Intal

MERCOSUR Report
N° 5

REPORT

MERCOSUR

1998-1999

Inter-American Development Bank
Integration and Regional Programs Department

Institute for the Integration of Latin America and the Caribbean IDB - INTAL
Esmeralda 130, 16th and 17th Floors (1035) Buenos Aires, Argentina
tel 54 11 4320-1871 fax 54 11 4320-1872
E-mail: int/inl@iadb.org http://www.iadb.org/intal

Printed in Argentina

IDB - INTAL
MERCOSUR Report
Buenos Aires, 1999. 92 pages.
Report Nº 5. 1998-1999.

I.S.B.N. 950-738-089-2
US$ 15,00

Cover design-Editing:
Alicia Pinotti
Assistance:
Susana Filippa

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 annual 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 sub-region as a whole. Likewise, in order to promote MERCOSUR within and beyond the sub-region, 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° 5 covers the second semester of 1998 and the first of 1999 and has been prepared by Dr. João Bosco M. Machado, UFRJ (Instituto de Economía de la Universidad Federal de Río de Janeiro) Professor and FUNCEX (Fundación Centro de Estudios de Comercio Exterior) researcher in Rio de Janeiro, Brazil with the collaboration of Mr. Ricardo A. Markwald, FUNCEX Director, Rio de Janeiro, Brazil; Mr. Per Mario Floden, from the John Hopkins University Masters Degree Program -SAIS; and Miss Carolina Brandão, from the Graduate Program of the UFRJ Institute of Economy. The main text of this report is complemented by an Appendix on Uruguay and MERCOSUR; an academic article prepared by Mr. Juan Ignacio García Pelufo, an Economist and Consultant in Montevideo, Uruguay.

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.

C O N T E N T S

A P P E N D I X

URUGUAY AND MERCOSUR

EXECUTIVE SUMMARY

The second half of 1998 was a turning point in the macroeconomic evolution of the MERCOSUR countries, and will very probably mark the beginning of a new phase in relations between them. Despite some difficulties and setbacks, the initial stage – from the signing of the Treaty of Asunción in 1991 to the Russian moratorium in August 1998 – should be viewed as an entirely successful stage of an original project to create and consolidate a commercial bloc made up of economies that are not fully developed.

The choice of the Russian moratorium as the dividing line, ushering in a period of uncertainty and of serious difficulties for MERCOSUR's integration process, might seem out of place. In fact the Asian crisis, with its undeniable contribution to the downturn in world trade, to the fall in commodities prices and to the greater sensitivity of international financial markets towards emerging economies, was undoubtedly the main factor in the marked deterioration of the international context. The Brazilian crisis, in turn, by sparking recession in the sub-region's main market and by prompting a drastic change in the relative competitiveness of the MERCOSUR economies, was obviously a much more precise and immediate marker of the start of a new and less favorable phase of the Southern Cone integration process. A particular convergence of negative signals, however, became explicit after the crisis in Russia.

First, mention should be made of the acceleration in the fall of commodities prices and the abrupt decline in the growth rate of world trade. Strictly speaking, the fall in international commodities prices began in 1997, just prior to the outbreak of the crisis in the Asian countries. The devaluations undertaken by those Asian countries that were affected by the crisis also helped to hasten the fall in prices of some tropical commodities of which they are important producers. For the MERCOSUR countries, meanwhile, the unfavorable price shock only became evident in 1998, mainly from the second quarter of the year, as evidenced by the evolution of the export price indices of Argentina and Brazil.

The loss of dynamism in intra-and extra-subregional exports, which also affected industrialized products, was concentrated in the second half of 1998 and coincided with the crisis in Russia. In the same period, the volume of world trade – which had grown by 9.9% in 1997 – quickly slowed, and 1998 ended with modest growth of 3.3%. Moreover, the value of world trade fell in relation to 1997, something that had not happened since 1983. In MERCOSUR, intra-zone trade declined for the first time since the creation of the bloc, following an annual growth rate of over 26% in the period 1991-97. More seriously, intra-subregional trade flows began to record falls the same as or greater than those with third markets, a situation that became generalized in the first third of 1999.

The restrictions on international private financing, the decline of commodities prices and the slow growth of world trade prompted a reversal of the main macroeconomic variables in the four countries of the sub-region, even before the outbreak of the crisis in Brazil. In fact, besides the deteriorated external context, output levels fell sharply in mid-1998, such that by the end of that year negative growth rates (Argentina, Brazil, Paraguay) or falling rates (Uruguay) were generalized. This is unprecedented in MERCOSUR's economic development, since until then the member countries had never experienced a phase of simultaneous contraction in their economies' output levels.

The Brazilian exchange crisis undoubtedly contributed to the deterioration of economic conditions in the sub-region. It should be stressed, however, that the decline in intra-zone trade and the widespread downturn in output preceded the most acute phase of the crisis that culminated, at the beginning of 1999, in the modification of Brazil's exchange rate regime.

The boom phase for the MERCOSUR economies has therefore ended in the face of the Asian and Russian crises. The reduced dynamism of intra- and extra-subregional trade, as well as the contraction of output and employment, stemmed from changes sparked by those crises. The current stage began with the adoption of a new exchange regime in Brazil. To date, the main effect of this has been the devaluation of the Brazilian currency by more than 30% in real terms. That is a new economic circumstance, one that is undeniably important for the future of MERCOSUR's integration, since its effects on intra-zone trade flows will continue. Another circumstance, political in nature but one that also has significant potential to affect subregional economic conditions, will be the way the Argentine economy acts in the current electoral period, as well as the results of the October elections. MERCOSUR's agenda in the immediate future will be shaped by both events.

MERCOSUR's current crisis, unleashed by the modification of the exchange regime in Brazil, revealed the imperfections and frailties of the integration process. Notwithstanding the progress made in the negotiations and in market integration, MERCOSUR's present state indicates that the implementation of a full Customs Union in the sub-region still depends on a set of initiatives. The integration process is currently characterized by obstacles to intra-subregional trade flows, imperfections in the common external tariff, the low level of harmonization of trade policy instruments, and institutional weakness. As if such problems were not enough, trade disputes among the countries began to show signs of worsening last year, when a series of unilateral measures placed new obstacles in the way of sub-regional trade.

Such problems, coupled to stagnation in the calendar for consolidating the Customs Union and the modest progress made in external negotiations to enlarge MERCOSUR, did not lead to the conclusion that the integration process was in crisis, since bilateral trade between the two biggest partners continued to grow at annual rates of over 20% up to 1997.

The first signs of a crisis that had long been foreshadowed became evident in 1998. The slump in trade between Brazil and Argentina was not seen, of itself, as a clearer warning of the exhaustion of the integration process. This was because trade with third countries declined even more, which increased MERCOSUR's relative importance as an export market for the two countries. Offsetting this, on the Argentine side, were indications of the risk of so-called “Brazil-dependence”.

The crisis in the international financial market and the constraints on the supply of credit following the Russian moratorium exacerbated conditions that were already broadly seen as “worrying”. The change of direction in Brazil's economic policy, with the devaluation, directly affected the relative competitiveness of the countries and threatened the long-term operability of the integration process.

Some months after the changes to Brazil's exchange regime, a consensus arose around the idea that sub-regional economic relations were going through their most serious crisis since the signing of the Treaty of Asunción in 1991. There is no doubt that common sense prevailed, and that the governments were willing to renounce hasty decisions that might have led to the imposition of indiscriminate barriers to sub-regional trade. Such a course could undoubtedly have meant the end of MERCOSUR.

The way in which the negotiating process evolved after the Brazilian exchange crisis seems to suggest that the resolution of commercial questions, the main item on MERCOSUR's negotiating agenda to date, will be subordinated to discussion of macroeconomic policy harmonization between the countries.

Despite all the initiatives geared towards the inclusion of macroeconomic policy coordination on MERCOSUR's negotiating agenda, it cannot be said that the effects of the modification of Brazil's exchange regime on the countries of the sub-region have been overcome. An effective devaluation of the real of some 30% by the end of the year, combined with a decline in the Brazilian economy's absorption capacity, must disrupt Brazil's trade with the other MERCOSUR countries. Most significant will be the effects on the smaller economies – Paraguay and Uruguay – for which the sub-region represents a substantial portion of their exports. Hence Brazil will export its recession to the other countries of the sub-region, and the impact will be inversely proportional to the size of their economies.

What lessons can be drawn from the current crisis? The danger that MERCOSUR might break up is a specter that frequently appears at times of difficulty.

On what points can the negotiations advance? In the short term, it is essential that the countries ratify the commitment they made in the Treaty of Asunción that they will under no circumstances set up barriers to intra-subregional trade which might compromise the achievements of the integration process to date. However, more precise rules should be negotiated, specifically as regards the use of commercial safeguards, of sectoral agreements that involve voluntary export restraints, and of sectoral restructuring programs. The aim would be to guarantee selectivity, transparency and limited periods for applying such instruments so as to avoid the dissemination of intra-subregional non-tariff barriers, even at times of crisis.

In the long term, progress must be made on the consolidation of the Customs Union. MERCOSUR operates, in fact, as an integration program that combines characteristics of an incomplete free trade area with a common external tariff that does not cover the entire tariff schedule. This circumstance is the result of a process pressured by time and compromised by a scarcity of resources. Such difficulties – which are inherent in any integration process – cannot nevertheless curb initiatives geared to overcoming the current problems. It is fundamental that the negotiators reassess and reaffirm, as they are doing, MERCOSUR's strategic role, and that they strive to negotiate policies and to implement the necessary measures. The aim is to create conditions in which relations between private agents can lead to the deepening of economic integration between the countries. In this connection, the coordinated management of microeconomic policies in the sub-region offers the right way of eliminating the remaining obstacles to intra-subregional trade and of creating comparative advantages that allow exploitation of the opportunities spawned by the operation of the enlarged market. This makes it possible to upgrade the model of international insertion pursued by the economies of the sub-region to one that is geared towards sectors with greater technological content and greater dynamism in international trade.

MERCOSUR's current crisis and its repercussions should prompt a more careful consideration of the relationship between macroeconomic policy coordination in integrated economic areas and the effects of the management of other, microeconomic policies. Although in the future, with the present crisis overcome, the countries might consider implementing mechanisms that ensure greater policy coordination in the exchange area (in line with the proposals of their own presidents), it will be essential that MERCOSUR attains a higher level of microeconomic policy convergence. This is necessary to obviate situations in which national-level instruments distort the relative competitiveness of industries located in the different countries of the sub-region, and that consequently undermine the maintenance of the exchange rate parities already negotiated. In fact, not even a convergence of macroeconomic performance is enough to establish stable competition conditions if the development models and the policies applied by the various countries differ among themselves.

Hence in the current context, which combines an acute crisis with structural problems, much remains to be resolved, and the deepening of the integration process might be synonymous with its "survival". This therefore seems to be the task of consolidating MERCOSUR: betting on its future success entails reassuming commitments and implementing effective initiatives now, as a means of preserving its role as a strategic initiative for the economic and social development of its members.

CHAPTER I. MACROECONOMIC TRENDS

A. The General Context

The second half of 1998 was a turning point in the macroeconomic evolution of the MERCOSUR countries, and will very probably mark the beginning of a new phase in relations between them. Despite some difficulties and setbacks, the initial stage – from the signing of the Treaty of Asunción in 1991 to the Russian moratorium in August 1998 – should be viewed as an entirely successful stage of an original project to create and consolidate a commercial bloc made up of economies that are not fully developed.

The sub-regional and international environments were particularly favorable for advancing the integration process in the first stage. The success of the stabilization plans in Argentina, Brazil and Uruguay, the convergence of liberalization and trade opening initiatives in the two main economies of the sub-region, and the staggered implementation, at different speeds, of reasonably similar structural reform programs, were fundamental in intensifying trade links between the MERCOSUR countries, despite the absence of any formal mechanism for macroeconomic policy coordination.

The contribution made by the international context cannot be understated. Despite the Mexican crisis of 1995, which had a severe impact on the Argentine economy, and the outbreak of the Asian crisis in mid-1997, which most acutely affected Brazil, the international scene was characterized by circumstances that positively conditioned the integration process: the wide availability of financing lines, low interest rates, the swift expansion of world trade, and the marked growth of direct investment flows. The MERCOSUR countries derived substantial benefits from this context, both during the phase of economic stabilization and during the implementation of more structural reforms.

The choice of the Russian moratorium as the dividing line, ushering in a period of uncertainty and of serious difficulties for MERCOSUR's integration process, might seem out of place. In fact the Asian crisis, with its undeniable contribution to the downturn in world trade, to the fall in commodities prices and to the greater sensitivity of international financial markets towards emerging economies, was undoubtedly the main factor in the marked deterioration of the international context. The Brazilian crisis, in turn, by sparking recession in the sub-region's main market and by prompting a drastic change in the relative competitiveness of the MERCOSUR economies, was obviously a much more precise and immediate marker of the start of a new and less favorable phase of the Southern Cone integration process. A particular convergence of negative signals, however, became explicit after the crisis in Russia.

First, mention should be made of the acceleration in the fall of commodities prices and the abrupt decline in the growth rate of world trade. Strictly speaking, the fall in international commodities prices began in 1997, just prior to the outbreak of the crisis in the Asian countries. The prices of most commodities peaked in the biennium 1995-1996, and 1997 saw the start of a cycle of falling prices. The abrupt import contraction in the countries involved in the Asian crisis, coupled to the stagnation of the Japanese economy, helped weaken demand in the commodities markets at a time when supply had expanded, stimulated by the high prices of the preceding stage and by recent technological changes. The devaluations undertaken by those Asian countries affected by the crisis also helped to accelerate the fall in the prices of some tropical commodities of which they are important producers. For the MERCOSUR countries, however, the unfavorable price shock only became evident in 1998, mainly as of the second quarter of the year, as evidenced by the evolution of the export price indices of Argentina and of Brazil.

The loss of dynamism in intra-and extra-subregional exports, which also affected industrialized products, was concentrated in the second half of 1998 and coincided with the crisis in Russia. In the same period, the volume of world trade – which had grown by 9.9% in 1997 – quickly slowed, and 1998 ended with modest growth of 3.3%. Moreover, the value of world trade fell in relation to 1997, something that had not happened since 1983. In MERCOSUR, intra-zone trade declined for the first time since the creation of the bloc, following an annual growth rate of over 26% in the period 1991-97. More seriously, intra-subregional trade flows began to record falls the same as or greater than those with third markets, a situation that became generalized in the first third of 1999.

A third factor, directly linked to the panic that swept international financial markets that were surprised by the Russian moratorium, concerned the contraction of flows of private capital to developing countries. The Asian economies in crisis had been affected by a dramatic reduction of such flows from 1997, and in 1998 suffered a net exit of capital. In the case of the Latin American countries, the phenomenon was sparked by the Russian crisis, to such an extent that in the second half of 1998 the gross entry of capital fell by half over the preceding period, a situation that was maintained in the first quarter of 1999. Flows of direct investment were little affected, however, and the forecasts for Latin America point to a fall of around 15%-20% in 1999, with respect to the previous biennium.

The restrictions on international private financing, the decline of commodities prices and the slow growth of world trade prompted a reversal of the main macroeconomic variables in the four countries of the sub-region, even before the outbreak of the crisis in Brazil. In fact, besides the deteriorated external context, output levels fell sharply in mid-1998, such that by the end of that year negative growth rates (Argentina, Brazil, Paraguay) or falling rates (Uruguay) were generalized. This is unprecedented in MERCOSUR's economic development, since until then the member countries had never experienced a phase of simultaneous contraction in their economies' output levels.

The Brazilian exchange crisis undoubtedly contributed to the deterioration of economic conditions in the sub-region. It should be stressed, however, that the decline in intra-zone trade and the widespread downturn in economic activity preceded the sharpest phase of the crisis that culminated, at the beginning of 1999, in the modification of Brazil's exchange rate regime.

In the light of Brazil's economic performance in the first half of 1999, it is surprising to note that many of the forecasts which predicted that the program agreed with the IMF at the end of 1998 would attenuate the crisis have been shown, despite everything, to be substantially correct. This is the case for the balance of the public accounts, output performance and the evolution of the trade balance, variables for which analysts' projections, by mid-1999, differ little from those of six months earlier.[1] From that perspective it can be said that the main outcome of the Brazilian exchange has not yet occurred, since the effects of the significant variation in exchange rate parities between Brazil and its other MERCOSUR partners are currently very slight.

The boom phase for the MERCOSUR economies has therefore ended in the face of the Asian and Russian crises. The reduced dynamism of intra- and extra-subregional trade, as well as the contraction of output and employment, stemmed from changes sparked by those crises. The current stage began with the adoption of a new exchange regime in Brazil. To date, the main effect of this has been the devaluation of the Brazilian currency by more than 30% in real terms. That is a new economic circumstance, one that is undeniably important for the future of MERCOSUR's integration, since its effects on intra-zone trade

---

[1] In December 1998, a month before the modification of the exchange regime, the National Confederation of Industry was working on the following reference scenario: a -1.5% fall in GDP, a -3.0 fall in industrial production, a negative trade balance of US$ -1 billion and a public primary surplus of 2.0% of GDP. Six months later, the scenario was as follows: a –0.5% fall in GDP, a –1.20 fall in industrial production, a positive trade balance of US$ 1 billion and a public primary surplus of 3.0% of GDP (CNI, *Economia Brasileira. Desempenho e Perspectivas*, December 1998 and June 1999).

flows will continue. Another circumstance, political in nature but one that also has significant potential to affect regional economic conditions, will be the way the Argentine economy acts in the current electoral period, as well as the results of the October elections. MERCOSUR's agenda in the immediate future will be shaped by both events.

B. Macroeconomic Performance in the Second Half of 1998 and the First Half of 1999

Output and employment

In 1998, gross sub-regional product registered modest growth of barely 1.2%, which represents a fall of more than 3.5 percentage points in comparison to 1997 (4.9%).[2] The stagnation of the Brazilian economy (0.1%) was fundamental to this outcome, since Argentina (3.9%) and Uruguay (4.5%) performed much more satisfactorily. However, even the two best performing economies in 1998 also registered lower growth rates than those in the previous year (Table I.1). The decline in the pace of growth in 1998 was therefore widespread.

---

2 The average sub-regional rates of output and inflation mentioned were derived from the following weightings: Argentina (0.2610); Brazil (0.7126); Paraguay (0.0078); and Uruguay (0.0186).

TABLE I.1
MACROECONOMIC INDICATORS

INDICATORS		ARGENTINA				BRAZIL				PARAGUAY				URUGUAY			
		1995	1996	1997	1998	1995	1996	1997	1998	1995	1996	1997	1998	1995	1996	1997	1998
OUTPUT LEVEL																	
GDP - Total	(annual %)	-2.8	5.5	8.1	-3.9	4.2	2.8	3.7	0.1	4.7	1.3	2.6	-0.5	-1.8	5.3	5.1	4.5
Industrial production	(annual %)	-6.7	5.2	10.2	0.8	1.8	1.8	3.9	-2.3	3.0	-2.2	-0.2	0.0	-3.1	4.8	5.6	n.a.
Fixed gross domestic investment	(% of GDP)	18.3	18.9	20.6	21.1	20.6	20.5	21.5	20.8	13.6	13.7	13.9	n.a.	16.1	15.0	15.3	n.a.
Unemployment rate	(%)	16.6	17.3	13.7	12.4	4.6	5.4	5.7	7.6	5.3	8.2	7.1	14.3	10.3	11.9	11.5	10.2
PRICES AND NOMINAL EXCHANGE RATE																	
CPI	(% Dec/Dec)	1.6	0.1	0.3	0.7	22.0	9.1	4.3	2.5	13.4	9.8	6.2	14.6	35.4	24.3	15.2	8.6
Nominal exchange rate	(% Dec/Dec)	0.0	0.0	0.0	0.0	13.8	7.1	7.4	8.3	2.8	6.7	8.7	24.2	26.5	22.7	15.2	8.1
PUBLIC SECTOR AND INTEREST RATE																	
Deficit (-) of the public sector	(% of GDP)	-0.6	-2.2	-1.6	-1.4	-7.2	-5.9	-6.1	-8.0	-0.3	-0.8	-0.3	-1.5	-1.2	-1.1	-1.0	-0.8
Passive interest rate	(% a year)	9.5	6.2	6.6	6.8	53.1	27.1	24.7	28.6	15.8	12.8	8.8	6.7	38.2	28.1	19.6	15.1
EXTERNAL SECTOR																	
Exports	(annual %)	32.1	13.6	9.9	-0.8	6.8	2.7	11.0	-3.5	23.6	-5.4	-9.9	-6.2	12.2	14.0	13.6	-0.0
Imports	(annual %)	-6.7	18.5	28.1	3.1	50.0	7.3	15.1	-6.2	23.6	-2.5	-3.8	-13.2	4.3	15.7	11.7	2.6
Current transactions	(% of GDP)	-2.0	-2.5	-4.3	-5.1	-2.5	-3.1	-4.2	-4.5	-4.1	-3.3	-6.7	-2.8	-1.2	-1.2	-1.6	-2.1
BALANCE OF PAYMENTS																	
Exports	(US$ billions FOB)	21.2	24.0	26.4	26.2	46.5	47.7	53.0	51.1	4.2	4.0	3.6	3.4	2.1	2.4	2.8	2.8
Imports	(US$ billions FOB)	18.8	22.3	28.6	29.4	49.7	53.3	61.3	57.5	4.5	4.4	4.2	3.6	2.7	3.1	3.5	3.6
Trade balance	(US$ billions)	2.4	1.8	-2.1	-3.2	-3.1	-5.5	-8.4	-6.4	-0.3	-0.4	-0.6	-0.3	-0.6	-0.7	-0.7	-0.8
Current transactions	(US$ billions)	-4.9	-6.5	-12.0	-14.7	-17.8	-24.3	-33.3	-35.1	-0.4	-0.3	-0.6	-0.2	-0.2	-0.2	-0.3	-0.4
Foreign direct investment	(US$ billions)	5.3	6.5	8.1	5.7	4.3	9.9	17.1	26.1	0.16	0.25	0.22	0.24	0.16	0.14	0.16	0.16
Total gross foreign debt	(US$ billions)	98.5	109.8	124.3	139.3	159.3	179.9	192.9	235.1	1.3	1.3	1.4	1.6	10.4	11.6	12.6	n.a.
Foreign reserves	(US$ billions)	18.5	21.5	24.3	26.5	51.8	60.1	51.4	44.6	1.1	1.1	0.8	0.9	1.8	1.9	2.1	2.4
MEMORANDUM																	
GDP	(US$ billions)	243.2	256.6	277.4	288.2	705.4	775.4	804.1	786.6	9.0	9.7	9.6	8.6	18.0	19.1	19.8	20.5

Note: Paraguay's external accounts and balance of payments include recorded imports and re-exports, according to the Central Bank of Paraguay.

Sources: Argentina: MOSP, *Informe Económico*, April 1999 and CEI, *Panorama del MERCOSUR*, July 1999.
Brazil: FGV, *Conjuntura Econômica*, June 1999 and IPEA, *Boletim Conjuntural*, April 1999.
Paraguay: Central Bank of Paraguay; Sain/MF, *Nota sobre la economía paraguaya*, December 1998; and CEI, Panorama del MERCOSUR, July 1999.
Uruguay: Instituto de Economía, Universidad de la Republica; Sain/MF, *Nota sobre la economía uruguaya*, October 1998 and IDB, *Country Assessment*, 1999.

Strictly speaking, the same pattern is evident in the rest of Latin America. Indeed, in 1998 ten of the LAIA's eleven member countries recorded economic growth rates lower than those of 1997. For these countries as a whole, the decline also exceeded three percentage points, a value that is unchanged even if Brazil is excluded.

Argentina. Until mid-1998, the Argentine economy maintained the high growth rates that it has enjoyed following the recession caused by the Mexican crisis. At the end of the first half of 1998, however, there were signs of a slight decline in industrial production. Two factors hastened the downturn: the increase in the interest rate a result of the Russian moratorium, and the loss of dynamism of industrial exports. The fall in industrial output production was substantial: after growing at a rate of 6.5% in the first half, industry expanded at a rate of 0.2% in the period July-September and recorded a fall of –5.1% in the last quarter of the year. The industrial sectors most susceptible to interest rate changes and the increase in financing costs – such as consumer durables, construction materials and automobiles – were the most affected. In the final quarter of 1998, quarterly GDP already compared negatively with 1997, and in the first quarter of 1999 the gravity of the recession became apparent, since GDP fell 3.0% compared to the same period of the previous year (Table I.2).

TABLE I.2
ARGENTINA: QUARTERLY GDP
Variation (%) compared to the same period of the previous year

SECTORS	Year 1997	I/98	II/98	III/98	IV/98	Year 1998	I/99
Total GDP	8.1	6.4	6.7	3.3	-0.6	3.9	-3.0

Source: CEI, *Panorama del MERCOSUR*, July 1999.

The progressive decline in economic conditions in 1999 is evident in the monthly performance of industrial production, which by May was recording an accumulated fall of 9.5% over the same period of the previous year (Table I.3). Significant industrial sectors, such as the automotive industry, metal-mechanics or paper and cellulose, nevertheless accumulated much more significant declines which oscillated between 20% and 50% in comparison to 1998.

TABLE I.3
ARGENTINA: MONTHLY INDUSTRIAL ESTIMATOR (MIE)
(Monthly variations in the period May/98 to May /99)

Variation %	05/98	06/98	07/98	08/98	09/98	10/98	11/98	12/98	01/99	02/99	03/99	04/99	05/99
Comp. same month prev. year	2.5	7.3	0.9	0.5	-1.5	-6.4	-2.4	-6.8	-6.1	-8.1	-10.9	-11.4	-10.2
Accumulated in the year	6.7	6.8	5.9	5.1	4.3	3.1	2.6	1.8	-6.1	-7.1	-8.5	-9.3	-9.5

Source: INDEC, June 1999.

As regards unemployment, it was expected that the gently declining curve of the last two years would be reversed (Table I.1).

Brazil. In the second half of 1998, Brazil's economy developed in a manner quite similar to that of Argentina, although on the basis of a significantly lower level of economic activity. The recession was therefore more serious, and by the end of 1998 the economy had accumulated two successive quarters of negative growth rates (Table I.4). In the first quarter of 1999 GDP again showed a negative variation (-1,0%) compared to the same period of 1998 but, surprisingly, it also registered growth of 1.0% (in non-seasonally adjusted terms) over the preceding quarter. This circumstance has underpinned moderately optimistic expectations of Brazilian economic performance in the second half of 1999 (Table I.4).

TABLE I.4
BRAZIL: QUARTERLY GDP
Variation (%) compared to the same period of the previous year

SECTORS	Year 1997	I/98	II/98	III/98	IV/98	Year 1998	I/99
Agriculture	2.7	-1.6	8.1	-0.3	-6.9	0.3	9.2
Industry	5.5	1.6	1.0	-1.8	-4.2	-0.9	-4.6
Services	1.2	0.9	1.0	1.0	-0.0	0.7	-0.2
Total GDP	3.7	1.0	1.6	-0.1	-2.0	0.1	-1.0

Source: IBGE

The most recent data on industrial output to May, however, suggest the need for greater caution. In fact, in the first five months of the year Brazilian industry experienced an accumulated fall of about 3.5% over the same period of 1998, and the non-seasonally adjusted series do not reveal any strong recovery trend. It should be noted that, until June, exports had not still responded to the sharp stimulus provided by the devaluation. As regards the statistical records, therefore, the most optimistic indicators are limited to the spectacular growth of agriculture in the first quarter of the year (9.2%) and to the slight fall in services (-0.2%), which was much lower than expected.

