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N° 4



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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 is fostered through the publication of this report in English, as well as in Portuguese and Spanish, the two official languages of the process.

Report N° 4 covers the first half of 1998 and includes the month of July with relevant information from the XIV Meeting of the Common Market Council, the Presidential Summit and the XXX Meeting of the Common Market Group.

This Report has been prepared by Dr. João Bosco M. Machado, UFRJ Professor and FUNCEX researcher in Rio de Janeiro, Brazil with the collaboration of Mr Ricardo A. Markwald, FUNCEX researcher. The main text of the report is complemented by an Appendix on Paraguay and MERCOSUR; an academic article prepared by Mr. Fernando Masi, senior researcher from CADEP in Asunción, Paraguay.

Mr. Juan José Taccone and Mr. Uziel Nogueira, INTAL's Director and Integration Economist respectively, were responsible for the coordination and general and technical editing of the Report.

Following upon the goal and expectations raised in previous issues, readers are encouraged to keep on sending their comments and/or suggestions in order to improve the scope and content of these publications in the future.

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EXECUTIVE SUMMARY

I. Macroeconomic trends

In the first half of 1998, the impact of the Asian crisis on the level of economic activity in the four MERCOSUR countries was, in addition to being reasonably differentiated, much less severe than had been forecast at the end of 1997. However, the sub-regional gross domestic product (GDP), after registering 3.2% growth in 1996 and 4.7% growth in 1997, is expected to register much more modest growth this year, probably less than 3%.

At the end of 1997, it appeared that the MERCOSUR countries were going to be faced with some serious difficulties due to the effect of the Asian crisis on the sub-region. Brazil's adoption of severe fiscal and monetary adjustment measures, as an attempt to slow the loss of foreign exchange reserves and strengthen foreign investors' confidence, led to forecasts of an abrupt drop in the economic activity in the bloc's primary member. The expected contraction of Brazilian imports would inevitably impact the aggregate demand of the other members, thereby promoting a rapid reverse of the economic growth cycle, which began at the end of 1995.

However, the cooling of the Brazilian economy was less severe than expected and the impact on the other members of the bloc was much more diluted. Nevertheless, beginning in May the signs of a slowing in economic activity in the Argentine economy were clear. Soon after, the fragility of the economic situation in Japan and Russia became evident, advancing the possibility of new turbulence. Therefore, it is too early to formulate any more optimistic prognostic in terms of the medium range forecasts for the economies of the MERCOSUR Member Countries.

The sub-region's average inflation rate, measured by the evolution of the consumer price indices of the four members, fell from 6.9% in 1996 to 3.4% in 1997. Last year's more than 50% reduction in the average inflation rate in MERCOSUR occurred in a phase of expansion in sub-regional economic activity, and resulted in a lower dispersion of national indices. In 1998, the results will certainly be less auspicious, without this implying a threat to the increasing stabilization of inflation in MERCOSUR.

In terms of public finances, the recent efforts to promote a reversal of fiscal deficits in MERCOSUR will not result in very significant advances in 1998. The evolution of fiscal accounts in the first half of the year point to a worsening of the deficits in Brazil and Paraguay, while Uruguay and Argentina registered a slight improvement.

Until now the MERCOSUR countries have not been able to harmonize satisfactory economic growth levels with moderate deficits in the current account. The deficits in the foreign accounts have become recurrent, promoting stop and go growth, based on cycles of short duration the amplitude of which tends to be larger in some countries (Argentina and Uruguay) than in others (Brazil and Paraguay). However, the result is only moderate growth for the sub-region as a group, accompanied by a high and growing foreign deficit. The year of 1998 will not be an exception, the foreign deficits are worsening in the two economies which are still in an expansion phase (Argentina and Uruguay), while the deficit in the current accounts is shrinking in the two economies that are in a cooling phase.

The macroeconomic policy in MERCOSUR shows wide convergence in the general lines of actions of the national economic authorities. The stabilization, based on the use of a nominal exchange rate to anchor the price system, the adjustment and fiscal regime reform policies, the reform of the state and particularly the privatization programs constitute the common ingredients of the macroeconomic policies of the sub-region's two main economies, Brazil and Argentina. The macroeconomic policy in Uruguay also shares many of

these characteristics, showing last year greater convergence with the larger members as exhibited by the results. Paraguay's situation is definitely different, but it is likely that the new government will attempt to move its domestic macroeconomic policy closer to the general orientation in the other MERCOSUR countries.

II. Trade and Foreign Direct Investment

In the first seven years after the formation of MERCOSUR, the sub-region's global trade evolved at very high rates of more than 15% per year. The expansion of trade between the members of the bloc was much larger than that registered in trade with non-members. In fact between 1991 and 1997 the extra-zonal trade flows doubled, while the trade between members quadrupled. Consequently, the intra-zonal trade flows currently account for close to 25% of exports and more than 20% of the sub-region's total imports, thereby establishing the bases for an effective interdependence between the MERCOSUR economies.

In 1997, a convergence was registered in the growth rate of intra and extra-zonal trade flows, in both exports and imports. The narrowing of differences is explained primarily by the less vigorous growth of intra-bloc trade, which decreased from an average of 27.3% between 1991-96, to 19.9% last year. This cooling is not surprising, but rather is a natural occurrence from the increased participation of intra-zonal trade flows in the sub-region's global trade. Nevertheless, it is possible that the decreasing rate of expansion in commercial exchanges between the members may be signaling the exhaustion of the initial phase of quick and easy increases in intra-zonal trade.

The MERCOSUR trade imbalance, which increased from US\$ 8.2 billion in 1996 to US\$ 16.7 billion in 1997, also deserves to be registered. The trade deficit doubled despite the improved performance of exports in the four countries, which grew above the average registered over the 1991-96 period.

Since the formation of MERCOSUR, the trade of automobiles, auto-parts, and cargo and transportation vehicles, developed under the protection of special sector regimes, has constituted one of the main axes to sustain bilateral trade between Brazil and Argentina.

In 1997, the sector flows totaled US\$ 4.6 billion, being responsible for more than 31% of bilateral trade. If the expansion rate registered over the first seven months of the year is maintained, the automotive trade between Brazil and Argentina may reach US\$ 5.0 billion in 1998, increasing its percentage of bilateral trade to 33-34%.

In the last three years the sector trade has resulted in trade balances in favor of Argentina, which is expected to be the case in 1998 as well. The breaking up of the automotive trade in sub-sectors suggests the existence of industrial specialization between the members: Brazil dominates the trade of engines and auto-parts, while Argentina registers surpluses in the automobile and cargo vehicle sectors.

The evolution of flows of Foreign Direct Investment (FDI) in 1997 confirms the importance of MERCOSUR as an attractive global pole for foreign capital. Between 1994 and 1997 the growth of FDI in MERCOSUR was above 62% per year.

In terms of the distribution of FDI flows between the bloc's four members, Argentina and Brazil always received more than 95% of the resources directed to the sub-region. Between 1990 and 1994, Argentina by far surpassed Brazil in the dispute for FDI flows directed to MERCOSUR, which highlighted the importance of economic stability as a factor to attract this type of capital. In 1995, the year after the implementation of the Real Plan, the distribution of FDI flows between the two primary members balanced out. However, in the last two years Brazil's participation grew rapidly and in 1997 represented more than 70% of the total resources that entered the sub-region.

III. Market Access and Conditions of Competition

Despite the fact that more than three years have passed since the implementation of the MERCOSUR Customs Union there are still several national policies that have maintained or created new obstacles to the consolidation of the free trade regime in the sub-region. Practices such as the use of trade defense measures to impede intra-zonal imports or the adoption of other non-tariff restrictions to imports, such as the establishment of limits for the financing of imports or the use of a previous license mechanism for imports has generated complaints and disputes in several countries.

In the case of sectors such as the sugar and automobile sectors, for which there are still not common policies for the management of trade and investment, the advances reached in the negotiation process have yet to delineate the format of the rules that will regulate the sectors in the next decade.

IV. Common Policies, Policy Harmonization and other Strengthening Measures

During the last six months, the primary advance of the MERCOSUR integration process, in the area of measures designed to strengthen it, was the approval of the Montevideo Protocol on the Trade of Services in MERCOSUR. The agreement defines the intra-sub-regional framework that will permit the countries to present specific offers so that within a maximum period of ten years the liberalization of services trade program between the countries will be complete.

The requirements and general rules and regulations of the agreement are based on the following principles: (i) “most favored nation treatment,” under which each Member State is required to immediately and unconditionally grant services and service providers from other Member States treatment which is no less favorable than that granted to any other specific partner, within MERCOSUR or under any other international agreement; (ii) “national treatment” under which each Member State is required to grant services and service providers from any other Member State treatment which is no less favorable than the treatment conferred upon its own services or similar service providers; (iii) the non-adoption of measures that set quantitative limits to the number of service providers, the number of total operations, the total value of assets or the service transactions in the form of numerical contingents or that establish restrictions to specific people and legal entities or the participation of foreign companies; and (iv) transparency in terms of all of the domestic measures that may affect intra-bloc services trade. The procurement of governmental purchases does not fall under the principles and rules of the Services Protocol.

The definition of specific commitments to liberalization will be established through successive negotiating rounds designed to complete, within a maximum period of 10 years, the Liberalization Program of services trade between countries. The negotiating rounds will be held annually and their main objective will be the progressive incorporation of sectors, activities and modes of providing services in the Liberalization Program, as well as an increase in the level of specific commitments assumed by the Member States.

V. Infrastructure

One of the challenges of the MERCOSUR integration process is to adapt infrastructure, especially in the areas of transportation, energy and communications, to the requirements and perspectives of development of the economic bloc. By doing so a double objective would be reached: (i) the removal of physical obstacles to the flow of merchandise that currently results in the existence of a limited number of transport routes between the countries in almost all modes of transportation operated in the region, and (ii) the shared use of scarce resources in the energy area, in such a way as to promote an improved adaptation of the consumption pattern of countries to the profile of resource supplies in the bloc.

The attainment of new investments will depend on the capacity of the national governments of making the quality and the price in the provision of services compatible with rates of return sufficient for firms to mobilize private capital. Furthermore, when the region's different countries are analyzed, the process of deregulation and the opening of the infrastructure sector to private capital are at different levels of progress. In Argentina, Bolivia and Chile, the change in the regulatory frameworks has already led to the execution of a number of projects in both energy and transportation, if compared to the situation of Brazil, Paraguay and Uruguay.

It is also necessary to achieve technical improvements with relation to the evaluation on the functionality of the current physical infrastructure to the objectives of sub-regional integration, by means of the creation of a system of integrated planning and exchange of information, specifically in the case of projects which impact the economies as a whole. In the evaluation of these projects the needs of the expanded market and the supply of resources should be taken into consideration. This method is different from that which was employed in the past, when due to a low degree of economic integration in the region, the infrastructure projects were planned and implemented in an independent manner by the countries. No attention was paid to the possibility of synergies that could result from the shared use of resources and from the integration of transportation and energy systems.

In this context, the role of international organizations, especially the IDB, is gaining increasing importance. The participation of the Inter-American Development Bank (IDB) in the physical and energy related integration projects might help to consolidate a new standard of regulation and financing of the activity in MERCOSUR. This may signify a change in the profile of the actions of multilateral credit agencies in the sense of conferring preferential support to: (i) the formation and consolidation of regulatory agencies designed to create the bases for the entrance and permanence of private capital in infrastructure projects; (ii) conducting operations to guarantee low-risk private investment, primarily in the case of bilateral projects; and (iii) the development of new forms to finance investment, especially those such as *project finance* which reduces the amount of guarantees required and induces the concerted participation of governments, investors, suppliers and financial agents.

VI. Foreign Economic Relations

The MERCOSUR agenda of international negotiations is overloaded because of the increase of long negotiation processes. During the first half of 1998, the bloc was engaged in the definition of preliminary agreements for the negotiation of the MERCOSUR-Andean Community Free Trade Zone, in the preparatory activities of the IV Ministerial Meeting on Trade held in San Jose, Costa Rica and the Santiago Hemispheric Summit Meeting, which launched the negotiations for the creation of the Free Trade Area of the Americas. Furthermore, the following agreements were signed: the Framework Agreement of Trade and Investment between the Central American Common Market and the countries of MERCOSUR and the Canada-MERCOSUR agreement.

The IV Ministerial Meeting on Trade held in San Jose, Costa Rica on March 19 examined the results of the preparatory works for the negotiations of the Free Trade Area of the Americas. The San Jose Declaration, signed by the 34 State Ministers responsible for trade and ratified by the Chiefs of State at the Hemispheric Summit held in Santiago April 18 and 19, prompted the beginning of negotiations by September 30, at which point the working programs should be prepared for the negotiating groups.

The proposal for the establishment of the FTAA involves the creation of an area of free trade in the Americas through negotiations that should be concluded by December 2004 at the latest. The Agreement should facilitate the progressive elimination of barriers to the trade of goods and services and to investments. Its terms should be compatible with the rules and regulations of the World Trade Organization, especially Article XXIV of the General Agreement on Tariffs and Trade and Article V of the General Agreement on the Trade of Services.

The following points presented by MERCOSUR were incorporated into the San Jose Declaration: (i) the FTAA and its agreements should be the object of consensus between all of the countries of the hemisphere and the result of negotiations, of a gradual and progressive character, should be compatible with the consolidation and improvement of the several integration initiatives that are underway on the American Continent (*building blocks approach*), allowing such initiatives to coexist with the FTAA, when the rights and requirements of these agreements are not covered or exceed the rights and requirements of the FTAA; (ii) the FTAA should be constructed based on commitments that are balanced, equitable and advantageous for each of the members and should be assumed completely and simultaneously by the 34 countries; (iii) the different negotiation areas should move forward at the same time and no agreement should come into effect separately, but rather should wait until the whole package of agreements is negotiated and approved (*single undertaking*); and (iv) the trade agreements will come into effect beginning in 2005; however, the countries signed the commitment to achieve concrete advances in the negotiations by the year 2000, especially in regard to business facilitation measures.

PARAGUAY AND MERCOSUR

Since the implementation of the Treaty of Asunción, Paraguay has played a less active role than its partners in MERCOSUR. The increase of trade in the sub-region, as well as the rise of investments -especially of investments from outside the sub-region- have brought only marginal gains to the country. As a result of the elimination of tariff barriers, Paraguay simply concentrated its exports in the sub-region without significantly increasing their total amount. However, Paraguay did increase substantially its imports from the sub-region, showing signs of trade diversion. The results have confirmed the economic model that characterizes this country: that of an open economy with a strong trend towards imports, that has built its comparative advantages as a trade middleman and as an exporter of agricultural raw materials.

While for the rest of the member countries of MERCOSUR, the integration process coincided with a change in their economic models (from inward-oriented growth to outward-oriented growth), this coincidence was not so evident in the case of Paraguay. The reason is that the economies of the member countries were built on the productive sector while the Paraguayan economy supported itself on its commercial base. Thus, the lack of competitiveness of its industry and its agriculture when compared to their counterparts in the other member countries. Paradoxically, although the Paraguayan economy appeared to be the most open and balanced of MERCOSUR, it nevertheless turned out to be the least akin to the sub-regional integration process.

This paper, examines the effects of MERCOSUR on Paraguay over the first seven years since its implementation, and the main causes of the Paraguayan situation in the sub-region are outlined. In the first part, factors that led to the decision of joining MERCOSUR are analyzed; while the second part of the paper, refers to the main variables that explain the lack of growth of the Paraguayan economy. The characteristics and the evolution of foreign trade and foreign investments, during the above mentioned period, are analyzed in the third part. Finally, the main obstacles to the country's competitiveness are studied, which in turn explain the nature of Paraguay's country-cost.

CHAPTER I. MACROECONOMIC TRENDS

At the end of 1997, the outlook for the MERCOSUR countries was one of serious difficulties, due to the developments in the sub-region sparked by the Asian crisis. Brazil's adoption of severe fiscal and monetary adjustment measures, in an attempt to stop the loss of exchange reserves and strengthen foreign investors' confidence, led to forecasts of an abrupt drop in the economic activity of the bloc's primary member. The expected contraction of Brazilian imports would inevitably impact the aggregate demand of the other members, thereby promoting a rapid reverse of the economic growth cycle, which began at the end of 1995.

The cooling of the Brazilian economy was less harsh than expected, and the impact on the bloc's other members was less severe. However, beginning in May, signs of a cooling of Argentina's economic activity became evident. Soon after, the fragility of the Japanese and Russian economies was manifested, forecasting the likelihood of new turbulence. However, it is too early to formulate any more optimistic prognostic in relation to medium term perspectives for MERCOSUR member countries.

A. Macroeconomic performance in the first half of 1998

Economic activity and employment

The impact of the Asian crisis on the economic activity of the four MERCOSUR countries in the first half of 1998 was, in addition to being reasonably differentiated, much less severe than expected by the forecasts conducted at the end of last year. However, the bloc's gross domestic product, after registering growth of 3.2% in 1996 and 4.7% in 1997, is expected to register growth below 3% in 1998.¹

The cooling of the **Brazilian economy**, whose contribution to MERCOSUR GDP approaches 70%, was less dramatic than what was forecast at the end of 1997, right after the doubling of domestic interest rates and the announcement of the fiscal and tributary reform measures. The GDP of the first quarter registered a slight drop of 1.1%, in comparison with the last quarter of the previous year; it is an analogous magnitude of growth when compared with the same period in 1997. This relatively weak performance helps soften the blow of the Asian crisis on the MERCOSUR sub-region as a whole.

The expectation, in Brazil, of the beginning of 1998 being marked by depressed economic activity or even a strong retraction did not come to fruition, due to at least three factors: (i) the expansion of public sector demand, explicitly manifested by the increase in the primary deficit, implicitly revealing a partial and not very strict implementation of the fiscal reform measures adopted in November 1997; (ii) the continuity of the privatization program, that sustained the demand for capital goods and basic inputs in the industrial sectors which supply privatized services; and (iii) the significant increase of the exports of industrialized products (CNI [1998]). Supporting this diagnostic, the index of accumulated industrial production up to May registered a slight drop (-0.35%), however the trend for the rest of the year is for a gradual recuperation. The factor that is much more alarming is the labor market. The average unemployment rate from January to May reached 8%, registering a 2.3 percentage point increase in relation to the same period last year. For some metropolitan areas, such as São Paulo, the unemployment rate is much higher, reaching a percentage double the national average. The increase in unemployment is not restricted to the industrial sector or civil construction, but also affects the service sector, suggesting the presence of other factors, such as technological modernization, notably in financial services and retail trade, as well as the retraction of industrial activity.

¹ The average sub-regional rates of GDP and inflation mentioned were derived from the following percentages: Argentina (0.2744), Brazil (0.6990), Paraguay (0.0089), and Uruguay (0.0177).

The **Argentine economy**, which ended 1997 with truly notable growth of 8.4% of GDP, continued to register a favorable performance during the first half of this year. In the first quarter of the year the GDP grew 6.9%, in comparison with the same period in the previous year, and 1.2% when compared to the last quarter of 1997. Furthermore, up to May manufacturing production had increased 6.5% in relation to the same period in 1997, totaling 26 consecutive months of uninterrupted growth in industrial activity. However, developments in the last two months point to a clear cooling of the manufacturing industry for the rest of the year.

The current growth cycle of the Argentine economy, based on the expansion of domestic investment and industrial exports, is surprising. At the end of 1997, it was thought that the cooling of the Brazilian economy would be sufficient to promote a rapid decline of the level of domestic activity due to the predictable retraction of imports from the main trading partner. Brazil's total imports fell 2% in the first half of 1998, but its imports from Argentina increased 5.5% over the same period. This asymmetry is explained entirely by the excellent sales performance of Argentina's automobiles and cargo vehicles, which grew 52.5% and 78.5% respectively in the first half of the year, reaching a value of over US\$ 1.1 billion. Paradoxically, in Brazil, sales at vehicle dealerships suffered a strong retraction over the same period, affected negatively by the elevated domestic interest rates, which adversely impacted the production and the sale of durable consumer goods. The increase in imports of Argentine vehicles, coupled with the retraction phase of the Brazilian market, can only be explained by the enactment of the Automotive Regime. The administered trade in the automobile sector acted as an important stabilizing factor for trade relations between the members, weakening the impact of the cooling of the Brazilian economy on the demand for Argentine exports.

The continuity of the strong growth of the Argentine economy should also be attributed to the expansion of credit, which maintains investment demand high and has been feeding private consumption. The repercussions on the labor market have been positive, promoting a decrease in the unemployment rate from 16.1% in May 1997 to 13.7% in May 1998.

The **Uruguayan economy** continues to evolve in a satisfactory manner despite the Asian crisis and the cooling of economic activity in Brazil. In the first quarter of 1998 the GDP grew 6.8% in relation to the same period the previous year, but it is important to point out that this rate overestimates the actual growth registered in the quarter. This is due to distortions that affect the base of comparison, primarily the shut down of a petroleum refinery in February-March 1997. However, the unemployment rate has registered a favorable decrease, falling from 11.5% on average in 1997, to 10% in the three-month period.

Over the first half of this year, the import demand of the MERCOSUR members continued to stimulate the good performance of the Uruguayan economy. From January to June Brazil's imports from Uruguay increased 14.9%, in contrast with a total decline of Brazil's imports over the period. Furthermore, Uruguay's exports to Argentina grew 62.5% over the first quarter of the year, according to Argentina's import records.

The recuperation of the **Paraguayan economy** in 1997, after the contraction of the level of activity registered the previous year, was only moderate. In fact, the gross domestic product increased 2.6%, falling short of the government's forecast of close to 4%. This poor performance can be partially explained by domestic factors such as the financial crisis, which resulted in a tightening of liquidity, the political uncertainties connected to the presidential elections and fiscal difficulties. The same factors have been influencing the Paraguayan economy's performance in the first half of this year, as well as the instability of the exchange market. There is no information regarding the development of economic activity in the first months of this year, but the forecast for 1998 is for a worse performance than that registered last year.

Inflation

The sub-region's average inflation rate, measured by the evolution of the consumer price indices of the four member countries, fell from 6.9% in 1996 to 3.4% in 1997. The more than 50% reduction in the inflation rate in MERCOSUR last year, deserves distinction because it occurred during a phase of expansion of sub-regional economic activity, as well as resulting from a smaller dispersion of national indices.

In 1998, the results will certainly be less promising, without this implying any threats to the increasing stabilization of inflation in MERCOSUR. In **Argentina**, the accumulated inflation rate over the first half of the year already points to a 1.1% increase. In December 1997, the government eliminated several subsidies to public services and simultaneously authorized an increase in tariffs, in an attempt to compensate companies that provide these services for the decrease in margins. The impact on the inflation indices during the two-month period January-February was significant and the accumulated inflation rate at the end of the year will definitely be higher than that registered in 1997.

In **Brazil**, the majority of the indices show a decrease in the inflation rate over the first half of the year, with the exception of the official index (INPC-IBGE), which registers a 3.2% increase. This figure is slightly higher than that registered in the first half of 1997. Nevertheless, the forecast is for the trend of declining inflation, registered over the last four years, to continue, thereby consolidating the stabilization process of the Brazilian economy.

TABLE I.1
MERCOSUR: MACROECONOMIC PERFORMANCE

INDICATORS	ARGENTINA				BRAZIL				PARAGUAY				URUGUAY				
	1994	1995	1996	1997	1994	1995	1996	1997	1994	1995	1996	1997	1994	1995	1996	1997	
LEVEL OF ACTIVITY & EMPLOYMENT:																	
GDP - Total	(% annual)	8.5	- 4.6	4.3	8.4	5.9	4.2	2.8	3.2	3.1	4.7	1.3	2.6	6.3	- 1.8	5.3	5.1
Industrial Production	(% annual)	5.0	- 6.5	5.5	10.4	7.8	1.7	1.8	4.1	1.5	3.0	- 2.2	1.0	2.9	- 3.1	4.8	5.6
Gross Fixed Domestic Inv.	(% annual)	21.8	- 16.3	8.3	27.1	13.6	12.5	6.0	6.0	---	---	---	---	1.8	- 4.6	11.2	8.3
Unemployment rate	(% of EAP)	11.4	17.5	17.2	14.9	5.1	4.6	5.4	5.7	---	5.3	8.2	8.2	9.1	10.3	11.9	11.5
PRICES, SALARIES & EXCHANGE RATE:																	
CPI	(% Dec./Dec.)	3.9	1.6	0.1	0.3	929.3	22.0	9.1	4.3	18.3	10.6	8.1	6.2	44.1	35.4	24.3	15.2
Real industrial salary	(% annual)	0.7	- 1.3	- 2.0	1.0	9.5	8.7	5.4	5.6	2.7	6.9	2.5	nd	0.9	- 2.8	0.6	0.2
Nominal exchange rate	(% Dec./Dec.)	0.0	0.0	0.0	0.0	736.7	13.9	7.1	7.4	9.8	2.8	6.7	8.7	27.4	26.5	22.7	15.1
Real exchange rate	(% IV quart./IV quart.)	- 0.6	0.9	3.0	1.7	- 35.1	- 7.3	- 2.0	2.1	- 7.9	- 5.0	1.2	4.0	- 7.5	- 6.5	1.5	2.2
FISCAL INDICATORS AND INTEREST RATES:																	
Deficit (-) of public sector	(% of GDP)	- 0.1	- 0.5	- 1.8	- 1.4	- 45.2	- 7.2	- 5.9	- 6.1	1.0	- 0.3	- 0.8	- 1.5	- 2.9	- 1.7	- 1.6	- 1.4
Interest rate	(% per year)	8.1	11.9	7.4	7.8	1,327	53.1	27.4	24.7	17.4	15.7	12.8	8.1	37.0	38.2	28.1	19.6
FOREIGN SECTOR:																	
Exports	(annual % in US\$)	20.8	32.4	13.6	10.1	12.8	6.8	2.7	11.0	12.6	12.5	13.5	4.3	16.3	10.6	13.8	13.9
Imports	(annual % in US\$)	29.2	- 6.7	18.5	27.7	29.8	50.1	7.3	15.1	45.0	30.0	2.5	3.7	19.2	2.9	15.9	11.8
Current transactions	(% of GDP)	- 3.5	- 0.9	- 1.3	- 2.8	- 0.3	- 2.5	- 3.0	- 4.2	- 4.9	- 7.6	- 5.9	- 6.9	- 2.7	- 1.2	- 1.2	- 1.6
BALANCE OF PAYMENTS:																	
Exports	(US\$ millions FOB)	15,840	20,964	23,811	26,215	43,545	46,506	47,747	52,986	817	919	1,043	1,089	1,913	2,148	2,448	2,781
Imports	(US\$ millions FOB)	20,078	18,726	22,189	28,335	33,079	49,858	53,286	61,358	2,140	2,782	2,851	2,957	2,600	2,711	3,135	3,504
Trade balance	(US\$ millions)	- 4,238	2,238	1,622	- 2,120	10,466	- 3,352	- 5,539	- 8,372	- 1,323	- 1,863	- 1,807	- 1,868	- 687	- 563	- 687	- 723
Current transactions	(US\$ millions)	- 9,978	- 2,768	- 3,787	- 9,044	- 1,689	- 17,972	- 24,347	- 33,439	- 387	- 683	- 574	- 699	- 439	- 213	- 233	- 321
International reserves	(US\$ billions)	16.0	15.9	19.7	22.8	38.8	51.8	60.1	52.2	1.0	1.1	1.1	0.8	2.3	2.5	2.6	2.8
Total gross foreign debt	(US\$ billions)	77.4	89.3	99.1	109.4	148.3	159.3	179.9	193.7	1.2	1.4	1.4	1.4	9.1	10.4	11.6	12.6
MEMORANDUM:																	
GDP	(US\$ billions)				317.3				793				10.0				20.0
Population	(10 ⁶ hab.)				35.7				163.4				5.1				3.2
GDP <i>per capita</i>	(US\$ / hab.)				8,888				4,853				1,961				6,250

Sources: Inter-American Development Bank databases. Updates and corrections: *Informe Macroeconómico 1997*, Ministry of Economy and Works and Public Services (Argentina); *Conjuntura Económica*, Getúlio Vargas Foundation, and *Informe à Imprensa*, BACEN (Brazil); *Breve Informe de Coyuntura - Junio de 1998*, Economy Institute, Universidad de la República (Uruguay) and the Central Bank of Paraguay. For real exchange rates (CPI deflator), *Comercio Exterior Argentino*, International Economy Center (Argentina).

Notes: The figures for foreign trade for Paraguay corresponds to registered trade. EAP: Economic Active Population.

In **Uruguay**, inflation indices are registering a decelerating path, and are expected to end 1998 with a single digit inflation rate. In fact, after ending 1997 with inflation of 15.2%, the 12-month accumulated inflation rate registered 10.6% in May 1998. The increase of the consumer price index in the first five months of 1998 was only 3.8%, suggesting that the government's goal of inflation between 8.5% and 9.0% for 1998 may be achieved.

However, **Paraguay**, which has been registering declining inflation rates in recent years, is expected to suffer a significant setback in 1998 in its fight against inflation. In the first half of this year, the Paraguayan economy registered inflation of 10.7%, surpassing by almost four percentage points the government's goal for the entire year. The alarming inflation observed in the first half of the year, after ending 1997 with the lowest variation in prices (6.2%) in the last 20 years, can be explained by three factors: the readjustments of 12% in public tariffs; an equal increase in the minimum wage; and the nominal devaluation registered by the exchange rate (around 18.5% up to May). In June, the Central Bank believed that the impact of these readjustments had already been absorbed and the new government goal for 1998 was redefined for 12%. Nevertheless, it will be necessary to wait for the announcement of the economic policy measures of the new government, to have a more accurate forecast for the inflation rates for the rest of the year.

Public Finances

The efforts to promote a reversal of MERCOSUR fiscal deficits are not expected to result in very significant advances in 1998. The evolution of the fiscal accounts from the first half of the year point to a worsening of deficits in Brazil and Paraguay, while Uruguay and Argentina are registering slight improvements.

In **Brazil**, the fiscal package approved at the end of 1997 resulted in a significant increase in federal tax collections, which grew 18.8% in the first half of the year despite the moderate expansion rhythm of the economy. However, the impact of the increase in domestic interest rates on public debt charges more than counterbalanced the increase in tax collection, thereby worsening the fiscal deficit. The financing needs from the public sector increased from 6.1% of the GDP at the end of 1997 to 6.7% of the GDP over the 12-month period ending in April. Payments with interest totaled 5.9% of the GDP, but the primary accounts also provided a deficit, adding an additional 0.8 point of a percentage of the GDP to the imbalance of the public accounts. This last result is the one that causes the most concern, because it shows a failure in controlling spending.

Argentina is expected to complete the fiscal goals it agreed to with the IMF for the first half of the year, which established a deficit below US\$ 1.8 billion. The tax collection registered lower than that forecasted by the IMF, despite the significant expansion of economic activity. Nevertheless, the early use of measures to reduce spending and the postponement of some expenditures seem to have been enough to reach the fiscal goal.

