MERCOSUR REPORT
N° 3

REPORT

MERCOSUR

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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 No. 3 covers the second half of 1997 and was prepared by the distinguished professor Roberto Bouzas of FLACSO with the collaboration of Paula Gosis and Hernan Soltz, researchers at FLACSO. The main text of the Report is complemented by an appendix on the association between Chile and MERCOSUR one year after the free trade area between the two came into operation. The appendix was prepared by Dr. Manuel R. Agosín, a prominent economist and professor at the Economics Department of the University of Chile, with the collaboration of Roberto Alvarez E., a researcher at the same university. Dr. Uziel Nogueira, INTAL economist, was responsible for the technical supervision of the Report.

We hope that the material we present meets the expectations raised by Reports Nos. 1 and 2, and we invite our readers to keep making comments or suggestions so that we can continue to improve the scope and content of these publications in the future.

Juan José Taccone
Director

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ASSOCIATION BETWEEN CHILE AND MERCOSUR: COSTS AND BENEFITS AFTER ONE YEAR

Analysis to date suggests that the association accord between Chile and Mercosur will be extremely favorable for Chile's economic development. The gains that Chile can anticipate from this agreement are dynamic: the accord will probably stimulate greater foreign investment flows and higher levels of national investment. It should also increase intra-industrial trade and promote benefits through economies of scale.

At the same time, the accord will help move Chile's comparative advantages from natural resources to light manufacturing, some sophisticated manufactured goods (MERCOSUR is the main market for Chilean exports of vehicles and autoparts) and modern services (engineering, public utilities, banking, finance and insurance). Chile has developed comparative advantages in these areas during the last decade, which it is already exploiting in other countries of the region through foreign direct investment (FDI). A high proportion of Chilean manufactured exports already go to MERCOSUR.

It is in these sectors that productivity increases and intra-industrial complementarity are concentrated. The association accord with MERCOSUR should give a strong push to these vanguard sectors of the Chilean economy. New trade flows will induce new reciprocal investment flows in manufactures. Moreover, foreign investment by Chilean service firms will undoubtedly prompt greater export of goods and services to the MERCOSUR countries.

The experience of the first year of the agreement confirms the benefits that the accord could offer Chile. Although favorable macroeconomic conditions in the last year stimulated Chilean-MERCOSUR trade, the Chilean exports which grew most were precisely those benefiting from the fastest and steepest tariff reductions. This was not necessarily the case for Chilean imports from MERCOSUR, perhaps because the Chilean tariff is already quite low, and because both the strong increase in internal demand and the appreciation of the real exchange rate were extremely favorable for import growth, even for those products that MERCOSUR placed on lists of exceptions.

What are the chances of Chile entering MERCOSUR as a full member? The stalling of Chile's negotiations to join NAFTA and the new difficulties that are already appearing in the country's trade with Asia (because of the financial crisis that has recently shaken several Asian countries) could bring Chile closer to its new MERCOSUR partners. However, high MERCOSUR tariffs for some goods which Chile does not produce, and which are essential for its development and international competitiveness (capital goods and transport material, for example), militate against this option. To the extent that the two sides grow closer on trade policy, deeper integration between them is feasible. For the moment, however, it is important to consolidate relations and avoid the kind of exceptional measures (taken because of macroeconomic or balance of payments problems) that could disturb them.

EXECUTIVE SUMMARY

I. Macroeconomic Trends

During 1997, MERCOSUR countries again experienced both an acceleration in their economic growth rates and a reduction in inflation rates. This favorable performance was accompanied by an improved fiscal position and the stabilization of real exchange rates. Given that exchange policies in MERCOSUR countries play a central role as inflation-control instruments, the stabilization or improvement of real exchange rates is good news for the future development of external disequilibria. This is a particularly important issue given the recent deterioration in the current account balances of all member countries.

During the second half of 1997, MERCOSUR countries were affected by the turbulence in Asian currency and financial markets. This began with the July crisis in Thailand and continued with the fall in the Hong Kong stock market and South Korea's currency and financial crisis in October. Throughout the region, but especially in Brazil, these events entailed a loss of confidence in domestic assets and a rise in risk premiums. Such repercussions encouraged the adoption of severe fiscal and monetary adjustment measures, particularly in Brazil. In light of these developments, MERCOSUR countries' macroeconomic scenario will probably be complex in 1998.

In the final months of 1997, the debate on how to manage the tensions that could arise from a deterioration of prevailing economic conditions in the sub-region (for example, through a modification of exchange rate policies in one or more countries of MERCOSUR) acquired renewed intensity. The options examined in public debate ranged from the establishment of a safeguard mechanism for intra-bloc trade, to the establishment of macroeconomic convergence criteria after the model of the Maastricht Treaty. The safeguard mechanism could either be applied widely or limited to use only in the event of exchange rate modifications (the Asunción Treaty foresaw the end of the safeguard regime that was in place during the transition period; currently, the countries only have the safeguard regime of the WTO at their disposal). Government authorities have responded to such speculations with an increase in dialogue and informal exchanges.

II. Foreign Trade and Investment

During 1997 intra-regional trade continued to grow rapidly, at a faster rate than total MERCOSUR exports. Indeed, intra-regional exports grew twice as fast as total exports. This gap was nevertheless much smaller than that experienced in the 1991-96 period, when intra-regional trade expanded nearly three times as fast as total exports. The difference in the growth rates of extra-regional and intra-regional exports has increased the latter's participation in total trade to around 25%.

Since the signing of the Treaty of Asunción in 1991, growth in MERCOSUR's intra- and extra-regional exports has not been homogeneous. This has prompted significant changes in the composition of trade. Although such changes have been greatly influenced by the performance of Brazilian exports, the latter's impact on extra-regional exports (of which almost 70% were from Brazil in 1996) is much more pronounced than in the case of intra-regional exports (where Brazil's share is less than 45%). Between 1991 and 1996, the composition of MERCOSUR's extra-regional exports underwent significant changes. Central among these are the increased participation of Food and Beverages (whose share in extra-regional exports rose from 13.6% to almost 50%) and a fall in the share of Minerals and Metals, Primary Agricultural Commodities and Manufactures. The most notable change in intra-regional trade was the substantial growth in the share of Petroleum and Fuels (albeit from a modest base). Such changes in the composition of trade resulted in the fact that, by the end of the period, intra-regional exports were much more concentrated in Manufactures, and in Petroleum and Fuels, than exports to the rest of the world.

FDI flows to MERCOSUR countries have grown significantly in recent years. In 1996, they totaled an estimated US$ 14.2 billion, equivalent to 37% of all FDI flows to Latin America and the Caribbean, and 11% of total flows to developing countries. In 1996, Brazil was the main recipient of FDI flows to MERCOSUR (and the second largest among developing countries), with total inflows of US$ 9.5 billion. According to preliminary data this favorable trend continued in 1997.

The outlook is good for FDI flows to the sub-region over the next few years. According to official Argentine estimates, investments announced by foreign companies for the period 1997-2000 amount to around US$ 14 billion a year in Argentina, three times the amount registered in the period 1990-96.[*] Prospects for FDI inflows to Brazil are also favorable, particularly in light of the privatizations still planned for the remaining years of the century. According to official estimates, the privatization of public services such as telecommunications and electricity services is likely to attract around US$ 30 billion in foreign investment between 1997 and 2000, equivalent to 37% of total estimated revenues from privatization for the whole period. These estimates contrast with the participation of foreign capital in the first six years of the National Privatization Program, when such contributions reached only 13% of total revenues obtained. One reason for the significant projected increase in the participation of foreign capital lies in the nature of the privatizations to come: in most cases, these activities face severe supply restrictions and are in need of modern technology in order to respond to a large, unsatisfied demand and projected growth. Planned investments in the telecommunications sector (estimated at US$ 90 billion for fixed and cellular phone services in the next five years) are simultaneously inducing the establishment of equipment producers, making Brazil an important production center for telecommunications equipment.

III. Market Access and Conditions of Competition

In January 1998 MERCOSUR celebrated the third anniversary of its formal establishment as a customs union. During this time the member countries have improved some of the mechanisms allowing for the free movement of goods in the sub-region, while also advancing with the establishment of some of the bases necessary for the effective operation of the customs union. Significant progress has been achieved in the area of market access, although there are still questions that have not been satisfactorily resolved by some of the member states, including unilateral measures that affect the trade in goods. In 1997, these questions acquired particular relevance because of the adoption of measures with effects on goods trade. Although in most cases these issues were resolved after negotiation and the exemption of MERCOSUR members from the effects of the measures, such incidents have revealed elements of unilateralism and a lack of prior consultation.

Progress was more modest in terms of regulating competition conditions: regulations for the Protocol to Safeguard Competition, approved in December 1996, were not established, nor have member states advanced significantly in addressing the existing asymmetries in public policies which affect competition. Resolving these matters is necessary to guarantee effective and stable market access.

IV. Common Policies

In contrast to the advances made in the area of free circulation of goods, 1997 saw little progress on the effective implementation of common policies. The common external tariff (CET) was temporarily increased by three percentage points at the end of the year, but it was left to each country to decide how this might best be applied, thereby opening new loopholes in the effective maintenance of the CET. There

[*] This information is taken from the “Investment Database” of the Center for the Study of Production of the Argentine Ministry of Industry, Trade and Mining.

were few steps towards adopting the common customs code and progress was slow in implementing integrated border controls, mainly because budgetary constraints made it difficult to establish the required infrastructure. In December 1997 the Common Market Council (CMC) approved the regulatory framework for establishing a Common Regulation on Import Dumping from Non-MERCOSUR Countries, as a first step towards instituting such a regulation.

V. Policy Harmonization and Deepening

In the Rio de Janeiro Declaration of April 1997, the presidents of Argentina and Brazil stressed trade in services and government procurement as the key issues for deepening the MERCOSUR integration process. This commitment led to the signing of the Protocol on Trade in Services at the meeting of the Common Market Council (CMC) in Montevideo in December 1997, and to the creation of an *ad hoc* group to address the issue of government procurement. Some progress was also made in the social and labor fields, (such as the signing of the MERCOSUR Multilateral Agreement on Social Security), in the areas of education and culture, and at the institutional level. With regard to the environment, no agreement has yet been reached that might allow for the signing of a corresponding additional protocol.

VI. Infrastructure

The rapid growth of the MERCOSUR economies and the accelerated expansion of intra-MERCOSUR trade has highlighted deficiencies in infrastructure which promise to transform investment in this sector into one of the most dynamic components of the sub-regional integration process. As well as the inadequate transport and communications infrastructure linking the sub-region, there is significant potential for energy integration that would maximize the efficient exploitation of MERCOSUR's installed capacity and available resources. These demands, together with the fiscal constraints faced by the countries' public sectors, open a vast potential for private investment, whose access has been facilitated by the privatization process underway throughout MERCOSUR. Investment in infrastructure on a sub-regional basis also opens up an important field of action for the multilateral development banks and other public finance agencies. This was the basis for the proposal to transform the Financial Fund for the Development of the River Plate Basin (*Fondo para el Desarrollo de la Cuenca del Plata*, FONPLATA) into a financial mechanism for development and integration with financial, operational, technical and administrative autonomy. This initiative is still being studied.

VII. Foreign Economic Relations

MERCOSUR is developing an extensive agenda of external trade negotiations. Parallel to the WTO's examination of the preferential agreement, negotiations are underway in the ALADI framework with the Andean Community and Mexico, while the negotiations on the FTAA and with the European Union are being prepared. It proved impossible to meet the 31 December 1997 deadline for concluding either the negotiations on a free trade accord with the Andean Community or an agreement with Mexico to multilateralize existing bilateral preferences. In the FTAA process, MERCOSUR has continued to participate actively in the preparatory meetings of the vice-ministers for trade, which are being held in anticipation of the ministerial meeting scheduled for next March in San José, Costa Rica, and of the presidential summit scheduled for April. MERCOSUR and the European Union have almost completed the stage of "mapping" their trade relations, an activity for which INTAL has provided technical assistance.

CHAPTER I. MACROECONOMIC TRENDS

During 1997, MERCOSUR countries again experienced both an acceleration in their economic growth rates and a reduction in inflation rates. This favorable performance was accompanied by an improved fiscal position and the stabilization of real exchange rates. Given that exchange policies in MERCOSUR countries play a central role as inflation-control instruments, the stabilization or improvement of real exchange rates is good news for the future development of external disequilibria. This is a particularly important issue given the recent deterioration in the current account balances of all member countries.

In 1997, MERCOSUR economies also experienced a greater synchronization of their national economic cycles. This was particularly true in Argentina, Brazil and Uruguay. Coupled with relative stability in bilateral real exchange rates, such synchronization allowed for balanced growth of intra-regional trade. Rapid growth in Brazil's imports nevertheless stimulated aggregate demand in the other economies. [1]

During the second half of 1997, MERCOSUR countries were affected by the turbulence in Asian currency and financial markets. This began with the July crisis in Thailand and continued with the fall in the Hong Kong stock market and South Korea's currency and financial crisis in October. Throughout the region, but especially in Brazil, these events entailed a loss of confidence in domestic assets and a rise in risk premiums. Such repercussions encouraged the adoption of severe fiscal and monetary adjustment measures, particularly in Brazil. In light of these developments, MERCOSUR countries' macroeconomic scenario will probably be complex in 1998.

A. Macroeconomic Performance in 1997

Continuing the upward trend in economic growth rates initiated in 1996, regional gross domestic product (GDP) expanded by 4.8% in 1997, higher than the rate of 3.2% recorded in the previous year (Table I.1). While economic growth accelerated in all countries of the region, Argentina and Uruguay (the economies most affected by the Mexican crisis of 1995) registered the highest levels of growth. The Argentine economy, whose recovery had begun in the second quarter of 1996 and gained momentum after the middle of the year, grew by nearly 8% in 1997, stimulated by an expansion in fixed gross investment and exports. In contrast to what had occurred in the previous phase of expansion (1991-94), private consumption grew more slowly than GDP. The financial and currency turbulence in Southeast Asia had an impact on Argentina's economy in the final quarter of 1997; growth is therefore expected to slow in 1998.

With an estimated growth rate of 3.5%, the Brazilian economy also grew slightly faster in 1997 compared to the previous year. Economic activity was more dynamic during the first half of 1997, with GDP expanding by 4.3% relative to the same period in 1996. The slowdown experienced in the third quarter of 1997 (a result of the exhaustion of the expansion cycle that had been led by demand for consumer durables, as well as the deterioration and instability of labor market conditions) continued in the final months of the year. At the end of October, moreover, the Brazilian authorities were forced to adopt severe monetary restriction measures in order to counteract the crisis of confidence provoked by the financial and currency turbulence in South Korea. A few days later, and in response to evidence showing that the repercussions of the crisis could not be controlled merely by an increase in interest rates, the Brazilian authorities announced an ambitious program of fiscal adjustment. [2]

[1] For example, while Argentine exports to Brazil grew by almost 17% in the first nine months of 1997, domestic demand in Argentina expanded by around 10%.

[2] A rise in interest rates discourages domestic demand but generates higher interest payments on the short-term domestic debt of the Brazilian public sector.

TABLE I.1
MERCOSUR: MACROECONOMIC PERFORMANCE

Indicator	Participation 1996	1994	1995	1996	1997e	1998f
Real GDP	**%**	**Annual growth rate (%)**				
Argentina	27.44	7.5	-5.0	3.5	8.0	3.8
Brazil	69.90	5.8	3.9	3.1	3.5	0.8
Paraguay	0.89	2.9	4.5	1.0	2.5	3.4
Uruguay	1.77	6.4	-2.3	4.8	6.5	4.2
MERCOSUR	**100.00**	**6.3**	**1.4**	**3.2**	**4.8**	**1.7**
Inflation (CPI, end of period)	**%**	**Annual growth rate (%)**				
Argentina	27.44	3.9	1.6	0.1	-0.1a	1.9
Brazil	69.90	929.3	22.0	9.1	4.1a	4.2
Paraguay	0.89	18.3	10.6	8.2	5.4b	9.8
Uruguay	1.77	44.1	35.4	24.3	15.7a	13.1
MERCOSUR	**100.0**	**651.6**	**16.5**	**6.9**	**3.2**	**3.8**
Current account balance	**%**	**Millions of dollars**				
Argentina	--	-9,363	-2,446	-4,005	-9,800	-12,128
Brazil	--	-1,153	-17,972	-24,347	-33,800	-26,999
Paraguay	--	-754	-495	-635	-820	-896
Uruguay	--	-439	-213	-296	-300	-354
MERCOSUR	**--**	**-11,709**	**-21,126**	**-29,283**	**-44,720**	**-40,377**
Real exchange rate (deflated by the CPI)	**%**	**Annual growth rate (IV quarter/ IV quarter, %)**				
Argentina	--	-0.6	0.9	3.0	1.5c	na
Brazil	--	-35.1	-7.3	-2.0	2.7c	na
Paraguay	--	-7.9	-5.0	1.2	1.9c	na
Uruguay	--	-7.5	-6.5	1.5	2.4c	na

Source: Data for the period 1994/97 were taken from ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean*, 1997, except the real exchange rate which was taken from CEI, *Comercio Exterior Argentino*, October 1997. The forecasts for 1998 are from *The Economist Intelligence Unit*.

Notes: e, Preliminary estimate; f, Forecast; a, Represents the variation between November 1996 and November 1997; b, Represents the variation between October 1996 and October 1997; c, September 1997; --, not applicable; na, not available.

The estimated growth of 6.5% experienced by the Uruguayan economy during 1997 was also led by fixed gross investment and exports, as was the case in Argentina. The strong expansion in aggregate demand in Argentina and Brazil contributed to this process, mainly until mid-1997. Cheaper and more abundant consumer credit and a slight increase in household incomes also had a positive influence on private consumption (Instituto de Economía [1997]). In contrast to its three partners, Paraguay's economic activity was adversely affected in 1997 by the financial crisis and the consequent restriction in liquidity which became apparent in June. Although the crisis appears to be much less grave than that of 1995, credit restrictions had a negative impact on various sectors; this, in turn, affected the overall performance of the economy. Such influences were partially compensated by a favorable performance in the agricultural sector. This grew by an estimated 10% in 1997 and was the main explanation for the slight improvement in economic growth relative to 1996.

As in the previous year, higher economic growth did not prevent a further fall in inflation rates. During 1997 the region's inflation rate (measured by the consumer price index) contracted by more than 50%, from

6.9% in 1996 to just 3.2% in 1997. Argentina recorded the best performance in this area: for the second consecutive year, the country's consumer price index remained more or less stable. Brazil's inflation performance was also very positive: in the period January-November its consumer price index rose by only 4.1%. In Brazil's case, the strong slowdown in the growth of retail prices and their behavior *vis-à-vis* wholesale prices indicate an improvement in the relative prices of tradable goods, as well as the weaker impact of inertial factors which traditionally played an important role in generating inflationary pressures in Brazil.

Inflation rates also declined in Paraguay and Uruguay. In the former case, this performance was helped by the banking crisis and the stabilization of the nominal exchange rate. During the first ten months of 1997, Paraguay's accumulated inflation rate reached 5.4%, which compares favorably with the 8.2% registered in 1996. This accumulated figure, moreover, was accompanied by a trend towards slower growth in retail prices.

Uruguay was the only MERCOSUR member to record two-digit inflation in 1997. The downward trend is nevertheless clear: during the first eleven months of 1997 retail prices rose by an accumulated total of 15.7%, compared with 24.3% in the previous year. Despite this slowdown, the annual inflation rate for 1997 will probably exceed the official forecast of 15%. In Uruguay, too, the use of the exchange rate as a nominal anchor facilitated a reduction in the inflation rate through its impact on the price of tradable goods. Moreover, the convergence between the rate of the peso's devaluation and the inflation in retail prices that has occurred in the past two years has stabilized the real value of the local currency, following the appreciation experienced in the period 1991/93. (Table I.1).

Along with higher growth and lower inflation, MERCOSUR economies experienced a significant increase in their external disequilibria in 1997. The sub-region's aggregate current account deficit expanded by nearly 50% relative to the values recorded in the previous year, reaching almost US$ 45 billion. Argentina's deficit grew fastest in relative terms (according to private estimates, it may have reached US$ 9.8 billion, or 2.8% of GDP). Higher current account imbalances sprang from a significant increase in the region's trade deficit which, in turn, was a result of rapid import growth. In Argentina, for example, imports in the first ten months of 1997 grew four times faster than exports (the growth rates were 25% and just over 6%, respectively).

While Brazil's current account deficit grew relatively more slowly than that of Argentina, it reached almost US$ 34 billion in 1997, equivalent to over 4% of GDP. As in Argentina, around half of the deterioration in the current account deficit is explained by the growth in the trade deficit. In Brazil, too, imports expanded faster (15.7%) than exports (8.2%), although the divergence was not as notable as in Argentina. In contrast to what occurred in Argentina, moreover, Brazilian export growth accelerated in 1997, achieving double-digit growth rates for the first time since 1994.

The rapid growth in current account imbalances in the two largest economies of MERCOSUR indicates a degree of external fragility that renders both countries vulnerable to exogenous shocks. In the medium term, moreover, such a trend limits the possibilities for sustained growth. This was not a problem during the first part of 1997, given the favorable conditions prevalent in international financial markets. Indeed, during the first three quarters of 1997, neither Argentina nor Brazil encountered any difficulties in financing their current account deficits, and in both countries the stock of international reserves actually increased. By September, before the situation in the Asian markets deteriorated, Argentina's international reserves (US$ 20.4 billion) covered approximately seven months of real goods and services imports. Brazil's position was even more comfortable, with international reserves (of close to US$ 60 billion) covering nine months of imports. As the events of last November nevertheless demonstrated, portfolio changes resulting from modifications in the expectations of foreign and domestic investors can be highly disruptive in a context of external fragility. Indeed, despite the accumulation of reserves in the first nine months of 1997, speculative attacks on the domestic currency explain why Brazil closed the year with an estimated loss of around US$ 8 billion in its reserves.

Paraguay's current account deficit also expanded (from US$ 625 to US$ 820 million) as a consequence of a deteriorating trade balance. While Paraguayan exports remained stable in 1997, imports grew by almost 4%. In Uruguay the current account balance showed practically no changes, remaining at a deficit of around US$ 300 million. During the first nine months of the year Uruguay's exports increased by more than 15%, while imports expanded by 11.2%. The rapid growth in Uruguay's exports is largely explained by demand conditions in Brazil and Argentina, its two most important export markets. Together, they absorb almost 50% of Uruguay's total foreign sales.

B. Macroeconomic Policy Developments

There has been a significant convergence in the general orientation of MERCOSUR members' macroeconomic policies in recent years. This is particularly apparent in the sub-region's two largest economies. Both the Brazilian and the Argentine governments have given priority to the reduction of (or maintenance of low) inflation rates, using the nominal exchange rate – under different institutional mechanisms – as an anchor for the price system. Simultaneously, both have pursued fiscal adjustment and reform policies which have included ambitious privatization programs. This common orientation in macroeconomic policy gave rise to similar results and economic policy dilemmas in both countries. The evolution of the real exchange rate, labor market conditions and the behavior of the external sector were matters of concern for both the Argentine and Brazilian governments.

Despite the general trend towards convergence, however, differences remain with regard to the speed and intensity of the reform process. During 1997, the Argentine authorities focused much of their energy on securing the necessary finance for the public sector, improving the profile of the country's external debt, and encouraging the consolidation and strengthening of the banking system. The results were satisfactory in all three areas. Taking advantage of the favorable conditions prevailing in international financial markets, during the first nine months of 1997 the authorities pursued an active policy of securing advance liquidity. This strategy enabled them to confront the financial turbulence of the final quarter of the year without major difficulties. Similarly, the exchange operations for Brady bonds and lengthening the term of new issues of public debt enabled consolidation of the strategy for extending their maturity profiles. Finally, the financial system in Argentina was strengthened through a variety of mechanisms (such as contingent credit facilities contracted with foreign banks, the adoption of strict capital and reserve requirements, the implementation of rigorous bank supervision criteria and stimulation of mergers). The country’s position is now much stronger than it was at the time of the Mexican peso crisis in December 1994.

The situation in Brazil is somewhat different from that of Argentina. This is partly because Brazil is in a different stage of its stabilization and reform process. First, the Real Plan was initiated three years later than the Convertibility Plan. Second, the nature of Brazil's political and institutional system has slowed the reform process, especially in the fiscal area. Until the final quarter of 1997, the Brazilian government's macroeconomic strategy appeared to focus on maintaining the economy at a moderate rate of expansion (in order to contain the current account imbalances) and consolidating low inflation rates. Given that the prevailing composition of Congress made it difficult to implement new fiscal reform and adjustment measures, and in a pre-election context, this strategy appeared to aim primarily at “gaining time” until the next presidential elections. One consequence of this strategy was the excessive level of responsibility that fell on monetary policy which, in turn, reflected itself in high real interest rates. Moreover, with the objective of containing a further deterioration in the external accounts, the authorities implemented a series of measures aimed at discouraging imports (through restrictions on import finance), encouraging exports (through export credits) and promoting greater investment in some sectors (such as the automotive sector and telecommunications).

The economic difficulties in Korea in October 1997 produced a severe crisis of confidence. The Brazilian authorities nevertheless responded swiftly to the crisis with monetary restriction measures (which led to a doubling of interest rates) and the announcement of a fiscal package including 51 measures – some of which require legislative approval – to generate estimated savings worth 2.3% to 2.5% of GDP (US$ 18 billion). The new measures were successful in containing the crisis of confidence and allowed the authorities to maintain the general orientation of their exchange rate policy; that policy is itself the main pillar of the stabilization process. The cost was a substantial slowdown in economic activity, a situation that is expected to prevail throughout the first months of 1998. The authorities expect that, if the international context stabilizes, the Brazilian economy will start to recover in mid-1998. Short and medium-term economic prospects are favored by Brazil's significant potential to obtain additional external finance from ongoing and pending privatizations. Moreover, and despite the financial turbulence mentioned above, the Brazilian economy has continued to be a very attractive destination for foreign direct investment. Indeed, in 1996 Brazil became the second main recipient of FDI among developing countries, surpassed only by China.