Uruguay and Paraguay. The economies of MERCOSUR's smaller members are significantly more open than those of Brazil and Argentina. It is therefore unsurprising that the deterioration of the sub-regional and international contexts since mid-1998 have severely constrained their growth. The fall of commodities prices (cotton, soya, wool) was coupled, in the second half of the year, to the weakening of demand in Brazil, the main export market for Paraguay and Uruguay. Uruguay grew at a satisfactory rate (4.5%) in 1998 but output fell abruptly at the start of 1999. Preliminary data for the first quarter of the year indicate a 1.0% fall in GDP in relation to the same period of the previous year, and an even more marked decline (-6,1%) in industrial production. Paraguay's economy has been relatively stagnant since 1996 (Table I.1). In 1998, the 0.5% decline in GDP can be explained not only by unfavorable external conditions but also by political instability and by the remaining problems in the financial system.

Inflation

The sub-region's average inflation rate, measured by consumer price indices, fell again in 1998, from 3,5% to 2,2%. Paraguay was the only country to experience a truly significant setback, since inflation doubled from 6.2% in 1997 to 14.6% in 1998. The devaluation of the exchange rate (24.2%), readjustments to public tariffs and the minimum wage, as well as the increase in food prices spurred by the "El Niño" phenomenon, explain Paraguay's unfavorable inflation performance. It should be stressed, however, that the pace of price variation fell throughout the year, such that a deflationary trend was evident in the first quarter of 1999 (a variation of -3.5% in comparison to the first quarter of 1998).

Argentina was deflationary in the first half of 1999, while in Uruguay the accumulated price variation barely reached 2.2%, anticipating a sustained reduction in inflation for the year. What is truly surprising, however, is the behavior of the inflation indices in Brazil. At the end of June, the exchange rate accumulated a nominal devaluation of a little less than 50%, while the inflation indices oscillated between 2.5% and 4.5% (in the case of consumer prices) and between 9% and 12% (in the case of wholesale prices). The increase in the price indices, which stemmed from the devaluation at the start of January, was concentrated in February and March. From then on, most of the indices have recorded monthly increases of between 0.5% and 0.6%, and there have even been negative variations (deflation).

TABLE I.5
BRAZIL: EVOLUTION OF CONSUMER PRICE INDICES
January-June 1999 – Monthly variation (%)

Price indices	January	February	March	April	May	June	Accumulated var. by June (%)
CPI (FIPE)	0.50	1.41	0.56	0.47	-0.37	-0.08	2.51
ECPI (IBGE)	0.70	1.05	1.10	0.56	0.30	0.19	3.96
IPC-DI (FGV)	0.64	1.41	0.95	0.52	0.08	0.65	4.33

Note: The IPCA (enlarged consumer price index), calculated by the IBGE, is the index chosen by the central bank of Brazil to mark its policy of inflation targeting. The goal for 1999 is an 8% variation in that index.

Source: FIPE, IBGE and FGV.

In view of the increases in some tariffs, particularly fuels, inflation should show a tendency to rise in the two-month period July-August. Hence, the expectation for 1999 continues to be of relatively low inflation indices, oscillating between 6.5% and 8.5% for consumer prices.

The low coefficient of the devaluation's transfer to prices has many explanations besides, obviously, the widespread dismantling of the formal mechanisms of indexation that happened after stabilization: (i) the recessive climate; (ii) the low prices of industrial commodities and the excellent agricultural harvest; (iii) the existence of a competitive atmosphere; and, (iv) the experience acquired by consumers after five years of stability.

External sector

In the external sector, the MERCOSUR economies exhibited some common features in 1998 and the first half of 1999. First, all the partners experienced negative growth rates for exports in that period. For Argentina, Brazil, and Uruguay that meant a particularly sharp reversal, since in 1997 their external sales had reached or were near to two-digit rates (Table I.1). As to imports, there was a drastic fall in the growth rate of international purchases, or a contraction in Brazil's case. Paraguay displayed the same tendency, but both its exports and imports recorded negative growth rates in 1997.

The simultaneous contraction of exports and imports had different effects on the trade balance of the four countries, increasing the deficit in the case of Argentina and Uruguay and reducing the negative balance in the case of Brazil and Paraguay (Table I.1). Despite that asymmetry, the trade balance remains in deficit in the four countries, and the disequilibrium in the current account balance worsened for three of them: Argentina, Brazil and Uruguay (Table I.1). The deterioration of the current account balance in

Brazil is wholly explained by the increase in the services account deficit, mainly factors services (interest, earnings and dividends), a phenomenon that is also apparent in Argentina's balance of payments.

The truly singular aspect of the performance of the external sector in the Southern Cone countries in recent years is undoubtedly the abrupt reversal of their export growth trends. The decisive factors in that respect, in line with what was mentioned earlier, were the fall in the growth rate of world trade – from 9.9% in 1997 to 3.3% in 1998 – and the decline in commodities prices. It is also important to highlight the intensity of the negative price shock experienced by the MERCOSUR economies, according to the export price indices of the bloc's two main partners [3] (Table I.6).

CHART I.6
ARGENTINA AND BRAZIL: EXPORT PRICE INDICES AND TERMS OF TRADE

	ARGENTINA (Base 1993=100)					BRAZIL (Base 1996=100)			
Period	Export price indices				Terms of trade	Export price indices			Terms of trade
	Total	**Primary**	**MAO**	**Comb.**	**Total**	**Total**	**Basic**	**Semi-man.**	**Total**
1996	115.9	135.8	108.6	120.4	109.8	100.0	100.0	100.0	100.0
1997	111.7	121.1	109.5	112.4	108.3	100.7	108.0	98.5	94.7
1998	101.2	106.4	101.0	78.8	103.7	93.9	90.7	91.0	93.5
I/98	103.8	107.4	105.7	85.8	102.5	99.0	103.7	97.0	97.2
I/99	90.6	99.1	89.0	62.4	97.0	86.9	82.8	77.7	80.9

Source: INDEC and FUNCEX.

The fall in export prices between 1997 and 1998 was quite similar in both countries: Argentina recorded a decline of 12.1% and 7.8% in the prices of its exports of primary products and of agriculture-based manufactures, respectively, while in Brazil the decline was 16.0% in the price of basic products and 7.6% in the price of semi-manufactures. The terms of trade deteriorated more acutely in Argentina (-4.2%) than Brazil (-1.3%), owing to at least three factors: (i) a higher proportion of industrialized products in Brazil's export mix; (ii) the higher share of fuels in the Argentine mix, since their prices fell by almost 30%, between 1997 and 1998; and (iii) the differences in the evolution of import prices in the two countries.

It should be stressed that the fall in export prices intensified in the second half of 1998, and worsened further in 1999. In the case of Brazil, the price indices of April and May were lower than those in the first quarter of the year.

Finally, the importance of the modification of the Brazilian exchange regime bears repeating. This amounted to a nominal devaluation of some 45% against the US dollar, according to the latest rates (June 1999). By May, the impact of the devaluation on Brazilian exports had still not become evident: in fact, total exports fell by 14% in that period, and the decline in sales to the MERCOSUR countries was exactly double (28.6%). On the import side, meanwhile, the impact of the devaluation

[3] Also selected, besides the two countries' total price index (or general level), were the price indices for primary products, manufactures of agricultural origin (MAO) and fuels, in the case of Argentina, and of basic and semi-manufactured products, in the case of Brazil. These indices best capture the effect of the decline in commodities prices. The trade relation is based on the quotient between the total indices of exports and imports, covering all sales and purchases, including industrialized products.

was significant, and was particularly harmful to the other MERCOSUR countries: to May, total imports recorded an accumulated decline of almost 20%, but purchases from MERCOSUR fell by 30%. The change in relative prices undeniably affected import trade, given that the fall in GDP was of barely 1% in the first quarter of the year.

Prospects

Three factors seem set to be significant determinants of the sub-region's economic performance for the rest of the year: (i) the evolution of world trade and of commodities prices; (ii) the recovery of the Brazilian economy; and (iii) the reaction of the financial markets to the vicissitudes of the electoral period in Argentina (Table I.7).

As regards the international context, the most recent IMF forecasts for this year indicate modest growth in the volume of the world trade (3.8%) and a fall in commodities prices (-4.0%, excluding oil). In line with what was said earlier, the sub-region's export performance and the evolution of export prices confirms those forecasts. Additionally, some important Latin American trade partners (Chile and Venezuela) and extra-subregional partners (China) have cut their imports from MERCOSUR dramatically.

CHART I.7
ARGENTINA AND BRAZIL: PROJECTIONS FOR 1999

INDICATOR		ARGENTINA		BRAZIL		PARAGUAY		URUGUAY	
		Effective 1998	Projected 1999	Effective 1998	Projected 1999	Effective 1998	Projected 1999	Effective 1998	Projected 1999
GDP - Total	(annual %)	3.9	-2.5	0.1	-1.0	-0.5	-1.5	4.5	-0.9
Inflation	(% Dec./Dec..)	0.7	-0.6	2.5	7.5	14.6	14.0	8.6	6.5
Public Deficit *	(% of GDP)	-1.4	-1.5	0.0	3.0	-1.5	na	-0.8	na
Export	(US$ 10^9)	26.2	23.6	51.1	50.6	3.4	na	2.8	na
Import	(US$ 10^9)	29.4	26.5	57.5	49.1	3.6	na	3.6	na
Trade Balance	(US$ 10^9)	-3.2	-2.9	-6.4	1.5	-0.3	na	-0.8	na
Current trans.	(US$ 10^9)	-14.7	-13.5	-35.1	23.5	-0.2	na	-0.4	na

Note: * The public deficit, in Brazil's case, is that of primary deficit. The nominal deficit foreseen for 1999 is -9.5%.

Source: Argentina: *Latin American Consensus Forecasts* (June 1999). Brazil: authors' forecast.

As regards the recovery of the Brazilian economy, it is likely that the final quarter of 1999 will see positive growth in comparison to 1998. That is, in fact, the implicit hypothesis in most of the projections undertaken recently. The industrial indicators made public at the end of the first half of 1999 do not preclude the possibility of a slower recovery.

Finally, the reaction of the financial markets to the elections in Argentina is hard to predict. In any event, it is worth considering the possibility of some nervousness, as was evident at the end of the first half of the year.

In sum, it is almost certain that the four MERCOSUR countries will record negative growth rates and a significant contraction of intra- and extra-subregional trade in 1999. However, it cannot be ruled out that the Brazilian economy might recover sufficiently fast to mitigate the effects of the devaluation, when these in fact occur. That is a desirable, but somewhat uncertain scenario.

CHAPTER II. EVOLUTION OF TRADE AND FOREIGN DIRECT INVESTMENT

A. Trade Flows: Recent Developments

Between 1991 and 1997, intra-subregional trade grew at the truly remarkable rate of 26.2% a year (Table II.1). In the same period, however, extra-subregional exports grew at the relatively modest rate of barely 7.4% a year. Such a rate, moreover, was a little below that for world exports. Consequently, MERCOSUR's share of world trade was unchanged, or rather declined slightly, while intra-bloc commerce more than doubled its share of the sub-region's total exports, increasing from 11.1% in 1991 to 24.8% in 1997. On the export side, in turn, three points should be highlighted: the clear progress in the process of trade integration between the partners, the growing interdependence of their economies and, less favorably, MERCOSUR's relative failure to improve the insertion of its exports in the world economy.

TABLE II.1
INTRA- AND EXTRA-MERCOSUR TRADE
(selected years - in US$ millions)

Category		1991	1993	1995	1997*	1998**	Growth (annual %)	
							1991-1997	1997-1998
EXPORTS								
Total	(US$ millions)	45,911	54,162	70,401	83,210	81,208	10.4	-2.4
Intra-MERCOSUR	(%)	11.1	18.5	20.4	24.8	25.0	26.2	-1.8
Extra-MERCOSUR	(%)	88.9	81.5	79.6	75.2	75.0	7.4	-2.6
IMPORTS								
Total	(US$ millions)	32,140	47,823	75,311	96,740	93,204	20.2	-3.7
Intra-MERCOSUR	(%)	15.9	19.6	18.7	20.7	20.7	26.2	-1.8
Extra-MERCOSUR	(%)	84.1	80.4	81.3	79.3	79.3	18.8	-4.2
TRADE VOLUME								
Total	(US$ millions)	78,051	101,985	145,712	179,950	174,412	14.9	-3.1
Intra-MERCOSUR	(%)	13.1	19.1	19.5	23.0	23.3	26.2	-1.8
Extra-MERCOSUR	(%)	86.9	80.9	80.5	77.0	76.7	12.6	-3.5
TRADE BALANCE								
Extra-MERCOSUR	(US $106)	13,771	6,340	-4,910	-13,530	-11,996		

Note: * Preliminary and **Estimate. In Paraguay's case, unregistered exports and imports are excluded.
Source: IDB (1990-1996 data). INDEC, SECEX, BCP and BCU (1997-1998 data).

Turning to the import side, the difference in the growth rate of intra- and extra-bloc flows is substantially less, since extra-subregional imports grew at the notable rate of 18.8% a year. The share of intra-bloc flows in MERCOSUR's total imports therefore grew in a markedly less spectacular way, increasing from 15.9% in 1991 to 20.7% in 1997.

From that viewpoint, the integration process should still be judged as very positive, but other considerations should be stressed. The main one is undoubtedly the remarkable growth of sub-regional imports in the first half of the 1990s, the result of the trade liberalization swiftly undertaken by the MERCOSUR countries. The opening of the sub-regional market prompted the spectacular growth of exports to MERCOSUR, both from the members of the bloc and from other trade partners. For both groups, exports to MERCOSUR were largely above those to other markets in the world.

It is therefore obvious that a contraction of sub-regional imports, such as that recorded from mid-1998, would concomitantly affect the member countries' exports and help narrow the gap between intra- and extra-MERCOSUR exports. That is indeed what happened: 1998 saw a simultaneous decline in exports and imports, and intra- and extra-zone flows differed little (Table II.1).

The situation worsened in 1999, since the decline in both exports and imports became more acute and, for the first time, intra-zone flows suffered the most (Table II.2).

TABLE II. 2
INTRA- AND EXTRA-MERCOSUR TRADE
(January-April 1999)

Category		January-April 1999-1998 (% variation)
EXPORTS		
Total		-15.8%
Intra-MERCOSUR		-28.1%
Extra-MERCOSUR		-11.8%
IMPORTS		
Total		-22.2%
Intra-MERCOSUR		-28.1%
Extra-MERCOSUR		-20.6%
TRADE BALANCE (EXTRA-MERCOSUR)		
January-May 1998	(US$ 10^6)	-4,656
January-May 1999	(US$ 10^6)	-1,956

Source: CEI, *Panorama del MERCOSUR*, July 1999.

The decline in intra-subregional exports at a rate higher than that for extra-subregional exports raises few questions. The recession in MERCOSUR is quite severe and widespread, prompting sub-regional exporters to seek other markets, traditional or otherwise. In that regard, the two biggest partners have had some success: in fact, in the period January-May, Brazil expanded its exports to the United States (basic and industrialized products) and to the Middle East (basic and semi-manufactured products), while Argentina mainly increased its exports to the EU (Table II.3).

TABLE II.3
ARGENTINA AND BRAZIL: EXPORTS BY REGION AND PRODUCT CATEGORY
(January-May 1999)

Categories and Destination Markets	ARGENTINA			BRAZIL		
	January-May 1999		% var.	January-May 1999		% var.
	(US $106)	Part. (%)	1999-1998	(US $106)	Part. (%)	1999-1998
Total exports	**9,520**	**100.0**	**-13.0**	**18,133**	**100.0**	**-14.0**
Primary/Basic	**2,758**	**100.0**	**-14.0**	**4,552**	**100.0**	**-13.7**
MERCOSUR		22.7	-10.0		3.4	-36.1
EU		35.5	16.0		54.8	-9.8
USA		8.0	23.0		8.5	10.6
Asia		12.8	2.9		17.6	-29.0
Rest		21.0	-50.0		15.7	-9.5
MAO/Semi-manufactures	**3,289**	**100.0**	**4.0**	**3,023**	**100.0**	**-9.5**
MERCOSUR		14.0	-20.0		2.8	-29.5
EU		28.1	23.0		28.3	-15.0
USA		10.4	-5.0		25.3	-9.4
Asia		8.3	-15.0		23.2	0.9
Rest		39.2	11.6		20.4	-8.5
MIO/Industrial	**2,574**	**100.0**	**-26.0**	**10,215**	**100.0**	**-16.0**
MERCOSUR		51.5	-37.0		23.0	-28.4
EU		10.2	40.0		21.6	-5.2
USA		14.8	-7.0		27.9	4.8
Asia		3.4	20.0		5.7	6.4
Rest		20.1	-28.0		21.8	-32.3
Fuels	**829**	**100.0**	**-17.0**			
MERCOSUR		35.2	-19.0			
Rest		64.8	-16.0			

Source: SECEX and INDEC.

The reason for the sharp decline in intra-subregional imports in relation to extra-subregional imports is, however, less obvious and more worrying, since it suggests negative discrimination in the harm suffered by the partners in the sub-region. The gap, however, seems to be explained in large measure by the substantial share of automotive trade - a sector severely affected by the recession - in intra-zone flows.

TABLE II.4
VEHICLES AND AUTO-PARTS IN INTRA-ZONE TRADE
(evolution in the period January-April 1999)

	Variation (%) Comp. previous year
Automotive sector trade	-48.8
Other sectors	-22.0
Total intra-zone trade	-28.2

Source: CEI, *Panorama del MERCOSUR*, July 1999.

In 1998, automotive trade was responsible for approximately ¼ of intra-zone trade, while in the first quarter of 1999 that share had fallen to 1/6 of intra-subregional commerce. Excluding automotive trade, the decline in intra-zone flows is seen to be equivalent to that of extra-zone flows: both contracted by about 21% to 22% (Tables II.2 and II.4).

Finally, it should be stressed that there is unlikely to be a recovery of intra-subregional trade flows in what remains of the year. In May, Brazilian exports to MERCOSUR fell by 26.5%, over five times more than the decline in total exports (-4.8%). In the same month, Brazil's imports from MERCOSUR fell by 30%, while total imports declined by less than 20%.

B. Investment Flows in MERCOSUR: Evolution and Trends

MERCOSUR's consolidation has spurred an intense process of new investment and of capital restructuring among companies in the sub-region. The enlargement of the market and the growth potential of demand are the main reasons for the expansion of investment in the sub-regional market. In general, the big national firms and the transnational companies that were operating from bases in two or more countries of the sub-region pursued policies geared to the rationalization of the production and marketing structure. For these companies especially, the integrated market allowed firms to redefine their production methods so as to exploit economies of scale, of specialization, of production and of the rationalization of supply. An attendant phenomenon in terms of trade flows has been the growth and consolidation of a pattern of intra-industrial trade, especially between Argentina and Brazil.

MERCOSUR allowed firms to implement multiple corporate integration strategies geared towards: (i) increased productive efficiency (efficiency seeking), exemplified by the companies in the automotive sector; (ii) the acquisition and control of existing companies (asset seeking), which concentrates the investments of companies in the purchase of public utilities services, the aim of the national privatization programs; (iii) control of the sub-region's abundant raw materials and natural resources (resource seeking), which explains the investments by large companies in the areas of mining, petroleum, petrochemical and agricultural commodities (Bonelli [1999]).

Notwithstanding this broad trend towards restructuring and new investment, the MERCOSUR countries still hold only a small share of the world's stock of foreign capital. In 1997 the amount was around US$ 1.6 billion, which represented about 2.4% of the total stock of foreign direct investment (FDI) (CEPAL [1998]). In recent years, new FDI flows to MERCOSUR have basically concentrated on the services sector. In 1997, for example, of US$ 15.3 billion in new FDI flows, about 84% were in the services sector. There is no doubt that such a concentration is linked to the entry of foreign capital to buy the assets of privatized companies in the areas of telecommunications, electricity production and distribution, and water and drainage, among others.

Information gathered by Reuters and published in *Gazeta Mercantil* on planned foreign investment for the first quarter of 1999 reveals that, despite the slow-down in economic growth foreseen for this year, there will be a significant increase (73%) in FDI compared to 1998. The number of planned projects has increased from 65 to 87. A significant feature evident in Table II.5 is the high concentration of FDI: of the US$ 14.2 billion in investment planned for the sub-region in the first quarter of 1999, Argentina and Brazil account for 38% and 58%, respectively, of the total.

TABLE II. 5
PLANNED FDI FLOWS TO MERCOSUR AND ITS ASSOCIATE COUNTRIES

Countries	1st quarter 1998				1st quarter 1999			
	US$ 10^6	(%)	Projects	(%)	US$ 10^6	(%)	Projects	(%)
Argentina	1,605	19.6	16	24.6	5,400	38.1	37	42.5
Brazil	6,112	74.8	34	52.3	8,167	57.7	41	47.2
Paraguay	35	0.4	1	1.5	100	0.7	1	1.1
Uruguay	84	1.0	2	3.1	299	2.1	2	2.3
Bolivia	10	0.2	4	6.2	13	0.1	1	1.1
Chile	326	4.0	8	12.3	177	1.3	5	5.8
TOTAL	**8,172**	**100.0**	**65**	**100.0**	**14,156**	**100.0**	**87**	**100.0**

Source: *Gazeta Mercantil*

Long-term estimates of the investments of foreign firms in MERCOSUR, undertaken by Argentina's *Centro de Estudios de Producción* (CEP), forecast investments of about US$ 152 billion in Argentina and in Brazil for the period 1998-2000 (Table II.6). In these countries, most of the resources will be applied to capital formation, greenfield investments or in expanding businesses – 87% in the case of Argentina and 75% in the case of Brazil. For Brazil, the significantly greater weight of the transfer of companies category reflects future investment in Brazilian privatizations.

TABLE II. 6
INVESTMENT BY FOREIGN FIRMS IN MERCOSUR (1998-2000)

Category	ARGENTINA		BRAZIL		TOTAL	
	US$ billion	%	US$ billion	%	US$ billion	%
Transfer of companies:	**6.8**	**12.8**	**24.7**	**24.8**	**31.5**	**20.7**
Privatizations	0.4	0.7	17.5	17.6	17.9	11.7
Mergers and acquisitions	6.4	12.1	7.2	7.3	13.6	9.0
Capital formation:	**46.3**	**87.2**	**74.7**	**75.2**	**121.0**	**79.3**
Greenfield	22.3	42.9	28.7	28.9	51.0	33.4
Expansions	24.0	45.2	46.0	46.3	70.0	45.9
TOTAL	**53.1**	**100.0**	**99.4**	**100.0**	**152.5**	**100.0**

Source: CEP (partly based on Bonelli [1999]).

The CEP study also projects investment by economic activity for the period 1998-2000. Most of the investment by foreign firms in MERCOSUR will concentrate, in descending order, on the telecommunications, electricity, automotive (including parts), petroleum and gas, mining and petroleum by-products, construction, banking and financial services sectors.

Despite being quantitatively less important, investment by companies of the sub-region and their installation in neighboring countries is a trend that has become more marked in recent years. According to

Gazeta Mercantil Latinoamericana, more than three hundred Brazilian companies have decided to establish a presence in Argentina. These companies were responsible for investment of about US$2.5 billion, making Brazil the fourth most important foreign investor in Argentina.

Using the estimates of the CEP study, it is possible to evaluate the reciprocal bilateral investments of Argentina and Brazil. In the period 1990-1997, bilateral investment flows reached US$ 2.2 billion, 54% of which was investment by Brazilian companies in Argentina and 46% was by Argentine firms in Brazil. The CEP study projects bilateral investment of US$ 6.9 billion for the period 1998-2000, bringing the total stock of bilateral Argentine and Brazilian investment to US$ 9.1 billion. The main novelty indicated by the CEP study is the significant increase in investment by Argentine companies in Brazil, from US$ 1.0 billion in the period 1990-1997 to US$ 5.4 billion in the period 1998-2000. Argentina will therefore account for around 78% of bilateral investments flows in next two years.

The sectoral distribution of Argentine-Brazilian bilateral investment for the period 1990-2000 will be as follows: (i) investment by Argentine companies in Brazil will concentrate on the petroleum and gas sectors (26%), construction (22%), food and beverages (9%), electricity (8%), communications (8%) and transport (7%); and (ii) investment by Brazilian companies in Argentina will center on electricity (33%), construction (13%), banks (12%), food and beverages (11%), vehicles and parts (6%) and petrochemicals (5%).

Bonelli [1999] has set up a database of mergers and acquisitions in MERCOSUR between 1990 and 1998. Table II.7 summarizes the main results of that study, showing the number of companies acquired by sector, country and capital ownership. The information in the study does not specify the financial scale of the operations. However, it can be used as proxy to evaluate the relative share of the investment of transnational companies (TNCs) and cross-border investment *vis-à-vis* mergers and acquisitions that exclusively involve national companies in each of the respective markets. Of the 441 merger and acquisition operations registered in the period, 57% had a national company as the acquirer, 25% a subsidiary of a TNC, and 18% were cross-border investments – that is, most of the operations were between firms from the country itself. The greatest number of mergers and acquisitions was in the financial (85 operations), chemicals (71), foodstuffs (66) and services (55) sectors.

It should be stressed that the change to the exchange rate regime in Brazil could affect the location of investment in the sub-region, since the dollar value of Brazilian companies fell by more than 40% after the devaluation of the real in mid-January. From the viewpoint of bilateral investment flows between Argentina and Brazil, the trend noted in the CEP study of an increase in the relative share of investment by Argentine companies in Brazil in the period 1988-2000 should become more marked.

The question of the location of FDI from transnational companies in MERCOSUR should also be considered. In some sectors, especially the vehicle and parts industry, where investment is based on efficiency seeking strategies, there is already a tendency to reverse productive specialization by country. As exports of automobiles manufactured in the Argentina to Brazil became costly after the devaluation of the real, the parent companies decided to transfer to Brazil the production of some models (examples being Chevrolet’s Corsa Station Wagon and the Fiat Siena) previously manufactured only in Argentina. The Brazilian companies also decided to increase the nationalization index of the vehicles. In the short term, that will reduce Brazilian imports of vehicle parts made in Argentina. In the long term, it is probable that new investment in the parts sector will concentrate on the vehicle production poles located in Brazil.