In **Uruguay**, the fiscal situation is also developing in a positive manner. The tax collection has increased, aided by the good performance of economic activity, and the consolidated deficit is registering a downward trend. In the 12 months ending in March 1998, the fiscal deficit was less than 1.3% of GDP, but it is necessary to point out that the public accounts show a balance when the State's reform cost is discounted.

In **Paraguay**, the central administration accounts show an accelerated deterioration in recent years. The deficit, which was 0.3% of GDP in 1995, rose to 0.8% in 1996 and reached 1.5% in 1997. The 1998 fiscal budget did not include any measures to reverse this trend, and the fiscal adjustment was left to be handled by the next government. The result in 1998 will most likely be less favorable than last year, even if drastic measures are adopted in the last quarter of the year.

Foreign Sector

Until now, the MERCOSUR countries have not been able to harmonize satisfactory levels of economic growth with moderate deficits in the current account. The deficits in foreign accounts have become recurrent, promoting stop and go growth, based on short lasting cycles whose amplitude tends to be larger in some countries (Argentina and Uruguay) than in others (Brazil and Paraguay). The result, however, is moderate growth for the bloc as a whole, coupled with a high and growing foreign deficit. This year will not be an exception; the foreign deficits are worsening in the two economies that are still in an expansion phase (Argentina and Uruguay), while the deficit in the current account is shrinking in the two economies that are in a phase of deceleration.

The decrease in commodity prices on international markets has affected in a diverse manner, although reasonably generalized, MERCOSUR exports. The prices of agricultural products and metals fell 25% in relation to the peak registered in 1995, while the international prices of energy products fell 33% in relation to the maximum value reached in 1996. As a consequence, the revenue of sub-regional exports from exports of basic products, primary or traditional, depending on the designation in each country, shows a negative evolution over the first half of the year.

In fact, in Brazil exports of basic products fell 10.9%, over the period January-June, while Argentine exports of fuels and manufactured agricultural goods fell 37.1% and 18.2% respectively, in the first quarter of the year. The same phenomenon is observed in the two smaller economies: exports of traditional products fell 5.6% in Uruguay, while Paraguay's total registered exports, concentrated strongly in primary products, shrunk 5.2%, both when comparing January-May 1998 to the same period the previous year. In all of the cases, the weak performance is explained by the fall of international prices of products with high levels of participation in the list of exports, such as soybeans, poultry, wool, petroleum and cotton, to name the most important.

The opposite situation has been observed in the case of exports of industrial products, manufactured goods of industrial origin or non-traditional products, as they are designated in Brazil, Argentina and Uruguay respectively. Over the first half of this year, the rate of expansion is expected to fluctuate between 12% and 18%. It is definitely a positive development, and different from previous years, the increase in industrial exports has not been restricted to intra-zonal trade. In fact, double-digit growth rates are beginning to also be registered in exports of manufactured products from the sub-region to NAFTA and the European Union.

The composition of this differentiated growth results in modest total export growth rates. In Brazil exports have grown 4.8% (January-June) and 1.0% in Argentina (January-May), while Paraguay's total exports decreased 5.2% (January-May). In Uruguay, exports increased 8.5% in January-May, in relation to the same period the previous year, but the real exports only grew 5.4% in the first two-month period, according to the most recently released figures. In conclusion, the performance of exports is not very encouraging, and in 1998 the four countries are expected to register much smaller increases in exports than those registered last year.

Sub-regional imports are also expected to register smaller growth rates than those registered in 1997. Over the first half imports have decreased in absolute terms, in both Brazil (-2.0%) and Paraguay (-27%), due to the slow growth of these economies. In the case of Paraguay a major factor was the effect of the nominal devaluation of its currency (18.5% from the end of 1997 and May 1998). Over the January-May period, Argentina and Uruguay registered positive import growth rates (12.0% and 6.2%, respectively), however the growth of imports this year is expected to be less than last year.

The forecast for the current year is that both the sub-region's trade balance and the balance of the current transactions will register a slight deterioration in relation to 1997. However, the primary change will not be in

the size of these deficits, but in the distribution among the bloc's members. In fact, Brazil and Paraguay are expected to register a reduction in their foreign deficits, while Uruguay and especially Argentina are expected to increase their foreign deficits.

TABLE I.2
MERCOSUR: FORECASTS FOR 1998

INDICATOR	ARGENTINA		BRAZIL		PARAGUAY		URUGUAY		
	Actual	Projected	Actual	Projected	Actual	Projected	Actual	Projected	
	1997	1998	1997	1998	1997	1998	1997	1998	
GDP - Total	(% annual)	8.4	5.6	3.2	1.5	2.6	1.9	5.1	3.8
Industrial Product	(% annual)	10.4	5.9	4.1	1.2	1.0	1.0	5.6	3.0
CPI	(% Dec./Dec.)	0.3	1.0	4.3	3.1	6.2	13.6	15.2	8.5
Public sector deficit	(% of GDP)	- 1.4	-1.1	- 6.1	- 7.0	- 1.5	- 2.0	- 1.4	-1.6
Exports FOB	(% annual)	10.1	2.0	11.0	6.0	4.4	- 5.0	13.9	4.0
Imports FOB	(% annual)	27.7	14.4	15.1	1.2	3.7	- 20.0	11.8	5.0
Trade balance	(US\$ 10 ⁶ FOB)	- 2,120	- 5,700	- 8,372	- 5,900	- 1,868	- 1,300	- 723	- 800
Current account	(% of GDP)	- 3.1	- 4.1	- 4.2	- 3.9	- 6.9	- 3.6	- 1.6	- 2.0

Source: *Latin American Consensus Forecasts* (June 1998) and authors' forecasts.

B. Evolution of macroeconomic policy

MERCOSUR macroeconomic policy shows, as confirmed by previous reports, a wide convergence in general lines of action of the national economic authorities. The stabilization, based on the use of a nominal exchange rate to anchor the price system, reform policies and fiscal adjustment regimes, the reform of the state, and particularly privatization programs, constitute common ingredients of the macroeconomic policies of the two primary economies, Brazil and Argentina. Uruguay's macroeconomic policy also shares many of these characteristics, showing this last year a greater convergence with its larger partners as exhibited by the results. Paraguay's situation is definitely different, but it is important to point out that it is likely that the new government will promote a closer approximation of its domestic macroeconomic policy to the general policy, which is predominant in the other MERCOSUR countries.

In **Brazil**, the focus of economic policy, in the first half of 1998, was centered on the administration of the fiscal and monetary measures adopted in October and November 1997, immediately after the significant loss of international reserves sparked by the Asian crisis. Between November 1997 and June 1998, the Central Bank carefully administered an almost 25 percentage point drop (from 46% to 21.6% per year) in the economy's basic interest rate. In June, the level of the interest rates was still slightly above the pre-crisis level, but the international reserves were already far surpassing the level reached at the end of September 1997. There was, however, a decrease in the indicators of payment default in the financial sector, although it was accompanied by an increase in provisions by the banks. From the fiscal side, the results were less satisfactory: the increase of public debt commitments was obviously expected, but not the poor performance of the primary accounts, which continue to provide deficits despite the exceptional tax collections.

In terms of constitutional reforms, the approval of the Administrative Reform must be highlighted. The Reform's results, in fiscal terms, will only become evident beginning in the year 2000. The Welfare Reform is ready to be definitively approved, but the government proposal suffered important alterations in the Legislative. Lastly, in regard to the foreign sector, in April the government announced a change in the administration of the exchange rate policy, consistent with the gradual expansion of the exchange rate band

through the quicker devaluation of its upper limit. The explicit objective of this change is to make room for a policy of nominal devaluations at a slower pace than those practiced up to present, in case the inflow of foreign capital remains intense.

In **Argentina**, the main economic policy actions, over the period, were directed to the promotion of fiscal adjustment and the continuity of the structural reforms program, measures that are included in the letter of intent signed with the IMF. The aforementioned fiscal goals from the first half of the year were met. In terms of reforms one worth mentioning is the auction, held in January, for the concession for the management of the airports and the continuity of the sale of shares of already privatized companies that are still under the control of the public sector, as is the case of YPF.

The fight against inflation, developed from a pre-announced exchange rate devaluation policy and from fiscal deficit reduction measures, continued to guide the economic policy implemented in **Uruguay**, in the first half of the year. For 1998, the goals announced by the government include: (i) an accumulated annual inflation rate between 7% and 9%; (ii) a nominal devaluation of the same size; (iii) a fiscal deficit of 1.1% of GDP, already including the state reform costs; and (iv) a deficit in the current account of approximately 1.3% of GDP. The program, which has the approval of the IMF, was developed based on GDP growth of around 3%.

In April, in accordance with the program's objectives, the government reduced from 0.8% to 0.6% the rate of the monthly nominal devaluation, simultaneously promoting a narrowing of the exchange rate band from 7 to 3 percentage points. Another point that deserves to be highlighted is the regulation of the new law to promote investments and the relatively expansionistic character of the credit policy over the first half of this year, with a focus on civil construction.

The crisis in the financial sector and the exchange rate instability represented the primary challenges for **Paraguay's** economic policy over the first half of the year. The difficulties in the financial sector have assumed the form of recurrent crises, culminating in repeated interventions from monetary authorities in banking and financial institutions. The first wave of interventions came in May 1995, the second in August 1997, while the most recent ended in July 1998. Since the beginning of the crisis, in 1995, Paraguay's Central Bank has intervened in 10 banks, 20 financial institutions and another 8 mortgage credit or savings entities. The fragility of the Paraguayan financial sector is due to several factors, including: (i) poor banking administration, characterized by the concession of loans to companies within its own group; (ii) an excessive number of entities in relation to the size of the market; (iii) the practice of sub-registering financial operations; (iv) the high level of financial default; and (v) the high level of fundraising rates, as a result of the dispute for the customers deposits. Liquidity problems, or equity problems, may still turn out, due to the precarious financial situation of some banks. The improvement process of the financial system is still incomplete.

The exchange rate instability resulted from the monetary authority's decision, adopted in December 1997, to reduce the participation of the foreign exchange markets, in an attempt to slow the outflow of foreign reserves. The exchange rate underwent a rapid devaluation, of about 20%, but at the end of May the nervousness on the exchange market had subsided significantly.

Austerity, the primary expectation in terms of a change in the economic policy is raised by the economic program that is expected to be implemented by the new authorities beginning their term in the middle of August. The agenda of the new government will most likely include a reduction of the public deficit -through a cut in spending, an increase in taxes, combating tax evasion and the reduction of subsidies- the privatization of companies which provide public services and the improvement and clean-up of the financial system.

C. Macroeconomic coordination, institutions and productive configuration

The institution of formal mechanisms of **macroeconomic coordination** between the MERCOSUR members has been a recurring issue since the creation of the sub-regional bloc. However, the debate is almost always restricted to the academic environment, but never in an explicit manner, to the MERCOSUR policy negotiation agenda.

The option for informal coordination mechanisms, based on consultation and the exchange of information, or still in the definition of *ad hoc* criteria for overcoming points of conflict, would appear to justify itself from the beginning due to the scarce interdependence between the members, primarily between Brazil and Argentina, the two largest economies. Furthermore, the economic stabilization was, until very recently, a very incipient process in MERCOSUR, demanding from national economic authorities a wide degree of liberty in the use of economic policy tools, with the objective of guaranteeing its consolidation. For one reason or another, the trade-off between formal coordination rules and flexible mechanisms to find a consensus was always resolved in favor of the second option and undoubtedly with a reasonable degree of success.

In the last seven years since the formation of MERCOSUR, the level of trade between the members has registered impressive jumps. Currently, one fourth of the exports and more than 20% of the imports of the four countries are within MERCOSUR. In addition three of the four member countries are expected to register single digit inflation figures for 1998, while the sub-regional average inflation rate is similar to international standards. The structural reform processes also show significant advances. More important still, the reforms are resulting from a consensus that is constructed and negotiated in open and democratic societies. In this context, the continuity and predictability of macroeconomic policy begins to acquire a “public” character, reducing the scope and minimizing the advantages of a flexible or discretionary use of economic policy tools. Given these background, nothing would be more natural than return to the debate on the convenience, or not, of instituting formal macroeconomic coordination mechanisms for MERCOSUR.

Nevertheless, there are two new and surprising aspects in the most recent attempt to face this question: first, the implicit degree of demand in the proposed scheme, a mechanism of “strong” coordination and intensive in pre-requisites and redistribution of institutional roles, based on the adoption of a single currency for the region; second, a clear political will expressed by Argentina, the defender of the proposal, translated into the desire to register the debate formally on the MERCOSUR agenda. Even though the proposal has been submitted to a more technical forum, some of the arguments discussed in this new round of debates deserves some attention because the issue is formally written on Article 1° of the Asuncion Treaty, which instituted MERCOSUR.

Among the arguments in favor of the establishment of formal coordination mechanisms, two appear particularly relevant for MERCOSUR. The first is in respect to the relation between the degree of the openness of the economies that participate in the preferential agreement and the level of coordination of the policies. According to this argument, preferential agreements between economies with low degrees of openness require low levels of coordination, given that the simple removal of barriers guarantees the expansion of trade between the members of the bloc. Nevertheless, as the degree of openness increases, it reduces the barriers to third countries, and the expansion of intra-bloc trade begins to depend on increasingly demanding levels of policy coordination. The absence of coordination would lead to a dilution of regional preferences (Lavagna and Giambiagi [1998]).

The second relevant argument highlights the fact that the MERCOSUR countries are perceived as a reasonably undifferentiated economic entity, as much by foreign investors as by investors of international financial resources. In this sense, contagious effects may occur, even in the absence of a real economic interdependence between the bloc’s members. Therefore, the demand for coordination comes less from “spill-overs” and more from contagious effects.

The debate regarding the definition of formal coordination mechanisms is directly associated to the institutionality of MERCOSUR. In the recent debate about the adoption of a single currency for the sub-region, a long-term objective, little emphasis was given the suggestion, inserted in one of the proposals to create in the short term a new institutional forum of an extremely “flexible” character (Lavagna and Giambiagi [1998]).

The debate about a possible institutional redefinition in the heart of MERCOSUR finds itself in an even more embryonic stage than the discussion about the adoption of alternative coordination schemes. The impasse may be at great extent attributed to the polarization generated by proposals that advocate the creation of supranational bodies, to substitute the inter-governmental format currently in place. The discussion, placed in these terms, makes facing the controversial topic of the distribution of voting power between the MERCOSUR members inevitable.

Despite the aforementioned considerations, the redefinition of the MERCOSUR institutional framework is a moot issue. It is difficult to imagine that substantive advances can be made in diverse political and economic disciplines while maintaining the current work overload facing the Common Market Group or, alternatively appealing to the creation of *ad hoc* groups.

No less urgent, is the need for the four countries to fix deadlines for the internalization of the norms, which have already been approved by the Common Market Group. The low degree of coordination, added to the current *modus operandi* and the delay in the internalization of the common norms contributes to make the guarantees required by the investors less solid relative to what is expected of an unrestricted access to a wide market and to a “leveling of the playing field.” Under these conditions, the localization of investments, to mention just one example, tends to privilege the relative size of the national markets, exacerbating an asymmetry that should be ameliorated.

In this case the bloc’s smaller economies could end up being negatively affected in this scenario. However, an even more serious case could be if one of the members were to face difficulties in being able to generate a satisfactory productive insertion in the bloc, given that the sub-regional instruments that could be used to reverse such a situation are extremely limited.

To reach a sustainable productive configuration for all of the members of the sub-regional bloc would unquestionably constitute one of the main objectives of the signatories of the Asuncion Treaty. This is the reason why the problems of policy coordination and the reformulation of institutions and sub-regional instruments, as well as the speeding up of the internalization process of common norms, should remain on MERCOSUR’s agenda.

CHAPTER II. TRADE AND FOREIGN DIRECT INVESTMENT

In the first seven years after the formation of MERCOSUR, the sub-region's global trade developed at very high rates, above 15% per year. However, the expansion of trade between the bloc's members was much higher than that registered in trade with non-members. In fact, between 1991 and 1997 the extra-zonal trade flows doubled, while the trade between the MERCOSUR members quadrupled. As a consequence, the intra-zonal trade flows currently account for almost one fourth of exports and for more than 20% of the sub-region's total imports, thereby establishing the bases for a real interdependence between the MERCOSUR economies.

In 1997, a convergence was registered in the growth rate of intra and extra-zonal trade flows, in both exports and imports (Table II.1). The decrease in differences can be explained primarily due to less vigorous intra-bloc growth, shown by the decrease in the expansion rate from an average of 27.3% during the 1991-96 period, to 19.9% in 1997. This deceleration is not surprising, but rather is a natural result of an increased participation of intra-zonal trade in the sub-region's global trade. Nevertheless, it is possible that the decrease in the expansion rate of commercial trade between the members may be a signal of the exhaustion of the initial phase of fast and easy intra-zonal trade increases.

The MERCOSUR trade deficit, which increased from US\$ 8.2 billion in 1996 to US\$ 16.7 billion in 1997, also deserves attention. The trade deficit doubled, despite the improved performance of extra-MERCOSUR exports, which grew about the average registered during the 1991-1996 period.

TABLE II.1
INTRA & EXTRA-MERCOSUR TRADE
(years selected)

Category	1991	1993	1995	1996	1997 *	Growth (% per year)	
						1991/96	1996/97
EXPORTS							
Total (US\$ 10 ⁶)	45,910.6	54,162.4	70,401.4	74,997.6	83,071.0	10.3	10,8
Intra-MERCOSUR (%)	11.1	18.5	20.4	22.7	24.3	27.3	18,5
Extra-MERCOSUR (%)	88.9	81.5	79.6	77.3	75.7	7.3	8,5
IMPORTS							
Total (US\$ 10 ⁶)	32,140.0	47,822.7	75,311.0	83,216.7	99,790.0	21.0	19,6
Intra-MERCOSUR (%)	15.9	19.6	18.7	20.5	20.9	27.2	22,5
Extra-MERCOSUR (%)	84.1	80.4	81.3	79.5	79.1	19.6	19,2
TRADE VOLUME							
Total (US\$ 10 ⁶)	78,050.6	101,985.2	145,712.3	158,214.3	182,861.0	15.2	15,6
Intra-MERCOSUR (%)	13.1	19.1	19.5	21.6	22.4	27.3	19,9
Extra-MERCOSUR (%)	86.9	80.9	80.5	78.4	77.6	12.8	14,4
TRADE BALANCE							
Extra-MERCOSUR(US\$ 10 ⁶)	13,770.6	6,339.7	- 4,909.6	- 8,219.1	- 16,719.0		

Source: INTAL trade database.

Note: (*) Preliminary data.

A. Foreign trade over the first half of 1998

MERCOSUR foreign trade growth over the first half of 1998 registered a drastic decrease. In fact, according to preliminary data from the January-May period, the sub-region's total exports grew only 4.0% in the first five months of 1998, while total imports increased 2.3% in the same period.

The decrease in trade growth simultaneously affects the intra and extra-bloc trade flows, involving imports and exports. The asymmetry between the intra and extra-zonal growth rates was reduced significantly and for the first time since the formation of MERCOSUR, the extra-zonal exports grew at a slightly faster pace than the exports between MERCOSUR members. Examined closely, the development of MERCOSUR foreign trade appears atypical, and in 1998 it is expected to signal a break in relation to the performance registered in the previous 7 years.

TABLE II.2
INTRA & EXTRA-MERCOSUR TRADE
(January-May 1998)

CATEGORY	ARGENTINA			BRAZIL			PARAGUAY			URUGUAY			MERCOSUR			
	1997	1998	Var. (%)	1997	1998	Var. (%)	1997	1998	Var. (%)	1997	1998	Var. (%)	1997	1998	Var. (%)	
EXPORTS																
Total	(US\$ 10 ⁶)	19,944	21,082	5.7	490	465	- 5.2	490	465	- 5.2	1,071	1,151	7.5	32,229	33,520	4.0
Intra-MERCOSUR	(%)	51.0	49.3	- 8.3	49.1	53.6	17.3	51.0	49.3	- 8.3	49.1	53.6	17.3	23.6	23.5	3.6
Extra-MERCOSUR	(%)	50.9	46.4	- 2.0	76.4	76.5	4.1	49.0	50.7	- 1.7	50.9	46.4	- 2.0	76.4	76.5	4.1
IMPORTS																
Total	(US\$ 10 ⁶)	11,562	12,901	12.0	23,342	23,129	- 0.9	1,241	906	- 27.0	1,432	1,507	6.2	37,577	38,443	2.3
Intra-MERCOSUR	(%)	23.9	25.2	17.7	15.8	16.5	3.9	53.0	52.9	- 27.1	44.6	43.8	3.4	20.6	21.3	5.8
Extra-MERCOSUR	(%)	76.1	74.8	9.7	84.2	83.5	- 1.8	47.0	47.1	- 26.9	55.4	56.2	6.7	79.4	78.7	1.4
TRADE BALANCE																
Total	(US\$ 10 ⁶)	- 838	- 2,079		- 3,397	- 2,047		- 751	- 441		- 361	- 356				
Intra-MERCOSUR	(US\$ 10 ⁶)	746	300		- 452	- 173		- 410	- 250		- 112	- 43				
Extra-MERCOSUR	(US\$ 10 ⁶)	- 1,584	- 2,379		- 2,945	- 1,874		- 341	- 191		- 249	- 312		- 5,119	- 4,756	

Sources: Argentina (CEI); Brazil (SECEX/MICT); Paraguay (BCP) and Uruguay (BCU). Preliminary data.

Extra-bloc trade flows

The Asian crisis is unquestionably the main factor for the poor performance of extra-zonal exports. Its impact on the sub-region's exports was manifested in at least three effects: (i) an income effect, which results from a contraction in import demand from the Asian markets directly affected by the crisis (ii) a price effect, which translates into a decrease in export revenues, due to the decline in prices of some commodities with important participation in the import or export registries of these same countries; and (iii) a substitution effect, which results from the dislocation, in third markets, of sub-regional exports, primarily manufactured goods, due to the more competitive Asian production which is helped by the recent exchange rate devaluation of this region.

Studies developed by international financial institutions point to the substitution effect as potentially being the most harmful for the exports from the main emerging markets (including Brazil and Argentina), followed in importance by the income and price effects, in this order.

The first half of 1998 has shown that the reduction of commodity prices, whether from the Asian crisis, or due to climatic or cyclical reasons, has been up to now the main factor for explaining the poor performance

of sub-regional exports. The price effect has been blamed for a 10% decrease in Brazil's primary product exports and for losses of 18% and 37% in the case of Argentine agricultural manufactured goods and combustibles respectively.

The income effect also had negative repercussions on MERCOSUR exports. Argentine exports to the countries which were directly affected by the Asian crisis, fell 10% in the first half of 1998 and Brazilian exports to these countries fell almost 20% over the same period. Paradoxically, contradicting previous forecasts, the performance of extra-bloc manufactured products exports was reasonably satisfactory. Until now, only localized examples of MERCOSUR export dislocation have been registered due to more competitive Asian producers. However, none of the four MERCOSUR countries was able to expand its extra-zonal exports to rates above 4.3% over the first half of the year.

The extra-bloc imports, which always registered growth in the recent past in the double digits, virtually collapsed, growing only 1.4% between January and May. In this case the individual performances were quite heterogeneous: Brazil and Paraguay reduced their imports in absolute terms, while Argentina and Uruguay, the two economies that are still in an expansion phase, increased their extra-zonal imports at quite reasonable rates.

Intra-MERCOSUR flows

In terms of intra-bloc trade flows, the cooling of the Brazilian economy, an indirect result of the Asian crisis, constituted without a doubt the primary factor to explain the decrease of trade within the bloc's members. However, there are statistical discrepancies between Brazil's imports records and the export records of the other MERCOSUR members, mainly Argentina, that make a more precise evaluation of the intra-bloc trade flows difficult. In fact, according to the Brazilian import records from the first half of 1998, imports from Argentina and Uruguay would have grown 5.5% and 14.9% respectively. This would provide evidence for a performance much above the average of Brazil's total imports (-2.0%), over the same period, and much more satisfactory than that registered by the partial export statistics of these countries.²

There are some factors that have affected in a very particular manner the intra and extra-zonal trade of one of the MERCOSUR members, Paraguay. In fact, the domestic financial crisis and the currency devaluation contributed for the dramatic reduction (around 27%) of Paraguay's MERCOSUR and extra-MERCOSUR imports, while the decline of the prices of some commodities significantly damaged its exports. Furthermore, the re-exportation trade is also shrinking, due to more strict monitoring measures. In Paraguay's case there are no discrepancies between its export statistics and Brazil's import records, which confirm a 34% drop in Paraguay's exports to Brazil over the first half of 1998.

The contraction of imports in Brazil and Paraguay contributed to stabilizing the MERCOSUR trade deficit with the rest of the world. The trade imbalance from the first five months of the year (US\$ 4.8 billion) is slightly less than the US\$ 5.1 billion registered over the same period last year. Nevertheless, all four countries continue to present deficits in their extra-bloc trade balances.

Argentina is the only country that has significantly expanded its extra-bloc trade deficit at the same time as registering a quick erosion of surpluses in intra-zonal trade balances. If the current trends are maintained, the intra-subregional trade is not expected to register any significant deficits for any of the MERCOSUR members.

² Uruguay's statistics attribute the good performance of its intra-zonal exports (17.3%), exclusively to exports to Argentina.

B. The automobile, vehicle and auto-parts trade between Brazil and Argentina

Since the formation of MERCOSUR the trade of automobiles, auto-parts, and cargo and transport vehicles, developed under the protection of special sector regimes, has constituted one of the primary axes to sustain bilateral trade between Brazil and Argentina.

The automobile industry in both countries was one of the first to adhere to a globalization and industrialization strategy based on the location of sub-regional centers for the production of models of mass distribution, by implementing the concept that both the vehicle and its parts and pieces are interchangeable between the different manufacturing plants and production centers (Kosacoff and Porta [1997]). MERCOSUR currently represents one of these centers, by providing a home to almost all of the international automobile manufacturing companies. These companies have been developing, almost without exception, an integration strategy for their units, with the manufacturing of complementary sub-regional products, taking advantage of the ease of exchanging pieces and ready-vehicles, without paying the import tariff between the bloc members. This is the case of companies such as Volkswagen, Fiat, Renault, Scania Latin America, Mercedes-Benz and Ford.

The importance and the rapid growth of the automotive trade between the two primary members of MERCOSUR is outlined in Table II.3, developed with a base on Brazil's export and import records. The data covers the trade of a wide range, although not exhaustive, of 120 products (at the 8-digit level) from the automotive sector.

In 1997, the trade flows of the sector totaled US\$ 4.6 billion, accounting for more than 31% of bilateral trade. If the expansion rate registered over the first seven months of the year continues, automotive trade between Brazil and Argentina could reach US\$ 5.0 billion in 1998, increasing its participation to between 33-34% of bilateral trade.

In the last three years the sectoral exchange has resulted in trade balances in favor of Argentina, which is expected to be the case in 1998 as well. The disaggregation of automotive trade in sub-sectors suggests the existence of industrial specialization between members: Brazil dominates in the business of auto-parts and engines, while Argentina specializes in automobiles and cargo vehicles. However, some of these specializations are transitory and are expected to change with the beginning of operations that are still in development phases.

TABLE II.3
BRAZIL: DEVELOPMENT OF AUTOMOBILE, VEHICLE, AND AUTO-PARTS
TRADE WITH ARGENTINA (1) - 1995-1998
(US\$ million)

Category	1995			1996			1997			1998 *		
	Exp.	Imp.	Bal.	Exp.	Imp.	Bal.	Exp.	Imp.	Bal.	Exp.	Imp.	Bal.
1. Engines and their parts	173.8	144.1	29.7	245.2	200.0	45.2	304.0	282.2	21.8	172.9	113.4	59.5
2. Passenger automobiles	180.6	204.7	-24.1	334.1	765.1	-431.0	671.0	1,344.6	-673.6	386.6	862.0	-475.4
3. Transport vehicles	7.3	0.4	6.9	12.6	0.1	12.5	6.8	74.6	-67.8	10.7	53.8	-43.1
4. Cargo vehicles	87.0	358.0	-271.0	238.7	229.8	8.9	439.5	555.6	-116.1	363.7	467.0	-103.3
5. Chassis and bodies	31.7	83.4	-51.7	47.7	84.1	-36.4	64.2	17.8	46.4	39.4	4.7	34.7
6. Parts and auto-parts	420.5	363.4	57.1	534.4	275.0	259.4	566.3	313.9	252.4	345.4	159.0	186.4
TOTAL	900.9	1,154.0	-253.1	1,412.7	1,554.1	-141.4	2,051.8	2,588.7	-536.9	1,318.7	1,659.9	-341.2
Memo:												
(%) In the total flow	22.3	20.6		27.3	22.9		30.3	31.9		32.3	35.3	

Source: Basic data from SECEX/MICT (Brazil). Developed by FUNCEX.

Notes: (1) Includes 117 products (8 digits) corresponding to Chapters 84 and 87 in the Harmonized System (SH). (*) Period January-July.

The sub-regional specialization in the automobile industry headquartered in MERCOSUR is unquestionable (Table II. 4). In 1997, for example, almost 40% of Brazil's imports and exports in the automotive sector were conducted with Argentina. In some sub-sectors (passenger automobiles and cargo vehicles) this specialization was even more intense, highlighting the sub-regional center character attributed to MERCOSUR.

TABLE II.4
ARGENTINA'S PARTICIPATION IN THE FOREIGN TRADE OF
BRAZIL'S AUTOMOTIVE SECTOR (1) - 1997

Category	Argentina's participation (%) in Brazil's automotive trade	
	Exports	Imports
1. Engines and parts	26.8	24.3
2. Passenger automobiles	45.9	54.5
3. Transport vehicles	5.2	33.9
4. Cargo vehicles	49.1	76.9
5. Chassis and bodies	17.0	60.1
6. Parts and auto-parts	40.4	18.8
AUTOMOTIVE SECTOR (Σ 1 A 6)	38.0	41.2

Source: Basic data from SECEX/MICT (Brazil). Developed by FUNCEX.

Note: (1) Includes 117 products (8 digits) corresponding to Chapters 84 and 87 of SH.

Finally, note that the sub-regional specialization plays an important role as a stabilizing factor for the bilateral trade flows. This is what happened in the first half of 1998 when the Brazilian imports of products from the Argentine automotive sector registered significant growth of 38%, more than counterbalancing the 6% drop suffered by the other products on the bilateral import list.

C. Flows of foreign direct investment

Since the middle of the 1990s, global flows of foreign direct investment (FDI) have been growing at impressive rates. In fact, after suffering a sharp reduction in 1991-92, the FDI flows recovered in the following years, registering an average annual growth of 17.7% during the 1993-96 period. The decline in the flows in the first half of the decade only affected the developed countries. In the other regions in the world, the flows of FDI increased uninterruptedly between 1990 and 1996.

