7.46 billion in January-April 1997, 76% higher than the total recorded in the same period of 1996. The growth is particularly significant in the case of direct investment, which reached US$4.1 billion in this period, 152% higher than in the first four months of 1996.[4] Improvement in the quality of foreign capital was also clear in the growth of long-term financing (+100.6% in the first four months of 1997 over the same period of 1996) and in the reduction of the share of short-term financing in the structure of the balance of payments.

Direct investment related to federal and state privatizations, to the sale abroad of stock in private and state companies, and to the entry of foreign capital in the financial and insurance sector are the government's main mechanisms for selecting "quality" foreign capital and eliminating doubts about its policy.

According to the estimates of a renowned Brazilian economist, potential inflows from privatization alone could amount to US$55.7 billion for the 1997-98 period. Of this amount, US$42.3 billion would come from the sale of federal companies and US$13.4 billion from the same of firms in the federal states.[5]

C. Conclusion: The External Situation of MERCOSUR

Of the economic policy alternatives, Brazil's strategy for managing its external imbalance offers the fewest costs for its MERCOSUR partners and has the least effects on moves towards the establishment of a customs union. The recourse to strong measures to constrain domestic demand—as yet unaccompanied by any moves towards exchange rate management—would have obvious effects on imports. Eventual exchange devaluations will simply multiply those effects.

The alternative presented by the use of trade policy instruments, on both the import and the export side, and the setting up of sectoral programs of investment support[6], have prompted significant tensions between Brazil and its partners, as happened when MP 1569 was issued in March 1997.

The main effects on MERCOSUR of Brazil's external situation—and of the efforts of the government to control the current account deficit—center on the impact of periodic trade policy measures on the access to the Brazilian market of exports from Brazil's MERCOSUR partners. A secondary effect could be that sectoral industrial policies have prompted new tensions in the integration process, as well as conflicts over the regulatory asymmetries that distort competition in the trading bloc. This means that the effects of such measures will be differentiated according to the size of the exporting businesses and industrial sectors, as seems to have been the case of the effects of MP 1569.

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[4] In May 1997 Brazil received about US$ 1.8 billion in direct investment. The total for the year was US$ 5.9 billion. International reserves increased by US$ 3.1 billion in that month, recovering the losses accumulated between January and April, to reach US$ 58.5 billion in cash reserves and US$ 59.3 in international liquidity.

[5] *Gazeta Mercantil,* 20 May 1995. The estimates were made by Edmar Bacha, ex- President of BNDES and former special adiser to then- Minister of Economy, Fernando Henrique Cardoso.

[6] As it is happening in the telecommunications equipment sector, in which increase of domestic demand is estimated to become very significant in the next years, given the privatization of Brazilian companies in the telecommunications and energy services sector.

CHAPTER II. EVOLUTION OF TRADE AND INVESTMENT IN MERCOSUR

Two phenomena mark MERCOSUR's consolidation from the perspective of trade flows: the significant growth of intra-regional commerce and the sharp reduction in levels of protection towards the rest of the world.

Intra-regional trade grew from US$3.6 billion in 1990 to US$14.7 billion in 1996, while the fall in the sub-region's levels of protection (see Table II.1a for the case of Brazil and II.1b, in 1995 and 2006, for MERCOSUR) also allowed the rapid growth of imports from the rest of the world. Hence, in the 1990-1996 period, intra-MERCOSUR exports grew 26% a year while imports from the rest of the world expanded at an annual rate of 19%.

TABLE II.1A
BRAZIL: NOMINAL AND EFFECTIVE TARIFFS
(in percentages)

Discrimination	1990	1991	1992 (*)	1993 (**)	1994 (***)
1. Nominal Prot.					
simple average	30.0	23.3	19.2	13.2	11.2
weighted average width	25.4	19.80	16.4	11.4	9.9
standard diversion	0 - 75	- 60	0 - 50	0 - 34	0 - 25
	15.1	12.7	10.5	6.7	5.9
2. Efective Prot.					
simple average	45.5	35.1	28.9	18.9	14.4
weighted average	33.7	26.5	21.7	14.5	12.3
width standard	-4.3 - 219.5	-3.3 - 225.2	-2.8 - 185.5	-2.0 - 129.8	-1.9 - 44.6
diversion	53.3	39.7	32.7	21.7	9.7

Source: FUNCEX, Table 2.2 of Machado, J.B. & Markwald, R. - "Dinamica recente do processo de integracao do Mercosul", mimeo, 1997.
Notes: since 1992 the Brazilian government has accelerated the program of tariff reduction, implementing reforms every six months. The weighted average presented in the table is reflected according to the value added free trade.
(*) existing duties following the reform of January 1992;
(**) tariffs in force after the reform of June 1993;
(***) duties in force after the reform of December 1994.

TABLE II.1B
MERCOSUR: NOMINAL AND EFFECTIVE TARIFFS
(in percentages)

Discrimination	1995 (CET1)	2006 (CET2)
1. Nominal Prot.		
simple average	13.9	11.9
weighted average	11.5	10.6
width	0 - 55	0 - 20
standard diversion	9.5	4.6
2. Efective Prot.		
simple average	23.4	19.9
weighted average	12.9	15.3
width	-1.9 - 270.9	-1.7 - 53.1
standard diversion	45.9	9.2

Source: FUNCEX, Table 2.2 of Machado, J.B. & Markwald, R. - "Dinamica recente do processo de integracao do Mercosul", mimeo, 1997.
Notes: CET1 = tariffs in force in December 1995; CET2 = tariffs to enter into force in 2006,when the national lists of exceptions are to be eliminated.

Moreover, in those industrial sectors where the growth of intra-MERCOSUR trade was dramatic, such as the automotive sector, the increase of imports from the rest of the world also accelerated. Intra-MERCOSUR imports in the automotive sector grew by 75% annually between 1990 and 1995, while imports from the rest of the world expanded by 61% annually (69% in the case of the European Union)[7].

The insufficiences and vulnerabilities of MERCOSUR appear to be related less to trade diversion —as a result of significant intra-bloc trade preferences—than to the difficulties involved in bringing discipline concerning the member countries' use of instruments that may bloc the free flow of trade in the sub-region and the goals of the customs union.

In this sense, the harm done by MERCOSUR's imperfections would have a much greater effect on its own members, given that they cannot fully exploit the potential of trade and investment expansion associated with integration, while the rest of the world would benefit from the sharp reduction in the levels of trade protection in the sub-region and from the liberalization of national investment regimes.

A. Trade Flows in 1996 and Early 1997

In 1996, MERCOSUR's total exports grew by 6.4% while imports increased by 9.7% (see Tables II.2 and II.3). While the growth rate of foreign sales shows only a slight decline compared to the 1990-1995 period (87% annually), the growth rate of imports fell sharply from the 22.5% annual average recorded in 1990-1995.

Intra-regional exports increased by 17.9%, lower than the average for 1990-1995 (28.4%). Intra-regional imports also grew by 18.5%, again below the rate recorded in the 1990-1995 period (27.8%).

As was shown in Chapter I, the sub-region's economies recorded positive growth rates and were increasingly converging, and trade flows do not appear to have been affected by macroeconomic asymmetries. In this period the fall in the growth rate of imports (from the rest of the world and from MERCOSUR itself) may signify the start of a new movement in the expansion of trade flows, slower than that of 1990-1995 and compatible with a context in which the immediate effects of commercial opening to the rest of the world, and of intra-regional liberalization, are dissipating.

The share of MERCOSUR itself in the sub-region's total exports climbed from 8.9% in 1990 to 22.6% in 1996, when the growth trend continued. MERCOSUR's share of the bloc's total imports also continued to grow in 1996, reaching 20.15% of the total against 15.08% in 1990.

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7 Rodríguez Mendoza, M " Afinal, que MERCOSUL é este? in *Revista Brasileira de Comercio Exterior* N° 50, January/ March, 1997.

TABLE II.2
MERCOSUR: EVOLUTION OF EXPORTS BY DESTINATION (1990/95/96)
(Millions of US$ and percentages)

	1990	1995	1996	annual growth1990-1995	annual growth1990-1996	annual growth1995-1996
ARGENTINA						
Total	12,350.4	20961.9	23,734.5	11.16%	11.50%	13.2%
Exports to MERCOSUR	1,832.4	6,769.3	7,885.3	29.87%	27.54%	16.5%
Exports to rest of the world	10,518.0	14,192.6	15,849.2	6.18%	7.07%	11.7%
MERCOSUR participation in total	14.84%	32.29%	33.22%	16.83%	14.38%	2.8%
BRAZIL						
Total	31,413.1	46,503.4	47,774.9	8.16%	7.23%	2.8%
Exports to MERCOSUR	1,320.5	6,153.4	7,419.0	36.04%	33.33%	20.6%
Exports to rest of the world	30,092.6	40,350.0	40,325.9	6.04%	5.00%	- 0.1%
MERCOSUR participation in total	4.20%	13.23%	15.54%	25.78%	24.35%	17.5%
PARAGUAY						
Total	958.2	819.6	1,028.9	- 3.08%	1.19%	25.5%
Exports to MERCOSUR	379.5	465.5	636.9	4.17%	9.01%	36.8%
Exports to rest of the world	578.7	354.1	392.0	- 9.36%	- 6.29%	10.7%
MERCOSUR participation in total	39.61%	56.80%	61.90%	7.48%	7.73%	9.0%
URUGUAY						
Total	1,703.5	2,116.3	2,398.29	4.44%	5.87%	13.3%
Exports to MERCOSUR	590.6	995.3	1,015.5	11.00%	9.45%	2.0%
Exports to rest of the world	1,112.9	1,121.0	1,382.8	0.15%	3.69%	23.4%
MERCOSUR participation in total	34.67%	47.03%	42.34%	6.29%	3.39%	- 10.0%
MERCOSUR						
Total	46,425.2	70,401.2	74,906.6	8.68%	8.30%	6.4%
Exports to MERCOSUR	4,123.0	14,383.5	16,956.7	28.39%	26.58%	17.9%
Exports to rest of the world	42,302.2	56,017.7	57,949.9	5.78%	5.39%	3.4%
MERCOSUR participation in total	8.88%	20.43%	22.64%	18.13%	16.88%	10.8%

Source: DATAINTAL.