TABLE II.7
NUMBER OF MERGERS AND ACQUISITIONS IN ARGENTINA, BRAZIL AND CHILE

SECTOR	COUNTRY		ACQUIRER					
			National		Subsidiary of TNC		Cross-border	
Foodstuffs (66)	Argentina	(31)	20	(65%)	5		6	
	Brazil	(32)	9		15	(47%)	8	
	Chile	(3)	3		-		-	
Vehicles and parts (40)	Argentina	(11)	2		1		8	(73%)
	Brazil	(29)	13	(45%)	11		5	
Beverages (29)	Argentina	(20)	4		3		13	(65%)
	Brazil	(6)	3		-		3	(50%)
	Chile	(3)	3		-		-	
Communications (35)	Argentina	(31)	25	(81%)	6		-	
	Brazil	(4)	4		-		-	
Financial (85)	Argentina	(23)	10	(43%)	6		7	
	Brazil	(60)	43	(72%)	11		6	
	Chile	(2)	2		-		-	
Electrical and communications material (26)	Argentina	(2)	-		1		1	
	Brazil	(24)	11		13	(54%)	-	
Metallurgy (34)	Argentina	(7)	3		-		4	
	Brazil	(27)	19	(70%)	6		2	
Chemicals (71)	Argentina	(26)	14	(54%)	5		7	
	Brazil	(42)	25	(60%)	14		3	
	Chile	(3)	3		-		-	
Services (55)	Argentina	(22)	16	(73%)	1		5	
	Brazil	(31)	18	(58%)	11		2	
	Chile	(2)	2		-		-	
TOTAL (441)	**Argentina**	**(173)**						
	Brazil	**(255)**	**252**	**(57%)**	**109**	**(25%)**	**80**	**(18%)**
	Chile	**(13)**						

Source: Taken from Bonelli [1999].

CHAPTER III. CONSOLIDATION AND DEEPENING OF THE CUSTOMS UNION: COMMERCIAL DISPUTES, POLICY HARMONIZATION AND TRADE AGREEMENTS

A. Introduction

The functioning of a full customs union requires the absence of barriers to the intra-subregional flow of goods and a high level of harmonization of trade policy instruments. An examination of what is necessary for a Customs Union to work requires an attempt to resurrect the idea that the main prerequisite for the consolidation of MERCOSUR is the harmonization of trade policy.

The undeniable success of the integration process in recent years, as demonstrated by high levels of trade growth between the four countries, contrasts with the emergence of new trade disputes since 1996, when a series of unilateral measures created new obstacles to sub-regional trade. Disputes over the system of prior licensing for imports, restrictions on financed imports, and the use of fiscal incentives by states in the automotive regime (to take just the Brazilian practices opposed by the other countries) have dominated negotiations despite their being in violation of the terms of the Treaty of Asunción (Article 5). In addition, aspects of trade management reveal the low level of harmonization of policies and instruments among the MERCOSUR countries since the Customs Union was established: (i) there is no common legislation covering the use of mechanisms to combat unfair trade practices (dumping and subsidies) in the case of third-market imports, in line with World Trade Organization (WTO) rules; (ii) there is no common policy on defense of competition, which has led to the application of instruments against unfair trade practices to intra-subregional imports; (iii) establishing common rules for intra-subregional trade in specific sectors, such as the automotive and sugar sectors, is very difficult; and (iv) individual MERCOSUR members are establishing preferential trade agreements with extra-zone partners.

B. A Typology of Trade Policy Asymmetries

In a broad sense, the problems of asymmetry in the management of MERCOSUR trade policy involve:

- the creation of barriers to intra-subregional trade as a reaction to the immediate difficulties related to external account management;
- the lack of harmonized trade and industrial policies and other economic policy instruments that distort competition and affect the behavior of private economic agents;
- the proliferation of isolated negotiation initiatives for commercial agreements with extra-zone trading partners, which means both an abandonment of the "4+1" negotiating format and the possibility that the common external tariff (CET) might be perforated.

The increase in external vulnerability and the deterioration of the balance of payments in Argentina and Brazil were the main arguments given by economic policy managers for erecting new barriers to imports. As a general rule, it can be said that "unilateral" management of microeconomic policy, particularly of trade policy instruments, has aimed to counteract external restrictions by compensating for the loss of freedom to manage macroeconomic policy with the timely and discretional use of import control mechanisms. What is questionable here is the absence of selectivity in the application of these instruments. That is to say, as a rule, intra-MERCOSUR trade was not preserved, which has led to an increase in diplomatic and trade disputes in the sub-region.

Practices such as the use of trade defense measures to control imports, or the adoption of other non-tariff barriers – such as setting limits on import financing and using a prior licensing mechanism for imports – prompted complaints from the members and disputes between the MERCOSUR countries. For the first time, the dispute resolution mechanism was activated to examine the Brazilian government's use of prior licensing for imports. The dispute settlement committee decided that the measure could not be used, thereby forcing the Brazilian government to suspend the use of prior licensing for imports from MERCOSUR.

The change to the Brazilian exchange rate regime increased the risk of a proliferation of unilateral measures to restrict intra-subregional trade. Although discussions led to the signing of the Presidential Declaration of São José dos Campos – in which Argentina and Brazil agreed not to erect new barriers to intra-subregional trade – elements in the private sector have placed considerable pressure on the Argentine government to erect barriers to Brazilian products. The spread of private sectoral agreements on voluntary export restraints – tolerated and, in some cases, even motivated by the governments – poses another risk to the maintenance of an open market among the MERCOSUR countries. "Negotiated trade" functions, in this case, as a substitute for government action to create barriers to intra-subregional trade.

The current context is not new for the MERCOSUR countries. Recent historical experience revealed the risk of trade conflicts resulting from the lack of macroeconomic convergence between the two main economies of the sub-region. The implementation of the Convertibility Plan in Argentina in 1991 caused a reversal in its trade balance. Over a three-year period (1992-1995), Argentina's accumulated trade deficit with Brazil reached US$ 2.7 billion. The deficit would have been larger had the government and the Argentine private sector not threatened to impose barriers on Brazilian exports. They also pressured Brazil to increase its purchases of Argentine products. Brazil's program of buying Argentine oil served as a palliative. This masked the problems generated by the diverging macroeconomic performance of the two countries by lessening the risk of new intra-subregional trade barriers at a time when the integration program was seeking to liberalize trade between the members.

The second type of asymmetry in the trade policy of the MERCOSUR countries is not related to the spread of trade barriers to counteract the difficulties of deepening external restrictions. Rather, it concerns the problems associated with the regulated competition that arises in the absence of harmonized industrial and foreign trade policies. The idea is that the harmonization of microeconomic policies is a desirable goal, but in a Customs Union these policies do not necessarily have to be harmonized. It is enough that their application produces converging results.

The classic case of regulated competition in MERCOSUR is the operation of national incentive regimes for the automotive sector in Argentina and Brazil. The practice of government incentives, and the participation of state governments in the new investments made by companies in Brazil, are the target of criticism from sub-regional partners, particularly Argentina. They allege that the use of these instruments affects company decisions on the territorial location of investments in MERCOSUR, diverting them from Argentina to Brazil.

Competitive differences between productive sectors in different countries can lead to regulatory asymmetries which impede free trade in the sub-region. An illustrative case is Argentina's use of anti-subsidy mechanisms against Brazilian imports of steel products. Although there is no rule that bars the use of instruments against unfair trade practices among the MERCOSUR countries, the compatibility of their application with the operation of a Customs Union is questionable. The suspicion that falls on Argentina is that using instruments to combat unfair trade practices is really the government's response to demands for protection on the part of industrial sectors, which cannot compete with more efficient Brazilian supply.

Another example is that of the difficulties involved in the liberalization of the sub-regional trade in sugar. MERCOSUR negotiations over the sugar sector have not progressed significantly since the Customs Union was created, leading Brazil to question whether there is free intra-subregional trade. Argentina's sugar import tariff varies from 23% for intra-subregional purchases and 39% for extra-zone purchases, which increases with a specific tax. Sugar is usually included in the adaptation regime and has gradually falling tariffs until intra-MERCOSUR trade in the product is completely liberalized. However, the differential in competitiveness between Brazilian and Argentine production constitutes enough of a reason to block trade liberalization. Argentine producers hold that government policies for sugar/alcohol production in Brazil – especially "Proálcool" – constitute "implicit" subsidies to the sector. For example, Brazilian producers have access to extremely cheap raw material (sugar cane) for sugar production with which Argentine producers cannot compete.

The third type of trade policy asymmetry is related to the negotiation of preferential tariffs between individual MERCOSUR countries and other members of the LAIA. The agreement between Argentina and Mexico in 1998, and that recently signed between Brazil and the countries of the Andean Community, are two initiatives which go against the principle of the "4+1" negotiating format. In fact this does more than just break the negotiating principle. Individual agreements between the members of MERCOSUR and third countries make the universality of the application of the common external tariff unworkable. In the long term this puts the very operation of the Customs Union at risk. In addition, uncoordinated action and the spread of free-rider strategies in the negotiation of trade agreements with Latin American partners can compromise the consolidation of MERCOSUR as the polarizing axis of negotiating positions in future agreements within the FTAA, as well as with the European Union (Veiga [1999]).

What follows is a detailed description of:

- the main obstacles to trade in MERCOSUR, both from the point of view of barriers generated by the arbitrary application of economic policy instruments, and of restrictions applied to specific sectors;
- policy harmonization and convergence initiatives; and
- the negotiation of trade agreements between MERCOSUR members and third countries.

C. Obstacles to Trade

Trade restrictions generated by the application of economic policy instruments

- The Brazilian system of prior import licensing

In the first half of 1998, Argentine products began to face difficulties entering Brazil. Procedures that previously took between 24 and 48 hours started to take an unpredictable amount of time. This was because of the Brazilian government's increase in control requirements on imports. Agricultural, pharmaceutical, chemical and food products were required to have prior import licenses (IL) before and after the merchandise entered the country. Argentina had already registered a complaint against the use of this mechanism during the 18th Meeting of the Common Market Council in April 1998.

The Argentine Industrial Union (*Unión Industrial de Argentina*, UIA) and the Chamber of Exporters of the Argentine Republic (*Cámara de Exportadores de la República Argentina*, CERA) asked Brazil to exclude MERCOSUR from the norm that requires prior licensing for sales to its market, or at least to create a “green channel” so that members of the bloc could speed up the passage of products across border, thereby avoiding the prejudicial treatment of Argentine exports. Brazil, however, responded that it did not plan to revise the measure.

In April 1998, the Brazilian government increased to 170 items the list of products subject to prior import licensing. The measure did not exclude products imported from MERCOSUR. In addition, the government did not discount the possibility of new increases in the number of imported products subject to quality certificates based on compliance with voluntary norms.

In November 1998, through the ruling of the National Meteorology Institute (*Instituto Nacional de Metrologia*, Inmetro), Brazil also adopted mechanisms requiring quality certificates for imports of about 170 items (including electronic equipment, safety glass and white goods), which continued to be subject to non-automatic import licenses prior to embarkation.

Exporters from Argentina, Paraguay and Uruguay voiced their concerns about the new control and tax procedures for merchandise introduced by Brazil through the Siscomex import licensing system. Exporters alleged that the measures created operational difficulties at the bloc’s main border crossings.

Despite the complaints of the MERCOSUR members, the Brazilian government extended the IL system to cover all animal-based products. Prior to that, the requirement had only affected some goods, such as dairy products.

The use of prior licensing by Brazil led to a dispute among the MERCOSUR members. The instrument was judged under the dispute settlement system, and in April 1999 the final ruling was issued. The decision of the judges required Brazil to suspend the use of the mechanism until 31 December 1999 – the date when the MERCOSUR adaptation regime comes to an end – as it was incompatible with the rules governing the operation of the Customs Union. If a country does not obey the Arbitration Tribunal’s ruling, the other member states can adopt temporary countervailing measures.

- Control measures on Argentine imports

Argentina adopted new import control mechanisms in March 1999. The system of destination requests for consumer imports will oblige Argentine importers to fill in a form indicating the FOB quantity and value of what they want to import. The form is mandatory and affects imports above US$ 80,000. The verification mechanism for Argentine imports has just been effected via Resolution 150/99 and Resolution 11/99 of the Secretariat of Industry, Commerce and Mining. Presenting an import form, though not a condition for gaining approval of imports (which is authorized automatically), can delay the process of purchasing goods abroad.

From 1 June Argentine importers will also have to make a detailed declaration of all goods imported or placed in fiscal deposits in the *Sistema Informático María*, which is similar to Brazil’s Siscomex. The requirement was determined by Resolution N° 565/99, sanctioned by Argentina’s Federal Administration of Public Revenue (*Administración Federal de Ingresos Públicos*, AFIP). The measure does not exclude the MERCOSUR countries, nor overland imports. The only exception relates to firms that had carried out at least 2,000 definitive or temporary import/export operations last year, with a combined CIF and FOB value of not less than US$ 200 million. However, they will still be subject to a guarantee deposit payable to the AFIP and must have a computerized accounting system.

Argentine importers managed to increase the timeframe from five to fifteen days for registering merchandise. They argued that Resolution N° 565/99 would only add another bureaucratic procedure to be dealt with in import offices and that it would be impossible to put it into practice since the Resolution required that depositors know the exact contents of containers. These are normally shared by several exporters. The measure will oblige importers to gain clearance for the entry and release of the merchandise.

The Argentine government maintains that the measure will obviate unfair competition and damage to local industry, and will substantially reduce the time that importers have to wait while documents are checked and merchandise is physically verified at customs. Large autopart and white goods firms are exempt from the Resolution, since they are already required to give details about their operations. According to some analysts Resolution N° 565/99 would be similar to the Prior Import Licensing System (IL), the use of which in Brazil was condemned by the MERCOSUR Arbitration Tribunal.

Concern about its effects made the Resolution a priority for Brazilian negotiators in MERCOSUR. They alleged that it was a non-tariff barrier. Consequently, they requested that imports from MERCOSUR should be exempt or at least that the documents could be presented after the entry of the merchandise.

In Uruguay, the import regime is automatic, regardless of the country of origin of the item acquired. Exporters and importers, however, have to register the purchase with the appropriate government agencies. In Paraguay, imports are free and importers only have to register with the Ministry of Economy and Customs. The measure exists simply as a mechanism of tax control on imports.

Another measure to control imports was implemented by the Argentine government covers trade in foodstuffs. Since 1 July 1999, a ruling by the National Food Health and Quality Service (*Servicio Nacional de Sanidad y Calidad Agroalimentaria*, SENASA) has prohibited animal or vegetable-based foods from entering the country *in natura* without health certification. The rule particularly affects trade on the border. In February, the Argentine government had already limited purchases of food products from abroad to US$ 100,00 per month. As a consequence of the Argentine government's decision, the flow of trade in the Brazilian city of Uruguaiana fell by over 20% in the first half of this year, according to the city's trade association.

- The Brazilian system of foreign exchange purchase

In October 1998 the Brazilian government suspended for four months the special regime of foreign exchange purchase for merchandise imports from MERCOSUR, Chile and Bolivia. Without a suspension, purchases of less than US$ 40,000 from those markets would continue to be subject to a requirement obliging importers to buy foreign exchange beforehand, a demand which in practice would restrict import financing. The policy establishes that foreign exchange for imports to arrive in less than 360 days should be arranged at least 180 days before the operation is to be redeemed.

In March, as part of the package of measures announced by the Argentine and Brazilian governments during the presidential meeting of São José dos Campos (see chapter IV of the Report) to minimize the impact of the real devaluation on sub-regional trade flows, Brazil announced new rules for the exchange purchase system. It decided that only imports over US$ 80,000 with a payment period of up to 90 days would remain subject to the prior exchange arrangement. All imports from MERCOSUR with a payment period of between 91 and 360 days were also exempted from the arrangement. Imports originating in third countries and financed up to 360 days would come under the general rule which obliges prior purchase of foreign exchange.

- Trade defense mechanisms

Brazil alleges that Argentina resorts to the use of anti-dumping measures to protect its domestic market from Brazilian competition. Argentina denies this and maintains that there is no arbitrary measure or special policy against Brazilian imports. Whatever the case, there are currently eight anti-dumping actions affecting Brazilian industry and an open investigation against the entry of laminated steel sheets.

The Argentine iron and steel producer, Siderar, launched an anti-dumping case in mid-April. This is awaiting the endorsement of the Economy Ministry, and Siderar hopes that the government would apply a surcharge of between 9.44% and 51.05% on imports of Brazilian cold and hot laminates. If the Ministry accepts Siderar's arguments, the government would impose tariffs to compensate for the difference in price between the value of exports and that prevailing in the markets of origin. Brazil aims to appeal against the decision but will first try to resolve the case by diplomatic means.

- The Argentine drawback system

With the recent increase in drawbacks (tax reimbursements), Argentina gave no indication that it would remove such incentives for products circulating in MERCOSUR. In June 1999, the drawback increased from 4.1% to 10% for de-boned meat, from 5.4% to 10% for dairy products and from 6.3% to 10% for onions, garlic and olives. The measure also benefits exports of fruit, wheat products (which rose from 4.1% to 10%) and tinned fish.

Sectoral trade restrictions

- Alcohol-sugar sector

Among the concerns about free trade in MERCOSUR, the sugar industry is one which particularly worries the governments of the sub-region, particularly in Brazil and Argentina. In July 1998, the Brazilian government presented the MERCOSUR Trade Commission (*Comisión de Comercio del MERCOSUR*, CCM) with a proposal for liberalizing intra-bloc trade in sugar. Brazil proposed the gradual elimination of taxes over three years (between 1999 and 2001) to achieve free intra-zone trade in 2002. Brazil requested that Argentina consolidate its rates for the import duty aliquots on sugar.

The sugar sector is one of the few exempt from free trade between the MERCOSUR countries. Trade in sugar is affected by the adaptation regime which should be eliminated by 1 January 2000. To enter the Argentine market, Brazilian sugar pays a tariff of 23%. The final formula of the regime should take into account the neutralization of distortions which could cause asymmetries between national policies for the sugar sector. Despite the initially established date, Argentina and Brazil should postpone the date for the entry into force of the sugar regime.

Argentine producers have doubts about liberalizing trade. They argue that since Brazilian production is 15 times greater, opening the Argentine sector to Brazilian imports would lead to the bankruptcy of local producers. In addition, the Argentine sector maintains that the subsidies given to Brazilian alcohol producers imply a reduction in the final price at which sugar is sold in the domestic market. There is also an Argentine law which prohibits the reduction of import tax rates on Brazilian sugar. This clearly demonstrates dissatisfaction with the Brazilian subsidies.

According to Brazilian producers, levels of protection on sugar in Argentina are very high. In addition to the import tax on Brazilian production, there is also a moveable import aliquot, calculated on the basis of international sugar prices. This currently hovers at around 30%, so that the total aliquot is over 50%. This tariff is far above the 35% consolidated by Argentina in the WTO. The São Paulo Sugar Cane Union is discussing with the Brazilian government the lodging of formal complaints against Argentina with the WTO.

Paraguay backs the Argentine position and maintains that the sugar/alcohol production chain needs to keep current protection levels until 31 December 2000, so as to give the sector time to adjust to the intra-subregional free trade regime. In May this year, the Paraguayan Sugar Centre asked the government to sanction a law maintaining customs protection that favors the local producer, as a way of protecting the sector and guaranteeing investments which increase the competitiveness of the refiners. The Argentine sugar producers supported their Paraguayan counterparts in this initiative.

On 10 December 1998, Argentina and Brazil signed a bilateral agreement which will facilitate the lowering of the Argentine sugar import tariff, currently fixed at 23%, as well as the moveable tariff, which varies quarterly depending on international sugar price fluctuations. In addition, the MERCOSUR members agreed to neutralize national policies which distort sugar prices. The agreement defined the application of a margin of preference of 10% on the current external tariff, reducing the tax on Brazilian sugar from 23% to 20.7%. However, the 10% reduction in the import tariff agreed last December came into force on 25 April 1999, through the publication of Resolution 457/99 by the Argentine Economy Ministry.

A measure that is contrary to the liberalization of the sector was taken on 10 May 1999, when the Argentine courts annulled a government decision, implemented a few days previously, that granted a tariff preference of 10% on the import tax for sugar coming from Brazil, Paraguay and Uruguay. The Argentine tariff on sugar imports thus returned to 23%. The courts considered the act of the Argentine executive to be unconstitutional, since it contravened a law approved by Congress that prohibits tariff reductions while Brazil keeps its Proálcool subsidies for the production and export of sugar.

On 19 May 1999, the confectionery industries of both countries presented a joint request to the governments that the MERCOSUR sugar trade be liberalized. The Argentine sector proposed the reduction of the price of sugar in the internal market or the establishment of a quota system for sugar imports. This met with strong opposition from local sugar producers.

Negotiations for the introduction of a common regime for the sugar sector are still confused and do not seem to be facilitating understanding between the interested parties. Effective progress on the liberalization of the sugar trade among the countries of MERCOSUR will depend on: (i) the evaluation of the effects on sugar prices of government subsidies to Brazilian alcohol products; and (ii) the competitiveness of the Argentine sugar sector. If granting subsidies to alcohol producers does not have a significant effect on the price of sugar produced in Brazil, but Argentine producers still have competitiveness problems, the elimination of barriers to intra-subregional trade could lead to a reduction in the planted area in Argentina, as occurred with Brazilian wheat cultivation.

- Electronic products

On 18 August 1998, Argentina adopted a new law for electronic products which could affect Brazilian exports. Resolution N° 92/98 of the Secretariat of Industry, Trade and Mining Secretariat establishes that any product of up to 1,000 volts which is connected to a plug should meet safety, quality and environmental requirements. This will be controlled by a body registered in Argentina, which will check the manufacturer's declaration. The exporting firm is obliged to obtain a "type certificate" – proving that the product was checked in the factory – and a "compulsory certification", which involves the testing of the product in the factory and periodically in the market.

The Brazilian certification body (Uciee) and the Argentine Norms Institute (*Instituto Argentino de Normalización*, Iram) are still not accredited with the Argentine Accreditation Body (*Organismo Argentino de Acreditación*, OAA) which is responsible for the registration of such bodies. The Resolution is therefore still being considered as a technical trade barrier. There is a temporary period in which firms can self-certify their products. This is valid both for foreign and Argentine producers. Self-certification will be possible until a Certification Institute is established in Argentina.

Brazil agrees with the certification but maintains that it should not be applicable immediately. As soon as the Resolution came into force, Brazil and Uruguay presented a request to the MERCOSUR Trade Commission that the measure be delayed for a year. From September, however products can only enter the Argentine market if they have a technical certificate from Argentine bodies. According to the Brazilian National Association of Electronic Goods Producers (Abinee), the need to carry out conformity tests in Argentine laboratories effectively blocks the export of Brazilian electronic goods: almost 1,000 low voltage electronic products will have to have the Argentine seal of certification, while the country does not have an adequate infrastructure of laboratories to meet the demand for tests. Brazil exports about US$ 750 million in electronic goods to Argentina each year.

It is also important to remember the recent end to the exception regime for over 200 electronic items in MERCOSUR. The regime ended in January 1999 for Argentina and Brazil (in the case of Paraguay and Uruguay it will last until 2001) after five years, placing surcharges of between 16% and 18% on Brazilian articles sold in Argentina and vice-versa.

- Cleaning products

Resolution 730/99 of the Argentine Secretariat of Industry, Trade and Mining, which came into force in November 1998, is seen as a non-tariff barrier by Brazilian business. As a result of this Resolution, all cleaning products sold in Argentina should have a child-proof lid and a tamper-proof security seal.

- Footwear

During their meeting in São Paulo on 2 July 1999, the Buenos Aires Chamber of the Footwear Industry asked that the Brazilian Footwear Association (Abicalçados) implement a program of voluntary export restraints. Brazilian producers are concerned that if the industry rejects the proposal, Argentina will impose some kind of restrictive measure on the entry of footwear made in Brazil. In the first five months of 1999, the Brazilian surplus of trade in footwear with Argentina reached US$ 32 million, which is twice that registered in the same period of last year. For now, the governments of Argentina and Brazil are not involved in negotiations, since this is a voluntary restraint agreement that only involves representatives of the industry.

- Steel

The Argentine government decided to erect barriers to imports of certain types of Brazilian steel. With the Resolution, issued in April 1999, Argentina decided to apply a minimum FOB export price of US$ 410,00 per tonne on Brazilian exports of cold steel or iron laminates, of a width equal to or above 600 mm, and for untreated hot sheet laminates, of a width under or equal to 12.7 mm. This penalty will be applied for four months.

The measure was taken following complaints about the Brazilian sector. These were directed at the CSN, which sold at prices lower than those of Usiminas although it is known that the products of the two firms are similar.

- Meat

In September 1998, Argentina banned pork exports from the firms Frangosul and Aurora owing to allegations that they had sold lots containing traces of sulfa, an antibiotic. The companies considered the measure a technical barrier to trade and in contravention of MERCOSUR resolutions.

The firms argued that Argentina infringed WTO rules by not informing them of the new sanitary rules 60 days in advance. As a result of those rules, Argentine firms (alleging phytosanitary problems in the Brazilian herd), pressured the Brazilian authorities to impose stricter sanitary controls on the product. In addition to foot-and-mouth disease, they complained about subsidized corn used in pig food. For their part, Brazilian producers complained that Argentina did not have an open market for on-the-bone pork exports from Brazil.

In April 1999, Argentina banned Brazilian beef from entering the country. The measure is part of the government's strategy to obtain the certificate from the International Office of Epizootics (*Office international des épizooties*, OIE), which is given to countries free of foot-and-mouth disease. It is only valid for live cattle.

Brazilian chicken exporters met representatives of Argentine refrigeration firms to negotiate a supply quota for 1999. The aim was to calm local producers who feared an influx of Brazilian products. In compensation, Brazil wants the anti-dumping case opened by the Argentines against their product to be closed. According to the evaluation by the Argentine refrigeration firms, after the change in the Brazilian exchange rate regime they would lose competitiveness in the domestic market to products from Brazil. Because of price, Argentina is having difficulties exporting its products to Brazil, which began to import meat by-products from the United States and thereby substituted purchases previously made in the sub-regional market.

- Taxation on foreign cigarettes in Uruguay

Argentina considered Uruguay's Specific Domestic Tax (*Impuesto Específico Interno*, Imesi) on foreign-made cigarettes to be discriminatory. Throughout August 1998 the Uruguayan authorities were analyzing some changes to the Imesi, a tax paid by importers and producers, which caused a trade row between the MERCOSUR countries. Argentina and Brazil consider the tax to be "discriminatory" and have already had several discussions with Uruguay in the MERCOSUR Trade Commission. The application of the Imesi on imported cigarettes from neighboring countries could be taken up by the Brasilia Protocol for dispute resolution. Cigarette makers in Uruguay pay a tax of 66.5%, corresponding to the Imesi, on the estimated value of sales to the public. Cigarettes imported from Argentina have to pay a surcharge of 30% of the Imesi on a "general imaginary" value.

- Textile products

In July 1999, the Argentine government decided to impose import quotas on five Brazilian textile products. The safeguard measure, which also applies to other exporting countries (China and Pakistan) will last for three years. According to industry estimates, this will limit Brazilian sales to half those exported to Argentina in 1998.

Members of the Argentine textile industry argued for the application of the WTO anti-subsidy code and the establishment of countervailing duties against imports from Brazil. They maintain that Brazilian producers receive a number of support measures, such as subsidized credit from BNDES, repayment of PIS, loans from FINAME and export financing at a preferential interest rate.

The Argentine authorities sought protection for the safeguard application under article six of the Clothing and Textiles Agreement of the WTO, alleging that the exports would damage their industry. From January to May 1999, Brazilian textile exports to Argentina fell by about 20%. The Brazilian government argued that Argentina could only use the measure if it could effectively prove the existence of damage to its domestic industry. Since textile imports from Brazil fell during the first five months of 1999, it seemed difficult to sustain the argument that damage was incurred. The Brazilian government is waiting for the publication of the measure in Argentina's Official Bulletin before requesting its revision. According to figures from the Brazilian Textile Industry Association (ABIT), in 1998 Argentina exported US$ 340 million in textile products to Brazil and imported US$ 350 million.