In both Argentina and Brazil, the fiscal situation in any case tended to improve during the year, as reflected by reduced disequilibria in public sector accounts relative to GDP (Table I.2). In the case of Brazil, the burden of servicing the public debt (principally domestic) negatively affects the performance of the fiscal accounts. The recent rise in domestic interest rates will further aggravate this situation. In Uruguay and Paraguay, by contrast, the public sector deficit has continued to expand, albeit for different reasons. In Uruguay, the authorities have continued to focus on reform of the public sector and the social security system, which has had a negative short-term impact on public finances. Data show that the Uruguayan government has successfully maintained the downward trend in the public deficit, if the costs of the fiscal reform are excluded from the overall balance. Economic policy-makers in Uruguay have continued to give high priority to reducing inflation, using for this a narrowing of the existing exchange rate band. In 1997, the maximum rate of devaluation permitted was adjusted downward three times, accompanying the desired fall in retail price indices.

In contrast to Uruguay, the reform process in Paraguay has suffered some delays. These are closely related to the prevailing political context in the country. Fiscal accounts have deteriorated as a result of lower tax revenue, salary increases for teachers and the effects of the banking crisis. Monetary policies, in turn, were greatly influenced by the effects of the banking crises of 1995 and June 1997. The presidential elections scheduled for May 1998 may resolve some of the uncertainties related to the future development of Paraguay's reform process.

TABLE I.2
MERCOSUR: FISCAL INDICATORS

Public sector deficit	% of GDP			
	1994	1995	1996	1997e
Argentina (NFNPS)	-0.1	-0.5	-1.7	-1.4
Brazil (NFPS)	1.1	-4.9	-3.9	-2.7
Paraguay (CG)	1.0	-0.3	-0.8	-1.5
Uruguay (NFPS)	-2.5	-1.3	-1.2	-1.5

Source: ECLAC, *Preliminary Balance of the Economy of Latin America and the Caribbean*, December 1997.

Notes: NFNPS, Non-financial national public sector; NFPS, Non-financial public sector; CG, Central government; e, Estimate

C. The Transmission of Macroeconomic Influences

Macroeconomic influences between countries are transmitted through the trade of goods and financial assets, and the movement of factors of production. Their intensity depends on the degree of integration achieved and the type of policies adopted by the governments, particularly in the area of exchange rates (Genberg and Nadal Simone [1993]). In the case of MERCOSUR, given the restrictions that still affect trade in financial assets (mainly in Brazil) and the movement of factors, the principal vehicle for increased macroeconomic interdependence has been the increase in trade flows. Between 1991 and 1997, intra-subregional exports more than doubled their share in the sub-region's GDP, from 0.86% to 1.8%. As shown by Table I.3, such participation shows a clear upward trend, although it is still modest in absolute terms.

The differences in size of the MERCOSUR economies impose structural limits on the extent to which relatively symmetrical interdependency links can be established between them. This situation is particularly evident in the case of the two small economies of MERCOSUR, which together contribute only 3% of the region's GDP. Links between Brazil and Argentina are also asymmetric, albeit to a lesser extent. Measured in terms of GDP, the Brazilian economy is two and a half times larger than that of Argentina. Although this indicator does not adequately reflect market potentials (per capita income in Argentina is double that of Brazil, and better distributed), it is illustrative of the nature of interdependency links.

For MERCOSUR's two smaller economies, the importance of their links with their neighboring economies is clearly apparent in the higher concentration of their goods and services trade and, in the case of Uruguay, its traditional role as an off-shore center (more pronounced in the past than in recent times). Almost 50% of Uruguay's total exports go to its two larger neighbors; the figure is almost 60% for Paraguay. In Uruguay, moreover, income from tourism (mostly servicing the Argentine population) constitutes an important share of foreign exchange earnings. Such links are not new, although some of them have intensified following the establishment of MERCOSUR. On the contrary, both countries are familiar with the idea that developments in Argentina and Brazil greatly influence the external context in which their own economies must develop.

TABLE I.3
MERCOSUR: SHARE OF INTRA-SUBREGIONAL EXPORTS IN GDP
(percentages)

	1991	1992	1993	1994	1995	1996	1997e
Argentina	1.04	1.00	1.43	1.70	2.41	2.66	2.86
Brazil	0.60	1.09	1.24	1.06	0.88	0.98	1.17
Paraguay	4.18	3.78	4.16	4.36	5.17	6.95	7.48
Uruguay	5.58	4.74	4.89	5.50	5.59	6.05	6.67
Total MERCOSUR	**0.86**	**1.16**	**1.40**	**1.39**	**1.42**	**1.58**	**1.80**

Source: Calculations based on IMF, *International Financial Statistics* and DATAINTAL.
Note: e, estimate

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Argentina's links with Brazil display some special features that distinguish them from those of the smaller economies, and from Brazil's links with its MERCOSUR partners. The size of the Argentine economy is a little more than a third of Brazil's. As indicated earlier, this inevitably limits the potential symmetry of interdependency links that can be established between the two countries. Unilateral opening and the establishment of MERCOSUR have led to a strong increase in Argentina's economic links with Brazil, and the intensity of these ties is something new. Between 1991 and 1997, the share of total Argentine exports going to the Brazilian market rose from 12.7% to almost 30%. For some sectors, the share is much higher

than that: in the automobile industry, for example, more than 90% of Argentine exports go to Brazil.[3] The growing importance of the Brazilian economy for Argentina has naturally attracted the attention of analysts and policy-makers, giving rise to the controversial term "Brazil-dependency". The turbulence in the Southeast Asian currency and stock markets in the final months of 1997, and their repercussions on the Brazilian economy, have given this topic a particularly significant place in the public debate.

A variety of factors determine the magnitude of the effects on the Argentine economy of real shocks transmitted through the country's exports to Brazil. Prominent among these factors are the elasticity of demand, the degree of dependency on the Brazilian market, and the ease with which the latter can be substituted with other export markets. An examination of the composition of Argentine exports to Brazil suggests that the most sensitive products are concentrated in the category of transport equipment. Here the goods are characterized by a high income elasticity, exhibit a strong concentration in the Brazilian market (around 90% of Argentine exports in this category go to Brazil), and are difficult to redirect towards other markets (owing to the characteristics of bilateral trade flows in this sector, which are strongly influenced by the bilateral agreement and the special sector promotion regimes). Exports of transport equipment to Brazil represent a little more than 7% of total Argentine exports. Other products that could encounter difficulties because of their high concentration in the Brazilian market are textiles and garments, footwear, electrical appliances and machinery, paper and cardboard, chemical products, dairy products and eggs, dried or processed fruits, processed fish and seafood, and vegetable and fruit preparations (more than 40% of total exports within each category go to Brazil). However, exports of all these products together represent no more than 7% of total Argentine exports. The rest of the country's exports to Brazil (just over 50%) are either not heavily concentrated in the Brazilian market, or consist of commodities that have a low demand elasticity, or can be exported to other markets quite easily (fuels or cereals).[4]

The situation of the Brazilian economy is different from that of its three smaller MERCOSUR partners. Owing to the size of its economy, Brazil's level of interdependence with its neighbors is weak, albeit growing. According to preliminary estimates, Brazilian exports to MERCOSUR represented just 17% of the country's total exports in 1997, equivalent to 1.2% of GDP. Moreover, Brazil's neighboring economies have not been important sources of foreign investment owing to their relative size and the fact that all four MERCOSUR economies are net recipients of foreign capital. Despite these structural limitations, the Brazilian economy's links with its neighbors, and particularly with the Argentine economy, have intensified substantially. For some sectors the regional market has become an important destination; this market has also been one of the most dynamic: during 1997, for example, MERCOSUR was one of the main driving forces behind the recovery of Brazilian exports of manufactures (*Instituto de Pesquisa Económica Aplicada* [1997]). Moreover, some productive activities, and particularly the automotive industry, have firmly embarked on a process of specialization in which the regional environment (and particularly the link with Argentina) plays a key role.

In sum, economic links between the countries of MERCOSUR are characterized by three features: first, by their varying depths owing to the differences in the relative size of the economies; second, by a trend towards more intense links, particularly between the two larger economies; finally, by the asymmetric nature of those interdependencies that have been established. This configuration detracts from national incentives to coordinate policies. Managing the attendant tensions constitutes one of the principal challenges for MERCOSUR.

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[3] In the first eight months of 1997, exports of transport equipment represented 26.2% of total Argentine exports. This product category was, moreover, one of the most dynamic in terms of export growth.

[4] Uruguayan exports to Brazil, on the other hand, consist mainly of processed agricultural products which in general have a low elasticity of demand. The effects of demand would probably be more severe in the case of textiles, chemical and plastic products and the automotive industry. These sectors represent around 25% of Uruguayan exports to Brazil.

In the final months of 1997, the debate on how to manage the tensions that could arise from a deterioration of prevailing economic conditions in the sub-region (for example, through a modification of exchange rate policies in one or more countries of MERCOSUR) acquired renewed intensity. The options examined in public debate ranged from the establishment of a safeguard mechanism for intra-bloc trade, to the establishment of macroeconomic convergence criteria after the model of the Maastricht Treaty. The safeguard mechanism could either be applied widely or limited to use only in the event of exchange rate modifications (the Asunción Treaty foresaw the end of the safeguard regime that was in place during the transition period; currently, the countries only have the safeguard regime of the WTO at their disposal). Government authorities have responded to such speculations with an increase in dialogue and informal exchanges.

Convergence in macroeconomic performance (in terms of similar trends in monetary and fiscal indicators) was the result of internal considerations and external restrictions. At the same time, convergence in government policy priorities (particularly in the two larger economies) and, in particular, the importance assigned to stabilization of price levels and the role of the exchange rate as an anti-inflationary anchor, gave rise to shared objectives and performances, including a relative stabilization of real bilateral exchange rate parities. However, and in spite of this “exogenous” convergence, the member states display considerable differences in the institutional nature of their monetary and exchange rate regimes (measuring different preferences against policy trade-offs) and in the solidity of the institutions that administer public policy. Such differences will probably not disappear in the near future.

CHAPTER II. EVOLUTION OF FOREIGN TRADE AND INVESTMENT

As mentioned in previous issues of this report, MERCOSUR's trade is marked by two trends. The first is a rapid growth in intra-regional trade flows, prompting a significant increase in the share of intra-regional commerce in the member countries' total trade. Between 1991 and 1996, the share of intra-regional exports in total exports grew from 11 .% (US$ 5.1 billion) to 22.7% (US$ 17 billion). This trend continued in 1997, with intra-regional exports reaching 24.7% of total foreign sales. The estimated value of such exports was around US$ 20 billion. This performance was greatly influenced by the behavior of MERCOSUR's two larger economies, whose bilateral trade accounts for almost three quarters of total intra-regional commerce.

The second trend characterizing MERCOSUR since its inception is the substantial decline in protection, not only within the sub-region but also *vis-à-vis* the rest of the world. This decline springs from the unilateral liberalization programs implemented by the member countries since the beginning of the 1990s, in parallel to progress in the sub-regional integration process. Unilateral trade liberalization, coupled to the real appreciation of the domestic currencies, explain the rapid growth in MERCOSUR's extra-subregional imports. The latter have grown by almost 20% a year, almost three times the growth rate of world trade (7.8% in the same period). This performance should dispel some of the doubts that have arisen about the potential for trade diversion and its effect on the welfare of the member countries and the rest of the world.

A. Foreign Trade in 1997

During 1997 intra-regional trade continued to grow rapidly (Table II.1), at a faster rate than total MERCOSUR exports. Indeed, intra-regional exports grew twice as fast as total exports. This gap was nevertheless much smaller than that experienced in the 1991-96 period, when intra-regional trade expanded nearly three times as fast as total exports. The difference in the growth rates of extra-regional and intra-regional exports has increased the latter's participation in total trade to around 25%.

During 1997 Brazil recorded the highest growth rate for intra-regional exports (23.1%), followed by Uruguay and Argentina. Brazil's exports to MERCOSUR reached an unprecedented 17.1% of the country's foreign sales. This was the largest increase experienced by any member of MERCOSUR, and almost one and a half times the share recorded at the beginning of the decade. In contrast, and unlike previous years, Paraguay's exports to MERCOSUR grew at a slower pace than its total exports in 1997.

TABLE II.1
MERCOSUR: EVOLUTION OF EXPORTS BY DESTINATION
(US$ millions and percentages)

	1991	1996	1997e	annual growth 1991-96	annual growth 1997
Argentina					
Total	11,975.9	23,810.4	25,443.1	14.7%	6.9%
Exports to MERCOSUR	1,976.8	7,921.8	9,217.2	32.0%	16.3%
Exports to the rest of the world	9,999.1	15,888.6	16,225.9	9.7%	2.1%
MERCOSUR's share in the total	16.5%	33.3%	36.2%	101.7%a	119.3%b
Brazil					
Total	31,623.6	47,745.4	53,030.0	8.6%	11.1%
Exports to MERCOSUR	2,308.6	7,305.2	9,047.1	25.9%	23.1%
Exports to the rest of the world	29,315.0	40,440.2	43,982.9	6.6%	8.8%
MERCOSUR's share in the total	7.3%	15.3%	17.1%	109.6%a	134.3%b
Paraguay					
Total	736.9	1,043.5	1,171.8	7.2%	12.3%
Exports to MERCOSUR	259.3	660.1	726.1	20.5%	10.0%
Exports to the rest of the world	477.6	383.4	445.7	-4.3%	16.2%
MERCOSUR's share in the total	35.2%	63.3%	62.0%	79.8%a	76.1%b
Uruguay					
Total	1,574.1	2,398.3	2,622.3	8.8%	9.3%
Exports to MERCOSUR	557.6	1,150.5	1,348.3	15.6%	17.2%
Exports to the rest of the world	1,016.5	1,247.8	1,274.0	4.2%	2.1%
MERCOSUR's share in the total	35.4%	48.0%	51.4%	35.6%a	45.2%b
MERCOSUR					
Total	45,910.6	74,997.6	82,267.2	10.3%	9.7%
Exports to MERCOSUR	5,102.3	17,037.6	20,338.7	27.3%	19.4%
Exports to the rest of the world	40,808.3	57,960.0	61,928.5	7.3%	6.8%
MERCOSUR's share in the total	11.1%	22.7%	24.7%	104.5%a	122.5%b

Source: DATAINTAL
Notes: e, Estimate; a, Accumulated change 1991-96; b, Accumulated change 1991-97

Table II.2 provides an overview of intra-regional trade for the period January-September 1997, for which official disaggregated data is available. Argentina was the fastest-growing destination for sub-regional exports because of the rapid expansion of its total imports which, in turn, was stimulated by a strong growth in aggregate demand. Among MERCOSUR members, Brazil took most advantage of this situation; its exports to Argentina increased by almost a third during the period. Indeed, Brazil's exports to Argentina grew three times as fast as its total exports.

The Brazilian market was the second most dynamic destination for intra-regional exports. Argentine and Uruguayan exports to Brazil grew considerably faster than these countries' total exports; the Brazilian market thus increased its relative importance as a destination for their exports. During the first nine months of 1997, Brazil absorbed 29.6% of Argentina's exports and 37.1% of Uruguay's sales abroad. Paraguay's exports to Brazil grew more slowly than its total exports. Paraguay nevertheless continues to be the MERCOSUR economy most closely linked to Brazil in terms of bilateral trade flows; in the period examined, 47.9% of its total exports went to Brazil.

TABLE II.2
MERCOSUR: INTRA-REGIONAL EXPORTS
(January-September 1997)

DESTINATION: / ORIGIN:	Argentina	Brazil	Paraguay	Uruguay	MERCOSUR	World
Argentina						
Value (millions of US$)	--	5,627.4	426.9	520.9	6,575.2	19,001.4
Annual growth rate (%)	--	19.4	2.2	4.9	16.8	6.9
Brazil /a						
Value (millions of US$)	5,572.4	--	1,178.4	699.8	7,450.6	44,478.1
Annual growth rate (%)	30.7	--	9.3	3.7	23.8	11.1
Paraguay						
Value (millions of US$)	81.9	450.6	--	32.5	565.0	940.8
Annual growth rate (%)	10.8	11.6	--	-9.5	10.0	12.3
Uruguay						
Value (millions of US$)	218.8	651.2	40.6	--	910.6	1,755.7
Annual growth rate (%)	13.7	18.0	23.4	--	17.2	9.3
MERCOSUR						
Value (millions of US$)	5,873.1	6,729.2	1,645.9	1,253.2	15,501.4	66,176.0
Annual growth rate (%)	29.7	18.7	8.2	3.8	19.8	9.8

Source: DATAINTAL
Notes: a, Data for Brazil corresponds to the period January-October; --, not applicable.

Trade between Argentina and Brazil accounts for almost three quarters of MERCOSUR's total intra-regional trade. A more disaggregated analysis of the evolution of this bilateral trade during the first nine months of 1997 allows us to identify its main sources of dynamism. Passenger vehicles and capital goods were Argentina's fastest-growing imports from Brazil (imports in these categories grew by 134.5% and 61.4%, respectively). Meanwhile, Argentine exports of industrial manufactures to Brazil grew by around 41%, almost double the growth rate of Argentina's total exports. Leather manufactures (88.2%) , footwear and parts (74.7%) and transport materials (66%) were the fastest-growing categories within this section. In the first nine months of 1997, Argentine exports of transport equipment to Brazil accounted for more than half of its exports of industrial manufactures, and more than 28% of total exports.

According to estimates for 1997, bilateral trade balances in MERCOSUR show a surplus for Argentina (slightly above US$ 2 billion - FOB base) and deficits for Brazil, Paraguay and Uruguay. Argentina's trade surplus with MERCOSUR is equivalent to 22% of its total exports to the region; slightly more than half of the surplus is explained by its trade balance with Brazil. The rest of the surplus is divided in equal proportions among Paraguay and Uruguay. With both of these economies, Argentina has significant surpluses as a proportion of trade. These results contrast with the aggregate trade deficit recorded by Argentina in 1997, which is estimated at around US$ 4.5 billion.

Brazil's trade deficit with its MERCOSUR partners reached US$ 400 million, the result of negative balances in the country's trade with Argentina and Uruguay, and a significant surplus with Paraguay (equivalent to 60% of exports to the latter country). Uruguay also registered a deficit in its intra-regional transactions in 1997. This is mainly a consequence of its trade balance with Argentina. Although there are some deficiencies in the available data, Paraguay records the largest deficit in intra-regional trade (US$ 1.4 billion), equivalent to almost double the value of Paraguay's exports to the sub-region (US$ 726 million).

B. Changes in the Composition of Trade

Since the signing of the Treaty of Asunción in 1991, growth in MERCOSUR's intra- and extra-regional exports has not been homogeneous. This has prompted significant changes in the composition of trade. Although such changes have been greatly influenced by the performance of Brazilian exports, the latter's impact on extra-regional exports (of which almost 70% were from Brazil in 1996) is much more pronounced than in the case of intra-regional exports (where Brazil's share is less than 45%). Between 1991 and 1996, the composition of MERCOSUR's extra-regional exports underwent significant changes. Central among these are the increased participation of Food and Beverages (whose share in extra-regional exports rose from 13.6% to almost 50%) and a fall in the share of Minerals and Metals, Primary Agricultural Commodities and Manufactures. The most notable change in intra-regional trade was the substantial growth in the share of Petroleum and Fuels (albeit from a modest base). Such changes in the composition of trade resulted in the fact that, by the end of the period, intra-regional exports were much more concentrated in Manufactures, and in Petroleum and Fuels, than exports to the rest of the world.

TABLE II.3
MERCOSUR: CHANGES IN THE COMPOSITION OF EXPORTS, 1991-96

Category	Share of each category in the total (%)					
	MERCOSUR		Rest of world		Total	
	1991	1996	1991	1996	1991	1996
Food and Beverages	28.2	25.0	13.6	42.5	15.8	38.5
Primary Agricultural Commodities	4.8	3.1	6.4	4.9	6.2	4.5
Petroleum and Fuels	3.6	9.8	3.4	3.3	3.4	4.8
Minerals and Metals	3.5	2.3	15.3	8.3	13.6	6.9
Manufactures	59.8	59.8	61.2	41.0	61.0	45.4
Total	100.0	100.0	100.0	100.0	100.0	100.0

	Annual growth rate (%)		
	1991-96	1991-96	1991-96
Food and Beverages	24.2	42.6	38.7
Primary Agricultural Commodities	16.7	7.6	8.8
Petroleum and Fuels	55.3	13.0	24.1
Minerals and Metals	16.6	0.5	6.8
Manufactures	27.3	4.9	9.4
Total	27.3	13.6	16.0

Source: Calculations based on DATAINTAL.

Notes: Food and Beverages (CUCI 0+1+22+4); Primary Agricultural Commodities (CUCI 2-22-27-28); Petroleum and Fuels (CUCI 3); Minerals and Metals (CUCI 27+28+68); Manufactures (CUCI 5+6+7+8-68). Section 9 (non-classified) was excluded from the calculations.

Manufactures account for almost 60% of MERCOSUR's intra-regional exports and 41% of its exports to the rest of the world. A somewhat more disaggregated analysis of the composition of trade in manufactures shows that this sector, too, underwent changes in the period examined. In 1991, the composition of extra-regional and intra-regional exports of manufactures, classified according to their factor content, was quite similar. Some differences were nevertheless already apparent in 1996. Among these were a smaller participation of natural resource-intensive products and a higher participation of technology- and human capital-intensive manufactured goods in intra-regional exports, compared to those going to extra-regional markets (Table II.4).

TABLE II.4
MERCOSUR: COMPOSITION OF EXPORTS OF MANUFACTURES, 1991-96
(percentages)

Type of manufacture	Participation of each category in the total					
	MERCOSUR		Rest of World		Total	
	1991	1996	1991	1996	1991	1996
Intensive in natural resources	10.7	11.1	8.4	20.8	8.7	17.9
Intensive in non-skilled labor	14.4	9.1	19.5	10.2	18.7	9.9
Intensive in human capital and technology	74.9	79.8	72.1	68.9	72.5	72.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Calculations based on DATAINTAL.

Notes: The classification was made undertaken on the basis of the two-digit level of CUCI, Rev 3. Manufactures intensive in natural resources (52+56+63+64+66); Manufactures intensive in non-skilled labor (61+65+82+83+84+85). The remaining categories (except 68) were classified as intensive in human capital and technology.

C. Flows of Foreign Direct Investment (FDI)

FDI flows to MERCOSUR countries have grown significantly in recent years. In 1996, they totaled an estimated US$ 14.2 billion, equivalent to 37% of all FDI flows to Latin America and the Caribbean, and 11% of total flows to developing countries. In 1996, Brazil was the main recipient of FDI flows to MERCOSUR (and the second largest among developing countries), with total inflows of US$ 9.5 billion. According to preliminary information this favorable trend continued in 1997, as shown by the partial data in Table II.5.

TABLE II.5
MERCOSUR: FLOWS OF FOREIGN DIRECT INVESTMENT, 1993-97
(millions of US$ and percentages)

	1993	1994	1995	1996	1997a
FDI flows to:					
Argentina	3,482	603	1,319	4,285	2,222a
Brazil	1,292	3,072	4,859	9,500	14,013b
Paraguay	111	180	184	225	na
Uruguay	102	155	124	169	na
MERCOSUR	**4,987**	**4,010**	**6,486**	**14,179**	na
FDI flows to MERCOSUR as a percentage of FDI flows to:					
Latin America and the Caribbean	27.6%	14.9%	25.5%	36.8%	na
Developing countries	6.8%	4.4%	6.7%	11.0%	na
World	2.3%	1.7%	2.0%	4.1%	na

Source: *World Investment Report,* 1997; Bacen; Ministry of Economy and Public Works and Services (*Ministerio de Economía y Obras y Servicios Públicos*), Argentina.

Notes: a, Period January-June; b, Period January-October; na, not available.

The growth in FDI flows during 1997 was especially significant in Brazil, where accumulated FDI for the period January-October totaled US$ 14 billion, a 108% increase over the same period of 1996. In Argentina, accumulated FDI inflows in the first half of the year (US$ 2.2 billion) were 5.6% higher than in the corresponding period of 1996. Extrapolating this trend for the whole of 1997, total FDI inflows to MERCOSUR could reach an estimated US$ 20 billion for the year, a 41% increase on the already high inflows registered in 1996.

There are several reasons for this sustained growth of FDI inflows to the region. Prominent among them are the region's economic recovery, "pro-market" reforms (liberalization, privatization and deregulation) and economic stabilization. Although the privatization of public enterprises was a key factor in attracting FDI, more recent experiences in Argentina and Brazil show that investment growth has more fundamental determinants. For example, while privatizations accounted for more than 60% of FDI inflows to Argentina in the period 1990-93, they accounted for just 15% in the period 1994-96. Moreover, and as Table II.5 shows, FDI flows to Argentina did not decline but showed a consistent upward trend even following the end of the most important part of the privatization program. In Brazil, the privatization process is less advanced than in Argentina, but here too the available evidence suggests that privatizations alone are insufficient to account for the growth in FDI inflows in the past two years. Argentina and Brazil are in fact part of a wider phenomenon, wherein FDI flows to a group of developing countries have recovered in recent years.

The new FDI flows are directed towards a variety of sectors, including both the exploitation of natural resources (such as mining in Argentina) and the manufacturing and services sectors. Investment in the services industry was stimulated by the privatization process. This is demonstrated by the Brazilian experience in 1996 and 1997, when the government began to transfer electricity and telecommunications services, including cellular phone services, from the public to the private sector. The available evidence also suggests that the FDI "boom" in the region shares another characteristic with the boom at the global level: the growing importance of mergers and acquisitions among existing enterprises. This was a particularly important feature in sectors such as the food and beverages industry, where established distribution channels constitute an important specific asset. In the particular case of Brazil, the number of mergers and acquisitions (considering only the private sector) increased by 100% between 1991 and 1996. Foreign investors, who were responsible for 25% of these operations in 1991, accounted for 49% of mergers and acquisitions undertaken in 1996.