TABLE II.3
MERCOSUR: EVOLUTION OF IMPORTS BY ORIGIN (1990/95/96)
(Millions of US$ and percentages)

	1990	1995	1996	annual growth1990-1995	annual growth1990-1996	annual growth1995-1996
ARGENTINA						
Total	4,079.5	20,067.5	23,679.9	37.52%	34.06%	18.0%
Imports from MERCOSUR	877.8	4,744.5	5,764.0	40.14%	36.84%	21.5%
Imports from rest of the world	3,201.7	15,323.0	17,915.9	36.77%	33.24%	16.9%
MERCOSUR participation in total	21.52%	23.64%	24.34%	1.90%	2.08%	3.0%
BRAZIL						
Total	20,639.8	49,581.6	53,286.0	19.16%	17.13%	7.5%
Imports from MERCOSUR	2,318.0	6,820.8	8,257.6	24.09%	23.58%	21.1%
Imports from rest of the world	18,321.8	42,760.8	45,028.4	18.47%	16.27%	5.3%
MERCOSUR participation in total	11.23%	13.76%	15.59%	4.14%	5.51%	12.3%
PARAGUAY						
Total	1,193.0	2,796.9	2,656.3	18.58%	14.27%	- 5.0%
Imports from MERCOSUR	367.3	1,170.0	1,293.0	26.08%	23.34%	10.5%
Imports from rest of the world	825.7	1,626.9	1,363.3	14.53%	8.72%	- 6.2%
MERCOSUR participation in total	30.79%	41.83%	48.68%	6.32%	7.93%	11.8%
URUGUAY						
Total	1,411.9	2,865.7	3,029.9	15.21%	13.57%	5.7%
Imports from MERCOSUR	558.6	1,320.6	1,336.7	18.78%	15.65%	1.2%
Imports from rest of the world	853.3	1,545.1	1,693.2	12.61%	12.10%	9.5%
MERCOSUR participation in total	39.56%	46.08%	44.12%	3.10%	1.83%	- 4.3%
MERCOSUR						
Total	27,324.2	75,311.7	82,652.1	22.48%	20.26%	9.7%
Imports from MERCOSUR	4,121.7	14,055.9	16,651.3	27.81%	26.20%	18.5%
Imports from rest of the world	23,202.5	61,255.8	66,000.8	21.43%	19.03%	7.7%
MERCOSUR participation in total	15.08%	18.66%	20.15%	4.35%	4.94%	8.0%

Source: DATAINTAL.

Analysis of the trade performance of the MERCOSUR countries in 1996 reveals a fair degree of heterogeneity among them. On the export side, all countries except Brazil recorded high growth rates: about 13% for Argentina and Uruguay, and 25.5% for Paraguay. However, the positive performance of these three marked sharp differences. The growth rate of Argentine exports was high both to MERCOSUR and to the rest of the world (16.5% and 11.7% respectively). Paraguay's performance was much less even—a + 36.8% increase in exports to MERCOSUR against a 10.7% increase to the rest of the world—while Uruguayan exports were driven largely by sales to the rest of the world (23.4% increase, against 2.0% growth in sales to MERCOSUR).

Brazil's total exports grew by 2.8% last year, a positive performance in light of the strong increase of Brazilian exports to MERCOSUR: 20.6%, against –0.06% to the rest of the world.

For Argentina, Brazil and Paraguay, therefore, MERCOSUR was the main source of dynamism for exports in 1996. The sub-region's share of Uruguay's total exports, by contrast, fell from 47.0% in 1995 to 42.3% in 1996.

Last year the differences in the MERCOSUR countries' import performance were even more marked than for exports. Argentine imports grew by 18.0% and Paraguay's fell by 5.0%, while Brazil and Uruguay recorded import growth rates of 7.5% and 5.7% respectively. In Uruguay's case the higher growth rate was in trade with the rest of the world(9.5%), while imports from MERCOSUR grew only marginally (1.2%). This is in contrast to the growth of Uruguayan imports from MERCOSUR in 1990-1995 (+18.8% annually). Hence Uruguayan imports from the sub-region, as a proportion of the country's total imports, fell from 46.1% in 1995 to 44.1% in 1996.

The growth rates of Argentine, Brazilian and Paraguayan imports from MERCOSUR was higher than that for purchases from the rest of the world. As with exports, Argentina recorded high growth rates for intra- and extra-MERCOSUR imports. Brazilian and Paraguayan imports from MERCOSUR, however, grew at much higher rates in 1996 than their imports from the rest of the world.

In sum, for the MERCOSUR countries 1996 was characterized by three performance patterns as regards trade within the bloc and with the rest of the world:

- Dynamism in intra and extra-MERCOSUR trade, with emphasis on intra-bloc flows. This was the case for Argentina, where MERCOSUR increased its share of the country's total exports and imports.

- Significant dynamism in intra-MERCOSUR imports and exports, contrasting with the rates of growth observable in trade with the rest of the world. This was the case for Brazil, largely on the export side, and of Paraguay on the import side.

- Low dynamism of intra-MERCOSUR trade flows, simultaneous to the significant growth of extra-bloc trade, especially on the export side. This was the case for Uruguay.

Data for Argentine trade in the first three months of 1997 confirm the dynamism of its imports and exports in relation with MERCOSUR and with the rest of the world: total exports grew by 18.5% while sales to MERCOSUR expanded by 17.0%. Imports from MERCOSUR increased 22% and total foreign purchases grew by 28.3% compared to the first quarter of 1996. In the first three months of 1997, therefore, Argentina's trade with the rest of the world was more dynamic than its trade with MERCOSUR.

In the first quarter of 1997 Argentina recorded a surplus of US$489 million in its trade with MERCOSUR, in contrast to the total accumulated trade deficit of US$785 million for 1996.[8]

Brazil's results for the first quarter of 1997 reveal the continuance of a sharp contrast between the performance of its exports to MERCOSUR and those to the rest of the world. Total Brazilian exports grew by 3.6% compared to the first quarter of 1996, while sales to MERCOSUR increased by 23.3%. The subregion therefore absorbed 16.8% of Brazil's total exports, against 14.2% in the first quarter of 1996. On the import side, purchases from MERCOSUR grew at a lower rate (21.2%) than total imports (27.6%) compared to the first quarter of 1996.

Between January and March 1997 Brazil accumulated a trade deficit with MERCOSUR of US$334 million, 11.0% greater than that of the first three months of 1996 and equivalent to 11.0% of the country's total trade deficit.

B. Argentine-Brazilian Trade: Specialization and Bilateral Sectoral Balances

Independently of the trends towards a reduction in the growth rate of intra-MERCOSUR commerce, which suggest a growing divergence of trade performances among the members of the group,[9] subregional trade remains marked by a notable specialization in manufactured goods. This is particularly the case for the two biggest economies of the subregion, as indicated by Table II.4, which compares the ranking of Argentine and Brazilian exports to MERCOSUR, the Latin American Integration Associations (LAIA), and other blocs or countries.

Bilateral trade between Argentina and Brazil has recorded substantial growth in recent years, as well as significant changes in its composition. Total bilateral commerce grew about 34% annually between 1990 and 1996, the most intense growth being in the 1990-1993 period when it reached 46% a year. The 23.4% growth for 1993-1996 still reveals significant dynamism.

The period of greatest dynamism, from 1990 to 1993, also saw the greatest changes in the structure of bilateral trade. In that period the share of vegetable and animal products (cereals, coffee, cacao, meats, etc.) fell from 37.7% to 18.7%. The chemical sector's share also fell, from 14.8% in 1990 to 10.5% in 1993. In this period the transport materials sector's share grew (from 6% to 21.8% of the total), as did mineral products (from 7.1% to 11.3%). The latter reflects the growth of Argentine oil exports.

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8 In the first quarter of 1997 Argentina's trade deficit with the European Union was US$ 989 million, and that with NAFTA stood at US$ 1.1 billion.

9 Especially as regards the relative dynamism of intra - and extra - MERCOSUR trade.

TABLE II.4
BRAZIL AND ARGENTINA: EXPORT SPECIALIZATION BY PRODUCT GROUPS, ACCORDING TO ECONOMIC BLOCS (*)

EU	NAFTA	MERCOSUR	LAIA	JAPAN
Exports from Brazil				
1. Residues/Waste (23)	1. Shoes (64)	1. Plastics (39)	1. Steel and Iron (72)	1. Aluminum (76)
2. Oil seeds (12)	2. Aircrafts (88)	2. Rubber (40)	2. Vehicles/autom. (87)	2. Minerals (26)
3. Meat Products (16)	3. Fruit (08)	3. Vehicles/autom. (87)	3. Boilers/machinery (84)	3. Chemical products (47)
4. Fruit Products (20)	4. Fuels (27)	4. Organic Chemical Products (29)	4. Rubber (40)	4. Meat/meat parts (02)
5. Leather and Skins (41)	5. Cocoa (18)	5. Other textiles	5. Electrical Appliances/Machinery (85)	5. various foodstuffs (21)
6. Tobacco (24)	6. Electrical Appliances/Machinery (85)	6. Electrical Appliances/Machinery (85)	6. Plastics (39)	6. Oil seeds (12)
Exports from Argentina				
1. Oil seeds (12)	1. Horticultural preparation (20)	1. Vehicles/autom. (87)	1. Plastics (39)	1. Aluminum (76)
2. Meat/meat parts (02)	2. Meat Products (16)	2. Plastics (39)	2. Oil and fat (15)	2. Meat Products (16)
3. Residues/Waste (23)	3. Leather and skins (41)	3. Milk and Dairy Products (03)	3. Cotton (52)	3. Fish and seafood (03)
4. Fruit (08)	4. Tobacco	4. Horticultural products (07)	4. Steel and Iron Works (73)	4. Chemical Products (47)
5. Chemical products (47)	5. Fuels (27)	5. Boilers/machinery (84)	5. Boilers/machinery (84)	5. Leather Works (43)
6. Leather works (43)	6. Milk and Dairy Products (03)	6. Fuels (27)	6. Aluminum (76)	6. Residues/Waste (23)

Source: Machado, J.B. - "Dilemas da consolidacao de uma Uniao Aduaneira", in *Revista Brasileira de Comercio Exterior,* N¼ 49, October-December 1996.
Note: (*) The values in brackets refer to the categories of the Harmonized System. The categories were selected on the basis of the index of export specialization, IES (average 1990/93/95 for Brazil and 1992/93/95 for Argentina). The IES = **(Xij/Xj) / (Xiz/Xz)** compares the share of the export category of country **i** in the exports of country **z** going to market of country **j** with the share of the same category in the total exports of country **z**.

TABLE II.5
BILATERAL ARGENTINE-BRAZILIAN TRADE

	Bilateral flows (exports + imports) (US$ millions)			% Total			Brazilian balance / bilateral flows (%)		
Sectors / Years	1990	1993	1996	1990	1993	1996	1990	1993	1996
Transport material	125.2	1,386.7	2,624.5	6.1	21.8	22.0	4.6	31.3	- 3.9
Elect. equip. and machinery	250.0	931.9	1,514.4	12.2	14.6	12.7	- 5.4	58.3	39.4
Chemicals	303.5	664.9	1,319.1	14.8	10.5	11.0	6.4	50.6	27.7
Metallurgical products/Tools	105.5	412.5	588.7	5.1	6.5	4.9	37.8	32.3	66.2
Textiles and Clothing	62.5	238.0	692.5	3.0	3.7	5.8	- 61.8	32.3	- 19.3
Mineral Products	146.2	718.8	1,433.2	7.1	11.3	12.0	61.8	- 48.2	- 73.9
Foodstuffs Industry	72.4	151.7	414.4	3.5	2.4	3.5	- 43.1	71.3	- 2.2
Cellulose and Paper	63.9	213.4	359.8	3.1	3.3	3.0	- 43.2	91.0	39.8
Vegetable Products	590.2	978.1	1,606.6	28.7	15.3	13.5	- 91.8	- 85.3	- 85.8
Animal Products	185.3	215.8	573.0	9.0	3.4	4.8	- 97.2	3.0	-62.4
Sub-total of the 10 sectors	1,904.4	5,911.8	11,126.2	92.7	92.7	93.1	- 35.6	14.5	- 10.7
Total trade	2,053.8	6,376.1	11,944.7	100.0	100.0	100.0			

Source: Secex/MICT Brazil.