Asian countries were the primary recipients of the FDI flows, among the developing economies, and their participation in global flows more than doubled. In 1996, Asian countries absorbed almost one fourth of the global flows of FDI, or the equivalent of two thirds of the total FDI destined to developing countries.

Nevertheless, the flows of foreign investment directed to countries in Latin America and the Caribbean grew at an even faster rate, in such a manner that the region tripled its participation in the global total. Even more impressive is the performance of the MERCOSUR countries, especially over the most recent period. In fact, between 1993 and 1996, the flows of FDI grew at an average rate of 57.1% per year, a rate which is twice as high as that registered in the other countries in Latin America and the Caribbean, and three times above that registered by the Asian countries.

TABLE II.5
NET FOREIGN DIRECT INVESTMENT FLOWS - 1990-1996
(US\$ billion)

Group/Region	1990	1993	1996	Growth (% a.c.) 1993-90	1996-93	Part. (%) 1996
DEVELOPED COUNTRIES	176.3	138.8	208.2	2.8	14.5	58.8
ECONOMIES IN TRANSITION	0.3	6.3	12.3	85.6	24.9	3.5
DEVELOPING COUNTRIES	31.0	72.3	133.8	27.6	22.8	37.8
Africa	2.2	3.7	4.9	14.8	10.3	1.4
Developing Europe	0.1	0.3	0.6	25.1	28.5	0.2
Latin America & the Caribbean	8.4	17.3	43.6	31.7	36.1	12.3
MERCOSUR	2.9	4.1	15.8	32.6	57.1	4.5
Others	5.5	13.2	27.8	31.2	28.1	7.8
Developing Asia	20.3	51.0	84.7	26.9	18.4	23.9
TOTAL	207.6	217.3	354.2	9.3	17.7	100.0

Source: CEPAL (1998).

The development of the FDI flows in 1997 confirms the importance of MERCOSUR as a major area to attract foreign capital (Table II.6). Note that in this sense between 1994 and 1997 the growth of FDI in MERCOSUR was above 62% per year.

The reasons that explain the recent surge of growth of FDI flows to MERCOSUR are diverse, but the primary reasons are without a doubt the stabilization and structural reforms (trade liberalization, privatization, and deregulation).

In terms of the distribution of FDI flows between the four MERCOSUR countries, Argentina and Brazil have always received more than 95% of the resources directed to the sub-region. Between 1990 and 1994, Argentina greatly surpassed Brazil in the competition for FDI flows directed to MERCOSUR, a fact which highlights the importance of economic stability as a factor in attracting this type of capital. In 1995, the year after the enactment of the Real Plan, the distribution of flow between the bloc's two primary members balanced out. However, in the last two years Brazil's participation grew rapidly and began to receive more than 70% of the total resources invested in MERCOSUR.

In Argentina, privatization played an important role as a factor in attracting foreign capital in the first years of the 1990s. In fact between 1990 and 1993, privatizations were responsible for more than 60% of the FDI flows to this country. Beginning in 1994, its contribution fell drastically to percentages not above 15%. In Brazil estimates for the 1994-97 period show that privatizations were responsible for approximately 22% of the gross FDI flows (Sobeet [1998]). However, this participation is growing and reached almost 30% in 1997 and is expected to grow even more in 1998 due to privatizations scheduled for telecommunication and electrical energy companies. The importance of privatizations as a factor for attracting FDI should not be exaggerated. Proof of this is the continual increase of FDI in Argentina, even after the privatization process had practically been concluded.

The Asian crisis, despite fears expressed directly after its emergence, does not appear to have affected the intensity of FDI flows directed to MERCOSUR. This appears to be the case of Argentina, according to studies conducted (CEP [1998]) with a base in methodology different from that presented here, which makes a comparison difficult. In terms of Brazil, the FDI flows registered between January and May totaled US\$ 5.5 billion, which was 15% less than the value registered over the same period in 1997. However, it must be noted that the base of comparison includes the participation of foreign capital in the privatization of Cia. Vale do Rio Doce (CVRD), finalized in May 1997, which contributed to magnify this year's decrease. A measure

of the importance of the FDI flows in the Brazilian case is given by the contribution to the financing of deficits in the current account. In 1997, this contribution reached 51.1%, while over the January-May period this year it remained high at 49.1%.

TABLE II.6
MERCOSUR: NET FOREIGN DIRECT INVESTMENT FLOWS - 1990-1997
(US\$ million)

	1990	1991	1992	1993	1994	1995	1996	1997	Accumulated 1990-97	
									Flows	Structure (%)
FDI flows to:										
Argentina	1,836	2,439	4,044	2,557	3,067	4,783	5,090	6,327	30,143	42.3
Part. in the flow of FDI to MERCOSUR (%)	63.3	66.7	64.2	62.7	55.2	50.7	32.9	26.6		
Participation of FDI in GCF (%) *	9.3	8.9	10.9	5.8	5.5	9.9	8.9	na		
Participation of FDI in GDP (%) *	1.3	1.5	2.2	1.3	1.3	2.1	2.1	na		
Brazil	989	1,103	2,059	1,301	2,150	4,313	9,976	17,085	38,976	54.8
Part. in the flow of FDI to MERCOSUR (%)	34.1	30.1	32.7	31.9	38.7	45.7	64.5	71.8		
Participation of FDI in GCF (%) *	1.1	1.2	2.5	1.4	2.8	3.5	7.8	na		
Participation of FDI in GDP (%) *	0.2	0.3	0.5	0.3	0.6	0.8	1.8	na		
Paraguay	76	84	137	119	180	184	225	230	1,235	1.7
Part. in the flow of FDI to MERCOSUR (%)	2.6	2.3	2.2	2.9	3.3	1.9	1.5	1.0		
Participation of FDI in GCF (%) *	6.6	6.5	11.2	9.3	12.8	11.8	14.2	na		
Participation of FDI in GDP (%) *	1.4	1.5	2.3	1.9	2.7	2.6	3.0	na		
Uruguay	---	32	58	102	155	157	169	159	832	1.2
Part. in the flow of FDI to MERCOSUR (%)		0.9	0.9	2.5	2.8	1.7	1.1	0.7		
Participation of FDI in GCF (%) *		2.5	3.8	5.6	7.9	8.4	8.0	na		
Participation of FDI in GDP (%) *		0.3	0.5	0.9	1.2	1.2	1.2	na		
MERCOSUR	2,901	3,658	6,298	4,079	5,552	9,437	15,460	23,801	71,186	100.0
FDI flows to MERCOSUR as a percentage of FDI flows to:										
Latin America and the Caribbean	34.7	23.7	35.6	23.6	18.4	31.3	35.7	na		
Developing countries	9.4	8.8	12.3	5.6	5.9	9.3	11.6	na		
World	1.4	2.3	3.6	1.9	2.3	2.9	4.4	na		

Sources: CEPAL (1998). The data for 1995 and 1996, in the case of Brazil and Argentina, are different from the CEPAL data, they incorporate recent corrections. The data from 1997 is preliminary.

Notes: (*) Calculated from series in constant 1990 dollars, according to estimates by CEPAL (1998), with correction by the authors for Argentina (1995 and 1996) and Brazil (1995 and 1996). GCF: Gross Capital Formation.

Mention must also be made to the performance of the smaller economies throughout this decade. In Paraguay the participation of FDI in the GDP has proven high throughout this period, while in Uruguay this participation increased significantly between 1991 and 1994, stabilizing in later years.³ However, last year the FDI flows remained stagnant or decreased in both countries, not following the vigorous growth registered in Brazil and Argentina.

With the goal of attracting a greater inflow of foreign capital, Paraguay approved, but has yet to regulate, a Law aimed at promoting assembling plants (Maquila) which has generated some apprehension among members of the bloc. In Uruguay a new law was approved and regulated to promote investments (Law N° 16,906).

³ However, the estimates of FDI in Uruguay are recognizably weak. The stagnation may be the result of underestimates.

CHAPTER III. MARKET ACCESS AND CONDITIONS OF COMPETITION

Although it has been more than three years since the implementation of the Customs Union in MERCOSUR there are several national policies which have kept or created new obstacles to the consolidation of the sub-region's free trade regime. Practices such as the use of defensive trade measures to restrain imports from other member countries or the adoption of other non-tariff restrictions to imports, such as the establishment of limits for the financing of imports and the use of previous license on imports has generated complaints and disputes from several countries.

In the case of the sugar and automobile sectors, which still do not have common policies for the management of trade and investment, the advances achieved in the negotiation process have yet to delineate the format for the rules that will be used to regulate the sectors in the next decade.

A. Trade restrictions, non-tariff measures and trade disputes

In December 1997, Decision N° 17/97 of the Common Market Council (CMC) established that the countries should present to the MERCOSUR *Pro-Tempore* Presidency a time-frame for the partial or total elimination of non-tariff trade barriers placed on intra-bloc trade identified by Resolution N° 32/95. This resolution contains an inventory of the non-tariff measures and restrictions reported by Working Sub-groups, Technical Committees, Specialized Meetings, and MERCOSUR *Ad-Hoc* groups.

The MERCOSUR Trade Commission (MTC) will submit a report to the Common Market Group (CMG) which will include 26 measures identified by the Technical Committee N° 08 (Committee on Non-Tariff Measures and Restrictions) to be withdrawn from Resolution N° 32/95 for not having a legal base or for being duplicated. Furthermore, a new list was developed which includes non-tariff measures and restrictions related with government purchases, customs valuation, services and the automobile sector. The CMG will be requested to provide instructions on the treatment to be conferred by the countries to facilitate the reduction or elimination of these restrictions.

The following section covers the primary trade disputes that have occurred in MERCOSUR during the first half of 1998.

Brazilian restrictions on the imports of milk, dairy products, and other foodstuffs

The governments of Argentina, Paraguay and Uruguay have expressed their concern in relation to the various measures applied by the Brazilian government, which would affect the trade of milk and dairy products in the sub-region. In particular the countries cited Decree 2503/98 which raised from 27% to 33% the import tariff tax charged on determined tariff positions in the sector which were already included in the Brazilian list of goods to be exempted from the Common External Tariff (CET). Also mentioned was the Communication DECEX/SECEX N° 7/98 by which the mechanisms were modified for the previous licensing system which was not automatically enforced for the sector's products, as well as the reduction to 30 days for the maximum import financing period.

Dairy products are among the primary tariff items of Argentine exports to Brazil. In 1997, Argentina's sales to the Brazilian market reached US\$ 467 million, which represents almost 70% of Argentina's total exports of products from this sector.

The National Agriculture Confederation (CNA) submitted a document to the Brazilian government which denounces both Argentina and Uruguay for having bought powdered milk from New Zealand and re-exporting the product to Brazil as if it had been produced in MERCOSUR. Brazilian producers allege that the powdered-milk exported to Brazil at a price that varies from US\$ 0.61/l and US\$ 0.66/l is sold in Argentina and Uruguay for US\$ 1.16/l and US\$ 0.88/l, respectively. It appears that there is no evidence that Argentine or Uruguayan producers are benefiting with the concession of government subsidies to milk production. The difference of prices between the countries should reflect the greater relative competitiveness of Argentine and Uruguayan production *vis-à-vis* Brazilian production and of arbitrage gains in interest rates won by the importers, given the possibility of buying dairy products in MERCOSUR with payment periods that surpass one year and selling the products on the Brazilian spot market.

The Argentine government is also afraid that Brazil will extend the rule, which limits the financing period for all agricultural imports to 30 days, which could affect a significant part of Argentina's exports to Brazil.⁴ In 1997 of a total of US\$ 5.5 billion imported by Brazil in fresh and processed foodstuffs, 41% came from Argentina. In the specific case of wheat, another conflict may arise if the Brazilian government is sensitive to the request made by the Brazilian Wheat Industry Association (Abitrigo) which is pleading for the common external tariff on wheat to be reduced from 13% to zero. The argument of representatives from the milling industry is that the importing of wheat from third markets is necessary to be able to produce flour with an adequate mix. According to Argentine producers, the lowering of the tariff would imply a significant reduction in "preference margins" conferred by the common external tariff on wheat produced in the region in relation to other important competitors such as Canada and the US. Brazil imports 5.3 million tons of wheat annually, of which 3.9 million tons is supplied by Argentina.

Brazil's previous license system on imports

During a bilateral meeting between the Chilean and Brazilian governments, held in Rio de Janeiro in March, the Chilean representatives consulted with Brazil requesting the revision of restrictions on Chilean exports. The demand of a previous license on imports, regulated by SECEX N° 37/97, would operate, according to the Chilean government, as an obstacle to the sale of Chilean products to Brazil, especially textiles and foodstuffs. The Chilean representatives also allege that Brazilian customs officials would be using a list of minimum prices on fabric imports, a procedure, which would conflict with the rules of the GATT-WTO Customs Valuation Code.

Representatives from Chilean industry allege that the use of such instruments by Brazil contradicts the terms of the MERCOSUR-Chile Agreement, which forbids the application between the countries of new barriers or non-tariff restrictions after having countersigned the agreement. Part of the solution submitted by the Chilean government was the creation of a bilateral commission to debate the issue. If an agreement is not met between the governments on the issue, the Chilean business sector believes that Chile should submit the case to the GATT-WTO for examination.

During the XXVI Meeting of the MERCOSUR Trade Commission, held February 16 and 17, the delegations of Argentina, Paraguay and Uruguay also expressed their concerns regarding the procedures adopted by Brazilian trade authorities that would introduce a measure of administrative character, contradicting the

⁴ In 1997, the Brazilian Central Bank had established the minimum period of one year for the financing of imports with values above US\$ 10,000. Since then, MERCOSUR countries have been included in an exception regime by which financing can be authorized for up to 89 days for imports of less than US\$ 40,000. In February 1998, dairy products were no longer included in this special regime. Currently, of Argentina's total exports to Brazil, almost US\$ 1.5 billion are made under this exception regime. Through Circular N° 2863 from June 18, 1998, the Central Bank of Brazil extended for the fifth time, until October 31 of this year, preferential treatment for the payment of all of the financed imports from MERCOSUR countries, under the aforementioned criteria.

sacred principle of Article 1° of the Asuncion Treaty. Based on this argument, the three countries requested the Brazilian government to exclude MERCOSUR partners from the reach of the Communication.

However, the Brazilian government alleged that by bringing together in a single Communication the controls that are already enforced on the licensing of imports, which are compatible with the GATT-WTO Agreement on Import Licensing, Brazil has contributed to increasing the degree of transparency of the trade policy. Therefore, there would not be incompatibility between the instrument and the MERCOSUR standard. However, the Brazilian representatives are prepared to examine the exact and concrete problems that may be brought up by the members in the application of the Communication.

GATT-WTO trade defense mechanisms

The opening of anti-dumping and anti-subsidy investigations, as well as the imposition of claims against disloyal trade practices, is incompatible with the functioning of a Customs Union. The absence of internal barriers to the circulation of products means that abusive trade practices should be examined with a base in competition policy mechanisms. MERCOSUR has yet to approve common rules for the application of a competition defense policy, which would imply the elimination of the use of defense mechanisms against disloyal trade practices within the integrated market.

A report from the Anti-dumping Practices Committee of the GATT-WTO reveals that Argentina's anti-dumping legislation has been widely employed against Brazilian exports. Of the 25 cases filed in Argentina, ten lawsuits are against China, eight against Brazil,⁵ two against South Korea, and one against Hong Kong, Hungary, India, Taiwan and Venezuela. There are still 29 investigation processes underway, seven of which involve products exported by Brazil. Among the Brazilian products accused of the charge of anti-dumping in Argentina are: aluminum cables, photoelectric cells, disks and blades for saws, and fuses for voltage less than 100 volts.⁶ The Brazilian products under investigation in Argentina are the following: bicycle tires, compressors for domestic refrigeration, diaphragms and aluminum cables. In 1997 alone Argentine authorities began 14 new investigations, three of which relate to merchandise from Brazil and are still underway.

In the case of Brazil, of a total of 24 anti-dumping measures enacted there have not been any investigations, which have resulted in the imposition of claims against imports from Argentina. The primary countries affected by the charge of anti-dumping claims by Brazil are China and the United States, with five cases each.

Customs valuation regime

Since March 2, 1998 Brazilian customs houses have been operating the customs valuation system that allows the customs control to perform the charge of the import tax, taking as a base the value of imported merchandise different from that being declared by the importer. If for example, it is suspected that the price of the imported product is under-invoiced, the customs officers use a table with a sample of import prices and charge the import tax taking into consideration the difference between the product's constant average price and the price registered in the import guide. The customs valuation system has rules for its application defined in the GATT-WTO and is used by more than 130 countries.

Since then, Brazil has applied the customs valuation system especially in the imports of electronic products, textiles and foodstuffs. In the case of these last two products, the imports from MERCOSUR countries are

⁵ Among the eight measures underway, the investigation processes of three of them began before the formation of MERCOSUR.

⁶ The purchases of these products account for almost 1% of the total Argentine imports from Brazil.

inspected according to the rules of the customs valuation system, which has elicited a protest by some importers that allege being unfamiliar with the parameters that the Federal Revenue (Receita Federal) uses to construct its price tables. Furthermore, the price tables are not released by the customs inspection system that prohibits the release of trade information such as, for example, the value of import operations, because it considers the data relative to secret private transactions. Importers are demanding greater transparency in regards to the application of the customs valuation system. For them, not having access to information regarding the prices used by customs officials means acquiring merchandise abroad without knowing how much the import tax will be that is charged on the product upon its arrival in the importer's country.

Argentina uses quite different methods in the application of the customs valuation system. Customs publishes the minimum import prices and the import guides, even releasing the name of the vendor, the importer, the prices and the quantities of the operation. According to the Argentine government, by providing the import prices it hopes to avoid practices such as dumping or the occurrence of any other type of import irregularities.

Pork subsidies

In the May meeting of the Common Market Group, Argentine negotiators requested an arbitrated solution for the dispute about pork trade between Argentina and Brazil, according to the rules established by the Brasilia Protocol for the Solution of MERCOSUR Controversies. According to the Argentine negotiators, Brazil is exporting subsidized pork to Argentina. The subsidy comes from two sources: (i) the special assistance the Brazilian government grants agricultural production, in particular corn; and (ii) the benefits of the Export Stimulation Program (Proex) which directs resources from the Treasury for the equalization of domestic and international interest rates.

The use of these mechanisms would explain the significant increases in Brazilian pork exports. Between 1991 and 1997 Brazilian pork exports jumped from 2,000 tons per year to 57,000 tons per year.

Brazilian negotiators tried to delay the decision on the matter, nevertheless the Argentines have alleged that the time allotted for the reaching of an agreement of consensus on the issue has expired. With the Argentine request that the subject be examined according to the procedures of the MERCOSUR controversy resolution system, a committee of specialists from the four MERCOSUR countries will be created. The committee will determine the existence or non-existence of subsidies and the procedures that will be applied in the export of Brazilian pork to Argentina.

Taxation of Foreign Cigarettes in Uruguay

Argentina is expected to appeal to the MERCOSUR Solution of Controversies System to reach a solution to the problem involving the charging by Uruguay of a Specific Internal Tax (*Impuesto Interno Especifico* - IMESI) on cigarettes. The Argentines question the differentiated tax treatment conferred on imported cigarettes in comparison to cigarettes made in the domestic market. The IMESI tax corresponds to 66.5% over the sales price of cigarettes produced in Uruguay. When imported from the other MERCOSUR countries the cigarettes suffer an additional 30% taxation from IMESI, besides the charge of the specific tax. Such a procedure, in addition to disrespecting the GATT-WTO principle of national treatment, functions as a non-tariff barrier to cigarette imports.

Once it is established, the arbitrage tribunal will have 60 days to make a judgement on this issue. This time limit may be extended by 30 days. Three members will form the tribunal, one of which will be from Argentina, another from Uruguay, and a third from one of the other two MERCOSUR member countries. According to the standard of the Brasilia Protocol on the Resolution of Controversies, the parties involved will be required to accept the sentence issued by the tribunal.

Consultations to the MERCOSUR Trade Commission

The use of the mechanism of consultations with the MERCOSUR Trade Commission (MTC) is designed to facilitate resolutions related with the instruments of trade policy and with the implementation of MERCOSUR standards in the trade area. The general procedures for the submittal, discussion and solution of complaints of the members can be found in the Attachment of the Ouro Preto Protocol and were regulated by way of the MTC Directive N° 6/96. The consultations are presented in a specific formula defined by this directive and in each MTC meeting the agenda includes a program entitled “Consultation of the Member States”, in which “new consultations”, “answers to the consultations” and the “follow-up of the consultations” are presented.

The new consultations presented in the MTC meetings in the first half of 1998 are as follows:

- Consultation N° 01/98: answer from Argentina to Brazil about the anti-dumping investigation opened against Brazilian exports of “low and medium tension electrical energy transmission cables”.
- Consultation N° 02/98: Brazil requests Argentina for information about the anti-dumping investigation opened against exports of “soldered open link chains”.
- Consultation N° 03/98: answer from Argentina to Brazil about the divergence in the classification of “PVC joints”.
- Consultation N° 04/98: Brazil requests Argentina to make the final copy of Resolution 630/94 on chicken imports available for the other MERCOSUR countries, before its internalization.
- Consultation N° 05/98: Brazil requests Argentina to clarify the charge of a customs tax on vegetable and animal products in international transit.
- Consultation N° 06/98: Brazil requests Uruguay to have the National Customs Management to resolve the problem of the embargo of equipment for use in the civil construction industry.
- Consultation N° 07/98: answer from Argentina to the Brazilian question about the need to meet the rules of origin established in MERCOSUR for refrigeration equipment or for air conditioning with a determined capacity.
- Consultation N° 08/98: answer from Brazil to Argentina about the difference in the tariff classification for “silicone sealants.”
- Consultation N° 10/98: Brazil expresses concern regarding the criteria used by Argentina for the certification of low-tension electrical equipment.
- Consultation N° 11/98: Brazil requests Argentina to clarify the tariff charged on temporary exports of “train engines” for repair in other MERCOSUR member countries.
- Consultation N° 12/98: Brazil requests Argentina to exclude “high density polyethylene” from the list of products included in the Argentine “transitory regime”.
- Consultation N° 13/98: Brazil requests Uruguay to exclude “refrigerator and freezer combinations” from the list of products included in the Uruguayan “transitory regime”, since the product is not produced in that country.
- Consultation N° 14/98: Paraguay requests Argentina to eliminate the customs tax on animal and vegetable products in international transit.
- Consultation N° 16/98: Argentina requests Brazil that the regulation decreed by the State of São Paulo, which establishes authorization procedures for the sale of imported products, will not apply to products from other MERCOSUR nations.

- Consultation N° 17/98: Argentina requests Uruguay to completely eliminate the discrimination in the application of the IMESI charged on non-alcoholic concentrated juice-based beverages, establishing national treatment for products from MERCOSUR members.
- Consultation N° 18/98: Paraguay requests Argentina to provide information about the rules for labeling beer, due to supposed difficulties Paraguay has encountered in exporting this product to the Argentine market.
- Consultation N° 19/98: Paraguay requests Uruguay to provide information about the origin of “bath towels” which were exported as a Uruguayan product, when it appears that they were really produced in Chile.

B. Special Sectors

Automotive regime

During the first half of 1998, the governments of the MERCOSUR countries continued discussions regarding the automotive regime, which is expected to be in force in MERCOSUR beginning in the year 2000. During the July summit meeting of the MERCOSUR chiefs of state held in Ushuaia (Argentina), it was still not possible to overcome the impasses so that the member countries could reach a final agreement. The establishment of common rules for the automobile sector is of chief importance, given that it currently represents almost 30% of the total trade flows between MERCOSUR countries.

The debates about the characteristics of the future regime focuses on three aspects: (i) the levels of protection for the final products and their parts; (ii) the level of sub-regional content; and (iii) the deadline after which no new subsidies may be conceded, as well as the future of subsidies which have already been granted. In the case of automobiles, a proposal is being discussed which would fix the import tax at 35% *ad valorem*, the maximum tariff of the Common External Tariff (CET) and corresponds to tariff levels ratified by the MERCOSUR countries with the GATT-WTO. In the case of tractors, trucks and buses, there are still differences in the levels of the CET. For auto-parts imports the proposal is for the import tax tariffs to remain between 14% and 18%. No agreement has been reached on the minimum level of sub-regional content. The most likely is that the percentage will be set at 60%, which means that the manufactured automobiles, to be considered local goods, must contain a minimum of 60% of inputs, parts and pieces produced in MERCOSUR countries. Nevertheless, there is no consensus about the distribution of the content of parts and pieces between the countries. Argentina expressed its desire that of the 60% sub-regional content, half should be supplied by Argentine producers and the other half by Brazilian producers. Brazilian negotiators allege that such a proposal is unacceptable because it contradicts GATT-WTO rules that do not allow sub-regional “discrimination” in the application of rules of origin.

The difficulty in reaching an agreement is complicated by the position of Paraguay and Uruguay that are against the Brazilian proposal, supported by Argentina, of fixing at 35% the import tax tariff for final goods beginning in the year 2000. Paraguay is not interested in maintaining this level of protection because there is no local production and in addition the government has just approved a law which provides fiscal advantages, for a ten-year period, to automobile companies that establish operations in the country. The program includes the exemption of import taxes on capital goods, raw materials, components, parts and kit pieces for assembly. Another advantage that can be gained by the industry is the import of finished vehicles with a 50% discount of the customs tariff for values corresponding to the manufacturers’ exports.

In the case of Uruguay, which has Citroën, Peugeot and Renault factories, the automobile sector counts on a tariff policy which was established in 1990: the final products imported from third markets pay a 20% import

tax. In an attempt to provide incentives for manufacturers to open operations in the country, the Uruguayan government charges a tariff of 2% on the import of unassembled automobiles (*CKD*). According to the position defended by its negotiators, the signing of the automotive agreement by Uruguay would be conditional on the concession of a waiver for the maintenance of the current system and of the preferences negotiated bilaterally under the PEC agreements (Brazil-Uruguay) and CAUCE (Argentina-Uruguay) until the year 2005. This means that the Uruguayan industry would be able to use a larger percentage of extra-zonal parts and pieces, around 60%. Within certain periods, the Uruguayan industry would begin to operate with a “sub-regional preferential content index”, under which 50% of the parts of the vehicles it assembles would be required to be produced in the sub-region.

Another item of the new agreement involves the concession of governmental incentives and the participation of state governments in new investments made by manufacturing companies. Such events, according to the evaluation of certain countries, in particular Argentina, have introduced distortions in the spatial allocation of manufacturers’ investments in MERCOSUR. In this case the Argentine negotiators presented a proposal under which by the year 2000 the manufacturers in the sub-region which receive benefits from any type of subsidy (from Brazil or Argentina) will have their products taxed as if they were from outside of the sub-region. This would mean that in the intra-subregional trade of these automobiles they would pay a tariff of 35%. Representatives from the Brazilian industry, through the manifestation of the National Association of Automobile Manufacturers (ANFAVEA), believe the Argentine proposal is unacceptable.

According to the GATT-WTO standards ratified in the TRIMs (*Trade Related Investment Measures*), the automotive regime also cannot use investment stimulus mechanisms that require, as a counterpart the concession of benefits, the meeting of export goals, the balance of the sector’s import and export flows or the fixing of a minimum local content requirement for the production of goods. In fact these measures, ratified in the industrial policies for the automobile sector enacted in Argentina, Brazil and in Uruguay should be eliminated by December 31, 1999, when the five year transition period set by the TRIMs for developing countries ends.

A consensus has been reached between negotiators on at least three of the future agreement’s points: (i) the date for the enactment of the automotive regime, January 1, 2000, is maintained; (ii) there will be free intra-zonal trade; and (iii) the subsidies which generate distortions in the relative competitiveness of the countries will be eliminated.

The associations of automobile manufacturers from Argentina and Brazil, Adefa and ANFAVEA respectively, defend with their governments the inclusion in the automotive regime of a clause that would permit the lowering of 50% of the import tax tariff on final products and auto-parts, when these are bought by producers established in MERCOSUR. For the importers of brands not established in one of the four countries should be charged the full tariff rate. According to the understanding of the representatives of the automobile industry, the charging of differentiated tariffs would be in force between the years 2000 and 2005, the period necessary for the industry to be able to implement the necessary adjustments to be able to compete, without disadvantages, with imports. However, the regime would only benefit the companies that already have operations in the Argentine and Brazilian markets, excluding the manufacturers that open operations in the sub-region after the new system is approved.

The independent importers established in Brazil demand the maintenance of the current tariff quota system. According to the regime in force in Brazil, the imports for an annual quota of 50,000 vehicles, distributed between countries, pay 50% of the full tariff, which during 1998 is equivalent to an import tax of 24.5%.

Sugar sector

The negotiations involving trade in the sugar sector in MERCOSUR have not presented significant advances since the creation of the Customs Union. Today sugar represents one of the few cases in which it was not possible to reach any kind of agreement for the liberalization of the intra-bloc trade. The last time that negotiators faced the issue occurred during a meeting of the Common Market Group in July 1997. The subject was included again in the agenda of negotiations by the request of the Brazilian negotiators.

Brazil has been demanding the liberalization of intra-subregional trade. The import tariff charged on imported sugar by Argentina varies between 20% on intra-subregional imports and 39% on extra-zonal imports. The procedure in this case would be the inclusion of sugar in the “transitory regime” and the setting of decreasing tariffs until the complete liberalization of intra-MERCOSUR trade has been achieved. The classification of sugar in the “transitory regime” as a sensitive product should imply the reduction to zero tariffs charged on intra-bloc trade by January 1, 2001.

According to the estimate of the Argentine sugar production sector, the governmental policies that affect the production of sugar/alcohol in Brazil, especially Proalcool, would imply the concession of “implicit” subsidies to the sector, providing raw materials (sugar cane) for the production of sugar at extremely low prices. For example, when the Brazilian government sets at 22% the percentage of sugar cane alcohol that should be mixed to gasoline, it creates a captive market, which ends up reducing the costs of sugar production. If the Brazilian alcohol sector reduces production, the Argentines are concerned that an increase in sugar production may occur and lead to a consequent market loss of the local production.

In the last harvest, 1996-1997, Argentina produced 1.65 million tons of sugar and 102 million liters of alcohol. Brazilian production is significantly larger: 14.8 million tons of sugar and 14 billion liters of alcohol. The average productivity of a sugar cane plantation is 59.1 tons per hectare in Argentina compared with 47.1 to 75.5 tons per hectare in Brazil.

