

REPORT

MERCOSUR

1999 - 2000

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The MERCOSUR Report series represents a new effort of INTAL aimed at promoting understanding and dissemination of information about the current dynamic process of integration in Latin America and the Caribbean. As part of this integrationist trend, the Southern Common Market has become, since the signing of the Asunción Treaty in 1991, a leading case for the evaluation of the achievements and challenges encompassed by this ambitious initiative.

The purpose of INTAL, through the publication of this 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° 6 covers the second semester of 1999 and the first of 2000 and has been prepared by Dr. Ricardo Rozemberg, advisor on issues related to industry and its insertion in the regional and international markets, and Dr. Gustavo Svarzman, assistant Professor at the Economic Sciences Faculty, University of Buenos Aires and consultant for different organizations on issues related to export promotion and the North-South negotiations agenda. The main text of this report is complemented by an Appendix on EU-MERCOSUR negotiations; an academic article prepared by Mrs. Mónica Rubiolo, from the Institute for European Latin American Relations (IRELA).

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

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EXECUTIVE SUMMARY

MERCOSUR: BETWEEN SKEPTICISM AND THE RELAUNCH

Although the leaders of the four member countries repeatedly affirmed their complete faith in the integration process, the outlook for MERCOSUR has been uncertain and gloomy as a result of Brazil's modification of the exchange regime in mid-January 1999, the negative effects of the fall in commodity prices, and the severe recession affecting Argentina and Brazil since the end of last year.

The end of 1998 was "dominated" by the need to defuse and/or find new solutions to a series of trade conflicts that had developed as a result of the macroeconomic fragility of the sub-region's largest economies. However, 1999 was largely marked by efforts to administer, channel and/or resolve the successive and recurrent sources of conflict sparked by the new, post-Brazilian devaluation environment. Some of these disputes cast doubt on the very foundations of a process begun in the mid- to late-1990s.

In a climate of skepticism about the future, and with an upsurge of doomsday scenarios, most of the issues on the internal agenda were "frozen" for much of 1999 in the hope that macroeconomic conditions in the sub-region would stabilize. This would enable the member countries to define national strategies for tackling new and complex sub-regional conditions, and to devise the bases of their new economic and trade relationship with each other.¹

Although the financial effects of the devaluation of the real were not as serious as first thought, and there was no influx of Brazilian products into the rest of the sub-region as many feared had feared,² the downturn in output affecting the member countries and the region's other economies acted as a natural barrier to the competitiveness gains of Brazilian firms. The deterioration of fiscal, labor and social indicators during the recession that affected the whole region in 1999 exacerbated the sensitivity and pessimism of many sectors and actors. This reduced the "field of vision" of some analysts, politicians and opinion formers, and created an environment conducive to ideas that were directly or indirectly critical of integration.

The lack of "emergency" sectoral mechanisms or temporary escape clauses in the MERCOSUR agreements, which could be activated or used by some countries to counter trade imbalances in specific productive sectors, helped increase domestic pressure on governments to take unilateral decisions and prompted uncertainty about keeping and abiding by the rules of the games agreed to by the member states.

Although the trade disputes that emerged during 1999 were to some extent "processed", and fears of a breakdown were gradually overcome, the sectoral agreements reached during the second half of 1999 (which resulted in voluntary restraints on Brazilian exports to Argentina) are clearly temporary or marked by an attitude of "wait-and-see". More lasting alternatives for the sectors in question will have to be found this year. The "breath of fresh air" implicit in the changeover of governments and negotiating officials in

¹ Although this was not the first time since the start of the integration process in the mid-1990s that one of the main member countries had devalued its currency, it was the first time that a strong fluctuation in exchange rate parity between the member states had taken place in the framework of zero tariffs for almost all tariff categories, and in an international financial and trade context that after almost two years of uninterrupted crisis was particularly unfavorable.

² It is worth noting that apart from the fact that bilateral exchange rate values were marked by strong and sustained falls, some analysts have also noted that Argentine and Brazilian exporters were forced to accept significant reductions in the price of their products in respect to those before the real devaluation in order to maintain their respective market shares. However, while in the case of Brazil the reduction of costs in dollar terms for a significant share of its inputs and salaries made it easier to adapt cost structures to the new environment, in the case of Argentina there was, although with some specific exceptions, a significant fall in profit margins. This raises an important question mark about the long term viability of these trends (Markwald [2000]).

Argentina, Uruguay and Chile at the end of 1999/start of 2000, and signs (evident since the last quarter of 1999) that the main economies are beginning to recover, have improved prospects for finding lasting solutions for trade disputes and sectoral demands, as well as for resolving outstanding issues on the agenda for deepening and completing the integration process.

According to some analysts, the crisis that followed the Brazilian devaluation exposed some of MERCOSUR's structural weaknesses and the gaps in its regulatory framework. This has determined the priority issues of the future agenda: the search for greater understanding in terms of macroeconomic policy coordination, the need for mechanisms to soften the negative effects of sharp fluctuations in macroeconomic variables, the elimination or neutralization of regulatory asymmetries, completing the institutional mechanisms of the Customs Union, improving the system for the transposition into national legislation of MERCOSUR standards, and devising definitive common regimes for sectors with special treatment.

The outlook in 1999 was not, however, wholly negative. Despite severe business and social unease and the Argentine and Brazilian governments' loss of political maneuverability during that year (due to the fall in President Fernando Henrique Cardoso's popularity and the gradual erosion of presidential power in Argentina as President Menem's second mandate drew to a close, while the opposition performed well in the opinion polls), senior officials in the four member countries repeatedly affirmed their strategic willingness to preserve and maintain the spirit of the process.

Progress was also made in some less high-profile, although still important, areas of the sub-regional agenda. MERCOSUR's dispute settlement system (set up by the Brasilia Protocol) was activated twice during that difficult year. This was an important and unprecedented advance in the institutionalization of the Customs Union, since it prepared the ground for member countries to resolve, in a non-political way, disputes arising from the interpretation and practical application of agreements and rules. This was a qualitative leap in the complex (and non-linear) process of constructing a MERCOSUR that is less dependent on the will of current officials or on "presidential diplomacy"; it created a potentially appropriate channel for a more rational and efficient use of negotiating energies.

The late-1999 Argentine-Brazilian understanding on the mutual recognition of quality certificates and technical requirements for a series of industrial products, as well as progress on negotiating a similar agreement for trade in foodstuffs, helped eliminate the costs of duplicating health and quality control procedures. It also acted as a kind of institutional guarantee of the elimination of a recurrent source of conflicts, disputes and differences in a particularly important sector of intra-subregional trade.

Apart from this balance sheet of progress and pending issues, the sub-regional agenda raises other important questions. Until then, fluctuations in bilateral exchange rates had led only to a broadly similar contraction in the value of intra-subregional trade. The key question, therefore, concerned the likely qualitative or structural effects of the devaluation of the real – that is, the changes in both the pattern of intra-zone trade and the trends in the respective bilateral balances, which threatened to become evident once the MERCOSUR economies emerged from the recession and recovered their growth capacity.

The difficulties of negotiations on the sensitive automotive industry in the previous two years were another source of disruption and conflict, since the sector is both politically and macroeconomically important. The repeated failure to comply with previously announced deadlines for designing a common regime and, consequently, the uncertainty about the future of national regulatory schemes were sources of concern for the sub-region's key players.

Some Lessons of the 1999/2000 Crisis

One of MERCOSUR's main achievements has been to eliminate the historically defensive and mutually distrustful attitude of the two largest members, evidenced by their unnatural economic and commercial disconnection throughout much of their history. Because of the asymmetries and differences between the two countries – which stem from the nature of their economies, their recent history, and their socio-economic and even socio-cultural peculiarities – many actors in both Argentina and Brazil hold different views on their rights and obligations towards, and respect for, the other country.

A caricature of Argentina's attitude towards Brazil would hold that various social sectors have a somewhat "possessive" view of the large Brazilian market. On several occasions, therefore, certain Brazilian policy decisions have been interpreted or perceived by Argentines as an attack on their "natural right" to exploit the trade opportunities derived from Brazil's size and characteristics. The predominant view of a large part of Brazil's political and business community is that Argentina has benefited greatly from and exploited the situation over recent years; that Brazil is not the only large market, although it is one of the few with which Argentina has a favorable trade balance (which has continued despite the devaluation); and that the benefits that Argentina has secured over the years "are more than enough".

Despite the progress made towards creating a new "MERCOSUR culture", when regional and international crises affect the sub-region one of the two countries (or both simultaneously) tends to blame the other of violating its rights or of acting improperly. This serves as a pretext to demand compensation (or to take some kind of retaliation). This asymmetry of perceptions sometimes broadens or deepens sectoral conflicts of interest and/or spurs the feeling that the results obtained are always less favorable than what they "should have been". This leads to situations in which some actors seek to obtain benefits or minimize losses to the detriment of the neighbor, and creates the risk that the progress made in more favorable periods might be reversed.

In this complex and sometimes contradictory general context, the societies of the sub-region have over the years undergone a learning process in which an understanding (and the need for observance) of sub-regional and multilateral norms and the "written and unwritten" rules of politics and international negotiations is gaining an increasingly important role in political, trade and financial decision-making in MERCOSUR. An ever larger number of the sub-region's economic and social actors are realizing (sometimes after receiving some "blows") that if sub-regional and international negotiations are to be understood in stylized terms as a positive sum game, these talks must not only examine who has the best arguments and reasons. On the contrary, what is at stake are interests ranging from the purely material to the politically important.

For MERCOSUR societies, some of the situations affecting MERCOSUR in 1999 (such as the July "incident" on the applicability of LAIA safeguard measures to intra-subregional trade) have been practical examples of the scope of this phenomenon, of the risks associated with persistent asymmetries of perception regarding what is expected from the other party, and of the responsibility of officials and policymakers from the main member countries to manage and harmonize legitimate sectoral and general interests.

Another of the "lessons" of 1999 and 2000 is that MERCOSUR could not and cannot be more than a reflection (often amplified and/or distorted) of the virtues, flaws and limits of internal conditions in its member countries. To claim that the integration process must be more meticulous, "prolix" and predictable than its individual parts is a worthy aim and an understandable benchmark, but has little to do with the past and present circumstances of its member states. Neither does MERCOSUR appear to have been (nor is) the cause of the recurrent problems and difficulties facing the sub-region's economies at various points. On the contrary, more often than not it has helped resolve such problems in a positive way, although always within the range of "sub-optimal" possibilities with which these economies often operate.

This circumstance should be kept in mind. Indeed, the most reasonable approach, for the purposes of a constructive and dispassionate reading of the ups and downs of the bloc in the complex years under study, is not to demand from the integration process (or of some “magical” juridical or institutional instrument) a miraculous cure for micro or macroeconomic imbalances in the member countries themselves.

The often stated (but not always realized) political commitment of governments to MERCOSUR as a strategic, long-term option is a necessary, but clearly insufficient precondition to guaranteeing its survival, deepening and/or further progress. The “secret” is therefore to exploit those moments in which endogenous and exogenous variables (such as macroeconomic conditions in the member countries, the international financial situation, or trends in the domestic policies of the sub-region’s governments) foster progress in the integration process. The aim would be to create new mechanisms to facilitate the operation of the Customs Union, to reach new agreements, and to move towards neutralizing asymmetries. This would provide the process with the political strength and critical mass necessary to more effectively address situations where, inevitably, there are greater differences of interests and motivations, or where contradictions are more evident.

From a more strictly economic perspective, the results of the crisis at the end of 1999 and the start of 2000 has been a practical demonstration of the fact that macroeconomic stability and political legitimacy are prerequisites *sine qua non* for the survival and progress of the integration process. In other words, the overall performance of the sub-region’s main economies (in the production, exchange rate, fiscal and labor areas) is an inevitable fundamental for the other economies. A natural consequence of the recent crisis has been the “re-introduction” of macroeconomic coordination as a priority issue (and not as an abstraction to be considered in the future) in the negotiation agenda and the political debate.

After the Devaluation

MERCOSUR experienced the most difficult and conflictive period of its short life in the 12 or 13 months after the Brazilian devaluation. The countries of the sub-region not only suffered from the effects of the devaluation but also from a sharp and simultaneous contraction in their levels of output and trade. This was already evident in the second half of the previous year, but the situation deteriorated significantly in 1999.

Beyond the unease that certain sectors in the member countries at times expressed about MERCOSUR, it once again became clear that in a context of political and economic rationality, the progress made on integration throughout the last decade will be difficult to reverse.

Eliminating MERCOSUR or reducing it to a free trade zone would also not prevent the “export” of Brazil’s and Argentina’s macroeconomic imbalances to the rest of the sub-region. In other words, just as no one could rationally believe that the Brazilian economy is an irrelevant variable in the design of Argentina’s trade policy (“with or without” MERCOSUR), a growing number of Brazilian analysts and businessmen acknowledge that Argentina is an increasingly important factor on Brazil’s foreign policy agenda.

Independently of the lessons learned from the crisis, and of pending tasks and obligations, it is clear that the 1999 crisis is having and will continue to have an impact on the integration scheme. It should therefore be kept in mind that some productive sectors that have so far “won” from MERCOSUR are now benefiting less, or have ceased to benefit, while the aforementioned minority of critics and MERCOSUR-skeptics has tended to grow both quantitatively and qualitatively.

For the future, this circumstance makes it necessary to somewhat reformulate and/or redesign sectoral coalitions, or the balance of general and specific interests (both between and within the member countries)

that were responsible for the significant commercial and political progress made between 1991 (when the Treaty of Asunción was signed) and the end of 1997 (when the Asian crisis started).

Aside from sub-region's extremely unfavorable macroeconomic environment in 1999, it is clear that the "boom" stage of integration has ended. In this phase, the unstoppable dynamism of intra-subregional trade and the broadly spontaneous convergence of the trade and exchange rate policies of the main member states facilitated the signing of agreements and/or the positive resolution of more complex issues or points of disagreement. It would be excessively willful and even dangerous to expect this stage to be repeated, beyond the significant recovery of trade flows that has been evident so far this year.

It is thus reasonable to conclude that MERCOSUR has entered a new phase in which future progress on integration will not only require that member states demonstrate a strong political commitment, but also collective efforts that transcend the limited field of government action. This will enable them to identify the issues, the degree of commitment that each of must make, and the right moments to seal strategic points of agreements in specific, concrete and "finely-tuned" accords.

The Agenda for 2000: New Challenges and Questions

MERCOSUR economists and officials have in recent years agreed that different exchange rate schemes in the two main countries have not *per se* hampered progress on macroeconomic policy coordination, and that efforts to create more austere and orderly fiscal mechanisms have fostered convergence of the general policies and strategies of the MERCOSUR countries. However, the member countries are still far from overcoming the effects of the recent crisis. It also remains unclear as to how these commitments will be translated into concrete progress on creating a less volatile sub-regional environment, one that is less susceptible to the vagaries of the world economy and international finances.

The progress made this year by Brazil and Argentina in converging their foreign and economic policies has made it easier to identify common interests and points of contact in terms of MERCOSUR's new agenda of priorities and negotiations with third countries. However, changes to the "chess game" of regional politics and, consequently, the emergence of a "twin-speed MERCOSUR", have raised concerns in Paraguay and Uruguay which, as in the past, fear that insufficient account is taken of their interests in the agreements signed by the larger countries. They have therefore begun to adopt a much more active and contentious attitude to Argentine and Brazilian negotiating positions.

Another challenge of this new phase is undoubtedly to design and reach agreement on a new sub-regional agenda that adequately combines and balances the political and economic interests of the two main members with the legitimate demands of the two smaller economies, and which simultaneously maintains the degree of political cohesion necessary to prevent integration from becoming a "two plus two" process. A similar consideration is related to the regional economies within each country. These are partially or totally affected by the productive changes induced by the MERCOSUR process, which in some way could sustain itself exclusively around the São Paulo-Buenos Aires axis.

A closer relationship with Chile will have obvious political benefits, since it entails the inclusion of a stable and dynamic economy into the Customs Union. However, it will be hard to resolve some problems in the short term, such as the many unresolved issues between the two main members of the bloc, the "project asymmetries", and the structural differences between the MERCOSUR economies and Chile (particularly in terms of productive diversification, tariff structure and how the agricultural sector is treated). The political will shown by all sides is undoubtedly a positive and important factor, but this will not "magically" resolve the economic, geographical and historical obstacles to integration.

A good example of the scale of the difficulties, despite the will and the political and strategic agreement between the governments of the sub-region, is provided by the problems involved in securing parliamentary approval of the Argentine-Chilean Mining Integration Agreement, signed in December 1997. These difficulties will take time to overcome even in the best possible circumstances.

As regards strengthening MERCOSUR's institutional framework, the significant progress made in the two previous years, in the area of the dispute settlement mechanism established by the Protocol of Brasilia, is a significant, although partial and insufficient, step forward. Despite recent efforts to make these mechanisms more flexible and stable, and to create a "MERCOSUR jurisprudence", the differences of size in the four member states (and therefore of their bargaining capacity) have sparked significant differences of perception and interest between the parties. These appear unlikely to be resolved in the short term.

The persistence of structural difficulties in some productive sectors in the various countries – and consequently the "chronic" emergence of complaints and conflicts that have become apparent to varying degrees throughout the integration process – make it necessary to implement measures to resolve such situations positively and constructively. One of the main challenges in this respect is to restructure those sectors in crisis and to increase intra-sectoral complementarity, in an effort to preserve the cooperative spirit explicit since the start of the rapprochement between Argentina and Brazil. This would help obviate traumatic or zero sum situations that would inevitably exacerbate pre-existing regional imbalances.

It is however no less certain that the management of intra-subregional trade (either through a sectoral "umbrella" mechanism or informal private and/or more or less voluntary agreements) is simply a temporary and conjectural alternative to facilitate the reorientation of the national productive structures of each country towards a sub-regional and international environment in which an infinite range of special treatment and/or *sine die* protection mechanisms are not viable alternatives.

In other words, although one logical and desired consequence of an integration process is the creation of some degree of specialization and the "crossing" of industries between the member countries, such intra-zone specialization would only be viable if and when none of the member countries individually accounted for all (or almost all) the most dynamic and strategically important sectors.

The success and durability of the integration process will largely depend on the member states behaving and negotiating not only with "firmness", but also with intelligence and strategic sense. This would facilitate the introduction of domestic and foreign measures to change and restructure their productive structures, in order to make them more micro- and macroeconomically efficient. Only under such circumstances would the costs incurred by a few sectors be more than offset by the benefits to the economy as a whole, which is the foremost objective of integration.

Without succumbing to juridical temptations or simplistic and overly optimistic proposals, the success of the "relaunch" or, put more simply, the revitalization of the MERCOSUR process, should mainly stem from the need to maintain a balance of interests that ensures that each member (including the relatively smaller countries) continues to view the process as politically reasonable and economically useful. In this phase, no amount of institutional engineering – nor any arbitration tribunal in which one country "wins" and another "loses" – can replace the political necessity of redefining a common idea about MERCOSUR's strategic direction, one that takes particular account of the implications of these agreements on obligations and commitments for the nature of domestic policy in each member country.

As regards the external agenda, the busy timetable for the 2000-2002 period (during which the WTO talks and the FTAA and MERCOSUR-EU processes will enter decisive phases) is a new "outward" challenge and an excellent opportunity for the four members to identify common interests and objectives in different areas and disciplines. The firm and decisive anti-subsidy positions adopted by the four MERCOSUR

countries in various multilateral and plurilateral fora during the last few months of 1999 and the start of 2000 (such as the Cairns Group meetings, the FTAA Ministerial Summit in Toronto, the EU-MERCOSUR Mixed Commission meetings and the WTO Summit in Seattle) are important starting points for defining common strategies on other issues of the various negotiating agendas, in many of which there is less apparent agreement on trade and political issues.

Another test of fire for the integration process, both in terms of the FTAA and MERCOSUR's internal performance, concerns the pending issues on the MERCOSUR-LAIA agenda, particularly those relating to the Andean countries and Mexico. Although there is much to be gained in this area, many potential obstacles arise from the persistent, and often natural, political and trade differences between MERCOSUR's four member countries.

The second half of 2000 is therefore likely to be a new launch phase for MERCOSUR, similar to earlier important cycles of progress in the integration process (such as those of 1985-1986, 1990-1991 and 1994-1996, each of which had its own characteristics). The political climate has been refreshed by the coming to power of new governments in Argentina, Uruguay and Chile; the institutional strengthening of the Brazilian government; the superb political relations between the member countries; and the recovery of the main macroeconomic indicators in practically the whole sub-region.

The broadly convergent domestic agendas of the two main member countries – particularly in terms of fiscal policy, where the two federal governments are making serious efforts to improve the efficiency of their tax systems and to increase their control over the different state administrations – has also made it easier to cooperate and complement their efforts. MERCOSUR is playing a useful and positive role in this area.

There is some doubt, however, as to whether these goals can be met in practice. Such doubts spring from the performance of the international economy and finances, the economic and social consequences of the crisis of the preceding years, and the still fragile institutional situation in Paraguay.

The Brazilian Presidency of MERCOSUR – which will begin in the second half of 2000 – is likely to be a key political opportunity to consolidate (actively, in real agreements) the critical mass and partial understandings reached by the member countries' negotiators in recent years, including a greater level of political and strategic agreement at the government level. This will prevent an opportunity that is unlikely to be repeated in the next few years from being squandered.

MERCOSUR's future, however, is neither more simple nor more complicated than the economies and foreign policies of its member states; new proposals or magical solutions are not to be expected. On the contrary, the process is likely to continue to be marked by a "learning by doing" approach. This combines efforts to transpose into national law the existing agreements and the harmonization, wherever feasible, of regulatory norms and frameworks with "by pass"-type solutions for issues or disciplines over which speedy consensus cannot be reached. One of the great challenges facing the various sectors of the sub-region's societies over the next few years will be to make concrete and noticeable advances in this respect. This will help preserve, complete and strengthen a strategic tool that the countries of the sub-region can use to quantitatively and qualitatively improve their insertion into the world economy.

Future Prospects

An important step forward was the significant progress made during the Argentine Presidency in terms of unblocking the agenda of trade disputes between the member states, identifying a new series of common strategic interests, signing agreements on a number of politically and macroeconomically significant issues (such as the automotive sector), and designing a short-term work program that will allow movement towards

a single undertaking that takes account of the interests of all the sides. In some respects, this represents a “before and after” in terms of the critical year of 1999. These achievements, however, should be viewed as nothing more than a starting point for a journey that is both long and complex, and that entails numerous short- and long-term risks and challenges.

Although the agreements signed in the recent Buenos Aires Presidential Summit can be viewed with some optimism, it is also worth bearing in mind that the history of Latin American integration (before and after the Treaty of Asunción) is full of pro-integration declarations, as well as ambitious timetables and commitments that eventually amounted to research material for economists and historians.

In the recent Buenos Aires Ministerial Summit, Argentine Economy Minister José Luis Machinea stated that “MERCOSUR is again an opportunity for our country and not a threat, as once seemed to be the case”. This is a striking reflection of the change in climate over the last few months, and of Argentina’s new perception of the integration process. What was achieved in the first half of 2000, when MERCOSUR “breathed again”, is a significant positive step. It is, however, not enough.

CHAPTER I. MACROECONOMIC AND COMMERCIAL TRENDS

A. General Overview of the Economies of the Sub-region

The international context

Two years after the start of the Asian crisis, the global financial markets gradually began to calm down in mid-1999. The crisis began with the devaluation of the Thai currency and spread to the whole of East Asia. This spawned a climate of uncertainty about all emerging markets that was exacerbated by Russia's quasi default in August 1998 and, in Latin America, by the devaluation of the real in January 1999.

However, the performance of the global economy in the second half of 1999 and world economic prospects for 2000 have improved sharply because of the strong recovery of the Asian economies affected by the 1997-1998 financial crisis; robust US growth; the improvement in the European economies; and the modest, albeit fragile and still incipient, recovery of the Japanese economy.

Although the IMF estimated that the world economy would grow by 2.2% in 1999, the evidence suggests that it recovered more rapidly and deeply (by 3.3%). Estimates for 2000 have also been revised upwards to almost 4% (4.2% according to the IMF, and 3.5-4.5% according to the main private consulting firms).