Between 1993 and 1996 the composition of trade flows remained fairly stable. The only developments of real note were the growth of the share of textiles and clothing in bilateral trade (from 3.7% to 5.8%), the expansion of Brazilian rubber sales (which reached 5.4% of the total in 1996), and the fall in the share of leather and skins in Argentine exports to Brazil.

Analysis of the balance of Brazilian trade by groups of sectors reveals that, initially, flows were fairly balanced for transport material, chemicals and machinery, and metallurgical products. Argentina had a surplus in animal and vegetable products, as well as in industries processing such products (foodstuffs, cellulose and paper, and textiles and clothing). On the other hand, sectors where there were sharp imbalances in bilateral flows accounted for two thirds of bilateral trade.

The scenario changed radically in 1993, when there was bilateral balance only in animal products. The balance for mineral products was inverted to Argentina's benefit, while the high Argentine surplus in animal products remained unchanged. For all other groups Brazil recorded surpluses of more than 30% of bilateral trade, including those that had been in balance in 1990.

In 1996 the balance was concentrated in transport materials and foodstuffs, which account for 25.5% of total flows. Argentina had a high surplus in mineral products, as well as in animal and vegetable products, which account for 30% of bilateral commerce. Argentina also recorded a surplus in textiles and clothing in 1996, though relatively lower than that for the other groups. Brazil's' positive balances were in machines and equipment, chemicals, metallurgical products, and paper and cellulose, which represented 31.6% of bilateral trade. Evaluation of these results suggests that, despite the growth of intra-industrial trade between Argentina and Brazil, (Machado and Markwald [1977]) bilateral trade flows are still broadly subject to the patterns of specialization prevalent at the beginning of the 1990s, originating in the endowment of "natural" comparative advantages or instituted in the period of import-substitution in the two countries as reflected by the comment in the above paragraph and the figures in Table II.5. Deviations from this rule are centered in sectors where bilateral negotiations or unilateral trade defense initiatives produced some kind of trade administration mechanism (such as in transport material, minerals, oil and fuels, textiles and clothing).

C. Investment Flows in MERCOSUR: Recent Trends and Short-term Prospects

The radical change in the business environment in MERCOSUR has been determined by the macroeconomic stabilization of the sub-region's economies, commercial and financial liberalization towards the rest of the world, revision of the regulatory framework governing private domestic and foreign investment, and integration. This change has motivated investment decisions on the part of firms that were already operating in MERCOSUR, as well as by newcomers.

In practically all cases of new investment that have any significance, MERCOSUR seems to be the "domestic market" of reference for business strategies. This is the case for industrial investments, and is also beginning to be true in service sectors as diverse as finance and electricity supply.

Data from the Argentine Economy Ministry's Center for Production Studies on current and projected investment by manufacturing industry indicate a heavy concentration in the automotive and autoparts industry (31.3% of the total), chemicals and petrochemicals (26.3%) and foodstuffs and beverages (15.1%). Together, these three sectors account for 72.7% of current or projected investments, totalling US$13.26 billion by the year 2000. The iron and steel sectors (8.6% of the total) and the cellulose sector (5.4%) also feature significantly among current and planned investment.

In Argentina, recent investment in the mining sector (over US$1.0 billion in 1995 and 1996) suggest a significant increase in production in 1997 and, for the first time, a mining industry trade surplus.

In Brazil, a recent study by the National Confederation of Industry and ECLAC identified ongoing investment projects (begun since January 1995), as well as planned investments to 1999, for a multi-sectoral sample of over 700 companies throughout the country. Investments in the mining industry are also of note in Brazil—an estimated total of US$3.4 billion, of which more than 44% concern projects already finished or being carried out. In the case of manufacturing industry, metallurgical products (24.7% of the total) and chemicals and petrochemicals (15.3%) are the salient sectors, followed by transport material (9.6%) and pharmaceutical products ((7.2%). Textiles (5.0%) and foodstuffs (5.4%) also have a substantial share of the total.

The data reveal, moreover, that the transport material, machinery and electrical material sectors currently account for at least 50% of the investments already made or being effected.This reflects the ongoing adjustment effort in these sectors as they face greater competition in the domestic market.[10]

[10] It is nevertheless important to note that the NCI/ECLAC research only includes businesses that are already operating in Brazil, excluding the investments of newcomers that are particularly important in the automobile industry, in electro-electronic material and in autoparts.

The entry of new players into the sub-regional market and the growth of foreign investment flows is directly related to the regulatory changes introduced by the member countries in recent years. These changes are also determining the transformation of the sectoral profile of direct investments, in which the financial and infrastructural services sectors—often the objects of privatization programmes—stand out.

In 1996, for example, 62% of the direct investment received by Brazil went to the services sectors, with public services (electricity, telecommunications, and rail transport) absorbing 32% of total inflows.

Four major, ongoing patterns of investment should be highlighted, not only for their strategic links to the new regulations but also because of their potential to affect the industrial structure of the sub-region and its international competitiveness:

- First, foreign investment in the automotive sector, analyzed in the first issue of the *MERCOSUR Report*. In recent months Brazil has benefited from the announcement of new investment decisions linked to the federal incentives system, and to the policies of the federal states for attracting investment in the sector. Investments in the south and south-east of the country were announced by, among others, General Motors in Rio Grande do Sul, Santa Catarina and São Paulo; and by Chrysler and Audi/VW in Paraná. There were also announcements of investment in various states of the north-east, as well as Goiás. In the case of these latter investments in Brazil's poor regions, the companies benefit from a federal program especially established for these regions and whose deadline for mounting new projects passed on 31 May. The projects approved in the framework of this "special " program, amounting to over US$2.75 billion in new investments according to Brazil's MICT, include various associations of local capital (from the poor regions) with foreign—generally Asian—companies for the implementation of small-scale projects to produce tractors, motorcycles etc. There are also important projects being carried out by Korean companies (Hyundai and Asia) and Japanese firms (Subaru and Honda), the latter to produce motorcycles. Additionally, General Motors has announced that it will install a jeep factory in the north-east, without specifying which state will be the target of the investment. Overall, Bahía was the state to benefit most from the provisional measure establishing the "special" automotive regime, securing the establishment of three car/truck plants and a motorcycle plant.

It is still too early to tell if all these investments will be realized, nor the kind of automotive industry that will emerge from this cycle of investment; the phase of announcing planned investment seems to be reaching its end. However, the investments so far announced suggest that the players already established in MERCOSUR strengthened their positions in the sub-region and are gearing investment towards broadening the range of vehicles produced, as well as towards consolidating national specializations in the sub-regional strategies: as are the cases of VW, GM, Fiat and Ford.

Moreover, those investors just beginning to act in the MERCOSUR context or focusing on a specific product segment seem to have decided for a greater share of the subregional market by broadening their production and diversifying their product range: as is the case for Mercedes Benz, Toyota and Renault. Finally, other automobile makers have newly arrived on the scene— Chrysler, Asia Motors, Honda and Hyundai—indicating a significantly greater role for Asian producers in MERCOSUR.

- Second, foreign investment in the financial services sector, mainly in Argentina—where liberal legislation eliminated a series of restrictions to the activities of foreign capital—and in Brazil, where the restructuring of the sector opened opportunities for the entry of new foreign institutions with the approval and authorization, case-by-case, of the government.

In the case of Argentina, three large acquisitions changed the profile of the banking system in May 1997: Banco Santander acquired 51% of the voting capital in Banco Río de la Plata, thereto controlled by the local group Pérez Companc; Banco Bilbao Vizcaya bought 71.5% of the Banco Crédito Argentino (after having acquired Banco Francés); and the Shanghai Banking Corporation of Hong Kong acquired Grupo Roberts for more then US$600 million, according to press reports.

In Brazil, Banco Santander acquired the Banco Geral de Comercio and HSBC acquired Bamerindus, one of the biggest retail banks in the country. The privatization of the states' banks should also offer other foreign banks the opportunity to gain access to the Brazilian retail banking market, which would bring a new and significant element of competition to the market. In Brazil, some major international insurers (Aetna, Hartford, Allianz and Cigna) are positioning themselves to widen their market activity, generally associating with Brazilian financial and/or insurance groups (Excel-Econômico, Sul-América etc.).

- Third, foreign and domestic investment linked to the privatization of public services. In Argentina a significant part of this process has already occurred, although there are plans for the privatization of the postal service, the airports and the National Mortgage Bank (*Banco Hipotecario Nacional*). In May the province of Buenos Aires privatized its electricity supply company, ESEBA, attracting consortia comprising local and foreign businesses.

In Brazil, the cycle of investment is becoming more active, with the planned sale of more than US$50 billion in shares in state telecommunications and electricity companies during the next three years. Now that the phase of privatizing industrial concerns has ended—with the sale of the Vale do Rio Doce last May—and with the sale of the federal rail transport company, the policy of state disengagement would focus in the second half of 1997 on the privatization of the cellular telephone service and the preparations for privatizing electricity generation and transmission; the latter case will also involve companies in the federal states. A significant participation of foreign capital is planned for all these cases, generally in association with large Brazilian groups.

- Fourth, recent investments in the Argentine mining industry. Despite the fact that such flows were less in volume than those directed at the other three areas,[11] this is a doubly paradigmatic case. It is an example of rapid business reaction to a regulatory environment—established in 1993—that is favorable to investment, including foreign investment. It also reflects the emergence and development of a strongly export-oriented industrial sector, strengthened by the success of the structural reforms undertaken in Argentina, and of efforts to reduce the "Argentine Cost", composed by variables that affect the costing structure of companies performing in the local economy.

The new investments in this sector brought some of the world's most important mining companies to Argentina, particularly those with Australian, Canadian and South African capital, boosting the exploitation of copper, gold, lithium and other minerals and an output of US$850 million in 1997, double that of 1992. Argentina's Secretariat of Industry, Trade and Mining estimates that output will rise to US$1.95 billion by the year 2000, of which US$1.3 billion will be exported, compared to US$32 million in 1996.

These four movements largely involve inflows of foreign capital, although investment linked to the privatization of services in Argentina and Brazil, as well as those in the Argentine mining industry, also contemplate the participation of large national groups.

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[11] According to Argentine government estimates, investments already made, now being made and planned by the year 2000 total about US$3.7 billion.