In industry, the automotive sector was one of the main recipients of FDI: established producers invested to achieve higher efficiency, while non-established producers sought entry into one of the most promising markets in terms of growth potential. According to private sources, the world's twelve main car companies plan to invest more than US$ 22 billion in MERCOSUR in the period 1996-2000. By the year 2000, these investments should allow for the export of more than one million vehicles to extra-regional markets. Such investments are being undertaken as part of "complex integration" strategies, in which the subsidiary forms part of integrated regional and global production and distribution networks. During 1997, investments in the financial sector were also very dynamic; they occurred through the sale of local financial institutions to foreign banks in both Argentina and Brazil.

The outlook is good for FDI flows to the sub-region over the next few years. According to official Argentine estimates, investments announced by foreign companies for the period 1997-2000 amount to around US$ 14 billion a year in Argentina, three times the amount registered in the period 1990-96 [5]. Prospects for FDI inflows to Brazil are also favorable, particularly in light of the privatizations still planned for the remaining years of the century. According to official estimates, the privatization of public services such as telecommunications and electricity services is likely to attract around US$ 30 billion in foreign investment between 1997 and 2000, equivalent to 37% of total estimated revenues from privatization for the whole period. These estimates contrast with the participation of foreign capital in the first six years of the National Privatization Program, when such contributions reached only 13% of total revenues obtained. One reason for the significant projected increase in the participation of foreign capital lies in the nature of the privatizations to come: in most cases, these activities face severe supply restrictions and are in need of

[5] This information is taken from the "Investment Database" of the Center for the Study of Production of the Argentine Ministry of Industry, Trade and Mining.

modern technology in order to respond to a large, unsatisfied demand and projected growth. Planned investments in the telecommunications sector (estimated at US$ 90 billion for fixed and cellular phone services in the next five years) are simultaneously inducing the establishment of equipment producers, making Brazil an important production center for telecommunications equipment.

D. Intra-regional Investments

Intra-regional investments account for a very small proportion of total FDI in MERCOSUR. They have nevertheless grown in recent years as a result of the internationalization of local firms, as well as the interest of these firms in establishing a presence in neighboring markets. The privatization process in Brazil, in particular, has generated business opportunities for Argentine firms which had already acquired experience from the earlier privatizations in their own country. During 1997, several Argentine firms participated in consortia that secured concessions to operate road networks and electricity companies in Brazil.

TABLE II.6
ARGENTINA-BRAZIL: MAIN INTRA-REGIONAL INVESTMENT PROJECTS FOR THE PERIOD 1997-2000

Matrix	Subsidiary/Partner	Amount (US$ millions)	Activity	Period
Argentine companies in Brazil:				
Sancor	Sancor	300	Foodstuffs	1997-2000
Pérez Companc	Pérez Companc	150	Equipment assembly	1997-2000
SOCMA	Canale-Itrón-Sideco	150	Food-Telecommunications	1997-2000
IMPSAT	IMPSAT Brasil	126	Telecommunications	1997-2000
Pérez Companc/PASA	Copesul	105	Petrochemical	1997-99
YPF-Enron	YPF-Enron	100	Fuels	1997-99
Techint Argentina	Techint	70	Equipment assembly	1997-98
Arcor	Arcor	50	Foodstuffs	1997-98
Brazilian companies in Arngeitna:				
Petrobrás	YPF	275	Petrochemical	1997-99
Petrobrás	YPF	200	Petroleum	1997
AGA Bras.	AGA Arg.	60	Industrial gases	1997-99
Praxair	Praxair Arg.	50	Industrial gases	1997-99
Brahma	Brahma	40	Beverages	1997

Source: Argentine Embassy in Brazil.

According to the most recent data provided by Brazil's Central Bank, Argentine investment in Brazil reached US$ 450 million. Some 80% of such investment was in processing sectors (mainly food, vehicle parts and beverages). Brazilian investment in Argentina, meanwhile, amounted to US$ 425 million, making Brazil the eighth largest source of investment in Argentina. Projected investment by Argentine companies in Brazil amount to US$ 1.2 billion for the period 1998-2000. This figure does not include investment linked to future participation in consortia that secure concessions to operate privatized public services.

CHAPTER III. MARKET ACCESS AND CONDITIONS OF COMPETITION

In January 1998 MERCOSUR celebrated the third anniversary of its formal establishment as a customs union. During this time the member countries have improved some of the mechanisms allowing for the free movement of goods in the sub-region, while also advancing with the establishment of some of the bases necessary for the effective operation of the customs union. Significant progress has been achieved in the area of market access although, in the view of some member states, some issues have not yet been resolved satisfactorily. Such issues include the application of unilateral measures affecting trade in goods. Progress has been more modest in terms of regulating competition conditions: regulations for the Protocol to Safeguard Competition, approved in December 1996, have not yet been established, nor have member states advanced significantly in addressing the existing asymmetries in public policies which affect competition. Resolving these matters is necessary to guarantee effective and stable market access in MERCOSUR.

A. Adjustment Regime

The "Adjustment Regime", which provides temporary protection for a limited list of "sensitive" products in each of the four countries, is now in its final phase. On 1 January 1998, the tariff reduction schedule for those Argentine and Brazilian products which are exempted from intra-bloc free trade enters its final year. This will bring the preference margin on the most favored nation (MFN) tariff to 75%.[6] For Paraguay and Uruguay, the tariff reduction schedule has entered its third year, implying a 50% preference margin during 1998.[7]

The imminent completion of the Adjustment Regime has caused concern in some of the protected sectors. To date such concern has been most evident in Argentina, since in Brazil the regime covers only a small number of products (29), while the lists for Paraguay and Uruguay still maintain a 50% protection on the MFN tariff. Such concern is apparent, among other things, in domestic pressures on governments to accelerate the process of harmonizing and/or eliminating non-tariff restrictions and measures, and to move toward the neutralization of distortions originating in asymmetries of public policies or regulations. At the same time, some affected sectors have called for greater use of safeguard mechanisms against unfair practices in intra-bloc trade. Such demands will probably increase during the year. In December 1996 the Argentine government had already suggested studying whether it might be convenient to adopt an intra-bloc safeguard clause. However, this proposal failed to win the support of the other MERCOSUR members, particularly that of Brazil.

During 1997 four consultations on the Adjustment Regime were presented to the MERCOSUR Trade Commission (MTC). Most were settled.[8] Compared to previous years, the relative importance of the consultations on this regime has clearly diminished (in 1997 they represented 6% of all consultations, compared to 9% in 1996 and 11% in 1995). In 1997, moreover, three pending cases were resolved. In April 1997 the Argentine government

6 Although, starting on 1 January 1999, the preference margin that Argentina and Brazil will grant each other *vis-à-vis* the MFN tariff will be 100% for the entire tariff nomenclature (except in the special sectors of sugar and automobiles), trade in some products will continue to be subject to minimum special import duties resulting from the application of measures against "unfair practices" in intra-bloc trade. Argentina is the country that has made greatest use of anti-dumping and compensatory duties.

7 Paraguay and Uruguay will conclude their respective adjustment regimes on 31 December 1999.

8 A consultation is "settled" when the party initiating it is satisfied with the response of the party to which it is addressed. Three of the consultations were presented by Argentina and directed towards Uruguay, asking the latter to examine the possibility of removing certain products from its adjustment regime since they were apparently not produced in Uruguay (sunglasses and plastic frames, joined woven interlinings and some products in the category of electric and non-electric household appliances). In the first two cases Uruguay argued that national production did exist, thus ending the process of consultation. In the third case, Argentina continues to request the exclusion of other products from the category of electric and non-electric household appliances, as well as color televisions. The fourth consultation was initiated by Brazil against Argentina, requesting the removal of automobile tires from the Argentine adjustment regime. This consultation was concluded satisfactorily, among other things, through a rise in the import quota for such products.

decided to remove instant coffee from the adjustment regime, and raised the quota for intra-bloc imports of tires with 100% tariff preference. The dispute between Argentina and Uruguay over the inclusion in the Argentine adjustment regime of tariff items from the paper sector was finally resolved via an agreement between the two countries' business sectors, before the panel of experts designated by the Common Market Group (CMG) announced its decision. [9] Some consultations on the inclusion of certain products in national lists of the adjustment schedule nevertheless remain pending .[10]

The progress made in establishing and accepting the national lists of products included in the Adjustment Regime has allowed the member states effectively to initiate the procedures for registering the regime with ALADI. This task, originally to be completed by 31 December 1994, was successively postponed because of differences among the member states over the inclusion of products.

B. Rules of Origin

MERCOSUR members continue to demand origin requirements for all products entering their markets from other member states. This is inconsistent with the existence of a unified customs area, and constitutes an obstacle to the free movement of goods. Despite the existence of a list of products subject to MERCOSUR rules of origin, with respective requirements applicable to each of them, member states can request the certification of origin for products excluded from the list until 1 January 1999. The problem lies in the fact that the list excludes products not covered by MERCOSUR's common trade policy, such as those which benefit from the special import regimes currently in force in some member countries. This is one of the most conflictive issues on the sub-region's negotiating agenda. These problems will intensify as a consequence of member states' varying application of the three-point increase in the common external tariff (CET), decided at the end of 1997 (see the section on Common Policies).

The list of products subject to MERCOSUR rules of origin and their respective requirements was approved by the MTC in June 1997. This replaced the preliminary list approved by the Common Market Council (CMC) in December 1996. It includes new, specific origin requirements. It also lists products for which compliance with the rules governing a change in tariff classification, and with the rule on regional value added, must be demanded .[11]

With respect to the specific origin requirements, and following the instructions of the MTC, members of Technical Committee Nº 3 on "Trade Standards and Disciplines" began assessing the need to regulate the procedures for the temporary suspension of such requirements in exceptional cases, such as in the event of supply shortages. An agreement has not yet been reached. Among other things, this is due to differences among the member states over the degree to which the MTC should intervene in this process. [12]

All member states have transposed the instructions for applying the MERCOSUR origins regime into their national legislations. These instructions are to be used by the customs authorities and the bodies authorized to

[9] This was the first time that the countries used the dispute settlement mechanism established by the Brasilia Protocol.

[10] There are two pending consultations initiated by Brazil against Argentina, concerning the latter's inclusion of paper (since 1995) and cold-laminated steel strips (since 1996) in the list of its adjustment regime. Argentina, in turn, has initiated a consultation against Brazil concerning the increase in the Brazilian import quota of wines with a tariff preference of 100% (since 1996).

[11] Specific rules of origin that already existed for products of the chemical, iron and steel, information technology and telecommunications sectors have been modified, and new rules were approved for the dairy sector. The list of products for which "double criteria" are requested did not previously exist.

[12] While the Argentine delegation argues that its intervention should be subject to prior approval by all member states, the Brazilian delegation does not see the need to regulate this procedure. The delegations of Paraguay and Uruguay, in turn, do not agree with the prior authorization requirement suggested by Argentina.

issue the corresponding certificates. A consolidated list of institutions authorized to control the issuing of such certificates has also been completed. Some problems have nevertheless arisen with respect to the certifying bodies. In October 1997 the Argentine Industrial Union reported that products of extra-regional origin were entering Argentina with false origin certificates, mainly "triangulated" via Uruguay, Paraguay and Chile .[13] Argentine industrialists argued that the origin certificates had been issued by agencies which lacked the technical capacity to establish the production location of these products, an argument that was rejected by their Uruguayan and Chilean counterparts. Argentine industry representatives also called for the conclusion of an agreement between MERCOSUR's industrial bodies to formalize mechanisms for the exchange of information, with a view to guaranteeing the transparency of the procedures. The Argentine government, for its part, decided to reinforce the control of imports through audits in the place of origin, whenever there is suspicion that such products enter the country with false certificates of origin. Such audits could also include the certifying agencies.

Complaints also emerged regarding the triangulation of food products (rice, dairy products and wheat) originating in the European Union and entering Brazil via Uruguay and Argentina. These complaints subsequently gave rise to a conflict (see the section on Non-tariff Restrictions and Measures).

C. Non-tariff Restrictions and Measures

There has been scant progress in the past year on the elimination and/or harmonization of non-tariff restrictions and measures. According to a report issued by the MTC's Technical Committee Nº 8 on "Non-tariff Restriction and Measures", 21 measures were resolved between November 1996 and August 1997. Of these, seven were excluded because their treatment was not deemed to correspond to the area of non-tariff restrictions; the remaining 14 were harmonized.[14] Around half of the 368 identified measures for which harmonization was foreseen remained pending for treatment at the time .[15] They mostly concern food products, pharmaceuticals, plant health measures and technical specifications for industrial products .[16/17]

As regards the completed measures, slightly less than half (43%) were harmonized. Some 27% were deemed justified and 16% were eliminated (because they are incompatible with the WTO or because they significantly restrict trade). The remaining measures were either excluded (due to duplication or non-correspondence, or because there were no relevant items) or consist of measures with regional application (that is, they were eliminated for intra-bloc trade but remain in force for extra-regional imports).

Harmonization has led to the drawing up of several technical standards establishing the characteristics with which products and/or production processes must comply. These regulations aim to eliminate technical barriers to intra-bloc trade while guaranteeing compliance with certain conditions in the areas of health, safety and environmental and consumer protection, in line with WTO norms. Once approved by the CMG, such regulations must be incorporated into the legal system of each member state through the promulgation of administrative regulations

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13 The protests referred to products manufactured in China (bicycles) and Mexico (textiles, footwear and agricultural machinery).

14 Through Resolution 9/97 of the CMG, tax measures (domestic duties, discriminatory tax treatment) were excluded from the list of non-tariff restrictions and measures. These measures will be treated in the *ad-hoc* group on public policies that affect competitiveness.

15 60% of the pending measures are to be harmonized, 12.5 % are to be eliminated, 10% are to be classified, 9% have been partially harmonized and 8.5% will receive some other form of treatment.

16 These tasks are being carried out by the sub-working groups (WSGs) primarily in WSG Nº 3 "Technical Standards" and WSG Nº 8 "Agriculture". At its Montevideo meeting the CMG approved the new negotiating guidelines for WSG Nº 3, re-scheduling the latter's tasks with deadlines between June 1998 and December 1999.

17 Some cases should receive priority treatment, given that the existing asymmetries are causing significant disruptions to intra-bloc trade. This is particularly evident in the case of food products, where the absence of mutual recognition of control systems is generating delays in border transactions.

and, when necessary, through legislative procedures. [18] This process has nevertheless advanced very slowly, prompting disputes in sectors such as food and medicine. In the latter case, Argentina presented a demand to the MTC requesting the transposition into national regulations of MERCOSUR standards on the registration and marketing of those medical products which are imported from within the sub-region and which are similar to those registered and manufactured in the respective countries. [19]

At the Fortaleza meeting in 1996, the CMG had requested that special priority be given to the elimination and/or harmonization of non-tariff restrictions and measures. On that occasion, all sub-groups and technical committees were asked to establish, before 31 July 1997, a deadline for eliminating or harmonizing the identified non-tariff restrictions and measures. Since this mandate was not completed, in June the CMG instructed the MTC to submit to its meeting of December 1997 a report outlining the maximum timeframe for concluding the procedures for each measure. The MTC was not able to comply with this instruction.

In its December 1997 meeting, the CMC insisted on the need to accelerate the process of eliminating and/or harmonizing non-tariff restrictions and measures. To that end, it requested that those measures already identified for elimination should be removed before 31 March 1998. In addition, TC 8 was asked to submit a report to the MTC before 31 March 1998, specifying a list of non-tariff measures and restrictions that require priority treatment because of their negative impact on intra-bloc trade (the planned deadline for processing these measures is 31 December 1998).

Members of TC 8 are working to improve the database on non-tariff restrictions and measures. The latter was designed in collaboration with the Administrative Secretariat of MERCOSUR, with a view to improving administration and coordination of the available information. One of the ongoing tasks is the up-dating of national measures in force in MERCOSUR member countries, including the specification of their coverage (in terms of affected products) and their legal basis. With a view to future negotiations with third countries, the Committee has begun the preliminary classification of non-tariff measures in accordance with WTO norms (agreements on the application of Health and Phytosanitary Measures, Technical Obstacles to Trade, and Articles XX and XXI of GATT/1994). TC 8 has been asked to finalize the classification by 30 June 1998.

During 1997 the negotiating agenda was also affected by new measures which prompted reactions among the member states. In the first six months of the year, the main conflict concerned the restrictions on import financing periods established by the Brazilian authorities. Brazil eventually exempted its MERCOSUR members from the measure. [20] More recently, the Brazilian government ruled that some imports - among them dairy products, cereals, fuel products, minerals and some textiles - would be subject to prior authorization by the ministries of trade and agriculture, in view of alleged deficiencies in phytosanitary controls on these imports. Although MERCOSUR members were informed that such restrictions would not be applied to intra-bloc trade, by the beginning of January this decision had not yet been formalized beyond a notification to the customs authorities. Apparently, one of the reasons behind this measure was

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[18] Member states have three months to announce the administrative actions needed to transpose MERCOSUR's technical regulations. This deadline does not have to be met in cases where a special legal procedure is required for their incorporation.

[19] The Argentine delegation decided in April 1997 to suspend its claim, in view of the commitments assumed by Brazil and Paraguay to incorporate these regulations into their national legal systems. To date, however, Brazil has not yet complied with this procedure.

[20] In mid-October, the Brazilian government announced that the exemption given to MERCOSUR countries, as well as to Chile and Bolivia, would be extended to 28 February 1998.

Brazil's interest in discouraging "triangular" imports of subsidized dairy products originating in the European Union and entering Brazil via Argentina and Uruguay. [21]

In sum, the recent experience in MERCOSUR highlights the need to establish a timetable for addressing the treatment of non-tariff measures and restrictions as soon as possible. Priority must be given to those measures that obstruct intra-bloc trade. It is equally important for the member states to adopt the necessary measures for transposing the harmonized technical standards into their national legislation. The lack of fixed deadlines and of sanctions against non-compliance has led to a break in the "harmonization-implementation" sequence. Finally, the experience of the past year has underlined the importance of respecting the commitment not to apply new measures that might restrict intra-bloc trade flows and, especially, to comply with the requirement of prior consultation.

D. Special Sectors

The peculiar treatment of special sectors in MERCOSUR is explained by the existence of significant asymmetries in national public regulations, and by the importance of these sectors in terms of employment or regional economic development. Both the sugar and the automotive industries are examples of sectors which are governed by distinct public policy regimes in each member state, and by strong and well-organized private interests. Designing a system that incorporates the basic interests of the principal actors involved is one of the main challenges for MERCOSUR in the next two years.

The sugar sector

At the Montevideo Summit, the CMG reiterated the mandates approved via Decision 16/96 in December 1996. These concern the preparation of a proposal that includes the gradual liberalization of intra-bloc trade for products of the sugar sector, and the neutralization of distortions that may originate in asymmetries of national policies. This sector will remain excluded from intra-bloc free trade and from common policies until 2001. No deadlines were established at Montevideo for concluding the negotiations, but MERCOSUR members agreed to "make the greatest efforts to comply with both mandates as soon as possible". From January 1998, the Argentine and Brazilian governments will begin meetings with the aim of quantifying the existing asymmetries.

In December 1996 the CMG had instructed the *ad-hoc* group on the sugar sector to establish, by 31 May 1997, a regime to adapt the sugar sector to the customs union. However, divergent positions among the member states, and particularly between Argentina and Brazil, prevented concrete results from being attained.[22] The sugar conflict escalated in April 1997 when the Argentine Congress approved a law making tariff reductions in intra-bloc sugar trade conditional on the elimination of the distortions arising from the Brazilian sugar-alcohol program. The Argentine Executive tried unsuccessfully to modify the law, proposing instead the use of trade safeguard mechanisms in cases of damage or the threat of damage. The precautionary attitude of the Argentine legislators is probably explained by the fears of the Argentine private sector, given the imminent deadline for concluding a proposal on a common MERCOSUR sugar regime. While the constitutionality of the Argentine law is subject to debate, its promulgation is itself indicative of the sensitivity of the issue.

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[21] At the end of November the Paraguayan government also initiated a more rigorous control of fruit and horticultural products imported from Argentina and Brazil, in response to similar measures applied to its own exports to those countries. Paraguay announced that this measure would be applied even in cases where such imports were accompanied by the corresponding phytosanitary certification.

[22] The Argentine delegation proposed that the same tariff should continue to be applied to intra- and extra-regional imports of sugar (that is, a preference margin of 0%) until the level of subsidy in Brazil, and a mechanism for neutralizing the distortions, could be determined. The Paraguayan delegation proposed maintaining the current regime for intra-regional trade until 1 January 2001, as had been envisaged, and then to start a process of progressive tariff reduction, to be concluded within five years after that date. The proposals of Brazil and Uruguay include a gradual liberalization of intra-bloc trade as of 1 January 1998, achieving a preference margin of 100% *vis-à-vis* extra-regional imports by 2001.

Automotive sector

On the recommendation of the MERCOSUR industry ministers, the CMC decided at its Montevideo summit to extend to 30 April 1998 the deadline for defining a common automotive regime, which should enter into force on 1 January 2000.[23] According to the mandate established by the CMC at Ouro Preto, such a regime would essentially include the complete liberalization of intra-bloc trade in this sector, the establishment of a CET, and the elimination of national incentives which distort competition in the sub-region .[24] In its December meeting the CMC also requested formulation of a proposal on negotiating rules of access to the markets of countries with which MERCOSUR has or will conclude free trade agreements.

One of the most conflictive issues will undoubtedly be the treatment of national incentives which affect competition in MERCOSUR. As in the case of the sugar sector, the Argentine government is inclined to address incentives for the automotive sector in parallel with questions related to the free movement of automotive products in the sub-region, associating the existence of a free trade regime with the absence of differential sectoral incentives. This view is not shared by the Brazilian negotiators, who argue that the subject of differential incentives should be treated in the a *d hoc* group on public policies that affect competition, just as has been done in all other cases in which similar situations arose.

Argentina also proposed that the member states consider a regime for transition to intra-bloc free trade which would maintain some degree of balanced trade until 2003. This proposal was not backed by the Brazilian negotiators. Consensus does exist with respect to the CET, which both of the larger MERCOSUR members set at the level of 35% consolidated before the WTO. As regards autoparts, a study of the CET level was requested from one of the technical groups created within Technical Committee Nº 9.

Another technical group is analyzing the issue of the level of regional content in the future common automotive regime. There is technical consensus that the index should measure a minimum regional content (and not the imported content), using as a basis of calculation the value of the “ex-factory” vehicle before taxes. The measurement would be undertaken for each model, with some flexibility regarding new models. The technical group will undertake a study on the import content of the production of autoparts, in order to determine a rule of origin for the automotive sector. The index of national content constitutes one of the main asymmetries between the automotive regimes of Argentina and Brazil, given that the two countries’ methods of measuring the index differ. This has given rise to complaints by Argentine autoparts producers, who claim that with the current system, vehicles produced with some 90% of imported contents are considered national. They therefore argue that imported autoparts should be measured on the basis of the total value of autoparts, as in Brazil, and not by the value of the finished vehicle (including administrative costs and profit margin).

The member states have also analyzed the possibility of granting Uruguay and Paraguay some flexibility with respect to the regional content index, in order to promote the development of the automotive industry in those countries. This exception will be limited to a previously agreed volume.

[23] Technical Committee Nº 9 on the “Automotive Sector” had been asked to submit a proposal for a common automotive regime before 31 December 1997.

[24] Other issues that should be considered while performing this task concern the import regime on parts and spares for factories and parts manufacturers, the import regime for vehicles, the indices of regional content, rules for the protection of the environment and the consumer, and a mechanism for the transition from national regimes to a common regime including the harmonization of existing promotion mechanisms.

E. Export Incentives

Asymmetries among the larger MERCOSUR members in the area of export incentives have continued to provoke disputes. Their divergent positions have been accentuated in recent years, given that the Argentine government has been forced to reduce benefits for budgetary reasons, while the Brazilian government has announced new credit and fiscal support measures for export promotion. In early 1997 Brazil enhanced the coverage of the Program to Finance Exports (PROEX). More recently, and in view of concerns about the devaluation of the Asian currencies, the Argentine government announced, among other measures, the opening of a credit line by the Foreign Trade and Investment Bank (BICE) amounting to US$ 500 million with a maturity of eight years and an annual interest rate of 7.11%, of which extra-subregional exports can make use. Despite this initiative, the asymmetries between the two countries continue to be significant.

During 1997, export incentives granted by the Brazilian government were for the first time subject to two consultations presented by Argentina in the MTC. Argentina asked the Brazilian authorities to limit credit incentives for exports to MERCOSUR to capital goods only, as established by the MERCOSUR regulations in this area.[25] As part of its package of measures aimed at reducing the trade deficit, the Brazilian government had announced at the beginning of the year that it would increase the number of products covered by PROEX, although the deficit problem in fact predated this measure. Argentina also requested that Brazil desist from applying fiscal incentives to exports through the restoration of the PIS/Pasep and COFINS taxes with a credit on the Tax on Industrialized Products (IPI). The argument is that these taxes do not fall under the category of indirect taxes (rather, they are social contributions), and their restoration would therefore not be admissible with respect to intra-bloc exports.

F. Public Policies that Affect Competitiveness

Existing public policy asymmetries between the member states, and the unwillingness of the national governments to cede authority in the matter, explain the scant progress achieved to date in this area. At the end of December 1996 the CMC had decided to create an a *d hoc* group on public policies that affect competitiveness, entrusting it with the revision and, where necessary, redefinition of the criteria, procedures and scope of the measures originally established, as well with ensuring the application of disciplines in those public policies that distort competition .[26] The issue of public policies had been discussed in the MTC since the beginning of 1995, but all that had been achieved was an exchange of information and ideas on distinct criteria which might be applied in guiding the process of eliminating and harmonizing the measures.

Despite the importance of the subject, however, the *ad hoc* group only met twice during 1997, and made no significant progress on what had already been discussed in the MTC. A key obstacle is the fact that the subject under discussion requires political decisions without which the technical work cannot advance.

In their first meeting, the delegations agreed to prepare a consolidated list that would serve as reference for the negotiation process. The group discussed a variety of preliminary criteria (equality, overall range, compatibility with the customs union, non-discrimination and conformity with WTO norms), but did not specify their scope or definition. The group also exchanged opinions on the procedures to be used for the

[25] The member states have agreed not to apply incentives to intra-bloc exports beyond export financing, rebates or exemptions from indirect taxes and special customs regimes, which may be applied with certain restrictions.