Taking into account the difficulties in incorporating the sugar sector into the customs union regime, the Common Market Group (CMG) in its XXX Meeting decided to submit to the Presidents (who met in the Common Market Council) a proposal which would permit the liberalization of intra-zonal trade of the sugar sector as a result of the application of the MERCOSUR Common Sugar Policy. The primary commitments to be met by the countries would be: (i) the definition, by January 1, 1999, of all of the tariffs applicable to the sector’s products for both intra-MERCOSUR trade and trade with third countries; these tariffs should “incorporate” non-tariff restrictions, substituting the protective regime enacted in the countries; in the cases in which the tariff level is higher than those ratified in the GATT-WTO, the current level of protection will be maintained; (ii) for the intra-MERCOSUR imports beginning January 1, 2000 there will be a progressive reduction in import tax aliquots set by countries to come into effect from January 1, 1999 until reaching 0% on January 1, 2002; (iii) the level of the common external tariff will be 16% and will be charged on imports from third countries beginning January 1, 2002, with the exception of trade agreements signed or under negotiation between MERCOSUR and third countries.

C. Competition Defense Protocol

Technical Committee N°5 is continuing its activities for the preparation of the MERCOSUR Competition Defense Protocol Regulation project. The CMG examined the technical cooperation project in the framework of the IDB-MERCOSUR Program. The objectives of the project to be executed together with the national competition defense bodies are: (i) to make the implementation of the MERCOSUR Competition Defense Protocol viable, through the analysis of the experience of the European Commission on the matter and the holding of annual seminars for the discussion of case studies; (ii) to conduct activities and to put into action the necessary means for the diffusion of a competitive culture in MERCOSUR; (iii) develop programs for the training of employees and technicians from the national competition defense bodies; and (iv) strengthen the administrative capacity of the national competition defense bodies.

CHAPTER IV. COMMON POLICIES, POLICY HARMONIZATION AND OTHER STRENGTHENING MEASURES

Everything indicates that during the last six months the primary advance in the MERCOSUR integration process, in the area of measures to strengthen it, was the approval of the Montevideo Protocol on Trade of Services in MERCOSUR. The agreement defines the framework of intra-bloc negotiation which will allow the countries to present specific offers in a manner which will complete, in a maximum period of ten years, the program of services trade liberalization between the countries.

A. Liberalization of the services sector

The “Montevideo Protocol on the Trade of MERCOSUR Services” was signed in December 1997. Inspired, in large measure, by the General Agreement on the Trade of Services (GATS), the Protocol defines a framework of intra-bloc negotiation that will permit countries to present offers of trade liberalization in the sector.

The requirements and general system of regulations of the agreement are founded in the following principles: (i) “most favored nation treatment,” under which each Member State is required to immediately and unconditionally grant services and service providers from other Member States treatment which is no less favorable than that granted to any other specific partner, within MERCOSUR or under any other international agreement; (ii) “national treatment” under which each Member State is required to grant services and service providers from any other Member State treatment which is no less favorable than the treatment conferred upon its own services or similar service providers; (iii) the non-adoption of measures that set quantitative limits to the number of service providers, the number of total operations, the total value of assets or the service transactions in the form of numerical contingents or that establish restrictions to specific people and legal entities or the participation of foreign companies; and (iv) transparency in terms of all of the domestic measures that may affect intra-bloc services trade. The contracting of governmental services does not fall under the principles and rules of the Services Protocol.

The definition of specific commitments to liberalization will be established through successive negotiating rounds designed to complete, within a maximum period of 10 years, the Liberalization Program of services trade between countries. The negotiating rounds will be held annually and their main objective will be the progressive incorporation of sectors, activities and modes of providing services in the Liberalization Program, as well as an increase in the level of specific commitments assumed by the Member States.

Under Resolution N° 31/98, the Common Market Group (CMG) created the Services Group as an auxiliary body for the handling of issues related to the trade of services between MERCOSUR countries. The Services Group is expected to organize convocations and carry out the annual negotiating rounds on the specific commitments in the services area, bringing together, when it deems necessary, the coordinators and delegates of the Member States which participate in the sector’s negotiations.

During its XIV Meeting the Common Market Council approved the specific sectoral provisions which will guide the application of the Liberalization Protocol for the following types of service providers: (i) movements of people who are service providers; (ii) financial services; (iii) land and sea transport services; and (iv) air transport services. Also approved were the lists of initial commitments presented by the Member States which include offers for the following sectors:

- **Argentina:** (i) professional services and other services provided to companies; (ii) communication services (the offer of which is conditioned to the approval by the National Congress and ratification by the

Executive); (iii) construction and engineering services; (iv) distribution services; (v) financial services; (vi) tourism services and other vacation related services; and (vii) transportation services;

- **Brazil:** (i) professional services and other services provided to companies; (ii) communication services; (iii) construction and engineering services; (iv) financial services; (v) tourism services and other vacation related services; and (vi) transportation services;
- **Paraguay:** (i) telecommunication services; (ii) financial services; (iii) tourism services and other vacation related services; and (iv) transportation services;
- **Uruguay:** (i) professional services and other services provided to companies; (ii) communication services; (iii) financial services; and (iv) sports, cultural and entertainment services.

The national lists contain horizontal commitments, valid or applicable to all of the sectors, details of the offers by sectors and sub-sectors, limitation of the conditions of access to national markets, limitations to national treatment and the presentation of additional commitments.

B. Legal issues

MERCOSUR norms

During the XXVII Meeting of the MERCOSUR Trade Commission (MTC), Argentina presented a complaint to Brazil, Paraguay and Uruguay for these countries not having incorporated into their respective domestic legislations a group of resolutions from the Common Market Group (CMG) on the transitory system of the facilitation of the trade of phytosanitary products for MERCOSUR.

The Paraguayan representatives allege that the non-internalization of the measures will not affect the intra-MERCOSUR trade since their legislation about the issue is similar to the norms approved by the CMG resolutions. The Brazilian negotiators recognize the generic requirement of the Member States of incorporating to the respective legal regulations the norms issued from the MERCOSUR bodies, but they also highlighted that in the case in question, no deadline was set for the incorporation. Brazil also expressed interest in terms of the approval of the aforementioned system, so much so that it has already presented a proposal for a harmonization of the definitive character of SGT N° 8 “Agriculture”.

Argentina made a complaint of the same nature to the representatives of Uruguay, for Uruguay not incorporating CMG resolutions regarding the registration and sale of pharmaceutical products to its domestic legislation.

The CMG analyzed the situation of the incorporation of the MERCOSUR norms to national legal ordinances during its XXIX Meeting and decided to hold a technical meeting. During this meeting a base of common criteria will be used to prepare a consolidated list of the MERCOSUR norms that is facing difficulties for its incorporation to countries’ legislation, and detailed explanation about the motives that created this situation. The technical meeting is expected to be held in the month of August in Brasilia.

Two CMG Resolutions, N° 22/98 and 23/98, deal with the issue and attempt to reinforce the means to guarantee that the countries’ legislatures will begin to consider as priorities the projects underway that refer to the implementation of the MERCOSUR normative. In addition, the CMG decided that all of the MERCOSUR Resolutions and Decisions should be submitted to the National Sections of the MTC in advance, to allow for the internal analysis of the norms and of the necessary procedures for its incorporation to the countries’ legislation.

During its XIV Meeting, the Common Market Council (CMC) agreed to request the MERCOSUR Parliamentary Commission to establish the means by which the legislative powers of the Member States can confer priority to specific projects in the parliamentary channels that deal with the implementation by countries of the MERCOSUR normative, approved until now by the deliberative bodies.

Common Protocol of Consumer Defense

After five years of negotiations, the four countries have yet to reach an agreement about the common legislation on defense of competition. The proposal of the Protocol of Defense of the Consumer for MERCOSUR has become the target of criticisms by jurists and Brazilian specialists on the issue. The evaluation is that the proposal approved by the Ministers of Economy and Justice of the countries in November 1997, does not include certain laws which are already ratified in Brazilian law for the defense of the consumer. Among these points would be the prohibition of abusive contractual clauses and the punishment of practices of misleading advertising and abusive prices. Until now, the negotiators only reached an agreement about the content of the protocol in four areas: (i) definitions of consumer and supplier; (ii) reference to the basic rights of the consumer; (iii) health and safety of products; and (iv) duty of the supplier to inform the consumer about the risks of the product. While the MERCOSUR Consumer Defense Code is not approved, the trade of merchandise between the countries should follow the terms of Resolution 126/94 of the Common Market Group. According to the terms of this resolution, the exporter should adapt its product to meet the consumer defense standards of the country importing the product.

The main problem in the creation of the Consumer Defense Protocol is that Argentina, Paraguay and Uruguay do not have norms for the defense of the consumer at the same level as those found in Brazilian legislation. Therefore, there is an asymmetry in the legislation between the countries which is reflected in the terms of the approved Protocol. The alternative to turn this problem around would be, according to the jurists' opinion, the approval of unified legislation with the establishment of minimum criteria of observance by the countries.

Even with the approval of the Common Protocol of the Defense of the Consumer, there is no guarantee that the new regulation will substitute the current Brazilian legislation over the matter. Unlike what occurs in Argentina and Paraguay, the Brazilian and Uruguayan constitutions prohibit the automatic insertion of international law. In the case of Brazil, the incorporation of the MERCOSUR Competition Defense Protocol into national legislation still depends on the approval of the National Congress and is expected to face strong resistance due to the absence of or weakness of parameters of consumer defense already incorporated into Brazilian law.

Technical Committee N° 7 which covers the topic is expected to present in the next meeting of the MERCOSUR Trade Commission, in 1998, a report of issues that are pertinent to material that have the possibility of being approved as a common MERCOSUR norm.

Private Controversy Resolution Center

The existence of legal security and of criteria that guarantee uniformity in the interpretation of rules constitute a pre-requisite for the advance of economic integration, by reducing the risk that the conflicts between agents would lead to the weakening of economic ties that have been developed since the creation of the Customs Union in MERCOSUR. The existence of mechanisms for controversy resolution and arbitration represents one of the primary elements of the legal network responsible for providing stability for the integration process, as well as trade and investment flows, over the long term.

The MERCOSUR normative on this issue, until a short while ago, did not use the arbitration mechanisms for anything more than to resolve disputes that involved Member States or one state in particular. There is not an arbitration mechanism established in the case of conflicts that exclusively involve private agents. The approval by the Common Market Council of the "MERCOSUR Agreement on International Trade Arbitration" set the criteria that will regulate the arbitration as a private and alternative means for the solution of controversies that arise in international trade contracts between private agents from the sub-region.

In an attempt to overcome this limitation of the legal framework, the Argentine-Brazilian Chamber of Commerce, with the help of its sections -in Argentina and São Paulo- created the Arbitration and Conciliation Center, a body specially designed to resolve conflicts between private agents in MERCOSUR. Inaugurated on May 14, the private controversy resolution system will be based on the resolutions of a tribunal formed by three judges, whose decision the parties in the conflict will voluntarily agree to accept. The judges will be selected by the parties involved from a list with names of approximately 40 lawyers from the four MERCOSUR countries. A selection committee will be in charge of selecting the candidates to act as judges and the inclusion of their names on the list will depend on an academic evaluation and their specific knowledge of the matter to be judged.

Starting from their creation, the contracts established between private agents from MERCOSUR may contain a clause which elects the Center as a body to be consulted in the case of disputes or controversies between the private parties, saving time and resources in case the traditional judicial procedures are being employed to handle other issues. This system is expected to confer greater predictability and reliability to contracts signed between private agents from MERCOSUR, especially benefiting small and medium-sized enterprises, for which the trade conflicts and the costs of judicial processes may compromise the viability of the businesses, and in the long term the company's survival. In the case of Brazil, the new laws about arbitration established by Law N° 9,307 from 1996 confer reliability to the new system created in MERCOSUR, by impeding the parties from appealing to the Judiciary after having signed contractual terms opting for the use of arbitrage judgement for the resolution of controversies.

Another initiative in this direction is being developed by the Federal Capital's Court Clerks College Institutional Mediation Center, headquartered in Buenos Aires, which has provided mediation services since 1995. The Center is studying the proposal of the creation of a MERCOSUR Registry of Mediators and Technical Advisers which would bring together lawyers, clerks and specialists in diverse areas –from all of the member countries-, all with notable knowledge and experience in the processes of arbitration and controversy resolution. The Registry of Mediators would be supervised by an administrative body that would maintain the direct relation with the MERCOSUR Administrative Secretariat, which would guarantee the quality of the mediators and impartiality in their selection.

Security Cooperation

In April 1998, the MERCOSUR Ministers of the Interior and of Justice established the Security Plan for the Triple Border, Argentina-Brazil-Paraguay. The objective of the plan is to facilitate the planning and execution of concerted actions involving the governments of the three countries in the areas of fighting drug trafficking, automobile theft, contraband, and the trafficking of minors. In addition to the participation of the three countries, Uruguay and the two MERCOSUR associate countries, Bolivia and Chile also countersigned the plan. The planned actions include the creation of an information and coordination system between the police and security forces of the six countries. Furthermore, a sub-commission of representatives was established to monitor the fulfillment of the objectives outlined in the agreement.

Ciudad del Este in Paraguay, Foz do Iguaçu in Brazil and Puerto Iguazú in Argentina will be the cities in which the measures will be applied. Traditionally, these localities register a high number of incidents that according to authorities present a security risk to the countries.

Also ratified by the Common Market Council (CMC) was the understanding signed by the Ministers of the Interior and of Justice from MERCOSUR and the associated countries regarding the mechanism used to register the buyers and sellers of fire arms, ammunition and explosives. The mechanism will be formed by

the respective data bases and other information archive systems of the competent national bodies. Consultations and information requested by any of the member States will be responded to through the “Security Information Exchange System of MERCOSUR, Bolivia and Chile”.

C. Cultural and educational issues

Approved by the countries in December 1997 and presented to authorities during VI Meeting of MERCOSUR Ministers of Culture held in July 1998, the MERCOSUR Cultural Seal is expected to facilitate the transport of works of art and other cultural services and goods between the four countries. Nevertheless, of the four MERCOSUR countries, only Brazil has adopted the measure. In March 1998 the Brazilian Minister of Culture published a document that simplifies the procedures for the transport and the customs inspection of this type of goods. Works of Art that have received the MERCOSUR Cultural Seal do not need to be examined in customs, with their inspection authorized to be conducted solely on the site where they will be displayed or used. The approval of the measure also simplified and rationalized the documentation required in the temporary export of cultural goods.

Other issues are being negotiated by the Ministers of Culture, in particular the possibility of making cultural goods exempt from the charge of port taxes; developing a home-page on the Internet about Cultural MERCOSUR; the creation of a coordination and consultation system between the main libraries of the countries and the creation of new joint cultural activities.

In the area of education, the MERCOSUR Ministers of Education signed a “memorandum of understanding”, the purpose of which is to allow diplomas received in any of the sub-region’s universities to be automatically recognized in any of the member countries (including Bolivia and Chile). This would imply the immediate qualification of all superior professionals to practice their profession in any of the countries in the Customs Union. Until now, the qualification requirements for the practice of professions were negotiated only for a few careers and in general were based on bilateral agreements. The establishment of this memorandum of understanding will require the negotiation of common standards that will allow for the evaluation of the quality of the countries’ institutions of higher education, based on the activities of national agencies that supervise education. According to the proposed system, public and private universities will adhere to the system on a voluntary basis. Another important measure for the instrumentation of the memorandum is the creation of an information network on the educational systems of MERCOSUR countries.

D. Financial issues

Experts from the financial area of the MERCOSUR countries are settling the terms of an agreement that will permit banks and other financial institutions established in the bloc to sell shares of their investment funds to clients from neighboring countries. At first the goal is to authorize the negotiations just for shares in variable income funds.

In the meantime, a specific aspect is making the conclusion of the agreement difficult. In Brazil it is not allowed for investment fund portfolios to contain shares of companies outside of MERCOSUR. In the case of the other countries, the financial institutions are authorized to invest up to 25% of their resources in shares of companies that are not established in the sub-region. It is expected that Brazil will change its policy, allowing the resources from funds to be directed toward the purchase of those shares, to allow for greater convergence of the laws between the countries. The investors that invest their resources in funds managed by financial institutions from other countries in the bloc will have their revenues taxed based on the market where the investments are from.

E. Military issues

The XI Symposium on Strategic Studies held in Buenos Aires in July brought together the members of the Armed Forces of the countries that form MERCOSUR, as well as the associate members, Bolivia and Chile. The events began in 1987 with bilateral meetings between Argentina and Brazil; later the other members of MERCOSUR were incorporated. The purpose of these symposia is to strengthen the relations between the bloc's military forces in such a manner that it is possible in the future to establish a system of exchange and mutual advising. Under this system the possibility has been discussed of creating a joint instruction program for the armed forces, of advancing cooperation in the academic field, and developing studies of the sub-region's strategic problems.

During the Symposium, the Argentine military representatives presented their vision about the topic of "transparency and nuclear technological cooperation". The countries also debated the proposal of the creation of a future sub-regional defense plan, the beginning of which would be the advances reached in joint planning programs and the following of defense and security issues.

The XIV Meeting of the Common Market Council approved the "Understanding of the Cooperation and Reciprocal Assistance for Regional Security". According to the "Understanding" MERCOSUR and the associated countries have committed to adopting all of the measures, in accordance with their respective legislation, in such a manner that the available human and material capacities are directed toward increasing the works of prevention, control and repression of crimes, especially those associated with drug trafficking, terrorism, arms trafficking, vehicle theft, money laundering and the trafficking of individuals.

F. Labor and social issues

MERCOSUR Women's Forum and Specialized Council on Women

Created in 1995, the MERCOSUR Women's Forum held in March 1998 the first meeting of the Delegation of the Province of Buenos Aires in the Argentine city of La Plata. The meeting also included the participation of other national directors, as well as directors from the other three countries. The primary objective of the Forum was to create conditions whereby women may contribute effectively to advance the integration process through their experiences, their vision on general problems and on issues that affect women.

Similarly, in the area of the institutional structure of MERCOSUR, the Common Market Group (CMG) created, through Resolution 20/98, the Specialized Council on Women. The task of this Council will be to analyze the situation of the woman, taking into consideration the current legislation in the Member States in terms of the concept of equality of opportunities, to help contribute to the social, economic and cultural development of the sub-region's communities. The Specialized Council on Women will be formed by governmental representatives from the four member countries and national bodies determined by the States will conduct the national coordination of the respective National Sections.

In the development of its activities, the Specialized Council on Women will count on the advising of the MERCOSUR Women's Forum, as well as other legally recognized sub-regional associations that focus on women's issues in areas that are relevant to MERCOSUR principles and objectives.

Labor legislation

The increasing number of Argentine, Brazilian, Paraguayan and Uruguayan workers that work in neighboring countries is creating a sub-regional labor market where it is necessary to have greater flexibility for the transfer of labor so that workers and companies do not have to incur economic and social costs due to the need of adapting to new labor legislation.

MERCOSUR already approved bilateral agreements that allow workers to benefit from the Multilateral Social Security Convention. Currently, in addition to the lack of definitions in terms of the methods for computing the time of work in the neighboring country and the impossibility of transferring resources for the contribution of pension funds from other countries without the fiscal burden, national legislatures have shown little disposition in discussing the terms of this agreement.

The Economic and Social Consultative Forum (FCES) performed its role by presenting to negotiating authorities recommendations so that the MERCOSUR countries would approve 34 conventions of the International Labor Organization (ILO), which would facilitate an increase in the flexibility and greater integration between national labor markets. However, of the 34 conventions the member countries ratified only 12.

G Institutional aspects

The Common Market Group (CMG) received a consultation from the Economic and Social Consultative Forum (FCES) in which a proposal is presented which would strengthen the mechanisms of communication and joint work between the two bodies. The CMG highlighted that the inclusion of the FCES in the MERCOSUR institutional structure created a privileged channel for communication between the various social actors and negotiating authorities which should gain increasing importance as effective advances are reached in the integration process.

A meeting of FCES representatives with the Joint Parliamentary Commission (CPC), held July 23rd, determined that from now on the two bodies will undertake a joint project to increase their influence in the MERCOSUR institutional framework.

In the VII Plenary Meeting of the FCES, held July 22 and 23, the following issues were discussed: the sub-regional agreement on services trade, the current status of the FTAA negotiations, the investment promotion policy designed for the sustainable development of the sub-region, the problem of non-tariff restrictions charged on intra-subregional trade, Paraguay's "*maquila*" law and the policies for the small and medium-sized enterprises. Recommendations were also approved on the harmonization of standards for the defense of the consumer, which were submitted to the Common Market Group.

Taking into account the increasing importance of small and medium-sized enterprises (SMEs) in terms of income generation and job creation in the MERCOSUR economies, the CMG proposed, during a meeting in May 1998, that the officials from the four countries who are responsible for the issue of SMEs hold informal consultations to hold a seminar in the second half of 1998. The conclusions of the event should be evaluated by the negotiating authorities, to establish the criteria and rules for the treatment of SMEs in MERCOSUR.

Another initiative in the institutional area was the approval by the Common Market Council (CMC) of the Manual for the use of the "MERCOSUR" logo in agreement with the normatives developed with the support of INTAL.

The Ushuaia Protocol on the democratic commitment in MERCOSUR

During the XIV Meeting of the Common Market Council the presidents of the four MERCOSUR countries, Bolivia and Chile ratified the Presidential Declaration on Democratic Commitment of 1996 designated the “Ushuaia Protocol on the Democratic Commitment in MERCOSUR”.

According to the terms of the Protocol, in case of a breaching of democratic order in any of the countries, the other Member States will conduct consultations between themselves and the affected country. If the consultations prove ineffective, the Member States may decide to suspend the country’s right to participate in the different bodies that are responsible for the integration process or even to suspend the country from the rights and duties from the agreements that guide the functioning of the customs union. The application of these sanctions on the country that breaches democratic order will be decided by the consensus of the Member States. The terms of the Protocol will become an integral part of the Asuncion Treaty and should be extended to future trade agreements which MERCOSUR signs with third countries.

H. Government purchases

Through Resolution N° 34/98, the Common Market Group (CMG) established the criteria, directives, procedures, and terms for the negotiation of a regime of government purchases for MERCOSUR. According to the determination of the CMG, the *Ad Hoc* Group “Government Purchases” is expected to develop a normative framework that would assure the effective participation of companies established in the bloc’s countries in the processes of government purchases by December 31, 1998.

This standard framework will contain a general system of rules that will include the following principles: (i) national treatment; (ii) coverage of goods and services included by the regime, as well as of national jurisdictions and the inclusion of the performance of the companies; and (iii) rules of transparency to assure access to information and to the exercise of the right of interested parties, like the register and the qualification of suppliers, technical specifications, basic requirements for the holding of bids, the right to contest, the existence of a controversy resolution system, the availability of statistical information, etc.

I. Environment

In an attempt to facilitate concerted efforts and quick actions to prevent environmental disasters and combat their consequences, the Common Market Group in their XXIX Meeting decided to include the topic of “environmental emergencies” in the program of Working Sub-Group N° 6 “Environment”, which will define priorities and propose to the CMG the coordination mechanisms and general directives for the implementation of the cooperation between the MERCOSUR Member States on the issue. The Working Sub-Group N°6 “Environment” is also evaluating the information systems on the environment which are available in the different countries with the objective of creating, within a feasible amount of time, the “MERCOSUR Environmental Information System”.

J. Supply lists and common external tariff

The supply list is an instrument created to help the adoption of timely actions in the area of tariffs, in a unique character and for a limited time, with the purpose of guaranteeing a normal and fluid supply of products in the Member Countries. Due to this instrument, the members were, until recently, authorized to include each six months up to twenty items with tariffs for which they could apply tariffs below the Common External Tariff (CET).

In meetings held earlier in the MERCOSUR Trade Commission (MTC), some of the members had cited the need to restrict the use of this instrument, whether in terms of the number of items, or in its *modus operandi*. In the XXX Meeting of the MTC, held in July 1998, the instrument's validity was extended until December of the year 2000 (Resolution CMG N° 69/96), but with some modifications. The number of tariff items that may be incorporated to the list by each Member State was reduced from twenty to fifteen. Semiannually, the list may be updated, allowing for both the renewal of items or their replacement. If the supply problems persist, the interested country should make this situation known to the Technical Committee N° 1 "Tariffs, Nomenclature and Classification of Merchandise" so that, as a priority action, the possibility will be evaluated of promoting a definitive reduction of the CET.

K. MERCOSUR customs Code

Brazilian negotiators presented a reformulation to the MERCOSUR Customs Code Additional Protocol Project based on suggestions presented in earlier meetings by representatives from the other member states and enhanced with new contributions. The Brazilian proposal was accepted as the foundation for the continuity of the works. However, it was made clear that the decision did not imply the tacit approval of part or all of its content.

CHAPTER V. INFRASTRUCTURE

One of the challenges of the MERCOSUR integration process is to adapt infrastructure, especially in the areas of transportation, energy and communications, to the requirements and perspectives of development of the economic bloc. By doing so a double objective would be reached: (i) the removal of physical obstacles to the flow of merchandise that currently results in the existence of a limited number of transport routes between the countries in almost all modes of transportation operated in the sub-region,⁷ and (ii) the shared use of scarce resources in the energy area, in such a way as to promote an improved adaptation of the consumption pattern of countries to the profile of resource supplies in the bloc.

The attainment of new investments will depend on the capacity of the national governments of making the quality and the price in the providing of services compatible with sufficient rates of return for the enterprise to mobilize private capital.⁸ Furthermore, when the sub-region's different countries are analyzed, the process of deregulation and the opening of the infrastructure sector to private capital are at different levels of progress. In Argentina, Bolivia and Chile, the change in the regulatory frameworks has already led to the execution of a number of projects in both energy and transportation, if compared to the framework of Brazil, Paraguay and Uruguay.

It is also necessary to achieve technical advances with relation to the diagnostics on the functionality of the current physical infrastructure to the objectives of sub-regional integration, by means of the creation of a system of integrated planning and of the exchange of information, specifically in the case of projects which impact the economies as a whole. In the evaluation of these projects the needs of the expanded market and the supply of resources should be taken into consideration. This method is different from that which was employed in the past, when due to a low degree of economic integration in the sub-region, the infrastructure projects were planned and implemented in an independent manner by the countries. No attention was paid to the possibility of synergies that could result from the shared use of resources and from the integration of transportation and energy systems.

In this context, the role of international organizations, especially the Inter-American Development Bank (IDB), is gaining increasing importance. The participation of the IDB in the physical and energy related integration projects might help to consolidate a new standard of regulation and financing of the activity in MERCOSUR. This may signify a change in the profile of the actions of multilateral credit agencies in the sense of conferring preferential support: (i) the formation and consolidation of regulating agencies designed to create the bases for the entrance and permanence of private capital in infrastructure projects; (ii) conducting operations of risk guarantees for private investment, primarily in the case of bilateral projects; and (iii) the development of new forms of finance investment, especially those such as *project finance* which reduced the amount of guarantees required and induces the concerted participation of governments, investors, suppliers and financial agents.

⁷ To this difficulty is added the precarious situation of customs inspection posts, especially those on the border, which slow down the transportation of the merchandise, and consequently increase the transportation costs between the countries.

⁸ The implementation in Argentina and Brazil of the specific regulation for the concession for the operation of infrastructure by the private sector has operated as an important instrument to both improve the quality of the services and to compensate the deficiency of investments.

A. Energy infrastructure

Natural gas

The incorporation of natural gas into the energy matrix of Brazil and Uruguay is generating business opportunities and attracting new investments for the bloc's countries. In addition to the Brazil-Bolivia pipeline,⁹ Brazil's National Petroleum Agency (ANP) received from the US companies Enron and Pan American Energy and the English company British Gas a request to import natural gas from Argentina. This would imply the construction of a 920-kilometer pipeline, linking Porto Alegre to Montevideo and Buenos Aires. This pipeline would move between 15 and 20 million cubic meters of natural gas per day and require US\$ 450 million in investments. The construction of the pipeline would integrate Argentina's two primary production areas, the Austral Basin and the Neuquina Basin, to the consumption markets of Uruguay and Central-Southern Brazil, which is the location of the highest energy demand in all of Latin America. The volume of gas imported from Argentina would correspond to the generation of 3,300 megawatts of electrical energy, which is equivalent to 30% of the installed potential of the Itaipú hydroelectric dam, and would be consumed primarily by the new thermo-electrical plants that are beginning to be constructed in the Southern region of Brazil.

In the beginning of this year, the English company British Gas, associated to Pan American Energy and Ancap (Uruguay's state petroleum company), had already won the bid for the construction of a 220 kilometer gas pipeline linking Buenos Aires and Montevideo. The contract is worth US\$ 125 million and the pipeline will be operated as a concession regime for a thirty-year period beginning in the second half of 1999. By the year 2000, this pipeline will be extended to the Brazilian city of Porto Alegre. According to the expectations of ANP do Brasil, with the natural gas to be imported from Bolivia and Argentina, the participation of the product in the Brazilian energy structure is expected to increase from the current 2.5% to almost 12% by the year 2002.

Another project linking Argentina and Uruguay outlines the immediate construction of a gas pipeline on the coast, which would allow for the entrance of gas through the Argentine province of Entre Ríos. Two Argentine companies, Techint and Sade, are responsible for the construction of the gas pipeline which is budgeted at US\$ 20 million and will allow for the import by Uruguay of 2 million cubic meters per day. A consortium, formed by Gaseba Uruguay, Pacific Enterprises of the US and Unión Fenosa from Spain, will be responsible for the distribution of the gas in Uruguay.

According to evaluations from the Uruguayan government and from experts in the energy sector, the introduction of natural gas to the Uruguayan energy network through these two projects, is expected to allow for a significant reduction in energy costs for both residential and commercial consumption.¹⁰

⁹ With a total extension of 3,150 kilometers, the pipeline will link Santa Cruz de la Sierra in Bolivia to Campo Grande and São Paulo in Brazil. Investments are forecasted at US\$ 2 billion which will allow for the daily shipment of 16 million cubic meters of natural gas produced in Bolivia, at the price of US\$1 per million BTU (British Thermal Unit), with the purchase option of an additional 12 million cubic meters beginning in 2003. The first stage of the gas pipeline linking Santa Cruz de la Sierra to Campo Grande and São Paulo will enter in operation in December 1998 and will facilitate the daily burning of 5 million cubic meters of gas of which 3.5 million cubic meters will be consumed by the São Paulo distributor Comgás and the remainder will be directed to the market of the state of Mato Grosso do Sul. Over the medium run, an additional supply of 6 million cubic meters will be used to supply four new thermoelectrical plants, two in Mato Grosso do Sul, in the cities of Corumbá and Campo Grande, with the capacity of producing 150 and 300 megawatts respectively, and two with a single capacity of 450 megawatts in the state of São Paulo. The Bolivian company YPF created Chaco, which in partnership with Amoco and Andina (the consortium that brings together YPF from Argentina, Pluspetrol, Astra and Pérez Companc), is expected to realize investments of almost US\$ 1.5 billion to increase the exportable supply. On December 17, 1998 the Inter-American Development Bank (IDB) approved a US\$ 240 million loan that will help to cover the investment costs of the Petrobrás subsidiary, Transportadora Brasileira Gasoduto Brasil-Bolivia, one of the companies responsible for the management of the project. The operation will also count on resources from the World Bank, the Andean Development Corporation, the European Investment Bank, the Eximbank of Japan and Brazilian National Economic and Social Development Bank.