D. Initiatives for Policy Harmonization and Convergence

Automotive regime

The negotiations for the implementation of a Common MERCOSUR Automotive Regime are not yet finished. It should come into force on 1 January 2000. The common automotive regime will be based on three pillars: (i) intra-zone free trade; (ii) equal treatment for products from outside MERCOSUR; and (iii) the absence of national incentives which distort competitiveness.

To date, the following conditions have been agreed: vehicles imported by MERCOSUR from third countries will have to be taxed with a CET of 35% (the maximum rate allowed by the WTO); extra-zone imports of parts, spares and components – including tires – will have tariffs of 14%, 16% and 18%; tax subsidies will not be granted for the establishment of new factories; from 2000, the granting of new incentives will be conditional upon the approval of all the countries in the bloc.

The most controversial points of the agreement are related to the use of tax incentives by countries and to the definition of the national content index of vehicles.

There is a degree of consensus about the necessary prerequisites for a product to be considered as originating in the sub-region: vehicles produced in MERCOSUR will be those that have a sub-regional content index of 60% – that is, those whose production contains at least 60% of parts and components made in the sub-region.

Argentina, however, argues that the content of national parts, within the sub-regional percentage should be at least 50%. Brazilian negotiators continue to maintain that the sub-regional content should be 60%, independently of the origin of the parts or components. Pressing this position, in May 1999 the Brazilian government re-issued Decree 195/98, according to which parts from MERCOSUR are considered local for the purposes of calculating local content.

The Argentine government also advocates "compensated trade", so that for each Brazilian car that enters the local market, 3.5 or 4 Argentine vehicles should enter Brazil.

Discussions also focus on the time when the non-application of subsidies and the definition of the adaptation regimes for industries in Paraguay and Uruguay should come into force. For Brazil, a transition period of four years is necessary to enable progressive adaptation to conditions of fully free trade, especially for Paraguay and Uruguay, the sub-region's two smaller economies. With the adoption of the common automotive regime, Paraguay and Uruguay will also have to raise their tariffs considerably. They are demanding compensation, such as a more flexible timeframe for adopting the 60% sub-regional content index.

In August 1998, Brazil proposed that all production resulting from investment induced by tax exemptions, or by other mechanisms (to be agreed on after 2000) for attracting vehicle plants should be viewed as originating in third countries. In June 1999, the proposal to expand the fiscal incentives of the Brazilian automotive regime, so that Ford could open a new factory in the state of Bahia, reignited the row between the countries over the use of industrial promotion mechanisms and regional incentives in MERCOSUR. In June, the Brazilian Congress approved a provisional measure that changed the terms of Law N° 9440 of 1997. The law established 31 May 1997 as the deadline for the end of granting of tax incentives to firms that wanted to set up plants in the north-east region of Brazil; it was endorsed by the Argentine negotiators. The change really meant that the deadline for the use of tax incentives was being extended, which went against the agreement negotiated in MERCOSUR. At the beginning of July, the Argentine government sent an official note to the Brazilian foreign ministry, criticizing the subsidies and tax benefits that the country was going to give Ford to set up its factory in Bahia. Argentina maintains that the four countries of the bloc had already signed a resolution which, despite its somewhat declarative nature, reinforced the partners' commitment to abstain from applying incentives or subsidies that would distort foreign investment in the sector. The Brazilian government has defended this policy, arguing that it is a question of incentives to a poor region, which is compatible with WTO rules.

The automotive regime has a four-year transition period (from 2000 and 2004) within which the quota system for compensated trade will be eliminated. The period will also allow the countries of the bloc to harmonize their industrial policy instruments, in order to attract investment in a balanced and geographically even way. The proposal is to establish productive complementarity, with investment which facilitates the development of an automotive industry that is competitive in terms of price, quality and productivity, and which fosters the creation of an export platform for sales to extra-zone markets.

The Argentine and Brazilian automotive industries proposed that the common automotive policy should have a system of compensation for intra-subregional trade that is calculated in dollars rather than in units produced, as is currently the case. The two countries promised the WTO that they would liberalize their vehicle trade by 2000. In the meantime, the Brazilian Association of Automotive Producers (ANFAVEA), together with Argentine producers, supports the extension of the current regime in the two countries to 2003. A CET of 35% is already applied to imports of light commercial vehicles and vehicle bodies from third countries. There will also be a CET of 35% on buses, trucks, tow trucks and road tractors; and of 18% on agricultural tractors, combine harvesters and road machines. The document that proposes a new automotive policy for MERCOSUR by 2004 also envisages the elimination of discounts on and incentives for investment, the elimination of benefits on the import aliquot, and the opening of the balance of payments to free monitoring.

Since the beginning of negotiations on the implementation of a common automotive regime, there has been pressure in Argentina to extend the current policy, which is due to expire at the end of the year. The main argument of those who defend the continuation of the agreement is to impede the transfer to Brazil of firms established in Argentina. The continuation of the agreement would reinforce the tendency towards complementarity of the industry in the two countries, whereby "short series" are manufactured in Argentina and "long series" in Brazil. This would also provide the time necessary to eliminate Brazilian national and state subsidies, as well as to harmonize macroeconomic policy.

In April 1999, the Argentine Association of Automotive Producers (ADEFA) asked the government to modify the “drawback” (tax refund) system for Argentine exports. Instead of receiving this in cash, they wanted compensation in the form of tax bonds and the application of a preferential aliquot so that vehicle plants in Argentina could import vehicles at a tariff of 17.5%, which is half the CET agreed by the MERCOSUR members.

Brazil, in line with Argentine requests, finally suspended PROEX export financing in April 1999 for passenger cars and trucks sold in MERCOSUR, and extended the period in which importers could redeem their foreign exchange contracts. The rebate on two federal taxes (PIS and COFINS) to exporters, viewed as a subsidy by the Argentines, was also extended. At the same time, the Brazilian authorities expressed their concerns at the possibility that Argentina would expand its drawback system.

In May 1999, the Exchange Plan came into effect in Argentina, giving discounts of up to US$ 4,800 to car owners whose vehicles were more than 10 years old and who were willing to exchange them for new, nationally made cars. Since then Brazilian plants have been trying to negotiate with Argentina, so that their vehicles can also be included in the plan; no agreement has yet been reached. The Brazilians allege that when the Brazilian government reduced the IPI on national vehicles, Argentine plants asked for and received the same treatment. According to Argentine plant data, in June about 70% of the vehicles transferred to dealers were locally made, which amounts to a significant increase in the share of national cars in total sales.

During a meeting of the sector’s representatives in Buenos Aires in June 1999, the ADEFA and ANFAVEA drew up new proposals for the pending issues of the common automotive regime. The document, which will be presented officially to the government of each country, suggests the implementation of a trade monitoring scheme to be based on agreements between plants under government control, both for finished vehicles and parts. The two associations decided to ask the Argentine government to extend the benefits of the Exchange Plan to products made in Brazil.

Social and labor rights

One of the main results of the fifteenth meeting of the Common Market Council in Rio de Janeiro in December 1998 was the signing of the “MERCOSUR Socio-labor Declaration”, wherein the member countries adopted individual and collective principles and rights in the workplace, including child labor, trade union freedom, collective bargaining, the right to strike and professional training.

Rules of origin

Until 31 December 2000, all intra-MERCOSUR trade will remain subject to certification of origin. It was agreed during the fifteenth Meeting of the Common Market Council in December 1998 that from the end of 2000 the certificate of origin will only apply to: (i) products included in the CET convergence regime; (ii) products using inputs that were also in the convergence process; (iii) products subject to differentiated import policies – that is, products that were being levied with anti-dumping, anti-subsidy or safeguard duties; and (iv) those that fall under bilateral trade agreements not adapted to MERCOSUR norms. The governments are also still obliged to inform the Trade Commission which products satisfy these criteria. The end of the origin regime requirements for intra-subregional transactions eliminates one of the main distortions of the MERCOSUR trade regime. It is well known that a Customs Union is incompatible with the certificate of origin requirements for products circulating in the sub-regional market.

Adaptation regime

On 31 December 1998, Argentina and Brazil's adaptation regime came to an end. The mechanism had enabled the countries to keep some products outside the intra-subregional free trade regime. Hence, from January 1999, all Argentine and Brazilian imports from MERCOSUR countries are exempt from import tax. The adaptation regime for Paraguay and Uruguay will last until 31 December 1999.

Sanitary and phytosanitary controls

Through Resolution N° 77/98, the Common Market Council decided to negotiate an equivalence regime agreement for sanitary and phytosanitary control systems, in addition to agreements on mutual recognition of procedures for testing compliance. The principles, guidelines and parameters for the equivalence agreements should be defined before the end of 1999. The mutual recognition agreements will be signed once the members have identified the areas or sectors where there is a duplication of product certification.

Consumer protection code

In December 1998, norms on "contractual guarantees" were approved. These are offered by goods producers or service providers. According to Resolution 42/98, the MERCOSUR countries should transpose this norm into their own legal frameworks on consumer rights by 31 December 1999.

Export subsidies

In order to reduce the tension caused by the devaluation of the real, the Brazilian government agreed to two concessions that the Argentine government had been requesting for some time: a change to the benefits for products exported to the MERCOSUR countries, and the broadening of financing for importers bringing in goods from Argentina, Uruguay and Paraguay. The measure was announced during the São José dos Campos presidential meeting (see chapter IV). The Brazilian government gives financing to exporters through PROEX, which equalizes interest rates with those in lower risk markets (the volume of these operations is falling). The government also refunds ICMS, PIS and COFINS payments. As a result of the effects of the devaluation, Brazil agreed to cancel export financing operations through PROEX for the MERCOSUR countries, apart from capital goods exports.

Reciprocal Credit Agreement

In April 1999, the presidents of Argentina and Brazil decided to continue to exclude MERCOSUR products from the Reciprocal Credit Agreement (*Convenio de Crédito Recíproco*, CCR). This requires the importer to pay a deposit equal to the value of operation as a guarantee. Argentina determined that from 1999, imports would only be subject to the CCR when the bank responsible for the foreign exchange made a deposit equivalent to 100%, or 120% in the case of public bonds.

As well as covering the credit risk, the CCR also covers country risk – that is, if the central bank of the purchasing country does not honor its commitment, the central bank of the vendor country guarantees payment to the exporter. The CCR functions as a clearing house. The bank responsible for the exchange and for remitting or receiving foreign currency resources does not carry out the operations directly with the bank representing the counterpart. The operations are conducted by the respective central banks, which liquidate the net value after four months.

The Brazilian government is trying to prevent Argentina from extending to MERCOSUR the restriction adopted in January for paying for imports through the CCR, which is in force among the Latin American central banks. The end of restrictions for MERCOSUR was foreseen for 4 June, but Argentina delayed its extension to MERCOSUR for another three months.

Private sector negotiations and agreements

- Common safeguard regime for footwear

MERCOSUR footwear manufacturers proposed the implementation, from 1 January 1999, of a common safeguard regime to curb imports of Asian products. The main measures establish a CET of 35% for footwear imports into MERCOSUR and a maximum of 40% for imported components of the goods. Such a measure already exists, but is not enforced. In addition, firms in the sector want a zero tariff for capital goods imports from outside MERCOSUR.

- Textile industry

On 25 October 1998, representatives of the textile industry debated a series of measures to be discussed with the governments of the member countries. The main issues were: (i) a reduction in the tariff on textile machinery; (ii) the rules of origin for products from the Andean countries; and (iii) the creation of a credit line to boost exports.

An import aliquot of up to 6% was proposed for textile machinery (compared with the 20% and 14% imposed by Brazil and Argentina) and the implementation of common customs valuation systems for these products.

The textile sector aims to keep the Brazilian market open to purchases of Argentine and Paraguayan inputs. Cotton producers of both countries are negotiating with several Brazilian buyers to reduce operating costs, which are more expensive following the devaluation of the real and Argentina's temporary exit from the CCR system.

- Paper and cellulose

Representatives of the paper and cellulose sector in Brazil and Argentina held negotiations in the first quarter of 1999 to reach a voluntary restraint agreement on sales of Brazilian printing and writing paper to the Argentine market. The initiative was a precautionary measure in view of the imminent possibility of a substantial surge in paper exports from Brazil to Argentina after the devaluation. However, the negotiations did not develop as the sectors had hoped and the restraint system could not be implemented.

- Milk and derivatives

In May 1999, MERCOSUR producers of dairy goods decided to pressure governments to increase the CET from 16% to 30% on imports of powered milk and cheese from third markets. In line with this proposal, dairy products will be placed on the CET exception list until 2006, when the aliquots will be gradually reduced. The producers signed a commitment to avoid triangular operations in imports of powdered milk and cheese, aiming thereby to overcome differences in the name of common interest. The formal adhesion of Chile gave greater weight to the proposal.

E. Trade Agreements and Common External Initiatives

One of the principles that should govern the operation of a Customs Union is the negotiation, as a bloc, of preferential trade accords with third countries. Last year, the difficulties involved in renegotiating the old preferential agreements between MERCOSUR and other members of the LAIA led to the conclusion of trade accords between individual MERCOSUR members and LAIA countries or trade blocs. The agreement between Argentina and Mexico in 1998, and that recently concluded between Brazil and the countries of the Andean Community, are two initiatives that reflect a break with the principle of the "4+1" negotiating format. This type of agreement could in the long run endanger the foundations of the Customs Union.
Although the strategy of negotiating as a group has been retained for the MERCOSUR-European Union negotiations on the creation of a free trade area, it is worth noting the modest progress made during the Summit of Heads of State in Rio de Janeiro in June 1999.

Argentina-Mexico trade agreement

Argentina re-established tariff preferences under LAIA's Economic Complementarity Agreement N° 06. The renewed agreement came into force in October 1998 and was extended until 31 December 2001.

The extension of the accord included the granting of tariff preferences by Mexico to Argentina as compensation for the preferences given by Mexico to the other NAFTA members. The preferences include some products in the food, machinery, equipment and chemicals sectors.

MERCOSUR-Andean Community negotiations

It was not possible to conclude negotiations for a free trade agreement between MERCOSUR and the Andean Community (*Comunidad Andina*, CAN) by the original deadline of 31 March 1999.

In view of this, and after more than two months of talks, Brazil separately negotiated a temporary tariff preference agreement with the CAN countries. This will allow a reduction of up to 100% in the import tax aliquot for a list of about 2,700 selected products. Some 2,000 products already have defined margins of preference. A substantial proportion of the negotiated tariff preferences affect products that are not considered sensitive. However, the list will also contain some sensitive products such as agricultural, steel and textile products. Brazil aims to preserve preferential access to the Andean market following the repeated renewals of the partial scope agreements negotiated bilaterally in the 1980s with each Andean country in the LAIA framework. The bilateral accords between Argentina and the CAN countries, and between Brazil and those same countries, are valid until 30 June 1999. Paraguay and Uruguay have already extended their respective bilateral agreements until 30 December 1999.

The new Brazil-CAN agreement will have a duration of two years, during which negotiations should progress for a MERCOSUR-CAN free trade area. The Brazilian negotiators hope that the accord with the CAN will encourage the other MERCOSUR countries to re-start talks with the Andean bloc and that the original "4+4" format can be revived.

MERCOSUR's unity in the negotiation of preferential trade agreements had already been eroded in December 1997, when Brazil decided not to renew the bilateral agreements with Mexico. In the interim, Argentina negotiated a trade accord with Mexico although negotiations with Brazil remained suspended.

MERCOSUR-European Union negotiations

Negotiations between MERCOSUR and the European Union (EU) began in December 1995 with the signing of an Inter-regional Framework Agreement on Economic and Trade Cooperation. For three years, negotiators of the two blocs assessed reciprocal trade flows, trade polices and legislation in the areas of goods, services and technical norms that could affect trade between the two regions. Despite some opposing internal pressure, since then the EU has concentrated its efforts on the negotiation of a free trade agreement with MERCOSUR.

The EU's General Affairs Council, which brings together the foreign ministers of the fifteen member countries, approved an agreement to start negotiations with MERCOSUR on 1 July 2001 for tariff reduction and conditions of market access for goods and services. During the Summit of EU Heads of State and Government in Germany in the first week of June 1999, France had vetoed the start of negotiations with MERCOSUR since it felt that the agreement could endanger agricultural incentive mechanisms under the Common Agricultural Policy (CAP). The CAP consumes some $60 billion of the EU's budget every year. The first French proposal suggested that the talks should start in July 2003. Until then, biregional dialogue should be limited to issues such as food security, phytosanitary rules and non-tariff barriers. Not until 2003, when the Millenium Round negotiations have finished, should MERCOSUR and the EU deal with issues such as market access for agricultural products and the lowering of barriers to industrial products and services. The French strategy was supported by domestic producers. They alleged that they could not compete with MERCOSUR products, especially meat, dairy products and vegetables, which represent about 40% of MERCOSUR's exports to the EU.

The Europeans want at all costs to avoid an upsurge of US influence in the continent. They therefore want to negotiate, within a maximum of six years, a free trade agreement with MERCOSUR as a means of counteracting the FTAA initiative. In the June meeting of the Common Market Council, the presidents of the four MERCOSUR countries also reaffirmed their political will to continue negotiating with the EU, despite the crisis and the intensification of internal trade conflicts following the modification of Brazil's exchange rate regime.

One of the points to be negotiated in a future MERCOSUR-EU trade agreement are Brazil's 35% import tariffs, consolidated in the WTO since the Uruguay Round. The MERCOSUR countries could reduce this rate for industrial products in exchange for European concessions in the agricultural sector, beyond the 20% maximum MERCOSUR tariff for almost all products – except those on the list of exceptions. MERCOSUR's attempts to negotiate better market access for agricultural products is supported by Italy, Germany, Portugal and Spain. In addition to changes to the agricultural barriers, the MERCOSUR countries are interested in discussing the criteria used by the EU for applying the WTO instruments against unfair trade practices -dumping and subsidies.

In principle, negotiations for the creation of a free trade area between the blocs should be concluded by 2005, when trade liberalization will begin. As in the FTAA negotiations, the MERCOSUR members argue that the MERCOSUR-EU agreement should respect the single undertaking principle, according to which nothing can enter into force until everything has been agreed. Since it is hoped that the Millenium Round will end in 2003, the proposed timetable agreed by the EU will enable the MERCOSUR members to compare and evaluate the results of the WTO negotiations, especially in the area of agriculture, with the proposed trade liberalization between the EU and the MERCOSUR.

The joint communiqué on an association between MERCOSUR and the EU, issued at the Rio Summit, does not refer to the creation of a free trade area between the two blocs. The text of the communiqué only mentions that the countries are committed to: “...forging closer relations with the aim of encouraging the increase and diversification of trade, by means of gradual and reciprocal liberalization of trade and promoting conditions which are conducive to the establishment of an Inter-regional Association, taking into account, in conformity with WTO rules, the sensitivity of certain goods and services”. Apparently the result of pressure from the French government, the exclusion of any reference to the implementation of a free trade area removes the countries’ obligation to promote broad inter-regional trade liberalization, and consequently ensures compatibility with the WTO’s rules on the attributes of a free trade area.

The communiqué also failed to fix a date for the negotiations to begin. Definition of the structure, methodology and calendar of the negotiations was deferred until the meeting of the MERCOSUR-EU Cooperation Council in November 1999. Neither did the document mention a deadline for completing the talks, although it is to be expected that they will not conclude before the end of the WTO Millenium Round, scheduled for 2003.

The joint communiqué preserves the commitment to negotiate the agreement as an indivisible whole and with simultaneous implementation, in line with the single undertaking principle that is advocated by the MERCOSUR members.

A European Commission study has estimated that a biregional free trade area involving a substantial lowering of agricultural barriers would guarantee a net welfare gain for the EU countries of about US$ 6.2 billion, and close to US$ 5.1 billion for the MERCOSUR countries. The main business opportunities for the Europeans are in services, a sector with strong growth potential in MERCOSUR over the coming years. According to the Commission’s assessment, the liberalization of trade and investment in this sector will bring benefits equivalent to those recorded over the past forty years with the liberalization of trade in goods. MERCOSUR will secure greater benefits from the lowering of market access barriers to its agricultural products.

Declaration of Montevideo

In September 1998, the ministers and secretaries for agriculture of the four MERCOSUR countries signed the Declaration of Montevideo on agricultural protectionism. In addition to reaffirming the importance of cooperation and policy coordination on agriculture, the representatives of the member states ratified the principle which establishes that only free trade will provide secure, genuine and lasting opportunities to increase the global supply of agricultural products. The growth in supply, at levels higher than that of world population growth, is crucial to solving world food problems. The countries proposed maintaining the positions outlined in the Declaration during the coming rounds of international negotiations, in order to facilitate clear progress in the liberalization of agricultural trade.

CHAPTER IV. AN ASSESSMENT OF THE CRISIS AND THE PROSPECTS FOR THE MERCOSUR INTEGRATION PROCESS

Of all the integration projects conceived in Latin America since the 1960s, MERCOSUR is the only (and therefore forceful) case in which negotiations managed make effective progress in deepening economic relations between the countries of the region. The most notable feature of the process has been the significant growth of intra-subregional trade (which increased from US$ 4.1 billion in 1990 to US$ 20.3 billion in 1997) and its consequences: market expansion, greater locational efficiency, a higher degree of integration and complementarity between national productive structures, a reduction in costs, greater product diversity and an increase in well-being. Argentina, Brazil, Paraguay and Uruguay, in terms of size, currently constitute the world's third biggest trading bloc, with a GDP of approximately US$ 900 billion and a consumer market of about 200 million people.

In a short period, from the negotiation of the first integration agreements between Argentina and Brazil in 1985 to the establishment of the Customs Union in 1995, the member countries have developed a form of inter-relation that amounts to a historical novelty, and that includes negotiation of clauses that guarantee a commitment to the maintenance of democratic regimes in the four countries.

It is undeniable that the establishment of MERCOSUR has vastly benefited from the conjunction of political and economic factors: the establishment of democratic governments in Argentina and Brazil from the mid-1980s, and the implementation of liberal economic reforms that fostered a greater opening of national markets. The end of the political tensions that marked relations between the countries of the Southern Cone, coupled to a perception that development models inspired by notions of autarky were exhausted, created a fertile environment for reviving relations between the governments on more solid bases and with a new agenda. This led to the negotiation of integration initiatives and to the joint implementation of measures geared towards the elimination of intra-subregional trade barriers and, consequently, the deepening of economic relations between the countries.

The results achieved to date can lead to the false conclusion that the work of integration has been completed. MERCOSUR's current crisis, unleashed by the modification of the exchange regime in Brazil, revealed the imperfections and frailties of the integration process. Notwithstanding the progress made in the negotiations and in market integration, MERCOSUR's present state indicates that the implementation of a full Customs Union in the sub-region still depends on a set of initiatives. The integration process is currently characterized by obstacles to intra-subregional trade flows, imperfections in the common external tariff, the low level of harmonization of trade policy instruments, and institutional weakness. In addition to such problems, trade disputes among the countries began to show signs of worsening last year, when a series of unilateral measures placed new obstacles in the way of sub-regional trade.

Since 1995, the negotiating authorities have had an inventory of the non-tariff barriers affecting intra-subregional trade, but the worsening constraints on the balance of payments became the main obstacle to the elimination of sub-regional trade barriers. As a general rule, as the external fragility of the economies increased, economic policy-makers erected new barriers to imports, without providing sufficient safeguards for preferential partners and without assessing the consequent effects on intra-MERCOSUR trade flows. In this context, it can be said that that the "unilateral" management of microeconomic policies, especially trade policy instruments, served to contain external restrictions and thereby compensated for the freedoms lost in the management of macroeconomic policies.

Such problems, coupled to the paralysis of the agenda for consolidating the Customs Union and the modest progress made in external negotiations to enlarge MERCOSUR, did not necessarily lead to the conclusion that the integration process was in crisis, since bilateral trade between the two biggest partners continued to grow at annual rates of over 20% up to 1997.

The first signs of a crisis that had long been foreshadowed became evident in 1998. The slump in trade between Brazil and Argentina was not seen, of itself, as a clearer warning of the exhaustion of the integration process. This was because trade with third countries declined even more, which increased MERCOSUR's relative importance as an export market for the two countries. Offsetting this, on the Argentine side, were indications of the risk of so-called "Brazil-dependence". The trial balloon launched by President Menem and his advisers, proposing a single MERCOSUR currency, looked to the future by pointing to the possible costs of a devaluation of the real, costs that would be avoided if Brazil were to opt for an exchange regime similar to that of Argentina (see Chapter IV).

The crisis in the international financial market and the constraints on the supply of credit following the Russian moratorium exacerbated conditions that were already broadly seen as "worrying". The change of direction in Brazil's economic policy, with the devaluation, directly affected the relative competitiveness of the countries and threatened the long-term operability of the integration process.

Some months after the changes to Brazil's exchange regime, a consensus arose around the idea that sub-regional economic relations were going through their most serious crisis since the signing of the Treaty of Asunción in 1991. There is no doubt that common sense prevailed, and that the governments were willing to forego hasty decisions that might have led to the imposition of indiscriminate barriers to sub-regional trade. Such a course could undoubtedly have meant the end of MERCOSUR.

Thus, even under the effects of the modification of the exchange regime in Brazil, the Argentine and Brazilian Presidents met in São José dos Campos (SP) to analyze the MERCOSUR integration process. They agreed that it was then premature to draw conclusions about the effects of the devaluation on trade relations between the two countries. In the "Presidential Declaration of São José dos Campos" they reaffirmed their interest in accelerating the agenda for consolidating MERCOSUR, and recognized the need to deepen market integration by liberalizing trade in services and by adopting a common policy on government procurement. The issue of macroeconomic policy coordination was also to return to the negotiations, since this was the only mechanism capable of ensuring the stability of competition conditions in the sub-regional market over the long term. The Presidents suggested that the economy ministers and the Central Bank Presidents should meet periodically so as to strengthen information exchange, and that they should prepare a joint proposal for regular monitoring of economic conditions in the four countries.

The Presidents also addressed matters related to the management of trade policies. As a measure for immediate implementation, they suggested the establishment of a special group consisting of representatives of the Under-secretariat for Foreign Trade of Argentina's Economy Ministry and of the Foreign Trade Secretariat of Brazil's Ministry of Development. This group was to monitor bilateral trade flows so as to assess the possible effects of the current changes in their economies and, if necessary, to suggest courses of action to minimize any negative effects. They also decided to establish a consultation mechanism to evaluate the use of intra-subregional anti-dumping instruments. Additionally, cooperation on commercial defense against third parties was to lead, as soon as possible, to the entry into force of harmonized instruments against unfair trade practices.

To minimize the effects of the modification of Brazil's exchange regime on intra-subregional trade flows, it was agreed that (i) Brazil would exclude from its Export Financing Program (PROEX) merchandise export operations for other MERCOSUR member states; (ii) Brazil would grant, no more than 24 hours after presentation of the necessary documentation, import licenses for goods originating in other MERCOSUR member countries; (iii) the Brazilian authorities would begin an analysis of the impact on the relative competitiveness of Brazil's exports to the other MERCOSUR member states of possible changes to the rebate to exporters on taxes such as the IPI, the PIS and CONFINS; and (iv) Brazil would adjust its import financing system, which obliges purchases of up to US$ 80,000 and with a 90-day payment term to be paid in cash; in fact Brazil had periodically renewed the Central Bank ruling that excluded the MERCOSUR countries from the application of this rule.