OVERVIEW OF THE WORLD ECONOMY GROWTH RATES (in percentages)

Description	Variation from previous year	
	1999	2000 (e)
<i>Global Output</i>	3.3	4.2
Developed economies	3.1	3.6
Developing countries	3.8	5.4
Transition countries	2.4	2.6
<i>Volume of World Trade</i>	4.6	7.9
Developed economies	4.4	7.2
Developing countries	1.7	9.7
Transition countries	3.9	5.9

Note: (e): estimate.

Source: IMF.

World trade recovered significantly in 1999, particularly in the second half of the year: the volume of international trade flows increased by 4.6% in 1999, and is expected to grow by 7.9% this year. Although growth rates are higher than those recorded in the "critical" years of 1998 and 1999, they are much lower than those in years such as 1995 and 1997 (with growth rates of around 10.5%).

After declining for the last three years, commodity prices begun to stabilize in the second half of 1999. The price of certain commodities – such as oil and some metals – even recovered significantly, partly because of renewed dynamism in Asian demand. Even the price of food-related commodities, which failed to recover in 1999, begun to increase during the first three months of 2000. The general recovery in the price of basic products has been greeted with a certain relief in various emerging economies, which had in recent years incurred strong losses in their terms of trade and in their export earnings.

In the second half of 1999, the international financial environment also improved. In a related development, the US monetary authorities reversed the three emergency cuts in short-term interest rates that they had implemented between September and November 1998.

Private capital flows to the emerging economies – which fell by more than expected in 1999 and which have yet to recover to pre-crisis levels – have risen slightly this year. According to the Institute of International Finance (IIF), net private capital flows to emerging economies will reach almost US\$ 200 billion in 2000, compared to US\$ 150 billion in 1999. Although this is below the US\$ 330 billion recorded in 1996, it is still high given that most of these countries were hit by a severe economic-financial crises in 1997-1999.

The international environment for 2000 appears favorable because of the recovery of the East Asian economies, the continued growth cycle of the US economy (which is already at a record high), the growth of the European economies, and the gradual increase in Latin American growth. This favorable environment, however, is not risk-free. Although the likelihood of new crises has receded sharply since mid-1999, the still precarious recovery in the most affected countries/regions and, mainly, the seriousness of the events of the last two years, make it difficult to completely rule out such crises.

The development of the international economy in 2000 is perhaps more likely to depend on the performance of the US economy and on the realistic prospect that it will finally begin to slow down. In 1999, as has happened over the last three years, the performance of the US economy has continued to defy all the forecasts of multilateral credit organizations, the Federal Reserve, and most private sector observers. The US economy has posted its longest (nine years) growth cycle since the end of the Second World War.

In October 1999, the IMF predicted that the US economy would slow down significantly in 2000, with growth reaching 2.6%, after rates of 4.3% and 4.2% in the two preceding years. Current IMF estimates, however, now suggest that growth will reach 4.4% (it reached 5.4% in the first three months of 2000).

A downturn in US growth cannot be ruled out if increases in private sector spending and in the ensuing financial disequilibria are taken into account, despite evidence that new information technologies could boost productivity. A positive outlook for the world economy in 2000 will depend on if and when this slowdown occurs, and on whether it is smooth and orderly (as the government hopes) or sharp and violent.

The continuation of contractionary monetary policy in the first half of 2000 – which aims to dampen the dynamism of the US economy – led to an increase in interest rates, which now stand at 6.5%. This entails new challenges for international financial conditions and will particularly affect the developing countries. The sharp fall in the Nasdaq in mid-April, and the incipient increase in retail prices, were the first warning signs of a possible and eventual slowdown in the US economy.

This trend appears to have been confirmed at the start of June, with new symptoms in the labor market, the construction industry and consumer spending. Although still incipient and unclear, this gradual slowdown in the US economy will belie some of the forecasts of new and strong increases in short-term interest rates over the next few months. This will be greeted with relief in the emerging economies.

The sub-regional context. General features

Although the international economic/financial environment had negatively affected the productive, trade and financial performance of the MERCOSUR member countries since mid-1999, after the devaluation of the real in January 1999 the sub-regional economy suffered one of the worst years of the decade.

The economies of the four MERCOSUR member states (and associate members Bolivia and Chile) simultaneously slowed down for most of 1999. This negative convergence had not happened in earlier years: when Argentina experienced the negative effects of the Mexican peso crisis, Brazil underwent a period of strong growth that helped alleviate the recessionary impact of the crisis on the Argentine economy. This phenomenon was also evident in the transition period (especially in the 1992-1993 period) when the Brazilian economy was affected by high inflation and stagnation, during which some productive sectors in Brazil looked to the Argentine market to help offset the fall in domestic demand.

The feared “apocalyptic” financial consequences of a possible change to Brazil’s exchange rate parity for the other economies of the sub-region (in terms of its impact on the financial systems and even on the exchange rate policies of the other countries) were not as serious as first thought. The significant change in relative prices implicit in this phenomenon completely altered the sub-regional environment. It led to growing concern in the productive sectors of those member countries most affected by foreign competition, and to a significant change in the patterns of competitiveness that had prevailed for much of the 1990s.

Since mid-1998, the economies of Argentina, Paraguay and Uruguay had suffered the effects of Brazil’s economic weakness, and many productive sectors began to voice their fears of a possible influx of Brazilian products in their shrinking domestic markets.

However, this did not happen (at least in 1999) because of the problems that Brazilian exporters themselves faced, notably the existing uncertainty and, fundamentally, the sharp fall in economic activity in the MERCOSUR countries.

The change to the exchange rate parity affected the member countries’ earnings from trade and production activities and led to a recalculation of rates of return on earnings in the MERCOSUR countries.

Although Brazil’s economic situation was improving, and fears of chronic instability and the likelihood of an inflationary-devaluatory cycle were receding (bringing some “good news” to the sub-region’s economic outlook), the recession in Argentina and Uruguay was deepening, while intra-subregional trade was contracting by around 25% year-on-year.

Moreover, the endogenous determinants of sub-regional economic conditions were not too promising, nor were indicators from the international markets, especially during the first half of the year. A number of factors helped undermine the prospect of a solid recovery in the MERCOSUR countries. These included slow growth in world trade, the persistence of low prices for most of the sub-region’s exports, and a volatile and reticent capital market for emerging economies.

At the end of 1999, however, several factors helped improve the prospects for the international economy. The rapid recovery of the main Asian economies, higher growth in Europe, and the continued growth of the US economy were now accompanied by a stabilization in the fall in the prices of the main commodities – and even price recovery in some cases. This led to a recovery, albeit partial, in sub-regional exports.

The prospect of a change of government in Argentina and Uruguay also improved domestic and foreign expectations of the sub-region’s future. These factors, including a better-than-expected improvement in Brazil’s economic performance (and the country’s success in meeting its fiscal adjustment and inflationary commitments) helped improve the expectations of the sub-region’s private and public sectors, and even those of international financial institutions and investors.

This improvement in expectations and in the domestic economies, as well as the international economic-financial environment, suggested that the Latin American economies would begin to recover strongly at the end of 1999. This was confirmed in the first half of 2000. This new growth cycle in Latin America,

including in the MERCOSUR countries, was based on an improvement in export performance (due to a relative recovery in international prices), an increase in trade and global output, and a recovery in domestic demand (including a recovery of investment spending following the deep contraction in 1999).

The main risks or vulnerabilities of this expansion could be the region's growing need for foreign financing and the still uncertain conduct of international capital markets. The successive hikes in US interest rates, and international investors' growing concern about the repayment capacity of emerging economies, could limit (both in terms of quantity and prices) access to new financing. This could strongly affect countries that are highly dependent on foreign capital, such as Argentina and Brazil.

Since the economies of the sub-region were in full recession, the current account deficit in most MERCOSUR countries (Brazil, Argentina and Paraguay) increased to more than 4% of GDP (in Uruguay it reached only 2.5%). Renewed growth in these economies could exacerbate these imbalances,¹ to some extent limiting the strength and dynamism of the recovery.

Under these circumstances, most governments of the sub-region have implemented significant budgetary adjustments to boost the confidence of international investors and limit the risks associated with the strict foreign finance requirements. Many governments of the sub-region have made progress in strengthening the long-term stability of their countries' public finances by reforming their tax and spending systems, and by reorganizing/streamlining the public administration.

This reform of public finances, "adjusted" monetary policies, low inflation and more reasonable debt structures and repayment schedules could help broaden the access of MERCOSUR countries to foreign financing and improve foreign investors' confidence in them. This would help lower interest rates and promote a recovery of growth and of domestic confidence. It could, however, also have (as in Argentina in the first half of this year) a recessionary impact on domestic economic activity. This would limit the likelihood of a rapid recovery, as happened in the main East Asian countries in 1999.

Main developments and trends in each of the member states

ARGENTINA

The regional and international outlook and the weaknesses of the Argentine economy affected domestic economic performance in 1999 in a way similar to that observed after the Mexican peso crisis. While GDP fell by 4% in 1995, it dropped by around 3% in 1999. In 1995, the current account was adjusted because of a strong increase in exports and a logical fall in imports (following the economic downturn). In 1999, however, there was only a partial adjustment because of a sharp fall in both exports and imports.

The negative factors evident over the last year – low international prices, the slow dynamism of the world economy and trade, regional crisis – can be viewed as exceptional and therefore as unsustainable in the long term. However, the fact that the current account deficit fell by only one percentage point in a strongly recessive year (relative to 1998) is a cause for concern, since the success and sustainability of Argentina's economic program depends on reducing the current account deficit. The industrial sector, where output dropped by more than twice the fall in GDP, largely accounted for the decline in output. Gross fixed domestic investment also declined, from a record 21% of GDP in 1998 to 18.9% in 1999.

¹ In this respect, it is worth noting that Chile was the only country of the sub-region that significantly adjusted its current account in 1999, the deficit of which fell from 6% in 1998 to 0.7% in 1999.

Some positive economic signs began to emerge towards the end of the year. The fourth quarter marked the end of a trend in productive performance; industrial output increased by 2.2% after five quarters of continuous slowdowns, while GDP dropped by “only” 0.3% after three quarters with falls of more than 3%. However, the data for the first few months of 2000 were less favorable than expected, with GDP increasing by 0.9% in the first quarter and a similar performance in subsequent months.

ARGENTINA: QUARTERLY INDICATORS

Indicator	3 rd quarter 1999	4 th quarter 1999	1 st quarter 2000
<i>1) Output Level</i>			
GDP Variation	-4.1%	-0.3%	0.9%
Industrial Output Variation	-9.0%	2.2%	0.6%
Unemployment		13.8%	15.5%
<i>2) Prices</i>			
Consumer price index	-0.4%	-0.4%	0.3%
<i>3) Monetary Indicators</i>			
Short-term interest rates	10.1%	11.0%	11.0%
International reserves	24,484	26,100	26,444
<i>4) External sector</i>			
Export variation	-15.8%	1.8%	12.3%
Import variation	-18.7%	-5.5%	0.2%

Source: Calculated by the author on data from the Economy Ministry, the Central Bank and INDEC.

In the first five months of 2000, industrial output increased by only 2.4% compared to the same period in the “recession” year 1999; unemployment also increased, with almost 2,000 jobs lost in May alone in the capital and metropolitan area of Buenos Aires. These are signs that the economy is yet to “take off”, prompting doubts as to whether the government can meet its 3.5% growth target for this year.

In fiscal terms, the decline in output, imports and social security contributions led to a fall in income, while interest payments, the anti-cyclical nature of public spending, and the economic and social crisis in the most impoverished states led to an increase in spending. This significantly increased the deficit in public finances in 1999, which stood at 2.6% of GDP, and 3.8% if the provinces are included.

The situation did not improve in the first quarter of 2000, despite the significant increase in taxes and spending cuts introduced at the end of December 1999 and the start of 2000. The public account deficit reached US\$ 598 million, with a drop of almost 20% in income and of 11% in spending, compared to the first quarter of 1999. In the last two months, the tax reforms began to have an impact and the government continued to launch new adjustment measures that are likely to improve Argentina’s fiscal performance. However, analysts and investment banks still doubt whether the government can meet the targets agreed with the IMF – that is, a deficit of US\$ 4.5 billion.

As regards the external sector, the recovery of exports in the last quarter of 1999 and the first quarter of 2000 (1.8% and 12% respectively) and the stagnation of imports (because of slow economic dynamism) have led to a significant fall in the trade deficit. In the first three months of 2000, the trade deficit reached US\$ 182 million, a 76% fall on that posted the previous year.

For the rest of the year, the main consultancy firms and banks expect economic output to increase, but by less than in other expansionary cycles of the Argentine economy during the 1990s.

MAIN MACROECONOMIC FORECASTS 2000

Detail	%
GDP variation	2.0
Export variation	11.0
Import variation	5.1
Inflation rate	-0.1
Fiscal results (% of GDP)	-1.6
Current account (% of GDP)	-4.0

Source: Authors' calculation based on J. P. Morgan and Lehman Brothers.

This growth will continue to be based on exports, while investment spending will remain almost at 1999 levels. On the financial side, if international conditions are favorable (which is likely, since US rates are not expected to increase, while the dollar will fall somewhat in relation to the euro and the yen) Argentina could easily cover its financing need and look forward to better results at the start of 2001.

BRAZIL

Output levels have been much more favorable than expected since the change in exchange rate policy, with GDP even expanding by 0.8% in 1999. The implementation of anti-inflationary policies (in 1999, the CPI reached 6.3%, within the government's inflation target program), as well as policies to prevent a sharp increase in public debt, helped avoid a "historic" fall in output that had been expected to reach up to 5% of GDP.

This overall growth in GDP was driven by the agricultural sector, where production expanded because of cyclical factors and an increase of more than 9% in investment. Industry and services fell by 1.6% and 1% respectively, while unemployment fell by more than one percentage point in 1999.

GDP grew by 3.1% in the first three months of 2000, in line with projections of 4% growth for the year as a whole. Growth has been led by the industrial sector, which expanded by almost 4%.

BRAZIL: QUARTERLY INDICATORS

Concept	3 rd quarter 1999	4 th quarter 1999	1 st quarter 2000
<i>1) Output Level</i>			
GDP variation	-0.1%	3.6%	3.1%
Industrial output variation	-3.9%	3.0%	3.8%
Unemployment (annual aver.)	7.5%	6.3%	8.1%
<i>2) Prices</i>			
Consumer price index	2.0%	2.6%	0.8%
<i>3) Monetary Indicators</i>			
Exchange rate	1.86	1.91	1.8
International reserves	42,212	36,400	39,200
<i>4) External Sector</i>			
Export variation	-6.8%	11.3%	19.9%
Import variation	-16.4%	-8.9%	10.7%

Source: Calculated by the author based on the *Banco Central do Brasil*, IPEA and F.G.V.

This growth was accompanied by a significant quarterly increase of more than 20% in exports, and a rise in imports of a little above 10%. Brazil therefore posted a modest trade surplus of US\$ 26 million, compared to a deficit of US\$ 821 million in the first quarter of 1999.

This performance is significantly different from that of the year before. The trade balance was expected to improve fast immediately after the devaluation of the *real* but, due to poor export performance, this did not happen. The trade surplus forecasts were revised downwards on several occasions and the balance ended 1999 on US\$ 1.3 billion. As in Argentina, the current account deficit did not improve significantly. It ended the year at 4.3% of GDP, similar to the levels recorded in the two previous years.

In terms of the exchange rate, the relatively rapid drop in interest rates and some worsening of put pressure on the *real* in mid-1999. This pressure continued in the third quarter, forcing the Central Bank to intervene in the market on several occasions to stabilize the exchange rate. After breaking the “psychological barrier” of two *reais* per dollar on 20 October, the Brazilian currency began to strengthen in the last two months of 1999, reaching almost 1.8 *reais* at the end of the year.

Although the *real*'s upward trend continued (6.3% in the first quarter of 2000), the currency again fell to around 1.85 in April because of turbulence in the international markets and a concentration of overdue eurobonds and private company stock. Once the world markets calm down, the exchange rate is expected to stabilize at around 1.75/1.80 *reais* per dollar. It reached 1.81 *reais* in June.

On the fiscal side, the Brazilian economy displayed two contradictory signals in 1999: first, the government met its primary surplus target (it reached 3% of GDP) due to an increase in the Cofins tax paid by companies, the extension of this tax to financial organizations, and an increase in the aliquot of the provisional contribution on financial movements; second, the aggregate public sector deficit (including social security, interest payments and the states' deficits) was over 10% of GDP, compared to 8% in 1998.

The public sector deficit reached 2% of GDP in the first quarter of 2000, while the primary surplus was 13.5 billion *reais* (5% of GDP), well within the target agreed with the IMF.

MAIN MACROECONOMIC FORECASTS 2000

Detail	%
GDP variation	4.0
Export variation	18.0
Import variation	9.3
Inflation rate	6.1
Fiscal result (% of GDP)	-4.7
Current account (% of GDP)	-3.6

Source: Authors' calculation based on J. P. Morgan and Lehman Brothers.

Growth is expected to speed up in the rest of the year, while inflation is likely to stay within the pre-established target. This greater dynamism has forced the forecasts for import growth to be revised upwards and exports slightly downwards. Forecasts of a US\$ 5 billion trade surplus at the beginning of the year have therefore now been revised downwards, to around US\$ 1.5 billion.

In the fiscal area, it is likely that the significant adjustment in the first half of this year will continue. Estimates suggest that, in GDP terms, the fiscal deficit this year will be half that recorded in 1999. In terms of monetary policy, short-term interest rates are expected to fall to around 15% by the end of this year. Last month, the SELIC rate dropped to 17.5%.

PARAGUAY

In 1999, the Paraguayan economy was in a deep recession: GDP fell by 2.4%, while inflation rates fell significantly. The consumer price index dropped to around 5%, a third of the rate in 1998 and the lowest figure in the last two decades. The severe decline in trade exacerbated the recessionary trend already evident in 1998. This has been prolonged by the poor economic performance of the country's main neighbors in the sub-region (sales to MERCOSUR fell by 42%, while global exports dropped by 33%) and the fall in the international price of soya, which accounts for 50% of Paraguay's total exports to the world.

The economic recession and the decline in the re-export trade (because of the Brazilian devaluation) led to a sharp fall in imports (30%). The trade deficit thus fell to around US\$ 1.2 billion – the lowest in five years – while the current account deficit dropped to half the figure of the previous year (4.6%).

The Paraguayan economy began to improve this year, mainly because of the good performance of the Brazilian economy. Exports increased by more than 14% in the first quarter, while imports stopped falling, although they remain at similar levels to those in the same period last year. The trade deficit was also 9% lower than that recorded in the first three months of 2000.

The renewed dynamism of exports is based on an improvement in the international price of soya and cotton (which respectively increased by 17.2% and 24% compared to the minimum value recorded between July 1999 and May 2000), and on a larger cereal and cotton harvest. An 18% fall in the real exchange rate since the end of March has also helped improve the competitiveness of Paraguayan exports. It is therefore likely that Paraguayan exports to the world will increase by almost 20% this year.

MAIN MACROECONOMIC FORECASTS 2000

Detail	%
GDP variation	2.0
Export variation	20.0
Import variation	5.3
Inflation rate	8.3
Fiscal result (% of GDP)	-1.8
Current account (% of GDP)	-4.6

Source: Calculated by the author based on *Gazeta Mercantil* and *Latin American Consensus*.

This significant increase in exports is expected to lead to GDP growth of 2% (government estimates suggest 3% growth, while some consulting firms believe there will be zero growth this year), with inflation higher than that recorded last year, but under two digits.

URUGUAY

The Uruguayan economy suffered from the impact of the Brazilian crisis and the sharp fall in output in Argentina. GDP fell by 3.4% in 1999, more than the drop recorded after the 1995 Mexican crisis. Industrial output declined by 10% in the year as a whole.

This sharp contraction in GDP was accompanied by a significant drop in exports (19%) and a less sharp fall in imports (12%). The trade deficit thus topped US\$ 1.1 billion, the highest rate this decade. The sharp drop in exports was due to the fall in the international price of the main export products and to a decline in the purchasing power of the main sub-regional partners (sales to MERCOSUR fell by almost 40%).

The current account deficit also reached its highest level of the decade (almost 2.5% of GDP). As in Argentina, Uruguay was unable to adjust its external accounts despite last year's strong recessionary environment. However, its deficit levels were clearly lower than those of Argentina.

On the fiscal side, the low dynamism of domestic activity had a serious impact on tax income (especially VAT, which accounts for almost half of all tax income, and the specific domestic tax, which accounts for 18% of the total). This was because the government's anti-cyclical policy increased the costs of the central administration, particularly those of public investment and administrative operations. The consolidated deficit of the Uruguayan public sector therefore reached 2.8% of GDP, compared to 1% in 1998.

The economy did not perform as well as expected in the first quarter of 2000, mainly because of the poor performance of the Argentine economy, the impact of the change in relative prices in Brazil and, to a lesser extent, the devaluation of the euro with respect to the dollar. Uruguayan GDP therefore increased by less than 1% in the first three months of this year. This has led analysts to reverse their forecasts for the year as a whole – from 2.5% at the start of the year, to 1.5% at the beginning of June. Unemployment reached 11.7% at the end of the first quarter, compared to 11.1% during the same period last year.

Estimates suggest that trade flows will recover, with exports increasing by around 9% and imports by 6%. The current account deficit will therefore remain at a similar level to that recorded in 1999.

MAIN MACROECONOMIC FORECASTS 2000

Detail	%
GDP variation	1.5
Export variation	10.5
Import variation	6.0
Inflation rate	6.4
Fiscal result (% of GDP)	-1.8
Current account (% of GDP)	-3.0

Source: Calculated by the author based on *Gazeta Mercantil* and *Latin American Consensus*.

The slow dynamism of economic activity will continue to affect fiscal revenue, which fell by almost 1.5% in the first quarter, while expenditure still shows positive variations (around 6%). The accumulated central government deficit is therefore 55% higher than that recorded in the same period last year. Estimates for the year as a whole suggest a central government deficit of 2% of GDP, a Central Bank deficit of 0.4% and a 0.5% surplus for the rest of the non-financial public sector (public companies and administrative regions). The consolidated public sector deficit is therefore expected to reach around 2% in 2000.

Summary and Prospects

- After its worst year of the decade in 1999, the sub-region is gradually beginning to recover in 2000, boosted by favorable conditions in the world economy and global trade;
- although US interest rates hikes and the strengthening of the dollar with respect to the euro and the yen had a negative impact on the performance of the sub-regional economy in the first half of this year, the environment is likely to improve on both counts in the second half of 2000;
- Brazil, which has a flexible exchange rate and efficient monetary and fiscal policies, is likely to grow by 4% annually over the next few years.
- the Argentine economy, which is focusing on reducing the fiscal deficit inherited from the previous government, has been unable to “take off” convincingly, although most analysts forecast an improvement in economic performance in the second half of the year. Data released at the end of June (fiscal revenue and exports) give cause for greater optimism in this respect;
- there is evidence that Paraguay and Uruguay are recovering gradually, but at a slower pace than had been expected at the beginning of this year;
- sub-regional exports to the rest of the world are increasing significantly because of the rise in the international price of many of the sub-region’s agricultural export products, stronger international demand, and a depressed domestic market, especially in Argentina, Paraguay and Uruguay;
- the reduction of the sub-regional trade deficit in 2000 will continue to offset, albeit partly, the heavy burden of the current account deficit;
- the main consultancy firms and international organizations believe that the MERCOSUR economies will grow more aggressively as of 2001 because of the success of their fiscal and monetary adjustment efforts and the progress they have made in terms of structural reforms.

B. Trends in Foreign Trade

General overview

The crisis that hit Asia in 1997 and the MERCOSUR member countries after mid-1998 drastically altered the commercial trends that had been evident for much of the 1990s.

Between 1990 and 1997 intra- and extra-subregional trade increased by 26% and 11% respectively. In 1998, however, it fell for the first time in the 1990s (intra-zone by -1.3% and extra-zone by -3.8%), with a further sharp decline in 1999. The shock of the Brazilian devaluation at the beginning of that year, and the uncertainty and economic recession prevalent in the whole of the sub-region, greatly exacerbated the decline in trade flows that had begun in 1998. Intra-MERCOSUR trade therefore fell by 25% in 1999, while MERCOSUR's total trade with third countries contracted by 9.4%.