¹⁰ In the case of industry, it is estimated that the exchange of combustible fuel and oil for natural gas will represent savings of up to 20% in energy costs.

Another agreement in negotiation involving Argentina gas production companies and Brazilian distributors would imply the realization of investments of US\$ 2 billion, which would allow for the export of 57 million cubic meters of gas by Argentina by the year 2002. On the Argentine side the agreement involves YPF, Pan American Energy, Astra, Pluspetrol and Compañía General de Combustibles; and on the Brazilian side the participants include Comgás from São Paulo, Compagás from Paraná, SC-Gás from Santa Catarina, Sul Gás from Rio Grande do Sul and CEG and Riogás from Rio de Janeiro. In addition to the installation of an almost 3,000 kilometer gas pipeline, two thermo-electrical plants are scheduled to be built in the west of the Brazilian state of Santa Catarina with a production capacity of 450 megawatts and 130 megawatts. The price of the gas to be sold to Brazilian distributors would be lower than the price of the gas imported from Bolivia, which is currently set at US\$ 2.75 per cubic meter. This agreement complements another which was already signed between YPF from Argentina and Petrobrás which outlines the construction of a gas pipeline linking the Argentine producing regions to the Brazilian cities of Uruguai and Porto Alegre.¹¹

Electrical energy distribution networks

While the integration process of the electrical systems of Argentina, Paraguay and Uruguay advances, the first projects are beginning to be analyzed which would establish interconnection points in these countries with the Brazilian electricity distribution system.

The governments of Brazil and Uruguay created a bilateral commission formed by representatives from regulating bodies and state companies from the electricity sector from both countries to discuss the details of the interconnection of high-tension electricity systems. According to technical studies which have already been concluded, the necessary investments for the execution of the project are estimated at US\$ 394 million. The project would involve the installation of 450 kilometers of transmission lines with 250 megawatts between San Carlos in Uruguay and Presidente Médice in Brazil and of a conversion station to convert the electricity from 50 hertz frequency (Uruguay) to 60 hertz frequency (Brazil). In principle, Brazil's Southern Region would represent the import market and the capacity of the generation of the Uruguayan plants would compensate for the electrical energy shortages, especially in the state of Rio Grande do Sul.

Currently there is only one point of interconnection between the Brazilian and Uruguayan electricity systems that works on the border of Chuí, where the National Administration of Electrical Transmissions and Plants of Uruguay (UTE) provides 4 megawatts of energy to meet the demand of the city of Santa Vitória do Palmar in Rio Grande do Sul.¹²

The two countries are still preparing another project of electrical interconnection, linking Rivera in Uruguay to Santana do Livramento in Brazil with 70 megawatts of power. The project is budgeted at US\$ 42.9 million of which the Inter-American Development Bank (IDB) will finance US\$ 27.1 million. The bidding for the project's execution was already concluded and the work, to be performed by GEC Alstom T&D Power Electronic System Limited, is expected to begin operations in the second half of the year 2000.

¹¹ In addition to the Argentina-Brazil gas pipeline, YPF and Petrobras are developing joint projects for the production of petroleum and gas in the region of Aguaragüe in the northwest of Argentina. In another project entitled Mega, the two companies signed a partnership for the realization of investments in a gas separating plant in the south of Argentina.

¹² Argentina and Uruguay operate, in a multilateral enterprise, the Salto Grande hydro-electrical center on the Uruguay River, with a generation capacity of 1,890 megawatts per year.

On December 29, 1997 the governments of Argentina and Chile signed two agreements: the first is on electrical interconnection and the second is about integration and complementation in the area of mining exploration. The objective of the agreements is the joint exploration of natural resources, which according to the governments' forecasts, could lead to around US\$ 6 billion in investments in the coming years.¹³

In addition to outlining the investments for the implementation of infrastructure for the connection of the Argentine and Chilean electrical systems, the interconnection agreement will allow the distribution companies and the purchasing companies to freely negotiate the energy supply contracts, which will allow the consumer to select the best option in terms of cost and the conditions of the service. The two countries also signed commitments that ensure the adoption of pro-competitive practices by the sector, which in practice means that the national governments will be impeded from conceding subsidies, changing taxes or adopting other measures that may distort the conditions for competition in the sector.

The Common Market Council (CMC) approved during its XIV Meeting the "Memorandum of Understanding of Electrical Exchanges and Electrical Integration in MERCOSUR". The signing of the document, which is designed to create development mechanisms for the electrical integration process between the countries, authorized the free contracting of sources of electrical energy supply by distributors or big purchasers in any of the Member States. The countries also committed themselves to concede authorizations, licenses and concessions that permit the construction and operation of interconnections that tie the sub-region's electrical systems. The memorandum calls for technical studies to aid the joint operation of the markets, through the identification of the necessary adjustments to facilitate the electrical integration between the countries.

Distribution of petroleum and its by-products

The recent agreement signed between YPF from Argentina and Petrobras from Brazil establishes rules for the joint operation of gas stations in both the countries. The agreement allows the companies to open two customer service centers in the metropolitan areas of Greater Buenos Aires and Rio de Janeiro, with equal participation from both companies. The fuels will be sold under the brand of the national company and the other products will be supplied by both brands. For each gas station an investment of US\$ 2 million was budgeted, with their opening scheduled for September 1998.

B. Transportation and communication infrastructure

According to a diagnostic recently developed by the Institute for the Integration of Latin America and the Caribbean (INTAL) of the IDB, the actual transportation infrastructure of the MERCOSUR countries presents an extensive group of deficiencies and bottlenecks. This infrastructure is inadequate due to the current level of intra-bloc trade and a probable saturation of the existing systems in the near future, in addition to an increase in freight costs, as a result of the forecast growth of trade flows (IDB-INTAL [1997]).

The need for an immediate expansion of the existing infrastructure, requires the implementation of a wide range of projects, which will be difficult due to the shortage of resources, especially public resources. The removal of these restrictions depends on the creation of policies and instruments that facilitate the participation

¹³ The mining integration agreement authorizes the free circulation of goods and individuals between the new producing regions defined in the treaty. The two countries also promised to introduce improvements in their respective legislations to guarantee a better preservation of the environment. In the tax area the agreement establishes two rules: (i) the mine workers will be subject to the taxing conditions of the country where the contracting of the service is completed, even if the workers conduct their activities in the territory of another country; and (ii) the payment of "mining rights" will be required for all of the merchandise that enters or is extracted from the mine by the country which is not exploring.

of private capital in the investments. The primary project in the expansion of MERCOSUR transportation infrastructure is the establishment of new transportation axes which are discussed below.¹⁴

The trans-oceanic connection between the Atlantic and the Pacific may be operated through two complementary axes that would integrate, by way of an interconnection between waterways, highways and railways the entire region formed by the Basin of the Paraná River. This connection would even cover the region served by the Paraguay-Paraná waterway, allowing for the cargo to be transported from the Central-South region of Brazil and from Buenos Aires and Bahía Blanca in Argentina by highway and railway to the Chilean capital of Santiago or to the Chilean ports of Valparaíso and Talcahuano.

The first axis Buenos Aires-Mendoza-Valparaíso would constitute the main side of the trans-ocean corridor, where more than half of the bilateral trade between Argentina and Chile passes through. The biggest difficulties in terms of physical integration are found in the region of the Andes mountain range. On the Argentine side there is a group of highway routes that converge for the only available passageway to Chilean territory, known as the Cristo Redentor System. Several alternatives have been studied that would facilitate the passing of the Andes, including the construction of a low 28 kilometer tunnel which would cost an estimated US\$ 2 billion. The railway alternative linking Buenos Aires-Córdoba-Mendoza-Las Cuevas-San Felipe (a station that is located 79 kilometers from Valparaíso) has not operated since 1985, due to the obstruction caused by rockslides in the Andean region. A line runs between Buenos Aires and Mendoza in Argentina and from San Felipe to Valparaíso in Chile; to complete the connection a third track would have to be built to rehabilitate the stretch of railway between Mendoza and San Felipe.

The second highway-railway axis located further South would link Bahía Blanca and Neuquén in Argentina to Lonquimay, Concepción and Puerto Mont in Chile. The initiative will facilitate the development of trade between the Argentine provinces of La Pampa, Buenos Aires, Santa Fé, Rio Negro and Neuquén, with the Chilean regions of Bío Bío, La Araucaria and Los Lagos. According to calculations by the government of the Argentine province of Neuquén, it would be necessary to invest US\$ 300 million for the construction of the trans-Andean connection, with 210 kilometers between Zapala in Argentina and the Chilean city of Lonquimay.¹⁵

In the first week of April the Brazilian government issued the pre-bid specifications for the concession of the operation of the MERCOSUR transportation corridor, which includes the highways that connect the cities of São Paulo and Curitiba and connect Curitiba to Florianópolis. The winning group will have the right to manage the aforementioned highways for 25 years, which implies the raising of approximately US\$ 1.2 billion in investments. The resources to be supplied by the IDB and by the Eximbank of Japan will total US\$ 900 million. The Brazilian Treasury is expected to appropriate US\$ 283 million for the project.

The earlier stretch includes a section of highway that is expected to link Rio de Janeiro to the city of Buenos Aires, passing through Montevideo, with two lanes. A total of US\$ 2.5 billion is forecasted to be spent to recover, widen and place signs on the highway. The shortening of the Montevideo-Buenos Aires trajectory will depend on the construction of a bridge over the Rio de la Plata. The bridge would cut out almost 50 kilometers by linking the city of Colonia del Sacramento in Uruguay to the Argentine Capital, which would shorten the total distance of the highway between the two capitals to 345 kilometers.

¹⁴ The Transportation Commission of the Trade Exchange of Rosario, Argentina, also conducted a study which highlighted the need to adapt sub-regional transportation infrastructure to the present and future requirements of the integration process. The document proposes the creation of a "MERCOSUR Master Transportation Plan", which will be capable of mobilizing public and private investments in transportation infrastructure, preventing current competitive advantages from being compromised due to the growth of transportation costs. According to the institution's forecasts, for the year 2020, the circulation of merchandise between the sub-region's countries may reach the level of 400 million tons per year, which would mean the transportation of quantities 14 times larger than the current circulation of goods in Argentina.

¹⁵ The viability of the operation of trans-oceanic corridors of integration is being evaluated by the Bioceanic Corridors Multilateral Working Group, the objective of which is to present a group of projects that will allow for the establishment of connection axes between the Atlantic Coast, including the Argentine, Brazilian and Uruguayan territory, and the Pacific Ocean, for both Chilean ports and Bolivia.

As a result of their tenth meeting held in Buenos Aires, the MERCOSUR Working Group N° 5 on Transportation and Infrastructure recommended to the Common Market Group the approval of a resolution that establishes unified control for the highway transport of dangerous cargo. The existence of different criteria between the countries for the transport of this type of cargo was creating problems in the control and monitoring process, specifically when conducted by the customs officers of the country where the merchandise is being shipped. The resolution project outlines: (i) the requirement for truck drivers to obtain certification of having participated in the training course for the transportation of dangerous cargo after January 1, 1999; and (ii) the establishment of controls to regulate the use of packaging for this type of cargo after January 1, 2000.

According to the recommendation of Subgroup N° 5, the dangerous cargo transportation facilitation agreement should have come into effect on March 1, 1998. However, the negotiators recognized that those transporting the goods and the authorities responsible for their monitoring have little time to adapt to the new rules, which could lead to delays and difficulties in the shipping of the merchandise in the border customs check points.

In a meeting held July 22 and 23, the members of Subgroup N°5 discussed problems with maritime transportation in the bloc. During this meeting the negotiators from Argentina and Brazil decided to set a timeline for the opening of cargo reserves in Argentina-Brazil traffic. The private sector reiterated their position against any type of cargo reserve in the freight market. There was an agreement between Argentine and Brazilian users on the establishment of a timeline of six years for the total liberation of the freight market, which will not exclude the transport of wheat.

The intensification of the use of the Paraguay-Paraná waterway will significantly change the current transportation network, which serves the MERCOSUR countries, in which highway transport predominates. The waterway is formed by a natural canal which connects the regions of Central-West Brazil, Paraguay, Argentina and Uruguay, allowing for the transport of cargo from the Brazilian state of Mato Grosso do Sul to Buenos Aires and Montevideo. Currently, the waterway is used to export iron and manganese minerals, extracted from Maciço do Urucum, near Corumbá, and transported in barges to Argentina. The soybean producers also use the waterway as an alternative route for the soybean exports which allows for an almost 50% reduction in freight in comparison with the cost of highway transport to the Port of Paranaguá which is currently US\$ 36/t. The waterway's main problem is that during periods of drought larger capacity barges are impeded from navigating between the ports of Ladário (Brazil) and Concepción (Paraguay), being forced to use land transportation to arrive at the Paraguayan port. However the amount of resources necessary to place it in full operation has not been raised, the environmental impact from the deepening of the Paraguay River canal constituted the primary impediment to the realization of these investments. Even though the waterway's full operation is restricted to periods when the Paraguay River is high, its connection to other available modes of transportation (highway and railway) means the creation of an extensive multi-modal network capable of connecting the main markets of the Central-South region of South America.¹⁶ Furthermore, the functioning of the waterway, combined with the network of highways and railways, implies a significant increase in the potential of merchandise that can be transported to the Chilean port of Antofagasta, to later be shipped to Asian markets.¹⁷

¹⁶ The US company ACBL Hidrovias S.A. invested almost US\$ 80 million in the development and operation of transportation infrastructure in the Paraguay-Parana waterway.

¹⁷ Using the available transportation infrastructure it is already possible, by way of a combination of using highways and waterways, to establish a connection, although in precarious conditions, between Campo Grande, the capital of the state of Mato Grosso do Sul, and the port of Antofagasta in Chile. This gateway to the Pacific reduces by more than 7,000 kilometers the trajectory by ship between Brazil and the major Asian ports. The trajectory is the following: leaving from Campo Grande, the highway is taken to Ponta Porã, on the border with Paraguay, for a total of 330 kilometers. After another 225 kilometers of asphalt the truck reaches the port of Concepción in Paraguay. From Concepción, via the Paraguay River, the barge travels to the Argentine city of Resistencia. From there it is 756 kilometers to Salta near the Andes. The road between Salta and San Pedro de Atacama is gravel and can only be driven during the day, because at night temperatures in the region drop to 20 degrees below zero Celsius.

Another waterway, the Tietê-Paraná, which is navigable in almost 1,100 kilometers, facilitates the integration of the eastern region of the state of Mato Grosso do Sul (from Barragem de Ilha Solteira located to the North of the city of Três Lagoas) with the interior of the state of São Paulo and the East of Minas Gerais and Goiás, through the Paranaíba River. However, the connection of the Alto Paraná with the Paraguay River still depends on the construction of canal locks along the Paraná River from the Ilha Solteira plant to Itaipú. Even though there is a loss in time and financial burdens due to the need to transport the cargo from truck to barge, still the transportation cost through the waterway of merchandise sent from the interior of the state of São Paulo to the port of Buenos Aires is almost 50% less than the highway freight costs. In 1997, the volume of cargo transported by waterway was 5.7 million tons, with this volume forecast to increase to close to 20 million tons in fifteen years.

On December 22, 1997 a bridge was opened over the Paraguay River which links Santo Tomé, in the Argentine Province of Corrientes, to São Borja in Rio Grande do Sul. A total of US\$ 40 million was invested in the bridge's construction, of which US\$ 16 million were spent by the Argentine and Brazilian governments. The resources were completed by the concessionaire, Mercovia, which will have the right to collect tolls for a period of 23 years.¹⁸ With an extension of 1,400 meters, the new tie between Argentina and Brazil will serve to ease traffic at the only available terrestrial connection between the two countries, located 180 kilometers to the south of Santo Tomé, between Paso de los Libres, also in the Province of Corrientes, and Uruguaiana in Rio Grande do Sul. With the approximately 400% increase in the volume of cargo transported between the two countries from 1991 to 1996, the Paso de los Libres and Uruguaiana Bridge is receiving traffic of 600 trucks per day in the two directions. According to the calculations of experts from the transportation sector in Argentina and Brazil, by the end of 1998, the Santo Tomé-São Borja region is expected to be absorbing close to 30% of the traffic from the old bridge that links Paso de los Libres and Uruguaiana. Currently the trucks that cross the border at this point remain up to two days due to lines for the customs operations, which are performed on both sides of the border. Even though there is a toll on the Santo Tomé-São Borja Bridge,¹⁹ the first Integrated Border Center between Brazil and Argentina has made the customs procedures quite fast. Many companies have opted for the use of this bridge based on the evaluation that the time saved more than compensates for the cost of the toll.

According to a publication from Fundación Invertir of Argentina, the cargo transport operations between MERCOSUR countries by air have registered significant growth rates in recent years. In the case of some companies, the air cargo shipment increased 40% per year. Still, the use of air cargo transport is quite modest when compared with the other transportation modalities: close to 13% of cargo traffic between MERCOSUR countries is done via air, while almost 80% is transported on land. In spite of the reliability of the service, in terms of both cargo handling and meeting delivery deadlines, the cost of air transport still operates as a limiting factor in the quantity of cargo transported in this manner. To give an example, to transport 20 tons of cargo between Buenos Aires and São Paulo by truck would cost approximately US\$ 1,700; while the cost of transporting the same cargo by plane between the two cities would cost an average of US\$ 11,000.

At the end of the month of January the Brazilian telecommunications company, Embratel, launched into orbit Brasilsat B-3, a satellite which will be used in the retransmission of television signals, in telephone operations and in the transmission of data between MERCOSUR countries. The life span of the satellite will be 12 years and its operation has been made through its 28 repeaters in band "C" and one in band "X."

The governments of Argentina and Brazil are working to prepare a framework agreement for the integration of telecommunication services markets. In the current stage, the negotiators are studying the implementation of mechanisms, which are capable of increasing the transparency of rules and structures in each country. The primary objective of the agreement would be to guarantee free access and free circulation in the market of the neighboring country as a way to intensify the competition between the two countries and guarantee price and service quality.

¹⁸ The consortium was led by the Italian group Impregilo, which controls 52% of the shares, by the Argentine companies Necón and José Chediack, both with 19% shareholding control, and the Brazilian company Usifast Logística Industrial which has 10% shareholding control.

¹⁹ Currently, the cost of the toll for a four axle truck is US\$ 118 round trip.

CHAPTER VI. FOREIGN ECONOMIC RELATIONS

During the first half of 1998, the bloc was working on the definition of the preliminary agreements for the negotiation of the MERCOSUR-Andean Community Free Trade Area, the preparatory activities of the IV Ministerial Meeting on Trade held in San Jose, Costa Rica and the Santiago Summit, which launched the negotiations for the creation of the Free Trade Area of the Americas (FTAA). In addition, the Framework Agreement on Trade and Investment between the Central-American Common Market and the MERCOSUR countries and the Canada-MERCOSUR agreement were signed. An evaluation of the primary results of the external MERCOSUR negotiation fronts follows.

A. MERCOSUR-Andean Community Free Trade Area

On April 16 in Buenos Aires, MERCOSUR and the Andean Community signed the Framework Agreement that outlines the creation of a Free Trade Area between the blocs.²⁰ The negotiations will be conducted in two stages. The first stage will be finished by September 30, 1998 and will call for the establishment of a provisional agreement that will be in effect from October 1, 1998 to December 31, 1999. The transitory agreement will substitute the preferences negotiated bilaterally by the countries under LAIA (ALADI) and will attempt to preserve and stimulate the current trade flows. The second stage of negotiations will begin on October 1, 1998 and is expected to be completed by December 31, 1999; this time frame corresponds to the period of the transitory agreement. In this second stage the Agreement for the formation of a Free Trade Area will be negotiated, which will include not only the products cited in the provisional agreement, but also the remaining products which have tariffs.

The Framework Agreement also establishes commitments for the joint promotion of development and the use of the current physical infrastructure, with an emphasis on the creation of integration corridors that would reduce costs and facilitate the generation of competitive advantages in regional trade and with countries outside the region.

Also outlined is the creation of a legal framework that would promote reciprocal investments between the region's countries to allow them to better complement each other and cooperate in the areas of economics, energy, science and technology. The countries signed agreements to reach coordinated positions in the hemispheric integration process and in the multilateral negotiation fora.

Trade between MERCOSUR and the Andean Community countries reached US\$ 5.8 billion in 1997 compared with US\$ 4.7 billion the year prior. This represented growth of 21.4%. Trade between the Andean Community countries was similar: US\$ 4.6 billion in 1996 and US\$ 5.5 in 1997, registering 19.7% growth between the two years.

The list of requests consolidated by MERCOSUR covers 1,472 products with tariff preferences²¹ varying between 50% and 100%. Two criteria were employed in developing the MERCOSUR request lists: (i) products that were included in the lists negotiated under previous bilateral agreements maintained by MERCOSUR and Andean Community countries under the support of LAIA, which is usually called "historic patrimony"; and (ii) products that have relevance in terms of trade flows between the two blocs.

²⁰ Bolivia, which already signed a free trade agreement with MERCOSUR, will not benefit from the results outlined in the provisional agreements.

²¹ The concession requests of tariff preferences are presented in the form of "margins of preference" which indicate the discount percentage on the MFN customs tariff solicited by the bloc. If the tariff charged on the products is 15% and the bloc requests a margin of preference of 20%, the residual tariff charged in the importing markets would be 12%.

The Andean Community presented two lists of products. The first with 2,732 items in which the levels are fixed for the margins of preference solicited to MERCOSUR. A second list, which includes 42 products with a margin of preference of 100%, represents the specific requests presented by Ecuador which already received special treatment from the MERCOSUR countries, under a LAIA “regional tariff preference” (PTR) which is conceded to the region’s relatively less developed economies.

B. FTAA and hemispheric integration

The IV Ministerial Meeting on Trade held in San Jose, Costa Rica on March 19 examined the results of the preparatory works for the negotiations of the Free Trade Area of the Americas. The San Jose Declaration, countersigned by the 34 Ministers responsible for trade and ratified by the Heads of State in the Santiago Summit held April 18 and 19, proposed the beginning of negotiations by September 30, by which point the working programs for the negotiating groups should be developed.

The proposal of establishing the FTAA involves the creation of a free trade area in the Americas by means of negotiations that should be concluded in December 2004. The Agreement is expected to facilitate the progressive elimination of barriers to the trade of goods, services and to investments. Its terms should be compatible with the rules and regulations of the World Trade Organization, especially Article XXIV of the General Agreement on Trade and Tariffs and Article V of the General Agreement on the Trade of Services.

The primary issues proposed by MERCOSUR which were incorporated into the San Jose Declaration are as follow:

- FTAA and its agreements should represent a consensus between all of the countries in the hemisphere and be the result of gradual and progressive negotiations, it should be compatible with the consolidation and improvement of several integration initiatives that are underway in the Americas (*building blocks approach*), allowing for such initiatives to coexist with FTAA, as long as the rights and requirements of these agreements are not covered or exceed the rights and requirements of FTAA;
- FTAA should be built with a base in agreements which are balanced, fair and advantageous for each of the members and should be completely and simultaneously assumed by the 34 countries;
- The different sectors of negotiation should advance at the same time and no agreement should come into effect separately, but rather by waiting for the whole package of agreements to be negotiated and approved (*single undertaking*);²²
- The trade agreements will come into effect beginning in 2005; however, the countries signed an agreement to achieve concrete advances in the negotiations by the year 2000, especially in terms of measures to facilitate business.

Other general established principles assure: (i) the promise that the FTAA agreement will be compatible with the rules and regulations of the World Trade Organization (WTO) and that the countries should, as a result of the negotiations, domestically improve the policies that cover the implementation of the rules and regulations of the WTO, as well as those to be agreed upon under the FTAA; (ii) the evaluation of the needs, economic conditions and opportunities of the continent’s smaller economies; and (iii) the full participation of all of the countries in the negotiation process, regardless of the size and the level of development of their economies.

²² In the San Jose Ministerial Meeting, the US abandoned the idea of the implementation of early agreements (early harvest), but left open the possibility for the approval of preliminary agreements for the case of measures designed to facilitate business.

The Trade Negotiating Committee was created to provide the FTAA with an organizational structure. The country which hosts the ministerial meetings will also assume the presidency of the Committee, according to the following timeline: Canada (from May 1998 to October 1999); Argentina (from November 1999 to April 2001); Ecuador (from May 2001 to October 2002); Brazil and the US will share the Committee's presidency from November 2002 to December 2004, or until the end of the negotiations. A total of 9 Negotiating Groups were created to address the following issues and they will be presided over by the following countries: (i) Market Access (Colombia); (ii) Agriculture (Argentina); (iii) Anti-dumping and Compensatory Rights (Brazil); (iv) Governmental Purchases (United States); (v) Intellectual Property Rights (Venezuela); (vi) Investments (Costa Rica); (vii) Competition Policy (Peru); (viii) Services (Nicaragua); and (ix) Controversy Resolution (Chile). The presidential terms will be 18 months; in exceptional cases the presidents may be reelected to their positions.

Three other institutional mechanisms were established: (i) the Committee of Government Representatives, to receive proposals from civil society; (ii) the Consultative Group on Smaller Economies will examine the specific interest of the continent's relatively smaller economies; (iii) the Joint Committee on Electronic Business, formed by representatives from the governments and the private sector, will present proposals on the issue in the next ministerial meeting.

The FTAA will also include a Temporary Administrative Secretariat, formed by between three and six officials, which will function as the headquarters of the negotiations and the Secretariat. Three cities will host the Secretariat: Miami (from 1998 to 2001); Panama City (from 2001 to 2003) and Mexico City (from 2003 to 2004 or until the end of the negotiation process).

C. MERCOSUR-Mexico negotiations

The bilateral agreements between the MERCOSUR countries and Mexico, signed under ALADI, expired December 31, 1997. The agreements had been provisionally renewed since 1995, the year in which the Customs Union began. MERCOSUR has defended the proposal of making the agreements multilateral, while Mexico presented a proposal for the negotiation of a free trade area between the five countries. Of the four MERCOSUR countries, three decided for the renewal of the bilateral agreements: Argentina and Paraguay, for an additional 120 days and Uruguay for 180 days. The decision of the Brazilian Government, against the renewal of the agreement (Partial Reach Agreement N° 9), was supported by Brazilian businessmen, and was announced by the National Confederation of Industry (CNI) under the allegation of an absence of reciprocity. According to representatives from industry the concessions negotiated under the Partial Reach Agreement N° 9 were quite favorable to Mexican exports, while the preference margins offered by Mexico were minor. Two organizations, the Brazilian Chemical and Pharmaceutical Industry Association and the Brazilian Medical and Hospital Industries Association, which both benefit from extensive preferences in bilateral trade with Mexico, did not sign the manifesto. The main concerns of the Brazilian business sector in the signing of a new agreement with Mexico are related to a possible liberalization of trade in automobiles and electronic and electrical goods, sectors which Brazil plans to exclude from the negotiations.

D. MERCOSUR-CACM Framework Agreement on Trade and Investments

In parallel with the FTAA negotiations, the MERCOSUR countries signed a Framework Agreement on Trade and Investments with the Central American countries that form the Central American Common Market (CACM), Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. The primary initiative outlined by the Agreement will be the establishment of a cooperation program to conduct studies that will identify the existence of idle capacity and exportable supply to facilitate the expansion of trade flows between the countries. However, the negotiation of mutual concessions of preference margins is not outlined in the Agreement. The

primary objectives of the Agreement are: (i) the tightening of economic relations in terms of trade, investments and the transfer of technology; (ii) the creation of promotion and protection mechanisms combined with investments that stimulate the flow of investments in the countries; and (iii) the joint and active identification of specific steps and actions that lead to the strengthening of trade ties between the signatory countries.

The initiative resulted largely from the interest of Central American countries that identified MERCOSUR as a partner with potential to promote investments and technologies.

A complementary initiative to the agreement between the governments was implemented by the Argentine private sector. In an effort to stimulate trade between Argentina and the CACM countries, the Argentine-Central American Chamber of Commerce (CACE) was created. The entity will facilitate exchange and business contacts between these countries and Argentina.

E. MERCOSUR-European Union negotiations

Authorities from the European Union have announced that the beginning of 1999 will mark a new phase of negotiations between MERCOSUR and the European Union (EU). The negotiations are expected to be launched during the Summit Meeting of the 15 heads of Government and State of the European Union and the 32 heads of State and Government from Latin America, which is scheduled to be held in May 1999 in Rio de Janeiro.

Representatives from the European Commission reaffirmed the European interest in negotiating the formation of a free trade agreement with MERCOSUR. The negotiations between the two blocs began in 1995, with the signature of a framework agreement. In terms of the preparatory activities for the negotiation of the agreement, a document, which evaluates all of the aspects of trade between the two blocs, is expected to be finished by the first half of 1998. After this document is complete, the next step to be taken by the Commission will be to obtain a negotiating mandate with the European Council (formed by the trade ministers of the fifteen member countries) to allow for the negotiations to proceed.

The proposal presented by the Commission is that after obtaining a negotiating mandate it will be possible to promote, beyond the second half of 1998, a decrease in tariff and non-tariff barriers charged on exports from MERCOSUR countries to Europe. This initiative may include some agricultural products of interest to MERCOSUR countries.

F. MERCOSUR-Chile agreement

Based on the terms of the Economic Complementary Agreement (ACE) 35, signed in 1996 between the MERCOSUR countries and Chile and regulated by the ALADI trade negotiation mechanisms, MERCOSUR requested Chile for a concession of compensations as a result of the negotiations of the trade agreement signed between Chile and Canada. Chile agreed with the plea and presented a list containing 165 products for which the preference margins in relation to the Chilean import tariff would reach up to 100%. The Argentine Chancery contested the list, under the allegation that the list did not take into consideration the interests of the Argentine exporters; especially those involved in the agricultural-industrial sector. These exporters are concerned by the probable losses to their exports due to tariff preferences granted in the agricultural-industrial sector by Chile to its North American partner. Chile conferred additional preference margins for 105 products imported by MERCOSUR, which correspond to annual exports of almost US\$ 135 million for the Chilean market. However, the Argentine government still requested Chile to examine the possibility of expanding the compensations to cover certain products of its interest such as wheat and vegetable oils.

In April, the Administrative Commission of the Chile-MERCOSUR Free Trade Agreement held a special meeting to discuss the raising by three percentage points of the MERCOSUR Common External Tariff (CET), the liberalization of the automobile sector and to evaluate the previous licensing mechanism on imports established by the Brazilian government. In the meeting, Chile proposed to reduce tariffs one year ahead of time on the products considered “historic patrimony”, whichever of the products that were included in the bilateral agreements before the signature of the 4+1 agreement.