This all seems to suggest that the resolution of trade matters, the main item on MERCOSUR's negotiating agenda to date, will be subordinated to discussion of macroeconomic policy harmonization between the countries. The first steps in this direction have already been taken. In a bilateral meeting between the Argentine and Brazilian Presidents in the first week of June, some initiatives were announced with a view to the harmonization of the two countries' fiscal policies. This would begin with the enactment of the fiscal responsibility laws that are being examined by the national legislatures. Additionally, during the XVI Summit of Heads of State in Asunción in mid-June, the Presidents of the four countries approved other initiatives that suggest a real commitment to progress on macroeconomic policy coordination. A high-level working group was created (bringing together negotiators at the level of Central Bank management) with the aim of: (i) analyzing the economic policies of the countries, with emphasis on the question of the sustainability of the public and external accounts; (ii) formulating effective alternatives in terms of macroeconomic coordination; (iii) drawing up a work program that will aim to secure, gradually and over the long term, domestic policy convergence; (iv) the harmonization of macroeconomic and financial statistics; and (v) the provision of information on the methodological criteria adopted by each country in drawing up its relevant economic indicators. An *ad-hoc* group on "Monitoring the Economic and Trade Situation" was also created with the following responsibilities: (i) to examine the economic situation of the MERCOSUR countries and the evolution of the intra- and extra-zone trade flows; (ii) to update and harmonize statistical information on intra- and extra-zone trade; and (iii) to suggest agreed proposals on advisable courses of action.

Despite all the initiatives geared towards the inclusion of macroeconomic policy coordination on MERCOSUR's negotiating agenda, it cannot be said that the effects of the modification of Brazil's exchange regime on the countries of the sub-region have been overcome. An effective devaluation of the real of some 30% by the end of the year, combined with a decline in the Brazilian economy's absorption capacity, must disrupt Brazil's trade with the other MERCOSUR countries. Most significant will be the effects on the smaller economies – Paraguay and Uruguay – for which the sub-region represents a substantial portion of their exports. Hence Brazil will export its recession to the other countries of the sub-region, and the impact will be inversely proportional to the size of their economies.

MERCOSUR's historical experience has already revealed the risks stemming from a lack of convergence in the macroeconomic performance of the sub-region's two biggest economies. The implementation of the Convertibility Plan in Argentina in 1991 brought about a reversal in the trade balance. During the three-year period between 1992 and 1995, Argentina's accumulated trade deficit with Brazil reached US$ 2.7 billion. It was not more because the Argentine government and private sector threatened to erect barriers to Brazilian exports. At the same time, they put great pressure on Brazil to increase its purchases of Argentine products. The program for the purchase of Argentine petroleum by Brazil served to mitigate the problem, as well as the risks posed by the fact that the two countries' macroeconomic performances are out of step.

What lessons can be drawn from the current crisis? The danger that MERCOSUR might break up is a specter that frequently appears at times of difficulty. The position of some sectors of Argentine society are symptomatic in this regard, in that they have always invoked the greater risks (and costs) in choosing Brazil as a preferential trade partner, as against of the possible strategy of acceding to NAFTA.

In the short term, it is essential that the countries ratify the commitment they made in the Treaty of Asunción that they will under no circumstances set up barriers to intra-subregional trade which might compromise the achievements of the integration process to date. However, more precise rules should be negotiated, specifically as regards the use of commercial safeguards, of sectoral agreements that involve voluntary export restraints, and of sectoral restructuring programs. The aim would be to guarantee selectivity, transparency and limited periods for applying such instruments so as to avoid the dissemination of intra-subregional non-tariff barriers, even at times of crisis.

In the medium and long term, progress must be made on the consolidation of the Customs Union. MERCOSUR operates, in fact, as an integration program that combines features of an incomplete free trade area with a common external tariff that does not cover the entire tariff schedule. This circumstance is the result of a process pressured by time and compromised by a scarcity of resources. Such difficulties – which are inherent in any integration process – should not however curb initiatives geared to overcoming the current problems. It is fundamental that the negotiators reassess and reaffirm, as they are doing, MERCOSUR's strategic role, and that they strive to negotiate policies and to implement the necessary measures. The aim is to create conditions in which relations between private agents can lead to the deepening of economic integration between the countries. In this connection, the coordinated management of microeconomic policies in the sub-region offers the right way of eliminating the remaining obstacles to intra-subregional trade, and of creating comparative advantages that allow the opportunities spawned by the operation of the enlarged market to be exploited. This makes it possible to upgrade the model of international insertion pursued by the economies of the sub-region, to one that is geared towards sectors with greater technological content and greater dynamism in international trade.

MERCOSUR's current crisis and its repercussions should prompt a more careful consideration of the relationship between macroeconomic policy coordination in integrated economic areas and the effects of the management of other, microeconomic policies. Although in the future, when the present crisis is overcome, the countries might consider implementing mechanisms that ensure greater policy coordination in the exchange area (in line with the proposals of their own Presidents), it will be essential that MERCOSUR attains a higher level of microeconomic policy convergence. This is necessary to obviate situations in which national-level instruments distort the relative competitiveness of industries located in the different countries of the sub-region, and that consequently undermine the maintenance of the exchange rate parities already negotiated. In fact, not even a convergence of macroeconomic performance is enough to establish stable competition conditions if the development models and the policies applied by the various countries differ among themselves.

Hence in the current context, which combines an acute crisis with structural problems, much remains to be resolved, and the deepening of the integration process might be synonymous with its "survival". This therefore seems to be the task of consolidating MERCOSUR: betting on its future success entails reassuming commitments and implementing effective initiatives now, as a means of preserving its role as a strategic initiative for the economic and social development of its members.

CHAPTER V. ON THE POSSIBILITY OF MACROECONOMIC POLICY COORDINATION IN MERCOSUR

After the devaluation of the real and the subsequent application of the word "crisis" to the Brazilian economy, the press and some members of the academic community issued a series of alarmist predictions that envisaged a whole series of pessimistic scenarios for the country, for its partners and for the integration process. More sober observers, although equally pessimistic about the "domino" effect of the crises that began in Asia and that eventually struck Brazil, do not believe that MERCOSUR is about to break up. The direction that the bloc takes in the post-crisis period might be uncertain, but MERCOSUR's survival is not in doubt.

Since 1997 there has been a growing consensus around the idea that MERCOSUR, in its current state of integration, might be deficient, unable to produce equitable benefits for its member countries or to function as a strategic source of economic development for the sub-region as a whole. This situation gave rise to proposals to "deepen" sub-regional integration, first by improving the customs union and then by advancing towards a coordination of macroeconomic policies that would lead, in its maximum expression, to a monetary union of the kind now prevailing in Europe.

The idea of a MERCOSUR monetary union acquired a more official expression when the President of Argentina broached it in December 1997 at the meeting of the Common Market Council in Montevideo. The Brazilian response on that occasion could be characterized as cautious. With the devaluation of January 1999, the Argentine proposal for a common currency and other options for managing monetary policy regained their immediacy as a strategy to deepen MERCOSUR in the short and medium term.

Moreover, the Argentine position in favor of dollarization at the national level, the sudden modification of the exchange regime in Brazil, and the proposal for a common sub-regional currency, were seen as possible means of protection against the dangers of what became known as "Brazil-dependence". With an average of 30% of Argentine exports going to Brazil before the devaluation, the concerns provoked by the change in Brazilian monetary policy were justified.

On 7 June 1999, the Argentine and Brazilian heads of state jointly announced their intention to embark on what President Cardoso termed a "Little Maastricht", an attempt to coordinate the macroeconomic policies of the two countries with the aim of launching a common MERCOSUR currency at an unspecified future date. This convergence of the two countries' policies can be attributed to mutual recognition of the need to give a measure of sustainability to what is seen as a strategically relevant association between neighbors.

The declaration of the "Little Maastricht" is possibly the most potent official statement on the integration process to be made in 1999, although it clearly does not eliminate all the uncertainties. It can also be interpreted as an attempt to secure greater credibility in view of the imminent meetings between MERCOSUR and the EU in Rio de Janeiro at the end of June. Although such interpretations might be correct, it is also true that the Presidents' statement reflects an appreciation of the scope of the current situation on the part of the diplomats and academics of the two countries, according to which:

- better integration is preferable to disintegration, and
- greater coordination of macroeconomic policies is necessary to ensure MERCOSUR's operability, sustainability and development.

The statement should therefore be interpreted as substantial, and as the appropriate means of prompting a discussion of the deepening of integration and the coordination of macroeconomic policies.

As to whether the outcome of these activities will be the establishment of a common currency, the matter is probably still subject to extensive discussions in the academic community and in the decision-making circles of the integration process. Although the steps proposed for deepening integration, without necessarily leading to a single currency, are (as is analyzed below) concomitant with the strategy of monetary union or even included in such a strategy, the validity of integrating the sub-region's monetary systems is part of an extremely complex debate.

To make internal progress on the structure of a monetary union not only deepens MERCOSUR in ways on which all sides must agree but also, because of its clear calendars and aims, could become a very useful instrument for promoting timely policy-making, as well as the prompt implementation and enforcement of the necessary structural reforms. Moreover, a monetary union, albeit remote, is quite an "attractive" goal in terms of its benefits for the sub-regional economy, which could be used to "sell" the more difficult reforms domestically and internationally.

Finally, it is a commitment that confers a significant degree of credibility on the economies of the sub-region in the eyes of international investors and creditors. That, in turn, affords greater stability and fewer interruptions or delays in the integration process.

The common goals, from the debate's various sectors of opinion, would be as follows:

A) **The pending agenda** consists of: (a) completing the customs union by eliminating obstacles to intra-subregional trade and by consolidating the CET, and (b) the so-called "new issues", which include: common industrial and competition policies; government procurement; free trade in the services sector; and the harmonization of legislation in the areas of tax, labor and capital markets in order to foster the free flow of the factors of production.

B) **The standardization of statistical indicators** so as to allow more precise comparisons of the member countries' macroeconomic variables, which in turn would facilitate the initiation of the following point.

C) **Macroeconomic policy coordination** that would consist of establishing common goals for inflation indices, as well as fiscal and current account deficits, in order to equalize the performances of the participating economies. To that end, the creation of a Macroeconomic Coordination Committee has also been proposed.

Given these common goals, the initiative to unify the monetary systems of the MERCOSUR countries is only appropriate and constructive to the extent that it does not obstruct the continued progress of the integration process and that it appears formally on the official agenda at such a time as some reasonable degree of progress has been made on the issues outlined in the three points above.

However, the activities indicated in those three points cannot be embarked upon in the current absence of appropriate conditions for laying the foundations of a monetary union:

The inflation index must be brought to international levels (around 3%) to ensure its permanence, but such a level should be reached by establishing independent Central Banks in the whole sub-region. This measure would insulate monetary policies from the political pressures related to business cycles, thus eliminating possible inflationary turbulence. Moreover, it would serve as a test of the ability of the national governments to work with an independent sub-regional Central Bank.

- Linked to the above, a self-sufficient financial sector is necessary to protect the independence of the Central Banks in the face of inflationary pressures. In this sense, it is useful to have macroeconomic coordination in fixing debt and deficit limits, although only indirectly.

- Legislation that fosters the free movement of factors of production (e.g. labor) should be supplemented by greater flexibility of prices and wages. These two measures would replace exchange rate modifications as a mechanism for adjusting relative prices.

- Solid exit barriers should be erected in order to ensure a commitment to monetary union – and, therefore, to stability – by building a linked network of economic and political agreements that would hold firm if a country were to abandon the single currency. This implies a broader and deeper institutional structure to consolidate the formulation, implementation and enforcement of common policies, including economic, foreign and social policies, to name just a few.

- Finally, there should be a harmonization of domestic exchange rate policies before the single currency is launched.

With respect to the first three considerations there has been significant progress in the last years. There is currently some dispute, however, about the other two points, particularly in view of the various asymmetries between the MERCOSUR countries. Should the moment arrive, the disproportionate scale of the Brazilian economy in relation to the other countries could surely make it difficult to determine the structure of the necessary supra-national or other institutions. In the case of Argentina, if the currency board were retained, the greatest difficulty might concern the negotiation of a common exchange policy prior to the adoption of a common currency.

The tasks involved are undoubtedly difficult. In the meantime, the future growth of intra-subregional trade and the search for a deeper union could make exchange rate fluctuations increasingly turbulent, thereby undermining support for deepening the customs union. When there has been a significant measure of success on points A, B and C, therefore, consideration of monetary union (thus fostering progress in the other areas indicated above) will not only be a more tangible goal but also a prerequisite for deeper integration and cooperation.

If, on the other hand, the incomplete customs union were to remain in its current state, monetary union would have to be ruled out as unnecessary. In such a case the variability of exchange rates would be less important, but its consequences would nevertheless be felt sooner or later. Despite the fact that the effects of the Brazilian crisis have taken time to emerge, a 30% devaluation of the bloc's main currency cannot be without effect. In the absence of rigorous measures in pursuit of macroeconomic coordination and eventually (it being a necessity) of monetary union, protectionist reprisals and the consequent rolling back of the achievements made to date could disintegrate the customs union. The "Little Maastricht" reflects an understanding of this, and the dangers that such a situation poses for the development of the sub-region.

BIBLIOGRAPHY

BONELLI, RÉGIS. "Estratégias Empresariais no Mercosul: um estudo dos processos de fusões e aquisições, *joint ventures* e privatizações no Cone Sul". Expert report prepared for ECLAC. Rio de Janeiro (mimeo). 1999.

CENTRO DE ESTUDIOS PARA LA PRODUCCIÓN – CEP. "La Inversión Extranjera en la Argentina de los Años 90: tendencias y perspectivas", in *Estudios de la Economía Real* Nº 10. Buenos Aires. October 1998.

CEPAL. "La Inversión Extranjera en América Latina y el Caribe". Informe 1998. Santiago de Chile. 1998.

CNI. *Economia Brasileira. Desempenho e Perspectivas*. December 1998 and June 1999.

CONFEDERAÇÃO NACIONAL DA INDÚSTRIA - CNI. *Fax Mercosul*. Various issues. Rio de Janeiro.

GAZETA MERCANTIL. Various issues. São Paulo.

GAZETA MERCANTIL LATINO-AMERICANA. Various issues. São Paulo.

INTAL. *Monthly Newsletter*. Various issues. Buenos Aires.

__________ . *MERCOSUR Report N° 4*, January-June 1998. Buenos Aires.

LAVAGNA, ROBERTO. "Etapa Difícil para Converter em Oportunidade", in *Revista Brasileira de Comércio Exterior Nº 59*. Fundação Centro de Estudos do Comércio Exterior. Rio de Janeiro. 1999.

MACHADO, JOÃO BOSCO M. "Intercâmbio Comercial e Política Industrial em Espaços Econômicos Integrados: o caso de Mercosul". Doctoral thesis. Instituto de Economia of UFRJ. Rio de Janeiro. 1999.

VEIGA, PEDRO DA MOTTA. O Mercosul em perigo, in *Revista Brasileira de Comércio Exterior Nº 59*. Fundação Centro de Estudos do Comércio Exterior. Rio de Janeiro. 1999.

APPENDIX

URUGUAY AND MERCOSUR

1. INTRODUCTION

Over the last 25 years, Uruguay has undergone a series of significant transformations. This has been a gradual process, although sustained since the beginning of the 1970s, in response to the long period of stagnation which clearly exposed the limitations of a development strategy based on import substitution. The economy began to be liberalized from then on, a process characterized by the opening up of the capital account of the balance of payments, banking reform, trade opening, and sub-regional integration.

Some of these reforms were introduced quickly, particularly the opening up of the capital account and the total liberalization of financial transactions overseas. The country was one of the first in South America to opt for a strategy of complete insertion into the international capital markets. There were three main consequences of this: first, it provoked a significant restructuring of the banking sector and boosted Uruguay's position as a sub-regional financial center; second, the economy was almost completely dollarized; third, it increased external financing sources for the economy, particularly for the public sector.

The trade account of the balance of payments was liberalized very gradually over a period of almost 20 years. MERCOSUR represents the final stage in this process, which will result, by the end of a ten-year period that began in 1991, in the complete opening up of the Uruguayan economy. Given the size of Uruguay relative to its neighbors, and despite the entry into force of the external tariff, the opening up of the sub-region is equivalent to a complete multilateral opening, at least in terms of the adjustments that need to be made in order to reflect changes to the competitive environment.

Uruguay has a relatively diversified structure of production, including a significant agricultural-livestock sector and a reasonably high level of industrial development, especially in the agro-industrial sector. Economic opening has also led to the development of industrial activities geared towards non-agricultural exports to the sub-region. This has been based on the industrialization of imported inputs.

Services account for the largest share of GDP, especially energy and telecommunications, as well as financial, transport, and warehousing services. The natural features of the Uruguayan coast have also enabled the country to create a highly developed tourist sector, which has helped boost other domestic activities.

Economic opening and liberalization had diverse effects on the economy. They helped bring to an end the stagnation of the 1970s and created a pattern of economic growth that since 1984, and in per capita terms, has been one of the highest in Latin America. The production of commercial goods, which was particularly affected by import substitution, grew rapidly due to specialization and economies of scale.

Foreign trade not only grew significantly in terms of volume, but was also subject to a series of structural reforms. Of particular importance in this respect was the change in the destination of exports, which coincided with greater product diversification. MERCOSUR, and Latin America in general, have become increasingly important as export markets. At the same time, exports now consist of an increasingly diverse mix of manufactured products.

The strategy of stimulating investment was based on giving access to capital goods and inputs at close to international prices. Consequently, the import of capital goods increased, especially in the 1990s, reflecting the significant rise in investment registered by the economy. These factors emerged principally as a result of sub-regional integration and coincided with the opening up of Argentina and Brazil to the rest of the world.

In recent years, economic policy has emphasized the creation of a stable environment. It has sought to do so by reasserting macroeconomic equilibrium – after decades of disequilibria marked by persistently high rates of inflation – and by making the economy less vulnerable to negative external shocks. Both of these objectives have been pursued through the control of public finances.

The social security system has been reformed over the last five years. This has involved the partial replacement of the previous redistributive system with the capitalization of individual accounts and privately administered funds which, while placing additional demands on public finances in the short term, ensures their solvency. The level of public debt, after the critical situation that existed at the beginning of the 1980s, is now barely above 20% of GDP, and is still falling.

Uruguay's incorporation into MERCOSUR was the inevitable outcome of the ever closer political and trade ties between Argentina and Brazil. However, Uruguay's integration also reflected its own geography and history, notably its long-standing desire to become an autonomous part of a greater Latin American whole.

MERCOSUR has helped boost the development of a range of productive activities in the country, and has also helped Uruguay regain its position as the geographical center of a sub-region that has the greatest concentration of population and that is the main source of value added. Uruguay is the river-maritime link of the River Plate Basin, with strategic ports on the River Plate and at the mouth of the Paraná-Paraguay waterway. As such, Uruguay is keen to become a privileged entry and exit port for MERCOSUR.

In order to convert these strengths into opportunities, the government has introduced a number of economically important structural reforms, including a redefinition of the role of the state in the provision of infrastructure, social security reform, and the development of the capital market.

The provision of infrastructure has been radically reformed, with the private sector playing a role in the financing and management of transport services, as well as the management of infrastructure. Infrastructure financing, which has traditionally involved only public sector resources, has now been opened up to the private sector, mainly through concessions for public works on toll roads and concessions for the management of ports, airports and electricity generating companies. The following projects are on-going: the Paraná-Paraguay waterway; the highway between São Paulo and Buenos Aires (including the Colonia-Buenos Aires Bridge); railway interconnection; port development; the upgrading of Montevideo airport; and the interconnecting of the natural gas and electricity networks.

Social security reform has a part to play in this strategy, with domestic savings making available the necessary resources to part-finance this investment. This is complemented by a systematic policy of developing the institutions and instruments of the capital markets, allowing resources from pension funds to be used in projects associated with transport infrastructure and electricity generation.

MERCOSUR forms a key part of the country's development strategy. From the Uruguayan perspective, MERCOSUR represents two dimensions: first, the integration of infrastructure and the accompanying liberalization and growth of trade between the countries of the sub-region. This aspect of integration, which resulted from changes in the political relationship between Argentina and Brazil, is firmly consolidated and forms one of the most important pillars of the country's long-term development strategy.

The second dimension concerns the type of integration. MERCOSUR adopted the form of a Customs Union, the deepening of which requires a high level of commitment to economic liberalization and a certain loss of autonomy in implementing national strategies and economic policy, even beyond that which domestic policy constraints, particularly in the larger countries, appeared to allow.

The specific type of integration adopted in the Southern Cone is now at a crossroads. From the perspective of a small country such as Uruguay, the optimum model would be a consistent one, compatible with the domestic policy constraints of the member countries, rather than a precisely defined model.

Uruguay has to commit itself to a consistent model in which the costs and benefits are shared equally and the development capacity of all MERCOSUR members is promoted, without detriment to any one country. The model should also enable integration to be extended throughout Latin America and to increase the global integration of the subcontinent. If the current model becomes inconsistent and fails simultaneously to satisfy all these objectives, it might become a threat to the future development of the country.

2. URUGUAY'S ECONOMIC EVOLUTION

This section outlines the development of the Uruguayan economy from import substitution to opening. It examines the main structural changes that have occurred in recent years and concludes with current developments.

The main characteristics of Uruguay's economy and society will be examined first. For the purposes of a proper understanding of the current situation, and of possible future developments, it is important to note that this situation has not come about through any sudden or dramatic change in economic policy, but rather through a series of gradual and sustained reforms. These reforms, initiated in the 1970s in response to a prolonged period of economic stagnation, have evolved consistently over the last 25 years.

The second part of the section examines this development, principally in terms of output, overseas trade, and the two main factors of production: capital and labor. In order to supplement the description of the economy, as well as the longer term trends, the third part of this section analyses the main aspects of economic policy and the recent evolution of the economy.

Prominent Features of the Uruguayan Economy

Uruguay is a small country with a land surface of just over 175,000 km^2 and a population of 3.2 million. Its size is all the more significant given that there are no natural geographical features marking the borders that its shares with its two large neighbors, Argentina and Brazil. Uruguay is located in the center of the sub-region that has the greatest concentration of people and that is the main source of value added. It also has good communication links with the sub-region. It thus occupies a privileged location within MERCOSUR.

Its GDP is approximately US$ 21 billion, which represents US$ 6,400 per capita, making Uruguay a middle income country. This income is distributed fairly evenly among the population, with distribution levels similar to those of the European countries.

Uruguay also has several demographic and cultural similarities with more developed countries: 97% of the population over 10 years old is literate; life expectancy at birth is 74 years for both sexes, with life expectancy rising to 80 years for those aged 60. Birth and mortality rates are low, with a net balance that entails a slow rate of population growth. Indeed, between the last two censuses, it rose by only 0.64% per year.

TABLE 1

Uruguay's main characteristics	
Territory in thousands of square kilometers	175.25
Population in millions of people (1996)	3.2
Rate of population growth (1985 to 1996)	0.644%
Gross birth rate (1996)	1.87%
Gross death rate (1996)	0.98%
Life expectancy at birth (both sexes, 1996)	73.5 years
Life expectancy at 60 years (both sexes, 1996)	79.8 years
Infant mortality rate (1996)	1.75%
Literacy rate (% of population over 10 years)	97%

Source: Central Bank of Uruguay and the National Institute of Statistics.

Production is diversified, but based on agriculture. This has led to the significant development of agro-industrial complexes, with a high level of product diversification. Manufacturing industry generates 18% of GDP, followed by real estate services and services to companies (17%), trade, restaurants and hotels (12%), personal and community services (11%), government services (10%), financial and insurance services (9%), agriculture, livestock and fisheries (9%) and transport, warehousing and communications (7%).

As regards foreign trade, in 1998 the export of goods and services amounted to US$ 4.2 billion (20% of GDP). The export of tourism-related services, measured according to the travel category of the balance of payments and which consists of a number of activities, accounted for US$ 695 million. Transport services, also measured in terms of the balance of payments, totaled US$ 341 million in 1998. Among goods exports, the most significant were those of the refrigeration industry (US$ 509 million), the rice mills (US$ 244 million), wool and textile products (US$ 237 million), leather products (US$ 197 million), the dairy industry (US$ 182 million), automobiles and automobile parts (US$ 170 million), and the clothing industry (US$ 124 million).

The diversity of productive sectors and of exports extends to the size and number of companies operating on national territory, where the principal operators from each sector are located and oligopolies predominate. This company structure has been forced to confront the realities of integration and the opportunity to increase market scale, prompting a process of transformation in the size and style of companies.

Table 2 provides a summary of the principal macroeconomic variables for the last five years. GDP grew by an annual average of 3.8% during this period, with higher rates of 5% in 1996 and 1997. Inflation has continued to fall gradually from a high of 40% to single figures, an objective reached in 1998.

The trade balance for goods was in deficit during the five year period (US$ 762 million in 1998), but this was partially offset by the net income from tourism, which reached US$ 430 million in 1998. The current account of the balance of payments was also in deficit throughout this period, although at a limited and logical level given the scale of the capital inflows entering the economy during this period. The current account balance reached the equivalent of 1.9% of GDP in 1998.

The payment of foreign interests and dividends has not been a problem in the 1990s, since the net external debt is low relative to GDP. One of the main components of the external debt is that corresponding to the obligations of the non-financial public sector (see Table 2), which at the end of 1998 amounted to US$ 5.3

billion. If the international reserves held with the Central Bank are excluded, there is a net level of indebtedness to the non-financial public sector that has remained relatively constant in dollars and has, therefore, fallen in terms of GDP. This stood at 12.9% in 1998.

TABLE 2
SELECTED INFORMATION ON URUGUAY
(in US$ millions)

	1994	1995	1996	1997	1998
Gross Domestic Product					
In US$ millions	16,255	18,036	19,117	19,959	20,831
Real annual variation	6.3%	-1.8%	5.3%	5.1%	4.5%
Annual Price Variation					
Consumer	44.1%	35.4%	24.3%	15.2%	8.6%
Wholesale	41.0%	27.7%	23.5%	13.3%	3.3%
Average salary index	42.6%	33.5%	26.0%	16.2%	10.4%
Exchange rate	27.4%	26.5%	22.7%	15.1%	8.3%
Labor Market					
Activity (% pop. over 14 years old)	58.2%	59.0%	58.2%	57.6%	60.4%
Employment (% pop. over 14 years old)	52.8%	53.0%	51.3%	51.0%	54.3%
Unemployment (% of active population)	9.2%	10.3%	11.9%	11.4%	10.1%
Balance of Payments					
Exports (FOB)	1,913.5	2,147.6	2,448.5	2,793.1	2,832.3
Imports (FOB)	2,599.6	2,710.6	3,135.4	3,497.5	3,594.2
Trade balance	-686.1	-563,0	-686.9	-704.4	-761.9
Tourism balance	397.8	374.3	524.8	495.2	429.9
Income balance	-243.1	-227.1	-188.7	-192.7	-185.0
Other services balance	92.8	200.3	117.4	123.5	116.9
Current account balance	-438.6	-215.5	-233.4	-287.4	-400.0
Capital account balance	671.9	403.9	224.7	538.9	681.1
Balance of payments	238.0	209.4	143.8	330.4	361.9
International Reserves and External Debt					
International reserves of the Central Bank	1,679.2	1,818.0	1,915.7	2,066.8	2,589.3
External debt of the non-financial public sector	4,251.4	4,425.6	4,682.4	4,753.7	5,275.1
Monetary Variables (at the end of each year)					
Emission	588.4	663.7	600.1	648.0	660.9
M1	1,111.2	1,163.1	1,229.2	1,249.0	1,338.3
M2	1,790.3	2,017.7	2,064.4	2,121.4	2,286.9
M3	6,185.8	6,403.6	7,254.6	8,110.5	9,131.6
Public Finances					
Central government income	3,032.5	3,368.8	3,659.1	4,080.6	4,369.0
Central government expenditure	3,371.3	3,742.4	4,032.8	4,419.7	4,628.9
Financial balance of the central government	-338.8	-373.6	-373.7	-339.1	-259.9
Financial balance of the total public sector	-436.3	-281.4	-294.7	-282.8	-188.3

Source: Based on data from the Central Bank of Uruguay and the National Institute of Statistics.