[26] A consolidated list of credit and tax measures, as well as measures related to public procurement and other areas, has been prepared.

negotiations. However, the proposed tasks could not be completed within the established timeframe. [27]

In some cases, the existence of asymmetries in public policies and regulations led to the presentation of consultations and complaints to the MTC. These mostly concerned complaints about discriminatory tax treatment for imports. The protests have largely come from Argentina, and have been principally directed against Brazil and, particularly, Uruguay.[28] In early 1997 Argentina presented a consultation to Brazil requesting national treatment for MERCOSUR suppliers in international tenders. In December 1997 Argentina initiated another complaint against Brazil regarding the latter's subsidies to the production and export of pork, an issue which had previously been the subject of a consultation. [29] The delegations of Uruguay and Brazil argue that the member states must commit themselves not to resort to the use of the dispute settlement mechanism in matters that are being dealt with in the *ad hoc* group. The Argentine delegation does not agree with this proposal, as evidenced by its actions.

The leather sector is one that has presented problems. In December 1997 member states agreed to extend the term of the *ad hoc* leathers group of Sub-working Group No 7 on "Industry" until 30 June 1998. This *ad hoc* group has been asked to present a proposal to the CMG for the treatment of the leather-footwear-manufactures sector, which should identify sectoral policies that might affect competition in the sector. [30] The leather conflict springs from criticism of the tax that Argentina applies to exports of leather and "wet blue", in an effort to stimulate local processing. In this respect the Argentine government decided to re-apply, from 1 July 1997, the timetable for reducing the existing export duties for intra-bloc trade of the products mentioned above, cutting the taxes from 15% to 8%. The Argentine authorities nevertheless expressed the need to suspend their compliance with the timetable while competitiveness studies are undertaken, and until incentives are harmonized. [31] Uruguay and Brazil have said that they would present a timetable for reducing their respective taxes, but only if the means of calculating these are harmonized. In view of these differences, the delegations agreed to discuss the harmonization of existing export taxes through a unified timetable with identical calculation formulae and bases.

27 The schedule proposed to complete, by 30 September 1997, the definition of content, criteria, methodology and procedures. On 31 December 1997 the group would present an agreement on the classification of public policies, the negotiating agenda and the date for concluding the latter.

28 Three complaints presented by Argentina against Uruguay remain to be resolved. They deal with tax discrimination against imports of beverages and cigarettes. The complaint regarding cigarettes was taken to the CMG. The Uruguayan delegation insists that the complaints are inappropriate since they concern issues that are being negotiated within an *ad hoc* group of the CMG.

29 Since a consensus was not achieved within the MTC, a technical committee was convoked in line with the provisions of Article 2 of the Ouro Preto Protocol.

30 The *ad hoc* group was set up in December 1996. Its mandate was to prepare a proposal before 30 April 1997, a deadline that was subsequently extended several times. With the new extension, the authorities decided to modify the mandate of the *ad hoc* group to the extent that the existence of sectoral policies affecting competition was no longer taken for granted.

31 The *ad hoc* group is undertaking studies on competition in the leather sector, based on the benefits conceded to this sector by national or provincial authorities in each country.

Following a proposal from Argentina, public procurement regimes will be subject to a special negotiating agenda.[32] In December 1997 the CMC decided to create an *ad hoc* group on public procurement with the aim of devising a regime for the procurement of goods and services in MERCOSUR. Such a regime should include stipulations on coverage, national treatment, disciplines, procedures facilitating transparency and related institutional aspects. No deadlines have been established for the completion of these tasks.

G. Protocol to Safeguard Competition (PSC)

Some progress has been made on the implementation of the Protocol to Safeguard Competition (PSC), which was signed in December 1996.[33] In 1997 the main tasks of Technical Committee No 5 on "Safeguarding Competition" concerned the regulation of the Protocol. A draft Regulation is almost finished and will probably be approved in the first half of 1998. The regulation, which establishes the procedures for implementing the Protocol, will only be operational once the Protocol itself is ratified by the national parliaments and put into effect.

State aid to companies is a subject still to be discussed. The Protocol approved in December 1996 included the subject of government assistance in its Chapter 7 on transitory provisions. In this chapter the member states pledged to establish, within two years after the entry into force of the Protocol, common standards and mechanisms for controlling government assistance that might distort competition. During 1997, however, no progress was made on this matter, and the member states have decided to address this issue in the first quarter of 1998, along with the issue of mergers.

The fact that the PSC has not yet entered into force has enabled member states to apply national "trade relief" instruments, particularly national legislation on anti-dumping. Argentina's active use of this instrument has been a source of concern for the Brazilian authorities. The latter have argued that the existence of such a high number of investigations is affecting intra-bloc commerce.[34]

There has also been discussion of the procedure for exchanging information on intra-bloc anti-dumping investigations. Brazil has presented a proposal for the revision of MTC Directive No 5/95, which covers this issue. Argentina argues that the Brazilian proposal impinges on the principle of confidentiality established in the WTO's Anti-dumping Agreement, and that it prevents guarantees to the applicant and the government of the importing country that they will enjoy the full exercise of rights contemplated in that Agreement, as well as those rights which derive from national legislation. In the view of the Brazilian delegation, its proposal only covers the regulation of the Protocol to Safeguard Competition, which provides the legal basis for this issue in MERCOSUR and does not contradict WTO norms. Discussion of the matter has not yet concluded, and the MTC will consider the Brazilian proposal in its first meetings in 1998.

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[32] The remaining MERCOSUR members had previously opposed the Argentine proposal, arguing that this issue was included in the agenda of the a*d hoc* group on public policies that affect competitiveness.

[33] In June 1997 the CMC approved an annex to the PSC which established the value of the fines foreseen in the Protocol. These penalties are to be equivalent to up to 150% of the profits obtained through the offending practice, up to 100% of the value of the assets obtained or up to 30% of the gross sales of the companies in their final year, excluding taxes.

[34] A dispute has arisen over the anti-dumping investigation conducted by Argentina against Brazilian exports of airtight motor-compressors for domestic refrigeration. According to the Brazilian government, the investigation should have been concluded with the recommendation to apply anti-dumping duties despite the finding, in the preliminary phase of the procedure, that the damage is not caused by the pricing practices of the Brazilian company. For the Argentine delegation, however, the anti-dumping investigation is not yet concluded, since there is no ministerial decision on this issue. Brazil has responded that it sees no reason why the investigation is not yet concluded.

CHAPTER IV. COMMON POLICIES

In contrast to the advances made in the area of free circulation of goods, 1997 saw little progress on the effective implementation of common policies. The common external tariff (CET) was temporarily increased by three percentage points at the end of the year, but it was left to each country to decide how this might best be applied, thereby opening new loopholes in the effective maintenance of the CET. There were few steps towards adopting the common customs code and progress was slow in implementing integrated border controls, mainly because budgetary constraints made it difficult to establish the required infrastructure. In December 1997 the Common Market Council (CMC) approved the regulatory framework for establishing a Common Regulation on Import Dumping from Non-MERCOSUR Countries, as a first step towards instituting such a regulation.

A. Common External Tariff (CET)

The most significant development with regard to the CET in 1997 was the decision taken in the last CMC meeting to increase the tariff temporarily (not beyond 31 December 2000) by three percentage points. [35] This decision allowed a high degree of national discretion in the use of the customs union's main trade policy instrument. Hence each country was authorized to increase the CET to the degree and for the period it considered necessary, the only restrictions being that the increase should not exceed three percentage points, should not be continued beyond 31 December 2000, and should not cover goods included in the common exceptions. The increase entered into force in Brazil in mid-November and was presented as part of the package of anti-crisis fiscal measures adopted to address the effects of the turbulence in the Asian markets.[36] For the Argentine government the measure was a means of compensation for its elimination of the 3% statistical tax, as demanded by a WTO panel. [37]

The member countries continue to levy the CET on extra-subregional imports which enter via a member that has already imposed the corresponding duty. The central problems are the absence of mechanisms for assigning customs revenues, and the lack of clear rules of procedure for levying the differential between the national tariff and the CET in those cases where a product entered via a member country and was then re-exported to another which does not include it in the declining convergence regime. In the first half of 1997 the MERCOSUR Trade Commission (MTC) prepared a special analysis of the scope of the MERCOSUR regulations in this matter (Articles 82 and 84 of the Norms of Application on Customs Clearance, Dec. 16/94 of the CMC), but no common understanding was reached.

The member countries have discussed the possibility of establishing a special regime for extra-subregional capital goods imports, but have not agreed to do so jointly. Brazil had such a system ("ex-tariff") at the beginning of the 1990s, which exempted from payment of import tariffs those capital goods not produced in the country. At the time, the system reduced the asymmetries with Argentina, which had a zero tariff on capital goods irrespective of whether they were produced locally. In mid-1996 the Argentine government decided to increase the CET on capital goods to 14% for fiscal reasons, by bringing forward the CET's

35 Exceptions to the increase included some live animals, fish, eggs, products of animal origin, plants, garden produce, vegetables, oilseeds, fuels and mineral oils, and editorial products.

36 The measure was adopted following an agreement between MERCOSUR's Economy Ministers and Central Bank presidents in mid-November. It was later adopted formally at the CMC meeting in December 1997.

37 The Argentine government is appealing against the finding of the WTO panel.

convergence schedule. A year later, in July 1997, the Brazilian government decided to follow the Argentine lead by eliminating the "ex-tariff" regime and establishing a duty of 17% on capital goods (which should converge to 14% in 2001). This measure was adopted to contain the mounting trade deficit. The asymmetries began to reappear in December 1997, when Argentina announced a reduction from 14% to 6% in the tariff on extra-MERCOSUR capital goods imports.

Throughout 1997, Technical Committee Nº 1 continued working on adjustment of the Common MERCOSUR Nomenclature and the CET levels, as well as on the categories for goods classification. In 1997 the member countries also adopted tariff cuts in the framework of the system of periodic actions for supply reasons.

With regard to the harmonization of common extra-MERCOSUR trade policy instruments in the textile sector, in 1997 the MTC's Technical Committee Nº 10 restricted itself to an exchange of information on such instruments and other provisions affecting textile trade (like anti-dumping measures) prevailing in each country, as well as to an analysis of foreign trade. The divergences between the countries, however, continue to hamper agreement on common trade policy. The private sector has proposed the establishment of a 35% CET for garments, the maximum level agreed under the WTO.

B. Customs Affairs

In the area of customs affairs, activity in the second half of 1997 centered on perfecting the instruments which enable adoption of common procedures and norms. In June 1997, the MTC instructed Technical Committee Nº 2 on "Customs Affairs" to give priority to conclusion of an Additional Protocol to the MERCOSUR Customs Code (MCC), as well as to work on the MERCOSUR Single Customs Document (MSCD) and the Simplified Customs Norm for SMEs. The latter project, presented by Paraguay, did not flourish because some member countries considered a specific regulation on SMEs to be unnecessary. At its September meeting, the Common Market Group (CMG) ratified the MTC's decision to conclude an Additional Protocol to the MCC, fixing a deadline of December 1997.

The significance of the Additional Protocol to the MCC stems from the difficulties in applying the Customs Code as it was approved at the Ouro Preto summit in December 1994. These difficulties require substantial modifications if the MCC is to be put into practice. The problems of establishing the Additional Protocol are related to the difficulties of securing consensus in areas such as the definition of the customs territory (if it does or does not include free zones) or the CET (disagreements as to whether the nomenclature forms part of the tariff).

The definition adopted in some areas could entail the modification of domestic legislation in member states. This is the case for customs infringements and fines: while in Argentina smuggling is considered a crime, in the rest of the member countries it is an infraction. The importance of the issues yet to be agreed upon, and the repercussions that the MCC will have for member countries' fiscal situation and foreign trade, prevented TC 2 from meeting the deadline for concluding the Additional Protocol.

To advance with the preparation of the Additional Protocol to the MCC, TC 2 decided at its November 1997 meeting to begin a process of internal consultation in each member state, in public and private bodies concerned with external trade. Nevertheless, to define some basic terms the TC considers it necessary to receive the political definitions of MERCOSUR's higher institutions. The question of whether the MCC will be put into effect (a) during the process of consolidating the customs union, or (b) when the union has been fully established, will also depend on a political definition. Although no schedule was fixed for completing the work on the MCC, it was agreed that the meetings on the matter should be held frequently.

Similarly, little progress was made in defining an MSCD. In August 1997 the *ad hoc* group entrusted with preparing the MSCD was effectively suspended, because the member countries could not agree on what the document should include. Since each country wanted to include different information in the MSCD, the very idea of establishing a single document seemed in doubt. Work on the MSCD was also stalled by the high costs of modifying the computer software required for the proposal to be adopted. As regards the computerization of customs matters between the member countries, a regulated system has not been established – although some progress has been made in adapting the individual customs systems of each country in order to improve communication.

In August 1997, TC 2 recommended to the MTC a norm on the establishment of harmonized health precincts. This norm establishes that for cargoes of animal or plant origin, each country is obliged to use harmonized and unalterable zoo-phytosanitary precincts which guarantee the safety and inviolability of the goods. In its September meeting the MTC approved this proposal via directive 17/97.

Progress has been slow in the area of integrated border control points, both as regards defining new points and putting into effect those already agreed. In 1997 three new integrated border control points were agreed upon, all of them linking Argentina and Brazil: Bernardo de Irigoyen-Dionisio Cerqueira, Andresito-Capanema, and Santo Tomé-São Borja. Such progress is important: despite the fact that these two countries record the highest trade volumes, their common border has seen few advances in the area of integrated controls. It should be kept in mind, nevertheless, that the announcement of new, integrated border control points does not imply that they immediately become effective. In practice, some progress was made in establishing such control points between Brazil and Uruguay, and between Argentina and Brazil, although in the latter case some points are only partially operational.[38] The slow progress in applying integrated border control is basically due to the lack of adequate infrastructure, which the countries are prevented from providing by budgetary constraints.

In November 1997 the Argentine and Brazilian presidents signed an agreement to create a Border Cooperation and Development Committee. This Committee, together with the Bilateral Working Group on Border Security, is expected to help evaluate procedures and recommend flexible solutions to border problems.

TABLE IV.1
APPLIED AND NON-APPLIED BORDER CONTROLS, BY COUNTRY
(September 1996-August 1997)a

Country	Local and tourist traffic				Cargo transported by							
					Truck				Train			
	Yes		No		Yes		No		Yes		No	
	9/96	8/97	9/96	8/97	9/96	8/97	9/96	8/97	9/96	8/97	9/96	8/97
Argentina-Brazil	-	3 b	2	2	-	2c	2	4	-	1c	1	-
Argentina-Paraguay	1	1	1	1	2	2	-	-	-	-	1	1
Argentina-Uruguay	3	3	-	-	2	2	1	1	-	-	1	1
Brazil-Paraguay	-	-	3	3	-	-	3	3	-	-	-	-
Brazil-Uruguay	-	2	6	4	1	3	5	3	-	-	-	-
TOTAL	**4**	**7**	**12**	**12**	**5**	**7**	**11**	**12**	**-**	**1**	**3**	**2**

Source: Prepared by the author on the basis of the records of the meetings of TC 2 in 1996 and 1997; Resolution 43/97 of the CMG.

Notes: a, The official list of August 1997 was updated in December 1997 with the application of integrated border control points at Santo Tomé-São Borja and Andresito-Capanema (in the latter case for tourist and border traffic) b, in the case of Puerto Iguazú-Foz de Iguaçú, Brazilian immigration officials were still not working in the integrated control in the Argentine side; c, partial implementation in Paso de los Libres-Uruguayana.

[38] In the case of Paso de los Libres-Uruguayana, the integrated cargo control operates for Argentine exports/Brazilian imports in the customs terminal at Urugayana, but not for Brazilian exports/Argentina imports. Integrated control seems to be working at Puerto Iguazú-Foz de Iguaçú, although by August 1997 Brazilian immigration officials were still not operating.

C. Unfair Trade Practices and Safeguards

In 1997, Technical Committee Nº 6 on "Unfair Practices and Safeguards" devoted itself to preparing a regulatory framework for establishing a Common Regulation on Import Dumping from Non-MERCOSUR Countries. Eventually approved by the CMC in its December meeting, [39] this represents the joint understandings of the MERCOSUR members regarding the WTO framework on the application of anti-dumping measures. On the basis of the framework, the MTC is to draw up the necessary complementary norms for establishing and applying the Common Anti-dumping Regulation .

Among the most significant issues in this area, the member countries agreed that when one contracting party starts an investigation for the application of an anti-dumping measure against imports from third countries, it must inform the other partners in the agreement, in line with WTO mechanisms. If one contracting party considers that the extra-subregional imports of a partner, entering at dumping prices, are damaging its exports, it can request consultations via the MTC with a view to determining the access conditions to the partner's market. Eventually, a member may ask a partner to apply anti-dumping measures in its favor, in which case the partner will apply a treatment in line with WTO procedures. Such procedures establish that the decision as to whether such a request is approved lies with the importing country (in this case, the country to which the request was made).

The regulatory framework involves two levels: the technical and the decision-making. The technical level must ensure that members comply with the provisions of the regulatory framework, and conduct investigations in line with established procedures. The decision-making level must decide upon the application of measures, on the basis of reports from the technical level. The members have agreed that they will apply anti-dumping measures in accordance with their national laws until the Common Anti-dumping Regulation has been adopted (no deadline has been set), according to the provisions of the approved regulatory framework. They have also considered the possibility of an additional transition period, after the adoption of the Regulation, during which time the member countries will continue to apply their national laws in this area. This additional period would be used to improve the technical infrastructure so as to allow the correct application of the provisions of the Regulation. The members also agreed to establish a cooperation program to make their procedures on anti-dumping investigations compatible.

In the second half of 1997 the Committee on Trade Defense and Safeguards (CTDS) worked on the preparation of its internal rules of procedure, and on the paperwork necessary to request the application of safeguard measures. The CTDS was established in December 1996 (when the CMC approved the Regulation on the Application of Safeguard Measures to Imports from Non-MERCOSUR Countries), but began work in June 1997 when the MTC approved the Committee's functions, composition and competences. In addition to the functions mentioned above, the CTDS is to conduct the investigations, draw up reports, and coordinate the consultations on the application of safeguard measures by MERCOSUR as a single entity. It will also recommend to the MTC the complementary norms necessary for the application of the Common Regulation on

[39] Unfair trade practices linked to intra-subregional trade are addressed in the Protocol to Safeguard Competition, approved by the CMC in December 1996.

Safeguards.[40] The functions and competences of the CTDS will be expanded when its internal rules of procedure have been established, and when the common regulations on anti-dumping and countervailing duties have been approved. In those areas its functions will probably be similar to those related to safeguards. Work will resume in 1998 on drawing up a Common Regulation on Subsidies and Countervailing Measures.

D. Consumer Protection

After a series of postponements,[41] in its first meeting of the year (February 1997) the MTC instructed Technical Committee Nº 7 on "Consumer Protection" to complete the Consumer Protection Regulation by 30 May 1997. This deadline had to be extended again, however, because the members could not reach agreement on the various issues under discussion. The complexity of the issues and the broad scope of this Technical Committee's agenda (all goods and services) were the reasons given to justify a new postponement. In view of the fact that consumer protection was considered a basic requirement of the customs union, in June 1997 the CMG instructed the MTC to treat the issue as a priority. Consequently, in August 1997 the MTC underlined the necessity of completing the Regulation by the end of the year.

Following this instruction, TC 7 concentrated on attaining consensus on the various issues yet to be agreed upon. These included the scope and interpretation of the regulation; basic consumer rights (such as whether to include the burden of proof as an investment right); supply of goods and services (such as the scope of the concept of services and of public service, as well as the shelf-life of products); abusive supply practices; contractual guarantees for goods and services; advertising (harmonizing the concept of abusive advertising); contractual protection and non-negotiable contracts.

With a view to completing the Regulation by December 1997, the contracting parties agreed that discussion of the most conflictive issues should be left to a stage following approval of the Regulation, such a stage not to exceed two years after approval. These issues include some basic consumer rights, product supply questions and non-negotiable contracts, contractual protection in general and responsibility for prejudicial practices. The Protocol must also become enforceable within two years. It was agreed to include an article in the chapter on Temporary Provisions specifying those articles covering supply of goods whose application would be suspended until the regulations governing them had been drawn up. After the TC's most recent meeting in November 1997, the agreed draft Protocol was sent to the MTC for its elevation to the CMG and the CMC. Also sent to the CMG and CMC were norms on the quality of products and services.

Despite the efforts of TC 7 to meet the deadline stipulated by the MTC, the Protocol was not approved because of opposition from the Brazilian delegation. Brazil argued that the mandate granted by the MTC to TC 7 was not fulfilled in its entirety because some of the 13 issues to be included in the Protocol (which were listed by the MTC at its XXII meeting) were not agreed upon, while others were not even discussed by the Committee. Brazil therefore suggested that the methodology used should be modified so that further progress might be made. Brazil further argued that the agreed text was not in line with the guidelines

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[40] Its temporary provisions establish that, until 31 December 1998, the member countries will adopt safeguard measures by applying their national legislation in this field, in line with the provisions of the Common Regulation on Safeguards. After that date, MERCOSUR may adopt a safeguard measure for a product as a single entity, or on behalf of one of its members (in the latter case the measure will be limited to that member) in line with community norms.

[41] According to Res. 126/94, the CMG instructed the Consumer Protection Committee to present a draft regulation by mid-1995. This deadline was later extended to November 1995, following which a deadline of November 1996 was proposed. The latter deadline could not be met.

established in MERCOSUR, according to which the process of harmonization should take as a reference the most stringent legislation in force and international standards. It is worth noting that Brazil believed that approval of the Protocol would entail less consumer protection than that provided by Brazilian legislation.[42] Although the Argentine, Paraguayan and Uruguayan delegations declared their opposition to Brazil's position, and their desire to elevate the Protocol to the consideration of the CMG, this did not occur.

[42] The draft Protocol was approved by some of Brazil's consumer protection institutions: in the December 1997 meeting of the Economic and Social Consultative Forum, the Brazilian Institute for Consumer protection announced its opposition to the draft.

CHAPTER V. POLICY HARMONIZATION AND DEEPENING

In the Rio de Janeiro Declaration of April 1997, the presidents of Argentina and Brazil stressed trade in services and government procurement as the key issues for deepening the MERCOSUR integration process. This commitment led to the signing of the Protocol on Trade in Services at the meeting of the Common Market Council (CMC) in Montevideo in December 1997, and to the creation of an *ad hoc* group to address the issue of government procurement. Some progress was also made in the social and labor fields, (such as the signing of the MERCOSUR Multilateral Agreement on Social Security), in the areas of education and culture, and at the institutional level. With regard to the environment, no agreement has yet been reached that might allow for the signing of a corresponding additional protocol.

A. The MERCOSUR Protocol on Trade in Services

At its December summit, after three years of negotiations, the CMC approved the "MERCOSUR Protocol on Trade in Services", whereby the member countries pledged to liberalize services trade within a maximum period of ten years after the Protocol enters into force. [43] As mentioned earlier, the Common Market Group (CMG) identified liberalization of trade in services as one of the priority areas for consolidating and deepening the integration process.

The Services Protocol was drawn up in the light of the WTO's General Agreement on Trade in Services (GATS) and of the commitments assumed by the MERCOSUR countries under that agreement, as well as of other international experiences in the field (such as NAFTA's agreements on services). The Protocol establishes that each contracting party will immediately and unconditionally grant most favored nation treatment to MERCOSUR service providers. The benefits of national treatment will be limited to those sectors included in the list of specific commitments, in line with established conditions.

The benefits of preferential treatment will extend to residents of MERCOSUR who are nationals or who have permanent rights of residence in accordance with the legislation of the corresponding member country. Corporate entities will enjoy preferential treatment if they are constituted or organized in line with the legislation of the corresponding country, are based in that country and develop or carry out substantial commercial operations within its territory or that of any other member country. A member country can deny the benefits deriving from this Protocol to a service provider of another member country, subject to prior notification and consultation, when the former member is able to show that the service is being provided by a person or organization from a country that is not a member of MERCOSUR.

In the list of specific commitments, the governments must indicate the terms and conditions of, as well as the limitations on, access to markets and national treatment for each service on that list (a positive list including reserves). The lists of specific commitments will be incorporated into national legal frameworks in line with the procedures prevailing in each contracting party. [44] When appropriate, each contracting party will specify deadlines for the implementation of the commitments and for their entry into force. The commitments included in the list of specific commitments may only be modified or suspended in exceptional

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[43] The Treaty of Asunción (1991) established the free circulation of services, but at the time the member countries assumed no commitments as regards deadlines. The Protocol will enter into force when it has been ratified by at least three member countries.

[44] The contracting parties will take the necessary steps within their power to ensure compliance with the obligations and commitments of the Protocol by lower levels of government (provinces, states, municipalities, etc.).

circumstances, subject to prior consultation and agreement with the affected member on the type of measure and the period during which it is to be applied.

By means of successive, annual rounds of negotiations, the member countries will gradually include new sectors, sub-sectors or activities, and will reduce or eliminate the unfavorable impact of measures which affect trade in services. Such negotiations will aim to deepen the commitments assumed by each member country in the WTO, and will cover a broad range of services in terms of sectors and means of provision. The methodology will be based on exchanging lists of supply and demand. The *ad hoc* Group on Services, acting under instructions from the CMG, will complete the negotiation of initial specific commitments before 30 June 1998. It seems likely that the first sectors in which specific commitments are to be reached will include telecommunications and financial services. Both sectors have their own independent pace of liberalization, stemming from the structural reform process (privatizations) being undertaken by the member countries.

As regards institutional considerations, the Protocol establishes that negotiations on services fall within the competence of the CMG, whose functions will include convoking and supervising the negotiation of specific commitments, receiving notification of the modification or suspension of commitments, and periodically evaluating the development of services trade in MERCOSUR. To carry out these functions, the CMG will institute an auxiliary body, and will draw up procedural rules for its composition and operation. Application of the Protocol will be the responsibility of the MERCOSUR Trade Commission (MTC), which must be notified of new measures that might affect trade in services or the exceptions. The MTC will also deal with the consultations and claims arising from the Protocol. The CMC, for its part, will approve the results of the negotiations on specific commitments, as well as any modification and/or suspension. Disputes prompted by the application, interpretation or enforcement of the commitments established by the Protocol will be resolved in accordance with MERCOSUR's dispute resolution mechanisms.