With regard to intra-MERCOSUR investment, the joint undertaking of YPF and Petrobrás, concerning the Mega Project (*Proyecto Mega*)—which also includes DOW—and those targeting natural gas processing and fuel distribution in the two countries are perhaps the most representative, since they are directly related to the change in the regulatory framework of the sub-regional energy sector.

This same change is starting to motivate new projects that bring together intra- and extra-MERCOSUR private interests geared towards investment in infrastructure networks linking the countries of the sub-region. This is the case of those projects in the field of energy generation and transmission (hydroelectric and thermoelectric), of natural gas transport and the construction of waterways and ports (see *MERCOSUR Report Nº 1*).

In general, the main trends observed in the analysis of flows of productive investment in MERCOSUR suggest strong links between the areas of dynamism and the establishment of horizontal and sectoral regulatory frameworks favorable to new investment.

Moreover, there is a significant participation of foreign investment geared towards the acquisition of shares and which do not, therefore initially add to supply capacity. Since such investments are mainly targeted at the services sectors, the anticipated benefits are less concerned with an increase in supply than with the improvement of the quality of services and with their effects on the production and export costs of the industrial and agricultural sectors.

In the case of the Brazilian automotive industry and Argentine mining, the new investment does add supply and export capacity (at least potentially), the latter being realized in infrastructural projects of sub-regional scope and in the YPF/Petrobrás projects, although in the two latter cases the export potential is limited to the sub-regional market.

A final characteristic of foreign and domestic flows to MERCOSUR is their central goal of attending to the demands of the regional market—with the exception of investment in the Argentine mining industry—although in some industrial sectors growth of the exportable supply of goods is possible.

CHAPTER III. CONSOLIDATING AND DEEPENING THE CUSTOMS UNION

The top priority of the integration agenda is greater interdependence, brought about by the expansion of trade and investment and the convergence of macroeconomic performance among the MERCOSUR member countries. The objective is to maximize the profits of intra-regional liberalization and distribute its costs in a form acceptable to the member countries, all within the guidelines of "open regionalism".

As observed earlier, the insufficiences and weaknesses of MERCOSUR as an integration project are linked to the incomplete exploitation of the potential for expanding trade and investment flows between its members, more than with an alleged protectionism in relation to the rest of the world.

The prospects for consolidating and deepening the MERCOSUR customs union are related to four macro-issues:

- market access for the member countries and the conditions of competition prevailing in the sub-region;

- establishing common policies in a certain number of priority areas for the functioning of the customs union;

- harmonizing policies and adopting measures to deepen the customs union, the general agenda of which was defined in December 1995 by the Common Market Council (*Consejo de Mercado Común*, CMC) in the "MERCOSUR Action Plan to 2000";

- expanding and improving the quality of the transport, communications and energy infrastructure in the sub-region.

As was to be expected, the first two macro-issues dominated the negotiations during the period of transition to the customs union. They now occupy a good part of the concerns of governments and businesses to the extent that the agenda they defined essentially involves the establishment of rules of the game and of the minimum conditions necessary for the stable (and predictable) functioning of the customs union.

Automatic tariff reduction regimes, lists of exceptions and sectoral exemptions are compatible with the objective of consolidating the customs union as long as:

- negotiations advance on the rules and schedules for removing the remaining barriers to intra-bloc free trade, as well as for eliminating the discrepancies in national trade regimes towards third countries, and for the convergence of those regulatory regimes which distort trade flows and investment;

- the necessary mechanisms are established to ensure compliance with whatever is agreed, and resolve disputes resulting from differing interpretations of the rules.

The main tensions and conflicts that have recently characterized the construction of MERCOSUR involve the effectiveness and the stability of the rules of the game in the integration process. This includes those on free access of the member countries to the markets of the other partners, and maintaining equal conditions of competition in the expanded market.

In this scenario, the establishment of common policies and the goal of deepening the customs union are somewhat subordinated, although the decisions expressed in the Declaration of Rio de Janeiro (24 April 1997) by the presidents of Argentina and Brazil seem to signal a new primacy for the themes of "deepening" and the necessity to "develop procedures of dialogue and coordination with a view to establishing criteria and common policies in a growing number of areas and sectors."

The Declaration of Rio de Janeiro clearly illustrates the relevance that summits and presidential decisions have acquired in the history of MERCOSUR integration. This is a positive development for the expression of political will by the member countries, which is indispensable to sustain initiatives that aim to deepen integration. It is also an indicator of the difficulties of institutionalizing—in a broad sense—the process, and of providing mechanisms to resolve disputes that have not been addressed at the highest political level, such as trade barriers which apply to segments or to specific products.

A. Market Access and Conditions for Competition

In the first semester of 1997, three questions dominated MERCOSUR negotiations in this area, above all mobilizing Argentine-Brazilian bilateral relations:

- The discussions on Brazil's automotive regime and its effects on foreign investment flows to the sub-region. The debates began after Brazil adopted, in December 1996, a system to promote investment in the automobile sector in the country's less developed regions (the northeast, north and central-eastern regions), with a special emphasis on fiscal incentives and on specific rules for importing parts and supplies, equipment and complete vehicles.

The end of the period during which companies could benefit from this system had been set at 31 March and subsequently extended to the end of May. Several companies took advantage of the system, which especially benefitted the states of Bahia, in the northeast, and Goias, in the central-east, both sharing common borders with the south-east region of Brazil.

Although it is not yet possible to know which investment plans are concrete, the list of qualified projects indicates a strong interest of Asian manufacturers (Asia Motors, Hyundai, Honda and Subaru) and the presence of General Motors, which still has not announced the location of its new plant. Most of the announced projects are for the production of utility vehicles (vans, jeeps), motorcycles, tractors and trucks, with a small showing of factories for automobiles. The planned investments vary from $3.5 million to $700 million per project, suggesting a high level of heterogeneity, in terms of scales of production, value added, etc.

The announcements of decisions by Chrysler, Audi and Iveco, among others, to build plants in the south and southeast of Brazil, all during the first semester, highlighted the issue of asymmetries provoked by sectoral promotion regimes, reinforcing the need to look for an equitable distribution of the integration benefits.

Evidence that state governments in Brazil used fiscal and financial incentives to attract investments, especially in the automobile sector, point in the same direction, and indicate the need for some type of harmonization in this field.

At some point during the first semester, the Argentine negotiators proposed a discussion of clear rules on the granting of incentives to companies by member states, and/or the establishment of a unified regime of incentives applicable to the poorer regions of MERCOSUR. The issue was raised in the discussions on the approval of the "Protocol on the Defense of Competition", whose chapter on transitory provisions included a commitment by member states: within two years (as of December 1996), they will draw up norms and common mechanisms which regulate aid from MERCOSUR states that might restrict or distort competition and affect trade between the member countries.

Despite Argentine demands, and in view of the limited priority that Brazil gave to the issue, the discussions prompted by the prevailing automobile regimes have not advanced recently and the sectoral negotiations have concentrated on the Argentine request to increase its export quota for vehicles to Brazil until 1999.

However, the issue of equal competitive conditions within MERCOSUR, which dominated the first months of the semester, gave way to discussion of market access, especially after April.

- Sectoral non-tariff measures and restrictions within MERCOSUR provoke tensions in the integration process because they accumulate and remain unresolved.

The controversy between Argentina and Brazil (over the quotas for the sale of vehicles by companies established in Argentina and not in Brazil) is just one such conflict that was elevated to the presidential level during the Rio de Janeiro meeting at the end of April.

For example, bilateral issues not resolved by the MERCOSUR Trade Commission, and instead submitted to the presidential meeting, were as follows (presented below by plaintiff country):

Brazil	Argentina
1. Textiles and Clothing Argentina demands that each piece of clothing that enters the country, regardless of origin, bear a sown label in order to control payment of the import tax. It also demands a label containing alphanumeric codes of the importer and exporter. Brazil argues that such measures function as a non-tariff barrier.	**1. Automobiles** Argentina wants to establish quantitative quotas, with the proportional duty of the import tax reduced to zero, without the obligation to reciprocate in the same amount for foreign plants that are installed in just one country—the so-called "strips".
2. Sugar, Tires, Instant Coffee Brazil wants the liberalization of sugar in intra-MERCOSUR trade and demands the removal of "tires" and "instant coffee" from Argentina's transition regime.	**2. Medicines** Argentina has not been able to export to Brazil because of Brazil's intellectual property legislation, and argues that this is a non-tariff barrier.
3. Untreated Leather These products have a CET of 8% in MERCOSUR. Brazil wants to revise the CET and to eliminate the 15% export tax which Argentina also applies to the product.	**3. Non-synthetic Lubricants** Argentina claims that exports of this type of lubricant require the prior consent of the National Department of Fuels.
4. Anti-dumping Procedures Brazil wants to revise the anti-dumping procedures against its products such as compressors, electric transformers, and cables for transmitting electricity.	**4. Government Procurement and Public Policies** Argentina claims that public tenders are handled differently and that some states and municipalities levy the ICMS differently on national and imported products.

Source: Fax MERCOSUR/CNI - April 17, 1997.

The decisions expressed in the Declaration of Rio de Janeiro offer concrete answers to some of these issues, as shown by the following table (presented by the country responsible for the decision):

Argentina	Brazil
Leather As of 1 July, the Argentine government will reduce from 15% to 8% the proportional duty of the export tax levied on exports of this product to Brazil. **Textiles** As of 1 July, the Argentine government will suspend the requirement that a stamp and label be attached to each piece of clothing originating in Brazil. **Instant Coffee** The Argentine government will remove this from its transition regime, allowing the Brazilian product to enter with a zero duty. Normally, this product is subject to a 12% duty. **Sugar** The two countries assumed a commitment to reactivate the specific ad hoc group to present a proposal for the liberalization of intra-MERCOSUR sugar trade. **Anti-dumping Procedures** There will be bilateral information exchange before opening the investigations to determine the existence of dumping.	**Wines** The Brazilian government agreed to send to Congress, within 30 days, a bill which transposes the MERCOSUR Wine Growing Code into national law (Res 45/96 of the GMC). **Medicines** The Brazilian government agreed to send to Congress, within 30 days, legislation which authorizes transposing into national law the MERCOSUR resolution regulating the registration of pharmaceutical products (Res 23/95 of the GMC). **Non-synthetic Lubricants** The Brazilian government agreed to implement, within 30 days, a procedure of "swift prior consent", not exceeding 24 hours in working days, for requests to import these products. **Automobiles** Within the "strip" system, Argentina can export to Brazil an additional quota of automobiles, with the proportional duty of the import tax reduced to zero. This accord benefits plants which are located only in Argentina (Peugeot, Chrysler and Toyota), allowing Brazil to do the same when companies establish plants in Brazil but not in Argentina.

Source: Fax MERCOSUR/CNI - April 30, 1997.

As regards leather, the GMC extended to 30 May the period in which the ad hoc group could present proposals on a common MERCOSUR trade policy in this sector. The deadline for submitting proposals on national policies affecting competitiveness in the sector was set at 31 December 1997.