MERCOSUR'S TRADE PERFORMANCE (in US\$ millions)

	1999	% Var. 1998-1999
Total Exports	74,315	-8.8
Intra-zone	15,379	-25.0
Total Imports	80,047	-16.4
Total Trade with Rest of the World	122,969	-9.4

Source: Calculated by the author based on CEI.

The decline in intra-MERCOSUR trade in 1999 was therefore almost three times greater than that of extra-zone trade. The fall in demand in intra-MERCOSUR imports – one of the most useful indicators to measure the degree of contraction of a country's output – was also twice that of exports.

Improvements in the region's economy (and in many of its main partners) since the end of 1999 have been partly reflected in better trade performance, especially in exports to third countries. Intra-zone trade fell by almost 9% in the last three months of 1999, after three quarters of consecutive declines of more than 28%.

MERCOSUR TRADE - QUARTERLY PERFORMANCE % variation compared to the same period the previous year

	I quar. 1999	II quar. 1999	III quar. 1999	IV quar. 1999	I quar. 2000	II quar. 2000 *
Total Exports	-16.3	-11.5	-10.1	7.4	17.1	13.9
Intra-zone	-28.5	-28.0	-32.5	-8.7	17.4	19.1
Total Imports	-21.7	-18.2	-17.7	-8.2	7.1	6.8
Total Trade with Rest of World	-16.5	-11.0	-8.8	0.4	11.0	9.0

Note: * estimated.

Source: Calculated by the author based on data from CEI, INDEC, BCU AND FUNCEX.

This trend continued in the first quarter of 2000, with a strong recovery in intra- and extra-zone trade in Argentina, Brazil, Paraguay and Uruguay. This recovery was based on intra-zone sales, while the slower growth of total imports reflects the moderate dynamism of demand in the sub-region as a whole.

There was a clear and significant recovery in MERCOSUR trade in the first quarter of 2000, reversing the contractionary trend of the last year and a half. The rapid and strong growth of the East Asian economies, the continuation of the expansionary cycle in the United States and Europe, and an improvement in the performance of Latin America as a whole account for this improvement in trade performance.

The MERCOSUR economies have also begun to benefit from the recovery in the price of their export products, after almost 10 consecutive quarters of sharp declines.

EXPORT PRICE INDICES

Average base 1993=100

	Argentina	Brazil	Uruguay
Average 1998	100.3	118.1	108.0
1 st quarter 1999	88.7	109.4	101.9
2 nd quarter 1999	87.4	103.1	97.2
3 rd quarter 1999	88.5	102.0	95.6
4 th quarter 1999	92.2	103.9	86.4
Average 1999	89.1	104.6	95.3
1 st quarter 2000	95.4	110.0	101.1
2 nd quarter 2000	94.9	109.8	n/d

Source: Calculated by the author based on CEI, FUNCEX and the Banco Central de Uruguay.

This combination of supply and demand factors significantly reduced the bloc's trade deficit. While the trade deficit with third countries exceeded US\$ 13.7 billion in 1998, this fell by 63% in 1999, to almost US\$ 5.1 billion in 1999. A similar drop was evident in the first quarter of 2000, when the trade deficit with third countries fell from some US\$ 2.1 billion in the first quarter of 1999 to less than US\$ 730 million.

TRADE WITH THE MAIN ECONOMIC REGIONS

(in US\$ millions)

	Variation 1 st quarter 1999-2000		
	Exports	Imports	Balance
European Union	330	-386	716
United States	896	163	733
Chile	263	98	165
LAIA (excl. MERCOSUR and Chile)	298	191	107
East Asia	280	-9	289
Rest of the World	-33	588	-621
Total	2,034	645	1,389

Source: Calculated by the author based on CEI.

Although MERCOSUR still has significant trade deficits with the European Union, the United States and East Asia, much of the decline in its total deficit is in large part due to its trade performance with these regions. Of particular note is the increase of almost US\$ 900 million in sales to the United States, which accounts for almost 45% of the total increase in extra-MERCOSUR sales during this period.

The EU accounted for almost half the fall in MERCOSUR's trade deficit with third countries, mainly due to the severe decline in imports from Europe. The relative improvement in MERCOSUR's trade balance with Europe and the United States accounts for most of the reduction in its total deficit.

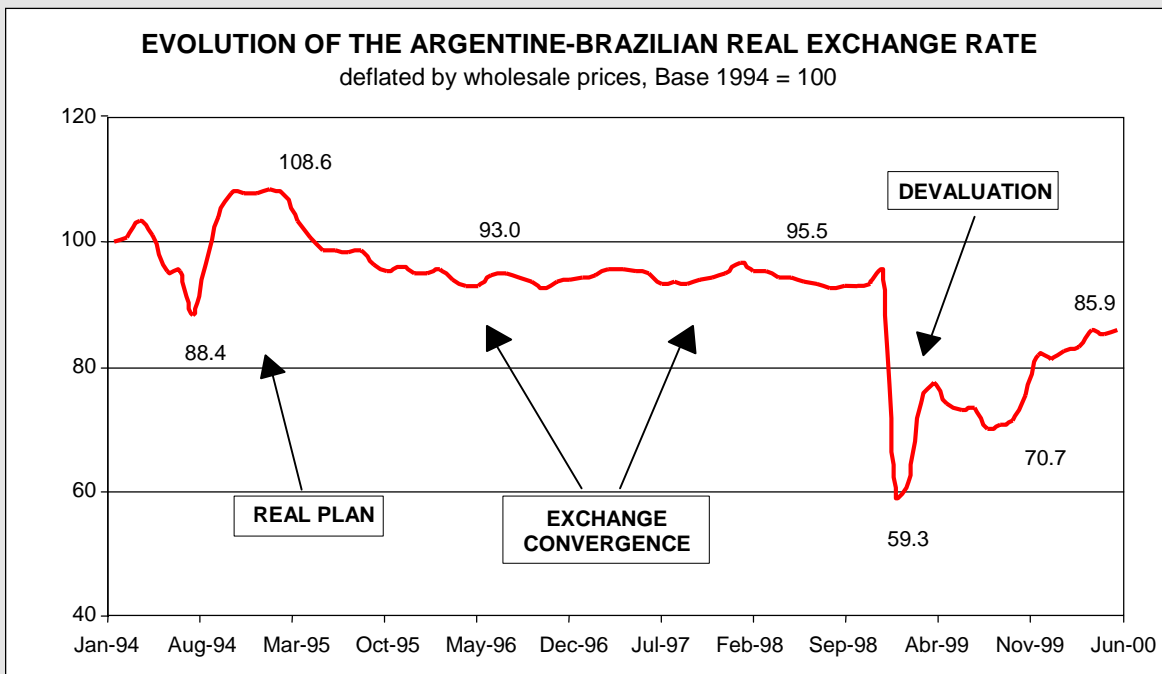
The larger trade deficit, with the countries here termed the Rest of the World (including Africa and Eastern Europe), is largely the result of a significant increase in imports, which rose by 33% compared to the same period the year before. MERCOSUR exports to these countries fell slightly.

Evolution of the Argentine-Brazilian Real Exchange Rate After the Devaluation of the Real

The devaluation of the real in January 1999 was clearly disruptive for the bilateral exchange rate parity that had existed for almost four years. Since the start of 1995 and until the end of 1998, the low inflation rates in the two economies and the existence of exchange rates that were more or less linked to the dollar had led to a period of high stability in terms of bilateral parity.

In the first month after the devaluation, this indicator – calculated as the quotient between the parity of each currency with respect to the dollar, deflated by the wholesale inflation rate in each country – reached its worst relative ratio for Argentina since 1986.

The devaluation of the real led to a sudden 40% modification in bilateral parity. However, this indicator gradually recovered after a sharp rise of 25-30% in Brazilian wholesale prices in 1999.



At the end of June 2000, therefore, bilateral parity was 11% higher in Brazil's favor compared to a month before the devaluation-flotation of the real.

As a reference, the average real/peso bilateral exchange rate in the second quarter of 2000 was 22 points more favorable for Brazil than in the period after the signing of the Protocol of Ouro Preto, and 10% higher than the average for the 1996-1998 period.

Trade trends by country

Although the trade performance of the four member countries during 1999 was similar, in that it reflected a significant and generalized decline in trade flows, there were certain differences between them.

Intra-and extra-zone exports, which in 1999 fell by 8.8% in the four countries as a whole, fell significantly in the two smaller members, less so in Argentina, and to an even lesser degree in Brazil.

TOTAL MERCOSUR EXPORTS (in US\$ millions)

	1999	Var.1998-1999
Argentina	23,318	-11.8%
Brazil	48,011	-6.1%
Paraguay	741	-32.8%
Uruguay	2,245	-18.9%

Source: Calculated by the author, based on CEI.

During most of 1999, Paraguayan and Uruguayan exports, which are strongly dependent on intra-zone trade, suffered the most from Argentina's and Brazil's economic recession. In the case of Paraguay, sales to the rest of the world also fell sharply throughout the year.

The decline in Argentine exports was somewhat less serious, but was also closely linked to the performance of sales to the sub-regional market. Exports fell systematically after the Brazilian devaluation and in the first three quarters of 1999, although this trend began to reverse itself during the last quarter of the year. This change in trend was also apparent, although more strongly, in Brazil's exports to the world, which curiously failed to react even after the January 1999 devaluation.

The recovery in the smaller countries only began in the first quarter of 2000. The exports of all four member countries therefore began to recover at the start of 2000, although to varying degrees, with Brazil's exports increasing the most (by 20%) and Uruguay's the least (by 10%).

TOTAL MERCOSUR EXPORTS - QUARTERLY PERFORMANCE % Variation compared to the same period the previous year

	I quar. 1999	II quar. 1999	III quar. 1999	IV quar. 1999	I quar. 2000	II quar. 2000 *
Argentina	-16	-9	-14	2	14	13
Brazil	-16	-12	-7	11	20	14
Paraguay	-34	-20	-38	-42	14	n/d
Uruguay	-25	-28	-27	-23	10	9,2

Note: * estimated.

Source: Calculated by the author, based on data from CEI, INDEC, BCU AND FUNCEX.

In Brazil and Uruguay, this renewed dynamism of sub-regional exports is largely driven by sales to non-MERCOSUR countries, whose growth rates were more than double those of intra-zone sales. The opposite is in Argentina, where intra-zone exports increased by three times as much as sales to third countries in the first half of the year. Paraguayan exports to non-MERCOSUR countries also continued to fall sharply while intra-zone sales rose significantly.

In 1999, there was a similar fall in Argentine, Brazilian and Uruguayan (but not Paraguayan) intra-zone sales. In the first quarter of 2000 this trend continued in Brazil and Uruguay, although it was reversed in the other two countries.

MERCOSUR EXPORTS TO THE WORLD

	Intra-zone		Extra-zone	
	% var. compared to year before		% var. compared to year before	
	1999	I quar. 2000	1999	I quar. 2000
Argentina	-25.2	23.9	-4.4	7.4
Brazil	-23.7	9.5	-2.4	21.8
Paraguay	-19.2	92.2	-54	-44.4
Uruguay	-34.0	5.9	-0.3	14.0

Source: Calculated by the author based on CEI.

MERCOSUR imports as a whole fell by 16.4% in 1999 (almost double the decline in exports to the world during that same period). In terms of individual member states, Paraguay recorded the biggest fall in imports (by more than 30%) and Uruguay the lowest (12%).

Argentine imports had only fallen once before in the 1990s: in 1995, following the Mexican crisis. Although in 1995 GDP had declined by a similar level as in 1999, imports fell by “only” 7%, almost a third of last year’s fall. Brazilian imports dropped by only 6% in 1998, a much more recessive year than 1999. In 1999, all the MERCOSUR countries recorded their biggest falls of the decade in terms of imports.

TOTAL MERCOSUR IMPORTS

(in US\$ millions)

	1999	1998-1999 Variation
Argentina	25,537	-18.7%
Brazil	49,218	-14.7%
Paraguay	1,935	-30.6%
Uruguay	3,357	-11.9%

Source: Calculated by the author, based on CEI.

The decline in sub-regional imports began to slow down towards the end of the year, mainly because of a partial recovery in economic activity. Total Argentine, Brazilian and Uruguayan imports, which had fallen by more than 15% in the third quarter, fell by less than two digits in the last quarter of 1999.

MERCOSUR imports only began to increase in the first three months of 2000, although to varying degrees. Brazilian and Uruguayan purchases rose by more than 10%, while the increase in Argentine and Paraguayan imports was barely noticeable because of the low dynamism of their respective economies.

TOTAL MERCOSUR IMPORTS - QUARTERLY PERFORMANCE

% variation compared to the same period in the previous year

	I quar. 1999	II quar. 1999	III quar. 1999	IV quar. 1999	I quar. 2000	II quar. 2000 *
Argentina	-23	-27	-18	-6	-1.9	1.9
Brazil	-21	-13	-17	-8	10.5	9.8
Paraguay	-34	-22	-42	-29	0.3	n/d
Uruguay	-12	-14	-17	-4	13.0	9.2

Note: * estimate.

Source: Calculated by the author, based on CEI, INDEC, BCU AND FUNCEX.

In this period, the recovery is based exclusively on Argentine and Paraguayan intra-zone imports, since those from third countries continued to fall. Brazilian and Uruguayan sub-regional imports were also more dynamic than those from non-MERCOSUR countries, although these also increased during this quarter.

There was thus a reverse in the trend evident in Argentina and Brazil in 1999, whereby the decline in intra-zone imports was greater than that in purchases from third countries. In Brazil, for example, the fall in intra-zone imports was two and a half times greater than that for purchases from the rest of the world. However, the level of Paraguayan imports from third countries in 1999 was three times higher than that of intra-zone purchases.

INTRA- AND EXTRA-ZONE IMPORTS

	Extra-zone		Intra-zone	
	% var. compared to year before		% var. compared to year before	
	1999	I quar. 2000	1999	I quar. 2000
Argentina	-20.6	7.9	-18.0	-2.3
Brazil	-28.7	14.7	-12.0	10.0
Paraguay	-18.9	15.2	-56.0	-15.0
Uruguay	-11.5	22.8	-12.2	5.8

Source: Calculated by the author, based on CEI.

Despite a number of differences and nuances, the recovery in the total imports of the four member countries in the first quarter of 2000 is largely based on the recovery of the sub-regional market.

Sub-regional trade prospects

- The recovery of growth in the MERCOSUR economies will continue to boost trade. If, as expected, output in the four member countries is more dynamic in the second half of 2000, intra-regional trade flows will recover significantly this year, offsetting much of last year's decline.
- The results of the Brazilian trade balance in the first six months of 2000 have been viewed as disappointing by most analysts and the government. Earlier forecasts of a US\$ 5 billion surplus have now been revised downwards to US\$ 3.5 billion, although most analysts expect it to reach some US\$ 1.5 billion. There was a US\$ 850 million surplus in the first six months of 2000.
- Brazil's relatively poor performance is largely explained by the strong recovery in imports of basic and intermediate goods, as well as fuel and lubricants (due to the increase in the price of oil) Imports rose by 10% in the first half of 2000 and are expected to increase by 7.5% in the year as a whole.
- Brazilian manufacturing exports grew particularly strongly: by 17.5% in the January-June 2000 period. This was due to an increase in both volume (18.4%) and prices (6.4%). Total exports are expected to increase by 13% in the year as a whole, compared to a 16.5% rise in the first six months of the year.
- Bilateral Brazilian-Argentine trade increased by more than 16% in the first half of 2000 (Argentine exports to Brazil by 15.6% and Brazilian exports to Argentina by 17.4%). Brazil therefore had a US\$ 300 million trade deficit with Argentina in the first half of this year.
- Total Argentine exports grew by 13% in the first five months of 2000, mainly due to an improvement in the international price of oil and naphtha and an increase in wheat exports. On average, half of this increase is explained by the improvement in prices and the other half by the volume increase in exports. Overseas sales are expected to increase by around 11% in the year as a whole.
- Argentine industrial exports also increased by 13%, mainly due to greater demand in the European, Asian and NAFTA countries. Industrial exports to MERCOSUR rose by 6% during this period.
- Total Argentine imports rose by almost 2% in the first five months of 2000. This increase speeded up slightly in the last two months. Total imports are likely to grow by 5.5-6% in the year as a whole.
- Total Argentine exports to Brazil increased by 13% in the January-May 2000 period, mainly due to the recovery of the Brazilian economy. According to Argentine data, the country had a US\$ 160 million trade surplus with Brazil, compared to US\$ 119 million in the same period the year before.

ANNEX

Comparative Evolution of Argentine-Brazilian Industrial Wages

Because of the sharp devaluation of the real, Brazil's average industrial wage fell by 34.5% in dollar terms in 1999, 9% lower than before the start of the Real Plan. It is worth noting that a change of this scale significantly affected the sub-region's relative conditions of competitiveness.

According to a different interpretation of this phenomenon, however, the devaluation also offset 40% of the industrial wage increase (in dollar terms) in the 1994-1998 period.

The average Argentine manufacturing wage (in dollars) fell by almost 1% in 1998, after having fallen gradually since 1994. In the 1994-1998 period, wages in the sector fell an average of 6.6%.

At the end of 1999, therefore, the average industrial wage in Brazil and Argentina was, respectively, 9.1% and 7.4% lower than that in 1994.

It is interesting to note that the significant decline in relative wages in Argentina and Brazil after the devaluation did not uniformly affect the industrial sector. Wage differentials in manufacturing sectors such as chemical products, furniture and foodstuffs rose by an average of 39% in a single year, while that of graphics and textiles, rubber and transport materials grew by 27%.

AVERAGE INDUSTRIAL WAGES IN ARGENTINA AND BRAZIL

Comparative evolution between 1998 and 1999

Activity	Variation 1998-1999 (in %)	
	Argentina	Brazil
Metallurgy	-3.4	-33.7
Metal-mechanic	0.9	-33.8
Electrical material	1.5	-33.4
Transport material	-5.3	-33.7
Wood	1.1	-34.5
Furniture	4.5	-33.4
Paper and cardboard	1.9	-34.3
Rubber	-9.6	-35.8
Chemicals	6.3	-34.2
Plastics	-0.9	-34.0
Textiles	-4.5	-34.1
Garments	-2.8	-34.1
Foodstuffs	2.9	-34.6
Publishing and graphics	-9.0	-33.5
Manufacturing Industry Total	-0.9	-34.5

Source: Calculated by the author based on INDEC and IBGE

C. Foreign Investment

General FDI trends in developing countries

Total foreign direct investment (FDI) flows reached a record US\$ 827 billion in 1999, a 25% increase on the previous year.

In 1999, and for the first time this decade, FDI flows to Latin America (almost US\$ 100 billion) surpassed those to Asia (under US\$ 85 billion). Latin America was also the region with the highest increase (33%) in FDI flows between 1998 and 1999.

Given this greater dynamism, accumulated net income from FDI flows to Latin America in the 1990s reached an unprecedented US\$ 400 billion. The region's success over the last decade has been the result of the structural reforms carried out by the countries of the region – which opened new and important business opportunities in a relatively more stable political and economic environment than in previous decades – and the fact that global risk capital has been more willing to invest in the emerging economies.

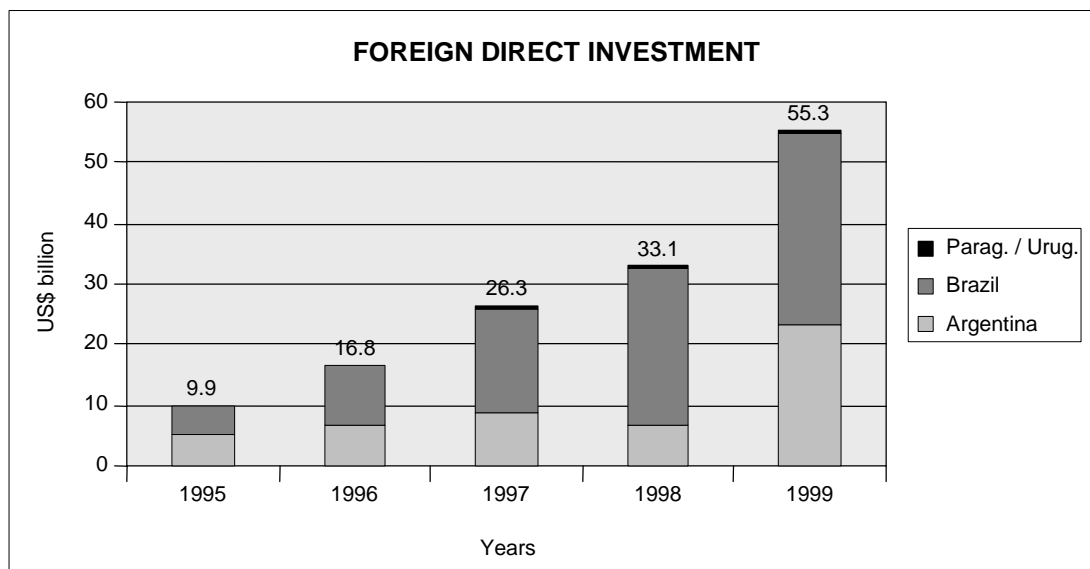
Unlike investment in the 1950s, 1960s and 1970s, most of this new investment was stimulated by company mergers and acquisitions, a phenomenon that responds to international trends. Although such operations in Latin America accounted for US\$ 75 billion between 1998 and 1999, this figure is small by international standards, accounting for only 6% of global operations in this period.

Mergers and acquisitions were particularly significant in the services sector during this period. This generally took the form of investment associated with the purchase of shares of privatized companies in the telecommunications, production and distribution of electricity, water and sewerage sectors. Mergers and acquisitions were also significant in the primary, industrial and commercial sectors.

There has also been a recent increase in mergers and acquisitions in the Internet business, in which foreign investment funds have played a particularly important role. In the first four months of 2000, for example, this type of activity accounted for 7% of FDI flows to Brazil.

Foreign direct investment in MERCOSUR in 1999

FDI flows to MERCOSUR continued to increase in 1999, despite the most serious sub-regional economic crisis of the decade. FDI reached US\$ 55 billion last year, two and half times the average flow in the last five years and 67.5% higher than the figure recorded in 1998.



Source: Calculated by the author, based on UNCTAD, ECLAC and national sources.

The increase in international risk capital in the last year has been largely the result of strong FDI growth in Argentina, which accounted for 75% of the increase in FDI to MERCOSUR in 1999.

RECENT EVOLUTION OF FDI IN MERCOSUR

	Variation 1998-1999 (US\$ billions)	Share (%)
Argentina	16.7	74.9
Brazil	5.4	24.2
Paraguay / Uruguay	0.2	0.9
MERCOSUR	22.3	100.0

Source: Calculated by the author, based on UNCTAD, ECLAC and national sources.

The increase in foreign investment in Argentina is largely explained by Repsol of Spain's purchase of YTF, Argentina's largest company, with annual sales of over US\$ 5.5 billion and assets of more than US\$ 13 billion. This single operation accounts for more than 55% of FDI flows to Argentina in 2000, making the country the second most important South American destination for FDI.

Other Argentine sectors also attracted significant foreign capital in 1999, including infrastructure (+5%), chemical and petrochemical industries (+49%) and foodstuff production (+75%). However, other sectors saw significant declines in investment, such as finance (-25%) and automobiles (-47%).

FDI in Brazil crossed the US\$ 30 billion barrier in 1999, making the country the most important Latin American destination for international capital. The most dynamic sectors were public and financial services, telecommunications and the chemical industry. Last year, these activities, which represent 40% of FDI flows to Brazil, accounted for almost all of the US\$ 5.4 billion increase in FDI.

At the sub-regional level, FDI in 1999 has helped boost almost all of MERCOSUR's productive activities.

**FDI IN MERCOSUR: SHARE BY SECTOR
1999**

Sector	Percentage
Oil and Gas	24
Telecommunications	15
Chemical Industry	10
Financial Services	8
Infrastructure	7
Automotive Industry	6
Commerce	5
Foodstuff Industry	4
Others	21

Source: Calculated by the author, based on CEP and *Gazeta Mercantil*.