In the area of anti-competitive practices, the MERCOSUR Protocol to Safeguard Competition will be applied. Moreover, since subsidies might in certain circumstances distort trade in services, the contracting parties have agreed that in the future they will establish and apply common disciplines. By 30 April 1998 the *ad hoc* Group on Services is to complete the appendices to the Protocol concerning specific sectoral provisions in those sectors where such provisions are necessary.[45] In drawing up these provisions, account will be taken of the sectoral appendices to the GATS (movement of persons providing services, telecommunications, air transport and the financial sector) and the proposals made by the CMG's working sub-groups, especially those responsible for communications, financial affairs, transport, labor, health, education and tourism.

In the final phase of drawing up the Protocol, most debate was prompted by the issues of government procurement, definition of a corporate entity, the number of ratifications required for the Protocol to enter into force, and restrictions on payments and transfers in the case of a balance of payments crisis. The Protocol eventually excluded government procurement from most favored nation treatment, national treatment and market access commitments, and established that procurement will be subject to common disciplines to be established by MERCOSUR in this field. [46]

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[45] Working Sub-group (WSG) Nº 5 on "Transport and Infrastructure" has already drawn up specific provisions covering the transport sector for the Protocol. They are being examined by the *ad hoc* Group on Services.

[46] As was pointed out in Chapter III, in line with an Argentine proposal, the government procurement regimes will have a specific negotiating forum by means of the creation of an *ad hoc* group on procurement. This group is to establish a regime covering government procurement of goods and services which will include provisions on coverage, national treatment, disciplines and procedures. Deadlines have not been fixed for completing these tasks.

With regard to the article on payments, transfers and balance of payments, the contracting parties agreed not to include it in the Protocol. The *ad hoc* group resolved to elevate it to the consideration of the CMG, which suggested it should be addressed by the member countries' central bank presidents and economy ministers. The aim is to establish a mechanism for consultation and decision-making to ensure that restrictions imposed on payments and transfers for balance of payments reasons are not discriminatory, and do not harm the commercial, economic or financial interest of the member states.

B. Labor and Social Affairs

In December 1997, via Decision Nº 17/97, the CMC approved the MERCOSUR Multilateral Agreement on Social Security, as well as its Administrative Regulation. This agreement, which had been discussed but not approved at the Fortaleza summit in December 1996, [47] states that the social security systems should grant workers who provide or have provided services in any member country the same rights and obligations as national workers. Each member country will offer the social security payments and health benefits accorded by its own legislation. The agreement also states that a member country may disassociate itself from these provisions if it so desires, but the rights acquired by virtue of the agreement will not be affected.

The agreement foresees the creation of a permanent Multilateral Commission whose main functions will be to ensure the application of the accord itself, of the Administrative Regulation, and of other complementary instruments; to effect any eventual modifications and complementary norms; and to maintain negotiations over a period of six months to resolve differences over the interpretation or application of the agreement. Beyond that period, conflicts will be settled by means of a dispute resolution mechanism. The Multilateral Agreement is one of MERCOSUR's first fruits in the social sphere.

Given the need for an instrument to guide the convergence of social objectives, in December 1997 the CMG broadened the negotiating remit of WSG Nº 10 on "Labor Affairs, Employment and Social Security" to give it the additional functions of analyzing the social dimension of the integration process and of proposing alternatives for addressing that dimension in the scheme's institutional framework. [48] To that end, an *ad hoc* Group on MERCOSUR's Social Dimension was established within WSG Nº 10. At the end of 1997 this *ad hoc* group presented to WSG Nº 10 a draft MERCOSUR Social-Labor Protocol, which was elevated to the consideration of the CMG.

The draft Protocol seeks to establish the basic principles in the labor field which should be recognized by each member's labor legislation. Among these principles, it was suggested that the Protocol should include workers' and employers' individual and collective rights; foster regional, tripartite, social dialogue; and encourage active policies on job-creation and protection against unemployment. Various points remain to be agreed upon. These include minimum working conditions, the right to information, international collective bargaining, and trade union representation in firms which operate in more than one country. Implementing and monitoring the Protocol is to fall within the competence of a tripartite body instituted at both the national and sub-regional levels. The CMG is still to decide on the nature and effective coverage of the Protocol, as well as on the location, institutional hierarchy and decision-making mechanisms of the implementing body. WSG Nº 10 has pledged to give priority to activities conducive to the establishment of the Social-Labor Protocol in the first half of 1998. The progress of the negotiations is expected to be slow, given the asymmetries of

[47] The draft was withdrawn from the Fortaleza summit because the Argentine government considered it necessary to undertake a more extensive analysis of its possible fiscal effects.

[48] The drawing up of a "MERCOSUR Charter of Basic Labor Rights" was to be included in the negotiating remit of the WSG when the latter was established in October 1996. The desire is related to trade union fears of "social dumping" stemming from the existing asymmetries in the area of labor legislation.

labor legislation in the member countries and the domestic debate on the issue within each of them. One of the three recommendations made by the Economic and Social Consultative Forum (ESCF) at its IV plenary meeting in September 1997 was a series of proposals concerning job-creation policies. To broaden the debate, the ESCF suggested that the CMG convoke a joint meeting between representatives of the Forum and WSG Nº 10, a proposal that was accepted by the CMG. [49]
After the Montevideo summit in December 1997, the first meeting on "MERCOSUR and Social Development" brought together the highest authorities in the social development field from each of the MERCOSUR countries, as well as Bolivia and Chile. Among other things, the meeting agreed to establish a joint work program for the 1998-1999 period, and to draw up an integration-oriented proposals on poverty alleviation.

C. Financial Affairs

WSG Nº 4 on "Financial Affairs" aims to harmonize the regulations governing the financial sector and market access conditions. The negotiating guidelines for this sub-group, approved via Resolution 38/95, divided the work among four committees: the financial system, insurance and reinsurance, capital markets, and macroeconomic indicators. The negotiating remit covers the preparation of treaties on consolidated global banking supervision; perfecting the procedures for exchanging information on financial systems; harmonization of the different regulations governing the financial system,[50] national treatment for member countries' banks; technical cooperation; the establishment of a common regulatory framework on money laundering; harmonization of insurance accounting periods; perfecting the norms governing capital markets; revising the lists of exceptions to the agreements on the promotion and protection of investments; monitoring the exchange rate system and the regulations on capital movements; and providing information on macroeconomic indicators. The long-term agenda (year 2000) included access to financial and insurance markets, and cooperation on capital movements. Except for the tasks of the long-term agenda, these activities should have been completed by December 1996. The scale and complexity of the issues, however, coupled to internal economic difficulties, justified the extension of the deadline for another year.

Since then, progress has been made on harmonizing systems for the regulation and supervision of the financial system. [51] Examples are Decision 10/93,[52] which deals with the Basle Committee norms on minimum capital levels; and Decision 12/94,[53] which recommended that the contracting parties adopt the principles of Consolidated Global Banking Supervision.[54] Progress is also reflected in the CMG's Resolution Nº 1/96 (based on a recommendation of WSG Nº 4) on classification of debtors and credit risk. This resolution establishes that the member countries' financial systems should incorporate basic international principles and norms for classifying debtors, and that the contracting parties should harmonize credit risk criteria in line with those norms. [55]

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49 Recommendation 3/97 addresses MERCOSUR's negotiations with the rest of the Latin American Integration Association (*Asociación Latinoamericana de Integración*, ALADI). Recommendation Nº 4/97 deals with unilateral measures by governments which might affect intra-MERCOSUR trade.

50 Such as risk control; net worth; reserves; classification and debtors' assessment system, and operational limits.

51 The most significant advances are evident between Argentina and Brazil.

52 Approved when WSG Nº 10 was called "Trade-related Fiscal and Monetary Policies".

53 *Ibid*.

54 Decision 10/93 has been transposed into domestic norms in the four member countries; Decision 12/94 has not been so transposed.

55 By December 1997, this resolution had still not been transposed by the governments of Brazil, Paraguay and Uruguay.

Proposals have been made to deal with money laundering, [56] but it was decided that the issue required a common regulatory framework and the political will to advance. As regards capital markets, work has continued on a proposed agreement on "Trans-border Negotiation of Investment Funds". The aim is to establish a mechanism for marketing, throughout the sub-region, shares in an investment fund administered in one MERCOSUR country, without the necessity to repeat the procedures for securing authorization and sharing the supervisory activities among regulatory bodies of the capital market. Progress has been slow in the insurance field, largely because of the differing natures of the four countries' markets. While Argentina has advanced with the deregulation of the insurance sector, the process has not been completed in Brazil. [57] These differences have hampered progress on harmonizing the norms of the sector.

Since WSG Nº 4 had not completed its assigned tasks by December 1997, the sub-group recommended to the CMG a new negotiating remit for the 1998-1999 period. This recommendation was approved via Resolution Nº 57/97 at the Montevideo summit. The new remit supplemented the sub-group's existing tasks with new activities: harmonization of other financial norms, [58] the drawing up of a draft agreement on trans-border negotiation of investment funds, and the preparation of a general program for eliminating asymmetries in the insurance sector (with fixed goals and deadlines). The previous negotiating guidelines had included the long-term tasks of market access in the financial system and in the insurance sector, but the new remit included this issue only in as far as it concerned insurance. [59] The issue of the financial system was excluded from the guidelines because much practical progress has been made in this area, independently of negotiations. There is agreement that subsequent progress will stem from political decisions. [60]

D. The Environment

In June 1997, WSG Nº 6 on "The Environment" sent to the CMG Recommendation Nº 9/97, with a draft Additional Protocol to the Treaty of Asunción on environmental matters. Despite agreement among all the delegations at the level of the sub-group, the Argentine representation in the CMG requested more time to analyze the draft. The Argentine request was motivated by the leveling of environmental standards and certification procedures, issues which Argentina considered to be unsatisfactorily addressed in the draft. [61] There are still differences in the stringency of the member

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[56] Such as a draft Memorandum of Understanding between the member countries' central banks, wherein they agreed on reciprocal exchange of information on money laundering.

[57] Although the new constitutional text of 1996 contemplated reinsurance ins titutions, which would end the reinsurance monopoly of the Brazilian Reinsurance Institute (BRI), the amendment has not entered into force and the BRI retains a *de facto* monopoly. Branches of foreign firms in Brazil may operate in this area, but their operations must be authorized by presidential decree and must conform to the principle of reciprocity.

[58] Such as prudential norms, liquidity of the system, and insurance of deposits. It has also been stipulated that the presentation of accounting information by banking institutions should be harmonized.

[59] The new guidelines stipula te the harmonization of market access conditions in insurance activities, giving priority to consideration of agreements geared towards allowing insurance market access via branches of companies based in MERCOSUR.

[60] In Brazil, presidential authorization is still required before a foreign bank may associate with a Brazilian bank. Elimination of this norm is not expected in the short term. Requests made by Argentine banks for access to the market were all approved (Banco de la Provincia de Buenos Aires, Banco Francés and Banco Galicia).

[61] The aims of the Protocol included th at of ensuring the harmonization of environmental legislation among the contracting parties, but later the text also recognized the right of each country to establish its own criteria, standards and juridic instruments on the environment, and on the use and management of natural resources.

countries' different environmental laws: Brazilian legislation is the most demanding, those of Paraguay and Uruguay are the least so, and that of Argentina falls in between. The Argentine delegates feared that if an adequate harmonization of environmental standards was not attained, a situation might arise in which a product that fails to meet the environmental standards of one member country would be excluded from the market, which could be viewed as a non-tariff barrier.

E. Educational and Cultural Matters

In December 1997 the CMC endorsed three decisions concerning education. By means of Decision 22/97 the Council approved a Protocol of Intentions between MERCOSUR and UNESCO with a view to fostering the implementation of cooperation programs and projects in the areas of education, culture, and science and technology. At MERCOSUR's request, UNESCO may help devise cooperation projects; support and work with the implementing institution in the realization of the projects; seek financial backing; and arrange studies and research to support the technical teams in developing activities which foster regional integration.

Decision 25/97 extended the duration of the "Triennial Plan for the MERCOSUR Education Sector". The Plan includes three programs: Program I concerns the Promotion of Pro-integration Citizen Awareness, and aims to cultivate knowledge of the effects of integration and disseminate such information via the education system. Program II deals with Training of Human Resources to Foster Development. Program III seeks the Compatibility and Harmonization of Education Systems. The Plan was signed in 1992 by the member countries' education ministers for the 1992-1994 period. Its duration was later extended for 1995-1997. Decision 25/97 extends it further.

Decision 26/97 is an Annex to the Protocol on Recognition of University Qualifications and Degrees for Exercising Academic Activities in MERCOSUR countries, approved via Decision 3/97 in June. The Protocol established that the contracting parties would recognize graduate and postgraduate degrees awarded by academic institutions, solely for the purposes of undertaking academic activities. [62] The Protocol covers graduate and post-graduate degrees attained in courses of a certain duration or with minimum demands on students' attendance. The Annex approved in December 1997 adds that specialized degrees, as well as masters and doctoral degrees, should be duly recognized by the prevailing legislation in the country where the degree was awarded. [63]

F. Institutional Affairs

In line with the CMG's instruction of April 1997, the *ad hoc* Group on Institutional Affairs undertook the preparation of a regulation for the Brasilia Protocol on Dispute Resolution in those circumstances which might be necessary. To that end, the delegations drew up a preliminary inventory of provisions which might be subject to regulation concerning the requirements and conditions for the lodging of complaints by individuals (in the case of measures adopted by any member country which violate MERCOSUR norms), the activities of groups of experts and of the Arbitration Tribunal, and the specification of time periods and means of notification for some procedures.

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[62] Paraguayan universities, Brazilian institutions of higher education, and Argentine university institutions. The recognition granted does not confer the right to undertake non-academic professional activities.

[63] Covering graduate degrees awarded after courses lasting at least four years, or 2,700 hours of courses, and post-graduate degrees in specialized courses demanding no less than 360 hours attendance, as well as for masters and doctoral degrees.

For its part, the Technical Committee of the Meeting of Justice Ministers has been preparing a Protocol on Arbitration between Individuals in the area of international trade, on the basis of proposals made by the Brazilian and Uruguayan delegations. [64] The Protocol should fill a gap in MERCOSUR's institutional structure, which to date has made no provision for mechanisms to resolve disputes stemming from contacts signed between private corporate bodies or individuals resident or based in one of the member countries.

Analysis of the institutional development of MERCOSUR has continued in various fields (academic, technical and political), and has become an issue of mounting interest in view of the fact that disputes arising between member countries have generally been resolved by political means.

[64] Private arbitration mechanisms operate in some of the sub-region's chambers of commerce, such as the Argentine-Brazilian Chamber of São Paulo and Arbitrasul (comprising several Southern Cone chambers of commerce).

CHAPTER VI. INFRASTRUCTURE

The rapid growth of the MERCOSUR economies and the accelerated expansion of intra-MERCOSUR trade has highlighted deficiencies in infrastructure which promise to transform investment in this sector into one of the most dynamic components of the sub-regional integration process. As well as the inadequate transport and communications infrastructure linking the sub-region, there is significant potential for energy integration that would maximize the efficient exploitation of MERCOSUR's installed capacity and available resources. These demands, together with the fiscal constraints faced by the countries' public sectors, open a vast potential for private investment, whose access has been facilitated by the privatization process underway throughout MERCOSUR. Investment in infrastructure on a sub-regional basis also opens up an important field of action for the multilateral development banks and other public finance agencies. This was the basis for the proposal to transform the Financial Fund for the Development of the River Plate Basin (*Fondo para el Desarrollo de la Cuenca del Plata,* FONPLATA) into a financial mechanism for development and integration with financial, operational, technical and administrative autonomy. This initiative is still being studied.

A. Transport and Communications Infrastructure

The need for adequate transport and communications infrastructure has become more evident with the intensification of trade links between the MERCOSUR countries. These demands extend to ties with Bolivia and Chile, countries with which MERCOSUR has reached free trade agreements.

Road transport

The highway network linking the MERCOSUR economies has developed as a natural extension of the national networks. It is completely inadequate for the fluid circulation of goods and people throughout the region. For instance, more than 1,000 trucks per day currently move between Argentina and Brazil, the majority on highways with just one lane in each direction. This explains the importance accorded to the issue in bilateral presidential meetings between the two countries. In the Rio de Janeiro Declaration of April 1997, the presidents confirmed the investment of $3.5 billion in bilateral physical integration projects as part of the Governing Plan for Communication Routes and Access Roads at Border Crossings.

During 1997, the Brazilian authorities made progress in defining how to privatize the highway corridor that links São Paulo-Curitiba-Florianópolis-Osorio, and whose enlargement is scheduled to be completed in June 2000. This highway is one of the 14 priority projects under the aegis of the ministry of transport which form part of the infrastructure modernization plan known as "Brazil in Action". At the end of 1997, the highway bridge was inaugurated between Santo Tomé in Argentina and São Borja in Brazil. This project was the first example of a public tendering process, including the granting of concessions to the private sector, to be conceived and executed on an integrated, bi-national basis.

Improving MERCOSUR's highway transport infrastructure demands the cooperation of the member states, so as to develop an integrated network. In view of this, in October 1997 Technical Sub-group Nº5 recommended to the Common Market Group (CMG) the approval of a Resolution on the Development of the MERCOSUR Basic Highway Network Infrastructure, a task that would fall to that sub-group. The development of the network would take place in four stages, to include the definition of a Preliminary Network of Highway Infrastructure and its eventual integration into a MERCOSUR Network of Intermodal Transport Infrastructure.

TABLE VI.1
MAIN ROAD INTEGRATION PROJECTS IN MERCOSUR

Project	Countries involved	Estimated investment	Current status
Colonia-Buenos Aires Bridge	Argentina-Uruguay	US$ 1/1.4 billion	Pre-qualification of consortia to participate in the data-room
Río de Janeiro-Buenos Aires Highway	Argentina-Brazil-Uruguay	US$ 2.5 billion	Pre-feasibility studies
Rosario-Victoria Bridge	Argentina	US$ 400 million	Tendered
Bridges in Uruguay	Uruguay	na	Preliminary studies
Second bridge, Ciudad del Este-Foz de Iguaçú	Brazil-Paraguay	US$ 75 million	Pre-feasibility studies
Master Plan of Border Passes, Argentina-Brazil	Argentina-Brazil	na	List of projects

Source: INTAL
Note: na, Not available

A recent INTAL study contributed to the definition of a sub-regional Basic Network (including Bolivia and Chile), based on an analysis of potential demand and existing infrastructure (INTAL, [1997]). This study also highlights the 28 main land inter-connection projects (road and rail) in the sub-region. Table VI.1 shows those projects concerned with the MERCOSUR highway network.

Rail transport

The laying of track for the sub-region's rail network, currently being addressed with even greater intensity than highway communications, has had as its main objective communication between production centers in the interior and ports. Inter-connection between points in the interior has had a very low priority, as has the laying of international lines. The sub-region's rail network has long been characterized by the absence of physical links, the existence of different gauges, and other inconsistencies.

The majority of the railways have been privatized as part of the economic reform process. In both Argentina and Brazil, most cargo transport is in the hands of private operators, while in Paraguay and Uruguay the railways are administered by the state. The railways were also privatized in Chile and Bolivia. In some cases, privatization coincided with a slump in international traffic (INTAL, [1997]). This process is partly explained by the decline in infrastructure investment and the retreat to highly short-term planning before privatization.

In general, the most important investment projects related to rail communications between Southern Cone countries are decades old, but have never materialized because of economic considerations and/or administrative obstacles. The operation of railway lines by the private sector adds other actors and requires additional coordination. Cost considerations and uncertainty about transport volumes for some construction projects suggest that realization would be difficult without the support of the state and international sources of financing.

TABLE VI.2
MAIN RAILWAY INTEGRATION PROJECTS IN MERCOSUR

Project	Countries involved	Estimated investment	Current status
Santos-Arica/Antofagasta Train	Argentina-Bolivia-Brazil-Chile	US$ 1 billion	List of projects
São Paulo-Buenos Aires Train	Argentina-Brazil	Brazil: US$ 22.5 million; Argentina: na	List of projects
Antofagasta-Asunción-Paranaguá Train	Argentina-Brazil-Chile-Paraguay	Paraguay: US$ 350 million; Brazil: US$ 250 million	Paraguay: preliminary studies; Brazil: with the project
Libertadores Project	Argentina-Bolivia-Brazil-Chile- Paraguay-Peru-Uruguay	US$ 150 million for 18 projects	List of 35 projects
Gen. Luz-Pelotas Railway	Brazil	US$ 270 million	Pre-feasibility studies
Restoration of the Ipacaray-Concepción Railway	Paraguay	na	Preliminary studies
Improvement of the *Nuevo Central Argentino*	Argentina	US$ 65.3 million	Pre-feasibility studies
Restoration of the Rivera-Montevideo and Rivera-Fray Bentos Railways	Uruguay	Between US$ 35 and US$ 40 million	Planning stage

Source: INTAL
Note: na, not available

Ports and waterways

MERCOSUR's water transport and port network infrastructure is undergoing substantial change, with significant implications for development. The modernization of the port infrastructure (in many cases associated with privatization) has become a powerful catalyst for the sector's activities, including its links with land transport (INTAL, [1997]).

Deepening and marking with buoys the lower stretch of the Paraná-Paraguay Waterway (Puerto Cáceres-Puerto de Nueva Palmira) has substantially improved access conditions, navigability and maneuverability in the stretch of the Paraná River extending south from the town of Santa Fe in Argentina. This project, carried out under a contract that granted a 10-year concession for the work at a total estimated investment of $650 million, includes the crossing of the River Plate by the Emilio Mitre Canal. This project offers a maritime egress as an alternative to the Martín García Canal. The dredging and maintenance of the latter was also transferred to the private sector for a period of eight years by the governments of Argentina and Uruguay. In November 1997, the Argentine government also decided to authorize the licensee of the stretch of river south of Santa Fe to dredge, mark with buoys, and maintain a canal between Santa Fe, Asunción and Puerto Iguazú, including a section of the Uruguay River.

The area of influence of the Paraguay-Paraná Waterway project covers the States of Mato Grosso and Mato Grosso do Sul (in Brazil), the Department of Santa Cruz (in Bolivia), the whole of Paraguayan territory, eight provinces of Argentina and the Department of Colonia in Uruguay. In 1996, transported cargo whose source and destination lay on the waterway reached an estimated at 3.1 million tonnes. Cargo volume is anticipated to reach 8.2 million tonnes in 2000. The Paraguay-Paraná Waterway is therefore one of the main, ongoing river communications projects to include not only making canals navigable but also enlarging shipping fleets and developing port infrastructure.

With regard to the Tieté-Paraná Waterway, the inauguration of the Jupiá lock in 1998 will connect the systems of the Tieté, and the Northern and Southern Stretches of the Paraná, which include more than 1,600 km of main navigable canals. With the opening of the Jupiá and Tres Irmaos locks, the difference in the water level at Itaipú will pose the only remaining obstacle to connecting the Brazilian regions of São Paulo, Mato Grosso do Sul, Goiás, Minas Gerais and Paraná with the markets of Argentina, Paraguay and Uruguay. Initially, this difference in water levels will be avoided by transporting cargo overland. Even with this obstacle, waterborne freight between Buenos Aires and São Paulo will amount to some 50-60% of road freight, according to official estimates.

The two waterways, which are the sub-region's main river inter-connection projects, will generate an estimated investment volume of around $1.2 billion in shipping and ports for the 1997-2000 period.

TABLE VI.3
ESTIMATED INVESTMENT VOLUME IN SHIPPING AND PORTS IN THE AREA OF THE PARAGUAY-PARANA Y TIETÉ-PARANA WATERWAYS

	Paraguay-Paraná-Río de la Plata Waterway	**Tieté-Paraná Waterway**
SHIPPING	**313**	**500**
PORTS	**250**	**160**
Argentina	80	
Bolivia	40	
Brazil	60	160
Paraguay	50	
Uruguay	20	
SHIPPING AND PORTS	**563**	**660**
TOTAL	**1,223**	

Source: INTAL. *Integración en el Sector Transporte en el Cono Sur. Puertos y Vías Navegables.* Buenos Aires, 1997.

B. Energy Infrastructure

MERCOSUR has a broad range of energy resources, among which electricity and gas play a major role in the integration process. Natural gas consumption will increase the most in the consumption structure of all the countries of the sub-region. The development of a network of gas pipelines is one of the most ambitious investment projects in MERCOSUR, prompted by the expansion in the capacity of electricity generation through the installation of thermal sub-stations fueled by natural gas. Since in all the countries of the sub-region there has been a tendency toward deregulation and the opening of the energy sector to private enterprise, the potential for project development has increased enormously (INTAL, [1997]).

The energy resource with the greatest possibilities for integration and trade in the medium term is natural gas. Several projects are in place for laying gas pipelines linking the Argentine oilfields to the Brazilian consumer market, including one that joins the north-east basin with the São Paulo market, and another that joins the province of Entre Rios with Uruguayana. The success of these projects, however, depends on an increase in proven Argentine reserves to a degree that can assure continuity of supply to the Brazilian market in economically profitable volumes. In addition, the preliminary formalities for awarding the work on the Buenos Aires-Montevideo gas pipeline are at an advanced stage, and are expected to be completed in the first trimester of 1998.

The laying of gas pipelines is more advanced between Argentina and Chile, and between Brazil and Bolivia. With respect to the former, the GasAndes pipeline was opened in August 1997 for transmission from Mendoza in Argentina to Santiago in Chile. The pipeline is 465km long and required investment of US$350 million. One month earlier, the presidents of Brazil and Bolivia signed the contracts between Petrobrás and the builders of the gas pipeline that will link Bolivia's eastern department of Santa Cruz de la Sierra and the Brazilian state of São Paulo, with the possibility of a later extension to Río Grande do Sul. The pipeline, 3,150 km in length, will cost an estimated US$2 billion. The export of Bolivian gas to Brazil will start with 8 million cubic meters daily and will reach 16 million in the eighth year of operation. The project is expected to be operational by the end of 1998. The Argentine and Bolivian authorities have already agreed to reverse the direction of the energy circulating in the pipeline that brings Bolivian gas to northern Argentina, such gas currently being unnecessary. Similarly, Argentine gas production in the north-east basin can be diverted to the Brazilian market even before a direct pipeline is built, by making use of the existing gas pipeline between Bolivia and Argentina, and the one now under construction between Bolivia and Brazil. The new gas pipeline will markedly alter Brazil's energy matrix, given that by 2010 natural gas will account for an estimated 12% of the country's total energy supply, compared with the current 2%.