Likewise, at the end of May, the Argentine government adopted a resolution to reduce from 12% to zero the duty levied on Brazilian exports of instant coffee. At the same time representatives of the Argentine and Brazilian lubricants sector, together with the Brazilian authorities, established 28 August as the date for eliminating the requirement that prior authorization must be sought from the National Department of Fuels to import non-synthetic lubricants from Argentina.

Negotiations between Argentina and Brazil to define a transition regime for sugar were to be concluded by 31 May, according to a CMC decision of December 1996. Their differences could not be overcome, however, and the discussions did not produce concrete results. At the end of May the Argentine Congress approved a law which made the elimination (not the reduction) of the import duties applied to Brazilian sugar conditional on the termination of incentives for alcohol production in Brazil. During its June meeting in Asunción, the ad hoc group advised the GMC that it could not fulfill its mandate on sugar as contemplated by Decision 16/96.

- The "horizontal" restrictions on access to the Brazilian market, in view of the external disequilibrium of the country's economy. The concerns aroused by Provisional Measure 1569 of March, which restricted the import financing period in Brazil, mobilized businessmen and official negotiators of the other MERCOSUR countries. Coupled to the other two questions concerning market access and conditions for competition, this contributed to a climate of opinion that was critical of the integration project.

From the Brazilian point of view, the measure is essentially financial. It aims to reduce the possibility that importers profit through "arbitrage", which is made possible by the internal and external interest rate differentials. Framed as a measure to establish financial order, Brazil's decision left little room for trade considerations, including for giving MERCOSUR countries different treatment. Internal MERCOSUR negotiations facilitated a provisional agreement (valid until 31 July) to treat the MERCOSUR countries (plus Bolivia and Chile) favorably, although the exemption was restricted to imports of between $10,000 and $40,000 and for financing operations with terms of less than 180 days.

It has not yet been possible to evaluate the impact of Provisional Measure 1569—which excludes wheat, petroleum, capital goods and other products significant for the patterns of Argentine exports to Brazil—given that it largely depends on the willingness of trade financing banks to set up refinancing schemes for their various clients which minimize the trade effects of the measure. It should be noted that the United States and the European Union reacted to the Brazilian measure in the WTO, where they sought explanations of the different treatment afforded to Brazil's MERCOSUR partners.

At the June meeting of the CMC, Brazil extended for three months (to 31 October) the exemption conceded to the MERCOSUR countries, plus Bolivia and Chile, on the grounds that it was not possible to confirm suggestions that Provisional Measure 1569 had caused harm in light of the evolution of recent levels of MERCOSUR exports to Brazil. The demand for exceptional treatment for the sectors "structurally affected" by the measure are to be examined case-by-case by a commission especially created in June for that purpose.

Paradoxically, in a semester during which the negotiations on market access and the conditions for competition in the sub-region were particularly intense, MERCOSUR for the first time witnessed the implementation of the dispute resolution mechanism contemplated in the Protocol of Brasilia.

The dispute formally began in February 1995 when a Uruguayan company presented a claim after Argentina included—in its transition regime for the paper sector—products which, according to Uruguay, did not meet the requirements for inclusion.

Having failed to reach an agreement through bilateral negotiations, the CMC designated a group of experts to arbitrate the dispute, in accordance with the Protocol of Brasilia. Before the final ruling, businessmen of the two countries reached an agreement which foresees exports "with a margin of preference of 100%". This was endorsed by both governments and ratified by the CMC.

Also in the area of dispute resolution, it is worth noting the speedy settlement of a problem originating in a judicial appeal by Chilean livestock producers against imports from MERCOSUR. In this case, defense of the domestic market against imports was justified on the grounds that exports from the MERCOSUR countries do not comply with Chile's health and quality norms.

Resolution of the dispute involved a special agreement between the two parties to regulate the inspection system and certification of origin (Argentina, Paraguay and Uruguay) of meat products. It also established training courses for inspectors in the exporting countries, to make them aware of Chilean norms for the certification process.

On the other hand, in June, Argentina announced the establishment of a program to inspect imports before they are shipped. This would be in force for two years as of the end of the current year, and will be effected via private companies authorized by the government.[12]

The annual $70 million cost of the program will be borne by the government, which will finance it through an increase in the import tax. It will levy a surcharge of 0.5% of the value of foreign purchases. According to press reports, exports of MERCOSUR countries are exempt from paying the surcharge.

Finally, during the June meeting of the GMC, the Paraguayan delegation presented a draft Decision to create a simplified mechanism for commodities trade originating in the member countries and produced by small and medium sized enterprises. The proposal will be analyzed by the MERCOSUR Trade Commission (*Comisión de Comercio del MERCOSUR*, CCM) in the coming months.

B. Common Policies

Concerns about the efficacy and transparency of MERCOSUR's trade policies, expressed principally by the common external tariff (CET), were present during the semester in three areas of negotiation:

- The Special Import Regimes: a Special Committee in charge of analyzing the regimes in force was established in July 1996 in the framework of the MERCOSUR Trade Commission. It identified those products which benefited from the regimes, so as to assess if they should be included on the consolidated list of products subject to MERCOSUR's rules of origin. During the GMC of December 1996 in Fortaleza, the CCM was instructed to present in July 1997 a complete analysis of the regimes in force. However, at least until the meeting of the GMC on 23-25 April 1997, the Special Committee did not meet again. At the same time, the delegations of three member countries felt that the GMC should expand the mandate for studying the potential effects of these regimes, and for undertaking a preliminary analysis of the suitability of harmonizing or eliminating some of them to avoid the perforation of the CET.

While the scope of the results of the negotiations in this field is limited, on 27 February Paraguay issued Presidential Decree 16146, which reduced to zero (until 1 January 1999) the import duties for inputs and primary materials bought by industrial and agricultural firms that have a government-supported production assistance program. The accord "establishes an equivalency with the mechanisms for stimulating industrial competition granted by the other MERCOSUR member states." (Gazeta Mercantil, 28 April 1997).

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[12] The program aims to establish prior control over the exports to Argentina, spanning the convergence of prices, freight and insurance costs, periods of validity, tariff positions and total value of the operation.

During the April meeting, the Argentine delegation to the GMC requested that the Decree be rescinded, but Paraguay argued that the issue should be discussed together with the special import regimes of the other MERCOSUR countries.

- Customs Issues: the inadequacies of infrastructure and harmonized norms continue to frustrate the adoption of integrated border controls. The Declaration of Rio de Janeiro, signed by the presidents of Argentina and Brazil, established the partial implementation, as of 17 May, of integrated control in the fields of migration, customs, phytosanitary matters and transport on the border at Paso de los Libres-Uruguayana, the primary land transit point for bilateral commodities transactions. Integrated controls at Puerto Iguazú-Foz do Iguaçu are also planned for the short term.

GMC Resolution 8/97 also established two new integrated control points between Argentina and Brazil, and approved a long list of points with these characteristics (see Table III.1)

TABLE III.1
INTEGRATED CONTROL POINTS IN MERCOSUR
- points authorized by the GMC (April 1997) -

Borders	Neighbouring and touristic transit	Land Cargo	Train Cargo
Argentina - Brazil	5	5	1
Argentina - Paraguay	2	2	1
Argentina - Uruguay	3	3	1
Brazil - Paraguay	3	3	-
Brazil - Uruguay	6	6	-

Source: Annex to Res. N¼ 8/97 of the GMC.

The June meeting in Asuncion discussed the creation of a Common Customs Fund that would act as a mechanism for allocating, between the member states, the revenues generated by any country's levying of the CET. This would eliminate the levying of the CET on the same product by more than one country, and the need for a certificate of origin for all products. The technical proposal for creating the Fund has not been completed, and work continues under the responsibility of the Central Banks of the sub-region.

Also signed via CMC Decision 1/97 was a cooperation and reciprocal assistance agreement between the customs administrations of the MERCOSUR countries, with the aim of combating smuggling.

- Rules on Unfair Practices and Safeguards: after the adoption of the "Common Rules Relating to the Application of Safeguard Measures Originating in non-MERCOSUR Countries" in December 1996, the CCM's Technical Committee (TC) Nº 6 has been developing a project to establish the functions of the Committee for Trade Defense and Safeguards created by CMC Decision 17/96. This Committee evaluates the existence of harm or the threat of serious harm, and conducts an investigation when the safeguard measures are examined by MERCOSUR as a whole.

As regards unfair trade practices—subsidies and dumping—TC Nº 6 continues to examine the proposals presented, with a view to drawing up a common regulation.

In the area of consumer protection, the CCM's TC Nº 7 made little progress in the first semester in preparing proposals for those issues not addressed in the sub-regional Protocol. During its June meeting the GMC had ruled that the CCM should prioritize this issue, given its relevance for consolidating and deepening the customs union.

At the end of the semester, the predominant impression is that of a slow start to the negotiations for implementing common trade policies and for overcoming practices and regimes that affect the free flow of goods within MERCOSUR, as well as to those concerning the conditions of competition in the region.

C. Harmonizing Policies and Deepening the Customs Union

The "MERCOSUR Action Plan to 2000", adopted by the GMC in December 1995, establishes, among other things, the deepening of the customs union as an objective of the integration process. Issues such as trade in services, investments, environment, labor relations, among others, are part of this agenda, which to date has received little attention from national governments.

The issue of deepening the customs union was prominent in the Declaration of Rio de Janeiro, which affirmed that "the crux of MERCOSUR strategy must entail the deepening of the process" and move it towards its "final objective" -the construction of the common market. The same theme was reiterated in the Presidential Declaration presented at the end of the MERCOSUR Summit in Asunción in June 1997, wherein the deepening of integration is associated, "among other initiatives", with a desire to encompass areas such as trade in services, government procurement and public policies that distort the conditions of competition.

The objective of deepening is associated with the preservation of the identity of MERCOSUR in a process framed by the concept of open regionalism. The Declaration of Rio de Janeiro selected two areas to make progress on "the conclusion of agreements": trade in services, with a view to "increased opening of the regional market (...) to the suppliers of the common market"; and government procurement. The ad hoc group for services was instructed to conclude, before the end of 1997, a framework agreement for services so that the definition of commitments in this area could start in 1998. The issue of government procurement is addressed by the ad hoc group for public policies that distort competition. The GMC has instructed the group to draft and submit a proposal on the manner in which the issue should be addressed in the MERCOSUR context.

The June meeting of the GMC defined the following schedules for the ad hoc group to develop its work in the second semester of 1997: by 30 September, define the contents, criteria, methodologies and procedures for addressing the issue; and, by 31 December, draft an agreement on the classification of public policies, a negotiating schedule and the date for concluding the negotiations.

In onother area, the decision of the member countries (plus Bolivia) to transform FONPLATA into a MERCOSUR development bank, announced in March, strengthened the agenda on deepening the customs union. It may also add a new dimension to the integration process: projects and initiatives whose conception derives from a fundamentally sub-regional vision.