G. MERCOSUR-Canada agreement

On June 16, 1998 an agreement of cooperation in the areas of trade and investments was signed between Canada and the four MERCOSUR countries. By means of a document entitled “Understanding of Cooperation on the Trade of Goods and Services and Investments”; Canada acquired a new legal status with the MERCOSUR countries. Canada reached the status of a “strategic partner” in future FTAA and GATT-WTO negotiations. In addition to a Plan of Action, a “Consultative Group on Cooperation in Trade and Investment” was created and will meet every 12 months, or whenever necessary, to examine and evaluate the progress of negotiations.

The Action Plan established priority areas for the expansion of trade and investment and for the strengthening of economic relations as a whole. Furthermore, a negotiation structure was defined involving the implementation of: (i) measures that allow for the elimination of obstacles to trade and investments, calling for the formation of an Advisory Council formed by business leaders from the member countries, the role of which will be to identify and discuss the possibility of removing barriers that create obstacles to business between the countries; (ii) bilateral agreements to protect foreign investment; (iii) cooperation measures on issues involving consumers’ interests; (iv) incentive mechanisms for the formation of mixed societies in the area of environmental technology; and (v) policies that allow for the increasing participation of small and medium-sized companies in the economic exchange between the countries.

The agreement did not outline the implementation of programs to reduce tariffs for trade between Canada and MERCOSUR, the discussion of which should occur in FTAA negotiations. Still, the MERCOSUR countries hope that as a result of the signing of the agreement, Canada will come to recognize the need to hold effective negotiations for the reduction of the agricultural subsidies and barriers within the FTAA.

The agreement should have already been signed in January 1998, during the official visit of the Canadian Prime Minister to Brazil. However, at the time the trade dispute between the Brazilian and Canadian commercial jet manufacturing companies, Embraer and Bombardier respectively, led the Brazilian government to suspend the implementation of the agreement.

In 1997, the trade flow between Canada and MERCOSUR was US\$ 2.7 billion, of which US\$ 1.9 billion corresponded to Canadian exports and the remaining US\$ 800 million to exports from Argentina, Brazil, Paraguay and Uruguay.

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APPENDIX

PARAGUAY AND MERCOSUR

1. PARAGUAY JOINS MERCOSUR

In the early eighties, the foreign debt crisis had meant the end of the protectionist economic models in Latin America. This crisis coincided with the return of democratic and civil political regimes. These two facts were added to the sub-region's loss of competitiveness in the international market, which was reflected in a limited participation of the sub-region's main countries in world trade and a marked technological and productive lag.

In this context, and more specifically in Latin America, maintaining the old geopolitical rivalry between two large countries such as Argentina and Brazil mainly served isolationist and less effective plans from the point of view of economic development. The Argentine-Brazilian approach which gave rise, in 1986, to an Integration and Economic Cooperation Program ("PICE"), broke with an hegemony-seeking political and commercial relationship and replaced it by economic complementation and integration oriented towards a new positioning of the two countries in the international market. The PICE's main objective had been the recovery of the commercial flows that existed before the debt crisis. A second objective consisted in reducing the bilateral trade disequilibria. To this effect, gradual mechanisms were applied for the promotion of intra-industry trade between both countries and the over-all expansion of bilateral commerce.

In 1988, the PICE became the Argentine-Brazilian Integration Treaty, with the object of creating a common market within a period of ten years. Nevertheless, in July 1990, an act signed by the presidents of both countries cut the term for the creation of this common market to five years. The integration treaty between the two countries proposed not only the harmonization of trade and tariff policies, but also of macroeconomic and sectoral policies (agricultural, industrial, etc.). The balance of the first four years of Argentine-Brazilian integration had been more than favorable for the two countries. For this reason, the Act of July 1990 resolved to accelerate the schedule for the creation of the common market. And it was precisely the execution of this act that caused the mobilization of the small countries of the sub-region, especially Uruguay, that did not want to be deprived of the benefits of a process which appeared to be serious and permanent, as a result of the political determination shown by the governments of Argentina and Brazil.

In fact, since the beginning of the Argentine-Brazilian integration, Uruguay has constantly accompanied the process. It could not have been otherwise, since Uruguay had moved to secure its interests long time before, when in the seventies, and due to the weakening of LAFTA (ALALC), it had signed two bilateral agreements with Argentina and Brazil ("CAUCE" and "PEC"). These agreements gave Uruguay tariff preferences for exporting a certain kind of products, in order to reduce the deficit of its trade balances with the two large countries of the sub-region, or to turn these deficits into surpluses.

By the mid-eighties, Uruguay succeeds in negotiating with Argentina a reform and expansion of the CAUCE, that benefits a greater number of industrial exports, incorporating a specific trade and complementation regime for the automotive sector, as a commitment to privilege reciprocal trade in the case of seasonal disequilibria. And in the middle of the Argentine-Brazilian integration process, Uruguay negotiates with Brazil the restatement of the PEC, by which the number of export items subject to concessions was doubled, expanding the exchange of agricultural products and promoting the trade of services and automotive industry products.

Uruguay could take advantage of certain rights and channels derived from the special commercial relationship that it had developed with its two large neighbors to request the expansion of the Argentine-Brazilian integration agreement in order to include the smaller countries of the sub-region, as foreseen in the Act of July 1990. The Treaty of Asunción has its origin in that act and in Uruguay's reaction to force the participation of the small countries, in view of the decision made by Argentina and Brazil to reduce the terms for the creation of a common market between them.

Paraguay, on the other hand, had not negotiated special agreements with its two neighbors, as Uruguay had done. This meant the gradual loss of trade preferences obtained through the provisions of the Treaty of Montevideo in 1960. In addition, Paraguay still had an authoritarian political regime in the past decade. This was an important obstacle at the time of transforming the country into a suitable partner for Argentina and Brazil during the integration process. Moreover, the signs emitted by Paraguay, after the fall of the authoritarian regime in 1989, regarding its attitude towards the sub-regional integration process, explain why Paraguay was excluded from the first constitutive meeting of what was later called MERCOSUR (August 1990), while Chile and Uruguay were invited to attend.

Paraguay's later decision to join MERCOSUR took into account the country's immediate foreign policy interests rather than the belief that economic advantages could eventually be obtained from this regional integration process; or to serious considerations about the economic disadvantages that MERCOSUR itself could provoke.¹ Paraguay, politically isolated by an authoritarian regime, had started the transition to democracy in 1989, and the invitation to join the MERCOSUR implied a favorable international projection and greater chances of foreign support.

Although Paraguay's political isolation during the last years of the dictatorship had not necessarily meant its commercial and financial isolation from the rest of the world, the national authorities could have argued that Paraguay should join the MERCOSUR for geo-economic reasons. Refusing to participate would have put Paraguay in an uncomfortable situation between two integrationist South American blocs: MERCOSUR, that was taking its first steps with great strength and the Andean Pact, that was starting to reactivate itself in response to the internal and external advantages to be derived by the sub-region from integration processes. Even in the case of a very open economy such as Paraguay's, it was difficult to think of an integration model with the world "the Chilean way", for two main reasons: (i) Paraguay's principal commercial partners are in the sub-region; and (ii) the country's limited productive and institutional capacity to obtain levels of international competitiveness in the short run.

In this way, and even though MERCOSUR did not give the smaller countries any favorable status on account of their being less developed countries, Uruguay's decision to join was consistent with its need to maintain the benefits obtained with the CAUCE and the PEC, and, consequently, not to lose the Brazilian and Argentine markets with which Uruguay had developed a growing relationship since the seventies. In the case of Paraguay, the commercial dependence on the Brazilian and Argentine markets was more than evident. It was inevitable that Paraguay joined MERCOSUR, since the country's economic opening and its integration with the sub-regional economies had been developed long before the execution of the Treaty of Asunción.

¹ In meetings between the Ministry of Foreign Affairs and representatives of the business sector held during the last quarter of 1990, to discuss Paraguay's entrance to MERCOSUR, consultations were limited to the eventual objections that the productive sector may want to pose, as well as to the comparison of such objections' importance *vis à vis* the arguments of national authorities based on Paraguay's impossibility of not being part of the sub-regional integration process or the fundamental priority of the country's participation in that same process (interviews with businessmen and government officials).

At this point, we should compare the economic evolution of Paraguay *vis à vis* its partners in MERCOSUR in order to understand the cause of Paraguay's delay or initial reluctance to join the sub-regional enterprise; as well as understanding why Paraguay would derive only marginal benefits from the Treaty of Asunción after seven years of its implementation.

Argentina, Brazil and Uruguay arrive at the process of sub-regional integration with highly protected economies, subject to cycles of strong macroeconomic disequilibria. The stabilization and adjustments plans implemented by these countries were consistent with the change of the economic model that had prevailed in the sub-region until the eighties: the passage from closed economies (inward-oriented growth) to open economies (outward-oriented growth). Paraguay, however, entered MERCOSUR with the most open economy of the sub-region, the best balanced in macroeconomic terms, and consequently, the one that showed the smallest public sector. Paraguay, unlike its neighbors, never followed an import-substitution policy, and its economic model has been based in the export of soybean and cotton and in the re-exportation or triangulation border trade. The latter explains the degree of openness of the Paraguayan economy when compared to its neighbors. Thus, one of the main comparative advantages developed by Paraguay, faced by its neighbors' protectionism, has consisted in buying "cheaply" goods from outside the region and resell them "cheaply" to the sub-region. For that reason, the stabilization policies first applied in the country by the nineties, were not the result of the change of economic model, but of the improvement of the accounts that had been partially disequilibrated in the last years of the authoritarian regime. But, even if Paraguay enjoyed trade liberalization long before the signing of the Treaty of Asunción, the subsistence of the Paraguayan economic model could not be totally consistent with the sub-regional integration process.

2. MACROECONOMIC EVOLUTION

In the eighties, smuggling made Paraguay the sub-region's most open economy. Its industrialization had just begun. The period of macroeconomic instability and foreign account's crisis that Paraguay underwent by the end of that decade was not part of the crises of the "inward oriented growth" that, as mentioned above, affected the economies of the rest of the sub-region. The recovery of macroeconomic stability did not necessarily imply the recovery of the real levels of economic growth. Since no profound reforms have been carried out, such levels have not yet reached the desired figures.

In order to understand this first characteristic, one fact must be underlined: Paraguay is among the late-reform countries of Latin America. Talk on economic and government reforms began in 1989. Such reforms have been mainly concentrated on economic stabilization and liberalization, through measures like the adoption of a flexible exchange rate, deregulation of certain domestic prices and of interest rates; monetary and fiscal policies aimed at eliminating fiscal deficits and cutting unusually high inflation levels by Paraguay's own historic precedents; and a tax and tariff reform, the latter undertaken for the sole purpose of adjusting the normative system to the realities of an open economy.

Nevertheless, advances on privatization of public services and social security, financial reform and public banking have been insufficient. The limitations of the reform of the state can be observed in the constant superiority of current expenditures over investment in the National Budget, lacks in the financial administration of the state, the absence of a public-service reform and of a modernizing and efficient handling of human resources in the public sector.

The Paraguayan gross domestic product has shown, as the average of the last fifteen years, a growth rate similar to the demographic increase. Such performance is an unquestionable sign of national economic stagnation. In the late eighties, other problems were added, such as inflation, fiscal deficits, depressed foreign-exchange reserves and foreign debt arrears. The first transition government (Rodríguez) managed to solve the problems of inflation and fiscal deficit, increase reserves, pay the default debt and stabilize the economy. The second government (Wasmosy) achieved greater price stability and a further reduction of inflation. Thus, a 44% annual inflation rate in 1990, decreases to 20% in 1993, and to only 7% in 1997. At the same time, the balance of foreign reserves was only US\$ 180 million at the end of 1988, to climb to US\$ 1,100 million by the end of 1996.² None of the two governments, however, has succeeded in re-launching the national economy towards growth.

GDP growth, after showing an annual rate of around 9.4% in the seventies, proceeded at a reduced rate of 1.9% in the eighties. A slight increase was achieved in the nineties, when a 3.2% annual growth rate was reached. This process was accompanied by an annual average demographic increase of between 2.7% and 3% in the last fifteen years. In turn, the real annual per capita GDP in 1982 was US\$ 1,582 , increasing to US\$ 1,623 in 1997.³

Compared to the other member countries of MERCOSUR, the Paraguayan economy as a whole (Table 1) presents as well a double disadvantage. On the one hand, it shows a lower level of GDP per capita (US\$ 1,471 in 1996); and on the other hand, a lower rate of economic growth (0.1% in 1990-96) than in the rest of the sub-region is evident.

² See the figures of the country's main economic indicators in Banco Central del Paraguay [1997].

³ Source: Banco Central del Paraguay. *Cuentas Nacionales*. 1985-96. Arithmetical average.

TABLE 1

MERCOSUR	GDP per capita (US\$)	Growth Rates	%
	1996	1980-90	1990-96
Paraguay	1,471	- 0.2	0.1
Argentina	6,191	- 2.5	4.6
Brazil	3,007	- 0.6	1.3
Uruguay	3,258	- 0.3	3.2

Source: Based on data taken from IDB. *Progreso Económico y Social en América Latina*. 1997 Report.

One of the indicators of the country's economic stagnation is related to the levels of private and public investment in Paraguay, which have undergone a decline in the last fifteen to twenty years. While private investment amounted to 21% of GDP in the period 1974-88, it decreased to 18.6% in the 1989-96 period. As far as public investment is concerned, the decline has been from 6% to 4.9% between the last decade and the present one. In addition, 58% of private investment has been concentrated in construction and foreign investment has accounted for only 2% of GDP.⁴

Private investment in Paraguay must face other costs as well. Consequently, public investment in infrastructure and basic services show the lowest coefficients in Latin America.⁵ Financing of investments is done primarily with foreign funds, since domestic savings have decreased from 20% of GDP in the eighties to 15% of GDP in the nineties. Additionally, high costs of financial intermediation reflected in very high active interest rates (32.7% annual average in 1990-97), shortage of medium and long-term credit, and the 1995-1997 financial crises have reduced private investments.

As far as the labor market is concerned, we must say, in the first place, that 45% of the Economically Active Population (EAP) is 29 or younger. This layer is the most seriously affected by unemployment and under-employment. According to the latest official figures, official unemployment amounts to 8% and under-employment, to 20% of the EAP. At the same time, under-employment growth has coincided with changes in the composition of the EAP by areas of activity. Such growth implies an equivalent and simultaneous increase of informality. Thus, the agricultural EAP has declined from 43% to 35% while that corresponding to services has increased from 17% to 21%, and that corresponding to commerce, from 8% to 14% (*Dirección General de Estadísticas y Censos* [1995, 1996 and 1997]).

The prolonged lethargy of the Paraguayan economy can also be explained by the stagnation of the productive system, as reflected both in the evolution of agriculture and industry in the nineties as well as in the performance of relative prices.

In relation to the agricultural product, growth achieved in the nineties has been of 3% annual average, while the equivalent figure for the industrial sector is 1.7%. Although it is true that the trade and financial sectors have increased by only 2.6% annual average in the decade, it is also true that these two sectors plus the basic services sector have concentrated more than 50% of national GDP; thus explaining the slow dynamics of the productive sector (see Table 2).

⁴ Ibid.

⁵ The following figures can serve as examples: Paraguay has 32 Km of roads per 1,000 inhabitants, while Uruguay and Argentina have 100 and 80, respectively; and only 19 telephone lines per 1,000 inhabitants, when the other countries of the sub-region can show much larger ratios.

TABLE 2
GDP VARIATION AT MARKET PRICE
(percentages)

	1990	1991	1992	1993	1994	1995	1996	1997	Share *
Agricultural Sector	2.2	-0.6	0.1	5.6	-0.6	8.1	1.3	4.1	26.4
Industrial Sector	-0.9	1.1	0.4	2.0	1.5	3.0	-2.2	1.0	15.3
Construction	1.7	3.0	5.0	2.7	3.6	4.0	3.0	3.0	5.3
Services **	3.6	4.5	2.8	4.3	5.4	3.7	2.1	2.3	52.3
GDP (US\$ millions)	5,285	6,254	6,447	6,841	7,857	8,970	9,686	10,029	

Source: Banco Central del Paraguay. Economic Report, 1997.

Notes: * Annual Average. ** Including basic services (water, electricity, transport and communications), trade, finance, government and other services.

Agricultural growth has been based on the production of four main items: cotton, soybean, wheat and corn. Nevertheless, it has been cotton cultivation that concentrates the greater number of producer families. And it is in the production of this last item where continuously decreasing returns (from 750,000 tons in 1990-91 to only 140,000 tons in 1996-97)⁶ have been experienced.

Growth of the productive sector has also been undermined by the inefficient prevailing pattern of agricultural land units (20 ha), and by an industrial sector which is predominantly composed of craftsmen or small-sized enterprises. Both kinds of productive units show a shortage of skilled labor, lack of adequate technology, the absence of modern entrepreneurial management, and little competitiveness. To all these characteristics, the exclusive orientation of these units to the domestic market must be added.

Nevertheless, the macroeconomic stability achieved by the transition governments has implied costs for the productive sector and for consumers. The depreciation of the *guaraní* below the inflation rate, or exchange rate lag, has punished the agri-exporting sector, and consequently, the primary producer by reducing the prices of cash crops. Sustained high interest rates, in spite of the reduction of the legal bank reserve requirement and a significant decline of inflation levels, have inhibited investments in the productive sector and have led to high levels of indebtedness in consumers and producers, particularly industrial producers.

At the same time, the real minimum wage has run behind inflation till 1993, showing a slight increase in the period 1994-96. Nevertheless, the average wage turns out to be low (US\$ 200 per month) when compared to the Argentine average wage (US\$ 600 per month) or the Brazilian (US\$ 400).⁷

Depressed prices for agricultural producers and low wages for the non-agricultural sector are two factors that have contributed to reduce the purchasing power of the Paraguayan people, to which the shortage of credit flows for the productive sector should be added, that is the job provider. This limited purchasing power of the Paraguayan people, or weakness of the aggregate demand, has also been strengthened by the unequal distribution of resources and income.

⁶ Figures obtained from the Ministry of Agriculture and the *Cámara Algodonera Paraguaya*.

⁷ Minimum wage in Paraguay acts as a ceiling rather than a base, as it does in the rest of the countries of the sub-region. It is estimated that between 35% and 40% of the EAP receives incomes lower than the minimum wage.

TABLE 3
PRICE PERFORMANCE

INDICATORS	Average 1984-88	Average 1989-93	Average 1994-97	Average 1989-97
CPI (%) (1)	25.2	24.5	12.3	18.4
Nominal exchange-rate variation (%) (2)	24.8	13.5	5.8	10.0
Real exchange-rate variation (%) (3)	2.0	-6.7	-7.1	-7.1
Active rate in national currency (4)	n.a.	33.2	33.8	33.1
Real wage index	93.6	104.6	109.7	107.1
PRICES-RECEIVED-BY-FARMERS INDEX (5)				
Cotton	163.0	153.5	129.3	144.4
Soybean	152.4	129.4	107.0	121.0

Source: Based on data taken from the Banco Central del Paraguay. Cuentas Nacionales, Informe Económico Mensual, Indicadores Financieros.

Notes: (1) Consumer Price Index from Dec. to Dec. (2) Annual Average. (3) Ibid. (4) Weighted Average, excluding credit cards and overdrafts. (5) Deflated by CPI, Base 1982=100, Local Market, 100=1980.

In Paraguay, in addition to the low level of the average income, a growing inequality in the distribution of the social product can be detected in the last three years. According to the *Dirección de Estadísticas y Censos*, in 1996, 55% of the EAP received a monthly income lower than US\$ 290, 22% of the EAP, incomes between US\$ 290 and US\$ 480, and only 18% of the EAP, had incomes higher than US\$ 480.

Also, and according to estimates made by international organizations, social inequality is reflected in Paraguay, for example, in a study performed by the IDB in 1992. This study shows that the poorest 10% of the Paraguayan population owns only 1% of the national income while the richest 10% receives 42% of the national income. In 1994, a study made by the World Bank found that 20% of the poorest Paraguayan homes controlled 6% of the income and that 20% of the richest homes controlled 46% of that income (Sauma et al. [1992] and World Bank [1994]).

Land is an important example of distribution of resources. In the last two decades there has been an increase of pastures for livestock, an increase of temporary crops by farming entrepreneurs, and a decrease of permanent crops, forest areas and natural prairies. In the same way, there has been an increase of farms of less than 5 hectares and units between 5 and 10 hectares, which constitute at present 83% of rural land; as well as an increase of properties of more than 1,000 hectares.⁸ In this way, land concentration is today greater than thirty or forty years ago, when there already existed a marked inequality in the distribution of this resource. This land concentration leads to a smaller absorption of rural labor, less employment and, consequently, less income.

In addition to private investment, employment generation and opportunities for higher income, the population's living standard also depends on the allocation of the Nation's general budget expenditures. The economic growth of a country also depends on the level of the population's quality of life.

However, capital investments (mainly on infrastructure) as well as social expenditures of the Paraguayan state are still below desired levels. Capital investments of the Nation's General Budget (NGB), represent only 1.6% of GDP. These investments represent 18% of total expenditures of the NGB, in comparison to

⁸ See *Censos Agropecuarios 1981 and 1991*.

82% of current expenditures (wages, fuel, expense allowances, etc.).⁹ As a result of low levels of public investment and lack of any significant advance in the privatization of basic services, Paraguay is in difficult shape for its development in the sub-region.

Although it is true that health and education expenditures have increased during the two transition governments, these expenditures, however, are still in low levels when compared to the rest of the sub-region. Thus, health expenditures represent 1.27% of GDP, while education expenditures amount to 3.1% of GDP. This last coefficient (education) is below UNESCO's recommendation (7% of GDP) and below the average of the Latin American region.

The economic stagnation prevailing since the eighties has been followed, in the last years, by an economic recession as a result of two marked financial crises, an important reduction on cotton cultivation as well as on border trade intermediation.

The financial crises of 1995 and 1997 have provoked massive interventions of the Central Bank, which in turn gave rise to tight monetary policies, reducing resources available for financing of production. This financial problem was accompanied, for the first time after several years of surplus in the state accounts, by the loss of fiscal equilibrium. Even though this deficit had represented only 1% of GDP in 1996, it was growing at almost 2.5% by the end of 1997, and its projection amounted to 3% of GDP for 1998.

Reduction of border trade intermediation had already appeared along with a small deficit in the 1996 balance of payments. This deficit in the external accounts was significantly higher by the end of 1997, causing an important fall of foreign exchange reserves: from US\$ 1,062.3 million at the end of 1996 to US\$ 768.8 million at the end of 1997 and a tendency towards further decrease during the first quarter of 1998. Consequently, both the nominal exchange rate and the real rate suffered an important decrease from December, 1997 onwards (19% and 10%, respectively), which have had significant influence on the inflationary upsurge that amounted to an annual cumulative percentage of 10.5% by the first semester of 1998 (Banco Central del Paraguay [1998]). Finally, the measures enforced by the government to avoid a further depreciation of the exchange rate brought about an increase of active interest rates, thus affecting economic activity, which was already showing signs of increasing recession since 1995.

Thus, the macroeconomic stability recovered in the present decade, has not become a take-off platform for the Paraguayan economy, for it weakened again in the last years, giving rise to fiscal disequilibrium and inflationary growth.

⁹ Figures taken from the Central Government's budget execution. See Banco Central del Paraguay [1997].

3. TRADE AND FOREIGN INVESTMENT PERFORMANCE

Seven years after the implementation of the Treaty of Asunción, it is clear that one of its main results has been the unprecedented increase of trade flows between the countries of MERCOSUR, as well as a significant number of foreign investments, especially since the creation of the imperfect customs union. In this way, intra-MERCOSUR exports increased from US\$ 5,000 million in 1991 to US\$ 20,000 million by the end of 1997; while foreign investment flows to the sub-region grew from US\$ 6,000 million to US\$ 20,000 million between 1995 and 1997 (IDB-INTAL [1997] pp. 12-15).

Paraguay has been one of the countries that profited less from these flows, not exclusively because it is one of the two smallest economies of the sub-region, but because it is a country that specializes on imports; and, in the last ten to fifteen years, on exports of foreign products. Consequently, there have been two main results affecting trade derived from Paraguay's entrance to MERCOSUR: a concentration rather than an increase of domestic product exports to the sub-region and clear signs of trade diversion, particularly when imports performance is analyzed.

Real trade

No Paraguayan foreign trade analysis could be valid if unregistered trade levels are not taken into account. The tradition of this kind of trade comes from the fifties and sixties, when the Paraguayan economy appeared to be more dependent of Argentina and, consequently, of its products. With Brazil's commercial irruption in the seventies (road opening and construction of Itaipú hydroelectric dam), unregistered trade reached important levels, first revealing itself in an unprecedented increase of purchases of goods from the neighbor country. Trade of illegal imports from Brazil continued in the eighties, with two additional characteristics: unregistered exports of Paraguayan soybeans and cotton as a result of the implementation of multiple exchange rate system in the country,¹⁰ and trade intermediation of Brazilian products through Paraguay destined either to Argentina or to countries outside the sub-region. Triangulation of extra-subregional products, another kind of unregistered trade, is developed in that same decade. That is, the import of the so-called "tourist goods" which was illegal for the most part,¹¹ and their re-exportation to the sub-region (also illegal for the most part).

From 1989 onwards, the national government began to establish an array of measures to discourage the illegal import trade and increase fiscal revenues. The first of such measures was a drastic reduction of import tariffs applicable to the so-called "tourist goods". A second decision was the reduction of the VAT levied on the sale of the same products, followed by a reform that reduced the average tariff for all goods, establishing a maximum level of 10%. Besides, MERCOSUR's schedule of tariff elimination complemented the measures taken by national authorities. Such decisions, however, did not achieve, as can be seen in Table 4, a reduction in the level of unregistered imports and re-exportations, at least until 1996. The decline of illegal border trade in the last few years is essentially the consequence of measures applied by the authorities of neighboring countries, whose fiscal and commercial policies have been affected by such traffic. It should be observed that the referred illegal trade was also beginning to pierce the common external tariff.

Table 4 confirms the historic trend towards deficits of the Paraguayan balance of trade, showing only the registered trade. Surprisingly, this trend continues when official estimates of unregistered imports and re-exports, that are part of the border trade intermediation, are added. In any case (including estimates of the

¹⁰ This exchange system imposed on exports an exchange rate much lower than the market level, penalizing them through prices.

¹¹ The expression "tourist goods" refers to those imported by Paraguay but destined mainly to the Brazilian market: electronic devices, household appliances, perfumes, toys, photographic cameras, computers, shoes and sport apparel, watches, etc.

unregistered trade or excluding them), however, the deficit of the Paraguayan trade balance would be so significant that it would reach around 15% of GDP, with strong impacts on the balance of payments and the exchange rate, and consequently, over the country's macroeconomic stability.

TABLE 4
PARAGUAY: TRADE BALANCE EVOLUTION
(US\$ millions)

	1989	1990	1991	1992	1993	1994	1995	1996	1997
Registered Exports	1,009.4	958.7	737.1	656.6	725.2	816.9	958.7	1,043.0	1,088.6
Unregistered Exports (1)	14.5	81.4	107.9	83.7	79.4	125.7	--	--	--
Re-exports (2)	124.7	300.3	321.3	304.0	694.0	926.0	1,883.1	1,723.7	1,554.8
TOTAL (3)	1,165.2	1,366.2	1,188.8	1,054.2	1,500.0	1,871.3	2,841.8	2,766.7	2,643.4
Registered Imports	660.8	1,193.4	1,275.4	1,237.1	1,477.5	2,140.4	2,871.0	2,850.4	2,957.5
Unregistered Imports	355.1	390.6	553.6	688.1	1,233.2	1,357.4	1,646.3	1,345.2	1,079.6
TOTAL (3)	1,015.9	1,635.8	1,867.6	1,925.2	2,710.7	3,497.8	4,517.3	4,195.6	4,037.1
Deficit/Surplus	149.3	-269.6	-678.8	-871.0	-1,210.7	-1,717.9	-1,675.5	-1,428.9	-1,393.7

Source: Based on official data and estimates by Banco Central del Paraguay.

Notes: (1) of domestic products; (2) of foreign products; (3) including valuation adjustments.

It is difficult to understand such volume of the Paraguayan trade deficit in the face of a persistent increase of foreign reserves throughout the entire decade of the nineties, with a moderate decline in the last year, together with low inflation rates and small depreciations of the national currency (even allowing for a lag in exchange-rate adjustments). An alternative explanation would result from the introduction of significant amounts in the item "errors and omissions" of the balance of payments (see Annex).¹² But such figures fail to reduce substantially the Paraguayan trade deficit in relation to GDP. Thus, it is possible to infer the existence of a larger unregistered, and consequently not estimated, trade flow, that should explain a much smaller deficit in the trade balance or even its absence.

Nevertheless, all these considerations do not affect the three main conclusions to be inferred from Paraguay's trade performance: (i) the historic trend towards imports, especially of consumer goods;¹³ (ii) the development of a comparative advantage through the country's role as trade middleman in the sub-region; and (iii) the stagnation of the country's genuine exports, as a reflection of its low productive growth. The impact of MERCOSUR on trade and investment in Paraguay has to be interpreted in this context.

Trade creation and trade diversion

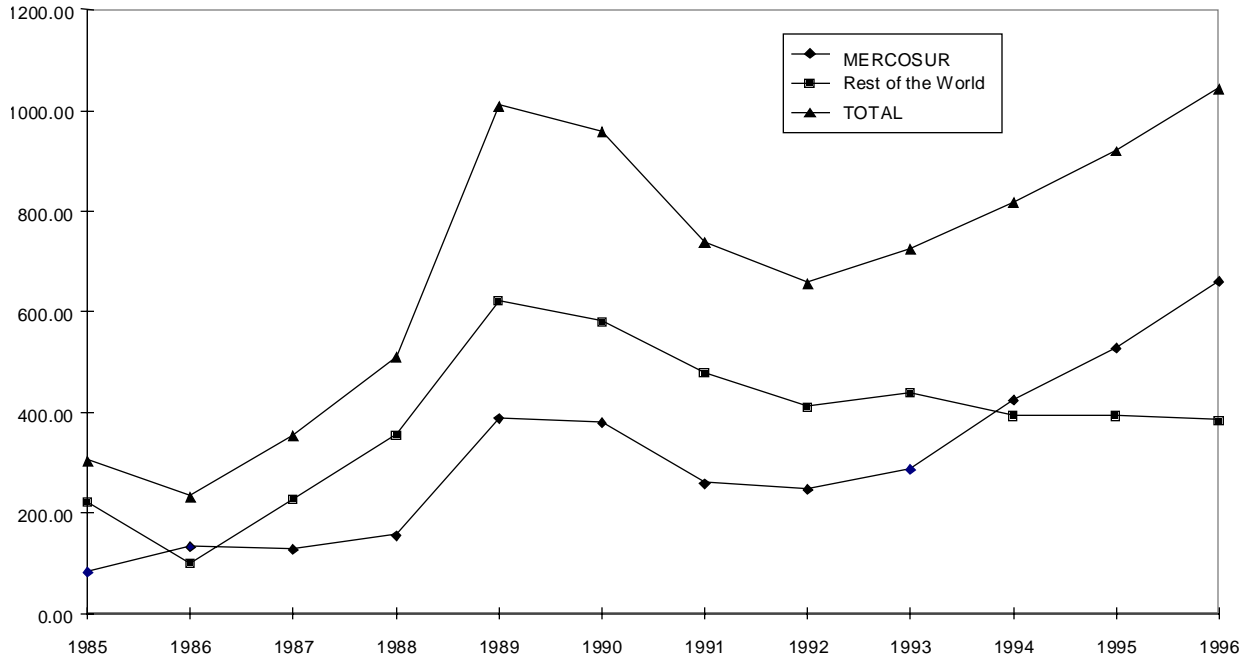
As already shown in Table 4, Paraguay's total exports, after reaching a maximum historical level in 1989, go through a process of significant decline until 1994. Recovery begins after that year and the same maximum level is reached by the end of 1997. Thus, at most, a slow evolution of the country's external sales can be

¹² According to explanations given by experts of the Central Bank, this item includes not only unregistered trade flows but unregistered trade capital flows as well.