TABLE VI.4
MERCOSUR: MAIN ENERGY PROJECTS AND ESTIMATED INVESTMENT
(US$ million)

Energy source	Project name	Estimated investment
HYDROELECTRIC STATIONS	Corpus	3,681
	Garabí	1,789
	Itatí-Itacorá	2,414
	Roncador	3,189
	San Pedro	1,953
	Conversora-Garabí	224
ELECTRICAL INTER-CONNECTIONS	Itaipú-Corpus-Yacyretá	150
	Rivera-Livramento	34
	Candiota-San Carlos	142
GAS PIPELINES	Río Grande- São Paulo	1,860
	Paraná-Uruguayana	100
	Salta-São Paulo	2,665
TOTAL		**18,201**

Source: Montamat, D. "Energía: la agenda pendiente del MERCOSUR", *Boletín Informativo Techint Nº 290.*

With respect to electricity inter-connections, the main novelty in the first half of 1997 was the signing of a memorandum of understanding between the governments of Argentina and Brazil for the development of electrical exchange, opening the door to the acquisition by Brazil of 1,000 MW. The protocol allows the distributors, marketers and large consumers of electrical energy to contract their sources of supply freely; the sources can be located in either of the two countries. The freedom to export electricity, which was established by a resolution of the Argentine Energy Secretariat, as well as Electrosul's demand, will make the operations possible. Exporting will require investment of US$180 million in laying high-tension 500kV line, and the installation of a station to convert the energy from 50 to 60 cycles. The new line to Brazil will be Argentina's first electrical connection with a neighbor after Salto Grande, which is shared with Uruguay. In addition, a call for bids has been made for the construction of the conversion station, and of the 16km of high-tension line that will connect Uruguay and Brazil through Rivera and Santana do Livramento. The service is scheduled to be operational in 1999. Studies are simultaneously being carried out to define the viability of extra high-tension connections between the electrical systems of the two countries.

CHAPTER VII. FOREIGN ECONOMIC RELATIONS

MERCOSUR is developing an extensive agenda of external trade negotiations. Parallel to the WTO's examination of the preferential agreement, negotiations are underway in the ALADI framework with the Andean Community and Mexico, while the negotiations on the FTAA and with the European Union are being prepared. It proved impossible to meet the 31 December 1997 deadline for concluding either the negotiations on a free trade accord with the Andean Community or an agreement with Mexico to multilateralize existing bilateral preferences. In the FTAA process, MERCOSUR has continued to participate actively in the preparatory meetings of the vice-ministers for trade, which are being held in anticipation of the ministerial meeting scheduled for next March in San José, Costa Rica, and of the presidential summit scheduled for April. MERCOSUR and the European Union have almost completed the stage of "mapping" their trade relations, an activity for which INTAL has provided technical assistance.

A. MERCOSUR-WTO

A working group of the WTO's Regional Trade Agreements Committee is examining MERCOSUR's compatibility with Article XXIV of GATT 94. Three meetings have so far been held (October 1995, September 1996 and May 1997). As far as MERCOSUR is concerned the assessment is finished, although other WTO members can still ask for a further meeting to pose additional questions.

The impact of MERCOSUR's creation on extra-regional trade is currently being evaluated, although there is substantial technical disagreement concerning the choice of years or periods to be analyzed, and the nomenclature to be used. The MERCOSUR countries have agreed on a general strategy to negotiate the compensation that trade partners might eventually demand in response to tariff increases stemming from the establishment of the Common External Tariff (CET). The strategy is being prepared for formal consultations on the compensation requests of other members.

B. MERCOSUR's Negotiations in ALADI

Following conclusion of the free agreements with Chile and Bolivia, MERCOSUR is still to renew its bilateral preferential agreements with the countries of the Andean Community and Mexico. Some progress was made during 1997 but negotiations were not completed by the end of the year, as had been planned.

Negotiation with the countries of the Andean Community has been complicated. From the outset, the aim of the talks was the signing of a free trade accord to replace the bilateral economic complementarity agreements linking each member of the Andean Community and MERCOSUR. The differences between the two groupings, however, included such issues as the range of goods to be included, the extent of the lists of sensitive products, tariff reduction schedules, the linkage between the degree of development and initial preference margins, rules of origin, and special safeguards for certain sectors.

As a general rule, MERCOSUR favors an agreement covering the entire tariff schedule without exceptions, with shorter periods for total trade liberalization (a maximum of 15 years for sensitive products), and does not anticipate differentiated treatment except for Paraguay and Ecuador. These two countries will start with a preferential margin of 10% for products included in the Regional Tariff Preference (RTP), and will be incorporated into the general tariff reduction program after the third year. With regard to rules of origin, MERCOSUR and the Andean Community differ on the application of the criteria for origin, the 60% regional integration requirements, and specific demands in certain cases. In addition, the Andean Community proposes a special regime of safeguards for the farming sector.

Existing disagreements made it impossible to sign an accord in December 1997, a deadline set the previous September. In that context the Common Market Council (CMC) proposed the renewal of bilateral preferences for a six-month period, to begin on 1 January 1998. In February 1998, a new vice-ministerial meeting will carefully examine ways of reconciling positions on essential points in the agreement. Depending on the outcome of this gathering, a ministerial meeting might be called to establish general guidelines that would give some continuity to these understandings. The slow progress of the negotiations at the technical level suggests that the talks will require a political agreement to give them momentum and dynamism.

MERCOSUR's negotiations with Mexico are also advancing more slowly than was originally expected. As with the Andean Community negotiations, the bilateral accords with Mexico expired in September 1997 but were extended by three months because of the expectation that a "4+1"-type economic complementarity agreement might be concluded. Negotiation of a free trade accord would be left to a later stage.

The MERCOSUR-Mexico talks have to resolve several issues. From the start, Mexico favored the signing of a free trade agreement; MERCOSUR preferred to work toward an accord that would multilateralize the bilateral preferences, including the negotiation of compensation arising from Mexico's participation in NAFTA. Even in this less ambitious format, however, the talks revealed differences over the list of products subject to trade liberalization, and the scope of the bilateral exceptions that would survive the new "4+1" format. One area of conflict has been the electronic and automotive sector (whose inclusion the MERCOSUR members, particularly Brazil, were reluctant to admit), as well as agricultural and agro-industrial goods. There were also differences over the general negotiating criteria: MERCOSUR favored a "4+1"-type agreement with only exceptional cases of bilateralism, while Mexico preferred more flexible criteria with additional, specific, bilateral concessions. It should be remembered that the partial scope accord between Mexico and Uruguay in the ALADI framework has a broad product coverage. The impossibility of reaching an agreement to multilateralize the preferences by December 1997 prompted the MERCOSUR members to decide that, until a new agreement had been completed, they would each determine independently the steps they were to follow with regard to the temporary renewal of the existing bilateral accords.

MERCOSUR's political links with Chile, at least, continued to deepen. In December 1997 the CMC decided that the presidential and CMC meetings will establish, in consultation with Chile, an agenda for advancing the integration process and other issues of joint interest. In addition, Chile will hold meetings with the Common Market Group (CMG) whenever the two sides deem it necessary. Chile will also participate in the Political Consultation and Coordination Mechanism, as agreed in the presidential meeting of June 1997. Moreover, Chilean representatives will take part in MERCOSUR's negotiating fora (working sub-groups, *ad hoc* groups, specialized meetings and ministerial meetings), particularly those concerned with issues related to the MERCOSUR-Chile accord. As regards the meetings of sub-groups, *ad hoc* groups and specialized meetings, Chile's participation will be recorded in the corresponding minutes and, if necessary, an aide-memoire will be signed to register any agreements and divergences between the bloc and Chile. This aide-memoire will be sent to the Administrative Committee of Economic Complementarity Agreement (ECA) Nº 35, and to MERCOSUR's higher bodies. With regard to the ministerial meetings, the agreements reached will be concluded in the first instance as MERCOSUR instruments. If both parties are willing, these agreements will be concluded between MERCOSUR and Chile, and incorporated in the framework of ECA Nº 35. Chile will also take part in meetings of economy ministers and central banks presidents which deal with matters of mutual interest, to be defined on an *ad hoc* basis.

An important aspect of this decision concerns external negotiations. MERCOSUR and Chile have agreed to establish regular coordination on all negotiations that are of interest to both parties, as well as to report progress to each other at least twice a year on the various negotiations that are underway. This is a particularly relevant agreement in light of the fact that the FTAA negotiations will be launched in Santiago in April 1998.

The Administrative Commission has meanwhile continued its regular meetings, prioritizing the issue of technical regulations, compensations stemming from the Chile-Canada accord, and the establishment of a definitive dispute-resolution mechanism. With regard to technical regulations, in April 1997 the Administrative Commission convoked a working group of experts in the field, with the aim of fulfilling Title X of ECA Nº 35.[65] The first meeting of the working group took place in September, when the participants agreed to exchange lists of MERCOSUR's and Chile's technical regulations on foodstuffs, pharmaceutical products and cosmetics. The group's second meeting addressed foodstuffs regulations and identified a problem with Decree 977/96, issued by the Chilean government, which referred among other things to item-by-item control of income and labelling norms. If any concrete topic requiring analysis arises under the heading of pharmaceutical products and cosmetics, or if there is any pending issue on foodstuffs, the working group will meet in March 1998.

The negotiations on compensation to MERCOSUR for the Chile-Canada free trade accord are still to be completed. In that regard, progress was made in drawing up a list of products for which it was agreed to give the same preferences, but there remains a more contentious list that includes products such as wheat, barley and oats, which have not yet been negotiated.

The first meeting of the Administrative Committee of ECA Nº 36, linking MERCOSUR with Bolivia in a free trade accord, was held in July 1997. The meeting addressed such issues as the Committee's draft rules of procedure and other operational issues. The latter included the registration of signatures and the new format of the certificates of origin, lists of experts to call on in cases of dispute, and the definition of specific requirements for some products. A second Committee meeting is scheduled for the first half of 1998.

C. The FTAA Process

In August 1997, at the First Preparatory Committee Meeting of the FTAA in San José, Costa Rica, the vice-ministers for trade instructed the working groups to make recommendations on possible ways of conducting future negotiations. The vice-ministers met for a second time in October 1997, and made progress in defining possible negotiating remits in each area. At that meeting, the working groups (with the exception of those on dispute resolution, and sanitary and phytosanitary measures) presented their proposals on the negotiating aims and principles of each issue area, specifying those questions on which no consensus had been reached.

The greatest level of agreement was reached on the negotiating aims and principles in the areas of services, investment, competition policies, technical barriers and the smaller economies. Differences remained in areas such as market access, customs procedures and rules of origin, subsidies, anti-dumping and countervailing duties, government procurement and intellectual property rights. The differences cover issues such as whether to admit limited exceptions or different liberalization timetables for different countries, sectors or products; more flexible rules of origin for smaller economies; the levels of government to be included in the negotiations on government procurement, and negotiating principles on intellectual property.

MERCOSUR decided to adjust its proposal for structured negotiation in three stages, while maintaining the criterion of gradual negotiation. It also suggested the adoption, before the start of negotiations, of the general principles of gradualism, simultaneity and balance, in addition to those already agreed at Belo

[65] This Title aimed to harmonize norms and make them compatible, so as to avoid their becoming non-tariff barriers.

Horizonte in May 1997 (consensus, single undertaking, WTO-compatability, and special attention to the needs of smaller economies).

There was also an exchange of views on the structure of negotiations, based on two proposals from Canada and the United States, as well as on contributions from MERCOSUR, the Andean Community, Costa Rica and Chile. The proposals differed with regard to the number of negotiating groups and the issues that each of the latter would address. The United States proposed the establishment of nine groups (market access, investment, services, government procurement, subsidies, competition policy, intellectual property, anti-dumping and countervailing duties, and dispute resolution) and two study groups on the environment and labor norms. The proposals from Canada and MERCOSUR are similar to each other in that they include a smaller number of groups, albeit with different agendas. Canada suggested four negotiating groups (rules; goods; services, investment and intellectual property rights; and dispute resolution) and an advisory group on smaller economies. MERCOSUR suggested setting up an additional group on agriculture, a different distribution of issues between the working group on rules and the group on goods, and made no mention of an advisory group on smaller economies (MERCOSUR has not been in agreement with the principle of differentiated treatment).

In the October meeting, consensus was reached on the role to be played in the negotiating process by the ministers and vice-ministers for trade. It was agreed that the ministers would guide the overall process, meeting to assess the concrete results in 2000, while the vice-ministers would constitute the negotiating committee which would meet at least twice yearly to direct and evaluate the negotiations. The October 1997 meeting was presented with a feasibility study on the establishment of a temporary Administrative Secretariat, prepared by the Tripartite Committee (the IDB, ECLAC and the OAS). Candidates for the headquarters of the Secretariat currently include Kingston, Lima, Mexico City, Miami, Panama, Rio de Janeiro and Bogota.

The upcoming meetings of vice-ministers (February 1998) and ministers (March 1998) should define the negotiating procedures (objectives, focus, structures and location) so that the negotiations can be formally launched at the Second Presidential Summit to be held in Santiago, Chile, in April 1998. If differences persist until then, the Presidential Summit could approve general mandates, leaving it to the negotiating committee to define the more specific aspects of the accord which remain pending.

D. MERCOSUR-European Union Negotiations

In the second half of 1997, the Trade Sub-committee's working groups continued to analyze trade flows, as well as to draw up and evaluate information on national and community legislation; such activities have been termed "photograph tasks" [66] They form part of the work program for 1997 approved by the Trade Sub-committee in its May 1997 meeting. To fulfill the commitments made on that occasion, in June the CMG instructed the corresponding technical fora of MERCOSUR to prepare the relevant data. Subsequently, at the November 1997 meetings in Montevideo, the delegations exchanged the information obtained, focusing on analysis of trade flows.[67] Reports from the working groups were also approved.

This first stage should be concluded by the time of the Trade Sub-committee's next meeting in April 1998, within the first half of the year as originally planned. After that date, a second stage will begin in which the countries of MERCOSUR and of the European Union should undertake an internal assessment and then devise their respective mandates for negotiating a trade liberalization process between the two groupings. In principle, after the Trade Sub-committee meeting in April 1998, the working groups will not meet again during the year, unless new guidelines are drawn up at that meeting.

[66] The Trade Sub-committee's working groups are: goods, services, and norms and commercial disciplines. They were set up in June 1996 and their operating guidelines were established in the meeting of the Commercial Sub-Committee in November of that year.

[67] II Meeting of the Joint Committee, III Trade Sub-committee Meeting, and II Working Groups Meeting.

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APPENDIX

THE ASSOCIATION BETWEEN CHILE AND MERCOSUR: COSTS AND BENEFITS AFTER A YEAR

1. CHILE AND FREE TRADE AGREEMENTS

In the mid-1970s, Chile became the first country in Latin America unilaterally and completely to liberalize imports as a fundamental component of its development strategy (Agosin and Ffrench-Davis [1993]; Ffrench-Davis, Leiva and Madrid [1993]). By the end of the 1970s it had introduced a uniform tariff rate of 10% and had eliminated all non-tariff barriers. Although Chile's trade policy underwent some changes in the 1980s, the fundamentals were kept in place. By the end of the decade, the uniform rate stood at 15%, which in 1991 was reduced to 11% by the democratic government.

Since the return to democracy in the 1990s, Chile has substantially modified its strategy to globalize the economy. Without abandoning the notion that a non-restrictive import policy is necessary for a country such as Chile (which has a very limited domestic market), the emphasis has shifted toward the signing of free trade agreements (FTAs) with its main trading partners.

Perhaps the main reason for this shift in emphasis lies in the fact that Chile's uniform tariff was already relatively low by the 1980s. Any benefits from further unilateral reductions would therefore be limited. Moreover, Chile's main trading partners maintained considerably higher tariff and non-tariff barriers for those products in which Chilean producers had already obtained comparative advantage, or others which the country was likely to start exporting soon.

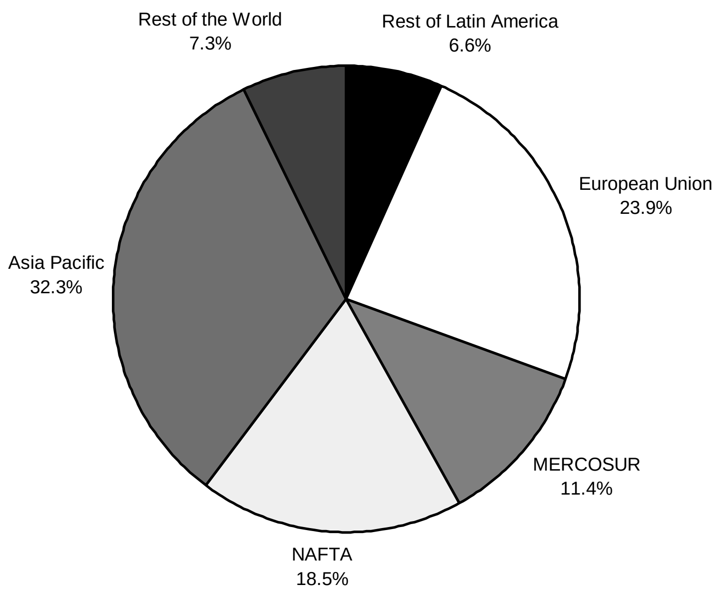
A further reason for negotiating trade agreements was the costs which non-participation in those agreements might have implied. In the case of MERCOSUR, failure to sign a free trade agreement with the bloc would have led member countries to increase imports from within the group to the detriment of Chile. Moreover, the entry into force of the common external tariff (CET) implied that preferences which member countries had granted Chile in the partial scope accords or economic complementarity agreements, signed under the Latin American Integration Association (*Asociación Latinoamericana de Integración*, ALADI), were *de jure* null and void. Similar costs were expected to derive from the expansion of the European Union (EU) to the east, and Mexico's association with the United States and Canada in the North American Free Trade Agreement (NAFTA).

A third reason for Chile's negotiating FTAs with its trading partners was linked to the fact that manufactured goods have higher tariffs than primary products. [1] A staggered tariff system is a characteristic common to all Chile's main trading partners. Most of these markets, including Asia-Pacific (Clark [1996]), the United States (Butelmann and Campero [1992] and the EU (Alvarez [1996]), impose high tariffs on the import of processed agricultural goods, which are of special interest to Chile. The FTAs have therefore sought to promote the export of processed goods, in which the reduction of duties in favor of Chile would be more substantial.

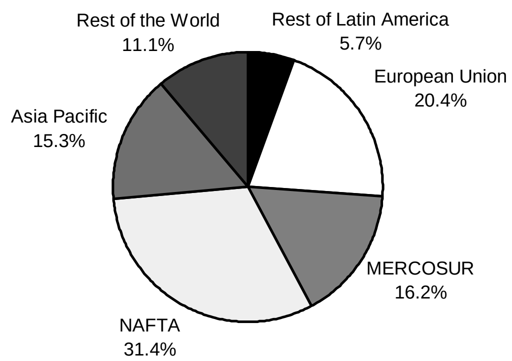
[1] The EU is the exception, as it strongly protects its agricultural production, as well as its agro-industrial products.

The fact that Chile's trade is highly diversified by origin and destination (Graphs 1 and 2) suggests that its optimum strategy is to seek trade agreements with all its main trading partners. If this were to be successful, the costs of the bilateral FTAs – that is, trade diversion – would be minimized.

GRAPH 1
DESTINATION OF CHILEAN EXPORTS



GRAPH 2
ORIGIN OF CHILEAN IMPORTS



This was the strategy adopted by Chile. At the same time, the economic authorities sought Chile's accession to NAFTA, negotiated an association agreement with MERCOSUR, took the first steps towards an FTA with the EU and signed free trade agreements with a number of less important partners (Mexico, Venezuela, Ecuador, Colombia, Canada and Bolivia).[2] Chile has also been actively participating in Asia-Pacific Economic Cooperation (APEC), although its remains

2 The benefit of these agreements is doubtful, given the low volumes of trade involved. Other countries in the region have followed a similar path. These agreements would make more sense if they were to act as a catalyst for the multilateralization of all the bilateral agreements with a view to signing a Latin American free trade treaty involving all countries.

unclear which direction this grouping will take. Of all the agreements Chile has sought with its main partners, the only one to have prospered thus far is the accord with MERCOSUR. This is fortunate, given the advantages which this association could have for Chile over the long term. Chile's strategy, if correct in theory, could pose some problems. First, the administration of many trade agreements entails high costs and could lend itself to corruption. Second, membership of different groups can occasionally lead to political incompatibility. Third, not all of Chile's partners have the same interest in negotiating with the country. Chile will always be of little quantitative importance for the United States or the EU. Fourth, Chile could secure greater benefits from an eventual negotiation with the United States or the EU as part of MERCOSUR than by negotiating individually. Fifth, Chile's historical trade pattern – today based on the export of primary products to developed countries and the import of manufactures from these same countries – is now beginning to change as new comparative advantages are established. With the consolidation of growth based on export diversification, the nature of its trade relations with other countries will change even further. The geographical proximity of countries with similar levels of development could play a much more important role in the long term, since intra-industrial trade benefits not only from geographical proximity but also from relatively similar patterns of demand between Chile and the countries of the region. Hence Chile and its neighbors are potentially much closer natural partners than the existing relatively low level of trade would suggest. [3]

In short, the main benefits which Chile can expect from its association with MERCOSUR are threefold. First, access to a large market for Chilean manufactures, which cannot develop within the confines of a limited domestic market. Light manufactured goods, agro-industry, processed primary products and some modern services (software, engineering services and financial services) are the new sectors which the Chilean economy must develop (and which in fact it is developing). Integration with MERCOSUR is part of a strategy actively to promote these sectors. Second, the association with MERCOSUR widens the domestic market. This is therefore likely to generate strong domestic and foreign investment, accelerating capital formation and the development of new technologies. Third, traditional agriculture (wheat, meat, sugar, oilseeds and lactose) is the sector with the highest number of comparative disadvantages in the Chilean economy. By contrast, the MERCOSUR countries are globally competitive in these sectors. Therefore, preferential tariff reduction in MERCOSUR's favor in these sectors amounts to a unilateral liberalization and confers the same static benefits as the latter.

In light of such considerations, the likely effects of the establishment of an FTA with MERCOSUR are discussed below, and an evaluation is made of the agreement at the end of its first year in operation. The significance of such analysis is that it allows the likely effects to be identified, and permits a comparison between those and the results stemming from the granting of tariff preferences.

Section 2 discusses the general background of the agreement between Chile and the MERCOSUR countries. In section 3, the main characteristics of trade flows are examined. Section 4 analyzes the likely effects of the agreement on the Chilean economy. Section 5 assesses the effects of the agreement on trade flows during its first year in operation.

[3] Integration with MERCOSUR and the likely benefits imply much more than simply an FTA with the bloc. It will be necessary to develop an appropriate physical infrastructure, improve aerial communications, financial services, etc.

2. BACKGROUND TO THE AGREEMENT

The signing of the Treaty of Asunción between Argentina, Brazil, Paraguay and Uruguay in 1991 marked the starting point of one of the most important integration processes ever undertaken in Latin America. Its significance derives from the size of the economies of the participating countries, especially Brazil and Argentina, which account for a relatively large proportion of Latin America's GDP and population.

Chile was invited to participate in the agreement from the start, but always expressed a strong preference to sign a free trade agreement with the MERCOSUR countries as a group rather than become a full member. The main reasons for this are as follows:

- Membership of MERCOSUR would have seriously limited Chile's freedom to set tariffs with respect to the rest of the world. An FTA allows individual countries to use tariffs to offset the negative effects of trade diversion which might arise from selective integration with other trading partners or with MERCOSUR itself. Moreover, it preserves the independence of the external tariff for trade negotiations with other countries or economic blocs. [4]

- Adopting MERCOSUR's common external tariff could have had a negative impact on the Chilean economy, given that in some sectors the CET is higher than the country's uniform 11% rate. In particular, MERCOSUR tariffs for capital goods are high. In contrast, Chile needs these to be as low as possible because its limited domestic market would prevent these sectors from developing efficiently.

The negotiations with the MERCOSUR countries ended on 25 June 1996 and the agreements on reducing trade barriers came into force on 1 October of the same year. The main aims of this agreement are as follows:

- Establishing a juridical and institutional framework for the creation of a wider economic space and a free trade zone within 10 years. Goods and services will therefore circulate freely between Chile and the MERCOSUR countries within a specific time period. [5]

- The promotion of physical infrastructure, bioceanic links and, in general, economic, energy, scientific and technological complementarity.

In terms of tariff barriers, the agreement's entry into force immediately reduced the average tariff on Chilean exports to MERCOSUR from 8.2% to 3.2%, while the tariff for imports from MERCOSUR fell from 11% to 5.7% (Table 1).

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4 As stated earlier, the benefits of signing agreements with other countries or blocs can be more theoretical than practical.

5 Tariffs on sensitive products will be completely eliminated after 18 years.

TABLE 1
TRADE WEIGHTED AVERAGE TARIFF
(to 1 October 1996)

Country	Exports		Imports	
	Without agreement	With agreement	Without agreement	With agreement
Argentina	11.0	6.2	11.0	6.4
Brazil	7.0	1.7	11.0	4.9
Uruguay	9.0	4.9	11.0	1.1
Paraguay	12.0	9.9	11.0	4.8
Average	***8.2***	***3.2***	***11.0***	***5.7***

Source: Chilean Economy Ministry.

Tariffs will be reduced according to the category in which each product has been placed. These categories are as follows:

- General Tariff Reductions (GTR): The tariffs on these products will be reduced linearly from the first until the eighth year, starting with a rate of 40%.