The country's remaining external debt is primarily with the public and private financial sectors. Given that Uruguay is a regional financial center with substantial offshore activities, the financial sector has high foreign liabilities, but these are offset by assets in terms of investment from abroad. At the end of 1998, non-resident deposits in private commercial banks reached US$ 4.4 billion. The private banking system also has international reserves of US$ 3.9 billion and other assets with non-residents worth US$ 3.2 billion.

The high level of capital inflows has not only financed the current account balance, but has enabled the net international reserves held by the Central Bank to expand, thereby increasing the capacity of the economy to respond to external shocks. At the end of 1998, the Central Bank of Uruguay held international reserves of US$ 2.6 billion. A comparison of reserve levels with total imports, annual external payments, debt service, and monetary emissions all indicate that the public sector is financially strong enough to withstand a demanding external financial environment. The main credit rating agencies have thus granted an investment grade (free of speculative risk) to Uruguayan debt in contrast to the risk rating awarded to the region.

Uruguayan debt has also been given an investment grade because of the financial situation of the public sector which, as shown in Table 2, has improved in recent years. In 1998, the public sector deficit stood at 0.9% of GDP, slightly below the central government's (1.2%), since public companies are in surplus.

The monetary variables reflect a very low monetization and a high level of dollarization of the economy. This situation arose because of the early liberalization (in 1974) of the country's capital account, the freedom to set up banking deposits in any currency, and the possibility of dealing in foreign currency. The outcome was the parallel circulation of the peso and the dollar.

Given the economy's long tradition of inflation, the dollar began to monopolize the functions of value deposits and currency accounts for long-term contracts, gradually replacing the domestic currency. The peso is used in very limited ways, and essentially for current transactions, although some of these – such as the sale of property, vehicles or consumer durables and various rental contracts – use the dollar. Emissions represent barely 3.2% of GDP. The predominance of foreign currency is yet more palpable for savings. The relationship between the monetary aggregate that includes deposits made in foreign currency (M3) widely exceeds the definition that only includes monetary assets denominated in pesos (M2).

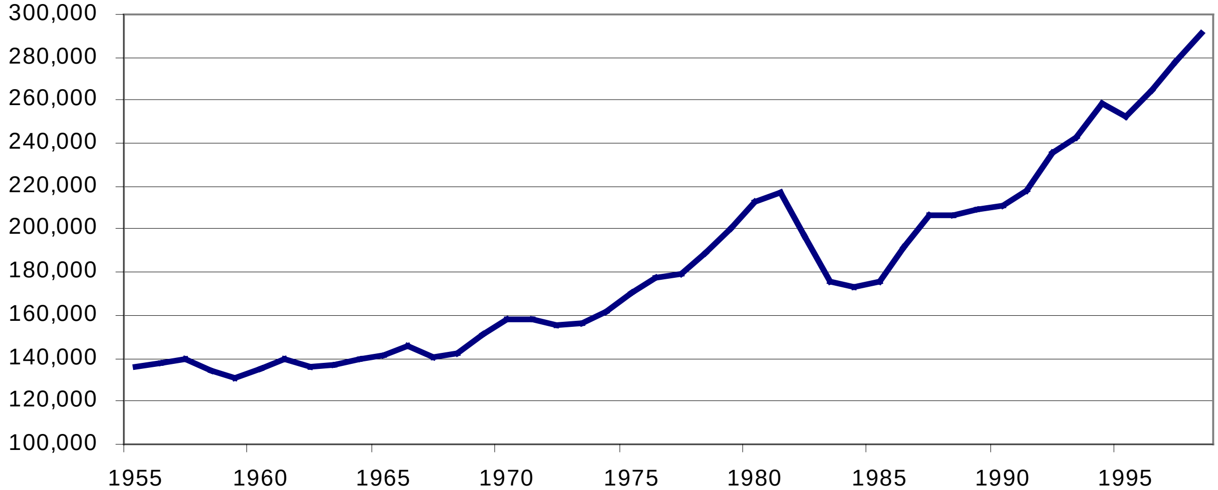
Evolution of the Uruguayan Economy

The policies of gradual and consistent opening and integration introduced from the 1970s onwards have played a central role in the development of the economy. These were applied only after a solid social consensus was reached and, as such, have been reversed in only a few cases.

Trends in output

Graph 1 shows that the Uruguayan economy began to experience a number of fundamental changes from the start of the 1970s. Since then, three periods stand out: (a) the start of reforms during the 1970s, (b) the crisis in the early 1980s and the subsequent recovery, and (c) the strong growth of the 1990s. Each stage had its own characteristics but, as is evident throughout this study, there is a high degree of continuity between the economic policies applied in each period.

GRAPH 1
EVOLUTION OF GDP (1955-1998)
(in constant 1983 values)



The economy grew by an annual average of 2.9% during the 1970s and per capita GDP expanded by an annual average of 2.3% (with population growth of 0.6%). To illustrate the changes experienced by the economy after the introduction of reforms of opening and liberalization, it is worth noting that GDP during the earlier 1955-1970 period reached average annual growth levels of only 1%, barely offsetting population increases during that period. This earlier economic stage was characterized by the collapse of the development model based on import substitution.

The growth that Uruguay experienced for much of the 1970s was abruptly interrupted by the debt crisis of the early 1980s. This was little different to what was happening in the rest of the Southern Cone. The exchange rate crisis of late 1982 and Uruguay's external debt crisis determined the country's macroeconomic environment during this period. Between 1982 and 1983, GDP fell sharply, by around 19.1%. Between 1981 and 1985, per capita GDP dropped by an annual average of 5.6%.

The economy began to move out of recession when GDP expanded at an average annual rate of 3.9%, if measured to the present day. A comparison of GDP across different time periods reveals only small variations in this rate. In terms of the observable effects of economic policy and the nature of factors linked to foreign trade, the difference between two periods are worth highlighting: (a) the end of the crisis in the latter half of the 1980s and (b) developments in the 1990s until 1998. Growth rates in the 1990s have not been significantly different from those for the whole period, with GDP expanding by an annual average of 3.7%, including a slight fall in 1995 as a result of the regional crisis triggered by Mexico at the end of 1994. Given the slow rate of population growth, between 0.6% and 0.7% per year, GDP per capita increased by around 3% annually in the 1990s.

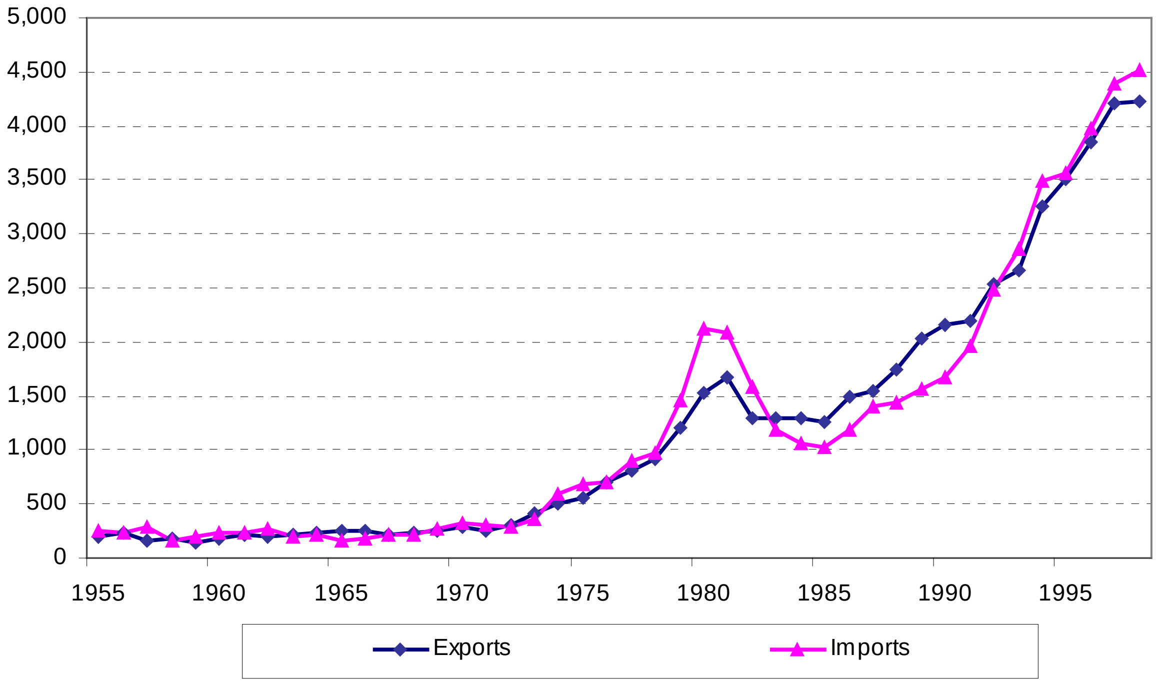
Given the present external environment, there is likely to be a slight contraction of not more than -2% in 1999. However, in light of the analysis below of the structural factors that sustained these growth rates, it could be argued that the rapid growth of the 1990s is deeply rooted and will probably persist in the medium term.

Impact of foreign trade on economic growth

The evolution of GDP was closely linked to the volume of trade in goods and services with the rest of the world. This reflected the fact that internal growth possibilities had been exhausted, that the country was taking advantage of the economy's potential competition conditions and that specific economic policy measures were being adopted. The latter will be outlined in more detail below.

The differences between the period prior to the 1970s and the subsequent period marked by the end of the 1980s crisis, are much more notable with respect to the foreign trade figures, even when the figures in dollars are corrected to reflect real values in international inflation rates in the US currency. Exports and imports have behaved similarly, both expanding in line with GDP, although the fluctuation of imports with the economic cycle has been much more marked than in the case of exports (see Graph 2).

GRAPH 2
EVOLUTION OF EXPORTS AND IMPORTS OF GOODS AND SERVICES, 1955-1998
(US$ millions)



The process of opening helped the economy grow and become more dynamic in the 1990s. However, its impact cannot be evaluated simply in terms of the combined growth of these variables (GDP, exports and imports). It is important to note that this kind of growth has led to changes in the structure of the economy, making it less vulnerable to external shocks. A more detailed analysis of the long-term evolution of trade enables us to observe some of the structural changes that have taken place over the last 25 years.

The first point worth noting is that the growth in goods exports has occurred in various sectors, and is therefore not confined to a few highly developed ones. Most exports are characterized by great diversity, both in terms of the range of products and their degree of processing.

The most traditional export products are those based on the livestock industry, such as meat, leather and wool, at various stages of the manufacturing process. If these exports are excluded from the total, the average share of the rest during the second half of the 1970s is only one third of the total. With the process of opening in the 1990s, and particularly with the establishment of MERCOSUR, intra-subregional trade in semi-manufactured and manufactured goods grew, while cross-border links between companies also increased. The share of non-traditional products rose to an average of 42% between 1991 and 1998, peaking at 48% in 1998. The share of those exports not based on traditional raw materials therefore increased from one third before opening to one half in the mid-1990s.

An examination of exports in terms of region or country of destination confirms the changes described above. One structural change indicated by this analysis is the increase in the number of destination countries or of countries with which Uruguay trades. There has also been a change in the destination structure, with Europe losing share to the countries of the Latin American Integration Association (LAIA), particularly Argentina and Brazil. At the beginning of the 1970s, Europe's share stood at 70%. This figure began to fall gradually, declining to an average of 66% between 1970 and 1974, to 47% in the latter half of the 1970s (despite a large increase in exports), and to 21% between 1995 and 1998. Latin America's share increased from 15% at the beginning of the 1970s to 57% between 1995 and 1998.

TABLE 3
URUGUAYAN EXPORTS
(US$ millions)

	1991	1992	1993	1994	1995	1996	1997	1998
LAIA	657.4	748.5	850.4	1,027.7	1,116.4	1,287.7	1,515.5	1,725.2
MERCOSUR	580.9	622.0	698.8	898.9	992.0	1,152.0	1,355.2	1,532.3
Argentina	188.7	328.9	316.4	382.3	267.1	271.5	354.3	513.2
Brazil	381.8	282.9	366.3	492.5	700.0	831.0	940.2	935.2
Paraguay	10.4	10.2	16.1	24.1	24.9	49.5	60.7	83.9
Rest of LAIA	76.5	126.5	151.6	128.8	124.4	135.7	160.3	192.9
United States	162.8	177.8	148.8	130.6	122.6	167.1	160.8	158.4
Rest of the Americas	36.2	22.6	22.2	28.6	30.3	29.4	46.2	45.5
Europe	470.8	467.0	365.4	425.1	477.5	511.8	575.3	496.4
Rest of the world	277.5	286.6	258.5	301.4	359.2	401.2	427.9	343.2
TOTAL	**1,604.7**	**1,702.5**	**1,645.3**	**1,913.4**	**2,106.0**	**2,397.2**	**2,725.7**	**2,768.7**

URUGUAYAN IMPORTS
(US$ millions)

	1991	1992	1993	1994	1995	1996	1997	1998
LAIA	775.4	988.9	1,229.1	1,473.5	1,469.4	1,665.5	1,847.8	1,845.7
MERCOSUR	662.6	882.5	1,126.5	1,370.8	1,320.8	1,416.6	1,616.3	1,649.1
Argentina	281.8	375.0	478.6	652.6	608.6	690.8	790.7	839.3
Brazil	369.9	496.6	641.1	709.6	698.6	745.5	801.9	793.4
Paraguay	10.9	10.9	6.8	8.6	13.6	25.3	23.7	16.4
Rest of LAIA	112.8	106.4	102.6	102.7	148.6	203.9	231.5	196.6
United States	196.7	203.2	222.6	259.6	282.0	397.6	432.2	459.8
Rest of the Americas	23.9	32.3	67.4	59.0	50.5	56.8	55.9	40.9
Europe	336.8	414.0	477.3	648.7	657.4	714.4	819.2	892.1
Rest of the world	303.6	406.8	329.3	345.4	407.4	488.5	560.9	569.7
TOTAL	**1,636.4**	**2,045.2**	**2,325.7**	**2,786.1**	**2,866.9**	**3,322.8**	**3,716.0**	**3,808.2**

Table 3 examines the development of Uruguayan foreign trade in terms of destination country during the 1990s. It shows that trade with the whole of MERCOSUR and with the rest of the LAIA countries was particularly dynamic, with average annual growth rates of 15% and 14%, respectively. In absolute terms, exports to the United States and Europe have remained relatively stable, thus offsetting their loss of market share. Exports to the rest of the Americas (principally Mexico and Canada) and the rest of the world have expanded by an annual average of 3%.

An analysis of the structure of imports also confirms the structural change experienced by the economy, and that will surely continue over the coming years. First, since Uruguay is a small economy, there is a correlation between export and import growth. Not only did more goods have to be imported to satisfy export demand, but the quality of these goods became crucial. In effect, the search for quality is key to the export diversification process and, as such, the import of intermediate inputs has been important. Second, foreign trade in services has also increased, mainly due to the tourist industry, where quality and diversity is fundamental. This has boosted the import of capital and consumer goods.

TABLE 4
THE STRUCTURE OF IMPORTS BY ECONOMIC DESTINATION

	1975 to 1978	1979 to 1982	1983 to 1986	1987 to 1990	1991 to 1994	1995 to 1998
Consumer	4%	10%	8%	13%	24%	28%
Capital	16%	14%	11%	14%	16%	18%
Oil and distilled products	29%	28%	29%	15%	10%	8%
Other intermediate goods	51%	47%	52%	58%	49%	46%
Total intermediate goods	80%	75%	82%	73%	60%	54%
TOTAL	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Table 4 shows the structure of imports by economic destination. Between 1975 and 1978, intermediate goods accounted for 80% of total imports. Oil and distilled products accounted for 29% of the total, reflecting the impact of the shocks in that sector. During this period, consumer goods represented only 4% of total imports, reflecting the closed nature of the economy. As soon as the economy began to be opened up and integrated, the share of these products increased to 10% between 1979 and 1982.

While the process of opening continued despite the 1980s crisis, internal consumption contracted. This reflected the need to increase savings in order to fulfil the foreign commitments of a highly indebted economy, and imports thus fell sharply. The import of consumer goods was particularly affected, with their share falling to 8% of a total which dropped by an annual average of 14% for three consecutive years.

The import of capital goods remained relatively stable during this period, at 14%-16% of total imports. Most of the increase in the share of consumer goods was therefore at the expense of intermediate goods.

The share of intermediate goods is relatively small. This is the key feature of the long-term examination of the import structure. This fall, which emerged gradually, reaching an average of 54% between 1995 and 1998, is the result of an 8% drop in the share of oil and distilled products during the same period.

From the above figures it can be concluded that there is a correlation between GDP and exports in the Uruguayan economy, and that intermediate inputs, excluding oil and its derivatives, account for between 45% and 50% of total imports.

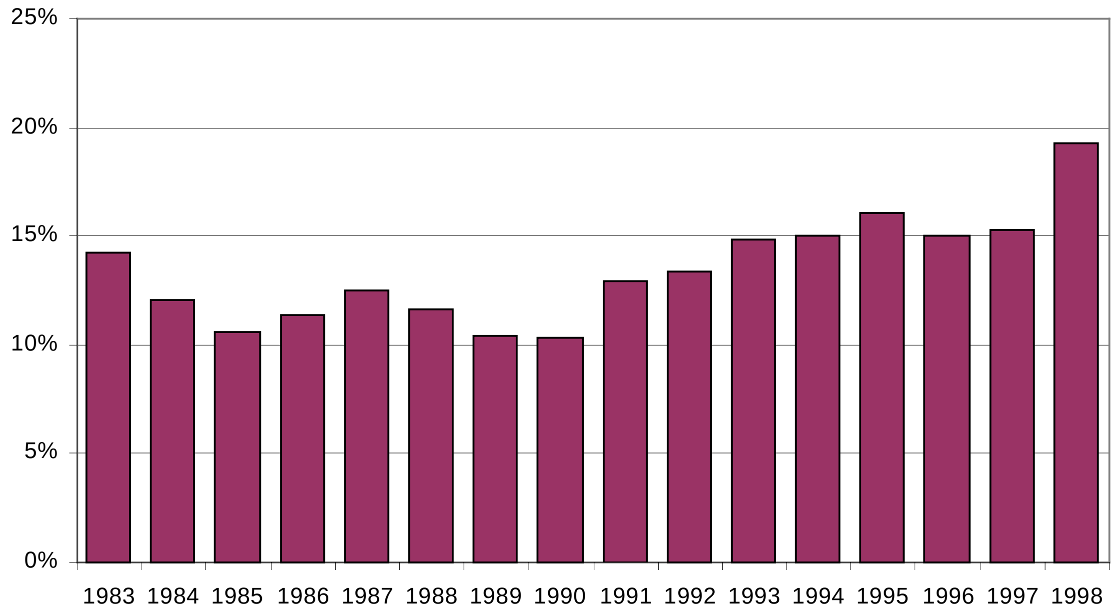
The behavior of capital goods imports is also indicative of the long-term changes experienced by the Uruguayan economy. Prior to the 1980s, this sector represented 15% of total imports. This fell to 11% after the crisis, but increased to 18% between 1994 and 1998. This again demonstrates the quality of growth in a system based on opening and sub-regional integration; the demands and size of foreign markets require global technology and more intensive use of capital.

Increased investment and economic growth

The growth and development of the economy in the 1990s has been underpinned by significant investment, in contrast with the growth experienced during the 1970s. The increasing role of imported capital goods is one feature of investment in recent years. The import of capital goods increased by 19% between 1991 and 1998, from US$ 168 million in 1987-1990 to US$ 700 million in the last two years.

According to the national accounts, total investment, including machinery and components, has risen considerably in recent years. Although investment levels remained relatively stable in the second half of the 1980s, reaching an average of 11.3% of GDP, they expanded strongly in the 1990s. Investment as a percentage of GDP increased from 13.3% between 1991 and 1994 to 16.4% between 1995 and 1998. This trend is evident in Graph 3.

GRAPH 3
INVESTMENT IN URUGUAY SINCE 1983
(as a percentage of GDP)



The increase in investment has been more notable in the private sector than in the public sector. In terms of gross fixed capital formation, private sector investment rose from less than 7% GDP at the end of the 1980s to more than 10% in the last three years, reaching a new high of 11.5% GDP in 1998. Gross fixed capital investment in the public sector has remained steady at around 3.5% GDP, although in recent years the increasing use of concessions as a mechanism for investment has lightened the burden on the state sector.

It is important to note that with opening, and with Uruguay's place in MERCOSUR now more established, the quality of investment has increased, reflecting the economy's more productive opportunities. It is for this reason that agricultural machinery and the agro-industrial sector are strongly represented in capital goods imports. These imports also reflect the strong growth of the hotel industry which, in turn, has helped boost the construction, transport, warehousing, computer, and data processing sectors.

An increase in capital resources will lead to improvements in labor productivity and economic competitiveness. This process has intensified in recent years, particularly in manufacturing industry.

The labor factor and economic growth

As regards the labor force, the low rate of demographic growth is likely to be a constraint. This problem was exacerbated by large-scale political and economic emigration in the 1970s. This undoubtedly had an impact on the recovery from the 1980s crisis, since employment possibilities were limited.

Figures from the most recent period of economic growth show that the available labor factor received a further boost from the growth in the rate of the population's economic activity. This structural change had the following characteristics: an average of 57.2% of the population over 14 years old was active in the 1987-1992 period, compared to 58.7% in the 1994-1998 period and 60.4% in 1998.

TABLE 5
LABOR MARKET IN URUGUAY

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998 [3]
Activity rate [1]	50.6	57.6	57.1	57.7	57.0	57.4	57.4	56.7	58.2	59.0	58.2	57.6	60.4
Employment rate [1]	50.6	52.4	52.2	53.1	53.5	52.3	52.2	52.8	52.8	53.0	51.3	51.0	54.3
Unemployment [2]	9.3	8.6	8.0	8.0	8.5	8.9	9.0	8.3	9.2	10.3	11.9	11.4	10.1

Notes: [1] As a percentage of the population over 14 years old.
[2] As a percentage of the economically active population.
[3] Different sample and therefore not strictly comparable.

In the second half of the 1990s, labor demand has not grown so spectacularly. Indeed, if one examines the 1990s as a whole, there is evidence of a slight downward trend. However, if the evolution of the population over 14 years old is included, it is possible to conclude that the economy created jobs in net terms but not in sufficient numbers to increase the employment rate in proportion to the activity rate. By 1994, therefore, the average rate of unemployment increased to between 8% and 9% of the economically active population. In the following four years, this figure rose to over 10%.

The problem of unemployment has been one of the most important political issues during this period. In Montevideo, unemployment peaked from 1986, affecting 13% of the economically active population.

Uruguayan Economic Policy

Together with the gradual process of economic opening and sub-regional integration implemented over the last 25 years, measures were adopted in other areas of monetary and economic policy, particularly in terms of public finances, stabilization policy, and control of public debt. The central objective of all these policies has been to help boost exports, to allow the private sector more room to develop projects, and to provide economic stability in order to increase confidence and promote investment.

Over the last decade, given the persisting negative impact of problems in the international and regional markets, reform and policy measures have focused on reducing the vulnerability of the economy.

Evolution of public finances

From the outset of the economic process and until the present day, financial management has been dominated by orthodox criteria, although this has been undermined by important events throughout the period. By the end of the 1970s, the fall in international prices, in addition to the cost of social security reform, led to financial problems which proved difficult to control. The 1980s were marked by the need to generate fiscal savings in order to meet the interest payments on public debt and the para-fiscal deficit. At the beginning of the 1990s, the external debt problem was solved through the Brady Plan, although the constitutional reform on pension contributions significantly increased social security costs.

TABLE 6
FINANCIAL MANAGEMENT OF CENTRAL GOVERNMENT
(US$ millions)

	1994	1995	1996	1997	1998
Total Current Revenue	**3,032.5**	**3,367.7**	**3,656.2**	**4,080.6**	**4,369.0**
- DGI	2,354.6	2,649.5	2,850.7	3,160.5	3,363.8
- Foreign trade	210.3	190.7	196.1	228.2	246.1
- Other	467.6	527.5	609.4	691.9	759.1
Total Current Expenditure	**2,934.5**	**3,335.6**	**3,678.2**	**4,017.9**	**4,132.0**
- Payments and social security	2,022.1	2,285.1	2,670.0	2,890.8	3,000.7
Payments	783.5	843.7	957.6	996.5	1,027.9
Social security	1,238.7	1,441.3	1,712.4	1,894.4	1,972.8
- Non personnel costs	474.7	538.4	521.3	554.1	599.1
- Transfers	135.7	170.4	167.9	211.6	187.7
- Public debt interest	204.6	266.2	264.8	301.2	295.3
- Affected income	97.4	75.5	54.3	60.1	49.3
Investment	**436.7**	**422.0**	**353.4**	**398.6**	**496.9**
Total expenditure	**3,371.3**	**3,757.6**	**4,031.6**	**4,416.5**	**4,628.9**
Financial results	**-338.8**	**-389.9**	**-375.4**	**-335.9**	**-259.9**
- AFAP transfers	---	---	67.0	170.2	200.1
- State reform	---	---	27.2	62.6	52.0
Corrected results	**-338.8**	**-389.9**	**-281.2**	**-103.1**	**-7.8**

Source: Central Bank of Uruguay.

Since the 1970s, fiscal policy and, in particular, tax policy, has been geared towards promoting export-led growth and opening. The reform of the tax system involved the streamlining and modernization of the tax collection system. A number of low-yield and administratively expensive taxes were eliminated and replaced by value-added tax. These reforms sought to pursue streamlining and impartiality, as well as to create a system to help boost exports, the latter through the elimination of double taxation. These reforms were therefore wholly consistent with a trade policy of opening and integration as motors of growth.

One of the most important developments in the financial evolution of the public sector was the approval of the constitutional reform on pension contributions at the end of 1989. As a result, pensions were adjusted periodically and index-linked to average salaries. This led to an increase in real terms, which matched, period by period, the concurrent fall in the inflation rate. Since salaries were index-linked, all the benefits accruing to the real wages of the active population were transferred to the passive population.

Consequently, the value of the average pension increased by approximately 75% between 1989 and 1998. Public spending on social security rose from 11.8% of GDP in 1989 to 15.9% of GDP in 1998.