Accumulated FDI in MERCOSUR reached some US\$ 156 billion in the 1990s; more than 90% of this total entered the sub-region in the last five years. These flows are important for MERCOSUR's productive development. Since they are also a significant source of long term capital (and consequently of greater relative stability) they have also been particularly important for those economies that are highly dependent on foreign finance.

Prospects for 2000

- According to estimates from the Argentine economy ministry (*Centro de Estudios para la Producción* - CEP), ongoing and planned investment in Argentina by foreign companies is likely to reach some US\$ 11.5 billion this year. Although this figure is significantly below than the exceptional total for 1999 (because of the YPF takeover), it still makes Argentina one of the main recipients of FDI in the developing world.
- The United States is the main investor (38% of the total), followed by Spain (22%), Italy (8,8%), France (7.5%) and Canada (6.9%). In sectoral terms, infrastructure (especially telecommunications) accounted for almost half of this investment, followed by manufacturing industry (especially foodstuffs and automobiles) with 25%, commerce and services with 12.5%. Mining and financial services accounted for the rest.
- Government estimates suggest that FDI flows to Brazil will reach some US\$ 25-30 billion in 2000. Investment in infrastructure is expected to account for 36% of this total (with half of this destined for the telecommunications sector), the financial sector for 8%, the chemical industry for 5% and Internet-related activity – the new “hot sector” for foreign capital investment – for 7%.

MAIN MACROECONOMIC INDICATORS IN MERCOSUR

	ARGENTINA					BRAZIL					PARAGUAY					URUGUAY					
	1995	1996	1997	1998	1999	1995	1996	1997	1998	1999	1995	1996	1997	1998	1999	1995	1996	1997	1998	1999	
OUTPUT LEVEL																					
GDP -Total	(US\$ billions)	243.2	256.6	277.4	288.2	281.9	705.4	775.4	804.1	776.6	761.0	9.0	9.7	9.6	8.6	8.5	18.0	19.1	19.8	20.5	20.1
GDP -Total	(% annual variation)	-2.8	5.5	8.1	3.9	-3.0	4.2	2.8	3.7	0.0	0.8	4.7	1.3	2.6	-0.4	-2.4	-1.8	5.3	5.1	4.5	-3.4
Industrial output	(% annual variation)	-6.7	5.2	10.2	0.8	-6.9	1.8	1.8	3.9	-2.3	-1.6	3.0	-2.2	-0.2	0.9	0.0	-3.1	4.8	5.6	2.4	-9.9
Fixed gross domestic investment	(% of GDP)	18.3	18.9	20.6	21.1	18.9	20.6	20.5	21.5	20.8	16.9	23.9	23.6	26.0	22.9	19.3	17.9	16.6	16.8	18.5	16.7
Unemployment rate	(%)	16.6	17.3	13.7	12.4	13.8	4.6	5.4	5.7	7.6	6.3	5.3	8.2	10.6	15.8	16.0	10.3	11.9	11.5	10.2	11.4
PRICES AND EXCHANGE RATES																					
CPI	(% variation Dec./Dec.)	1.6	0.1	0.3	0.7	-1.5	22.0	9.1	4.3	2.5	6.3	13.4	9.8	6.2	14.6	5.4	35.4	24.3	15.2	8.6	5.3
Nominal exchange rate	(% variation Dec./Dec.)	0.0	0.0	0.0	0.0	0.0	13.8	7.1	7.4	8.3	48.0	2.8	6.7	8.7	16.9	19.4	26.5	22.7	15.2	8.1	7.9
PUBLIC SECTOR AND INTEREST RATES																					
Public sector deficit (-)	(% of GDP)	-2.3	-3.2	-2.0	-2.1	-3.8	-7.0	-5.9	-6.3	-8.1	-10.1	-0.3	-0.8	-0.3	-1.0	-3.3	-1.2	-1.1	-1.0	-0.8	-2.8
Passive interest rate	(annual %)	9.5	6.2	6.6	6.8	6.9	53.1	27.1	24.7	28.6	25.2	15.8	12.8	8.8	6.7	10.2	38.2	28.1	19.6	15.1	14.2
EXTERNAL SECTOR AND BALANCE OF PAYMENTS																					
Exports	(% annual variation)	32.4	17.3	11.2	0.0	-11.8	6.8	2.7	11.0	-3.5	-6.1	12.0	13.5	27.6	-17.1	-32.8	12.2	13.8	13.7	1.6	-18.9
Imports	(% annual variation)	-6.8	17.9	28.3	3.1	-18.7	50.0	7.5	15.1	-5.9	-14.7	29.3	-0.9	12.0	-19.8	-30.6	4.3	15.9	11.9	2.5	-11.8
Exports	(US\$ billions)	20.3	23.8	26.4	26.4	23.3	46.5	47.7	53.0	51.1	48.0	0.9	1.0	1.3	1.1	0.7	2.1	2.4	2.7	2.8	2.2
Imports	(US\$ billions)	20.1	23.7	30.5	31.4	25.5	49.6	53.3	61.3	57.7	49.2	3.1	3.1	3.5	2.8	1.9	2.9	3.3	3.7	3.8	3.4
Trade balance	(US\$ billions)	0.1	0.0	-4.0	-5.0	-2.2	-3.1	-5.5	-8.4	-6.6	-1.2	-2.2	-2.1	-2.1	-1.7	-1.2	-0.8	-0.9	-1.0	-1.0	-1.1
Current account deficit	(US\$ billions)	-4.9	-6.5	-12.0	-14.7	-11.5	-17.8	-24.3	-33.3	-35.1	-32.7	-0.5	-0.7	-0.8	-0.7	-0.4	-0.2	-0.2	-0.3	-0.4	-0.5
Current account deficit	(% of GDP)	-2.0	-2.5	-4.3	-5.1	-4.1	-2.5	-3.1	-4.2	-4.5	-4.3	-0.1	-0.1	-0.1	-0.1	0.0	-1.2	-1.2	-1.6	-2.1	-2.5
Foreign direct investment	(US\$ billions)	5.3	6.5	8.8	6.5	23.2	4.3	9.9	17.1	26.1	31.5	0.2	0.3	0.2	0.2	0.3	0.2	0.1	0.2	0.2	0.3
Gross total foreign debt	(US\$ billions)	110.0	125.4	138.5	148.1	155.4	159.3	179.9	192.9	235.1	240.0	1.3	1.3	1.4	1.6	2.1	6.3	6.4	6.9	7.7	8.0
International reserves	(US\$ billions)	17.6	19.3	24.3	26.9	26.4	51.8	60.1	51.4	44.6	36.3	1.1	1.1	0.8	0.9	1.0	1.8	1.9	2.1	2.4	2.4

Sources: Calculated by the author, based on data from the Economy Ministry, INDEC, CEI (Argentina), the Central Bank, FUNCEX, Ibge, F. G. Vargas (Brazil), the Paraguayan and Uruguayan Central Banks, J. P. Morgan and Lehman Brothers.

CHAPTER II. COMMERCIAL AND SECTORAL CONFLICTS

Over the last year and a half, MERCOSUR has witnessed several internal disputes associated with problems of market access. These placed the two largest MERCOSUR member countries in an almost permanent state of conflict between the end of 1998 and the first quarter of 2000.

A variety of factors reinforced old and new tendencies for a clash of interests between the two countries. Some of these were linked to current developments in the macroeconomic environment, such as:

- The strong contraction in internal demand in the four member countries and, consequently, the shrinking of the potential market for companies operating in the sub-region.
- The sharp fall in the international price of many commodities and tradable goods and, therefore, a decline in the profit margins of many sectors.
- The severe economic and social crisis in various sub-regional economies, particularly those linked to the mono-production of agricultural commodities.
- The sudden change in the parity of bilateral exchange rates and its expected impact on the volume and/or direction of intra-subregional trade flows.
-

The effect of these phenomena was undoubtedly exacerbated by other more structural factors, such as:

- The final elimination of residual trade tariffs between Argentina and Brazil at the start of 1999. This had a particular effect on traditionally sensitive products.
- The impact of structural changes on sub-regional productive activities in recent years. This altered some of the MERCOSUR members' preconceived ideas about their respective trade roles (in this respect it is worth noting the boom in Argentina's dairy industry, the growing rice industry in southern Brazil, and productivity gains in Brazilian poultry farming).
- MERCOSUR's pre-existing (and still unresolved) juridical and institutional vacuums, particularly those related to "escape" mechanisms or general and sectoral emergency clauses.

From the perspective of the negotiations and general policy, it is worth noting that in the years after Ouro Preto the overvaluation of the real, and fears that a devaluation in Brazil would lead to regional chaos, somewhat legitimized the permanence of certain "grey area" sectoral regulatory regimes and financial mechanisms in Brazil. The change in the exchange rate parity in January 1999 strengthened the position of "combative sectors" in the governments and business sectors of the other member states. Therefore, while some earlier conflicts deepened, other sources of tension – which thereto had remained latent or had been successfully tackled by the authorities – developed into open disputes between the partners.

The gradual but sustained deterioration in the sub-region's social and labor indicators in 1999 led to a significant increase in sectoral pressures and demands on politically weak officials and governments. Such pressure sought to complicate the negotiations by unilaterally imposing general or sectoral restrictive trade measures to aid sectors badly affected by the fall in demand. Several justifications were made, such as

technical and health regulations, or claims of dumping, and production and export subsidies. This led to a number of market access-related disputes between the start of 1999 and the first quarter of 2000. Many of these disputes began to be resolved thereafter, which coincided with an improvement in the sub-region's macroeconomic and commercial conditions.

A. The Two great “Horizontal” Conflicts of 1999 and 2000

MERCOSUR has been affected by a number of serious crises during its short life. Nevertheless, the disputes between its two largest members in the four-year period between the signing of the Protocol of Ouro Preto and the end of 1998 can be viewed as relatively isolated incidents, set against a background of agreements and understandings on a variety of issues, or as the consequence of rapid progress in integration and an upsurge in business links, trade and common interests.² This new phase is, however, different.

The succession of trade clashes and political “incidents” spurred by the January 1999 Brazilian devaluation took place amid unease about the recession, the sharp contraction of intra-zone trade, and the two-year long stagnation or paralysis of the negotiations.

Two incidents during the period under study marked the high point of tensions between Argentina and Brazil: (i) the conflict arising from the unilateral decision of Argentina's economy ministry to activate LAIA's safeguard mechanism at the end of July 1999 and, consequently, the implicit threat of using it at the sub-regional level and (ii) debate and doubt about MERCOSUR's present and future in various political and business circles in Argentina between January and February 2000, particularly in relation to the alleged “flight” of companies and investment to Brazil.

These two episodes will be examined below, since in this respect a retrospective analysis could foster better understanding of the present state and future prospects of the integration process.

The winter of 1999: the “battle” of the safeguards

Early signs that the sub-regional economy had begun to improve in the first half of 1999 were quickly dashed at the start of the second half of the year. This undermined the view that relations between the two main MERCOSUR member countries would improve. Optimism had been fuelled by expectations that the Brazilian economy was recovering, by the end of the negotiations between Brazil and the Andean countries within a “MERCOSUR-compatible” format, and by the reasonably satisfactory results of the European Union-Latin American/Caribbean Presidential Summit held in Rio de Janeiro at the end of June.

Successive macroeconomic indicators in Argentina showed that output was continuing to fall and that the crisis was much more serious than originally thought. This limited the government's ability to respond to the complaints and demands of those productive sectors most affected by the contraction in domestic demand and output. The increase in sectoral lobbying (for measures to “alleviate” the effects of the recession) on a government increasingly weakened by the start of the final phase of its mandate triggered

² One of the most important Argentine negotiators viewed these conflicts as part of the “paradox of success”, in that advances in the integration process gradually included in sub-regional free trade numerous sectors and activities that had traditionally not been important at the sub-regional level. This prompted temporary episodes of resistance or opposition to the process. It was therefore natural that a greater volume of business in the sub-region would lead to a greater number of conflicts.

differing opinions among Argentine negotiators as to how to respond. It also fed the “imagination” of economists and business analysts, and their search for “creative” proposals and alternatives.³

Brazil’s economic crisis also led to a serious weakening of President Cardoso’s domestic position (his popularity sank to the lowest absolute and relative levels of his mandate), and to a cabinet reshuffle and a crisis in the coalition.

The Argentine Industry Secretariat’s decision not to exclude Brazil from a safeguard measure on the textile sector in mid-July was criticized by the Brazilian government;⁴ Brasilia publicly threatened to challenge Argentina before the WTO and MERCOSUR’s Arbitration Tribunal, arguing that the measure was incompatible with the Customs Union.⁵

Aside from specific issues and examples, the two main member countries appeared to have learned very different lessons from the sub-regional crisis and its implications. The predominant view in Brazil was that Argentina obstructed its bargaining room in order to defend its exchange rate (which had been badly hit by the real devaluation) to the detriment of Brazil. Such thinking concluded that most of MERCOSUR’s problems could be resolved immediately if Argentina “copied” Brazil and adopted a more flexible exchange rate. Unless it did so, Brazil should not accept the restrictions arising from Argentina’s “obstinate” preference for the convertibility system.⁶ The old problem of in-fighting among Brazil’s regions also contributed to MERCOSUR’s difficulties after the influential North-Eastern Senator Antonio Carlos Magalhães stated that “MERCOSUR is useful, but must be rethought” and that “all the member countries have exploited Brazil” (*Folha de São Paulo*, 18/7/99).

The main Brazilian newspapers also began to reflect increasingly virulent, “MERCOSUR-resistant” thinking. This viewed the new trade disputes with Argentina (such as the imposition of a safeguard on textiles, restrictions on the import of footwear and some electrical and electronic products, problems with poultry, and the persistently thorny sugar conflict) as part of an unacceptable Argentine strategy to gain ground to at the expense of its larger partner, which should be fought and resisted.

While the Brazilian magazine *Epoca* viewed the footwear conflict as “purely an Argentine problem”, in mid-July 1999 an editorial in the influential *Folha de São Paulo* made public the newspaper’s skepticism about the future of the integration process by stating that “the Southern Cone integration project has never been closer to collapse than now. (...) Perhaps the disintegration of the process would be better for Brazil than the unsustainable consequence of the concessions that the government has been granting to the Argentines over recent years” (*Folha de São Paulo*, 15/7/99).

From the Argentine point of view, however, the problem was that Brazil had been acting as if nothing had happened and had completely ignored the effects that changes to its exchange rate parity had been having on the rest of the sub-region, showing only a vague willingness to analyze alternatives for certain specific

³ It is worth noting in this respect that in the first few months of 1999, the opinion columns of the main Argentine newspapers included an exchange of opinions and positions between important trade and integration analysts and experts on the juridical applicability and/or viability for MERCOSUR of LAIA safeguard mechanisms. These were viewed as a “flawed, but valid and reasonable instrument, especially if the voluntary sectoral agreements failed”.

⁴ in a statement to *Ambito Financiero* [14/7/99] Brazilian Foreign Trade Secretary Mario Marconini stated that “we are forced to say that we do not accept this measure, which contravenes the Treaty of Asunción and is a precedent for any MERCOSUR member to do the same”.

⁵ See Chapter III of this report for more information on the general debate about the applicability of trade defense measures that are WTO-compatible for intra-zone trade.

⁶ A good example of this analysis can be found in the editorial of the *Journal do Brasil* del 14-10-99.

cases. Some analysts and businessmen also claimed that the devaluation of the real had undermined Brazil's last remaining argument for sectoral subsidies and mechanisms that distorted sub-regional competition, and that such schemes should no longer be tolerated by the other members

Brazil's argument was based on a question of principle,⁷ and on the fact that, even after the devaluation of the real, Brazil's sub-regional exports and imports continued to fall by around 20-30% year-on-year. This belied fears that Brazilian products would flood the Argentine market.

In the third quarter of 1999, therefore, Argentina was experiencing its worst recession of the decade, a sharp fall in its intra- and extra-zone exports, the latent threat of a Brazilian trade invasion, and increasingly public sectoral pressure on the government over foreign trade in general and MERCOSUR in particular.

This sparked a growing sense of unease about the sub-regional market, and prompted calls to reverse some of the advances made in recent years. In important economic and financial fora, therefore, some key Argentine analysts and former officials publicly spoke in favor of abandoning the ambitious but unrealistic idea of a Customs Union, which they claimed should be replaced by a more modest free trade zone scheme. This would provide the member countries with greater opportunities and more flexibility to use trade policy instruments that could help overcome the crisis.

At the end of July 1999, the two governments' inability to resolve their domestic difficulties, their lack of agreement on the recurrent theme of intra-zone trade safeguards, and the unlikelihood that bilateral or intra-MERCOSUR negotiations would resolve the problem led the Argentine economy ministry to "play rough" and apply LAIA Resolution N° 70/87, despite opposition from the foreign ministry⁸. The economy ministry argued that the "MERCOSUR agreements are vague on the issue of the application of safeguards" and that "LAIA Res. 70 is adopted nationally to fill this legal vacuum" (Felix Peña, *El Cronista*, 27/7/99).

Although this did not have an immediate or concrete effect on any sector in particular, Argentina left open the possibility of applying safeguards to imports from Brazil or any other country in the sub-region. In recent years, and particularly in the early months of 1999, Brazilian officials had reiterated their vigorous and complete rejection of negotiating a regime of this type in MERCOSUR, and hence Argentina's unilateral decision was an aggressive move with unknowable consequences.

⁷ "Once the transition and adjustment stages have been met, this should be a free trade area between the member states. If we accept new adaptation regimes, the whole process will become distorted and will lose all meaning") Statement made by José Botafogo to *Clarín* 17/3/00.

⁸ It is interesting to note in this respect that although the foreign ministry publicly opposed the "LAIA strategy" during the first half of 1999, it was the industry secretariat that strongly supported the unilateral approach. It argued that only through that approach would it be possible to force Brazil to negotiate a solution for the sensitive sectors.

The LAIA Trade Safeguard Regimes

The regime for the application of safeguard measures included in Resolution 70 of the LAIA Committee of Representatives (CR) is applicable in the framework of the LAIA partial scope agreements and has a “general and supplementary character” for bilateral agreements that do not include specific norms on this issue.

These safeguards aim to correct balance of payments disequilibria or situations where significant quantities imported from other LAIA countries “cause or threaten to cause serious damage”. The safeguards – which are applicable for one year, with the possibility of extending them for a further year – are applied unilaterally, although they include a notification and consultation system with the affected party. In terms of balance of payments disequilibria, safeguards can be applied against any LAIA member, except the less developed ones (Bolivia, Ecuador and Paraguay). The importing country, meanwhile, has to commit itself to gradually lessen the effects of the measure when “the conditions that motivated it improve”. In cases of serious damage or the threat of serious damage because of an increase in imports, the exemption for the less developed countries is more tenuous.

The measure can be applied by governments and by producers. The country applying the measure must unilaterally establish a quota – within which the preferences and other conditions established by the Partial Scope Agreement are maintained – which should be reviewed within 60 days together with the countries affected. Even in cases where there is no agreement on improving access conditions for the countries affected, the importing country can decide to maintain the measure.

Since LAIA Resolution 70 only establishes a general framework for the application of the regime but does not define the concept of damage nor threat of damage (nor the procedures required to test them), the countries have to establish the administrative system and mechanisms, after which the system will be valid in each country. The regulations of Argentina’s safeguard system were established at the end of July 1999 – that is, 12 years after it was set up – through Economy Ministry Resolution N° 911/99. However, the system did not have an immediate effect on trade *per se*, nor was it specifically directed towards a particular sector or product. It was instead introduced in a generic manner in order to enable the ministry to apply restrictive measures to imports from the LAIA member countries, on the basis of parameters established by the resolution.

Arguments "for" of the Applicability of Res. 70

- Preferential agreements often include “escape valves or clauses” that, since they make the system more flexible, increase their long-term viability and stability. This type of clause, which is not contemplated in the MERCOSUR Agreement, takes various forms in the WTO, EU and NAFTA.
- The safeguard clause included in the Treaty of Asunción sought to facilitate the functioning of the 1991-1994 Trade Liberalization Program. It is therefore reasonable to assume that the authors of the treaty supposed that, during the lengthy transition period, progress would be made towards a zero tariff and the elimination of non-tariff restrictions, and that agreements would also be reached on macroeconomic policy coordination. However, the lack of emergency mechanisms to resolve problems stemming from the lack of progress on macroeconomic coordination became clear when intra-zone tariffs were eliminated in January 1995 but the requirements were not met to justify eliminating the safeguard clause established in the Treaty of Asunción. It could therefore be argued that there was a legal vacuum in MERCOSUR, which could be filled by appealing to LAIA.
- In periods of economic and financial crises, it is preferable to have adequate instruments to regulate and/or “manage” possible intra-zone trade disequilibria in a cooperative and consensual manner, particularly those that can be viewed as temporary or short-term. This argument thus holds that once the transition period ended, Argentina repeatedly demanded the introduction of some system or mechanism of this type without ever having secured the agreement of most of the MERCOSUR member states.

Arguments “Against” the Applicability of Res. 70

- The N° 18 Partial Scope Agreements signed by Argentina, Brazil, Paraguay and Uruguay (which made the Treaty of Asunción compatible with LAIA) include specific safeguard norms that explicitly set 31/12/94 as the deadline for MERCOSUR countries to apply the safeguard measures.
- These norms are superior to LAIA’s safeguard regime because of their specificity (since they are part of MERCOSUR) and their timing (since the Treaty of Asunción and Partial Scope Agreement N° 18 were approved after LAIA Resolution CR 70).
- Those LAIA agreements in which the member states have decided that Resolution CR 70 is applicable include explicit rules in this respect. This is the case of Argentina’s agreements with Colombia, Peru and Venezuela.
- The conditions for applying safeguards in MERCOSUR until 31/12/94 were more rigorous and demanding than those established by LAIA Res.70. By accepting its applicability to MERCOSUR, the members would be accepting the applicability of a less restrictive regime during the consolidation of the Customs Union than existed during the transition. This is a juridical and economic contradiction.
- In the negotiations prior to the Ouro Preto agreements, Argentina insisted on the need to prolong the intra-zone safeguard regime, a view that was rejected by the other members, since they argued that this instrument had been applied to offset the negative effects of the tariff reduction timetable. An adaptation regime was therefore approved to facilitate the gradual inclusion of specific sensitive sectors in intra-zone free trade. According to the timetable agreed by the members, this transition period ended at the start of 1999 for Argentina and Brazil, and at the beginning of 2000 for Paraguay and Uruguay.

Argentina's announcement that it would apply the measure led to immediate and serious intra-bloc tensions in a climate already marred by the decision of the political wing of the Argentine government to request full NATO membership. This interrupted two years of unprecedented progress on the formulation of a common regional security policy.⁹

In other words, if the textile safeguard /applied by Argentina in the framework of the WTO agreements) could be interpreted as an issue of conflict or controversy between the countries, the LAIA Res. 70 rule was a challenge that seemed impossible to resolve. After President Cardoso stated that "there are certain rules that cannot be ignored" (*La Nación*, 29/7/99) and Under-secretary Graça Lima claimed that "the Argentine decision lacks a legal basis and damages the spirit of the Customs Union" (*El Cronista*, 27/7/99), the conflict reached a high point when the Brazilian Foreign Ministry publicly announced that it was willing to suspend its participation in all MERCOSUR negotiations until the Argentine government annulled the measure or explicitly exempted the member states from it. MERCOSUR was therefore experiencing its worst internal crisis in a decade, a fact that was reported in the international media.

Political tensions eased after the Argentine president made an unforeseen and unplanned visit to Brasilia to meet his Brazilian counterpart, after which the Argentine government reversed its position and excluded the MERCOSUR countries from the LAIA safeguard measures. Argentina thus explicitly reversed its position, and paid a not insignificant domestic political price, while Argentine Economy Minister Roque Fernández admitted that "this was not done to adopt an immediate protectionist measure, but to warn that there is a problem and that a solution must be sought" (*El Cronista*, 29/7/99). An extraordinary meeting of the CMG and the CMC was also urgently called to resume the dialogue and seek alternative solutions to the sub-regional crisis.