- Sensitive (S): The tariffs on these products will initially be reduced by 30%. This rate will be maintained until the third year, after which it will be reduced linearly until year 10. In terms of Chile’s exports to MERCOSUR, products in this category include a number of fresh or processed fruits and vegetables; methanol; wood, paper and cellulose products; some iron and steel products; toys; bicycles; and vacuum cleaners. For its part, Chile has placed in this category sensitive products such as maize, sorghum, leather products and iron and steel goods.

- Specially Sensitive (SS): The tariffs on these products will not be reduced for the first three years, after which they will be reduced linearly until year 10. MERCOSUR has included in this category items such as fresh and refrigerated tomatoes, chipboard, women’s stockings and refrigerators. Chile included denim textiles, bathroom and kitchen fabrics, and shoes with rubber soles.

- Exceptions (E): Tariffs for these products will be reduced from year 10, and the reductions will be linear until year 15. MERCOSUR included in this list of exceptions a number of fresh and processed fruit and vegetable products, paper products and automobiles. Chile included meat, oilseeds, rice, tractors, automobiles and vehicles.

- In the case of imports from Chile, three products enjoy special treatment: sugar, tariffs for which will be reduced from year 11 until year 16; and wheat and wheat flour, tariffs for which will be reduced in year 18.

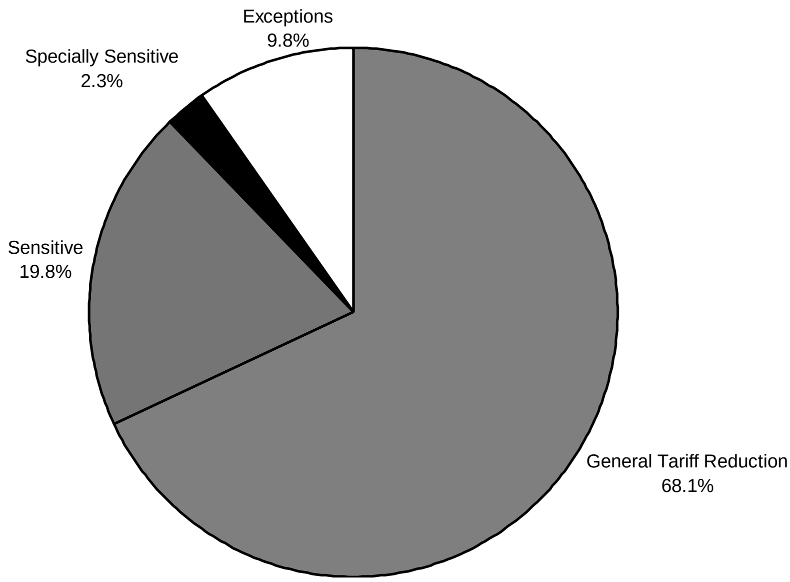
As Table 2 and Graph 3 show, some 70% of Chilean exports to MERCOSUR will be subject to general tariff reductions, compared to only 19.8% which will be subject to the sensitive products regime. Only 2.3% and 9.8% of exports, respectively, are classified as specially sensitive or exceptions.

TABLE 2
TARIFF REDUCTION CATEGORIES FOR CHILEAN EXPORTS
(percentages)

Category	Initial preference (%)	Agriculture (%)	Mining (%)	Industry (%)	Total (%)
GTR.	100	27.5	60.7	20.3	34.3
GTR.	90	7.1	0.0	2.4	2.0
GTR.	80	0.2	0.1	1.1	0.7
GTR.	70	2.5	0.0	1.2	0.9
GTR.	60	2.3	0.0	1.7	1.2
GTR.	50	0.0	0.1	0.4	0.3
GTR.	40	1.3	38.9	26.7	28.8
Total GTR		**41.0**	**99.7**	**53.8**	**68.0**
S	30	16.1	0.3	31.4	19.8
SS	0	2.0	0.0	3.7	2.3
E	0	40.9	0.0	11.1	9.8

Note: GTR., General Tariff Reduction; S, Sensitive; SS, Specially Sensitive; E, Exceptions.

GRAPH 3
EXPORTS ACCORDING TO TARIFF REDUCTION LIST



In the productive sector, tariffs will be reduced more slowly in the case of agricultural exports, where only 27.5% of goods qualify for general reductions. In contrast, 40.1% are exempt, with tariff reductions for these products beginning only in the tenth year of the agreement.

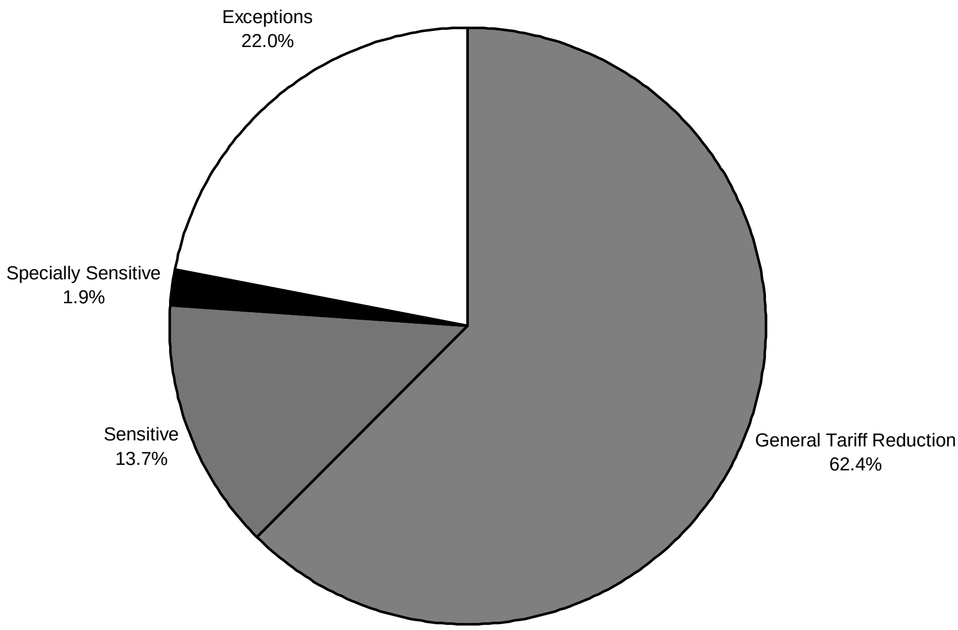
Nearly all mining products are in the general reductions category. As such, the benefits of the agreement will become immediately apparent. Moreover, some 60.7% of mining exports receive or will maintain an initial preference of 100%, and will therefore have tariff free access within MERCOSUR.

The tariffs on industrial products will not be reduced as rapidly as those for mining exports, but less slowly than those for the agricultural sector. Some 53.8% of industrial exports are classified in the general reductions category, with 20.3% receiving an initial preference of 100%. Nevertheless, a relatively high proportion (11%) are classified as exceptions.

This suggests that in the case of mining products, those which in most cases were already subject to low tariffs and a high degree of preference should have few difficulties of access to the MERCOSUR market. Mining products should also enjoy relative benefits, albeit to a lesser degree, given that prior to the agreement they faced high tariffs and very few preferences. In the case of agricultural products, there are unlikely to be any significant changes in terms of exports, since only a small proportion of these products will initially experience significant tariff reductions.

In terms of Chilean imports from MERCOSUR, 62% are in the general reductions category, 14% are sensitive, 2% are specially sensitive and 20% will have tariffs reduced over 15 years (graph 4).

GRAPH 4
IMPORTS ACCORDING TO TARIFF REDUCTION LIST



3. THE DEVELOPMENT OF TRADE FLOWS

3.1 Chilean exports to MERCOSUR

Significant changes in the relative importance of Chile's main trading partners can be observed over recent decades. The EU, for example, accounted for nearly half the country's exports in 1975, compared to only 23.9% in 1996.

In contrast, there has been a sharp increase in exports to the Asian countries. Japan, Chile's main trading partner in Asia, accounted for 16.2% of all Chilean exports in 1996, compared to 11.2% in 1975. Taking into account the main countries in the Asia-Pacific region, the extraordinary dynamism of exports to these markets has resulted in the region's share of Chilean sales increasing from 17.6% in 1985 to 32.3% in 1996.

MERCOSUR has recovered relative importance as a market for Chilean exports over the last decade. Between 1975 and 1985, the share of Chilean exports going to the countries which now form MERCOSUR fell from 16.4% to 8.2%. However, MERCOSUR's relative importance has increased over recent years, accounting for 11.5% of total Chilean sales in 1996. In general, MERCOSUR's loss of share in the 1980s is the result of the recession and balance of payments crisis which hit many Latin American countries during this period, especially those which are now MERCOSUR members.

Two observations can be made with respect to Chilean exports to MERCOSUR. First, Argentina and Brazil are the most important partners in the bloc, respectively accounting for 4.6% and 6.1% of Chile's total exports. In contrast, sales to Paraguay and Uruguay each account for less than 0.5% of the country's foreign sales .

Second, fluctuations in Chilean exports to MERCOSUR can be explained almost entirely by the trends in exports to Argentina, whose share of Chilean exports fell from 10% in 1975 to 2.2% in 1985, and then increased to 4.6% in 1996. In contrast, Brazil's share has been relatively stable at around 6%. The fluctuations have also been minor in the other two countries.

TABLE 3
MAIN EXPORT MARKETS
(percentages)

Destination	1975	1985	1996
European Union	**47.0**	**35.1**	**23.9**
Latin America	**23.2**	**13.2**	**18.0**
MERCOSUR	**16.4**	**8.2**	**11.5**
Argentina	10.0	2.2	4.6
Brazil	5.9	5.5	6.1
Paraguay	0.1	0.2	0.4
Uruguay	0.4	0.3	0.4
NAFTA	**10.6**	**24.9**	**18.5**
Canada	1.2	2.0	0.9
United States	8.8	22.8	16.6
Mexico	0.6	0.1	1.0
Asia Pacific	**n.a.**	**17.6**	**32.2**
Japan	11.2	10.3	16.2

Source: Chilean Central Bank.

3.2. The composition of exports

The traditional literature on international trade emphasizes the notion that trade patterns depend on the comparative advantages available to countries. These comparative advantages are determined by the relative availability of productive factors. Since Chile is a country rich in natural resources, it is clear that its exports will consist mainly of goods intensive in this factor, and that, the relative importance of industrial goods which are not natural resource-intensive should be considerably less.

Analysis of the composition of total Chilean exports to some extent confirms the conclusions of the traditional literature. Some 57% of exports consist of primary natural resources in the agricultural, forestry, fishery and mining sectors. Of these, the mining sector, which accounts for 50% of total exports, is the most important, with copper representing around 40% of total sales (table 4).

The industrial sector has over time become increasingly important in export terms. Its relative importance has increased from 32.9% of total sales in 1990 to 42.3% in 1996. Of total industrial exports, those which are directly based on natural resources represent the largest share. If the export of foodstuffs (primarily agro-industrial and fishery) and forestry products (wood, wooden furniture, cellulose and paper) are included, these natural resource-based goods account for around 68.1% of all industrial exports.

TABLE 4
COMPOSITION OF EXPORTS
(percentages)

Type of Product	1990	1991	1992	1993	1994	1995	1996
Agriculture, fruit and livestock	**9.9**	**12.5**	**11.3**	**10.9**	**9.7**	**8.2**	**10.0**
Agriculture	1.3	1.2	1.3	1.3	1.2	1.0	1.0
Fruit	8.3	11.0	9.8	9.4	8.3	7.1	8.7
Livestock	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Forestry	**0.9**	**0.7**	**0.6**	**1.4**	**1.0**	**0.9**	**0.7**
Fishery	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
Mining	**56.0**	**48.3**	**46.7**	**43.0**	**44.0**	**48.6**	**46.1**
Copper	46.1	39.6	38.6	35.4	36.0	40.4	38.2
Rest	9.8	8.7	8.1	7.6	8.1	8.1	7.9
Industry	**32.9**	**38.0**	**41.0**	**44.1**	**44.7**	**41.8**	**42.3**
Food	13.5	16.1	17.3	17.4	16.8	16.0	17.7
Beverages, alcohol and tobacco	1.0	1.3	1.6	1.8	1.6	1.4	2.2
Textiles and clothing	0.9	1.0	1.1	1.5	1.3	0.9	1.1
Leather and footwear	0.3	0.5	0.3	0.4	0.2	0.2	0.2
Forestry products and wooden furniture	4.3	4.7	4.1	5.2	5.0	4.5	4.7
Cellulose, paper, editorial and print prod.	4.9	4.9	6.8	6.6	7.9	9.9	6.2
Basic and processed chemical products	4.7	5.6	5.0	5.7	6.3	5.0	5.0
Earthenware, china and glass products	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Basic iron and steel industry	1.4	1.5	1.6	1.5	1.4	1.3	1.3
Metal products, machinery and equipment	0.8	1.1	1.4	1.7	1.9	1.4	2.3
Transport material	0.7	0.6	1.0	1.7	1.7	0.9	1.2
Other unspecified industries	0.1	0.5	0.5	0.6	0.3	0.2	0.2
Others	**0.1**	**0.2**	**0.3**	**0.4**	**0.3**	**0.3**	**0.7**

Source: Author's calculations based on data from the Chilean Central Bank.

An examination of the composition of exports to MERCOSUR reveals that these are relatively different to the composition of total exports. This is because the comparative advantages vary according to the economy of the country of destination. Given that the relative endowment of factors in the Latin American economies is similar, trade flows are likely to be intra-industrial in nature. Of total exports to MERCOSUR, therefore, 58.6% are industrial goods. This relative importance is substantially greater than is the case for exports to the more developed countries. Of total exports to the NAFTA countries, industrial sales account for 36.7%, Asia-Pacific for 37.9% and the European Union for 28.6% (table 5).

Industrial exports to the more developed countries consist principally of natural resource-based processed products such as food, wood and furniture, and cellulose and paper. In contrast, industrial exports to MERCOSUR consist more of products with greater value-added, especially editorial and print products (6.8%), chemical products (8.4%), metal products (5.9%) and transport material (4.2%). Moreover, the export of primary products to MERCOSUR is of less importance than those to other markets. Primary goods exports to MERCOSUR account for 41.4% of total exports, compared to 63.3% for NAFTA, 62.1% for Asia-Pacific and 71.4% for the European Union.

TABLE 5
COMPOSITION OF EXPORTS BY TRADE PARTNER, 1995
(percentage of total)

ISIC Sector	Description	MERCOSUR	NAFTA	Asia Pacific	European Union
	Primary products	**41.4**	**63.3**	**62.1**	**71.4**
111	Agriculture	1.9	2.2	0.2	1.4
112	Fruit	5.4	20.0	0.8	6.9
113	Livestock	0.7	0.1	0.0	0.1
120	Forestry	0.0	0.1	2.1	0.3
130	Fishery	0.0	0.2	0.2	0.2
220	Mining	33.3	40.7	58.6	62.4
	- Copper	29.3	27.6	54.3	50.9
	- Rest	4.0	13.1	4.3	11.4
	Industrial products	**58.6**	**36.7**	**37.9**	**28.6**
311	Food	12.7	16.5	19.6	9.5
313	Beverages and alcohol	0.9	2.4	0.1	1.4
314	Tobacco	0.1	0.3	0.0	0.0
321	Textiles	1.4	0.9	0.1	0.3
322	Clothing	0.8	0.5	0.0	0.1
323-324	Leather and footwear	0.5	0.4	0.0	0.1
331-332	Forestry products and wooden furniture	1.2	7.3	7.7	0.8
341	Cellulose and paper	9.3	1.7	9.1	12.2
342	Editorial and print products	6.8	0.2	0.0	0.0
351-352	Chemical products	8.4	2.5	0.9	3.0
353	Refined oil and by-products	1.0	0.1	0.0	0.0
355	Rubber	0.6	0.4	0.0	0.0
356	Plastics	1.2	0.2	0.0	0.0
361-362-369	Earthenware, china and glass	0.2	0.4	0.0	0.1
371	Iron and steel basic industries	0.1	0.2	0.0	0.0
372	Non-ferrous metals basic industry	0.2	0.6	0.1	0.6
381	Metal products	5.9	0.6	0.2	0.1
382	Machinery and equipment	1.3	0.4	0.1	0.1
383	Electrical material	1.4	0.3	0.0	0.0
384	Transport material	4.2	0.2	0.0	0.2
385	Profes. and ophthalmological equipment	0.1	0.1	0.0	0.0
390	Other manufactures	0.3	0.5	0.0	0.1

Source: Author’s calculations based on data from the Chilean Central Bank.

3.3 Chilean imports from MERCOSUR

Chile's foreign trade is diversified not only in terms of the destination of its exports, but also of the source of its imports. The country does not import most of its goods from a specific supplier. As shown by Table 6, the NAFTA countries are Chile's main import source, accounting for 31.4% of all Chilean imports. As with its exports, the United States represents the most important supplier within the bloc, accounting for 23.7% of total imports.

The Asian countries are becoming an increasingly important source for Chilean imports, as well as for its exports. However, unlike Chilean exports to Japan, imports have remained relatively stable. This implies greater dynamism in imports from other countries in the region, boosting Asia-Pacific's participation from 10.2% in 1985 to 15.3% in 1996.

Given the nature of the four economies which make up MERCOSUR, it is clear that the bloc's share of Chilean imports is much greater than its share of Chilean exports. Moreover, as is evident from Table 6, imports have tended to increase regularly during this period. In 1975, imports from these four countries accounted for 12.8% of total Chilean imports, compared to 14.1% in 1985 and 16.2% in 1996.

As with exports, Chilean purchases from Argentina have experienced strong fluctuations. Argentina's share of Chilean imports stood at 7.0% in 1975, falling to 3.9% in 1985 and increasing to 9.4% in 1996. By contrast, Brazil's share increased from 5.4% in 1975 to 9.1% in 1985, falling to 6.1% in 1996. The Paraguayan and Uruguayan shares of total Chilean imports have remained stable at under 0.5%.

TABLE 6
MAIN IMPORT MARKETS
(percentages)

Destination	1975	1985	1996
European Union	**22.7**	**23.9**	**20.4**
Latin America	**26.4**	**28.2**	**21.9**
MERCOSUR	**12.8**	**14.1**	**16.2**
Argentina	7.0	3.9	9.4
Brazil	5.4	9.1	6.1
Paraguay	0.1	1.0	0.4
Uruguay	0.3	0.1	0.3
NAFTA	**33.0**	**26.6**	**31.4**
Canada	2.4	2.2	2.4
United States	29.1	23.9	23.7
Mexico	1.5	0.5	5.3
Asia-Pacific	**n.a.**	**10.2**	**15.3**
Japan	5.1	6.9	5.5

Source: Author's calculations based on data from the Chilean Central Bank.

3.4 Composition of imports

In terms of the composition of imports, Chile's main purchases correspond to productive inputs **,** with intermediate goods accounting for 54.1% of total imports, capital goods for 27.2%, and consumer goods for 17.6%.

As with exports, there are significant differences in the composition of imports by source. The main products imported from the NAFTA countries and the European Union are capital goods (more than a third) or intermediate goods (nearly 50%). In the case of the main Asia-Pacific countries, the principal imports are consumer goods (more than 40%). In contrast, imports from MERCOSUR consist mainly of intermediate goods, which account for three quarters of total imports from the bloc.

In the case of consumer and capital goods, however, there is little variation in the composition of imports between the partners. In all cases, the largest share consists of metal products, machinery and equipment. As regards intermediate products, the share of goods such as oil and coal (17.6), chemicals (13.9%), foods, beverages and tobacco (13.1%) and basic metal industries (8.6%) is greater than in other sectors.

TABLE 7
COMPOSITION OF IMPORTS BY TRADE PARTNER, 1995
(Percentage of total)

Product	MERCOSUR	NAFTA	Asia Pacific	European Union
Consumer goods	**10.2**	**13.1**	**44.2**	**17.2**
Agriculture and livestock	0.1	0.0	0.0	0.0
Food, beverages and tobacco	2.4	0.6	0.5	1.2
Textile and clothing industry	1.8	1.1	8.5	2.4
Wood industry	0.1	0.2	0.5	0.4
Paper industry	0.5	0.5	0.1	0.8
Chemical industry	1.4	1.8	1.0	2.7
Non-metal minerals industry	0.2	0.1	0.6	0.5
Metal, machinery and equip. Industry	3.4	8.2	29.7	8.5
Other unspecified industries	0.4	0.6	3.4	0.8
Capital goods	**16.1**	**37.0**	**28.8**	**35.0**
Textile and clothing industry	0.1	0.0	0.6	0.2
Wood industry	0.0	0.2	0.0	0.1
Metal, machinery and equip. Industry	16.0	36.4	28.1	34.7
Other unspecified industries	0.0	0.4	0.1	0.0
Intermediate goods	**73.6**	**49.8**	**27.0**	**47.7**
Agriculture and livestock	2.8	3.8	1.0	0.2
Fishery	0.0	0.0	0.0	0.1
Oil and coal	17.6	0.7	0.9	0.0
Other minerals	0.2	2.6	0.1	0.1
Food, beverages and tobacco	13.1	1.0	0.2	1.3
Textile and clothing industry	4.6	2.7	4.3	2.4
Wood industry	0.2	0.2	0.1	0.8
Paper industry	3.8	3.3	0.4	4.3
Chemical industry	13.9	17.3	6.5	17.8
Non-metal minerals industry	2.1	0.7	0.2	1.3
Basic metals industry	8.6	2.9	1.5	4.3
Metal, machinery and equip. industry	6.5	14.1	11.5	14.8
Other unspecified industries	0.2	0.2	0.4	0.2

Source: Author’s calculations based on data from the Chilean Central Bank.

4. ANTICIPATED EFFECTS OF THE AGREEMENT ON THE CHILEAN ECONOMY[6]

A free trade agreement can have either static or dynamic effects. The former are short-term changes in trade flows, output, employment, well-being, etc., caused by the reallocation of productive resources once trade barriers are reduced or eliminated. However, greater trade integration is also likely to have longer-term effects on the economy; the so-called dynamic integration effects. With respect to trade, the dynamic effects are associated with the possibility of including new products in the export supply, once prohibitive trade barriers are eliminated or new comparative advantages are developed in sectors able to exploit economies of scale. Even more importantly, however, trade integration might affect economic growth, if it can have a positive impact on technological innovation, productivity and the accumulation of factors.

4.1 Static effects

From the static viewpoint of well-being, a determining variable in analyzing the usefulness of an FTA is the relative degree of trade diversion *vis-à-vis* trade creation. The creation of trade increases the well-being of those partners involved, while trade diversion reduces it. The overall impact on well-being will therefore depend on the scale of both effects.

Wonnacot and Lutz [1988] emphasize two relevant variables to determine the possible extent of these effects: the scale of trade barriers and the nature of the partners. With regard to trade barriers, Chile's 11% tariff is relatively high by current standards and any reduction is therefore likely to create trade between the signatories to the agreement. However, since Chile's tariff on those products imported from the rest of the world remains constant, a high degree of preference is bestowed on the MERCOSUR countries. This increases the possibility of considerable trade diversion.

With regard to the nature of the partners, it has traditionally been suggested that trade diversion was likely to be more limited in an FTA between so called "natural" trade partners: that is, those with substantial levels of bilateral trade prior to the agreement and which are geographically close to each other (in other words, where there are low transport costs between the signatories to the agreement).

In view of these two factors, the FTA with MERCOSUR appeared to imply considerable trade diversion, since the bloc is a relatively unimportant trade partner for Chile and is far from being a "natural" partner, despite the geographical proximity. As the previous section demonstrated, Chilean trade flows are highly diversified in terms of the destination of its exports and the origin of its imports.

Before the agreement came into force (data for 1995), the MERCOSUR countries were an important source of Chilean imports, accounting for 17.4% of the total. However, their relative importance was overshadowed by NAFTA, which accounted for 30.7%, and the European Union, with a 20.6% share. Moreover, the United States alone, with 24.7%, accounted for a greater share than MERCOSUR.

The arguments about the role of natural partners and transport costs have recently been challenged by Bhagwati and Panagariya [1996]. By deviating from the traditional view of constant production costs and perfect competition they present models which contradict the assumptions mentioned above. It therefore seems relevant to discuss the degree to which goods from different suppliers can be substituted, as a more precise measure of the potential extent of trade creation and trade diversion.

[6] For a more detailed discussion of these effects see Alvarez y Fuentes [1997].

It might be expected that the degree of substitutability between imports from MERCOSUR and those from other important markets for Chile – such as the NAFTA countries, the European Union or Asia-Pacific – is relatively low, since the composition of imports from these suppliers is quite different. As Table 7 shows, imports from MERCOSUR are mainly intermediate goods. Imports from NAFTA and the European Union, by contrast, basically consist of capital goods, while those from Asia-Pacific are made up primarily of consumer goods. Moreover, the composition of intermediate goods imports from MERCOSUR is different from those originating in other countries.

As regards the possible impact on Chilean exports to MERCOSUR, the agreement can benefit the country in two ways. First, it allows tariff preferences to be maintained for a significant number of products exported to MERCOSUR. Without the agreement, these would have faced an increase in tariffs, with negative effects on exports to these markets. Muchnick *et al* [1996] have calculated that in the Chilean agricultural sector alone, the benefits have totaled around US$ 300 million. Of this total, 67% corresponds to savings arising from the elimination of preferences which Chilean agricultural products received in these countries.

A second benefit of the agreement concerns the lowering of tariffs as stipulated in the tariff reduction program, which will lead to an increase in Chilean exports towards the MERCOSUR countries. However, the potential growth of exports to MERCOSUR will be quite limited, since the average tariff which Chilean products faced in these markets prior to the agreement was relatively low (8.2%). Considering the supply elasticity of Chile's exports, calculated by De Gregorio [1984] as being between 1 and 1.6, and a total reduction of tariffs, it is possible to estimate that exports to MERCOSUR will increase between 17% and 22%, resulting in an increase in Chile's total exports of between 1.8% and 2.4%. An increase on this scale is unlikely to have a great effect on output and employment.

Although the potential aggregate impact of the increase in exports will be relatively small, the existence of a differentiated tariff in MERCOSUR means that some export sectors, especially those corresponding to manufactured goods, could benefit significantly from the reduction and eventual elimination of tariffs. For example, clothing exports to Argentina face a 19.6% tariff, furniture one of 15% and metal products 14.4%. In these sectors, the growth potential of exports is quite high. Alvarez and Benavente [1996] have calculated that a total reduction in tariffs for Chilean products exported to Argentina would lead to an increase of 74.5% in the export of clothing, 55.4% in furniture products, and 52.9% in metal goods exports.