The aims of the MERCOSUR development bank are to: favor the consolidation of regional integration, which is better configured with a financial component; mobilize international resources in conditions suitable for lenders; attract capital from other countries or economic blocs, by exploiting in particular the favorable atmosphere offered by the MERCOSUR negotiations; increase competitive advantages through detailed knowledge of the countries in the region; and act in complement with other international lending organizations in identifying and devising pre-projects, co-financing and lines of credit transfer.

Also in the institutional area, MERCOSUR's Administrative Secretariat (*Secretaría Administrativa del MERCOSUR*, SAM) began work during the first semester of this year, having already published the first issue of the Official Bulletin of MERCOSUR. The GMC approved, at its meetings during this period, various basic regulations for contracting personnel for the SAM and for its administrative operation.

Additionally, the June meeting in Asunción decided to re-establish the routine of holding meetings of MERCOSUR economy ministers and central bank presidents as a mechanism for macroeconomic consultation and dialogue.

The third plenary meeting of the MERCOSUR Economic and Social Consultative Forum (ESCF), held in Asunción in April, presented its initial recommendations to the GMC on negotiating strategies for the FTAA, as well as on non-tariff barriers and restrictions prevailing in the sub-region.

As regards the FTAA, the ESCF argued for preserving intra-MERCOSUR preferences in the process and for the adoption of a stage-by-stage negotiating strategy; for encouraging the participation of civil society in the negotiations via the Business Forum and the Forum of Organizations Representing Labor; and for the need to strengthen the agenda on deepening, as well as on integrating the bloc's infrastructure.

With respect to non-tariff barriers and restrictions, the ESCF defended directives on harmonizing or eliminating obstacles to intra-regional trade flows, and supported the establishment of an institutional mechanism for consultation and coordination that should be operative before implementation of new norms that might result in non-tariff barriers.

In the environmental field, Working Sub-group (WSG) Nº 6 discussed the "Additional Protocol to the Treaty of Asunción Regarding the Environment", which addressed the juridical instruments necessary to facilitate the integration process in environmental matters, and which gave rise to WSG Recommendation 9/97. This protocol was brought to the consideration of the GMC during the June meeting in Asuncion, but the Argentine delegation requested an additional period to analyze the document, which will be put on the agenda of the next meeting.

Also within the scope of WSG Nº 6, in light of the differences between the environmental laws of the member states, those measures considered as non-tariff restrictions were discussed individually. In addition, the WSG approved the adoption of the ISO 14000 series of norms as an instrument to facilitate trade between the MERCOSUR countries, and as a reference for the introduction of environmental labeling (green stamps) programs in each MERCOSUR country.

In the area of education, the June meeting of MERCOSUR ministers approved the "Protocol on the Admission of Titles and University Degrees for the Exercise of Academic Activities in the MERCOSUR Countries." Still pending is approval of the quadripartite agreement discussed, but not adopted, in Fortaleza in December 1996.

D. Infrastructure

The problems of energy supply in Brazil, resulting from the stagnation of investment in the sector for more than a decade and the recent increase in demand, have contributed to the acceleration of projects to interconnect energy (gas and electric) involving at least two countries.

In the area of energy inter-connection, the Brazilian Ministry of Mines and Energy launched an international tender in May for the contract of a 1000 megawatts/year interconnected system of Argentina's *Mercado Eléctrico Mayorista.* The energy will come from the hydroelectric plant at Yacyretá (on the border between Argentina and Paraguay) and be transmitted across 460 kilometers, as part of a $320 million project to be developed by private capital. The tender includes the construction of a unified converter on the Argentine-Brazilian border at an estimated cost of $250 million. Electrobrás, through its regional subsidiaries Eletrosul and Furnas, will buy the transmitted energy for use in the southern and southeastern regions of Brazil.

In May, Brazil and Uruguay signed a memorandum to promote the inter-connection of their electricity networks, including the construction of a unified converter in Rivera (with a capacity of 70 megawatts at an estimated cost of $35 million).

To make these types of projects viable, and more specifically to enable Brazil to import 1000 megawatts/year generated in Argentina, the presidents of Argentina and Brazil reaffirmed in the Declaration of Rio de Janeiro (27 April 1997) their "commitment to define norms that permit electricity and natural gas transactions to be freely contracted between companies of the two countries, in line with the principle of equality of treatment, as well as granting authorization, licenses and concessions for the operation and exploitation of the gas pipelines and electricity transmission networks needed for exporting and importing activities". Discriminatory practices will be avoided. These norms allow "exporters and importers to agree on the prices for buying and selling the energy herein mentioned, whose tariffs and prices should reflect efficient economic costs, as well as related services, the volumes involved, the necessary guarantees, " etc.

In the Declaration of Rio de Janeiro, the two presidents also instructed their foreign ministries to review the 1980 bilateral treaty on exploitation of shared water resources in the bordering stretches of the River Uruguay and its tributary, the Peperí-Guazú. The revision will consider the inclusion of instruments allowing exploitation of hydro-electric potential at Garabí by granting concessions to risk capital for construction and maintenance work, and for the operation and marketing of electricity without state contributions, guarantees or subsidies.

In the area of gas integration, a new project to build a gas pipeline connecting Salta Province in Argentina with the southern states of Brazil and São Paulo was begun by a consortium interested in its construction and provision of gas supply services. The consortium includes Mobil Corp. (USA), Energy Corp. (Canada), Marubeni (Japan), in addition to Petrolífera San Jorge of Argentina. The project contemplates construction of a 3,100-kilometer gas pipeline with a capacity to transport 25 million cubic meters of gas per day.

E. Conclusions

MERCOSUR is one of the most dynamic integration processes. Among other reasons, this is because it emerged in a context wherein the largest economies of Latin America were liberalizing, and because it was able to base itself on mechanisms that promoted trade and investment while respecting the limits dictated by the prevailing macroeconomic conditions and policies.

Since it has overcome the stage in which macroeconomic asymmetries dictated, in a large scale, the pace of integration and the volume and direction of intra-regional trade flows, it is legitimate to ask about the relationship between the current "methodology" of integration and the objectives of consolidation and deepening the customs union in a context where MERCOSUR and the FTAA are implicitly concurrent.

The presidential declaration that emerged from the June MERCOSUR summit referred to the "growing political dimension" of the integration process. This vision is coincident with recent comments by the French researcher Alain Touraine, who sees the MERCOSUR process, and the rapprochement between Chile and the bloc, as signalling the "construction of a capacity of autonomous political decision and the defense of a social and cultural identity backed by an interregional economic strategy..."[13]

On the basis of this conception, MERCOSUR prioritizes the agenda that is able to contribute in the most effective way to the consolidation of this political initiative, by identifying instruments and means of resolving disputes and generating the new consensus necessary to consolidate the "qualitative leap" that its individual economies and societies require.

As has been observed, sectoral exemptions and lengthy periods of convergence of tariffs and regulatory regimes are not incompatible with the objectives of the customs union, as long as they are accompanied by mechanisms for enforcing the adopted decisions and by the resolution of disputes that spring from the deepening of interdependence between the member countries.

Anyway, the evolution of the negotiations still reveals some deficiencies as regards the transposition into national law of the norms agreed at the sub-regional level.

For the smaller countries of MERCOSUR, the unpredictability of the rules that condition the access of their products to the larger markets affects their main asset for attracting foreign investments, as well as their greater incentives to participate in the customs union.

The situations characterized by a fair degree of interdependence among the economies, as well as by scant institutional mechanisms able to impose on the member states some type of collective discipline, tends to benefit the larger economies. Hence, in the smaller countries, the cost-benefit analysis of the process might be negative, a perception that might be reinforced in a context wherein a concurrent integration project is emerging.

In the case of MERCOSUR, the issues of market access and equal conditions for competition in the region have acquired priority, but this has not yet translated into a concrete proposal for moving forward. This priority could be expressed by the proliferation of unilateral measures of industrial and trade policy, demands for protection of national markets and for the perpetuation of the transitory exceptions recognized in MERCOSUR.

In Brazil, concerns with the external balance have prompted growing activism in the area of industrial and foreign trade policy. The first semester of 1997 saw the expansion of the Export Promotion Program. This came to establish an equivalency of interests in the measures governing pre-shipment export financing with

[13] Touraine, A. *MERCOSUR: Unión más política que económica, Clarín,* 18 June 1997.

the announcement of a new policy on investment incentives in telecommunications equipment, as well as on the liberalization of multinational companies' access to the long-term financial resources of the BNDES.[14]

The most probable scenario in the short term is that this activism will be maintained which reinforces the need to relaunch the agenda for deepening integration—adopted by the presidents of Argentina and Brazil in April—and to find appropriate means of managing frictions in the area of market access and the conditions of competition in the region.

Despite the political directive for deepening the customs union, the June meetings of the GMC and the CMC revealed the persistence of various difficulties in achieving consensus between the member states as to how these guidelines should be put into operation. The Argentine negotiators argue for the adoption of a common investment policy and priority treatment for services, government procurement and public policies that distort competition. Brazil meanwhile defines a set of priorities concerning the bloc's "pending agenda": to negotiate a common automotive regime by the end of the year; to meet the deadlines for reducing to zero the tariffs on those products in the transition regime; to discuss the special import regimes; and to adopt common rules on consumer protection.

[14] Liberalization is not total but it benefits the infrastructure sectors (telecommunications, electrical energy and ports) and industrial sectors such as petrochemicals, automobiles, metallurgy, minerals, fertilizers, etc.

CHAPTER IV. FOREIGN ECONOMIC RELATIONS

A. General Framework

The FTAA dominated MERCOSUR's external agenda in the first half of 1997. The governments and business associations of MERCOSUR put great efforts and much of their negotiating capacity into the vice-ministers' meetings in Recife in February and in Rio de Janeiro in April, and the trade ministerial and III Business Forum of the Americas in Belo Horizonte in May.

The FTAA negotiations create a significant incentive for the MERCOSUR countries to negotiate intra-bloc agreements on consolidating and deepening the customs union, as building blocks in the hemisphere-wide negotiations. The bilateral Declaration of Rio de Janeiro and the Declaration of MERCOSUR presidents that emerged from the Asunción summit in June reveal a clear political orientation in that sense, as a means of meeting goals and reaching agreements that would confer "institutional density" on the ongoing integration process and express the growing economic importance of MERCOSUR for the national projects of its Member States.

In the framework of the Latin American Integration Association (LAIA), negotiations with Mexico, the Andean Group and, more recently, Peru, are encouraging the multilateralization of the preferences granted in the bilateral agreements and, in the latter two cases, the conclusion of free trade accords.

Negotiations with Mexico were particularly intense in the first half of the year. They gave continuity to the process begun in 1995, which led to successive extensions of the existing bilateral agreements in the expectation that a new Economic Complementarity Agreement could be concluded on a 4+1 basis.

At the beginning of 1997 the bilateral agreements in force were again extended to September 1997, while negotiations continued on the program of trade liberalization and on the trade norms to be applied: dispute resolution, safeguards, unfair trade practices, etc.