The extraordinary meeting of the CMG and the CMC only helped each side to explain their different positions on this controversial issue. The Brazilians, however, "completely rejected" any type of unilateral restrictive trade mechanism. Argentine Economy Minister Roque Fernández claimed that "internal criticism by those who reject MERCOSUR will be strengthened unless we favor those sectors affected by the unfavorable circumstances over those that are uncompetitive and inefficient in the long term". The Brazilian foreign minister responded by stating that "Brazil is not even in a position to examine safeguard measures or the reintroduction of an adaptation regime, since these affect sectors that have long been sensitive and as such receive special treatment".

Notwithstanding that, and as regards the sectors affected by specific and conjunctural problems, Brazilian Finance Minister Pedro Malan stated a few days later that "the Brazilian government is willing to support their resolution with the participation of the private sector". It was therefore made clear that Brazil might respond to specific sectoral complaints or demands, but would not accept an imposition or negotiations "from a position of strength" on the part of its main sub-regional partner.

After attempts to reach "more or less voluntary" private sector agreements failed to yield any concrete results, Argentina's economy ministry announced the imposition of new labeling and registration requirements for imports of footwear (Res. 619/99) and, weeks later, for certain types of packaged paper (Res. 653/99). In both cases, the measures sought to restrict bilateral trade in traditionally "conflictive" sectors. Tensions between the two main MERCOSUR countries resurfaced, however, despite a significant fall in the import price of certain sub-sector products and/or increases in Brazilian sales.

In mid-September, after a protest and a threat to take the matter to MERCOSUR's dispute settlement mechanism, Brasilia announced its decision to "reciprocate" by reimposing the prior license requirements

⁹ It is worth noting that tensions were still high over the proposal to dollarize the Argentine economy, which was announced at the height of the Brazilian crisis.

on the import of some 400 Argentine products that had been eliminated at the start of the year (mainly chemicals, foodstuffs and automobiles); to grant Argentina “similar treatment to other trade partners”; and to include the country in an arrangement whereby the health protection secretariat supervises the inspection of export companies, a norm introduced at the end of 1998 but which excluded Argentina.

Bilateral tensions reached a climax after the Brazilian foreign minister said that MERCOSUR was finished and that Brazil would respond by “playing rough” if Argentina applied generalized restrictions on Brazilian imports, while the vice-president of the *Unión Industrial Argentina* (UIA) responded by accusing Brazil of “imperialist sovereignty”. Tensions eased at the end of September after intense negotiations between official and private representatives led to an agreement between the Argentine and Brazilian Chambers of Commerce to voluntarily restrict footwear and paper exports in order to “to put the market in order”. In response, Brazil announced the suspension of the prior licensing requirements for the aforementioned imports from Argentina. In short, the “storm clouds” again began to disappear from the horizon.

It is clear that these sectoral agreements were far from being a panacea and that they offered no sustainable solution for the problems affecting the sectors involved, partly because they sparked new difficulties for those sectors further down the production chain whose inputs became more expensive,¹⁰ and partly because of possible legal claims by marketing companies. Given the complex circumstances of the previous few months, however, these agreements were a pragmatic and rational response to efforts to “gain time”, and thus diffuse a significant source of political tension between the two countries. This helped to dissipate the climate of tension and to create conditions more conducive to a search for sustainable alternatives for the sectors in conflict.

The summer of 2000: "MERCOSUR under fire"

A new government took office in Argentina at the end of 1999. The main Argentine and Brazilian negotiators were forced to work during the traditional end of year holidays to resolve a number of bilateral issues with concrete deadlines. These included the homogenization of their national automotive regimes, which expired at the end of 31 December. Additionally, a number of pending issues that had been “accumulating” since the second half of 1999 had to be agreed with officials of the new Argentine government.

The new presidents of Argentina and Uruguay have made numerous statements in favor of strengthening MERCOSUR politically and economically. This, coupled to the ideological-strategic similarities between all the governments of the sub-region, will help create a more propitious climate for reaching new agreements on economic and trade issues. The fact that two issues that were particularly irritating for the foreign ministry officials of Brazil and Argentina have disappeared from the bilateral agenda (the Menem government’s attempts to dollarize the Argentine economy and to gain full membership of NATO, both of which occurred during the complex year of 1999) also helped to renew mutual confidence and trust.

The idea of defining a minimum agenda to “relaunch” MERCOSUR was attractive for an increasing number of negotiators from the bloc’s two main countries. This minimum agenda included matters related to sectoral conflicts, as well as “chronic” problems and long-term issues such as macroeconomic coordination, redefining MERCOSUR’s institutional structure, and efforts to set up a sub-regional infrastructure plan. Given the uncertain and ambiguous evidence about the expected economic recovery, the various business and political actors also repositioned themselves in order to confront the new political conditions.

¹⁰ These include the garment industrialists grouped around the *Cámara Argentina de la Indumentaria* (CAI) and the foodstuff manufacturers belonging to the *Cámara de Industrias de Productos Alimenticios* (CIPA). The two associations complained about the extra costs their industries had to incur as a result of intra-zone import restrictions on inputs for their respective industries (cotton textiles and raw sugar, respectively), since overseas purchases of goods based on these inputs (which competed with their output) did not have similar tariff treatment.

Productive sectors affected or potentially affected by the severe recession and the change in bilateral exchange rate parity thus made public their demand that the Argentine government grant them special treatment. The Brazilian government publicly announced a greater willingness than in previous months to consent to a formal or informal “limited” sectoral negotiation of voluntary export restraints, if and when there was an explicit agreement on certain guidelines for productive restructuring in the weakest country, which might guarantee both the transitory nature of such schemes and their practical usefulness.¹¹

On 23 January, a confidential report from the *Unión Industrial Argentina* claimed that “more than 100 firms based in Argentina have this year decided to totally or partially relocate to Brazil, attracted by the fiscal and financial subsidies offered by different government institutions of the neighboring country”. A few weeks later, the main newspapers in Buenos Aires “denounced” the distribution of an investment guide by the Brazilian embassy in Argentina – through the Internet and together with a group of Brazilian entrepreneurs with interests in Argentina. The guide, published in Spanish, detailed the advantages, requirements and benefits for companies interested in investing in various Brazilian states. Although the guide was no more than a natural activity of a modern diplomatic mission (facilitating and promoting business with and investment in the home country) it was viewed by many in the agitated Argentine business and political community as an act of Brazilian “aggression” or hostility.

The *Unión Industrial Argentina* reacted angrily.¹² The governor of Buenos Aires province also criticized the Brazilian states’ policy for attracting investment (he accused them of adopting expansionist policies and scouting out the territory), alluded to the possibility that Argentina might withdraw from the Treaty of Asunción, and publicly threatened to impose sanctions on companies that partially or totally relocate to Brazil by excluding them from the register of suppliers to the provincial state for 20 years. He also publicly asked the national government to establish a “special dollar” to offset the impact of the Brazilian devaluation, and to design a tariff trigger clause to protect domestic industry from sharp devaluations of the Brazilian currency (*La Nación*, 15/3/00).

The chief of Argentina’s cabinet exacerbated the almost anarchic climate of declarations and counter-declarations to the press by making a public and off-the-cuff statement that called on the Brazilian government to introduce a compensation regime in case of possible trade imbalances caused by the devaluation of the real. This initiative stemmed from a proposal made by the previous government on a number of occasions during 1999, which was invariably rejected by the Brazilians. The industry secretary also noted that “MERCOSUR (...) cannot continue as it is”. The footwear union, the *Sindicato de Obreros del Calzado*, fanned the flames by conducting an aggressive poster campaign in the center of Buenos Aires, while MERCOSUR’s Arbitration Tribunal called on the Argentine government to eliminate within 15 days the quotas it had imposed on cotton textiles from Brazil in the middle of the previous year. This created a new source of conflict in the complex and agitated world of Argentine politics.

The Brazilian minister, José Botafogo – Brazil’s spokesman and senior negotiator – stated that the proposal of Argentina’s chief of cabinet was “unacceptable”, disqualified the governor of Buenos Aires as a valid interlocutor in bilateral negotiations, strongly rejected the idea of reversing the process towards a free trade zone, sharply criticized Argentine officials’ previous and current lack of cooperation in sustaining the exchange rate parity of the real (“I do not think that [Argentina] has adopted a good attitude

¹¹ In this respect, the head of the Brazilian negotiators told the Argentine press at the end of March that “to manage trade is not a backward step in terms of regional free trade if the transition implies an improvement in the productive quality of Argentina and Brazil”. (Statement to *Página 12*, 25/3/00).

¹² Its secretary general claimed that “this shows that MERCOSUR is in a bad way, that it is necessary to restructure it so that (...) it does not become a perverse system in which one country wins, companies disappear and unemployment increases in the other”. (*La Prensa*, 21/2/00).

(...) What kind of solidarity is that?), and counter-attacked by arguing that “Argentina’s exchange rate policy has costs and benefits for Argentina. There is no reason why Brazil should pay the costs of Argentina’s decision not to devalue” (*Clarín*, 22/3/00).

The climate was becoming politically intolerable by March, given that doom-merchants occupied center stage and the negotiations seemed to be taking place more in the newspapers¹³ than in the foreign and economy ministries. To bring its officials “into line” and make clear Buenos Aires’s official position on this issue, the Argentine foreign minister publicly admitted that “there have been many statements, but the only ones that carry weight are those approved in the international negotiations by the main authority of both countries. The rest is free thought” (*Gazeta Mercantil Latinoamericana*, 26/3/00 al 1/4/00).

Although the Argentine deputy foreign minister announced that 30 April would be the deadline for resolving the most urgent trade disputes (including the Brazilian government’s partial compliance with the previous year’s MERCOSUR Arbitration Tribunal ruling on the complete elimination of all non-automatic licenses for intra-zone trade by 31/12/99),¹⁴ he subsequently made a number of positive comments about the future of the integration process. The minister thus made a timely and valuable contribution to restoring the necessary calm lost by the negotiators on both sides.

Some of the companies that were allegedly relocating to Brazil publicly denied these claims. The UIA also acknowledged that there was no evidence of such a trend (which was limited to some 30 firms, almost all of them transnationals), while various analysts and businessmen claimed as absurd recent newspaper reports on the feasibility and logic of relocating companies or production lines to Brazil.

The agreement in principle between Argentina and Brazil on the Automotive Policy at the end of March (after tense and high-level negotiations) was a significant political and economic development that could reverse the negative climate evident in MERCOSUR during March, thus ending, at least temporarily, the lack of political definition and the “dangerous” negotiations via the media.

Relations improved because of two factors. First, the agreement was generally well received by the Argentine automobile sector (although with some notable exceptions), particularly because it included a local content requirement (which not surprisingly had been rejected by the Brazilian negotiators over the years). Second, Brasilia announced that it was willing to study the possibility of establishing some type of “umbrella” or mechanism to reverse the sectoral imbalances in intra-subregional trade.

Other developments also helped to “free up” the agenda and reverse the “climate of conflict” that had prevailed almost uninterruptedly since the end of the previous year, thereby creating a more constructive environment that was conducive to new agreements. These included the positive resolution of some border trade disputes related to the entry to Brazil of certain Argentine and Uruguayan agricultural and foodstuff

¹³ Another good example of Brazil’s perception of Argentine public attitudes to the national and sub-regional crisis can be found in an editorial in one of the main Brazilian current affairs magazines, published in mid-March 2000 and entitled “Why the Argentines are Angry with Brazil”. It describes the situation in Argentina with a certain irony the situation of its sub-regional partner, from both the economic and sociological point of view: “Immersed in a serious economic crisis and incapable of profitably exporting its products to the world, Argentina discovers a scapegoat: its neighbor. (...) The current national sport in Argentina is to blame Brazil for its domestic economic difficulties. (...) The Argentines are at a crossroads. They either devalue the peso, which would lead to generalized bankruptcies because the country’s debts are mainly in dollars, or they reduce prices and wages in order to make their economy more competitive, which would be politically unviable. (...) Added to this economic situation is the Argentine psyche, with its tendency to work to the rhythm of the tango. Buenos Aires has 19,000 psychologists, one for each 190 inhabitants, three times more than in São Paulo. It is no coincidence that the series with the highest rating on Argentine television is “*Vulnerables*”, which relates the neuroses and suffering of a group of psychotherapy patients” (*Revista Veja*, March 2000).

¹⁴ Invoking the exemptions established by Art. 50 of the LAIA Treaty, which the ruling admitted as valid for the maintenance of the non-automatic license regime. This situation has highlighted the need to establish criteria that are accepted by all the member states, in order to define more clearly the range of products and sectors to be given the aforementioned treatment.

products (after the intervention of the two countries' agriculture ministries and organizations representing producers) and the strong likelihood that progress would be made in the short term in signing a broader agreement. This would seek to apply coordinated production and trade policies and strategies to foster the efficient management of trade in foodstuffs.

Argentina's full compliance with the *Ad Hoc* MERCOSUR Arbitration Tribunal ruling (which called on Argentina to repeal the WTO safeguard clause imposed on some textile sectors in mid-1999), and the agreement reached at the CMG Coordinators' Meeting at the beginning of April on "relaunching" MERCOSUR, were a significant starting point in efforts to finally put aside disintegrationist proposals and to begin to make concrete progress on the various issues of the pending agenda. The second great "battle" of the 1999-2000 period (and the first of the new millennium) had thus finally ended.

B. The Main Sectoral Conflicts

The effects of the international crisis: the rice conflict

Brazil's domestic consumption of rice in recent years has stood at about 11.5 million tonnes of rice. Some 10 million tonnes were produced domestically and 1.5 million were imported from Argentina and Uruguay, for which Brazil is their main market (accounting for around 60% of total rice exports). This changed dramatically after the devaluation of the real, since it made more sense for Brazilian rice sector to become self-sufficient (it even generated significant surpluses). This change in the situation of the main recipient of rice surpluses in the sub-region strongly altered sub-regional production and trade patterns, and had a substantial impact on Argentina's and Uruguay's regional economies.

The strong fall in international prices (from a high of US\$ 320 per tonne in October 1998 to only US\$ 110/130 since mid-1999) led to serious anger among badly-hit producers from both countries, and even to frequent conflicts. Producers protested in August 1999 and blocked the border access route at Paso de los Libres-Uruguayana, in an effort to prevent lorries from crossing. In August 1999, the Brazilian Rice Producers' Federation accused Argentine producers of dumping, while numerous shipments were delayed after the Brazilian customs authorities imposed health and other requirements on imports.

Producer groups from the south of the country began to put pressure on the Brazilian border authorities to limit the impact of imports on their domestic consumption deficits by stopping or limiting Argentine paddy rice by an amount equivalent to half their 1999 purchases. In early April 2000, Argentine, Brazilian and Uruguayan rice producer organizations signed a voluntary agreement to put the market "in order" and to defend rice prices from seasonal pressures during the harvest period.

According to the agreement, Argentine and Uruguayan producers agreed to reduce their exports to Brazil by 55% and 45% respectively, compared to 1999 levels. This would cut imports to Brazil from 1.5 million tonnes to only 0.8-0.9 million. It was also agreed to limit rice shipments in March and April, in order to avoid saturating the market and thereby obviate seasonal drops in prices, although this would have a negative impact on producers on both sides of the border. There was a favorable reaction to this compromise from the Brazilian and Argentine agriculture ministries, which at the end of February had welcomed the implementation of mechanisms to avoid the saturation of the agricultural markets and to promote more orderly and "intelligent" intra-zone trade. The aim was to help the logistical management of Argentine sales in order to avoid over-supply during the harvest period, and to stimulate the diversification of sales to those areas in Brazil outside of São Paulo with supply needs.

When everything appeared to have been resolved, however, at the end of April 2000 the Porto Alegre Federal Regional Court approved a request by rice producers from Itaquí and São Borja, as well as the

farming unions of Itaquí, São Borja, Macambara and Uruguayana, to ban imports of Argentine and Uruguayan rice in all of Brazil. This measure, justified on the grounds that rice was being imported at below production costs, was viewed as “mistaken and contrary to the spirit of MERCOSUR” by the Brazilian government, which appealed against the measure through the attorney-general’s office.

The ruling was made by a regional court, but its impact was national since it banned all Brazilian companies from importing rice, at least until a higher court overruled or confirmed the original decision. During most of May, however, no difficulties were reported in importing Argentine rice to Brazil, but at the start of the last week of May a circular from Brasilia’s Division for the Control and Quarantine of Vegetables formally suspended the import of all types of rice from Argentina and Uruguay until the federal justice system ruled on the case. At the beginning of June 2000, Brazil’s Higher Court of Justice overruled the restrictive measure adopted by the Porto Alegre Federal Regional Court in April, arguing that it “compromised the credibility of Brazil’s foreign policy and undermined MERCOSUR’s consolidation”.

Although the higher court’s decision was welcomed by rice industry representatives from Entre Ríos and Corrientes, the difficulties of low international prices and sub-regional over-production created a highly complex situation in the medium-term. These organizations therefore asked the Argentine government to increase the common external tariff to 35%, in order to protect them from the subsidies granted to US and East Asian rice producers. These often produce surpluses that are then exported to third countries.

The poultry problem

Since mid-1998, the Argentine poultry sector (which is particularly developed in the Mesopotamian and Pampas regions) suffered from incipient but growing competition from producers in the south of Brazil. In recent years, these had begun to reach international levels of production and competitiveness. Towards the end of that year, therefore, representatives private sector representatives from both sides of the border signed a business agreement to introduce export quotas. Given serious enforcement difficulties, however, the agreement was not renewed in March 1999.

At the start of the second quarter of that year, the effects of the Brazilian devaluation and the uncertain climate in bilateral trade relations, provoked unease and conflict. Argentine producers repeatedly demanded that the national government implement measures to limit the import of Brazilian goods (which in 1999 accounted for only 6% of domestic consumption in Argentina). The *Centro de Empresas Procesadores Avícolas* (CEPA) also went before the relevant bodies to accuse Brazil of dumping.

At the end of December 1999, Argentina’s National Commission for Foreign Trade ruled that national producers of poultry for domestic consumption had suffered greatly from Brazilian imports (although not significant, these imports forced prices down and therefore affected the profits of the local industry). This ruling – which is not legally binding – was subsequently examined by the under-secretariat for trade (which is responsible for applying trade relief measures) although it had still not made a decision by June 2000.

With this issue still running its legal course, in mid-November 1999 the federal judge of Concepción del Uruguay (Entre Ríos, Argentina) ordered the various relevant bodies to restrict imports of Brazilian poultry to 3,742 tonnes a month until the under-secretariat of state finally ruled on the dumping issue. A month later, however, the Argentine economy minister succeeded in having the measure repealed by the appeal court. This led CEPA to make an extraordinary appeal to the federal court.

At the beginning of March, the federal court ruled that the appeal court’s decision was not sound, and that the import quotas imposed by the ruling of the Concepción del Uruguay judge would stand until there was a ruling on the extraordinary appeal. The economy minister again appealed against the ruling, this time to

the Supreme Court, which by mid-2000 had still not announced its decision. The Argentine government has repeatedly stressed that imports of Brazilian poultry have remained below 3,000 tonnes in recent months. It therefore argues that the limit imposed by the federal court has no practical effect.

The Argentine government's strategic gamble is to "encourage" producer and processing organizations from the two countries to reach a 3-5 year minimum price agreement that would allow them to "win time", enabling them to restructure the productive sector and to increase processors' specialization in products with greater value added. However, the dispersal of the production and rearing phase made it difficult to move forward in the areas being promoted by the industry secretariat.

At the beginning of February – as the concerns of poultry producers and processors became increasingly public – a Resolution by Argentina's agriculture secretariat introduced a questionnaire for countries interested in exporting poultry meat to Argentina. This asked them about their epidemiological situation as regards "Newcastle disease". This disease was eradicated in Argentina in the 1970s but still exists in some regions of Brazil. The *Servicio de Vigilancia Sanitaria* (SENASA) would analyze the responses to the questionnaire and would assess the risk from each supplying country. The requirements and controls to be applied to higher risk countries would obviously be more rigorous (form b).

In early May – and after the Brazilians refused to respond to the questionnaire – SENASA provisionally decided to classify Brazil as a high-risk country. Brazil interpreted this as a restrictive trade measure and protested to the agriculture ministry, asking it to prolong for a month the use of the existing certificate (form a) to give the relevant bodies time to collect the correct documentation.

After the issue was discussed at the technical level and included on the agenda of the bilateral agriculture ministers' meeting in February 2000, Argentina suspended form b for a month for Brazilian products, in order to enable SENASA officials to carry out a health inspection on the main Brazilian poultry factories. At the end of March, Argentina therefore decided to exclude those products from the southern states (Rio Grande, Santa Catarina, San Pablo, Mato Grosso do Sul and Paraná) – the main suppliers of poultry to Argentina – from the form b requirement. This measure was poorly received by Argentine producers.

Pigs: between subsidies and dumping

Argentine pig farmer organizations have for years claimed that the Brazilian government has subsidized Brazil's production and export of pork. In mid-1999, the Argentine government asked for an arbitration panel to be set up in the framework of the Brasilia Protocol's dispute settlement mechanism.

The Arbitration Tribunal rejected the complaint in November. This prompted sharp protests from Argentine producers, who asked for the immediate application of health measures to prevent the intra- and extra-zone import of pig-related products.¹⁵

Private sector representatives from the two countries met at the headquarters of the *Associação Brasileira da Indústria e Exportadora da Carne Suína* (ABIPECS) in mid-November in an effort to negotiate an agreement on restricting Brazilian pig exports to Argentina (which account for 60% of total imports). Although the two sides were unable to agree on Brazilian export quotas, the Brazilian private sector appeared willing to reach some kind of agreement on unilaterally limiting their exports.

¹⁵ According to claims by private sector representatives, Argentina imports 45% of its domestic pork consumption, with Brazil, Denmark, Canada, Spain and Chile the main suppliers.

In mid-March, the *Asociación Argentina de Productores de Porcinos* renewed its allegation about dumping practices in the price of pigs imported from Brazil, claiming that “Brazilian pigs are entering at a price that is lower than in the domestic market and lower than would be possible with the pre-financing facilities offered by the Brazilian government”. The Association also asked that the CET be increased from 15% to 35% for extra-zone pig imports (an initiative that was received favorably by the agriculture secretariat), that quotas be introduced for imports from Brazil, and that countervailing duties be applied for pig-based processed goods.

Barriers to the entry of Argentine garlic

The general problems surrounding the import of Argentine garlic to Brazil (which reached a total of US\$ 45 million in 1999, 60% of total exports in this sector) became public at the end of November of that year when Brazil’s secretariat for agricultural protection created a new garlic import register. This register made it more difficult to obtain the necessary garlic import licenses. This began to cause delays in the approval of import licenses at the border between the two countries. Two months later, the Argentine government issued a strong protest to the Brazilian agriculture ministry, which promised to intervene with the custom authorities to ensure that outstanding licenses were gradually approved.

However, despite the Brazilian minister’s commitment, made at the agriculture ministers meeting in Buenos Aires at the end of February 2000, the border problems continued during practically the whole of March. This led to a wave of claims and counter-claims through the media.

The issue appeared to calm down after further discussion between authorities in the sector in April. Brazilian goods did not face new difficulties at the border in the subsequent months.

Health problems with honey

In July 1999, Brazil’s health authorities unilaterally suspended bulk and packaged honey imports from Argentina,¹⁶ since they had detected American Loque disease in some consignments. This was rejected by Argentine officials, who argued that there was a broad consensus that refined honey posed no risk of infection.

In September 1999, Argentina announced that it was able to undertake the laboratory tests for analyzing the consignments, without the Brazilian authorities having responded concretely on the issue.

During the technical meeting in mid-April 2000, the Brazilian delegation agreed to allow the entry of Argentine packaged honey within 15 days, if and when the bulk consignments included a health certificate and a document proving that they complied with requirements agreed in relation to American Loque disease. As regards packaged honey, only the certificate was necessary

The dairy industry: conflict of interests and structures

After two years of threats, in mid-August 1998 the Brazilian *Confederação Nacional da Agricultura* (CNA) formally complained about the alleged dumping of lactose products (UHT and powdered milk) from Argentina, Uruguay, Australia, New Zealand and the European Union. According to the Argentine

¹⁶ These imports only totaled US\$ 1 million in 1999.

negotiators the complaint, which at the time of writing is being studied by the relevant bodies, is seriously flawed in form and substance and will thus be “easily refuted in the WTO”.