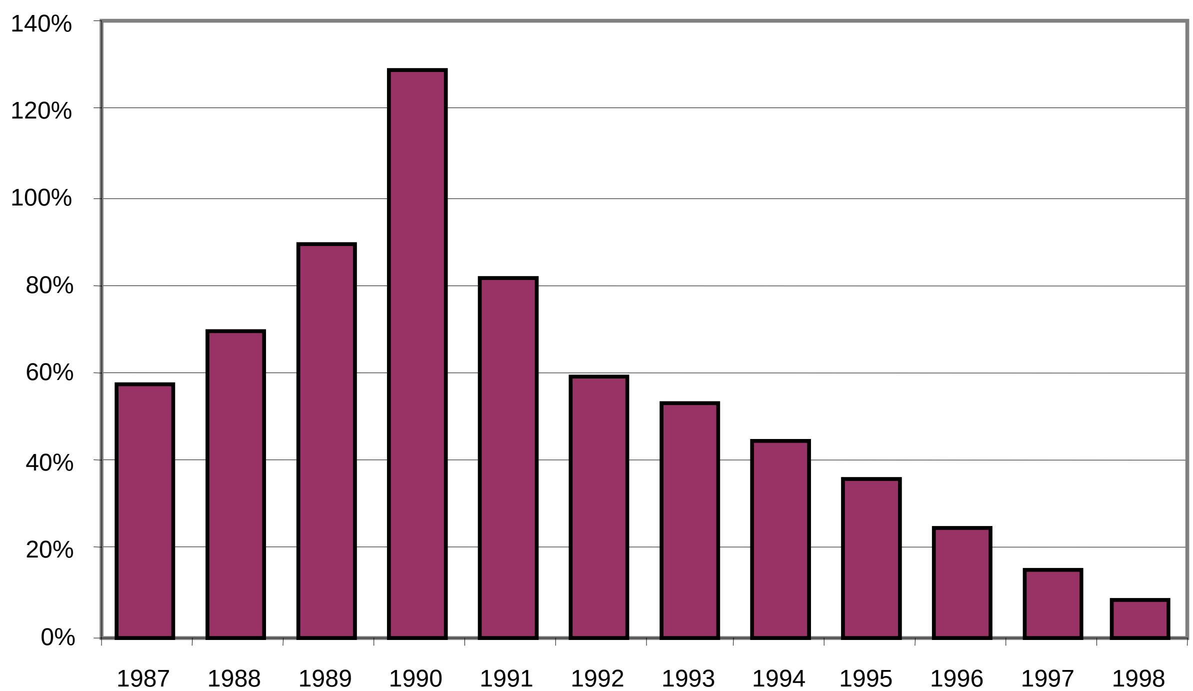
Table 6 details the main features of the financial management of central government. It illustrates the predominance, in terms of expenditure, of financial assistance to the social security system. In 1998, this totaled just under US$ 2 billion, compared to a payroll of around US$ 1 billion, non-personnel costs of US$ 600 million, and interest payments on public debt of US$ 300 million. Last year, public investment by central government stood at US$ 500 million.

Despite the increase in social security costs, the recent period can be described as orthodox from a financial management perspective. The rise in revenue, from US$3 billion to US$ 4.4 billion, has helped reduce the deficit. The main taxes in terms of revenue are those of the *Dirección General Impositiva* (DGI) and those on foreign trade, based on MERCOSUR's common external tariff.

Gradual reduction of inflation and foreign debt policy

This financial environment has helped inflation to fall gradually. As can be seen in Graph 4, after a peak of 129% in 1990, inflation dropped gradually, reaching a stable 40%-50% in the mid-1990s, and then fell further from 1996 on. In 1998, inflation fell to below 10%.

GRAPH 4
ANNUAL INFLATION
(percentage of variation in consumer prices)



The basis of this process of cutting inflation may be found in the public finances and in the possibility of foregoing the emission of money as a source of financing. Therefore, the gradual reduction of the deficit, which minimizes the social conflicts that a severe adjustment might generate, has led to a gradual fall in inflation. Again, the aim of a gradual reduction is to avoid the risk of changes in wealth patterns provoked by abrupt movements or changes in behavior that arise in an economy with index-linked medium-term contracts.

Exchange policy has been used as an instrument to help reduce inflation. To this end, an exchange band was adopted. Under this mechanism, the Central Bank of Uruguay commits itself to buy and sell dollars on a daily basis if the market requires it. The market sets the exchange rate on the basis of supply and demand, as long as the rate does not fluctuate beyond a maximum and a minimum band set by the Central Bank. This instrument enables the financial authorities to send a signal to the economy, as is the case in a fixed exchange rate system, while allowing a degree of flexibility when necessary.

This exchange rate mechanism is important for the private sector for two reasons: first, the speed with which the purchasing and selling band can fluctuate; and second, the width of the flotation band. In the first case, each change in the exchange rate constitutes a signal regarding the rate of price variation in the economy. In the second case, the width determines the risk of devaluation in the system; the wider the band, the greater the risk of devaluation, a situation reflected in interest rates.

Once the expected inflation rate for the year has been established, monetary and exchange policy determines the variation in the flotation band and the conduct of monetary variables, in particular the ability to finance the public deficit through emissions. The remainder of the financial results should be financed by debt or the sale of reserve assets, which links fiscal management with the management of public debt.

The management of public debt is an important aspect of the strategy to reduce the vulnerability of the economy to external shocks. The aim has been to ensure that debt does not continue to rise as a percentage of GDP and, if possible, to reduce it. The expiration date for public debt has also been extended, thus enabling the burden to be spread out. In 1998, the public debt of the non-financial public sector and the Central Bank totaled US$ 5.6 billion in external and US$ 1.9 billion in domestic debt, or 36% of GDP. To calculate the debt in net terms, government assets and, in particular, those held by the Central Bank must be included. The monetary authorities hold foreign assets worth US$ 2.8 billion from residents and non-residents. In net terms, therefore, the debt stands at around 22.5% of GDP.

This level has been falling since 1991, and has stabilized in subsequent years. In effect, in 1991 the gross external and domestic debt of central government and the Central Bank represented 47% of GDP, falling to a low of 32% in 1996. In net asset terms, the debt stood at 33% in 1991, reaching a low of 21.4% in 1996.

As stated earlier, the strategy also sought to extend the due dates for public sector debt. Short-term expiration relief, as well as limiting the volumes involved in the policy of continual debt renewal and the deferment of final payment dates, provides greater protection against unforeseen events. A review of the possible external shocks suggests that the probability of each one occurring is not low and it has therefore become necessary to establish the most efficient mechanisms to address the problem. Possible external shocks include a fall in international prices and in regional demand, as well as increases in international interest rates and a contraction of credit in world markets.[1]

---

1 As a reference point, in 1999 the Latin American countries suffered all these shocks almost simultaneously. In the case of Uruguay, the only one not to have affected the country was the restriction on international credit, since throughout the year it secured sufficient funds to meet the financial needs of the government.

An examination of the expiration structure of the foreign debt of the non-financial public sector and the Central Bank reveals that of the total by December 1998 (US$ 5.6 billion), only 13.7% falls due in 1999, while a further 10% falls due in 2000, 7.7% in 2001, and 38.8% after 2004.

There has also been an increase in the availability of international reserves for the monetary authorities. These reserves provide room for maneuver in case of any one of the unforeseen events mentioned above. A healthy level of international reserves means that it is possible to offset international credit restrictions, as well as to finance unforeseen deficits and, fundamentally, to guarantee or support the national currency. In the latter case, although Uruguay does not operate a legal currency convertibility regime, as in Argentina, total international reserves available to the Central Bank cover nearly four times total public emissions.

Balance of payments summary

International reserve levels are linked to the balance of payments. An examination of the evolution of the balance of payments at the national level serves as an interesting summary of the analysis presented thus far in the chapter. Table 8 provides a summary of the balance of payments for the last five years.

TABLE 8
BALANCE OF PAYMENTS
(in current US$ millions)

	1994	1995	1996	1997	1998
Current Account	**-438.6**	**-212.5**	**-233.4**	**-287.4**	**-400.1**
Trade balance (FOB)	-686.2	-563.0	-686.9	-704.4	-761.9
Exports	1,913.4	2,147.6	2,448.5	2,793.1	2,832.3
Imports	-2,599.6	-2,710.6	-3,135.4	-3,497.5	-3,594.2
Services balance[1]	247.6	350.5	453.5	417.0	361.8
Interest, dividends and profits	-243.1	-227.1	-188.7	-192.7	-185.0
Travel	397.8	374.4	524.8	495.2	429.9
Rest of current account	92.9	203.2	117.4	114.5	117.0
Capital Account [2]	**671.9**	**403.9**	**224.7**	**538.9**	**681.1**
Public sector	427.2	235.5	261.3	227.9	467.7
Private sector	244.7	168.3	-36.6	310.8	213.4
Errors and Net Omissions	**4.7**	**18.0**	**152.6**	**65.8**	**80.8**
Variation of Central Bank of Uruguay Reserves [3]	**238.0**	**209.4**	**143.8**	**330.4**	**361.8**

Notes: [1] Includes transfers.
[2] Includes D.E.G allocation.
[3] The plus sign indicates an increase in reserves.

Source: Central Bank of Uruguay.

As can be seen from the table, the balance of payments has posted a surplus in each of the last few years. Over the last two years, there has been a more than US$ 300 million increase in the reserves held by the monetary authorities. The other side of this growth lies with capital inflows, particularly to the public sector. This development implies that during this period the public sector incurred debts in excess of its external financing needs.[2] This does not, however, undermine the commitment to reduce the vulnerability

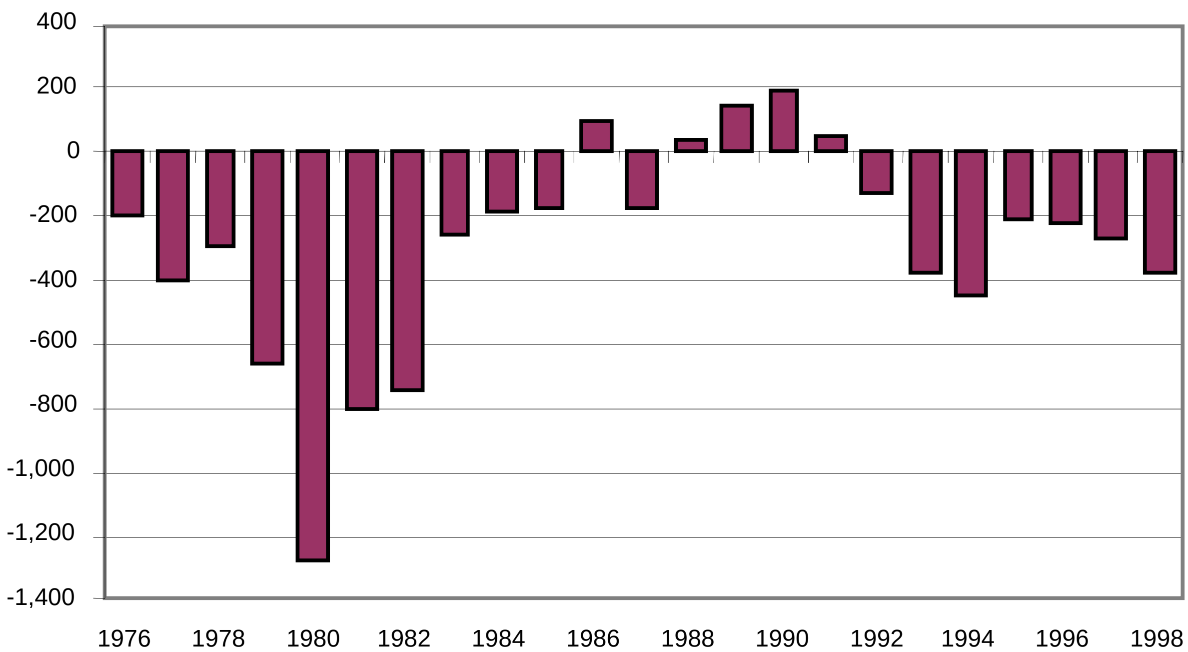
[2] In Uruguay, all debt in foreign currency is defined as external debt, except where ownership can be identified, as with institutional investors. In turn, the monetary base is very small in relation to GDP and the capacity to finance through seigniorage is limited.

of the economy, since the increase in output levels enables the government to increase its gross debt without increasing the debt-to-GDP ratio. Moreover, the net level of the debt is what is important and, since the excess is directed towards increasing reserves, the net balance has not varied greatly.

The parallel increase in the external debt and international reserves has a cost for the country, since the yield on reserves has not kept pace with increases in the cost of debt interest payments. The authorities are therefore keen to minimize this cost through the professional management of the international reserves, employing criteria of liquidity, yield and low risk. The impact of increased indebtedness is reflected in the current account through foreign interest payments. This, in addition to the payment of dividends and bonuses, requires amounts which are falling slightly on an annual basis in line with the interest rate. In 1998, foreign interests and dividends reached US$ 185 million, or 0.9% of GDP.

The current account is also in deficit with respect to trade in goods. As indicated in the first part of the section, imports exceed exports by US$ 762 million. The strong growth in tourism means that the contribution of services partially offsets these deficits, limiting the current account deficit to US$ 400 million in 1998. Last year, this deficit increased both in dollar terms and as a percentage of GDP when compared with previous years. Between 1995 and 1997, the deficit fluctuated between 1.2% and 1.4% of GDP and rose to 1.9% of GDP in 1998. This deficit can be explained by examining savings patterns.[3]

GRAPH 5
THE CURRENT ACCOUNT BALANCE OF THE BALANCE OF PAYMENTS, 1976-1998
(constant 1994 US$ millions)



In 1998, economic growth stemmed from an increase in the domestic consumption of the private sector and investment. In both cases, the increase was greater than that observed in income variables, that is, salaries and pensions. It is based on credit and, therefore, is linked to capital inflows. A similar conclusion can be drawn with respect to the current account balance for 1994 (2.7% of GDP).

[3] The link between the current account balance and savings emerges from basic macroeconomic equilibria which are based on accounting identities at the national level. The current account balance is equal to the sum of public and private sector savings.

Graph 5 examines the current account balance in dollar terms. In order to reflect international dollar inflation, the data has been adjusted to the US consumer price index and set at constant 1994 prices. Three specific periods can be distinguished, marked by the 1982 crisis and the establishment of MERCOSUR.

The 1980s crisis led to an increase in private and public indebtedness with the rest of the world. This was exacerbated by a rise in interest rates and a variation in the exchange rate that reflected an adjustment on the overvaluation of previous years. The need to reduce domestic consumption in order to help generate the necessary savings to transfer resources overseas led to a current account surplus between 1983 and 1991.

It is important to note that Uruguay always met its external obligations, even during the hardest periods of the crisis. An examination of GDP reveals that the rapid fall in output was severe, as were efforts to meet the country's external payments. If the current account balance – excluding the net balance of external interest payments – is used to measure the effort required to generate sufficient resources to meet external obligations, this effort was the equivalent of 36% of GDP in 1983-1999, or 5% per annum.

With the establishment of MERCOSUR and the opening up of the region to the rest of the world, a new trade period began and new challenges arose for developing the productive sector. At the same time, a solution to the debt problem emerged, principally through the Brady Plan. The current account balance also reflected this new environment, with the private sector embarking on a significant process of transformation which, as will be shown below, led to increased investment.

3. MERCOSUR FROM THE URUGUAYAN PERSPECTIVE

The Type of Integration in the 1990s

The political environment that emerged after the end of the Cold War helped bring the countries of South America closer together, both politically and commercially. However, this alone fails to explain the specific nature of relations between the countries of South America both as regards the type of Customs Union adopted by the four MERCOSUR countries and the integration of other countries, or groups of countries, into zones based on free trade.

To explain this phenomenon, it is necessary to consider two additional events that were characteristic of the early 1990s and that have since influenced elite attitudes in the countries of South America. First, there was the increasing interdependence of national economies, known as "globalization". In the 1990s, it became evident that countries were increasingly being affected by forces and events beyond their control.

Second, there was a domestic policy decision of the countries of the region to open up their economies. This was made possible by a social and political consensus which accepted the reduction of national sovereignty and the convergence of economic policy towards a multilateral position more disposed to liberalization. This laid the foundations for the process of closer political relations, the new era of peace, and closer international ties between neighboring countries, to develop into a fully fledged and sophisticated economic integration process which is also, to all effects, a process of liberalization. It is also one in which all the countries involved have renounced some degree of national sovereignty.

There are therefore a number of political and economic factors which, combined, have helped promote a deeper level of integration between the countries of the sub-region. The absence of a common hemispheric policy following the end of the Cold War, on the one hand, and the demise of the politics of confrontation between the main countries of the sub-region, on the other, have helped boost the interconnecting of infrastructure and the liberalization of trade.

The creation of a wide geographical space, and the liberalization of trade which this generated, are the pillars of the economic integration that took hold in South America in the 1990s, with MERCOSUR the best example of this process. As time passes, it appears that the process of consolidation is irreversible The impact of this issue on Uruguay's development strategies will be examined below.

On the other hand, the conviction of South American public opinion and its elite that they had embarked on an irreversible process of liberalization which, because of globalization, governments could not halt, forced this process to focus on economic integration and the creation of sophisticated relationships. Countries thus lost a degree of sovereignty to determine their own economic policies.

These factors account for MERCOSUR's developing as a Customs Union. The possibility of deepening this type of integration depends primarily on maintaining elite support for the process. As long as the elites, especially in the larger countries, remain convinced that a certain loss of autonomous policy decision-making is acceptable, and that it is necessary to converge towards a more internationally acceptable model of trade liberalization, the integration process can be consolidated; otherwise it will weaken.

Uruguay's Accession to the Argentine-Brazilian Agreement

Closer political links between Argentina and Brazil gave rise to the first trade agreements signed between the two countries. The Integration and Economic Cooperation Program was signed in 1986. In 1988, this agreement was extended to include the establishment of an economic union over a period of ten years and in 1990 the Act of July reduced the integration timetable to five years.

It subsequently became necessary to give added impetus to this process by including other countries. The obvious candidate was Uruguay, whose integration into the Argentine-Brazilian agreements was key to both sides. For the two larger countries, it was important to internationalize their agreement, since with Uruguay's participation, a bilateral agreement between Brazil and Argentina could form the basis of a Southern Cone economic integration process.

From Uruguay's perspective, there were several arguments in favor of closer links with Argentina and Brazil. First, it made economic and commercial sense to adhere to the agreements signed by its two neighbors. Uruguay has a relatively well-developed agro-industrial sector, with Brazil and Argentina its principal markets. Its competitors are also from the sub-region. As such, Uruguay could not afford to be discriminated against to the benefit of its neighbors in terms of access to these markets. If there was to be free trade between Argentina and Brazil, then Uruguay had to be an integral part of this process

Second, Uruguay would form part of any process bringing Argentina and Brazil closer together by virtue of geography. In fact, the only historical connection between Spanish America and Portuguese America was the dispute for the area that today makes up its territory. Uruguay was known as the East Bank (*Banda Oriental*), part of Argentina's federal provinces, as well as the Cisplatina, part of the Luso-Brazilian empire. It was thus not surprising that Uruguay should play a key role in the ever closer relationship between Argentina and Brazil.

Third, there were historical factors underlying Uruguay's participation. Uruguay became independent after the East Bank failed to agree to conditions acceptable to its inhabitants of the period on its integration into the Argentine federal project. Since the end of the last century, Uruguay has established itself as a modern, Europhile country, compatible with the international environment imposed by the Pax Britannica. However, the crisis of this model in the post-war period, and the regionalism that developed in the mid-1980s, enabled the country to rediscover its history and thus embrace the Latin American project. These considerations partly explain the virtually unanimous support that Uruguay gave to the Treaty of Asunción, as well as its adherence to it, despite the scant assessment made of its possible economic repercussions, and despite the fact that such considerations do not seem particularly relevant to the decisions made.

Although economic integration is not a controversial economic policy issue in Uruguay, the country did not choose the type of integration, that is, the way in which the agreements were set out in the Treaty of Asunción. Instead, it was determined by earlier agreements between Argentina and Brazil.

The 1991 Treaty of Asunción consolidated, through the mechanism of an international agreement, the objectives of free trade in a vast physical space with more than 200 million inhabitants. However, it was also an ambitious integration project, which aimed to create an economic and a Customs Union between the four countries, the latter within a short space of four years.

From Uruguay's perspective, integration with Argentina and Brazil is equivalent to global opening, because of the adjustment costs required. For Uruguay, the scale of the project made it difficult to anticipate its impact and the extent of the short-term costs associated with adjusting the economy to the new competitive environment. After signing the Treaty of Asunción, Uruguay fought hard to renegotiate the transition period leading up to the creation of the Customs Union.

On the other hand, although the adjustment costs required to join MERCOSUR were equivalent to a global opening, and in as much as the countries of the sub-region are not the most efficient suppliers of the products that Uruguay imports, the benefits of integration in terms of efficiency are lower than those resulting from global opening. The more that sub-regional products were to be protected by a high common external tariff, the more inefficient the process would be. The main aim of Uruguay's negotiating strategy was thus to set the structure and level of the tariff at a rate that would not undermine efficiency.

Both aims were to some extent achieved in the Protocol of Ouro Preto. The agreement established a new five-year deadline for introducing free trade and the Customs Union. This would be achieved through the introduction of two new instruments to implement the Treaty of Asunción: the "Adaptation Regime" and the "Exceptions to the Common External Tariff". A maximum 20% tariff was finally agreed. Its structure offered a level of protection that was more effective than the rate suggests.

Physical Interconnection and the Advantages of Geographical Location

In terms of population and land surface, Uruguay is the smallest country in the sub-region. It has an agro-industrial and service based economy. The most important sectors are transport, banking and tourism. MERCOSUR will boost Uruguay's exports of meat, wool textiles, beer barley, rice and dairy products. MERCOSUR is also likely to help Uruguay develop as an important financial center and a natural sub-regional destination for tourists, particularly from Buenos Aires and the Southern Brazilian cities. Uruguay is also well placed to consolidate its position as the capital of the MERCOSUR institutions.

However, MERCOSUR has been particularly important in strengthening the role that Uruguay's geographical location plays in the country's economy. The agreements with Chile and Bolivia created the final MERCOSUR boundaries within the South American map. The six countries constitute a natural geographical space for integration: they are all true neighbors, determined by common borders, river connections, and low transport costs. Other countries will follow Bolivia and Chile. However, these will not be neighboring states with a common border. In almost all cases, access would depend on costly integration projects, whose impact on trade and mobility of factors would be gradual.

Trade opening in this integrated geographical space has had an impact on trade flows and the allocation of resources by subjecting to competition markets previously disconnected by policy measures. It has also restored advantages associated with geographical location to countries, or regions within countries, including in areas such as transport and warehousing services. In turn, the expansion of transport infrastructure has promoted the development of other related services, such as tourism and finance. This has been a factor in determining whether industrial activities relocate to a particular area.

Uruguay became independent as a nation largely because of its geographical location. Situated in the eastern part of the River Plate, it has a natural port with the potential for almost unlimited expansion and without the need for large investment. It provides the river-maritime link for the Paraná-Paraguay waterway, which represents the most economical exit point for agricultural and mining products from Bolivia, Paraguay, the Brazilian center-west and the Argentine Mesopotamia.

These advantages of location, which were responsible for the country's political independence, were gradually lost as a consequence of its physical disconnection from the sub-region and the economic policies of "seclusion" adopted by the national states since the beginning of the century. There is little point in being in a good location in a sub-region that does not trade.

With the current opening to trade of large geographical and economic spaces, Uruguay is regaining the advantages associated with its location. Situated in the center of the most populated area in the south of the continent, which accounts for more than 70% of South America's gross product; it also forms the most natural, economical and efficient link for the future corridors connecting the Atlantic with the Pacific. Uruguay thus offers one of the most important entry and exit points in the south of the continent.

Uruguay is not the only country to have adopted such a development strategy. Other associated countries, or regions within countries, are seeking a specific role within this new enlarged physical trading space.

The Trans-Andean venture

Chile, on the Pacific and isolated by the mountains to the east and the desert to the north, has functioned historically like an island. Lacking a link to the Atlantic, it was particularly difficult for Chile to benefit from the Atlantic-based expansion of trade that occurred after the Second World War. The emergence of the Pacific as the area of greatest trade growth at the end of the century means that Chile, with 4,000 kilometers of Pacific coastline, is in a privileged position to monopolize Southern Cone trade with Asia.

In its agreement with MERCOSUR, Chile stressed issues of physical interconnection so as to become the Rotterdam of South America. Chile has embarked on a new phase of integration and has focused its efforts to that end, creating 12 border passes through and along the length of the long mountain border with Argentina. This provides access to the east for its strategic ports located along the entire length of the coast.

The recently inaugurated Paz-Arica route will provide Bolivia with access to the sea, thereby connecting the capital of the *altiplano* with the Pacific in five hours. Chile has placed priority on improving its road network and increasing the capacity of its ports. To this end, it has undertaken an extensive construction program, involving concessions to the private sector. This will enable the government to concentrate public spending on future physical integration projects.

Argentine provinces join the race

Similar initiatives are being undertaken by the provinces or states, demonstrating that regional governments are positioning themselves to take advantage of the possibilities of growth linked to the decentralization of trade. The province of Santa Fe, with 130,000 square kilometers and 2.7 million inhabitants, is the granary and dairy farm center of Argentina. With 700 kilometers of Paraná coast it is ideally placed to secure a large share of the growing trade along the Paraná-Paraguay waterway. This waterway currently extends between Corumbá, in Brazil, and Puerto Aguirre, in Bolivia, passing through Paraguay. The construction of the Paraná-Tieté canal link will extend the waterway to São Paulo, making it one of the most important communication networks in MERCOSUR.

The province has good ports: the main ones are in Rosario and Santa Fe, both grain ports that are well served by road and rail networks. The recent dredging of the Port of Rosario has increased its sure draft to 36 feet (equivalent to that of Buenos Aires), obviating the need for ships to stop off at other ports to load extra cargo. The province is also seeking to become the bridge between Rosario and Victoria and between Rosario and Córdoba, thus providing the key east-west link needed fully to develop the area.

A powerful Brazilian state wants to be more than a throughway

Rio Grande do Sul is one most important Brazilian players in MERCOSUR. This state has become an agricultural and industrial power base within the federation. Traditionally, Rio Grande do Sul's development has been inward-oriented. Although its deep water port is geographically and physically well located, it is difficult to access the coast from the state's interior. Communications and transport infrastructure is poor, with most development concentrated in an area of 120 square kilometers around Porto Alegre and Caxias.

The state government wants to use MERCOSUR to reverse these deficiencies. It is seeking to become the deep water port for MERCOSUR's center-south and has thus launched an ambitious program of public works privatization and concessions to expand transport infrastructure and increase port efficiency.

Uruguayan ambitions

Montevideo, like Buenos Aires, is the exit point from the River Plate Basin to the sea. The two ports' century-old struggle for domination was only interrupted by the economic seclusion of the post-war period.

Economic opening and free trade in goods helped boost this historical competition. The two ports are at present on an even footing, since both are carrying out an extensive process of renewal and reform. However, the Port of Montevideo is likely to triumph in the long term because of its superior natural location and the fact that the Port of Buenos Aires is almost at full capacity.

The Port of Montevideo is well served by a road network which has the greatest density per km^2 in Latin America. Work is also being carried out to boost its future development: a container and a cargo terminal. There are plans to improve the roads which form part of the Uruguay-Argentina-Brazil connection network.