In the final round of negotiations the two sides judged as unsatisfactory the outcome of the responses made by both of them to the lists of products that might be considered by tariff preference margins, since there was a significant proportion of negative responses.

Consequently, Mexico submitted a new proposal for trade preference criteria with a minimum preference margin equal to that of the Agreement of Regional Tariff Preference (*Acuerdo Referente a la Preferencia Regional*, PAR), which is 20%. Mexico proposed that each side could indicate 100 tariff items that would have no preference while the rest (almost 6,800 items) would have reciprocal preferences of 20%, apart from up to 1,500 items that would have preferences of at least 50%. Of these 1,500, each side could exempt 200-300 items.

Mexico's proposal was not accepted by MERCOSUR. The negotiations on tariff preferences therefore continue to face difficulties. As regards norms, despite the exchange of negotiating proposals last March, issues of particular importance for MERCOSUR—such as the treatment to be accorded to goods produced in free zones and *maquilas*, the special import regimes, and rules of origin—were not addressed in the meetings. It is therefore unlikely that the negotiations on a new economic complementarity agreement with Mexico will be concluded by 30 September 1997. Negotiations with the Andean Group also proved slow, while in May Peru sought to begin formal negotiations for a free trade agreement with MERCOSUR on a 4+1 basis, a situation that had to be reconsidered in view of Peru's reincorporation into the Group.

In the LAIA framework, MERCOSUR and Bolivia signed a new economic complementarity agreement on 28 February in Montevideo, registered with LAIA as number 36. As regards the accord with Chile, in December 1996 in Fortaleza the GMC confirmed the extension—until 31 March 1997—of the deadline for negotiating a safeguards regime on MERCOSUR-Chile trade, and for defining specific rules of origin for information technology and telecommunications products that fall within the agreement's rules of origin regime.

The second extraordinary meeting of the Administrative Committee of the MERCOSUR-Chile economic complementarity agreement was held in Asunción on 21-22 April. The meeting's enormous agenda included issues such as Brazil's Provisional Measure restricting import financing and Chile's presentation of the terms of its free trade agreement with Canada. Chile also argued for the necessity of establishing—in the framework of the Administrative Committee and in a period shorter than the three years foreseen in the complementarity agreement—mechanisms of prior consultation on issues of bilateral interest and of mediation for dispute resolution. Other items on the bilateral agenda include liberalizing services and defining the regime for the automotive sector, which were also discussed in the third meeting of the Administrative Committee in Montevideo at the end of May.

The Bolivian and Chilean presidents attended the Asunción summit in June, where President Frei—backed by his Bolivian counterpart—argued for a more effective Chilean participation in internal MERCOSUR discussions. Among other things, the aim would be to establish common negotiating positions in both sides' foreign relations, and especially in the FTAA context. He also argued that MERCOSUR should be endowed with institutional mechanisms for resolving disputes between its members, and which would also embrace Bolivia and Chile.

In political terms, the strengthening of Chile's relations with MERCOSUR is highly significant, underpinned by a substantial increase in Chilean exports to and investment in MERCOSUR. According to data from the Chilean Economy Ministry, Chile's exports grew 11.3% in the first five months that the agreement was in force, compared to the same period of the previous year, such that exports to MERCOSUR accounted for 11.5% of total exports (compared to 9.6% in the previous year).

Chile's international credibility is a notable asset for MERCOSUR in its external negotiations, particularly in the FTAA framework. Chile's experience of negotiating free trade agreements—most recently with Canada—could also bring added value to MERCOSUR's internal and external dynamic. Moreover, as a recent IDB document (1996) indicates, "in view of the progress made in the reform process and the opening up of the Chilean economy, and the country's experience of modern regulatory systems, an institutional framework that allows a fluid integration between Chile and MERCOSUR might support the future development of the integration process" (*Periodic Note*. Integration, Trade and Hemispheric Issues Division).

As regards MERCOSUR's negotiations with the European Union (EU), the three Working Groups established within the Trade Subcommittee of the Joint Committee (on goods, services and commercial disciplines) met in Brussels in March and established a deadline of November 1997 for responding to a broad range of questions on trade flows, trade barriers, tariff convergences and divergences, trade policy, etc. Those responses will be brought to the meeting of the Joint Committee in Montevideo in November.

Looking further ahead, the French president proposed a summit of the heads of state and government of the countries of the EU and MERCOSUR. But the prospects for advancing with substantive negotiations might be compromised by implementation of an April recommendation by the European Council that no new free trade agreement be signed by the EU, and that the Union should restrict itself to carrying out the existing accords. Moreover, together with MERCOSUR the EU is arguing for the proposal to prioritize the launching of a new multilateral round of trade negotiations, which seems compatible with the European Council recommendation mentioned earlier.

In the multilateral arena, three developments should be noted:

→ First, the World Trade Organization (WTO) Working Group examining MERCOSUR held its third meeting in Geneva in May. The GMC instructed the ad hoc Group to assess various methodologies for evaluating the impact of the application of the CET, with a view to defining a methodological proposal for presentation to the WTO. The Group must also analyze the means and criteria for any eventual request to renegotiate concessions.

→ Second, Brazil (but not the other members of MERCOSUR) signed the WTO's Telecommunications Agreement in February. At the end of June Brazil formally signed the WTO document that consolidates the offers of 70 countries for opening national markets. In the case of Brazil, this offer would be operational from 1 January 1998 for all services now contemplated by Brazilian law: mobile cellular service, satellite service, limited services and value added services. For the other services, Brazil's offer depends on approval of the General Law on Telecommunications currently before Congress, and on a presidential decree to establish conditions for the entry of foreign capital in the provision of basic telecommunication services. The additional Brazilian offer would enter into force a year after approval of the General Law on Telecommunications.

→ Third, the June meeting of the agriculture ministers of the Cairns Group in Rio de Janeiro saw the accession of Paraguay, until then the only MERCOSUR member not in the Group. The Group aims, before 1999, to define the agenda, the negotiating framework, and mechanisms for the resumption of multilateral talks in this area, scheduled for 1999. The issue of subsidies to the production and export of agricultural goods in the OECD countries, and accession to the WTO by large commodity producers and importers, dominated the meeting, underlining the importance of the fact that the new members of the WTO should respect multilateral rules and pledge to liberalize agricultural trade.

B. MERCOSUR and the construction of the FTAA

The meeting of the trade ministers and the Business Forum of the Americas in mid-May in Belo Horizonte marked the end of the "Brazilian cycle" in the process of negotiating the Free Trade Area of the Americas (FTAA).

The trade ministerial was widely reported by the MERCOSUR press, which emphasized the differences between the sub-region's position and that of the United States. However, an objective assessment of the meetings suggests that the regional process made substantial progress on the essential questions, and that even the differences and disputes may be making a significant contribution to the process of establishing the FTAA.

The Belo Horizonte meeting ratified the agreements reached in previous meetings, outlining a means of establishing the FTAA that accords, in its principles and goals, with the interests of MERCOSUR. The FTAA's prominence among the existing integration agreements in the hemisphere was explicitly affirmed, in as much as its coexistence with the other agreements was accepted "to the extent that the rights and obligations under these agreements are not covered by or go beyond the rights and obligations of the FTAA" (Ministerial Declaration of Belo Horizonte).

The participation of the private sector began to have a greater influence on the dynamic of the inter-governmental negotiations and on the national and sub-regional positions. There is a strong possibility that the negotiations will start in April 1998 after the Santiago Summit.

Evolution of the FTAA project

Background, Configuration and Evolution of the FTAA

In 1990, when President George Bush launched the Enterprise for the Americas Initiative, regional integration initiatives were proliferating in the Americas and the dynamism of "regionalism" was in sharp contrast to the slow pace and the difficulties of the ongoing multilateral negotiations.

In Western Europe the 1992 project overcame the "eurosclerosis" of the early 1980s and the integration process acquired new momentum, extending towards the east (German unification in 1990) and defining the bases for deepening with the plans for economic and monetary union (enshrined in the Maastricht Treaty in February 1992).

In Asia, the creation of the Asia Pacific Economic Cooperation forum (APEC) in 1989 was complemented by projects that exclusively involved the countries of the region: the East Asian Economic Caucus (EAEC), established in 1990, and the Asian Free Trade Area (AFTA) founded in February 1992.

In the western hemisphere, with the conclusion of the negotiations for the Canada-US Free trade Agreement (CUSFTA), the US government announced the start of talks with Mexico for the establishment of the North American Free Trade Agreement (NAFTA). In the United States, disappointment with the pace and results of the multilateral negotiations nourished such initiatives and encouraged the implementation of unilateral measures against partners accused of unfair trade practices.

On the other hand, in Latin America, integration agreements and economic cooperation accords re-emerged, now closely linked to the unilateral trade liberalization being undertaken by the countries of the region, and to the revision of the development model that had prevailed in Latin America in the previous decades. In the south of the continent the Act of Buenos Aires (June 1990) conferred a new dimension on the Argentine-Brazilian agreements by outlining an automatic and universal methodology of trade liberalization among the two countries, and by significantly broadening the credibility of the process.

The establishment of MERCOSUR—with the entry of Paraguay and Uruguay—and the goal of creating a customs union in December 1994 strengthened these trends. MERCOSUR witnessed a significant increase in intra-regional trade despite the macroeconomic problems of some of its members.

Regionalization suggested a tripolar world—the Americas, Europe and Asia—in which economic competition would supersede the political and ideological polarization of the Cold War, and where the future of multilateralism was viewed with growing skepticism. It was in this context that the United States launched the Enterprise for the Americas initiative in June 1990, barely two weeks after President Bush announced Washington's intention of negotiating a free trade agreement with Mexico.

When the Miami Summit was held, the international context was already less favorable for the trends of regionalization: the successful conclusion of the Uruguay Round revived the spirit of multilateralism and the world's main experience of economic integration—the European Union—faced growing economic and social difficulties on its path to deepening. In the United States concerns about NAFTA's impact grew, and Congress refused to extend the executive's fast-track authority for new trade negotiations. The Mexican crisis, coming shortly after the Miami Summit, and the emergence of high US trade deficits with its NAFTA partners, widened US domestic resistance to new liberalization initiatives that involved the United States and other countries of the Americas.

The Miami Summit of December 1994 approved an Action Plan that contemplated the conclusion of negotiations for the FTAA by the year 2005 and acknowledged that integration would proceed along two lines: "the widening and deepening of the existing agreements in the region and the development of liberalization norms in the commercial and other fields for accession to the FTAA agreement" (Garay, 1997).

The Process of Negotiating the FTAA

- The inter-governmental negotiations -

In the Action plan approved at the Miami Summit, as well as fixing the year 2005 as the deadline for concluding the negotiations, the hemisphere's heads of state affirmed that the FTAA process would advance in a twin-track manner; they also established a calendar of meetings for the established work program.

The trade ministers reaffirmed the compatibility of the FTAA with WTO rules and with the principles of open regionalism at their Denver meeting in June 1995. Seven Working Groups were created, and plans were made for establishing four more at the Cartagena meeting in March 1996.[15]

Additionally, it was specified that the agreement would include trade issues and the "new issues" of the Uruguay Round, as well as competition policy. Accession to the agreement would require acceptance of all rights and obligations in the form of a single undertaking.