¹³ In the last few years consumer goods accounted for 70% of the total composition of Paraguayan imports. See Borda and Masi [1998] p. 145.

observed along the entire decade of the nineties. The recovery of total exports has been due mainly to a rise in exports to MERCOSUR, as can be observed in Chart 1. But while Brazilian and Argentine total exports achieved an annual growth of 15% and 10% between 1991 and 1996, and Uruguayan exports rose at a rate of 8.4%, Paraguayan exports increased only 6% annually during the same period. In addition, Paraguay was the only MERCOSUR country that showed a decline in its exports to the rest of the world (-19.8%) in this period (IDB-INTAL [1996, 1997]).

CHART 1
PARAGUAY: EVOLUTION OF EXPORTS BY REGIONS
(US\$ millions)



Source: Banco Central del Paraguay.

Note: Including only registered exports of national products. Re-exports are not included.

Therefore, the increase of exports from 1994 onwards is determined by the rise in the sales to MERCOSUR. Thus, in 1991, MERCOSUR's share of total exports from Paraguay amounted to 35%, increasing to 63% in 1996, and then decreasing to 50% in 1997.¹⁴

But, do these numbers show a real growth of exports and, therefore, of trade creation within the sub-region? or what is seen is simply a greater concentration of trade? or perhaps its diversion towards MERCOSUR as a result of the elimination of tariff barriers? Observing we observe the composition of Paraguayan exports to MERCOSUR, in Table 5, it appears that non-traditional exports start an evolution that leads to their doubling from 1994 onwards, then decline towards 1996, but maintaining higher levels than the historical average for this kind of exports. In absolute values, this class of exports grows considerably from \$ 57 million dollars in 1993 to \$ 176 million dollars in 1996. This process coincides with an overall increase of the participation of this kind of products in the country's total exports, evolving from a share of 15% in 1985 to a share of 33% in 1996 (Borda and Masi [1998] p. 117).

¹⁴ Data from several economic reports by the Banco Central del Paraguay.

TABLE 5
MERCOSUR: COMPOSITION OF PARAGUAYAN EXPORTS
(US\$ millions)

Categories	1985	%	1986	%	1987	%	1988	%	1989	%	1990	%
Traditional	76.6	93.2	80.1	60.0	92.7	73.0	118.6	76.5	310.0	79.9	321.7	84.8
Non-traditional	5.6	6.8	53.3	40.0	34.3	27.0	36.5	23.5	78.1	20.1	57.6	15.2
TOTAL	82.2	100.0	133.4	100.0	127.1	100.0	155.1	100.0	388.1	100.0	379.3	100.0

Categories	1991	%	1992	%	1993	%	1994	%	1995	%	1996	%
Traditional	248.7	76.1	189.1	76.7	230.7	80.3	248.7	58.6	332.2	62.9	435.5	66.0
Non-traditional	62.1	23.9	57.3	23.3	56.6	19.7	176.1	41.4	195.8	37.1	224.6	34.0
TOTAL	259.4	100.0	246.4	100.0	287.3	100.0	424.8	100.0	528.0	100.0	660.1	100.0

Source: Banco Central del Paraguay.

Nevertheless, even though an interesting performance by non-traditional exports can be observed, it is traditional exports that are mainly directed towards the sub-region. And in the context of exports stagnation, it is difficult to conclude that MERCOSUR has brought about a real creation of Paraguayan trade. It is more accurate to speak of a greater concentration of Paraguayan products in the sub-region.

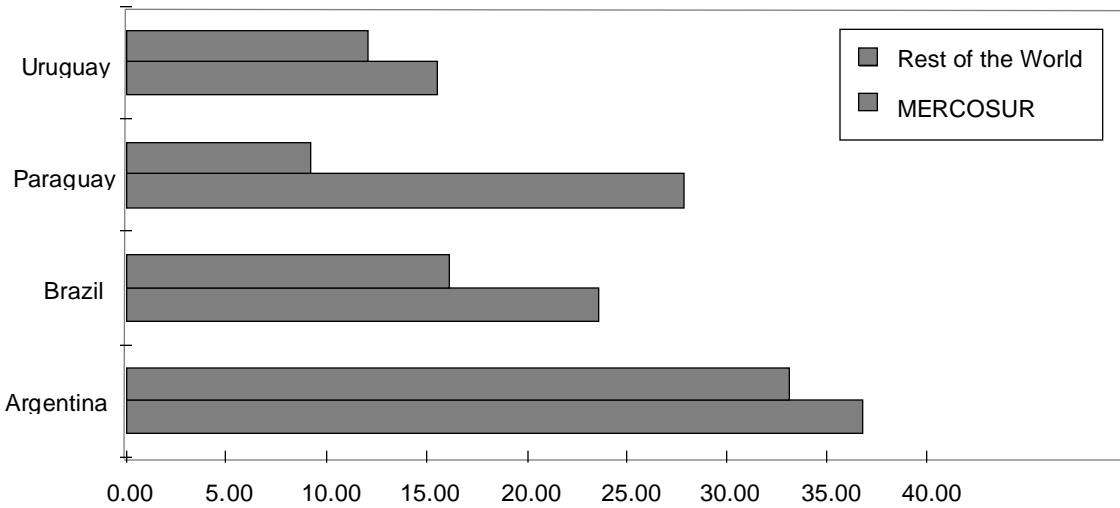
Turning now to imports, Paraguay is the MERCOSUR country that shows the most significant increase of purchases from the sub-region in comparison to those from the rest of the world, when this relation is compared to the performance of the rest of the member countries (Chart 2). Thus, while Paraguayan imports from MERCOSUR grew at an annual rate of 28%, imports from the rest of the world rose only by 9% annually, in the period 1990-96 (IDB-INTAL [1006]). This trend in the performance of Paraguayan imports, when compared to that of the other member countries of MERCOSUR, could be pointing towards the possibility of a strong trade diversion caused by the customs union.

In any case, the clearest signs showing that MERCOSUR has caused a diversion in Paraguay's trade could be obtained only through a more detailed analysis of the performance of the country's import categories. A recent study reveals that those items that make up 54% of Paraguay's registered imports (and therefore a major portion of the total), and that traditionally were purchased from the rest of the world, are now bought in the MERCOSUR (Borda y Masi [1998] pp. 122-126). When unregistered imports are included, this diversion indicator appears to be minimized, since the greater part of this kind of imports come from outside the region. Estimates made by CADEP, however, conclude that in the period 1991-96,¹⁵ Paraguay's unregistered imports have been distributed almost evenly among both zones or markets of origin. Thus, it is possible to assert the existence of signs of MERCOSUR-caused trade diversion in Paraguay. Moreover, such signs are clearer than in the other countries of the sub-region.¹⁶

¹⁵ According to the Centro de Análisis y Difusión de Economía Paraguaya (CADEP), in 1991, 48% of Paraguay's unregistered total imports came from MERCOSUR and 52% from the rest of the world. In 1994, the ratio was 46 and 54% respectively; and by 1996, 56 and 44%.

¹⁶ Studies by Robert Devlin (1997) and Machado and Markwald (1997) deny any possibility of trade diversion between Brazil and Argentina after the implementation of the Treaty of Asunción.

CHART 2
MERCOSUR: EVOLUTION OF IMPORTS BY ORIGIN
Annual growth 1990-1996 (%)



Sources: IDB-INTAL, Banco Central del Paraguay.

Notes: (*) Excluding unregistered imports.

In addition, a confirmation of the possibility of trade diversion can be derived from the fact that the rise in imports from MERCOSUR, unlike the performance shown by exports, occurs in the context of an over-all increase in Paraguayan imports in the present decade (Table 1). These data also confirm the country's trend towards imports, of which the country's trade balance *vis à vis* MERCOSUR is no exception. Along the same line, Table 6 also shows that the trend of growth shown by imports from MERCOSUR is greater than the "increase" (concentration) of exports to MERCOSUR. While exports have risen at a 26% annual rate in the 1991-1996 period, the annual increase in imports (registered) has been around 48% in the same period of time. Thus, the trade deficit with MERCOSUR shows a significant increase (236%) between 1991 and 1996. If estimates of unregistered imports from MERCOSUR¹⁷ are added such deficit becomes even greater in volume.

TABLE 6
PARAGUAY: TRADE BALANCE WITH MERCOSUR
(US\$ millions)

	1985	1991	1992	1993	1994	1995	1996
Exports	82.2	259.4	246.4	287.3	424.8	528.0	660.1
Imports	240.5	396.9	475.0	570.7	891.7	1,170.0	1,548.1
DEFICIT	-158.3	-137.5	-228.6	-283.4	-466.9	-642.0	-888.0
Unregistered Imports	-	286.7	348.0	590.7	655.7	747.7	535.3
Total Imports	240.5	683.6	823.0	1,161.4	1,547.4	1,917.7	2,083.4
TOTAL DEFICIT	-158.3	-424.2	-576.6	-874.1	-1,122.6	-1,389.7	-1,423.3

Source: Banco Central del Paraguay and data prepared by CADEP based on estimates obtained from Argentine and Brazilian official sources.

¹⁷ The illegal entrance of goods from Brazil and Argentina was not substantially reduced by the creation of a free trade zone (zero tariff), possibly as a result of internal tax evasion (VAT and income tax of enterprises).

But here again there are doubts about the real trade deficit of Paraguay with MERCOSUR. This deficit exists if the analysis is limited to registered exports and imports and it is even greater when estimates of non-registered imports are included. When estimates of products imported by Paraguay from outside the sub-region and later re-exported to Argentina and Brazil are taken into account, however, the trade deficit disappears and becomes a surplus.¹⁸ This fact confirms the role of Paraguay as a specialized trade middleman of extra-subregional products in MERCOSUR and the need of a greater real effort to develop alternative comparative and competitive advantages in the face of the market liberalization represented by MERCOSUR. This need becomes even more delicate as neighboring countries have decided to limit, in the last few years, such role of Paraguay as trade middleman in the sub-region. Consequences more serious than stagnation and retraction, with a rise of the current levels of fiscal and monetary disequilibria, could result for the Paraguayan economy from an abrupt termination of such border trade without a sustained increase in exports of national products to the MERCOSUR and to the rest of the world.

Destination of Investments

Even though the launching of MERCOSUR has not significantly changed the features of Paraguay's foreign trade, a process of productive diversification has begun in the country, mainly encouraged by the opportunities created by sub-regional integration and the international market. This diversification has caused, to a great extent, an increase in exports of non-traditional items from the country's agricultural and industrial sectors. That is, besides insisting with the trade middleman role in the sub-region, one portion of the private sector in Paraguay has started to build up comparative and competitive advantages in the production and sale of non-traditional items.

Among these items are the dairy products, of significant growth and quality in the country, and with penetration in the Brazilian market; also, the export of corn, wheat, fruits and vegetables to the Argentine and Brazilian markets; parts and pieces of furniture to the Argentine and Uruguayan markets; and wearing apparel and knitted articles to Argentina and Brazil. Other products that have been exported to MERCOSUR since the beginning of this decade are the so-called household-sanitary (insecticides, deodorants, etc.), printing, plastic and metal-mechanic products, products from the pharmaceutical industry and cement. Several of these products have also started to be exported to countries outside the sub-region, together with the Paraguayan "caña" (rum), leather goods and even toiletries and quality perfumes.

The Paraguayan government has enacted and supported several measures destined to encourage agricultural and industrial diversification: Investment Promotion Act 60/90 (with tax exemptions), Export Promotion Act 90/90, Rural Development Fund (for agricultural associations and cooperatives), Industrial Development Fund, Fund for Microenterprises and others. Since 1990, the benefits of the Investment Promotion Act have showed a cumulative balance of US\$ 2,529.6 million of national investment approved projects, and of US\$ 974.0 of foreign investment projects, as can be seen in Table 7. However, there are no precise data on the actual percentage of performance or the investment expenditures of these projects. A study performed by the Central Bank points out that between 1994 and 1996, an average of 38% of total expenditures of foreign direct investments (FDI) in Paraguay has been awarded to those benefited by Act 60/90 (Banco Central del Paraguay [1998] p. 46).

¹⁸ According to estimates, this surplus appears as from 1993 in the amount of \$ 227 million, \$ 282 million in 1994, \$ 652 million in 1995, and \$ 214 million in 1996 (See Borda and Masi [1998] p. 132). If we consider that these estimates are not sufficient to explain the unregistered traffic in Paraguay - as was already seen- the trade surplus with MERCOSUR is even higher.

In this way, and including what has really been performed in terms of FDI under the provisions of Act 60/90 in the total amount of such kind of investment, an aggregate sum of US\$ 1,090.4 million is reached between 1990 and 1997, at an annual average of US\$ 136.3 million, as can be observed in Table 7. In this table, it is also worthwhile noting the deceleration both of national private investment and of FDI in 1997, after the take-off experienced since 1994.

TABLE 7
PARAGUAY: PRIVATE INVESTMENT PERFORMANCE
(US\$ millions)

YEAR	National Investment	Foreign Investment	Total Foreign Investment
	Act 60/90 (*)	Act 60/90 (*)	Performed (**)
1990	212.1	66.7	70.4
1991	193.0	31.6	81.0
1992	278.3	139.4	117.1
1993	261.7	77.3	69.6
1994	492.7	130.8	122.6
1995	429.3	151.7	183.7
1996	577.6	211.0	252.9
1997 (1)	346.6	165.4	196.7
CUMULATIVE TOTAL	2,529.6	974.0	1,090.4

Sources: Banco Central del Paraguay, Ministry of Industry and Commerce.

Notes: (*) Approved Projects. (**) Disbursed Foreign Investment, including those benefited by Act 60/90. FDI flows are divided into: New investments and expansion of investments (including those benefited by Act 60/90), reinvested profits, capital increase, and loans from foreign direct investors. (1) Estimated figures.

The FDI evolution in Paraguay, since 1991, shows that both MERCOSUR and the European Union countries have been the most active in monopolizing between 70% and 80% of total annual foreign direct investments until 1996 (Table 8). Nevertheless, and even though when United States share has been maintained between 11% and 13% of the total, in the above mentioned period, the sums invested by this country have doubled as from 1995. In the same way, investments from other countries experienced a considerable increase at that time, with the outstanding participation of Chile as the principal investor.¹⁹ On the other hand, if we consider the MERCOSUR countries, Brazil appears as the main investor with an average share of 90% until 1994. In the following years, Argentina's share in direct investments has grown, as well as Uruguay's, even though Brazil continues to be the principal investor (see Annex).

As far as the FDI destination sectors are concerned, there has been a concentration in the national economy's primary (agricultural) and secondary (industrial and construction) sectors until 1994. The participation of the secondary sector during this period has been of significant importance, since direct investments in the primary sector started a descending process as from 1992 (Table 9). Nevertheless, from 1994 onwards, the greater part of direct investments occur in the tertiary sector or services sector, that reaches a share of 56% in 1996. Direct investments in the services sector, comparatively with the secondary sector, have been constant and increasing from 1994 onwards, when the total number amounted to US\$ 66 million, doubling it in two years. In the mean time, investments in the secondary sector that had reached US\$ 82 million in 1992, were declining, managing to recover only in 1995 (US\$ 91 million) and maintaining the same level in the following year.

¹⁹ In 1994, an investment worth US\$ 36.4 million corresponds to the purchase of the national air line's largest portion of shares (state owned) by an Ecuadorian company. Of the FDI figures appearing in Other Countries as from 1995, 90% or even more correspond to investments by Chilean companies.

TABLE 8
PARAGUAY: ORIGIN OF DIRECT FOREIGN INVESTMENT
(US\$ millions)

	1991	%	1992	%	1993	%	1994	%	1995	%	1996	%
MERCOSUR	36.1	44.5	50.2	42.9	35.5	51.0	39.2	32.0	72.9	39.6	78.3	31.1
United States	11.1	13.7	13.2	11.3	9.2	13.2	11.0	9.8	24.5	13.3	30.5	12.1
European Union	31.3	38.6	49.7	42.4	22.5	32.3	35.1	28.6	74.5	40.5	108.6	43.1
Asian Countries	0.3	0.5	0.8	0.7	1.2	1.7	0.9	0.0	0.1	0.2	6.7	2.7
Other Countries	2.2	2.7	3.2	2.7	1.2	1.7	36.4	29.6	11.7	6.4	27.8	11.0
TOTAL	81.0	100.0	117.1	100.0	69.6	100.0	122.6	100.0	183.7	100.0	251.9	100.0

Source: Banco Central del Paraguay. *Estadísticas y Marco Legal de Inversión Extranjera Directa*. March, 1998.

TABLE 9
PARAGUAY: DESTINATION SECTORS OF DIRECT FOREIGN INVESTMENT
(US\$ millions)

	1991	%	1992	%	1993	%	1994	%	1995	%	1996	%
Primary Sector	32.9	40.6	23.0	19.6	10.8	15.5	6.0	4.9	12.3	6.7	13.4	5.3
Secondary Sector	39.5	48.8	82.3	70.3	41.2	59.2	58.5	47.7	90.8	49.4	96.8	38.4
Tertiary Sector	8.6	10.6	11.8	10.1	17.6	25.3	66.1	53.9	80.6	43.9	141.7	56.3
TOTAL	81.0	100.0	117.1	100.0	69.6	100.0	122.6	100.0	183.7	100.0	251.9	100.0

Source: Banco Central del Paraguay. *Estadísticas y Marco Legal de Inversión Extranjera Directa*. March, 1998.

Two main conclusions can be drawn from the FDI performance in Paraguay in the present decade. In the first place, even though this kind of investment was increasing particularly from 1994 onwards, the amounts invested have been insufficient to keep up with a quick process of production and export diversification in order to take advantage of the opportunities that appeared as a result of the sub-regional tariff reduction. That is, an annual average investment of US\$ 136 million, representing less than 2% of the national GDP, turns out to be insufficient. In the second place, it is possible that the increase in the FDI of the last years had been caused by Paraguay's presence in MERCOSUR. Nevertheless, it is not possible to fully assure that this investment has been originated in Paraguay's importance as a convenient platform for sales to MERCOSUR. In fact, in the last years, there has been a concentration of FDI in those sectors of the Paraguayan economy that produce non-tradables.

Although Paraguay has less expensive labor than the rest of the MERCOSUR countries, lower prices in electric power and a smaller tax burden, FDI has not been generous neither for Paraguay nor for the development of comparative advantages other than the simple role of trade middleman, considering the possibilities offered by MERCOSUR. It is evident that within Paraguay's country-cost there are other elements that explain the FDI performance, that practically shows no differences with the performance of the national private investment.

4. TOWARDS A NEW ECONOMIC MODEL

In a recent study, performed by experts from LAIA (ALADI), regarding Paraguay's strategic features in MERCOSUR for the year 2000 (LAIA [1997]), opinions from both the public and the private sectors were reflected, concerning the country's main worries in view of the agenda for the deepening of the customs union. The public sector opinions concentrated on the difficulties imposed by the neighbors on the entrance of Paraguayan goods, that is, the so-called para-tariff obstacles or special regimes that result in distortions of competitiveness. The private sector opinions coincided with those of the public sector as far as the above mentioned aspects are concerned, but, however, two additional subjects were covered by the worries felt by businessmen: (i) the average common external tariff that has turned out to be higher than that prevailing in the country before the customs union and that has eliminated preferential tariffs for the importation of machinery and inputs; and (ii) the need to have jurisdictional rather than arbitral institutions for the settlement of controversies.

Nevertheless, both sectors' demands are framed within a larger demand or rather a guiding demand, that is, the need to obtain a preferential treatment for Paraguay that may favor the productive sector, or, what is practically the same, that may help to overcome this sector's lag in comparison with the other member countries of MERCOSUR, in such a way as to ensure greater competitiveness. This preferential treatment has already been discussed by the Paraguayan government with its equals from MERCOSUR, especially regarding the creation of equalization funds or funds to foster cohesion in the sub-region, "the European way". The private sector has also encouraged this proposal. Preferential treatment has been practically absent both in MERCOSUR's constitutive treaty and in the customs union negotiations, and only some advantages were offered to small countries in the process of tariff elimination or convergence.

MERCOSUR's agenda should include, as soon as possible, the preferential treatment issue, with the goal of establishing a set of mechanisms created to achieve a more equitable distribution of benefits derived from the process of integration between countries and regions. In this way, profound asymmetries will be avoided and more equitable conditions for competitiveness within the sub-region will be the new objective to be achieved. There is no doubt that in the Paraguayan case, the benefits of differential treatment will definitely contribute to give impulse to a change in the present economic model, replacing it by one with a more competitive productive sector, thus creating the necessary conditions for a real development of the advantages offered by the sub-regional tariff elimination. Nevertheless, there are other factors that affect competitiveness in Paraguay, and those are, at present, becoming important obstacles to overcome in order to allow permit the country's productive take-off.

In the Paraguayan case, those factors are mainly concentrated in the so-called exogenous or transactional costs rather than in the endogenous or combination costs. That is to say, the construction of competitiveness in Paraguay depends more on the reduction of exogenous costs than on the reduction of those more directly related to enterprises' productivity. In fact, the unprecedented increase of non-traditional exports in Paraguay is a phenomenon that clearly points out to a process of productive modernization through the incorporation of quality technology, skilled labor and more efficient enterprise organization, in sectors that are already showing the competitive potential of the country.²⁰

²⁰ The CADEP, in its publication *Mes Económico*, has performed 16 interviews to innovative businessmen from the industrial sector, with success both in the domestic and the foreign markets. The companies interviewed belong to the manufacturing sector of leather articles, food, textiles and garment, printing, metal-mechanic and electromechanical, automotive parts, plastics, perfumes and toiletries, packaging and cardboard. Besides, innovative businessmen are annually rewarded by business organizations and by the Ministry of Agriculture.

Competitiveness and costs

The governments are primarily responsible for transactional costs or endogenous factors. However, these transactional costs translated into economic policies affect not only competitiveness or the feasibility of building competitive advantages for the country, but also, and indirectly, the productivity of enterprises.

The greatest achievement of the governments that came after 1989, has been the recovery of the country's **macroeconomic stability**, with the control of inflation and the reduction or elimination of fiscal deficits. Nevertheless, this stability has not been enough to build bases for competitiveness. The liberalization of the exchange rate and interest rates did not succeed in reverting the phenomenon of lower domestic prices for the productive sector and higher financial costs for this same sector. The exchange-rate lag has mainly affected the agricultural production and the agri-industrial exports. In addition, the high interest rates that the financial system continued to charge, even after the beginning of the crisis of that same system as from 1995, has not allowed an adequate financing of production, mainly in the industrial and agricultural sectors. These sectors were the most affected by the economic recession, suffered by the country as a consequence of the financial crisis and that is still present in our days. Both the high price of money and the limited access to credits, as a result of successive financial problems, are a very expensive cost for Paraguay's productive sector and hinder its competitiveness in comparison to its counterparts in the other countries of the sub-region, even in those items where Paraguay has comparative advantages. Although it is true that the government has made efforts aimed at the creation of alternative financing funds, such as the "FDC", the "FDI" and of micro-enterprises, they have not had a significant and lasting impact on the production financing system.

Other exogenous factors within the macroeconomic policies which become relevant to evaluate the competitiveness of the productive sector are the fiscal system and the tax burden on the economy's global product. The tax reform enacted in Paraguay in 1992 and that has consisted in the reduction of the number and rate of taxes, has been oriented towards the creation of a more modern and agile system, and it has benefited the private activity in Paraguay. The tax burden on the domestic product (GDP), of only 10% to 11%, is low in comparison to the neighboring countries. Nevertheless, it reflects both lower tax levels than the other countries and a relatively high degree of tax evasion.²¹ In addition, Act 60/90 of Investment Promotion, creates important tax exemptions for industrial and agricultural investments.

The fiscal reform was accompanied by a tax reform, the main objective of which was to adapt rates to the real situation of an open economy such as Paraguay's as well as to benefit the industrial sector with low tariffs for the importation of inputs, machinery and raw materials. However, with the MERCOSUR's common external tariff in force, tax advantages for the industrial sector were lost because the greater part of inputs and capital goods were not included on a list of temporary exemption.

On the other hand, the National Government had made efforts to include in this list of exemptions finished goods from outside the sub-region and that the country mainly uses for re-exportation to the neighboring countries. In fact, with the objective of reducing unregistered border trade and encourage its legalization, the government granted preferential tariff and domestic taxes rates. Since 1992 onwards, the illegality of border trade has not been reduced to desired levels, and industrial investors pay higher taxes than those investors on unregistered border trading, many times piercing MERCOSUR's common external tariff.

²¹ The VAT accounts for a share of 28% of total incomes originated in tax revenues, but it represents only 4% of the GDP, less than half of the rate established by law (10%). Besides, tax on Companies Income, established at 30%, accounts for only 12% of total revenues, as a result of the great number of exceptions (see Borda and Masi [1998] pp. 63-64).

Later (1997), and in view of MERCOSUR's decision to approve a temporary increase (3%) in the common external tariff, the Paraguayan government once again included in its list of exceptions to this measure, an important list of "tourist goods", affecting the country's industrial and productive sector. This differential tax treatment continues to benefit the commercial sectors of the country with potential to export to the new sub-regional and international market.²²

The informality of a large sector of the Paraguayan economy has always been an important obstacle to the development of the country's productive sector. This informality, clearly shown by import transactions of finished products, and which consists essentially of tariff and internal tax evasion, directly affects the country's industrial and agricultural enterprises, whether large or small. Probably, an important flow of national and foreign investments on industry and agriculture will take long to arrive unless an effective control of informality is implemented and, consequently, formality costs are reduced.

Sectoral policies have not been consistently developed in the country, both since the beginning of the new political period (1989), and the signing of the Treaty of Asunción. These sectoral policies become a necessity given that the country's productive sectors suffer important deficits in skilled labor and in the incorporation or creation of technologies. The government has made efforts to strengthen the industrial and agricultural sectors by means of instruments such as the Investment Promotion Act, the Export Promotion Act, the creation of regional offices of the Ministry of Industry, the creation of the CEPAE to support the small and medium-sized enterprises, the creation of PROPARAGUAY (export promotion agency), and the first steps towards agricultural diversification and promotion of cooperativism.

However, these efforts have not been made within a framework of defined industrial or agricultural policies, nor of policies capable of strengthening specific productive sectors oriented towards the sub-regional or the international market. In this way, the process of diversification and export of non-traditional products has been almost exclusively undertaken by entrepreneurs of the private sector. Besides, the initiative to train labor and incorporate technology and quality in production processes, has also been mainly in the hands of the private sector. These initiatives have been taken individually and in isolated environments within the private sector, with no connection whatsoever with any official specific policy. The governmental effort represented by the *Servicio Nacional de Promoción Profesional (SNPP)*, has been outdated and no decision has yet been made regarding a strategic alliance with the business sector in order to keep it alive and make it more efficient.

As far as technology and quality are concerned, investment on research and development (R&D) is also related to the efforts of the business sector, carried out either separately and individually by enterprises or by business sectors. Something similar occurred with the introduction of quality standards (ISO), as a result of the weakness of the Instituto Nacional de Tecnología y Normalización.

Another important deficit and, consequently, an exogenous cost to be added to the obstacles that the country has to overcome in order to achieve competitiveness, is related to the **system of physical infrastructure and basic services**. The country has the smallest ratio of roads to inhabitants of the sub-region. It has 32 Km of road per 1,000 inhabitants, in comparison to 50 Km in Brazil, 82 Km in Argentina and 100 Km in Uruguay (Borda [1997] p. 68). This road deficit constitutes a serious bottleneck for the country's development, considering its situation as a land-locked country. National roads represent only 11% of the road network; department roads, 27%; and local roads, 62%. In the last five years, road building has been under an annual rate of 6% and in the last fifteen years it has not been able to double the figures, which means that the road infrastructure sector received an insufficient level of investment (CADEP [1997]).

²² The dispute between manufacturers and importers of luxury consumer goods have been long and conflictive at the time of negotiating internally both the exceptions to the common external tariff (1994-95), and the Paraguayan exceptions to the temporary increase of this tariff (1997-98).

The growth of land transportation is limited by road infrastructure and this implies a disequilibrium between the expansion of the number of motor-vehicles in circulation and the road system; inland transportation has not received any significant public investment that would allow its strengthening and, in the present conditions, it cannot compete with Brazilian and Argentine companies; railroad transportation is obsolete and in operational decline; air transportation has a very low incidence on international freights, but notwithstanding, its demand is increasing. Paraguay's export trade uses, to a great extent, land transportation: approximately 76% of the total volume. In the case of imports, inland transportation is mainly used: 52% of the total volume (CADEP [1997]).

The situation is aggravated if we consider the telecommunications sector: the Paraguayan average is 19 telephone lines per 1,000 inhabitants, compared to 47 in Brazil, 72 in Argentina and 100 in Uruguay. In addition, Paraguay has the lowest coverage of electric, water and sanitary services of the sub-region. Only 39% of the Paraguayan people have access to drinkable water; the sanitary sewerage system serves 35% of the urban population and only 5% of the rural population. Electricity has the lowest cost of the sub-region and 74% of the population has access to it (Borda [1997] p. 68).

The **institutional weaknesses of the public sector** are also costs or limitations imposed on the country's competitiveness and, consequently, on the productivity of enterprises. These institutional weaknesses are shown in the obsolescence of the normative system that regulates the State organization; in the lack of planning capacity and of strategies to carry out the public administration's reform; in the poor regulatory and controlling capacity of the Paraguayan State, due to the scarce professionalism of civil servants. This points out to the need of greater emphasis on the areas of training and promotion. These limitations have been followed by a high mobility rate in ministerial and public agencies positions and by a low implementation of external loans, especially in works of physical infrastructure, due both to insufficient management capacity and to the predominance of current expenses over capital expenses in the national budget, which constitutes the main strategy to maintain fiscal equilibrium.