The Argentine government therefore became an interested party in the case. It challenged various aspects of the CNA’s complaint, including the definition of a similar product, the methodology for calculating the nominal value and the export price, and the extent of the dumping.

Imports of Argentine and Uruguayan dairy products to the Brazilian market have as yet faced no problems or systematic barriers, despite the maintenance of non-automatic licensing system that should have been eliminated at the end of 1999. However, the sector’s particular situation in the two countries means this issue is a recurrent source of conflict, especially in those times of the year when Brazilian milk producers place their goods on the market. While the most efficient Argentine milk producers have significantly boosted their production capacity over recent years and thus increasingly “need” the Brazilian market in order to sell their surpluses, their counterparts in the south of Brazil have repeatedly asked the Brazilian authorities to “protect” their traditional share of the national market. Brazil accounts for 80% of Argentina’s milk exports, which increased by 28% in value terms in 1999, despite the recession.

Brazilian producers argue that the sharp increase in Argentina’s share of their market¹⁷ is the result of the strong growth in domestic demand in the period just after the implementation of the Real Plan. They therefore claim that while Argentine producers sold powdered milk at US\$ 2,3000 a tonne before the devaluation of the real, this fell to only US\$ 1,500 after the devaluation.

In February 2000, the Argentine government initiated consultations in MERCOSUR’s Trade Commission, asking Brazil to lift the agriculture ministry’s measure excluding powdered milk imports from the institutional food distribution programs. The Brazilian delegation argued that the issue was not a health matter and should thus be examined by the *Ad Hoc* Government Procurement Group. Since there is now a common regime in this area, each country can apply its national legislation.

Wheat and milling: a recurrent focus for disputes

Brazilian milleries have been putting pressure on their government to reduce extra-zone customs tariffs for wheat since the start of the MERCOSUR process. These pressures resurfaced again in mid-1999. The milleries argue that lowering the tariff would facilitate the extra-zone import of higher quality raw materials. This argument is based on the view that the quality of Argentine wheat (which accounts for 90% of Brazilian purchases overseas) has deteriorated over recent years because of the use of soft seeds instead of traditional hard seeds. Although this has resulted in greater yields for Argentine producers, it has had a negative impact on seed purity and protein levels.

Brazilian milleries argue that this has severely affected their profitability, forcing them to use lower quality inputs and/or to mix Argentine wheat with US or Canadian grain (which have a CET of 13%). The deterioration in the quality of the product therefore directly affects the Brazilian milleries’ breadmaking process. These either have to invest heavily in new techniques or use slower and more inefficient methods to eliminate the impurities in Argentine wheat. Hence, Argentine milleries argue that increases in production costs result in higher prices for Brazilian consumers or in final products of a lower quality.

Brazilian milleries claim that a reduction in the CET will lead to greater competition because of significant demand in the Brazilian market (Brazil is currently the second largest wheat importer in the

¹⁷ Argentine dairy exports to Brazil increased by 9,000% between 1994 and 1999, from US\$ 3 million to US\$ 245 million.

world). This might lead to an increase in the quality of Argentine production and/or lower costs for wheat-based Brazilian production. Argentine officials have strongly rejected the possibility of negotiating a reduction in the CET, noting that Brazil's claim of a deterioration in the quality of Argentine wheat is a pretext to facilitate the purchase of subsidized wheat from extra-zone countries.

Argentina also claims that the tariff level agreed by MERCOSUR reflects the need to favor the member countries in intra-subregional trade and to protect MERCOSUR producers from unfair trading practices (subsidies) applied by the EU and the United States in this sector over recent decades.

Between a trade war and a private sector agreement: the footwear sector

Contrary to what happened with most tradable products, trade opening was short-lived in the Argentine footwear sector. Since 1994, some footwear sub-sectors have benefited from protection mechanisms, the first of which related to specific duties for the import of some types of sports footwear products. This was introduced following protests from companies affected by competition from East Asia. These duties were extended and increased in 1995, after which they were challenged by the United States and the EU in the WTO, since they exceeded the tariff agreed by Argentina in the Uruguay Round.

In order to avoid a negative ruling from the WTO, in February 1997 the specific duties were replaced by a WTO safeguard for almost the whole of the sector, and definitive measures were imposed in September of that year. MERCOSUR imports were, however, explicitly excluded from the measure. In November 1998 the safeguard was broadened by means of a more restrictive quota regime, whereby customs duties were doubled for foreign purchases that exceeded the stipulated quantitative limit.¹⁸

The countries affected (EU, United States and Indonesia) again protested against these measures. This led to the creation of a panel in mid-1999 that ruled against the Argentine position in December 1999. In February 2000, Argentina informed the WTO's dispute settlement body that it had begun to interpret the concept of serious damage according to the WTO appeal body's recommendations, asked for consultations with Brazil, and provisionally extended the measure for a further six months for sports footwear (maintaining specific duties for the rest of the sector at a level lower than that agreed with the WTO). However, the Argentine legal system recently (June 2000) admitted a complaint from importers that called on the industry secretariat to suspend the extension of February 2000.

The special protection mechanisms granted to the Argentine footwear sector over recent years have also affected intra-MERCOSUR trade. Most intra-subregional trade was excluded from the automatic tariff reduction process that began in 1991 and ended in 1994, since 13 products from the sector (mainly footwear with leather and cloth uppers) were included in the intra-zone liberalization exemption lists.¹⁹ After the Customs Union was established, the footwear sector was exempt from free trade since it was included in the adaptation regime. This set a 27% tariff for intra-subregional trade, with a gradual tariff reduction timetable that ended at the beginning of 1999.²⁰

¹⁸ The safeguards were modified at the end of February 1999 in order to meet the WTO's maximum consolidated tariff level. As a result, the specific minimum import duty (SMIT) for products from WTO member countries did not exceed 35%.

¹⁹ Of the most important sectors, only rubber and plastic shoes were excluded from the adaptation list. This enabled Brazilian suppliers of these products to consolidate their position in the Argentine market, since Brazilian imports of these products had seen particular growth in recent years.

²⁰ Given the level of the established intra-zone tariff level, the affected sectors also had to be included in the list of exceptions to the CET, with an initial value of 29% that now stands at 33%. It should converge at 20% by 1 January 2001.

Brazil's share of the sports footwear sector had traditionally been small, since most trade in this product is intra-firm or is regulated by national licenses. The large international brands that dominate the market have been particularly affected by the introduction of safeguards, since most of their imports originated in their Asian plants. The new competitive situation after the 1999 devaluation-recession has, however, enabled Brazil to significantly increase its footwear exports. Its share of Argentine non-sports footwear imports thus rose from 66% in 1998 to 76%, and that of footwear imports from 23% to 40%.

In the critical year of 1999, two factors rapidly exacerbated the existing competitive disparities in the footwear sector: the elimination of the intra-zone adaptation lists and the depreciation of the Brazilian currency. Argentine imports of Brazilian footwear therefore increased by almost 28% in 1998 compared to the year before. This was in sharp contrast to the fall in total imports. Both non-sporting and sporting footwear accounted for most of this increase, the latter benefiting from the end of the adaptation regime. The sale of rubber footwear (already subject to free trade) fell because of lower domestic demand.

In the second quarter of 1999 – when the recession began to hit the two countries hard and Brazilian sales to Argentina begun to grow strongly (60%) – there was pressure from the Argentine footwear sector for the introduction of measures to “compensate” them for their loss of relative competitiveness, and to soften the impact of the “generous” subsidies that they claimed their Brazilian counterparts received.

While private sector representatives of the two countries were making strenuous efforts to reach an agreement on the voluntary restriction of Brazilian exports, the Argentine economy ministry unilaterally introduced a new technical regulation (Res. 508/99) at the end of June. This stipulated that all footwear sold in the country had to have a label with information on manufacturing materials and on the identity of the manufacturer or importer. A few days later, another regulation (Res. 977/99) introduced a non-automatic import license system to certify that the labeling requirement was being observed.

The sectoral conflict reached a high point in July 1999, after the footwear sector unsuccessfully called on the Argentine government to apply the “disputed” LAIA safeguards for intra-zone trade and the aforementioned measures were implemented (Res. 617/99, published at the end of August). According to the regulation, licenses had to be approved within a period of three months. In effect, this meant that intra-zone imports were virtually paralyzed until the end of 1999. During this period, Argentine producers lodged a complaint before MERCOSUR's Trade Commission on the alleged use of subsidies by Brazilian producers, and demanded the immediate application of countervailing duties on intra-zone trade.

While the Brazilian government expressed its anger at the Argentine measure, and the Brazilian business organization Abicalçados announced its intention to ask the Brazilian foreign ministry to take the issue to the WTO and MERCOSUR's dispute settlement mechanism to demand over US\$ 80 million in compensation, the Argentine footwear sector offered to negotiate a quota of 4 million pairs a year. This was quickly rejected by the Brazilian footwear sector as “unrealistic and unreasonable”.

During this period, the outlook became increasingly negative.²¹ The governments therefore finally agreed to convince their respective footwear sectors to sign a temporary agreement on voluntary export restraint. The agreement was to be overseen by the Brazilian business group Abicalçados and the Argentine consulate in Porto Alegre.

²¹ The Brazilian government announced its intention of retaliating by reintroducing a non-automatic import licensing system for Argentine export products, which the Brazilian under-secretary for integration described as “not retaliation but equal treatment”. This measure simply reintroduced the prior licenses that had been lifted as a result of the December 1998 summit agreements.

With the tacit “sponsorship” of the Argentine and Brazilian governments, the business groups of the two countries reached an agreement on quotas at the end of September 1999. Under the agreement, Brazilian exports were limited to 1.7 million units for the rest of 1999, and 4.4 million in the first half of 2000. However, the two sides repeatedly accused each other of not abiding by the commitments made.²²

A few weeks later, and partly as a result of this agreement, the Argentine government introduced Res. 736/99, which reduced the time period for granting import licenses from three months to only 30 days.

Given that the aforementioned business agreement was about to expire (at the end of June of that year), during the second quarter of 2000 the two governments sought to convince the private sector representatives to negotiate a new, broader agreement (which in principle could also include the tanning industry). This accord would not only cover the administration of trade but also promote greater complementarity and specialization between plants in the sub-region.²³

Argentine producers called for new quotas on Brazilian footwear exports and a greater commitment from Abicalçados and the governments to comply with the quotas yet to be agreed. Abicalçados, however, rejected any trade restriction, arguing that it was impossible to enforce effectively.²⁴ It also claimed that a system that favored the rest of the world over the sub-region should not be maintained,²⁵ given the WTO’s December 1999 decision rejecting the validity of Argentina’s extra-zone safeguard system.

The Brazilian business sector also called for the elimination of Argentina’s system for limiting intra-zone raw hide exports, which Argentine footwear manufacturers refused to include in their list of demands to the governments since it was “an issue beyond their remit”.²⁶ There was, however, agreement to raise the CET to the permitted 35% limit and to promote joint strategies in talks with the EU and the FTAA.

After the failure to reach a global agreement, the two countries’ business associations agreed to put an end to their deliberations, inform the governments of the results of their efforts, and ask them to “facilitate” an agreement between the two sides. The agreement expired at the end of June and future prospects are unclear at the time of writing.

²² For an examination of the juridical-institutional difficulties and problems of enforcing such agreements, see Chapter V of this report.

²³ The system of voluntary sectoral agreements has been questioned by the association representing the large footwear companies in Argentina. These have claimed that, in the framework of the aforementioned WTO safeguard, only extra-subregional trade has been affected to the benefit of intra-zone trade. The association has therefore stated that although imports from the rest of the world fell by 50% in the first four months of 2000, imports from Brazil have remained steady at 1999 levels. It has expressed its concern over the “official policy of promoting anti-competitive and monopolistic practices”, and has threatened to present a complaint to the National Commission for the Protection of Competition (for violation of the Competition Protection Law) and MERCOSUR’s dispute settlement bodies (because of the application of non-automatic import licenses).

²⁴ The quota originally agreed for the last quarter of 1999 (1.7 million pairs of shoes) was exceeded by almost 1 million units, while almost 6 million pairs were exported by Brazil in the first half of 2000, compared to an agreed quota of 4.4 million.

²⁵ It is worth noting that while Argentina has consistently maintained high specific tariffs for imports from non-WTO countries (such as China), it has also imposed specific duties of up to 35% on the extra-zone import of products not included in the extension of the safeguard imposed in February 2000 (non-sport footwear). This contradicts the “most favored treatment” argument presented by the Brazilian business association.

²⁶ It is worth noting in this respect that Argentina has an *ad valorem* export tax of 5% (applicable to intra- and extra-zone trade) for non-tanned and semi-tanned leather. This tax (which expires at the end of June 2000) has been formally challenged before the WTO by the EU. However, Argentine footwear producers have asked that it be increased to 10%, while representatives of the Argentine meat and livestock sector and Brazilian tanners and Morocco-leather dressers (who are interested in Argentine hide, which is more suitable for their activities than Brazilian hide) have asked for its definitive elimination.

The textile incident

At the start of 1995, the implementation of the MERCOSUR agreements implied a change to the system of protection enjoyed by the Argentine textile industry. Extra-zone imports thus became subject to the Common External Tariff (CET), except for two categories were included into the exemption regime. The pre-existing minimum specific duties (MSDs) were also broadened to cover more than two-thirds of the 900 products in the textile and garment chapters, including fabrics, garments, but not yarn.²⁷ In terms of intra-zone trade, 43 tariff categories in the garment sub-sector were exempt from free trade through their inclusion in the Adaptation Regime,²⁸ which ended on 31/12/99, although 18 of the 43 categories had zero tariff quotas.

The depreciation of the real at the beginning of 1999, and the recession it caused in Argentina, led to a sharp decline in imports. In the first half of that year, imports from Brazil fell by 13%, slightly lower than the 16.6% drop in purchases from the rest of the world. However, fears about a flood of textile products from Brazil and South-East Asia led Argentine textile manufacturers to ask for greater protection, especially because of a contraction in internal demand and serious employment problems in the sector.

In a presentation to the *Federación de Industrias Textiles Argentinas* (FITA) in October 1998, Argentina's National Commission on Foreign Trade announced that the country's cotton textile sector had suffered serious damage and was exposed to a real additional threat of serious damage as a result of imports from Brazil. The economy ministry thus introduced Resolution MEyOSP N° 861 in July 1999. The resolution established a safeguard measure (according to Art. 6 of the WTO-ATC) that fixed annual quotas for the import of cotton textiles from Brazil, China and Pakistan. This affected products that had previously been protected by the MSDs. This safeguard was activated on 31 July 1999 for three years.²⁹

The safeguard affected 124 tariff categories that in 1994 accounted for around 14% of textiles imported from Brazil. Fabric for sheets accounted for the highest share, with Brazil accounting for 36.5% of these imports. From the Brazilian perspective, Argentina was the main export destination for these products.

The Brazilian government made a vigorous diplomatic protest against this measure, repeatedly declaring that it was improper to apply the ATC to MERCOSUR. Having taken all the prior steps, the government announced that it would present the case to MERCOSUR's dispute settlement mechanism.³⁰ In February 2000, it also requested a WTO panel, arguing that the measure was inappropriate.

In March 2000, MERCOSUR's Arbitration Tribunal rejected the use of safeguards for intra-subregional trade. In early April, and after exhausting all judicial appeals and those for clarification, the Argentine government excluded Brazilian products from the list of products affected by the disputed safeguard measure and, in exchange, asked Brazil to withdraw its complaint to the WTO.³¹ Although the Argentine government initially sought to prolong the appeal for clarification, so as to allow more time for a private sector agreement, a license system was finally introduced to facilitate the monitoring of sectoral trade.

²⁷ Although the number of categories in the CET system of exemptions seems small, in effect the application of MSDs meant that the tariff level was equivalent to the CET.

²⁸ These categories were also exempt from the CET, since they were included in the Adaptation Regime.

²⁹ The quota volumes were defined by the ATC agreement, which stipulates that the quotas cannot be set below the level of imports over the last 12 months.

³⁰ For more information on this issue, see Chapter V of this report.

³¹ It is worth noting in this respect that although in December 1999 the WTO's Textile Monitoring Body recommended that Argentina lift the measure (because it claimed that imports from Brazil were not the cause of the damage to Argentine industry), in March 2000 the WTO's Dispute Settlement Panel rejected Brazil's claim.

This measure was poorly received by the Argentine business sector (which even strongly criticized Argentina's representative on the Arbitration Tribunal for not having abstained to support the country's official position). The Argentine business sector had until the last moment actively put pressure on government officials to secure some kind of commitment on special assistance for the sector.

While the two governments sought to find a structural solution for the most sensitive sectors in sub-regional trade, private sector organizations from the two countries met on numerous occasions during March and April. However, the meetings held between FITA (Argentina) and ABIT (Brazil) have thus far yielded few results, mainly because of the peculiar characteristics of the productive structures in the two countries and the large number of actors involved in the process. Early on in the negotiations, the two sides abandoned the idea of negotiating voluntary trade quotas or minimum price agreements, and instead focused their efforts on reaching agreements to integrate their respective production chains. However, at the time of writing no significant progress had yet been made in these negotiations.

Iron and steel: between dumping, lobbies and agreements

Since the start of the integration process there has been constant conflict between the Argentine and Brazilian iron and steel sectors, mainly because of issues relating to plant size, access to raw materials and the use of technology in the production plants. In the years after the signing of the Treaty of Asunción – and while the Brazilian iron and steel industry maintained a significant surplus in bilateral trade – the level of intra- and extra-zone tariff protection became a source of recurring debate and controversy between the two countries' iron and steel sectors. The Argentine automotive plants also intervened repeatedly in these disputes, since the industry relied heavily on inputs from the iron and steel industry.

In the two years before the 1999-2000 crisis, the iron and steel sector had been the main “theater of operations” in the dispute between Argentina and Brazil on the applicability of anti-dumping measures in intra-zone trade.³² The issue moved to the top of the agenda after Argentine businesses began to suffer the combined effects of the elimination of residual tariffs on intra-zone trade towards the end of 1999, the sudden contraction of domestic demand, and the devaluation of the real.

In mid-April 1999, the Argentine economy ministry admitted a complaint on dumping presented by the main Argentine steelworks, Siderar S.A., against Brazil's *Companhia Siderúrgica Nacional* (CSN). Siderar accused CSN of importing hot-rolled steel at a minimum import price of US\$ 410 per tonne, below the price at which additional duties could be applied. A few days later, the Brazilian foreign minister made public his government's opposition to the measure, which he described as “a bad precedence, contrary to the general spirit of MERCOSUR”. He also said the measure was “incorrect and groundless” and that he reserved the right to contest it before the WTO.

A few weeks later, Brazilian entrepreneurs presented an official note to the Argentine president asking him to revoke the measure since, in their view, it was based on mistaken arguments and prevented Brazilian hot-rolled steel from being imported to Argentina. They claimed that Siderar had provided false information, since the company's case included products that were not manufactured in Argentina, and that the price at which Brazilian steel plates entered the country before the application of the measure (US\$ 340 fob per tonne) was much higher than that for CSN's sales in third markets. Brazilian entrepreneurs noted that, given the minimum value imposed by the Argentine economy ministry's

³² For more information on the state of the negotiations and the debate on this issue, see Chapter III of this report.

resolution, it was better for them to import plates from outside the region (paying a CET of 15.5%³³) than from Brazil.

In July, Argentina's National Commission on Foreign Trade admitted a new complaint from Siderar and opened an enquiry into the dumping of Brazilian and Russian cold-rolled plates. This again provoked the anger of Brazilian producers, who asked their government to vigorously reject these measures at the extraordinary meeting of MERCOSUR presidents at the beginning of August 1999.

At the start of December 1999, the Argentine government approved a proposal for a five-year, WTO-compatible agreement on minimum prices presented two months earlier by representatives of the Brazilian business sector. Under the agreement, the Argentine government suspended the aforementioned anti-dumping duties and the Brazilian iron and steel companies agreed to limit their sales to Argentina to a maximum of 36,000 tonnes in the first year, 38,000 in the second and 39,000 in the third to fifth year, with a minimum price of US\$ 325-365 per tonne cif.

Because of the domestic recession and the application of restrictive measures, Brazilian iron and steel exports to Argentina fell by 24% in 1999 compared to 1998 (from US\$ 290 million to US\$ 220 million).

In January 2000, Siderar presented a new complaint on the dumping of Brazilian and Russian cold-rolled plates. This was quickly rejected by the National Commission on Foreign Trade for carbon and strip steel, but approved for general use and packaging steel plates. At the same time, the Brazilian company, *Usinas Siderúrgicas de Minas Gerais* (Usiminas), presented a complaint on the grounds that Argentine iron and steel companies were obtaining authorization (by using the Industrial Specialization Regime³⁴) to import heavy steel plates and hot-rolled plates from outside the region (Eastern Europe) with a preferential tariff of 2%. This was a serious perforation of the CET (13%).³⁵ The company also asked the Brazilian government to reject the inclusion of the iron and steel sector in any mechanism that sought to regulate trade in MERCOSUR, arguing that this was "a simple claim by Argentine protectionist interests".

At the start of June 2000, the two countries' private sectors reached an agreement on minimum prices for cold-rolled plates, similar to that which a year earlier had put an end to the anti-dumping measure on Brazilian exports of hot-rolled sheets. Under the agreement, Usiminas, CSN and the *Companhia Siderúrgica Paulista* (COSIPA) agreed to export cold-rolled plates to Argentina at a price not lower than US\$ 534 per tonne for five years. Brazilian products imported below that level (and up to a reference price) would also be subject to quotas. Unlike the previous year's agreement on hot-rolled plates, the new agreement excluded from the quota system products not manufactured locally but that were due to be placed on the market by Usiminas, particularly high-resistance plates for the automotive industry.

In mid-July 2000, new tensions between the Argentine and Brazilian iron and steel industries were aroused by the Argentine industry secretariat's decision to start a new official enquiry on the alleged dumping of hot-rolled iron plates from Brazil, the Czech Republic, South Africa and Turkey.

³³ During the public hearing on this case organized by the National Commission of Foreign Trade, the president of Siderar stated that dumping stems not only from the relationship between domestic and international prices, but also from that between domestic costs and prices. In this case, Brazilian steel mills exported plates to Argentina at below cost price plus a reasonable profit margin.

³⁴ This mechanism, implemented by Argentina between 1993 and 1996, allows companies that increase their overseas sales to import the same product at a preferential tariff of 2% for an equivalent value.

³⁵ In relation to this issue, Brazil lodged a complaint to MERCOSUR's Trade Commission.

Non-automatic licenses: an endless problem?

Once the intra-zone tariff reduction process was completed, issues related to the non-compatibility of national technical norms and import licenses have been, and in some cases continue to be, a recurrent source of conflict over market access issues between the member countries.

At the end of 1998, Argentina presented an official complaint about the difficulties of access to the Brazilian market associated with the non-compatibility issue. In April 1999, MERCOSUR's Arbitration Tribunal ruled that Brazil's non-automatic intra-zone import license system was incompatible with the Customs Union.³⁶ The judges therefore ordered Brazil to eliminate the system by 31/12/99, which coincided with the final end of the adaptation period established by the Protocol of Ouro Preto.

The use of non-automatic import licenses was thus limited to those situations contemplated in LAIA's Art. 50 (relating to non-commercial values, such as "the life and health of persons, animals and vegetables, national security, preservation of artistic heritage or public morality). The ruling also urged the countries to agree jointly on the limits and conditions necessary for the practical enforcement of these exemptions.

At the start of 2000, Brazil refused to eliminate the license regime completely because of the exemptions. The Argentines rejected what they viewed as the "generic and abusive application" of Art. 50. They also argued that while sanitary and phytosanitary arguments might be accepted as "special" cases (as stipulated by the Treaty of Montevideo), such licenses are in practice administered by a Brazilian trade body (DECEX) that is not the application body on these issues.

At the meetings held by the member states in recent months on the agenda for MERCOSUR's relaunch agenda, and in light of their concern about market access, they agreed to eliminate all licenses and prior consent applied to intra-zone trade by 15 November 2000,³⁷ except those covered by Art. 50 of the Treaty of Montevideo.