Work on the connecting roads to the east and the Colonia-Buenos Aires bridge will improve access from Buenos Aires to the coastal tourist resorts. There is optimism that the growth of trade and tourism associated with free trade and the interconnecting of infrastructure will improve the prospects for building, via private concessions, a road link between Argentina and Brazil at a cost of more than US$ 300 million.

Nueva Palmira, in Colonia, is the river-maritime link for the River Plate Basin. Its potential for growth is likely to increase with the dredging of the Martín García canal. This is being carried out with private capital at a cost of US$ 100 million. There are plans to privatize port operations to improve efficiency, and to build a private port. Fishing and tourist ports are also planned for Colonia and Rocha in order to meet growing demand. This is the result of improved trade and physical links between Argentina and Brazil.

The domestic policy response

Physical links and trade agreements have helped restore the advantages of geographical location, lost during decades of economic isolation, thereby enabling Uruguay to assume a new role. The country has sufficient strength to compete for a privileged place as one of the most important entry and exit points in the south of the continent, together with Buenos Aires and Rosario, in Argentina, and the Chilean ports on the Pacific. For this reason, most of the investment and the economic growth associated with integration in Uruguay will be targeted at transport: in particular, ports, airports, warehousing facilities, roads and railways.

To convert these strengths into opportunities, economic policy focused on two key problems; first, related to the resources needed for investment and, second, increasing the efficiency of existing facilities.

In Uruguay, two relevant policy trends emerged in response to this challenge. One of these is social security reform, as referred to earlier. This reform released substantial resources for public and private investment which eventually amounted to the equivalent of half of Uruguay's GDP. The other was the redefinition of the role of the state as a provider of public sector infrastructure. Infrastructure financing, traditionally the preserve of the public sector, was opened up to the private sector, principally through public works concessions, toll roads, railway privatization, port and airport concessions, and electricity generation. This policy has also engendered a radical change in the administration of these sectors by incorporating the private sector in the management of transport activities and infrastructure.

In this new environment, more than US$ 2 billion must be invested over the next four years in transport infrastructure alone (including the Colonia-Buenos Aires bridge), 75% of which should be provided by the private sector.

In order to complete this process, the financial instruments and mechanisms linking pension fund resources to the large public works projects must be adequately developed. The government has taken action on this issue: over the last three years, it has approved a law on investment funds; Congress is debating a bill on closed credit funds; and the Central Bank is designing an infrastructure bond to finance public works.

The Effects of MERCOSUR on Goods Production Activities

At the outset of the sub-regional integration process, Uruguay had a relatively diversified structure of production given the size of its economy. It had an important agricultural and livestock sector and good industrial development, particularly in the agro-industrial sector.

Over the last 25 years, the country also developed industrial activities geared towards non-agricultural exports to the sub-region, based on the industrialization of imported inputs. The preferential access for some Uruguayan industrial products to the markets of Argentina and Brazil was critical to this development. This access was based on the bilateral agreements Uruguay signed with its neighbors – the Argentine-Uruguayan Convention on Economic Complementarity (*Convenio Argentino-Uruguayo de Complementación Económica*, CAUCE) and the Protocol on Trade Expansion (*Protocolo de Expansión Comercial*, PEC) – as well as on access to inputs at international prices, thanks to the tariff structure itself and to other promotional instruments, such as temporary admission.

The production of tradable goods (which form part of overseas trade) was particularly affected by integration. Although MERCOSUR could have had a significant potential impact on a wide range of production activities – as noted in the previous section – and on services linked to the transport of goods, warehousing, tourism, and financial sectors, it has had a far greater impact on the production of those tradable goods that already existed. These represent a little over 30% of GDP.

MERCOSUR had an impact on this activity in two ways: changes to the tariff structure resulted in the national tariff being replaced by the external tariff, and the unrestricted opening of sub-regional trade.

Effects of the common external tariff

The common external tariff represented an important structural change in the provision of protection for the production of tradable goods. Although the national tariff had a nominal ceiling of 20% – like the common tariff – its structure was different in two fundamental ways: first, the national tariff had three levels of 6%, 15% and 20%, in which capital goods and non-produced inputs had the lowest tariff, and produced and consumer goods the highest. As an exception, some locally produced inputs had a 15% tariff.

This structure provided a high degree of effective protection for local activities, particularly for the processed raw materials and imported inputs industries. The external tariff implied a change in that it tended to harmonize protection along horizontal lines, while at the same time adopting an ascending tariff scale throughout the production chain. This structure, which was well suited to the sub-regional environment, forced Uruguay to modify its existing domestic protection mechanisms.

The other characteristic of Uruguay's nominal tariff was that it did not distinguish between agricultural and industrial products. In contrast, the common tariff discriminates in favor of industry, with a nominal protection rate of 20% for finished products and 10% for agriculture and livestock products.

These differences justified Uruguay's position in the 1991-1994 negotiations on the common external tariff, which was finally approved in the Ouro Preto agreements: first, to maintain the ceiling at 20%; second, to harmonize the nominal protection of agricultural and industrial goods, which was partially accepted; third, to secure a lower tariff for capital goods; and fourth, to establish temporary tariff exemptions. The latter were designed to help those industries dependent on inputs imported from third countries and those sectors involved in extra-sub-regional exports to adjust to the new environment

The changes to the tariff led to a reduction in, and a higher concentration of, the level of tariff protection for the Uruguayan industrial sector. The outcome was acceptable in terms of tariff consistency. However, a higher tariff (by over 2-4 points) was kept for some products, such as metals in the first stage of processing (billet, wire rod straps, rolled products, and unplated flat products) and some chemical and petrochemical products (active principles, monomers, polymers, dyes, etc.). This was a step backward in terms of opening, relative to each countries' previous tariff levels. Several agriculture, livestock, and industrial products, by contrast, should have been given a higher tariff for the sake of consistency.

The effect of tariff elimination on sub-regional trade

Market opening also had a significant impact on these activities. As indicated earlier, given its relative size to the other countries involved, the adjustment costs for Uruguay of sub-regional opening were equivalent to a multilateral opening.

Sub-regional competitors had an impact on all sectors. Agriculture was affected by competition from Argentina, and industry by competition from Brazil. This impact was all the more marked given

Uruguay's use of additional protection, apart from the tariff, known as "reference prices" and "minimum export prices" which in effect offered added protection against sub-regional competitors.

As a result of these effects of integration, the MERCOSUR members sought to extend the transition towards the full implementation of free trade in the sub-region which, according to the Treaty of Asunción, was due to come into effect in 1995. The "Regime of Final Adjustment to the Customs Union", approved in Ouro Preto, therefore extended the transition period to 2001.

The effect on extra-subregional exports

Production activity in Uruguay can be grouped according to its degree of dependence on sub-regional trade. One group is made up of liquid exports to the rest of the world. These include woolen textiles, beef, tannery products, fisheries, and less important products such as leather goods, tiles and sanitary equipment. Although these activities play a part in sub-regional trade and are affected by the sub-regional environment in terms of volume and price, the impact of sub-regional opening on these areas has been relatively minor.

Between 1994 and 1998, output levels in these sectors varied according to the product. Productivity levels in the refrigeration and tannery sectors increased. The production of leather goods, however, fell by a fifth, while employment in the washing machine and wool spinning and knitting sectors dropped by 30%.

This group of exports, as a whole, did not perform well. In this respect, the recession in the Asian markets had a significant impact, notably on the price of raw materials, especially wool and its derivatives. Wool top exports fell, while the sale of tanned leather, fish and leather goods remained stable. Meat exports increased, partly due to the consumer boom provoked by the Real Plan in Brazil. In 1998, the exports of this group totaled US$ 1.1 billion (a third of total exports), with meat accounting for US$ 509 million.

These products are highly competitive both sub-regionally and globally. The exports of each of them account for more than 20% of their total sales, while exports are greater than imports. Therefore, the opening of the sub-regional market had only a marginal effect on these activities. MERCOSUR was more relevant, however, in terms of the common external tariff. As is well known, a tariff on imports is equivalent to a tax on exports, and these sectors are the ones most likely to pay such a tax.

In particular, some of the changes in the tariff structure after the adoption of the common external tariff could have a negative impact on the activities. The first is that the aliquot applicable to inputs, such as chemicals, was increased from the minimum 6% in the national tariff to 14% in the common tariff. These inputs are widely used in both the textile and chemical industries in general, and the common tariff level that is applied is clearly inconsistent with the rest of the tariff.

Second, the tariff on capital goods used in these products was also increased from the minimum level to 14%. Third, the lamb and beef livestock sector, which represents the first link in the chain of production for these liquid export sectors, might be affected by the eventual elimination of the special import regimes on certain, until now tariff-free, inputs which are of key importance for the sector. Over the last 30 years, this has been the main policy instrument in government efforts to stimulate agricultural production.

The effect on sub-regional activities

The sectors most affected by opening can be divided into two groups: first, a sub-regionally competitive group, which benefited immediately from improved access to the region, such as clothing, knitted fabrics, dairy products, rice, barley and beer, and milling. Almost 50% of what these sectors produce is exported, 75% of which is exported to MERCOSUR. Within this group, higher prices account for Brazil's large share of total trade in goods such as rice and clothing, but other markets might begin to play a more important role. Other products, however, such as dairy goods and the category of barley, beer and milling are highly dependent on the sub-region. All these sectors performed well in the 1994-1998 period, particularly dairy products, rice, and milling, all of which grew in terms of production and exports.

Another large group of industries – which includes cotton and synthetic textiles; paper and cardboard; tires; automobiles and parts; oils; chocolates, preserves and sugar refineries – are the most dependent on tariff protection. In general, these sectors benefited most from the additional protection offered under the "minimum export prices" and "reference prices". In Ouro Preto, Uruguay agreed to introduce a tariff for these instruments of additional protection. These were subsequently subject to the automatic reduction until 2001, under the so-called "Adaptation Regime".

During this period of transition, some of these sectors underwent an important process of productive restructuring, based on increases in scale and specialization which, in turn, led to productivity gains.

This restructuring led to a change in the production mix of the companies in this sector, away from product diversity in sufficient quantities to meet domestic demand, and towards specialization in a few goods produced on a sub-regional scale. With the transition nearly complete, these sectors now depend more on access to sub-regional markets on equal terms with their competitors than on protecting domestic markets.

The Dilemma between Deepening and Broadening

Many across the length and breadth of the continent interpreted the creation of MERCOSUR as an attempt to create a protectionist fortress in the Southern Cone. However, an examination of the common tariff and other aspects of trade policy applied by the MERCOSUR countries does not bear this out. MERCOSUR's tariff area, with the exception of the automobile trade in Argentina and Brazil (which constitutes a closed bloc), can be considered as consistent with "open regionalism".

The trade figures confirm this. Although intra-MERCOSUR trade increased at a higher rate than the bloc's trade with the rest of the world, the latter has grown more quickly than world trade in the last five years.

The trade instruments adopted by MERCOSUR and the dynamic of trade are compatible with the explicit strategy that member governments have adopted. This has sought to use such mechanisms to increase South America's share of world trade through improvements in its negotiating position. This has enabled the sub-region to act as a global player in this respect.

Although MERCOSUR is the central pillar of this strategy, it not only requires the participation of the rest of South America in free trade, but also a unity of interests to define the criteria for negotiating market access with the big players in world trade. The next step of this strategy is therefore the bloc's negotiations with Europe, through the already-approved MERCOSUR-European Union framework agreement; with the countries that make up the North American Free Trade Agreement (NAFTA), through the Free Trade Area of the Americas (FTAA); or with the rest of the world via the World Trade Organization (WTO).

The MERCOSUR integration model, however, is too sophisticated to serve as a basis for the inclusion of new countries. A case in point was the incorporation of Chile. The country was the first to be considered for membership because of its geography, history, and trade compatibility. However, because of Chile's trade strategy and the nature of its tariff, it has proved virtually impossible to incorporate it into the Customs Union. At the same time as Chile negotiated its incorporation into MERCOSUR, it sought to give preference to its independence in foreign trade policy. Shortly before, it had concluded a broad free trade agreement with Mexico and was considering the possibility of starting talks with NAFTA. On the other hand, Chile combines a very low tariff for industrial products and para-tariff protection measures for the agricultural sector, a protection mix which is in direct contrast to that adopted by MERCOSUR.

The incorporation of Chile and Bolivia into MERCOSUR led to a conflict of integration models which affected the smallest countries of the bloc in particular. These countries compete for access to the same market but have different tariff coordination requirements and thus different conditions of competition.

The flexibility of the Ouro Preto Customs Union agreement – allowing six extra years for the transition towards uniform tariffs (and up to 12 years for capital goods) and for maintaining the temporary admission and special import regimes – did not run counter to the need to create a MERCOSUR Customs Union that was compatible with Chilean membership, at a time when it was negotiating its incorporation into the bloc.

The Deepening of the Customs Union

MERCOSUR has sought to neutralize the impact of Chile's association by deepening the bloc and by developing a privileged relationship between the four countries of the original agreement, consolidating their integration in such a way as to facilitate the incorporation of other South American countries, though on a more flexible and politically viable basis.

However, the deepening of MERCOSUR has clashed with the desire to maintain the right to autonomous policy-making. On the one hand, deepening requires the total uniformity of tariffs. This is in conflict with the policy of small countries of maintaining access to inputs and capital goods at close to international prices. These countries are not willing to accept the higher costs that protection implies without securing other concrete benefits. On the other hand, rules of origin in sub-regional trade must be eliminated, foreign trade policy coordinated, and exchange rate regimes harmonized. These demand a greater degree of coordination in economic policy making, which the larger countries appear unwilling to accept.

The requirements for deepening the Customs Union

The Customs Union is conceptually different from the free trade zone because it applies an external tariff and a common trade policy *vis-à-vis* third countries. The Customs Union is more integrated than the free trade zone and therefore demands a greater degree of political consensus and external coordination.

The Customs Unions will only be effective if there is a certain degree of consensus on the part of member countries, at least in two principal respects: economic opening and a willingness to renounce a degree of autonomy in terms of economic policy-making. If any one of the countries resists these policy requirements, its relations with its neighbors in the Customs Union are likely to suffer.

Tariff harmonization is one of the requirements of the Customs Union. As already stated, it is evident that for a country such as Uruguay – which is integrated with much larger countries – the costs of the structural adjustment (transitional unemployment, the loss of capital owing to resource immobility, etc.) associated with sub-regional trade liberalization are probably high, difficult to quantify and equivalent to those associated with multilateral liberalization. However, as indicated above, since its partners are not the most efficient suppliers of the goods that Uruguay imports, any benefits from sub-regional trade will be lower than those from multilateral opening. It would therefore prove costly for a small country to abandon the right to set its own tariff (to offset the diversion effect of trade with its neighbors). It would only be justified by the benefits associated with privileged access to its larger partners.

A further requirement of the Customs Union, and one linked to tariff harmonization, is the elimination of rules of origin. In a free trade zone, rules of origin constitute the only method of protecting sub-regional activities. In the Customs Union, that protection derives from the common tariff, which replaces rules of origin.

This is particularly important for MERCOSUR, where the protection of sub-regional activities as provided by the common tariff, was negotiated item by item over three years in discussions that were highly political and technically consistent. If rules of origin truly operate as a form of protection, then these negotiations, which were central to the Customs Union, will prove to have been meaningless.

The Customs Union also entails the coordination of trade policy towards third countries. This represents the flip side of the common tariff. Tariff concessions to third countries pierce the common tariff and should therefore be granted as a whole. On the other hand, if a country in the Customs Union has privileged access to third countries not available to its associates, it has an advantage in terms of investment and industrial relocation not enjoyed by its partners.

The common trade policy requires that the largest countries in the agreement firmly accept the model of the Customs Union. The largest country must therefore subordinate its trade policy towards the rest of the world to the interests of its smaller associates. This requires that the larger countries fully understand the requirements of this integration model and give it a high degree of policy priority. As will be examined below, it appears that in the current political environment the larger MERCOSUR countries are unwilling to accept these requirements for the effective operation of the Customs Union.

Improving the free circulation of goods

Unrestricted access to the markets of the associate countries is a requirement for the free trade zone and the Customs Union alike. However, the Customs Union, as the broadest model of integration, is more demanding than the free trade zone in this regard. A free trade zone can be partial, or can be applied gradually, in so far as the requirements are symmetrical for all participants.

However, any restriction in terms of market access is incompatible with the application of a common external tariff. The productive activities of one of the countries of the union could be subsidizing the cost of the common tariff with the sole aim of protecting the activities developed in another country in the bloc. This situation would not be justified unless it were offset by unrestricted access to the market of the latter country. The Customs Union not only demands the coordination of additional policy instruments than those required by a free trade zone, but that trade be very free.

There are three main aspects of improving the free circulation of goods in the markets of the members. First, all forms of trade barriers must be eliminated. Second, members must not develop competitive advantages for domestic production that might have a negative impact on the domestic activities of their partners, such as production subsidies and those for setting up industries. These were actively employed recently, most notably in the fiscal conflicts between Brazilian states.

Third, there must be exchange rate or monetary harmonization. This might help prevent the recessive effects of negative demand shocks (particularly in the larger economies) from spreading to the other (especially the smaller) members of the Customs Union, thereby giving domestic activities in the former an advantage over those in the latter. Policy and national objectives must therefore be highly coordinated. However, the MERCOSUR countries have a long way to go in this respect.

The Difficulties of Implementing the Common Trade Policy

Recent developments in MERCOSUR have highlighted the difficulties of reaching the necessary consensus to implement a common trade policy. Following the attempts by the Andean Community (*Comunidad Andina*, CAN) and MERCOSUR to conclude a trade agreement, Brazil this year decided to begin negotiations with the Andean bloc independently of its partners in the Southern Cone.

This is not the first time that the common trade policy has been a point of friction between the MERCOSUR members. At the beginning of 1994, the Brazilian government launched the idea of the South American Free Trade Association (SAFTA), proposing the conclusion of free trade agreements between Brazil and each of the non-MERCOUR countries in South America. The initiative provoked a serious internal debate in MERCOSUR and, following a process of reflection, resulted in Brazil's decision to present the project to its partners as part of a common policy. The subsequent agreement with Bolivia and Chile constituted the first important success of this new focus of the common trade policy.

However, MERCOSUR faced stiff competition at the time from other outside forces, which made it easier for Brazil to abandon the idea of a SAFTA. NAFTA was being consolidated, and was proving highly attractive to Spanish America, including Argentina. NAFTA therefore emerged as a serious competitor which threatened to scupper prospects for establishing an autonomous South American bloc, and which could eventually have isolated Brazil in terms of trade.

It thus appeared obvious that a common trade policy was a key requirement for Brazil's foreign policy interests and for the project being developed in the south. It was therefore easy for Brazil to become convinced that it had to overcome its anxieties about agreements with its South American neighbors in order to consolidate its role within MERCOSUR and its preferential alliance with Argentina.

NAFTA, however, has now lost its initial momentum, mainly because of the US government's failure to obtain congressional approval for fast track. The external pressure that forced Brazil to postpone the SAFTA in 1994 has therefore also disappeared. The arguments in favor of consistency in the agreements of the Customs Union, which proved so convincing in that year, therefore no longer appear persuasive.

Brazil's desire to conclude trade agreements with the rest of South America as quickly as possible is relatively well founded, at least from the perspective of its own national interests. First, those bordering countries which do not belong to MERCOSUR are a potentially rich source of trade and a point of access for Brazilian manufacturers, especially given that Brazil needs to boost exports. Second, the demands of international negotiations, with NAFTA as well as with the European Union, make it all the more important that Brazil consolidate its economic and trade relations with South America.

This provides further evidence of the inevitable trade-off between a deepening of an integration agreement and the need to incorporate new countries. In this instance, at least, the need to enlarge the free trade zone became a priority, while the development of key instruments for perfecting the Customs Union was postponed.

This process, which is practically irreversible, suggests that it will prove difficult to complete the Customs Union in the short term. For the MERCOSUR countries, especially the small ones, like Uruguay, external trade policy has been totally subordinated to the joint exercise of the common trade policy.

This has forced the smaller countries to take responsibility for their own foreign trade policies. In this respect, what Brazil started is likely to be followed by a series of actions from the other member states. This could seriously complicate short-term prospects for harmonizing the preferential agreements in a manner compatible with a single tariff. The single tariff would, therefore, be the clearest victim of Brazil's decision unilateral to adopt this policy *vis-à-vis* its partners.

Prospects for Macroeconomic Coordination

A certain degree of macroeconomic coordination is important in any deep integration process, especially on exchange rate regimes and the strategies adopted to counter the impact of negative demand shocks.

First, integration requires that problems of severe fluctuations of relative prices in the member countries be resolved. It is not possible to maintain fluid trade flows, much less consider the integration of the various economic activities, if trade is periodically subjected to such fluctuations.

The prospect of developing intra-industrial trade is one of the most tangible benefits, in terms of growth, of economic integration. Free trade in a larger geographical space enables domestic activities to benefit from economies of scale and specialization. This allows an industry to develop the different stages of its production in various countries, making the most of the competitive advantages of each. Obviously, this development would depend crucially on the stability of relative prices in member countries.

An immediate response to this type of problem, and one which is compatible with the deepening of the Customs Union, is to include in the integration agreements commitments to maintain basic economic equilibrium. To this end, the MERCOSUR Council met in Asunción in June. It instructed the economy ministers and the presidents of the central banks to make such commitments, especially on maximum fiscal deficit levels acceptable to all the MERCOSUR countries.

These initiatives are a step in the right direction, since by maintaining economic equilibrium some of the more notorious causes of exchange rate fluctuations can be eliminated. At the same time, this is not a difficult objective to achieve given that it is a key aspect of the economic stabilization programs agreed with the International Monetary Fund (IMF). The challenge is thus to give these commitments, already accepted by all the governments, a MERCOSUR dimension.

However, the Council's initiative only helps resolve a particular aspect of the problem. There are other aspects related to the exchange rate regime adopted by each country. Harmonization could prove more complicated in this respect, since the differences reflect more structural aspects of economic policy implementation.

Argentina has adopted a specific exchange rate regime, convertibility, which is characterized by the establishment of fixed parity between the peso and the dollar. Parity is enshrined in a law approved by Congress. The nature of the exchange rate regime, together with the international trade commitments the country has signed in the WTO or with other countries, means that relative price policy no longer has an impact on short-term balance of payments adjustments.

In contrast, Brazil has adopted a long term strategy which is incompatible with the establishment of a convertibility-style exchange rate "anchor". The policy priority here is to maintain a real exchange change that ensures the competitiveness of the goods-producing sectors and avoids political strategies that could cause a prolonged overvaluation of the exchange rate, since this would damage the export capacity of the industrial sector or its competitiveness in the domestic market.

The Argentine government is conscious of the costs of convertibility in terms of the loss of competitiveness suffered by domestic activities when demand falls. However, the introduction of objective rules which eliminate discretion in policy-making has offset its short-term impact on prices.

This strategy is based on evidence that capital flows determine the economic cycle in Argentina. In order to attract these flows, and maintain a high rate of growth, it is necessary to eliminate investor perceptions of risk. This requires the establishment of "anchors" which necessarily imply the elimination of a degree of discretion over exchange rate policy.

This is relevant to the consolidation of MERCOSUR for two main reasons: the first concerns the impact of the type of exchange rate regime adopted on the way an adjustment in a particular country affects the other members of the sub-region. For example, a negative demand shock in Argentina affects both it and the other members equally; in contrast, exchange rate flexibility allows Brazil to "export" to the sub-region part of its recession, boosting the competitiveness of its domestic activities. This concern is not theoretical, as was demonstrated on 13 January with the devaluation and subsequent flotation of the real.

This problem does not appear to be so evident in other integration schemes such as the European Union or NAFTA. The latter is a good case in point: here, the smaller members, Canada and Mexico, fix their parities according to the currency of the larger country. Parity fluctuations normally help maintain the competitiveness of the smaller countries. These exchange rate fluctuations have a negative effect in trade flows, but are significantly less important than the difficulties that emerge when the country that depreciates its currency is the main market and producer of the bloc, as with Brazil in MERCOSUR.

Second, the issue is relevant in as much as the different exchange rate regimes are not the result of casual policy choices. They are the consequence of an economic growth strategy which is different in each country, and which therefore makes exchange rates very difficult to harmonize. Argentina's priority is to insert the country into the world capital markets as a way of financing higher rates of growth than could be achieved from domestic savings. Brazil, on the other hand, seeks to maintain control over exchange rate and monetary mechanisms in order to ensure the competitiveness of its industries. Brazil also recognizes that, in order to maintain a certain degree of autonomy in exchange rate management and monetary policy, it cannot depend too greatly on international capital markets for investment financing.

There must be compatibility between these two policy options if MERCOSUR is to be deepened. This compatibility requires one of the two countries to abandon its strategy. This appears very unlikely given the high degree of consensus that exists in each for its own particular policy strategy.

For the smaller countries, such as Uruguay, this is one of the most important issue on the integration agenda. The Uruguayan economy is highly dollarized and as such is greatly affected by the recessionary impact of adjustments in the US economy. Over the last few decades, Uruguay has adopted a policy which, although not as radical as convertibility, is similar in several fundamental respects. Its economy is therefore bimonetary, in which the peso and the dollar coexist on equal terms. This is part of Uruguay's strategy of stabilization and insertion into the international capital markets. Its future policy is intrinsically linked to the harmonization of the MERCOSUR exchange regimes. There are two radical options in this respect. One is the creation of a single MERCOSUR currency, an option compatible with Brazil's strategy. The other alternative is to fix parity to another currency such as the dollar. This option is favored by Argentina and Uruguay. Both alternatives would be equally valid for deepening the Customs Union.

In contrast, the disparity between exchange rate regimes, as is the case today, is only compatible with a looser integration process. It would probably require additional safeguard measures to counter the effects on the smaller economies of uncoordinated exchange rate fluctuation in the larger countries of the bloc.

Given the political circumstances affecting the integration project, it is difficult to be too optimistic about prospects for resolving these issues in the short term. If the common trade policy and exchange rate harmonization – both of which require compatible global integration strategies – are to work, governments must give priority to the integration process in their domestic policies and be willing to surrender some of their autonomous decision-making capacity for the benefit of the whole. This could affect national interests which, apparently, the larger countries are not prepared to sacrifice.

BIBLIOGRAPHY

ACHARD, DIEGO; FLORES SILVA, MANUEL; GONZALEZ, LUIS. *Las elites argentinas y brasileñas frente al MERCOSUR*. Buenos Aires : BID-INTAL. 1994.

DAVRIEUX, ARIEL. “Reinserción internacional de Uruguay y reestructura productiva en los 80; perspectivas para los 90”. Montevideo. 1990. (mimeo)

FRITSCH, WINSTON. *A iniciativa Bush na área do comercio: una análise das escolhas estratégicas*. Rio de Janeiro. 1989.

KUME, HONORIO. *Principios básicos da reforma tarifaria no Brasil*. Rio de Janeiro. 1993.

MICHELIN, GUSTAVO. “Quantification of the Effects on Trade of the Preferences Granted to Argentina and Brazil under MERCORSUR”. Montevideo. Undated. (mimeo)

RODRIGUEZ, CARLOS. “Macroeconomic Aspects of Trade Liberalization in Uruguay”. Montevideo. 1990. (mimeo)

SARACHAGA, DARIO. *Acuerdos sectoriales, una perspectiva desde Uruguay*. Montevideo. 1994.

VAZ, DANIEL. “MERCOSUR: From the Treaty of Asunción to Ouro Preto”. Montevideo. 1996. (mimeo)