These institutional weaknesses have brought about, at the same time, other limitations to, or costs on competitiveness, exemplified in weak **information systems** for the management of the public and private sectors. If it is borne in mind that decisions on economic policies as well as on investment and production should be based on firm and clear information, the lack of information or the malfunctioning of these communication systems, turn out to be an important obstacle to overcome. In general, Paraguay's public and private information is scarce, of low quality, and not available in due time. The lack of updated management systems in the public administration as well as the fragmented handling of information in the private sector explain this limitation. An exception to this limitation of the public sector can be found in the implementation of a system of information and management of public finances in the Ministry of Finance, for the simplified and transparent handling of public funds, their control and information. Other similar systems have been installed in the Presidency of the Republic (Technical Department of Planning) and in the Ministry of Foreign Affairs, but are not yet operational.

Although they are not strictly economic, two other factors should be added to the above mentioned because they are determinant at the time of deciding an investment: **legal security and political stability**. As far as the former is concerned, the legal system in Paraguay starts renewing its structure with the appointment of the new Supreme Court in 1995, the designation of judges upon competitive examination by the *Consejo de la Magistratura*, and the creation of other institutions such as the *Jurado de Enjuiciamiento*. Nevertheless, improvements in speed and adequate procedure in the resolution of controversies are not sufficient. As far as political stability is concerned, there have been signs of its improvement since institutional crisis of 1996 which gave birth to the enactment of a democratic clause in MERCOSUR, today incorporated by the maximum

integration authority as a constitutive part of the Treaty of Asunción. Although the recent process of general elections has been accomplished, national businessmen consider that political stability and the adequate functioning of the Judiciary are two of the four most important factors for the development of the private sector in Paraguay.²³

A look to the future

As it can be observed, it is not enough to have natural resources and abundant and inexpensive labor, or to have electricity at lower costs, and a lower tax burden. These comparative advantages are not sufficient by themselves to achieve competitiveness. There is a country-cost that explains the low level of financing and investment in the productive sector, and a productivity-lag, in comparison with the other countries of the sub-region. In the end, this country-cost turns out to be higher for a small country with a less developed productive sector than the tax and wage costs as well as other items derived from macroeconomic policies that make up the country-cost of Paraguay's two large neighbors. At the same time, this is an opportunity worthwhile profiting and a challenge to conquer, striving to achieve the elimination or the reduction of the obstacles that interfere with the construction of Paraguay's model of development.

The first task to accomplish is the institutionalization of the country's economic policy, in order to achieve **macroeconomic predictability**. The central bank has applied a restrictive monetary policy that has caused an increase in interest rates and, consequently, a recession in the productive sector. Faced with an inflationary upsurge in the first semester of 1998, this effect has been intensified in the private sector. Adding to this situation an increasing fiscal deficit that absorbs more resources through the issue of bonds, a full circle of rationing of financing to the productive sectors is completed.

Although it is true that adopting drastic measures may be necessary to stop further fiscal deterioration and strengthen the financial sector, the country's economic policy should allow for the planning of medium and long term policies aimed at increasing macroeconomic predictability and, therefore, giving clear signals to investors.

Furthermore, the policy of macroeconomic stability must be based on long lasting and genuine resources generated in the country instead of those of a temporary nature, that imply a very low and partial use of local resources. A strong dependence of the Paraguayan economy with respect to capital flows generated by border trade intermediation could cause continuous disequilibria, which would have an expansive effect over key economic variables as has been the case in the first semester of the current year. In addition, this subordination would prolong the existence of informal activities, thereby making more difficult the generation of more employment. In conclusion, this model must be gradually minimized to be replaced by another model that should give a stronger backing to the policies of macroeconomic stability.

For the construction of this new model, **sectoral or competitive policies** aimed at channeling the investments towards the productive sector should be designed and implemented. These sectoral policies should naturally comprehend both the agricultural and industrial fields, and within them those items or areas that potentially may have a greater projection in the sub-regional and international markets. That is, all policies of competitiveness should be oriented towards exports. The public sector should work in direct alliance with the private sector in order to accomplish this task, through common actions aimed at the adoption of a full policy of incentives (tax, exchange-rate, financial, etc.) to investments in the productive sectors as well as for the

²³ Conclusions of a poll made by the World Bank in 250 enterprises of the country, in all the economic sectors and of all sizes (see World Bank [1996]).

training of labor and technological development. Business associations have a key role to play in the implementation of policies aimed at increasing competitiveness and are marked to replace the role played by the State in the framework of the traditional industrialization policy applied in past decades. Thus, Paraguayan private sector associations, together with the officials responsible for sectoral or competitive policies in the public sector, should create integrated environments for entrepreneurial development (especially for SMEs), the promotion of exports, the training of top management, middle level executives and labor, the creation of systems for technological research and development and dissemination. For such purposes, existing initiatives both in the public and private sectors should be considered, coordinated and integrated with the formulation of new initiatives that may, once implemented, strengthen sectoral policies.

Nevertheless, any policy of competitiveness towards exports and aimed at adapting the country's model of development will lack sound foundations without a fast **policy of improvement of physical infrastructure and basic public services**. No significant increase of domestic and foreign investments could be possible without a substantial improvement of such factors. Since 1993, the Government has borrowed large international funds to increase the number of paved highways in the country, in particular those which link the roads of the north, south and center of the country's eastern region, and which connect with the main highway of the western region (not yet finished). A delay, however, can be appreciated in the construction of roads that will connect the country's interior and with trans-oceanic corridors. In order to finalize those vital communication channels for the country and its export projection, measures must be analyzed with greater private sector participation.

Regarding river transportation, the project *Hidrovia Paraguay-Paraná* which has been launched, will mean for Paraguay, in the first place, the reactivation of its ports.²⁴ In the second place, this project shall allow for greater navigability of Paraguay's interior rivers as well as its river-rail-highway links for the multimodal transportation of cargo.²⁵ Participation by Bolivia as well as by the neighboring Brazilian states in the transportation through the *Hidrovia* shall significantly reactivate this sector of the infrastructure, activating, as it is already happening, the national naval industry and other related services.

Railroad transportation in Paraguay is completely obsolete and needs urgent restructuring. The state railroad company has a limited capacity of cargo and frequency and is presently undergoing a process of privatization. The restructuring of the railroad sector should be part of the plan of connection with the *Hidrovia* and the trans-oceanic corridors. Regarding air transportation, there are two international airports in the country and several regional or local airports. Both passenger and cargo transportation are not very significant, and also in this area it is imperative to make plans according to the new export orientation to be implemented.

One of Paraguay's most important achievements in the last years, regarding policy design and planning of the transportation system as part of an integral and long-term project for the country, is the *Plan Maestro del Transporte Nacional* or *Plan ETNA 2010* (National Transportation Master Plan); a contribution of the Government of Japan through its International Cooperation Agency (See Annex). This master plan's main function is to serve as a guide for short-term projects and for the formulation of policies in the following sectors: road, river-harbor, railroad, and air-traffic-airport. A term of 20 years, from 1990 to 2010, has been foreseen for the accomplishment of its projections.

²⁴ Several private harbors have already been built on the Paraguay River for the use of this project.

²⁵ Paraguayan cargo transported by inland navigation is currently around 500,000 tons. For the year 2000 the *Hidrovia* allows an estimated increase to 6,000,000 tons. One of the main items of export cargo transported by inland navigation consists of both domestically produced and Brazilian soybeans.

Regarding the state public services, electricity is the one that has achieved greater scope and coverage, increasing its share in the national GDP. However, this state company has already had financial problems to continue building the electric grids. Water and sewerage services cover a smaller portion of the country. The telephone company has technical difficulties and has had to resort to private enterprise for the extension of lines. Cellular telephones (two private companies) have come to mitigate the deficit of the country's telecommunication system. Improvement in the efficiency of these public services shall mean the introduction of total or partial privatization schemes. In the case of telecommunications, a process to eliminate the monopoly is already in progress.

Higher efficiency in public services together with the introduction of market criteria, implies to a certain extent, the improvement of public management. Overcoming institutional weaknesses in the public administration also implies the **reform of the State**, which is oriented not only towards making public management more efficient but also towards the provision of greater regulation and control capacity to the State. The greatest limitation to the functioning of the Paraguayan market is the lack of clear "rules of the game" and, consequently, the instability of state regulation and control, more than the lack of macroeconomic predictability or the absence of competitiveness policies. Privatization of public services with the object of making them more efficient, decentralization of the public administration, establishment of clear rules for investments, and legal security for economic transactions increase the State management capacity and discourage informality. Reform of the State, especially of its institutional management, shall mean the reform of the Paraguayan market.

All proposals towards the elimination of a high-cost environment that affects Paraguayan competitiveness, finally lead to the replacement of the present economic model: trade intermediation and exports of agricultural raw materials. This model is not compatible with MERCOSUR and, at the same time, does not appear to be capable of generating greater employment and sources of income in the country. The increasing exodus of the rural population to urban zones, the limited capacity of commercial and service activities to absorb this labor, the lack of skills that characterize it and the growing levels of poverty are factors of extreme importance that should be faced by public policies.

The aim is to increase production and export of goods manufactured in the country. The continuity of Paraguay's activity as trade middleman is not necessarily incompatible with this new model, provided that the intermediation is performed through free zones or areas having a special status conferred by MERCOSUR. Besides, this aim of increasing production and exports may include, among other objectives, the development of a *maquila*-type industry in Paraguay, which may turn out to be an alternative to triangular trade.

With a firm will to develop the country's natural and human resources and make them competitive, the creation of a new economic strategy in Paraguay is deemed possible. In the way towards this new strategy, building the structure for a clear policy of integration with well defined aims will become feasible. Such policy should provide the context upon which national demands for preferential treatment would be soundly based.

ANNEX

STUDY OF THE NATIONAL TRANSPORTATION MASTER PLAN (ETNA)

Background and Planning Period

In the eighties, Paraguay underwent a great advance in motorization, and the number of motor vehicles in circulation quadrupled in that period. In the same way, trade increase registered in that decade was highly significant, especially regarding soybeans. The production of this seed expanded from 650,000 tons to 1,610,000 tons, and together with cotton turned out to be one of the leading items of exports. Thus, the demand for both national and international transportation more than tripled in terms of weight.

On the other hand, transport infrastructure such as highways, harbors and railroads did not keep the pace with the above mentioned growth, with the exception of National Highway 6 (Encarnación-Ciudad del Este) and the Airport of Ciudad del Este. Consequently, the inadequacy of transport infrastructure appeared to be determinant for the restriction of national development and the expansion of production and foreign trade. The importance of reducing transportation costs in order to obtain competitive prices for its products in international markets cannot be denied, especially considering that Paraguay is a land-locked country.

Under these circumstances, the administration of the new government inaugurated in 1989, determined the need for the study of an integral national transportation plan that would establish the transport policies and the development of infrastructures for that sector in the medium and long term; and, to this effect, asked for the technical cooperation of the Government of Japan. Japan's Technical Cooperation Agency ("JICA") devoted itself to the study of the National Transportation Master Plan, for a period of 22 months (March 1990-December 1991).

Targets of this Study

The main target has been the design of a National Transportation Master Plan with the following specific targets:

- The design of a transportation plan aimed at national and regional development, and fostering production;
- The strengthening of the commercial corridor for export promotion;
- The reduction of transportation costs and energy expenses;
- The design of medium and long term transport policies, and of the infrastructure investment plan; and
- The strengthening of the organization and the regulation of the administrative sector of transportation.

Methods of Study

The studies were developed in the following order: (i) analysis of the current situation; (ii) projection of future demand; (iii) design of plans and policies, and (iv) evaluation and design of the investment plan. A data base was developed with the results obtained from a study of transit in its different modes, and the existing statistics, which constituted the basic source of information to recognize the current demand structure.

For the definition of the future structure, projections for population, GDP, agricultural production, volume of national consumption and of international trading were made and their results were extrapolated to the current transportation demand. Planning tasks were performed on the national level transportation network and foreign trade corridors.

The designed projects were evaluated in different manners, from the economic, social and demand points of view, and on these bases an order of priorities was determined and the investment plan was developed in which feasible amounts of investment were considered.

Master Plan Projects

The Master Plan comprehends projects that can be classified in four transportation groups (land, port, railroad and airport) amounting to a total cost of US\$ 2,252.7 million at constant prices of the year 1991. But within this plan projects of regional or international nature are contemplated as well (Hidrovia Paraguay-Paraná, bridges over international border-line rivers, etc.), the cost of which shall not be borne by Paraguay. Thus, the total cost of the Plan is US\$ 1,965.2 million distributed as follows: 68% of the projects' investments or costs is apportioned to the highway sector, 20% to the river-harbor sector, 5% of investments are destined to the improvement of railroads, and 7% to the sector of domestic and international airports.

The land transportation or highway plan includes the paving and/or graveling of 5,684.7 Km of national highways which comprehend 1,917.2 Km of main highways, 2,303 Km of secondary roads and 1,464.5 Km of other national highways. The total cost of these projects amounts to US\$ 981.4 million, and represents 66% of the total cost of highway projects. The rest of the projects is concentrated in the improvement of local roads for the equivalent of US\$ 390 million, reaching 12,256 Km.

As of now, 124 Km of national highways have been paved; 578 Km of pavement are in the process of termination; and 375 Km are projected to be paved in the next few years.

Harbor projects include: 7 ports for the exportation of grains, 2 overseas grain ports, 6 docking facilities in the Integrated International Port of Villeta (near Asunción), international ports in the main areas, harbors for the distribution of oil products and byproducts, improvement in the navigation of the Paraná and Paraguay rivers (Hidrovia) and a naval strengthening plan. Total cost of projects classified in the harbor sector reaches US\$ 489 million. Regarding performance, improvements have been made in the Villeta Port, several private harbors have been opened over the Paraná and Paraguay rivers and dredging works were performed in the Hidrovia Paraguay-Paraná.

In the railroad sector, projects amount to US\$ 162 million, and comprehend the following works: (i) improvement of Asunción's suburban railroad; (ii) improvement of sectors of rail tracks in the segment Asunción-Encarnación (center-south east); (iii) improvement of the railroad rolling equipment; and (iv) works related to the Nueva Palmira Port (Uruguay) such as the segment Encarnación (Paraguay) - Santo Tomé (Argentina-Brazil). There have been practically no advances in the execution of the mentioned works within the national territory.

Finally, costs of projects related to works in the airport sector amount to US\$ 129 million. The main projected works are linked with the improvement of Asunción's International Airport, the creation of several local airports, the development of the network of air routes and the strengthening of the land-based support equipment. In this sector, there have not been significant advances either. However, it should be noticed that several airports have been built in the main or capital cities of the Republic's departments.

PARAGUAY'S GROSS DOMESTIC PRODUCT

YEAR	GROSS DOMESTIC PRODUCT AT MARKET PRICES (US\$ millions)		GROSS DOMESTIC PRODUCT PER CAPITA (US\$)	
	Current US\$	1982 US\$	Current US\$	1982 US\$
	1980	4,448	5,034	1,429
1981	5,625	5,473	1,754	1,707
1982	5,419 1/	5,419	1,641 1/	1,641
1983	5,604 2/	5,257	1,647 2/	1,545
1984	4,387 3/	5,418	1,252 3/	1,546
1985	3,161 4/	5,634	876 4/	1,561
1986	3,547 5/	5,634	953 5/	1,513
1987	3,733 5/	5,878	972 6/	1,530
1988	3,951 6/	6,252	997 7/	1,577
Average	4,431	5,555	1,280	1,582
1989	4,115 8/	6,614	1,006 8/	1,618
1990	5,285 9/	6,818	1,253 9/	1,616
1991	6,254 10/	6,987	1,443 10/	1,612
1992	6,447 11/	7,113	1,448 11/	1,597
1993	6,841 12/	7,407	1,495 12/	1,619
1994	7,857 13/	7,636	1,672 13/	1,625
1995	8,970 14/	7,996	1,858 14/	1,656
1996 (*)	9,686 15/	8,097	1,955 15/	1,634
1997(**)	10,029 16/	8,311	1,971 16/	1,634
Average	7,276	7,442	1,567	1,623

Source: Banco Central del Paraguay. *Cuentas Nacionales*. 1985-1996.

Notes: 1/ 1 US\$ = 136 *Guaraníes*; 2/ 1 US\$ = 146 *Guaraníes*; 3/ 1 US\$ = 244 *Guaraníes*; 4/ 1 US\$ = 441 *Guaraníes*; 5/ 1 US\$ = 517 *Guaraníes*; 6/ 1 US\$ = 668 *Guaraníes*; 7/ 1 US\$ = 840 *Guaraníes*; 8/ 1 US\$ = 1,120 *Guaraníes*; 9/ 1 US\$ = 1,225 *Guaraníes*; 10/ 1 US\$ = 1,324 *Guaraníes*; 11/ 1 US\$ = 1,500 *Guaraníes*; 12/ 1 US\$ = 1,753 *Guaraníes*; 13/ 1 US\$ = 1,904 *Guaraníes*; 14/ 1 US\$ = 1,973 *Guaraníes*; 15/ 1 US\$ = 2,055 *Guaraníes*; 16/ 1 US\$ = 2,178 *Guaraníes*. (*) Provisional figures. (**) Estimated figures.

INTEREST RATES (averages, in nominal annual %)

Year	<i>Guaraníes</i>						Dollars					Call	
	Active Weighted Average	Passive				Interm. Margin	Active Weight. Average	Passive			Interm. Margin	Inter- bank	BCP
		At Sight	Fixed term	CDA	Weight. Average			At Sight	Fixed term	Weight. Average			
1990	30.00%	12.00%	17.00%	26.00%	15.85%	14.15%	14.05%	5.00%	9.00%	7.00%	7.05%	n.d.	n.d.
1991	32.44%	14.08%	11.36%	21.04%	14.80%	17.64%	14.77%	5.23%	7.73%	6.13%	8.64%	n.d.	n.d.
1992	34.96%	11.30%	16.64%	22.45%	15.36%	19.60%	14.05%	5.02%	6.57%	5.24%	8.81%	30.10%	24.00%
1993	35.40%	11.20%	17.87%	24.73%	17.06%	18.34%	12.39%	3.91%	5.08%	4.27%	8.12%	34.20%	27.17%
1994	35.47%	12.00%	16.80%	24.17%	17.38%	18.09%	12.68%	4.27%	5.87%	4.73%	7.95%	18.64%	20.39%
1995	33.97%	11.53%	15.21%	23.09%	15.74%	18.23%	14.03%	4.68%	6.46%	5.22%	8.81%	20.26%	21.29%
1996	31.88%	9.92%	14.42%	18.53%	12.78%	19.10%	14.35%	4.08%	5.66%	4.46%	9.89%	16.57%	19.50%
1997	27.91%	7.03%	11.48%	14.28%	8.89%	19.03%	13.62%	6.11%	5.62%	4.01%	9.60%	12.21%	n.d.
1990-97	32.75%	11.13%	15.10%	21.79%	14.73%	18.02%	13.74%	4.79%	6.50%	5.13%	8.61%	22.00%	21.23%

Source: Banco Central del Paraguay. *Informe Económico Mensual*.

COMPOSITION OF INDUSTRIAL PRODUCTION (%)

	1989	1990	1991	1992	1993	1994	1995	1996	Average
Food products except beverages	27.0	25.4	28.6	32.9	30.8	32.6	32.22	33.71	30.4
Beverage Industry	8.6	8.0	8.1	8.0	8.9	9.7	10.33	10.55	9.0
Manufacture of textiles	8.5	8.0	6.5	6.7	6.6	5.9	6.32	5.15	6.7
Leather and fur, sim. prod. except footwear	2.0	1.8	1.9	3.1	3.8	3.6	3.79	4.61	3.1
Manufacture of footwear except of rubber	2.5	2.3	2.5	2.1	1.6	1.2	1.23	1.39	1.9
Wood and cork products except furniture	11.1	11.8	11.7	13.1	13.6	14.8	15.21	14.93	13.3
Manufacture of wood furniture and accessories	1.3	1.2	1.3	1.2	0.9	0.9	0.88	0.87	1.1
Printing, editing and other related industries	3.2	3.0	3.1	3.6	4.3	4.6	4.85	5.16	4.0
Petroleum by-products	9.7	9.1	8.3	7.0	5.6	5.6	3.94	3.18	6.6
Manufacture of plastic products n.e.c.	1.8	1.6	1.7	2.1	4.2	3.2	2.74	2.81	2.5
Manufacture of non-metallic mineral products	4.1	3.9	4.0	3.4	4.2	3.8	4.28	4.4	4.0
Manufacture of metal products except machinery and equipment	1.8	1.7	1.7	1.4	1.1	0.6	0.63	0.64	1.2
Building of transport equipment	1.7	1.5	1.7	1.4	1.1	0.7	0.7	0.72	1.2
Handicrafts	7.5	11.9	10.0	7.2	7.2	6.9	7.12	6.44	8.0
GROSS VALUE ADDED AT MARKET PRICES	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

PARAGUAY: EVOLUTION OF LAND USE (hectares)

CONCEPT	1981	1991	var (%)
Total land in use	21,940,531	23,817,737	9
Temporary crops	1,208,570	1,576,835	30
Cultivated forage plants	917,769	2,315,739	152
Permanent crops	116,142	85,171	-27
Fallow lands	532,860	573,328	8
Natural or permanent pastures	10,419,680	10,256,156	-2
Cultivated forest plantations and natural woodlands	8,437,374	7,818,230	-7
Other land	308,060	1,192,085	287

STRUCTURE OF GDP BY ECONOMIC SECTORS (%) (1)

Sectors (*)	1989	1990	1991	1992	1993	1994	1995	1996 (2)	1997 (3)	1989-97 (4)
Agriculture	17.5	17.2	16.0	15.5	16.0	15.1	16.1	16.0	16.4	16.2
Livestock	7.4	7.5	7.8	7.8	7.7	7.6	7.5	7.6	7.6	7.6
Forestry	2.7	2.7	2.8	2.8	2.8	2.8	2.8	2.8	2.7	2.8
Sub-total Agriculture	27.8	27.5	26.7	26.3	26.6	25.7	26.5	26.5	26.9	26.7
Industry	16.2	16.1	15.9	15.6	15.3	15.1	14.8	14.3	14.1	15.3
Construction	5.4	5.2	5.2	5.4	5.3	5.4	5.3	5.4	5.4	5.3
Sub-total Production of goods	22.1	21.8	21.6	21.6	21.1	20.9	20.6	20.2	20.0	21.1
Electricity	2.5	2.8	3.0	3.3	3.7	4.3	4.7	4.9	4.9	3.8
Water and sanitary services	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.6	0.5	0.5
Transport and communications	4.6	4.6	4.7	4.7	4.7	4.7	4.7	4.7	4.8	4.7
Sub-total Basic services	7.5	7.8	8.1	8.5	8.8	9.5	9.9	10.3	10.2	9.0
Commerce and finance	26.3	26.4	26.9	26.6	26.5	26.8	26.0	25.4	25.1	26.2
General government	4.5	4.5	4.5	4.8	4.8	5.0	5.1	5.5	5.6	4.9
Housing	2.6	2.6	2.6	2.8	2.7	2.7	2.7	2.7	2.7	2.7
Other services	9.3	9.4	9.5	9.6	9.4	9.4	9.2	9.4	9.4	9.4
Sub-total Services	42.7	42.9	43.6	43.7	43.4	43.9	42.9	43.0	42.9	43.2
GDP (at market prices)	100	100	100	100	100	100	100	100	100	100
GDP (US\$ millions)	4,115	5,285	6,254	6,447	6,841	7,857	8,970	9,686	10,029	7,276
GDPper capita	1,618	1,616	1,612	1,597	1,619	1,625	1,656	1,634	1,634	1,623

Source: Based on data from Banco Central del Paraguay.

Notes: (1) 1982 = 100; (2) Preliminary figures; (3) Projected figures; (4) Arithmetic average. (*) Excluding: Hunting and Fishing and Mining.

GROWTH OF GDP BY ECONOMIC SECTORS (%) (1)

Sectors (*)	1989	1990	1991	1992	1993	1994	1995	1996 (2)	1997(3)	1989-97 (4)
Agriculture	9.8	0.9	-4.4	-1.3	7.6	-3.0	11.5	1.1	5.0	3.0
Livestock	4.3	4.8	6.1	1.3	2.7	3.0	3.1	1.7	3.0	3.3
Forestry	4.1	3.5	4.4	4.7	2.5	3.4	3.1	1.0	2.0	3.2
Sub-total Agriculture	7.7	2.2	-0.6	0.1	5.6	-0.6	8.1	1.3	4.1	3.1
Industry	5.9	2.5	1.1	0.4	2.0	1.5	3.0	-2.2	1.0	1.7
Construction	2.5	-0.9	3.0	5.0	2.7	3.6	4.0	3.0	3.0	2.9
Sub-total Production of goods	5.0	1.7	1.6	1.6	2.1	2.1	3.3	-0.8	1.6	2.0
Electricity	6.4	14.2	10.5	12.8	14.0	21.0	15.0	6.0	2.0	11.3
Water and sanitary services	3.7	10.9	1.3	-3.3	15.2	17.0	12.0	7.0	-3.0	6.8
Transport and communications	4.8	3.7	5.0	2.5	3.4	3.9	3.5	2.5	3.0	3.6
Sub-total Basic services	5.3	7.6	6.8	6.0	8.1	11.7	9.1	4.4	2.2	6.8
Commerce and finance	4.7	3.6	4.4	0.6	3.8	4.3	1.6	-1.0	1.5	2.6
General government	13.2	3.6	4.4	0.6	3.8	4.3	1.6	10.0	5.0	5.2
Housing	2.4	2.9	3.0	7.8	4.3	6.5	7.0	3.0	3.0	4.4
Other services	3.4	2.4	3.5	7.0	2.5	3.5	3.0	3.5	3.0	3.5
Sub-total Services	5.1	3.6	4.1	2.2	3.5	4.1	2.5	1.5	2.4	3.2
Total services production	5.1	4.2	4.5	2.8	4.3	5.4	3.7	2.1	2.3	3.8
GROSS DOMESTIC PRODUCT AT MARKET PRICES	5.8	3.1	2.5	1.8	4.1	3.1	4.7	1.3	2.6	3.2

Source: Based on data from Banco Central del Paraguay.

Notes: (1) 1982 = 100; (2) Preliminary figures; (3) Estimated figures; (4) Arithmetic average. (*) Excluding: Hunting and Fishing and Mining.

PARAGUAY: TRANSFORMATION OF LAND TENURE

Stratum (ha)	Number of Farm Enterprises		Variation (%)	Area (ha)		Variation (%)
	1981	1991		1981	1991	
0 < 5	89,658	122,750	36.9	169,100	231,304	36.8
5 < 10	48,881	66,605	36.3	322,000	430,658	33.7
10 < 20	57,106	66,223	16.0	694,200	806,802	16.2
20 < 100	43,015	39,096	-9.1	1,407,800	1,360,557	-3.4
100 < 500	6,932	7,782	12.3	1,396,900	1,619,203	15.9
500 < 1000	1,053	1,525	44.8	987,575	1,010,952	2.4
> 1000	2,285	3,240	41.8	9,696,246	18,358,260	89.3
TOTAL	250,911	309,212	23.2	14,675,802	23,819,727	62.3

Source: *Censos Agropecuarios* 1981 and 1991. MAG.

BUDGET EXECUTION-CENTRAL GOVERNMENT (millions of *guaraníes* and as % of GDP)

Concept	1989-93	1994-97	1989-97
A) TOTAL INCOME	1,020,110	2,654,123	1,746,338
Current Revenue	12.23	14.35	13.17
Capital Revenue	0.06	0.17	0.11
Donations	0.02	0.09	0.05
B) TOTAL EXPENDITURES	985,975	2,673,847	1,736,141
Current Expenditures	9.57	11.55	10.45
Capital Expenditure	1.91	3.10	2.44
Physical Investment	1.19	2.13	1.61
C) SURPLUS/DEFICIT	0.83	-0.01	0.46
GDP (Millions of Current Gs)	8,205,233	18,241,719	12,665,893
D) EXPENDITURE STRUCTURE (%)			
Current Expenditures/Total Expenditures	83.54	79.17	81.60
Capital Expenditures/Total Expenditures	16.46	20.83	18.40
Physical Investment/Total Expenditures	10.46	14.34	12.18
E) Public Enterprises			
Capital Expenditures	1.49	1.00	1.33
F) NON FINANCIAL CONSOLIDATED PUBLIC SECTOR			
Capital Expenditures	3.53	4.36	3.74

Source: Based on *Boletín de Estadísticas Económicas*, Banco Central del Paraguay. pp. 34, 39 y 41.

PARAGUAY: BALANCE OF PAYMENTS
(US\$ millions)

	1989	1990	1991	1992	1993	1994	1995	1996	1997
Current Account	256.0	-170.2	-332.4	-625.6	-834.0	-1,241.6	-1,060.3	-637.4	-669.4
Trade Balance	164.1	-269.6	-758.1	-871.1	-1,210.7	-1,717.9	-1,675.5	-1428.9	-1,393.7
Exports (1)	1,180.0	1,366.2	1,109.5	1,054.2	1,500.0	1,779.9	2,841.8	2,766.7	2,643.4
Imports (2)	1,015.9	1,635.8	1,867.6	1,935.3	2,710.7	3,497.8	4,517.3	4,195.6	4,037.1
Capital Account	-20.2	62.3	151.0	-212.3	219.9	362.6	360.0	285.6	321.0
Curr.Acc.+Cap.Acc.	235.8	-107.9	-181.4	-837.9	-614.1	-879.0	-700.2	-351.8	-348.4
Errors & Omissions	-90.5	327.4	480.6	490.9	700.3	1,206.8	747.9	307.5	86.4
Global Balance	145.3	219.5	299.2	-347.1	86.2	327.8	47.7	-44.3	-262.0

Source: Banco Central del Paraguay.

Notes: 1997, preliminary figures. (1) Including re-exports. (2) Including unregistered imports.

PARAGUAY: EXPORTS BY MAIN PRODUCTS
(in percentages)

Products	1991	1992	1993	1994	1995	1996	1997 *
Traditional	82.4	75.6	76.4	65.6	64.9	66.0	61.8
Non-Traditional	17.6	24.4	23.6	34.4	35.1	34.0	38.2
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Banco Central del Paraguay. Including only registered exports (domestic products).

Note: * Preliminary figures.

PARAGUAY: EXPORTS BY ECONOMIC REGION
(in percentages)

Region	1991	1992	1993	1994	1995	1996	1997
MERCOSUR	35,2	37,5	39,6	46,2	56,8	63,2	49,5
Rest of the World	64,8	62,5	60,4	53,8	43,2	36,8	50,5
TOTAL	100,0	100,0	100,0	100,0	100,0	100,0	100,0

Source: Banco Central del Paraguay. Including only registered exports (domestic products).

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