As regards the cases included in these exemptions, Argentina presented to the Buenos Aires Summit a draft decision to limit the application of Art. 50 to those cases that are proportional to the solution sought by the country invoking the article; that do not discriminate against imports; and that do not distort intra-zone trade. Argentina thus proposed that when a member believes that a situation justifies applying a measure under Art. 50 in future, it should demonstrate that it meets the required criteria.

After the CMG failed to agree on the proposal during its June 2000 meeting, the member states made an informal commitment to determine jointly the specific situations and products that would be covered by Art. 50, in order to avoid an overly general and non-transparent application of its provisions.

C. "Complex" Negotiations: Reaching the Final Stage

The automotive regime: a happy ending

CMC Decision 29/94 set 1 January 2000 as the deadline for establishing a common MERCOSUR automotive regime based on unrestricted intra-zone free trade without compensation requirements, a CET, and no national incentives that could distort the competitiveness of various sub-regional actors.

³⁶ For more information on this issue, see Chapter V of this report.

³⁷ It had initially been agreed to eliminate the licenses by 30 June, but because of the difficulties in drawing up the lists it was decided at the Buenos Aires Presidential Summit to postpone this move until November.

Soon after Ouro Preto, the Brazilian government's introduction of a general automotive investment promotion regime and, subsequently, of a special system for less developed regions marked a significant change in the general conditions of competition between the two countries. Most of the negotiating efforts during this phase therefore focused on the search for mechanisms to neutralize the distorting effects of these subsidies in intra-subregional trade – that is, on the idea that a common regime based on free trade required equal competition conditions between the member states.

After a series of meetings in which Argentina and Brazil made significant progress towards defining specific aspects of the regime (including the extra-zone CET for finished products and the sub-regional rules of origin), several factors gradually undermined the original aim of completing the technical studies by the end of April 1998. These factors included differences on some key aspects of the agreement, such as the extra-zone tariff for heavy vehicles and autoparts; the neutralization of asymmetries generated by the investment incentives already granted by some Brazilian states; the treatment of the two smaller members; and the existence of a national content requirement within the sub-regional one.

At the end of that year (when the effects of the international crisis were severely affecting the sub-region), the industry ministers of the four member states agreed to modify Dec. 29/94. The modification established a transition period for introducing free trade (the end of 2005), to include a mechanism to monitor sub-regional production, investment and trade. This would give companies more time to adjust to free trade and would resolve the problems associated with distortions caused by the subsidy regimes in several Brazilian states that, in principle, were due to be eliminated at the start of 2000.

Given the critical situation that sprang from the devaluation of the real and the fall in domestic demand, the negotiations entered a more complex phase, which was aggravated further in mid-year by the decision of the Brazilian Congress (finally ratified by Cardoso) to grant Ford special fiscal benefits to set up a plant in north-east Brazil (due to last for ten years). The recurring issues related to the neutralization of Brazilian subsidies and the role anticipated for the auto part sector bogged down the playing field even further, making it very difficult to meet the objective of establishing a regime by the end of July 1999. The problem lay in Argentina's request for lower external tariffs for extra-zone auto part imports, and for the inclusion of a national component requirement for goods produced in the sub-region. Both these demands were rejected by Brazil, which has a much more structured, developed and diversified auto parts industry.³⁸

In subsequent months, Argentina revived the proposal to give companies based in the sub-region preferential tariff treatment for fixed periods to extra-zone auto part imports in return for a firm's commitment to guarantee the use of a certain share of national parts. This proposal was strongly supported by Fiat. However, the difficulties facing bilateral relations (and sectoral trade) in the second half of that year did not create an environment conducive to resolving these issues, or for signing a definitive agreement in a sector of such political sensitivity and technical complexity as the automotive industry.

Since the national regimes were to expire on 31 December 1999 (as was the transition period imposed on Argentina by the TRIMs agreement) officials of the new Argentine government (which took office in December of that year) were forced into a series of hasty meetings with their Brazilian counterparts in an effort to conclude an agreement before the deadline.

After a series of personal and virtual meetings between the main Argentine and Brazilian negotiators, the presidents of the two countries agreed by telephone, two days before the deadline, to extend the bilateral

³⁸ It is interesting to note in this respect that Brazil has over the years obtained a surplus of around US\$ 600-700 million in its auto parts trade with Argentina. Total trade in auto parts stands at US\$ 1.8-2.1 billion a year.

auto trade system by 60 days (until the end of February 2000), in order to give the technical teams time to reach agreement on the more complex issues of the negotiations on a common regime.

In the last few days of 1999, the Argentine government unilaterally and unexpectedly decided to extend the national automotive regime indefinitely and to ask the WTO for a seven-year extension to its deadline for meeting TRIM provisions on local content and import-export balancing requirements. Brazilian foreign ministry officials reacted with surprise and anger,³⁹ viewing Argentina's stance as part of a strategy to "cover its back" in case the talks failed and/or to gain maneuvering room at Brazil's expense.

In a meeting in São Paulo in mid-January 2000, Argentine and Brazilian negotiators agreed to extend the bilateral trade regime by a further 60 days. They also agreed to hire an international consultancy firm to assess the real impact of subsidies and incentives in the two countries' automotive industry, and to propose corrective measures – including arbitration – to avoid damages to either party. The firm had to 90 days to present its findings. At the same time, Brazil rejected an Argentine proposal to create a fund to assist auto suppliers (to be financed by income from the CET), while the two sides agreed to continue talks on the Common Automotive Regime (CAR) in Buenos Aires in March.

The two sides disagreed on a number of issues, mainly on how to manage trade in the transition period; auto part tariffs; Argentina's support for a national content requirement within the sub-regional one; and the application of fines or sanctions for non-compliance with the trade guidelines to be agreed.

Hence, although the Argentine negotiators had for the first time succeeded in bringing to the negotiating table the complex issue of the distorting effect of Brazilian subsidies on sub-regional trade, the solution was a significant step forward given that MERCOSUR was at that time being criticized and questioned by numerous sub-regional political and business actors.

Although most analysts, and even the official negotiators, were predicting a new failure in the bilateral negotiations, in March Argentina and Brazil surprisingly announced the general framework of an agreement based on a six-year transition regime (a compromise between Argentina's demand for a seven-year transition period and Brazil's preference for a four-year period). Complete free trade in the automotive industry would therefore come into effect on 1 January 2006. As originally agreed, the CET was set at 35% for passenger vehicles, while extra-zone products could be imported free of quotas and quantitative restrictions. In the case of buses and trucks, the CET was set at an initial level of 35% for Brazil and 18-25% for Argentina (gradually increasing to the level currently levied by Brazil).

A CET of 14-18% was also set for parts manufactured in the sub-region (with an ascending convergence timetable for Argentina starting at 7.5% to 9.5% for new auto parts, and 17% to 21% for spares) and 2% for parts manufactured outside the sub-region (a category that should be defined jointly with AFAC and Sindipeças, the two main autopart industry organizations in the two countries).

During the six-year transition period, trade between the two countries will be compensated, with trade in cars, parts, trucks, tractors, and agricultural and road machinery measured jointly every six months. Argentina, however, had demanded that the each product be measured separately by sector, in order to avoid financing the autopart disequilibria with the surplus in finished vehicles. Although annually increasing

³⁹ It is worth noting that since Brazil did not notify its automotive regime within the transition period included in the TRIMs agreement, it could only appeal to the "umbrella" of an explicit regional agreement (such as MERCOSUR) to justify to the WTO the maintenance of such a sectoral system.

margins of permissible trade disequilibria were established,⁴⁰ it was also agreed to introduce a system of penalties and fines of around 70% and 75% of the external tariff for automobiles and autoparts, respectively.

A sub-regional content requirement of 60% was also established (measured as the share of the cif value of inputs in the factory door price of the final product), in which Argentina was finally allowed to include its long standing aim of incorporating a national component of 30% for vehicles and 25% for trucks.

The agreement was originally due to enter into force on 1 July 2000, which meant the previous system that expired in April had to be extended once again. Although the accord was well received by most sectoral actors from the two countries, the initial reaction of the smaller member countries was less enthusiastic given that, because they do not produce automobiles, their tariffs are much lower. The Uruguayan government therefore condemned this “pernicious bilateralism” by accusing Argentina and Brazil of using MERCOSUR only “when it suited them” and of ignoring Uruguay and Paraguay as minority members when the two “became obstacles for their objectives”. Uruguay argued that by leaving out the two smaller members from the MERCOSUR Automotive Policy (MAP), the bilateral agreement signed between the two main member states had been left without a “MERCOSUR umbrella”.

The day after the agreement, Uruguay’s foreign minister similarly noted that “the automotive agreement is very serious for Uruguay” and warned that “MERCOSUR is a good model that we want to continue belonging to, but we do not see it as the only model” and that “Uruguay will not bow to neo-imperialism” (*La Nación*, 24/3/00). A few days later, the minister welcomed Argentina’s and Brazil’s decision to begin talks with the two smaller members on their inclusion in the agreement. In this respect, he presented an “ambitious” proposal to have lower tariffs for extra-zone vehicle imports (20%), tariffs of 2% for auto part kit imports, and quotas for the export of vehicles to the two larger member states that would be tariff free and have a lower national and sub-regional content requirement than that established in the MAP⁴¹

For its part, Paraguay expressed its wish to demand monetary compensation for the damages that the new system will cause, basing its arguments on a technical study carried out by a Korean expert. The study concluded that the country should receive compensation of around US\$ 310 million a year. Uruguay also asked for the regime on farm machinery and tractors to be excluded from the automotive policy.

After Argentina and Brazil presented a new proposal to the negotiations, the four member states finally reached a fragile and tentative agreement at the start of May. The agreement consisted of an initial vehicle tariff of 23% for Uruguay and 10-20% for Paraguay, which will gradually increase to 35% by 2006. The Uruguayan tariff for trucks will rise from the current 20% to 35% in 2006, while auto part kits will be imported at 2%. The agreement also kept the current quotas for the duty-free export of finished vehicles (with a 50% sub-regional content) at 4,000 and 6,000 units a year to Brazil and Argentina respectively, and with the countervailing duties reduced annually until the national external tariffs converges with the sub-regional tariffs (from 23% at present to 7% in 2005) for surplus volumes.

Paraguay strongly objected to increasing tariffs that, according to its trade and industry minister, “tend to subsidize industries that we do not have”. The country’s negotiations with Argentina and Brazil thus focused on limiting the current import system for used vehicles to units that are less than three years old. Paraguay also made a commitment to increase its efforts to efficiently administer the automobile register.

⁴⁰ This will rise from 6.2% of trade in 2000 to 22.2% in 2003 with monitoring every six months. Acceptable disequilibria levels for the two final years of the transition to free trade have yet to be defined by an Automotive Committee set up for that purpose.

⁴¹ Uruguay’s small automotive industry produces some 30,000 vehicles a year and is highly dependent on the export of finished units to Argentina (65% of its overseas sales) and Brazil (35%), using imported parts (intra- and extra-zone) .

Despite these advances, the conflictive issues involving the two smaller member still had to be resolved at a summit the following month, at which Argentina would hand over the presidency to Brazil. The two countries also stated that the regime could be in force as of 1 July 2000 at the bilateral level.

These inconclusive understandings, and the need to negotiate the “small print” of the agreement (such as the method for certifying trade and the means for claiming that there had been trade diversion) before the Presidential Summit in Buenos Aires at the end of June, led to new tensions at the end of April that again put MERCOSUR’s future into doubt. Brazilian farm machinery producers criticized the draft version of the bilateral agreement (forcing the resignation of the relevant minister) and demanded that bus and truck coachwork, farm and road machinery and spare parts be excluded from the managed trade data (sectors that account for 20% of bilateral trade, and in which Brazil has an annual surplus of US\$ 200 million).

This demand was rejected by the Argentine negotiators, who viewed it as an attempt by Brazil to modify or distort the main text and the very basis of the agreements reached in Buenos Aires at the end of March.

A final agreement between the two countries was reached at the Buenos Aires Presidential Summit, and was based on the limits and criteria originally set in that city some months earlier.⁴² According to the agreement, once the first phase of the transition phase is completed (at the end of 2003), the nature of the transition to free trade will be determined by an Automotive Committee. This committee will have the authority to resolve the management of the agreement. It will also have the responsibility for assessing the negative effects of policies implemented by the members, and for designing and proposing measures for the consolidation, complementation and productive and competitive specialization of the sub-regional industry. It will assess the results of the independent consultancy report, which will determine the impact of incentives in the Argentine and Brazilian automotive sectors.

Over the next few months the Brazilian presidency will have to resolve the problem of Paraguay’s and Uruguay’s full integration in the common sub-regional regime. In the case of Paraguay, agreement is needed on convergence towards the CET and the national regime for used vehicle imports; and in the case of Uruguay, on the quantitative limits on imports of extra-zone auto part kits that have preferential tariffs, on the sub-regional content requirements, and on the maximum quota for intra-zone vehicle exports.

Sugar: between progress and disagreement

According to the agreement reached in Ouro Preto (CMC Dec. 19/94), the sugar sector should be totally incorporated into the MERCOSUR system (with a CET and an intra-zone free trade system) by 2001, although this will depend on the neutralization of distortions created by national policies. In this respect, since 1995 the four member states have pursued different systems of internal negotiation. The aim was to identify what Argentina and Paraguay claimed were the asymmetries caused by Brazil’s Pro-alcohol Program, and to define mechanisms to neutralize their distortionary effects on sub-regional competitiveness.

After the *Ad Hoc* Group failed to resolve the issue in talks during 1995-1997, in mid-1998 the two countries agreed to prepare a technical assessment of the Brazilian system. They each appointed private experts to prepare separate studies, which will later be harmonized in a single report.

At the CMG meeting in Río de Janeiro in December 1998, the four member countries reiterated their support for the commitments made in Dec. 19/94 and 16/96 to introduce free trade in the MERCOSUR

⁴² Although it was due to enter into force on 1 July 2000, for operational reasons it will not be fully effective until 1 August 2000.

sugar sector in 2001, by eliminating or neutralizing distortionary subsidies and incentives. Argentina and Brazil also agreed to negotiate a series of partial agreements in the first half of 1999. The two countries would thus present the aforementioned technical studies, since these might prove useful for that purpose.

At the end of 1998, Brazil asked MERCOSUR's Trade Commission to revoke Argentine law 24,822/97, arguing that it was counter to the MERCOSUR agreements. The law prohibits import tariffs on intra-zone sugar imports from being cut as long as "there is asymmetry caused by Brazil's sugar-alcohol system".

At the Technical Committee set up to examine Brazil's request, Argentina claimed that:

- the dispute settlement mechanism cannot be applied to questions concerning the constitutional compatibility of a law sanctioned by a member state;
- law 24,822 can only be declared unconstitutional by the courts, and only if the complaint has been presented by a party with a "legitimate" interest;
- it can only be revoked internally if the legislature takes action to that effect, since only Argentina's constitutional system has the authority to revoke a law that is exclusive to Congress; and
- law 24,822 has not prevented Argentina from negotiating the sugar sector in the framework of MERCOSUR.

In light of the commitment made by the Brazilian and Argentine foreign ministers in December 1998, the Argentine economy ministry decreed Res. 457/99 in April 1999. This granted the MERCOSUR countries a 10% preference over the intra-zone import duties in force. Brazil subsequently announced that it might withdraw its protests before MERCOSUR's institutional bodies. This did not occur, however, since three Argentine private companies secured a judicial order blocking the application of the 10% preference. The courts ruled that it was incompatible with law 24,822.⁴³

A number of bilateral and *ad hoc* meetings took place during 1999 at which Argentina and Brazil exchanged the technical studies prepared by the experts from the two countries.⁴⁴ However, these failed to resolve outstanding disagreements, or to identify mechanisms to ensure compliance with the commitment made in CMC Dec. 19/94. This sought to include the sector in the sub-regional free trade system on 1/1/01 by "neutralizing the distortions generated by existing national regulatory asymmetries".

At these meetings, Brazil (the world's largest sugar producer) argued that distortions that "should be neutralized" would not exist after prices and volumes were deregulated, and that only sugar cane producers in certain uncompetitive states enjoyed some kind of internal support. Argentina reiterated its traditional argument that distortions caused by policy asymmetries still existed, and that the conditions were still not right for the total inclusion of the sugar sector into the sub-regional free trade system.⁴⁵

⁴³ Argentina claims that the legal rulings relating to these three companies are not definitive and that the suspension of Res. 457/99 only applies to these three firms. Imports from Brazil channeled by other companies can still make use of the preferential tariff.

⁴⁴ The report presented by Argentina claims that the Brazilian sugar industry received US\$ 3.556 billion in subsidies in the 1997-1998 harvest. This claim was rejected by the Brazilian negotiators, who argued that there were "methodological and conceptual errors" in the report and that the figures were based on regulations that were on the whole no longer in force.

⁴⁵ For further information on Argentina's perception of the nature of the Brazilian sugar-alcohol industry and on the subsidy regulations and mechanisms still in force, see Pena and de la Guardia [1999].

In April 2000, Brazil asked for information on the state of the aforementioned legal actions before taking a final decision on its complaint, which is currently being examined by the CMG. The Argentine government announced that the preference was still in force, except in the three specific cases where the lower courts had implemented precautionary measures sought by individuals.

In the Buenos Aires Declaration, issued at the end of that month, the MERCOSUR relaunch agenda included a commitment by the member countries to “define before December 2000 a joint proposal on the mechanisms and timetable for the full inclusion of the sector in the Customs Union according to the criteria established in Decisions 19/94 and 16/96”.⁴⁶

In an effort to comply with this objective, Brazil presented a new proposal to the *ad hoc* Group for the adaptation of the sector in early June 2000. This aimed to introduce sub-regional free trade in January 2000 (with a 30% tariff reduction on 31 December 2000, a further 30% in June 2001, and the remaining 40% at the end of that year) and a CET of 16% in January 2002. According to this proposal, Brazil would progressively increase its current 2% external tariffs, while the other member countries would converge downwards. At the same time, Argentina would eliminate its current system of bands or variable tariffs.

While Uruguay (which produces very little sugar) welcomed the new Brazilian proposal, the other two member countries showed little enthusiasm and had several reservations.⁴⁷ These latter sprang from the persistence of regulatory asymmetries and non-neutralized distortions that made it impossible to liberalize intra-zone trade in this sector.

In the days prior to an *ad hoc* group meeting in Buenos Aires at the start of June, Argentine business sources, deputies and officials from the sugar producing provinces (Tucumán, Salta and Jujuy, where sugar generates US\$ 400 million a year and a very high percentage of private sector jobs) spread a report that the national government had decided to extend for five years the 20% *ad valorem* tariff for intra- and extra-zone trade. This caused much concern in the regions that would potentially have been affected.

In response to the incessant lobbying by the *Centro Azucarero Argentino*, the Argentine deputy foreign minister partially rejected the claim by stating that “the government has not totally committed itself to anything”. Given that the 1992 decree imposing mobile differential tariffs or price comparisons for the sector had expired, however, he admitted that Argentina might negotiate with Brazil a transition period with decreasing tariffs, although “it will probably not be for five years, as requested by the sector”. The Argentine agriculture secretary also stated that “we need protection for four more years to devise an orderly restructuring of the sector” (*Página 12*, 26/6/00) by promoting the development of alternative agriculture activities – such as the production of tomatoes, citrus fruit, strawberries and other regional crops – in the northern Argentine provinces affected by an eventual liberalization of the sector.

In mid-June, and in light of the high level of political sensitivity with which this issue was viewed in Brazil, the chief of the Brazilian negotiators noted that “if Argentina decides to give in to pressure from cane producers and their political allies by unilaterally extending tariff protection for the sugar sector, thus contravening the regulations agreed by the bloc, it will mean the end of the negotiations with Argentina”.

⁴⁶ In this respect, the inclusion of a reference to the bilateral automotive agreement (reached a few days earlier) in the discussions on pending issues gave rise to serious concern in the Argentine sugar sector, which interpreted the move as indicative of the government's intention to end the sugar regime before the end of 2000 “at any cost”.

⁴⁷ In relation to this issue, a novel and original proposal to facilitate the sub-regional liberalization of the sector was presented a few weeks earlier in Tucumán by Roberto Lavagna, former industry secretary and Argentine ambassador to the European Union and to the International Organizations in Geneva. Lavagna proposed that Argentine sugar producers join the *alconafta* program, by which quotas would be introduced for the sale of cane to the Brazilian alcohol industry.

While Brazil made explicit its decision to include the issue of sugar liberalization in the “Relaunch Agenda”, it asked Argentina to provide a clear sign during the Buenos Aires Summit at the end of that month that it wished to start negotiating before December (statement by José Botafogo to *Clarín*, 24/6/00). Brazil made clear its willingness to postpone the effective liberalization of the sector if Argentina made a clear commitment to abide by some kind of gradual tariff reduction timetable as of 2001.

At the Buenos Aires Summit, Brazil proposed to the CMG that the member countries make a formal political commitment on an intra-zone trade liberalization schedule before the end of the year. Argentina responded by requesting the joint preparation of a program for restructuring the regional sugar sector before the schedule was defined. To that end it asked for an independent international consultancy study, to be completed by March 2001. There was again no consensus on this issue, but there was agreement to redouble efforts to reach a final sectoral agreement in the second half of 2000.

A series of binational business fora was held at the start of July 2000 in an effort to identify new production and trade opportunities in non-traditional sectors and products, and to examine the chances of establishing joint ventures between companies in the two countries. The fora were jointly organized by the governments of Argentine provinces that would potentially be affected by a future liberalization of the sector, and by entrepreneurs from the two countries. There is thus currently a joint effort to examine mechanisms for promoting new “niche” markets and sectoral activities with export potential. The aim would be to reduce the region’s high dependency on sugar production.

Sugar is not an important sector for intra-subregional trade, but is still high on the Brazilian government’s list of integration-related political priorities. This is because the sector is a kind of test case in terms of Brazil’s historic demand for greater world liberalization of the sugar industry, and with respect to the country’s need to balance its regional and sectoral interests in the MERCOUR process. Soon after the Buenos Aires Summit, Brazil’s ambassador in Buenos Aires, Sebastião do Rego Barros, outlined Brazil’s position on this issue: “I do not believe that Argentina is a significant buyer of Brazilian sugar. But if this issue is not included in MERCOSUR, all other Brazilian agricultural sectors – dairy, rice, garlic, grains – will be placed in a disadvantaged position. The Brazilian government is therefore under pressure from agricultural producers for having made this concession” (*Ambito Financiero*, 12/7/00).

The quest for mutual recognition

Until the end of 1998, all MERCOSUR regulations relating to the control of technical norms, diseases and plagues were quadripartite. Some norms were thus harmonized, although certificates were not mutually recognized by the different countries. Since trade problems and conflicts (many based on sanitary or sanitary-related arguments) between Argentina and Brazil were a recurring issue, MERCOSUR decided to authorize partial mutual recognition agreements, even if a member state did not form part of that agreement. This would make it easier to resolve bilateral difficulties in sectors where a quadripartite agreement seemed unlikely.

CMG norm 77/98 formally enabled two or more member states to sign agreements on the equivalence of sanitary and phytosanitary control systems, as well as mutual recognition agreements on assessment procedures, in order to avoid the duplication of national controls and differences arising from the incompatibility of national regulations. The various relevant governmental agencies have begun to make progress in the areas of health and industry. However, a general mutual recognition agreement on agro-footstuffs is still pending.

(i) Health: At the end of November 1999, Argentina’s *Administración Nacional de Medicamentos, Alimentos y Tecnología Médica* (ANMAT) and Brazil’s *Agência Nacional de Vigilância Sanitária* (ANVS) signed a Memorandum of Understanding on the Transport of Foodstuff Products. The two countries will

streamline procedures for sanitary inspections and the transport of foodstuff in those areas where both organizations have competence. These will be based on two types of positive lists of products. In the case of lower-risk products, it was agreed that the country of destination will accept the evaluation of the country of origin as valid and sufficient if and when it certifies the identity and business license of the company, the satisfactory process and product checks, and proof that the regulations of the country of origin and destination have been observed. In the case of higher-risk products, it was agreed to introduce additional controls in depots in the country of origin, without the product being detained at the border.