With the start of the "Brazilian cycle" of meetings—inaugurated in Florianópolis in September 1996—the FTAA process had already defined a deadline for the conclusion of the negotiations (2005), the basic elements of its scope (the issues covered by the Working Groups), some fundamental principles (decision-making by consensus, WTO compatibility and the single undertaking), an embryonic system of negotiation (meetings of the trade ministers and vice-ministers) and the organizational support structure (the Working Groups and the OAS/IDB/ECLAC Tripartite Committee). It was acknowledged, moreover, that participation in the negotiations and accession to the FTAA could be undertaken as individual countries or as members of a sub-regional group such as MERCOSUR.

The "twin-track integration" defined at Miami safeguarded the interests of the MERCOSUR countries, which were involved in a customs union project, while preserving for the United States the viability of the strategy of expanding NAFTA.

On the other hand, there was no consensus on the starting date for the negotiations nor on the "nature and depth of the commitments" for the FTAA (Lande, 1996).

In the vice-ministerial meeting at Florianópolis, a debate began on the process of negotiation to be concluded by 2005. In accordance with the MERCOSUR proposal, negotiations would be conducted in three successive stages, with a series of issues indivisibly linked to each stage.

[15] The 11 Working Groups established inthe two meetings are as follows: Market Access; Customs Procedures and Rules of Origin; Investment; Standards and Non-tariff Barriers to Trade; Sanitary and Phytosanitary Measures; Subsidies, Anti-dumping and Countervailing Duties; Smaller Economies; Government Procurement; Intellectual Property Rights; Services and Competition Policy. A working group on conflict resolution was added later.

The first stage would seek agreements on business facilitation in fields such as customs procedures, health measures, etc. The second stage would include issues whose negotiation demanded more than simple agreements on business facilitation, without implying changes to concession on market access. These would be reserved for the third stage to start in 2003.

With the start of discussion on the negotiating process, five other proposals were added to that of MERCOSUR in the meetings of Recife (February 1997) and Rio de Janeiro (April 1997): those of the United States, Canada, CARICOM, the Andean Group and Chile.

The ministerial meeting of Belo Horizonte in May 1997, ratified the agreements thus far reached. The meeting's specific contributions to the process would center on four issues:

→ First, a more precise definition of the start of negotiations: the ministers agreed that "the FTAA negotiations should be initiated at Santiago, in March 1998, and we will recommend to our leaders that they do so at that time". Although this is not a particularly concrete affirmation, the formula used leaves little room for doubt about the date for starting the negotiations. The hemisphere's trade ministers, in their meeting in San José, Costa Rica, in March 1998, will "formulate how the negotiations will proceed, including such features as their objectives, approaches, structure and venue";

→ Second, a definition of the "organizational structures of transition" between the pre-negotiating phase and the negotiations themselves: the vice-ministers will have three meetings in Costa Rica to prepare the ministerial meeting of March 1998, precursor of the Santiago summit in April. The vice-ministers will institute a Preparatory Committee to coordinate and oversee the activities of the Working Groups and to recommend to the ministers a means of "reconfiguring" the WGs as negotiating groups. The WGs—to which the Group on Dispute Resolution has now been added—must "submit to vice-ministers at the second meeting under Costa Rica's chairmanship different technical alternatives on possible issues and negotiating approaches in their respective disciplines". The Tripartite Committee will continue to provide technical support to the WGs and will undertake a feasibility study on alternatives "for establishing a temporary administrative secretariat to support the FTAA negotiations";

→ Third, the reaffirmation of the specific needs of the smaller economies, in as much as "special attention should be given to the needs, economic conditions and opportunities of the smaller economies to ensure their full participation in the FTAA process"; and

→ Fourth, the qualification of the co-existence of the FTAA with other bilateral and sub-regional agreements among countries of the hemisphere. In as much as the principle of the single undertaking prevails as the model for adhesion to the agreement, such co-existence is possible "to the extent that the rights and obligations under these agreements are not covered by or go beyond the rights and obligations of the FTAA". This qualification suggests that some principle for regulating relations between the FTAA and the other integration agreements in the Americas, in all the fields contemplated in the hemispheric agreement, has been introduced into the negotiations. The definition of this principle, based on the primacy of the FTAA's provisions over other agreements in common areas, springs from pragmatic recognition of the difficulties involved in establishing hemisphere-wide disciplines on the basis of the diverse bilateral and sub-regional rules and norms originating in the agreements reached in the hemisphere during recent years.

Differences over the sequence of the negotiations were not overcome, and the matter will absorb the attention of the vice-ministers in their next three meetings in Costa Rica.

- The participation of the private sector-

The mobilization of the private sector in the preparations for the Belo Horizonte summit, through the sectors' Fora that preceded the ministerial meetings, consolidated the participation of business as a central element of the FTAA integration process. Intense business participation began to generate a negotiating dynamic with a fair degree of autonomy from the inter-governmental negotiations, and with a high "rate of convergence" between the different national (or sub-regional) proposals.

The conclusions of the business workshops prompt two comments:

- Differences over the sequence of negotiations—in stages or simultaneous—was also evident among the entrepreneurs. In their case, the position favoring negotiations in stages was maintained not only by the MERCOSUR representatives but also by those from Chile and the Andean Group.

- There was a high "rate of convergence" in areas that are not strictly commercial, such as investment and competition policy, with a consensus on the necessity and viability of advancing rapidly towards agreements of hemisphere-wide scope.

More recently, the participation of the trade union sector in the discussions arose from the Trade Union Forum of the Workers of the Americas, which was held in Belo Horizonte. The Forum declared its formal incorporation to the negotiating process and argued for the inclusion of five "social clauses" in the agreement: the fight against slave labor; the fight against child labor; the fight against racial discrimination; the right to trade union organization; and the right to the collective organization of workers (cf *Gazeta Mercantil*, 13 May 1997).

MERCOSUR and the FTAA

The participation of a country, or group of countries, in a regional integration agreement involves benefits and costs which might not be negligible. These can spring both from the "initial conditions" - that is, the start of the integration process - as well as from the trade and investment dynamic prompted by the original agreement and the policies applied by the various countries or a group of countries.

On the one hand, integration agreements that are not discriminatory to the rest of the world promote, as does multilateral liberalization, the specialization of countries in those sectors where they have a comparative advantage, enhancing their economies' efficiency as regards resource-allocation.

On the other hand, integration prompts other dynamic effects that "modify the rate of economic growth by accelerating the rate of productivity and/or the growth rate of capital formation". The dynamic effects of integration processes involve, tougher competition, fewer uncertainties and changes in the targeting and volume of investments (Bouzas and Ros, 1994).

The appearance of benefits in the shape of greater efficiency of resource-allocation does not preclude the existence of costs associated with the two kinds of effects generated by integration. As well as the "transition costs", coupled to its distributive costs, integration can strengthen—rather than reduce—structural differences between countries and regions. Yet to be proved empirically is the hypothesis that trade liberalization and the convergence of regulatory regimes will automatically reduce structural disparities and prompt a convergence of living standards in the different countries.

In this sense, the dynamic inter-action between means of market liberalization, the implementation of economic policies and structural economic change (especially in industry) can generate significant benefits, tensions and costs, giving rise to macroeconomic and structural developments that are more or less "virtuous" or "perverse" (Fayolle and Cacheux, 1996).

It is virtually impossible to quantify, *ex-ante*, the extent and nature of integration effects on a country or group of countries (Bouzas and Ros, 1994). However, this should not impede an attempt to map out, for one or more countries, the benefits (or incentives) and costs that might potentially be associated with a specific process of regional integration.[16]

From the viewpoint of MERCOSUR as a bloc, the strongest incentives concern the potential risks of exclusion (a defensive incentive), as well as the prospects of guaranteed and stable access to the US market and the expansion of intra-industrial trade flows and productive investment. The relative concentration of MERCOSUR exports to the United States in manufactured goods (especially those of Argentina and Brazil), leads to the assumption that the prospects for generating new flows of intra-industrial trade and new investments are fairly significant. On the other hand the "credibility" effect of integration, even though important, now seems less relevant than it was three or four years ago, in terms of making domestic reforms in Latin America seem irreversible.

The fact that MERCOSUR countries' exports to the United States and Latin America are concentrated in manufactures is also what gives particular relevance to the defensive incentive represented by the risks of exclusion or marginalization from the FTAA. In a scenario of marginalization, and given the price elasticity of demand for manufactures, MERCOSUR's exports could lose competitiveness *vis-à-vis* the other countries of the hemisphere in the markets of North America and the Latin American Integration Association.

Moreover, MERCOSUR's high potential for attracting new foreign investment, and for becoming the hub of FTAA-driven investments in South America, reinforces the view that non-participation in the FTAA could have high costs for the MERCOSUR countries in terms of investment diversion.

The potential costs of MERCOSUR's participation in the FTAA are essentially linked to the adjustments of transition, especially in industry, and to discrimination against extra-FTAA countries or blocs.

For MERCOSUR the costs of discrimination are potentially high, owing not only to some of its members' global trader characteristics but also due to the significant share of European and Asian investment in their economies' flows and stock of FDI.

As regards transition costs, these would have a particular effect on Brazil, the most diversified and industrialized economy of MERCOSUR.

For all MERCOSUR countries the benefits and costs of an integration agreement are not of an "invariable magnitude". They are contingent on the capacity of the countries to "articulate a strategy and implement policies appropriate for the challenge of competitively restructuring" their economies (Frischtak, 1997). For the MERCOSUR countries the results of integration would hinge, in the policy realm, on the following factors:

[16] Specific, in the sense that the partners are known, as are the historic circumstances in which the negotiations proceed.

- the capacity of the national economies to conclude the cycle of regulatory reforms geared to consolidating stabilization and reducing the costs of investment, production and export of goods and services;

- their capacity to design policies for the competitive restructuring of the sectors identified as sensitive to preferential liberalization; and

- the capacity of governments and national private sectors to implement MERCOSUR's agenda for consolidation and deepening, eliminating restrictions on access to national markets including services and public policies that distort competition, removing constraints on the placement of investment in the sub-regional context, and ensuring stability and certainty in the rules of the game for the customs union. MERCOSUR's effective participation as a building block in the construction of the FTAA will also depend on the group's internal capacity to implement the MERCOSUR Agenda to 2000, set out in December 1995, to present itself as a viable and credible integration model and to devise and apply proposals in the fields of policies and market access, validated by its own experience in building consensus and managing the tensions inherent in this kind of process. In this sense, the effective implementation of the obligations assumed in the Uruguay Round become particularly relevant.

If the MERCOSUR countries were able to advance in these three directions, the business response time to the new competitive challenge represented by the FTAA negotiations might well be minimized. Additionally, the new investment flows might, during the negotiating period, reduce the competitivity gap now apparent in some sectors.

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