Apart from these effects on trade, an agreement of this kind benefits Chilean exporters in other ways, although these are more difficult to quantify. By establishing norms to resolve disputes and preserve the stability of rules governing trade, the agreement reduces the vulnerability of exports. An examination of the historical development of trade policy in the countries of Latin America demonstrates that it has been strongly influenced by domestic economic problems. When faced with current account problems, for example, governments have resorted to temporary trade barriers, which have damaged the competitiveness of Chilean suppliers to these markets. Despite the fact that an association agreement does not completely eliminate this possibility (as shown by the recent measures adopted by Brazil), it does reduce the prospect of such measures being adopted and helps maintain clear and stable trade rules.

4.2. Dynamic effects

The trade integration literature demonstrates that the dynamic effects appear to be more important than the static for analyzing the impact of an FTA. In general, estimates of a static nature show that integration processes have relatively little impact on an economy. In the Chilean case, for example, Larraín and

Coeymans [1994] have suggested that an FTA with the United States would lead to an increase of only 0.3% in output in the short term.

Static models provide relevant information on the short-term impact of an FTA. However, it must be noted that the results obtained with this kind of methodology are only estimates of one-off changes in output levels, which implicitly ignore the possible effects of integration on economic growth rates. Estimates of this kind might therefore be underestimating the real impact of trade integration.

If an FTA can have a positive impact on economic growth, its implementation would translate into considerable benefits for the economy involved, This is because any economic policy which affects economic growth rates, even moderately, can over time have substantial impact on per capita income. A series of factors, such as technological innovation, domestic and foreign investment, learning processes and economies of scale – which affect economic growth – can be influenced by the establishment of an FTA.

In general, the most important dynamic effects of an FTA are those associated with the exploitation of economies of scale; increases in technical efficiency and productivity, as a result of greater competition stemming from the agreement; enhanced possibilities for absorbing foreign technologies; access to cheaper capital goods; and increases in domestic and foreign investment.

In the case of the association between Chile and MERCOSUR, the most important dynamic benefits which the Chilean economy is likely to experience include:

- Exploiting economies of scale in the manufacturing sector. This will accelerate productivity growth or develop competitiveness in new lines of production. As is argued below, this is particularly valid in the context of trade with MERCOSUR, since a greater level of intra-industrial manufacturing trade already exists in comparison to other regions

- Increases in investment flows, both domestic and foreign, owing to guaranteed access to a market which is significantly larger than the Chilean market.

4.2.1 Economies of scale and intra-industrial trade

Trade integration enables producers to exploit domestic and external economies of scale, since it increases the size of the relevant market for domestic companies and industries, encouraging a greater division of labor and thereby improving levels of technical efficiency in production. In this case, the possible effects on economic growth are based on the literature on endogenous growth, which highlights economies of scale as a mechanism for permanent growth. Empirically, these external economies are easier to find at the manufacturing industry level than at the primary sectors level. Intra-industrial trade which concentrates on manufacturing products is better placed to trade in differentiated products subject to economies of scale. Moreover, this type of trade enhances the possibilities for trading in specialized inputs, which would positively affect the economic growth of a country through improvements in the quality of existing inputs, or an increase in the variety of such products.

From this perspective, a trade agreement with MERCOSUR could potentially be more beneficial for Chile than for other integration schemes. This is because – as can be expected from countries with similar development levels and a similar relative endowment of factors – there is a greater degree of intra-industrial trade (which is concentrated in the manufacturing sector) with MERCOSUR than with Chile’s other partners.

The Grubel and Lloyd index has been used to determine the level of intra-industrial trade:

$$GL_k = \frac{\sum_{i}^{I} (X_{ik} + M_{ik} - |X_{ik} - M_{ik}|)}{X_k + M_k}$$

where X_{ik} represents exports of industry i to country k, M_{ik} represents imports of industry i originating in country k, X_k represents total exports to country k and M_k represents total imports from country k.

If trade is principally intra-industrial, only exports or imports in each industrial sector would exist, and the numerator and index would tend to be zero. In contrast, the greater the intra-industrial trade flows, the numerator would tend toward ($X_k + M_k$), and the index would consequently approach 1. In short, the closer this index is to 1, the greater the level of intra-industrial trade.

The Grubel-Lloyd index is higher in trade with MERCOSUR than with Chile's other partners if the industrial sector trade flows to three digits is used, according to the International Standard Industrial Classification (ISIC). As shown by table 8, the index has a value of 0.526 for Chile's trade with MERCOSUR, much higher than the value of 0.202 with the European Union, 0.130 with NAFTA and 0.046 with Asia Pacific.

The importance of intra-industrial trade for economic growth, through the use of economies of scale and trade in specialized inputs, has been documented by Backus *et al* [1992]. These authors, using panel data from 1970-1985, find that the level of intra-industrial trade, measured by the Grubel-Lloyd index, has had a positive and significant influence on the growth rate of manufacturing products per worker. This evidence suggests that increased intra-industrial trade, encouraged by trade integration, would lead to higher growth rates in the manufacturing sector, above that generated by the reallocation of resources. Considering the evidence presented in table 8, this effect will tend to be considerably more important in the trade agreement with MERCOSUR than in the agreements signed with Chile's other main trade partners.

TABLE 8
INTRA-INDUSTRIAL TRADE INDEX, 1995

Trade partner	Grubel-Lloyd index
MERCOSUR	0.526
European Union	0.202
NAFTA	0.130
Asia Pacific	0.046

Source: Author's calculations based on date from the Chilean Central Bank.

4.2.2 Domestic and foreign investment

There is ample empirical literature to show that investment rates are one of the main determinants of economic growth. Studies by Corbo and Rojas [1992] and De Gregorio [1992] on the determinants of economic growth in Latin America confirm a positive link between investment rates and long-term economic growth.

With respect to foreign direct investment (FDI), De Gregorio [1992] demonstrates that the growth rates of Latin American countries have been positively affected by the level of FDI in the GDP. Moreover, his calculations lead to the conclusion that a one-point increase in the FDI/GDP ratio has a greater impact on the growth rate than a one-point increase in the national investment rate (investment/GDP). This finding is consistent with the significant effect that FDI has on the process of technological absorption in less developed countries, through the incorporation of new production, administrative and marketing techniques.

In view of this evidence, it is likely that an FTA could have a positive impact on economic growth rates if it leads to an increase in domestic or foreign investment. In the case of domestic investment, the net impact of an FTA depends on the level of investment in sectors which expand and contract with the agreement. *A priori* it is impossible to determine if the growth of investment in the export sectors will be higher than the probable reduction of investment in the import-substituting sectors. In the long term, there is likely to be an expansion of investment in the export-oriented manufacturing sectors, and a contraction of investment in the traditional farming sectors. In general, the sectors which will expand with the agreement will have access to larger markers and will therefore develop economies of scale. On the other hand, those sectors which will contract are likely to be traditional and oriented toward the domestic market. Moreover, the agreement will lead to a greater degree of intra-industrial specialization. For these reasons, it is very likely that the total volume of domestic investment, as well as productivity, will increase.

As regards the likely effects on FDI flows, trade integration will probably lead to increases in investments from non-member countries. While the prime effect for country risk largely explains the likely benefits of an FTA with the United States**,** according to Larraín and Coleman [1994] the positive effects of an FTA with MERCOSUR can be explained by the fact that the agreement will allow goods produced in Chile tariff-free access to a market substantially larger than Chile's own. The population of MERCOSUR is 14.5 times larger than Chile's, and its GDP is 11.5 times bigger (Chilean Foreign Ministry [1996] p. 39). These effects are unlikely to be as great with Chile's accession to NAFTA, because the North American countries are geographically further away and the high transport costs offset the advantages of the preferential benefits which locating in Chile would imply.

4.2.3 Integration through FDI

Reciprocal FDI is one of the most novel aspects of the Chile-MERCOSUR association. Thus far, investment by Chilean companies in the MERCOSUR countries has been much greater than MERCOSUR investment in Chile, although the latter is on the increase. Such investments are promoting the real integration of the MERCOSUR and Chilean economies, far beyond mere trade links.

As Table 9 demonstrates, a high proportion of Chilean FDI (69%) is directed toward the MERCOSUR countries, primarily Argentina (57.5%) and Brazil (10.8%,).

TABLE 9
CHILEAN FOREIGN INVESTMENT
Country of destination

Country	1st half 1997 (US$ millions)	%	1990-1997 (US$ millions)	%
MERCOSUR	**1,858.7**	**68.5**	**12,180.2**	**69.0**
Argentina	1,338.2	49.3	10,148.9	57.5
Brazil	508.4	18.7	1,900.7	10.8
Paraguay	12.0	0.4	92.5	0.5
Uruguay	0.1	0.0	38.1	0.2
Venezuela	423.1	15.6	670.5	3.8
Peru	260.1	9.6	2,616.2	14.8
Colombia	33.0	1.2	1,085.7	6.2
China	30.0	1.1	30.0	0.2
Bolivia	29.1	1.1	338.1	1.9
Others	77.9	2.9	732.4	4.1
TOTAL	**2,711.9**	**100.0**	**17,653.1**	**100.0**

Source: Chilean Foreign Investment Committee.

Trade integration can prompt stronger FDI flows from Chilean companies to the MERCOSUR countries. First, trade growth will lead to investment in certain services, in particular the financial sector, since there is already a kind of complementarity between trade flows and some services (such as financial services), in which Chilean firms have developed comparative advantages. Moreover, it is important to note that Chile's new capital markets law allows Chilean banks to invest abroad, and it is very likely that these will first invest in the MERCOSUR countries.

Second, as manufacturing exports to MERCOSUR increase, Chilean companies will feel inclined to invest in these markets. The need to develop client services and adapt their products to the specific demands of consumers will boost Chilean FDI in MERCOSUR. This phenomenon is common at the global level, and it is likely that the same will happen in Chile's economic relations with MERCOSUR.

Third, as an FTA with MERCOSUR will boost intra-industrial trade between Chile and the bloc, it is also probable that intra-industrial investment will increase. It is worth noting that trade integration generally leads to increased reciprocal investment flows in industrial sectors of a similar type. For its part, investment in manufactures leads to new intra-industrial trade flows, in a kind of virtuous circle. Chilean firms investing in MERCOSUR are likely to be supplied with products produced in Chile, and vice-versa.

These three factors suggest that those sectors benefiting from Chilean investment in MERCOSUR will tend toward the financial and manufacturing sectors. However, energy-generating and -distributing companies could actively participate in the expected privatization of these sectors in Brazil.

In contrast, FDI flows from MERCOSUR represent only 2.8% of Chile's total FDI inflows Chile (see Table 10). The main sources of FDI are the United States and Canada, which provide 39.3% and 17.6%, respectively. Again, it can be expected that firms based in MERCOSUR will combine their increased exports to Chile with larger FDI flows, and that greater intra-industrial trade between MERCOSUR and Chile will result in new and larger investment flows from the country's main partners.

TABLE 10
FOREIGN INVESTMENT IN CHILE
Country of origin

Country	1st half 1997 (US$ millions)	%	1990-1997 (US$ millions)	%
MERCOSUR	**42.1**	**2.0**	**482.4**	**2.8**
Argentina	29.8	1.4	310.7	1.8
Brazil	8.9	0.4	92.9	0.5
Paraguay	0.0	0.0	0.0	0.0
Uruguay	3.4	0.2	78.8	0.5
United States	449.8	21.7	6,780.7	39.3
Canada	384.8	18.6	3,039.0	17.6
Spain	252.2	12.2	1,004.1	5.8
Cayman Islands	197.2	9.5	473.3	2.7
Australia	172.5	8.3	624.5	3.6
United Kingdom	125.8	6.1	873.9	5.1
Others	446.0	21.5	3,959.3	23.0
TOTAL	**2,070.3**	**100.0**	**17,237.1**	**100.0**

Source: Chilean Foreign Investment Committee.

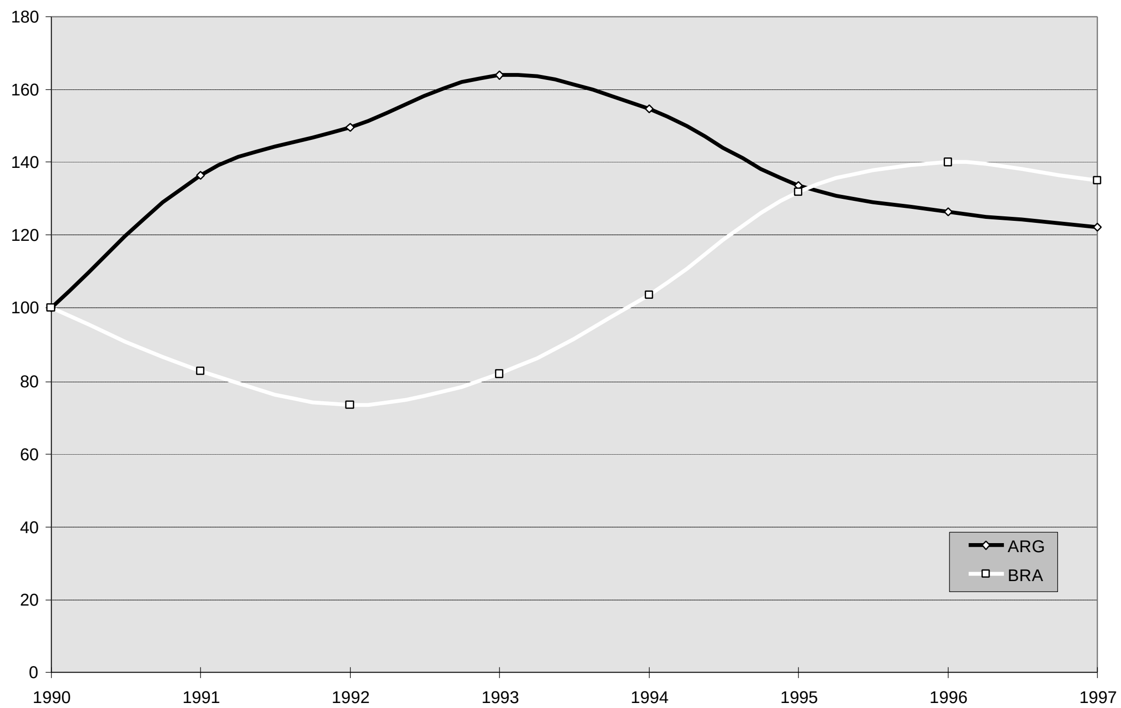
5. THE IMPACT OF THE AGREEMENT: A PRELIMINARY EVALUATION

Since the association agreement came into force only a little over a year ago, it is too soon to assess its effect on trade. The initial reductions in tariffs, although important, have been modest. Moreover, the likely impact on investment will also be difficult to gauge, since these will take time to mature. Furthermore, the fluctuations in MERCOSUR-Chile bilateral trade in 1997 were influenced more by macroeconomic variables (relative growth in Chile and MERCOSUR, and the variations in bilateral exchange rates) than the modest changes in relative prices resulting from reciprocal tariff reductions.

In 1997, the Argentine economy, which absorbs a high percentage of Chile's manufacturing exports, proved an interesting market for Chilean products, growing by 8%. Although Brazil's growth rate fell towards the end of last year, it increased by 3.5% for the year as a whole. On the other hand, the Chilean economy continued to expand rapidly (6.5%). This indicates that macroeconomic conditions had an impact on the growth of bilateral trade.

Bilateral exchange rates helped boost Chilean imports, while having a negative effect on exports (see Graph 5). Preliminary estimates suggest that the Chilean peso appreciated by 6% in real terms against the Argentine peso and the Brazilian real. In terms of the exchange rate with Argentina, this appreciation had been evident since 1993. Chilean products (dominated by manufactures and certain fruit products) have therefore lost competitiveness in Argentina, while Argentine products have substantially improved theirs in the Chilean market. This is reflected in a loss of dynamism which Chilean exports to Argentina have experienced since the early 1990s, as well as in an increase in Chilean imports from Argentina. With respect to the Brazilian real, the appreciation of the Chilean peso is a much more recent phenomenon, evident only since 1996. Its effect on trade is therefore yet to reverse the dynamism of Chilean exports to Brazil. Moreover, Brazil has been losing market share in the Chilean market in recent years.

GRAPH 5
REAL EXCHANGE RATE, CHILE-ARGENTINA AND CHILE-BRAZIL, 1990=100



5.1 The evolution of Chilean exports to MERCOSUR

The evolution of trade flows between Chile and MERCOSUR in 1996-1997 can be analyzed on the basis of the above considerations.[7] Exports grew by 9.2% during this period (see Table 11). However, some important differences emerge from an examination of exports by sector. Exports of industrial goods experienced the most notable growth, expanding by 14.3% during this period. This level of growth is higher than that for mining exports, which increased by 8.6%. In contrast, agricultural exports contracted by 17.3%.

This is consistent with the differences observed in the percentage of products subject to immediate tariff reductions. As was argued in Section 2, mining products already benefited from low tariffs in MERCOSUR and therefore the agreement was not expected to have a significant impact. In contrast, industrial exports in particular were expected to benefit since, in general, they faced substantial levels of protection. Moreover, over 85% received preferences according to the schedule of general tariff reductions and sensitive products, with initial tariff reductions of 40% and 30%, respectively. Disaggregation of the three sectors reveals considerable differences in the evolution of exports to MERCOSUR. In the case of agricultural products, there was a notable decline in fruit exports, which fell by 28.4%. Given its high relative importance in the exports of this sector, this decline is largely responsible for the 17.3% drop in agricultural sales.

In terms of mining products, note should be taken of the significantly different growth rates for copper and the other mining products. The former, which faced virtually no tariffs into MERCOSUR, increased by only 6.9%, while non-copper mining products, where tariffs were higher, grew by 19.9%.

Some industrial products have benefited more than others in terms of sales to MERCOSUR. Some 13 of the industrial sectors shown in Table 11 grew by more than the 14.3% in the sector as a whole. Some sectors, such as textiles (321), electrical material (383) and machinery and equipment (382), grew by more than 40%, and thus comprise a substantial share of total industrial exports to MERCOSUR.

There are also a significant number of sectors with little relative importance. However, if these maintain the dynamism evident in 1996-1997, they could experience an increase in their participation in total exports to MERCOSUR. This is the case with sectors such as basic iron and steel industries (371), which more than doubled their export value, and earthenware, china and glass (361-362-369), whose sales increased by more than 60%.

In the aggregate, the growth of exports to MERCOSUR can be compared favorably with the increase in sales to other trading partners. In 1996-1997, exports to MERCOSUR increased by 9.2%, higher than the rate for exports to other partners such as NAFTA (5.8%) and Europe (6.2%). Although it is the case that during 1997 the Chilean currency appreciated considerably in relation to all Chile's trading partners, in terms of its trade with MERCOSUR this appreciation was to some extent offset by the reduction in tariffs negotiated in the association agreement.

[7] The comparison is made on the basis of the value of exports between January and November of each year.

TABLE 11
CHILEAN EXPORTS TO MERCOSUR, 1995-1997

ISIC	Description	1996 (US$)	1997 (US$)	1997 %	Growth 1997/1996	1996/1995
110-130	**Agricultural**	**168,812**	**139,555**	**8.3**	**-17.3**	**20.5**
111	Agriculture	22,792	29,465	1.8	29.3	-25.5
112	Fruit	138,381	99,031	5.9	-28.4	41.3
113	Livestock	6,784	10,051	0.6	48.2	-42.6
120	Forestry	804	731	0.0	-9.1	10.6
130	Fishery	51	277	0.0	443.1	93.3
210-240	**Mining**	**432,486**	**469,601**	**28.1**	**8.6**	**-19.1**
	Copper	377,240	403,345	24.1	6.9	-18.8
	Other	55,246	66,256	4.0	19.9	-21.5
	Industry	**931,284**	**1,064,1**	**63.6**	**14.3**	**5.7**
311	Food	190,763	214,120	12.8	12.2	1.8
313	Beverages and alcohol	18,404	24,665	1.5	34.0	-12.9
314	Tobacco	946	939	0.1	-0.7	107.8
321	Textiles	28,958	45,288	2.7	56.4	35.2
322	Clothing	12,260	15,128	0.9	23.4	246.8
323-324	Leather and footwear	5,454	3,352	0.2	-38.5	3.1
331-332	Forestry and wood furniture	30,086	33,153	2.0	10.2	64.0
341	Cellulose and paper	114,971	106,744	6.4	-7.2	-21.8
342	Editorial and print products	97,335	104,040	6.2	6.9	-9.7
351-252	Chemical products	120,303	153,229	9.2	27.4	-6.8
353	Refined oil and by-products	9,769	13,184	0.8	35.0	-38.2
355	Rubber	7,560	10,667	0.6	41.1	-34.5
356	Plastics	20,554	26,733	1.6	30.1	7.0
361-362-369	Earthenware, china & glass	4,951	8,162	0.5	64.9	45.9
371	Basic iron and steel industry	3,466	7,403	0.4	113.6	12.4
372	Basic non-ferrous industry	66,791	46,067	2.8	-31.0	80.2
381	Metal products	45,343	55,336	3.3	22.0	5.6
382	Machinery and equipment	47,840	67,705	4.0	41.5	170.8
383	Electric material	30,674	44,332	2.6	44.5	-6.7
384	Transport material	66,221	75,243	4.5	13.6	7.4
385	Prof. and ophthal.equip.	3,173	3,874	0.2	22.1	233.0
390	Other manufactures	5,462	4,777	0.3	-12.5	22.7
Total		**1,532,5**	**1,673,2**	**100.0**	**9.2**	**-1.1**

Source: Author's calculations based on data from the Chilean Central Bank.

Consequently, exports of Chilean industrial products to MERCOSUR compare favorably with those to its other trading partners. In 1997, industrial sales to the MERCOSUR countries grew by 14.3 %, compared to only 6.5% for other regions. The tariff reductions for Chilean goods were more significant for industrial products, which might partly explain the sector's relatively strong export performance. In the mining sector, for instance, exports to the MERCOSUR countries increased by 8.6%, a far smaller rise than those to the rest of the world (17.3%). On the other hand, the 17.3% decline in agricultural exports to MERCOSUR was higher than the 6.1% fall in sales to the rest of the world.

5.2 The evolution of imports

Chilean imports from MERCOSUR were also very dynamic in 1997, increasing by 12.5%, compared to 5.1% in the previous year (see Table 12). Moreover, imports of some products not included in the general tariff reduction list (agricultural goods, iron and steel, transport material) also increased strongly. This corroborates the above argument that macroeconomic conditions were favorable for the development of trade between Chile and its new partners, and in particular for imports from those countries. The fact that Chilean imports from MERCOSUR have increased more than Chilean exports to the bloc is entirely explained by the behavior of bilateral exchange rates. Some sectors were subject to a more accelerated tariff reduction timetable: that is, their tariffs were initially reduced by 30% or above – such as textiles (321), clothing (322), furniture (332), print (342), plastics (356), metal products (381), machinery and equipment (382), electric material (383) and transport material (384). The increase in the imports of products from these sectors was relatively higher than that for total imports, with the exception of the first four sectors. In particular, imports in the plastics, machinery and equipment and electric material sectors increased by more than 20%. A significant increase in imports from MERCOSUR can also be observed for those products in which the initial reduction in the Chilean tariff was below 30%, such as footwear (324) and chemical products (352). Leather and footwear imports increased by 20.3% and chemical products by 12.4%. Again this confirms the argument that changes in the bilateral exchange rates, as well as strong economic growth in Chile in 1997, had an impact as important as that of the tariff reductions.

TABLE 12
CHILEAN IMPORTS 1995-1997

ISIC	Description	1996 (US$)	1997 (US$)	1997 (%)	Growth 1997/1996	1996/1995
	Agricultural	**70,018**	**109,757**	**3.5**	**56.8**	**-6.3**
111	Agriculture	68,604	107,911	3.4	57.3	-5.7
112	Fruit	95	205	0.0	115.8	-89.2
113	Livestock	1,145	1,149	0.0	0.3	10.6
120	Forestry	123	215	0.0	74.8	-49.7
130	Fishery	51	277	0.0	443.1	-51.1
	Mining	**567,826**	**629,302**	**19.8**	**10.8**	**30.3**
	Industry	2,189,530	2,442,064	76.8	11.5	0.0
311	Food	425,554	430,516	13.5	1.2	19.3
313	Beverages and alcohol	8,507	13,203	0.4	55.2	2.8
314	Tobacco	4,996	2,960	0.1	-40.8	-3.5
321	Textiles	113,863	111,685	3.5	-1.9	1.7
322	Clothing	22,835	15,884	0.5	-30.4	75.0
323-324	Leather and footwear	35,155	42,283	1.3	20.3	-7.1
331-332	Forestry and wood furniture	277,862	273,492	8.6	-1.6	10.7
341	Cellulose and paper	55,557	65,693	2.1	18.2	-41.1
342	Editorial and print products	9,957	9,953	0.3	0.0	18.0
351-252	Chemical products	263,895	296,615	9.3	12.4	1.3
353	Refined oil and by-products	51,310	72,184	2.3	40.7	35.1
355	Rubber	31,479	40,794	1.3	29.6	-5.4
356	Plastics	47,803	54,252	1.7	13.5	4.4
361-362-369	Earthenware. china & glass	58,532	57,704	1.8	-1.4	2.2
371	Basic iron and steel industry	133,483	177,738	5.6	33.2	-18.5
372	Basic non-ferrous industry	32,262	40,749	1.3	26.3	-27.1
381	Metal products	92,393	105,811	3.3	14.5	-7.6
382	Machinery and equipment	179,582	234,321	7.4	30.5	-5.3
383	Electric material	61,818	74,641	2.3	20.7	-14.8
384	Transport material	256,895	289,967	9.1	12.9	4.0
385	Prof. and ophthal. Equip.	15,657	17,370	0.5	10.9	25.4
390	Other manufactures	10,135	14,249	0.4	40.6	-3.9
Total		**2,827,3**	**3,180,8**	**100.0**	**12.5**	**5.1**

Source: Author's calculations based on data from the Chilean Central Bank

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