Once the new agreement entered into force (1 January 2000) the two agencies were authorized to issue certificates that will also be validated by the neighboring country

(ii) Foodstuff: After a number of serious trade disputes between Argentina and Brazil on the application by Brazilian customs officials of various restrictive health requirements, agriculture officials from the two countries signed a Bilateral Understanding on the Simplification of Oversight Procedures in Agricultural and Fisheries Trade in December 1998. This sought to provide greater certainty to trade flows, and to eliminate the duplication of controls and evaluation mechanisms.

Despite the commitments made on the issue of timetables and dates for its final implementation (30/06/99), the agreement never became operational because the corresponding annexes – which identify the animal and vegetable-based products that were to benefit from it – have yet to be signed. Following modifications made to the general normative framework for sanitary agreements at the end of 1999, Argentina and Brazil have this year been exchanging the list of products that will be complemented by the new agreement, including those that each country views as a product of major interest. Brazil has thus included chicken meat and pork, and Argentina has included dairy products, rice and temperate fruits.

At the bilateral agriculture ministers meeting in Buenos Aires at the end of February 2000, it was agreed to move towards a flexible and low-risk mutual recognition agreement based on the idea that, for the MERCOSUR member countries, “zero risk often implies a para-tariff barrier”. The two sides therefore prepared a draft agreement that would include measures related to the application of procedures to simplify health regulatory procedures at the border; the declaration of disease- and plague-free trade zones for products included in the accord; and a recognition mechanism for manufacturers of animal-based products.

The agreement is also one of the priorities of the MERCOSUR “relaunch agenda” and is expected to come into force and be fully operational at the quadripartite level by the end of the year.

The two countries have already agreed to create a working group to monitor compliance with the agreement. However, it has still not been decided whether the accord will enter into force once the product lists have been drawn up, or will be valid for each product as its inclusion is agreed by the two sides. In any case, however, the agreement will facilitate goods traffic since it will reduce the number of inspections necessary to acquire a certificate of guarantee. This will enable companies to export goods more cheaply and quickly, and the likelihood of trade conflicts or confrontations should be greatly reduced.

(iii) Industrial: In October 1999, Argentina’s industry secretariat and Brazil’s development, trade and industry ministry signed a Protocol on the Assessment of Conformity that will enable certification bodies from both countries to sign understandings. In this respect, progress has been made in several sectors:

- *Electrical and Electronic Products:* IRAM and UCIEE signed an Understanding on Mutual Recognition for the mutual certification of electrical products. This will reduce dead periods and cut bureaucratic and administrative costs (such as testing or factory and post certificate guarantees) by around 30% in a sector that generates some US\$ 500 million in bilateral trade.

- *Toys*: Argentine and Brazilian toy manufacturers signed an agreement by which they recognize the mutual certification of products from both countries. The *Instituto de Qualidade do Brinquedo (IQB)* will accept tests carried out by IRAM and *vice versa*. The product traded between both countries will therefore not have to be certified or verified by the control body in the neighboring country.

(iv) MERCOSUR Norms: After four years of negotiations, an agreement was reached on a Cooperation Agreement between MERCOSUR and the MERCOSUR Standardization Association (*Asociación de Normalización MERCOSUR, ANM*) during the Common Market Council meeting at the end of 1999. The agreement was not formally signed, however, since the ANM's change of name (it was formerly the MERCOSUR Standardization Committee) was still pending. In February 2000, the ANM president informed the Argentine foreign ministry that the name had been changed and announced the entry into force of the Extraordinary Assembly Act and the Statute of the ANM, whose headquarters will initially be in São Paulo.

The aforementioned body was thus formally and officially established at the start of April. Its main role will be to define, control and regulate the use and functioning of MERCOSUR's official technical norms, on the basis of a program of priorities that the bloc will have to prepare. Quadripartite norms approved by the four member states will thus in future have MERCOSUR status.

The main aim is therefore that these norms not only become instruments to facilitate trade between the member states, and that they also become a useful tool for the standardization of sub-regional products and productive processes so as to improve their insertion into third markets.

This organization consists of the Standardization Bodies of the four member countries (*Instituto Argentino de Racionalización de Materiales, Associação Brasileira de Normas Técnicas, Instituto Nacional de Tecnología y Normalización de Paraguay* and the *Instituto Uruguayo de Normas Técnicas*). Their work on the normalization of products will be based on that of international organizations such as the International Standardization Organization (ISO) and the *Comité Panamericano de Normas Técnicas (COPANT)*.

On the basis of concrete requests for norms, the ANM will create sectoral standardization committees. These will dictate norms in various areas, such as electricity, iron and steel, electronics and telecommunications, cement, cellulose and paper, environmental quality and management. This will also significantly limit a member state's ability to impose trade restrictions based on technical grounds.

CHAPTER III. THE CHALLENGE OF THE RELAUNCH: MAIN ASPECTS OF MERCOSUR'S INTERNAL AGENDA

A. The Consolidation of the Common External Tariff

Although MERCOSUR began to function as a Customs Union (albeit incomplete) on 1 January 1995, the member states have recently faced significant difficulties in uniformly applying the protection associated with the CET – an essential and defining instrument in MERCOSUR's current integration phase.

The CET has been and continues to be repeatedly perforated because of the failure to complete the renegotiation of existing bilateral agreements between each MERCOSUR member state and the other LAIA countries. The fact that non-multilateral trade preferences are still in force means that products traded with much of the rest of Latin America (principally the Andean Community and Mexico) enter MERCOSUR with tariffs that vary according to the country/port of entry.

The persistence of various special import regimes in the member countries, and the application of drawback and temporary admission schemes for intra-zone operations, have also affected the sub-regional agreement's structure of protection. The existence of non-multilateral free zones and special customs areas; the reduction of aliquots for supply reasons; the tariff benefits of public procurement mechanisms; and the non-tariff schemes in Brazil are evidence not only of different tariffs in the various economies of the sub-region but also of the need to apply rules of origin to intra-zone trade. *A priori*, however, this is incompatible with a Customs Union and makes intra-subregional operations more expensive.

The perforations in the CET have also created serious difficulties in external negotiations. In talks with the other LAIA countries, for example, the MERCOSUR member states have adopted differing positions on tariff issues. This has undermined efforts to secure balanced agreements that are acceptable to all the MERCOSUR countries. Although MERCOSUR has sought to present a common position in talks with non-LAIA members, it has not shown that it has a fully consolidated common external tariff.

Concluding the re-negotiations of the agreements with the LAIA countries, and progress in the elimination or harmonization of special import regimes, will therefore be priorities in future negotiations.

Three further issues relating to the common external tariff must also be examined in the near future:

- (a) the dual perception of the common external tariff, which clearly distorts the Customs Union;
- (b) the existence of aliquots higher than those individually agreed by the countries at the WTO;
- (c) reviewing the protection of some sectors more than five years after fixing the general tariff structure.

The four member states have identified CET-related issues as a priority on the future agenda, and have included them in the negotiations to relaunch MERCOSUR.

These talks will be further boosted by the completion in December 2000 of various instruments that affect the custom union's tariff structure: the convergence of the basic lists of exceptions and capital goods; the expiry of the deadline for the temporary and generalized 3% increase in the CET that was agreed in 1997; the end of the regime (created in 1995, at the high point of the Real Plan) that enabled temporary tariff reductions to be implemented for supply reasons; and the end of the agreed period for the use of drawback, temporary admission and the general application of the regime of origin for intra-zone operations.

In this context, various proposals for action were exchanged during the first half of this year. These have thus far resulted in several specific commitments.

Special import regimes

Special import regimes have prompted several negotiations, since they distort the protection afforded by the common external tariff. These regimes generally exempt importers from paying tariffs or allow goods to enter with reduced aliquots.

In the negotiations that preceded Ouro Preto, when the CET was discussed and the elimination of both the drawback and temporary admission regimes in intra-zone trade were agreed, Uruguay (the main user of these mechanisms) agreed to comply only if the special import regimes were given similar treatment.

Argentina – which during this phase was using different tariff exemption instruments, the most important of which concerned the industrial specialization regime and the system for the import of turn-key plants – opposed blanket treatment of these regimes. Although at Ouro Preto the member states finally agreed to limit the use of temporary admission and drawback in intra-zone trade, they only made a vague commitment to tackle the special import regimes in the future.

This asymmetry in the treatment of regimes, which in practice has a similar impact on MERCOSUR's protective structure, might have contributed to the failure to meet several commitments made at the end of 1994, such as the agreement to limit the use of drawback and temporary admission in intra-zone trade. Argentina, which in 1995 was the only country to transpose into national legislation the norm agreed at the quadripartite level, had to suspend the relevant internal resolution.

Another outcome of different regimes in the four countries has been the generalized application of MERCOSUR rules of origin to all products traded within the sub-regional market – when these rules should only apply to products exempted from the CET. In 1997, MERCOSUR's Trade Commission sent a report to the Common Market Group listing the special import regimes in force in each member state. Although the report revealed that a significant share of MERCOSUR imports from third countries were admitted under these regimes, the member states failed to make any kind of commitment on this issue.

These issues were kept discreetly in the background for two years, until they were again discussed at the quadripartite negotiations in the first half of 2000. These took place in the context of the general talks on all trade-related issues that alter the protection associated with the CET – drawback, temporary admission, free zones, etc. As a result of the bilateral Argentine-Brazilian talks at the end of April, the member countries agreed to work towards an agreement to limit the indiscriminate use of these regimes.

The member states thus proposed to identify mechanisms (including the list of products included in them) that could remain in force after 31/12/00, as long as they were compatible with the current state of the Customs Union. With respect to the remaining regimes, it was agreed that these should be eliminated gradually and progressively, and that the bloc should move towards a MERCOSUR common special import regime; this would come into effect on 1 January 2001.

At the meeting of the CMC at the end of June 2000, however, a consensus was only reached on defining a normative framework by 15 December 2000. This would regulate all the special import regimes – including the special customs areas – not geared to finishing and then exporting products to third countries.

As a basis for this normative framework, the CMC agreed to consider eliminating the special import regimes that affect intra-zone sales as of 1 January 2006 (excluding the special customs areas), and to set

up common special import regimes. However, the member countries only agreed to hasten the elimination (as of 1 January 2001) of special import regimes that were not in force on 30 June 2000. The CMC also urged the member states not to adopt new measures that could yield benefits beyond 1/1/06. With respect to this norm, the CMC called on the CMG to include the conditions under which products originating from special customs areas should be traded within MERCOSUR .

Far from speeding up the gradual elimination of special import regimes, as had been discussed in previous meetings, the agreement will instead act as a kind of official waiver for the widespread and unrestricted use of these instruments until 2006.

Drawback and temporary admission

These special customs regimes allow the duty-free import of inputs and intermediate goods that are then used in various productive processes and subsequently exported. In other cases, a duty is paid on the import, although this is reimbursed when the product is exported. The issue, however, is whether these should apply to intra-subregional sales – that is, to goods temporarily imported from third countries free of duty, for their subsequent export in a finished product to the other member states.

As noted earlier, at Ouro Preto it was agreed that these regimes could only apply to intra-zone trade in the case of exempted products and, broadly, those goods included in the application of rules of origin (for example, non-exempted products that use lots of exempted inputs). However, these mechanisms remained widespread and unrestricted for intra-zone sales, partly because in its negotiations with Chile it was agreed to continue applying these regimes for MERCOSUR trade during a transition period.

In the framework of CMC Decision 21/98 it was agreed to comply with an earlier commitment to eliminate these intra-MERCOSUR exports mechanisms at the end of 2000. During Argentine-Brazilian talks held in the first half of this year, the two countries reaffirmed this commitment, agreeing to identify those products and groups of products for which the countries could retain the drawback and temporary admission during a period to be agreed, and with a timetable for their gradual elimination.

Uruguay,⁴⁸ the main user of these instruments in intra-zone operations, proposed to keep them until 2013, or to negotiate their elimination together with other special import regimes and all investment and export incentives in force in the other countries in the sub-region. Drawback and temporary admission are critical for Uruguay, as for any small economy, since it needs to import most of the inputs and intermediate goods used in the production chain. The elimination of these instruments would thus lead to a sharp deterioration in the competitiveness of its exports to the sub-region, its main market.

Despite differences of opinion, the June 2000 CMC meeting agreed to extend the generalized and indiscriminate use of all drawback and temporary admission mechanisms for intra-zone sales until 1/1/2006, coinciding with the end of all the CET exemption programs.

It is worth noting that the extension of the deadline, as well as that for all special import regimes, creates an important precedent for the rest of the negotiations on trade agreements and disciplines. Similar arguments are likely to be used to postpone all the agreements still pending on these issues until that date.

⁴⁸ It is worth noting that in the negotiations before Ouro Preto, Uruguay was given special treatment since it was allowed to continue applying drawback and temporary admission in intra-zone trade, but only for products traded through the *Convenio Argentino-Uruguayo de Complementación económica y del Protocolo de Expansión Comercial* (CAUCE-PEC).

Reviewing the common external tariff

In recent months there has been a review of the CET. This is because the set of instruments related to the tariff will end after 1 January 2001; successive and not too orderly changes have been made to the tariff structure in recent years; old discussions have resurfaced on the level of protection for capital goods, information technology and telecommunication products; and imbalances in the CET in certain production chains have been identified.

The political will among the MERCOSUR governments to integrate Chile (which has a lower level of protection than the bloc) as a full member has also led to support for a certain, although not general, reduction in current protection levels. The Argentine economic team believes that Chile's accession would trigger a greater degree of opening, although not in the short term.

From the viewpoint of the Brazilian government, any reduction in tariffs should take into account the needs of productive sectors in MERCOSUR and the prospects for the international negotiations. It should also be borne in mind that the tariff structure cannot be "frozen" indefinitely and that future reductions should not be discounted. As a first step, the Brazilian government has already announced its decision to reduce the CET by three points from 1/1/2001 in compliance with the commitments made when the CET was temporarily increased for three years in 1997.

In the first half of 2000, Argentina expressed its interest in reviewing the CET for certain sectors (for example, textiles) but it is yet to make any reference to the generalized 3-point reduction in the CET foreseen for the end of 2000. In this respect, the *Unión Industrial Argentina* has warned the government not to reduce the CET at the end of the year. During this period, the Argentine government also insisted that there should be an assessment of the future changes to the levels of protection agreed for the capital goods (produced in and outside the sub-region) and for information technology and telecommunications products.⁴⁹

The countries have complied with the convergence schedule in recent years, but the Argentine government has proposed that the protection granted to goods manufactured outside the region (and some produced in MERCOSUR) should be re-assessed. The Brazilian government also appears willing to review the tariff for capital goods, but not those for information technology and telecommunications products. Uruguay proposed the creation of an *Ad Hoc* Group to examine a 14% reduction in the CET for capital goods.

After reviewing the various positions on the CET, the ministers assembled at the CMC meeting at the end of June 2000 called on the Trade Commission to prepare a proposal on a common regime for capital goods produced outside the sub-region before 15 December 2000. However, the CMC devoted only one paragraph to a review of protection levels for some production chains and to tariffs for capital goods produced in the sub-region (over which there had been some pre-agreements in previous meetings): "member states that support a review of some aspect of the CET, including those for capital goods produced in the sub-region, will present their analysis and proposals to the CMG before 30 September 2000".

⁴⁹ Argentina had a zero tariff for the import of these products for most of the 1990s, in order to stimulate the restructuring and modernization of its productive apparatus. Especially until 1994, Brazil protected its industry in capital goods and information and telecommunications products with high tariffs, although the import of goods manufactured outside the sub-region was totally liberalized. This "strategic" divergence resulted in some of the most difficult negotiations between the member states in the period before Ouro Preto, when MERCOSUR's common external tariff was being defined. It was therefore agreed to set up a gradual convergence schedule for capital goods, and another for information technology and telecommunications products. The maximum tariff for capital goods was set at 14%, with 2001 as the convergence deadline (2006 for Paraguay and Uruguay); Argentina increased tariffs and Brazil lowered. The maximum tariff for information technology and telecommunications products was set at 16%, with convergence by 2006.

During a visit by the Argentine economy minister to Brazil in early July 2000, the two countries made progress on the idea of reducing the CET on capital goods to a level that was compatible with the aim of facilitating and stimulating investment (3-5%). They also examined the possibility of maintaining the *status quo* in the convergence program for information and telecommunications products – that is, to halt tariff convergence at the level currently in force in each country (16% in Brazil and 8-10% in Argentina)

An issue that is not strictly linked to the review of protection levels, but that makes the Customs Union function more effectively, is that of the CET's double taxation. In this regard, the CMC instructed the Trade Commission to examine the issue of how to distribute custom revenue, and to present its findings by 31 December 2000. Progress was also made on the question of submitting an initial MERCOSUR offer to the WTO, replacing the individual consolidations of each country. The option that this CET should be five points higher than the one currently in force was considered.

*Perforations in the CET caused by bilateral trade agreements*⁵⁰

The failure to renegotiate the LAIA bilateral agreements (mainly with the Andean Community and Mexico), as happened with Chile and Bolivia, gives rise to systematic perforations of the CET.

After a new round of negotiations in the first half of 2000, therefore, the member states reaffirmed their intention that MERCOSUR should jointly negotiate with third countries or groups of countries. This requires common strategic criteria and a deadline for ending unilateral negotiations.

Although a short deadline was possible (at the last CMC meeting Argentina proposed 1/1/2001), Decision N° 32/00 set 30 June 2001 as the last date on which the countries could negotiate unilaterally. The CMC also proposed that joint negotiations with the Andean Community and Mexico be resumed. It further decided that if no agreement were reached, the current preferences could only remain in force until 30 June 2003.

Although the issue of renegotiating the LAIA agreements is as old as MERCOSUR, the problems facing the various unilateral negotiations over recent years seem to have given the governments a certain degree of confidence that the commitments will now be met in practice. The decision to set a medium-term deadline for eliminating the bilateral preferences is a realistic and pragmatic step forward.

Rules of origin

MERCOSUR's Origin Regime, approved in 1994, applies to all products exempted from the CET and other specific cases (such as products with anti-dumping duties and products with exempted inputs). However, the persistence of numerous regimes that perforate the CET forced the member states temporarily to extend the certification of origin to the whole tariff schedule.

While CMC Dec. 21/98 deferred until 31 December 2000 this irregular form of "limiting" the free circulation of goods in the expanded market, this regularization is largely linked to the treatment of some of the issues examined above (mainly special import regimes, drawback and temporary admission).

The member states are currently aware of this problem, but they have yet to find a solution. At the recent CMC meeting in June they agreed to make some technical adjustments to MERCOSUR's Origin Regime, but made no reference to what will happen after the regime is applied in 2001.

⁵⁰ For more information on this issue, see Chapter IV of this Report.

Nevertheless, extending the use of special import regimes until 2006 makes it likely that the application of the Origin Regime will also be widespread from that date.

B. Barriers to Market Access

MERCOSUR has significantly leveled the playing field since the signing of the Treaty of Asunción. However, the end of the adaptation regime and the increasing difficulties faced by the member states' external sector over recent years has somewhat reversed this process of dismantling barriers to intra-subregional trade.

The tariff-free zone was thus “threatened” by the implementation of various trade obstacles that have not only had a real and concrete impact but have also created a climate of uncertainty about whether the expanded market and unrestricted access for its members is indeed a reality. In recent years, therefore, the member states have consistently sought to negotiate the elimination of non-tariff restrictions that hinder trade and that block the harmonization of the different technical norms and regulations.

The member states identified and classified the existing barriers according to the nature of restriction and its impact on trade. They have worked on a schedule for eliminating and/or harmonizing these barriers, and have agreed in writing not to introduce new obstacles. However, none of these issues has been firmly resolved in practice.

At the end of 1997 a CMG study concluded that 350 non-tariff measures and restrictions were in force. It was decided to dismantle or harmonize these by the end of 1998, although only limited progress was made.

In mid-1999, a Trade Commission report on the state of those restrictions that were considered most important (38 measures and four consultations) revealed that 10 of these had been completely resolved. Resolution of the rest had been either partially or nil. The April 1999 ruling of MERCOSUR's *Ad Hoc* Tribunal that Brazil's non-automatic prior licenses should be eliminated was therefore an important step forward in this respect.⁵¹

This issue was closely examined at the bilateral and CMG coordinators meetings in the first half of 2000. In the bilateral meeting at the end of April, the countries agreed to complete the identification of obstacles and restrictions. The aim was to eliminate, by 30 June, all prior licenses and all other non-tariff barriers applied to intra-zone trade that were not contemplated in Art. 50 of the LAIA agreement.⁵²

The June 2000 CMC meeting formally reiterated the commitment not to adopt any new measures that restricted trade. The member states were unable to agree jointly on the identification and elimination of non-tariff restrictions by the deadline agreed in April at the bilateral level. The CMC therefore set 30 July as the deadline for completing the identification, and 15 November 2000 as the limit for deciding the course of action to be taken to solve the problems of intra-zone trade caused by these restrictions.

C. Measures to Facilitate and Simplify Border Procedures

In December 1998, the CMC decided to simplify and facilitate the administrative and operational aspects of trade so as to make intra-zone commerce easier. The significant increase in trade had exposed administrative/customs weaknesses, such as the lack of harmonization in customs procedures and opening

⁵¹ For more information on this issue, see Chapter V of this Report.

⁵² For more information on this issue, see Chapter V of this Report.

hours, border control problems, a lack of personnel and of adequate physical resources, and the great variety of procedures and documentation necessary to cross the border points.

The Trade Commission was given six months to submit a proposal in this regard. In mid-June 1999, the member states agreed on an action program to facilitate trade by streamlining administrative procedures (Program of Asunción). The deadline for completing the action program was set for 30 April 2000. In the first half of this year, therefore, the various alternatives to facilitate trade in the sub-region were examined.

These alternatives included setting maximum periods for granting automatic and non-automatic licenses; eliminating sanitary and phytosanitary border inspections; signing equivalence agreements⁵³ for sanitary and phytosanitary control systems; and coordinating a methodology for exchanging customs, technical, sanitary and phytosanitary information in real time.

Although there was consensus on many of these measures, the CMC meeting in June 2000 failed to agree on an overall program. The tasks set in the Program of Asunción are thus still being analyzed and assessed.

D. Public Policies that Distort Competitiveness

Subsidies and state support systems in the member countries directly affect the sub-region's competitiveness. These public policy "asymmetries" (manifest as the varying fiscal and financial treatment of investment, production or exports) distort the market signals offered by each country's "natural" condition.

Although the need to eliminate these asymmetries has been a concern since the signing of the Treaty of Asunción – and is included in the Las Leñas Timetable, the Protocol of Ouro Preto and the MERCOSUR Agenda 2000 – there has thus far been little progress in efforts to "level the playing field".

Continuing public policy differences have led to numerous tensions within the expanded market. As the level of reciprocal economic inter-dependence has increased, so the importance of this issue and the demands from the different countries' public and private sectors that they be resolved have grown exponentially.

These asymmetries affect companies' competitiveness and therefore have an impact on decisions about trade and, fundamentally, about the destination of investment. To remedy this problem, the "complaints department" has been gradually transferred from the national sphere to sub-regional fora.

Several of the consultations presented to MERCOSUR's Trade Commission over the last few years have concerned different aspects of this issue (export subsidies, financial incentives, etc). Argentina's complaint against Brazil (which was rejected by the Arbitration Tribunal at the end of September 1999) centered on the issue of subsidies for pork production and exports.

MERCOSUR has its own juridical instrument (Decision N° 10/94), which regulates the granting of incentives for intra-zone sales, while the issue of state assistance is covered by the Protection of Competition Protocol. However, the different interpretations of the former, and the fact that the latter is not in force, have meant that their concrete effects have only been partial. The issue of investment incentives, for its part, was not included in any specific legal framework.

In the negotiations to relaunch MERCOSUR in the first half of 2000, Argentina proposed the creation of a High-Level Group to address incentives. The aim was to complement the regulations in force by

⁵³ For more information on this issue, see Chapter II of this Report.

deepening the commitments on production subsidies and regulating some intra-zone trade incentives, with a view to defining their scope more precisely. The Argentine proposal also included limits on national, provincial/state and municipal incentives.

The proposal also made the elimination of the anti-dumping and anti-subsidy regime in intra-zone trade conditional on the removal of investment incentives and other state support mechanisms. In the negotiations, Brazil argued that the Protection of Competition Protocol could be used to counter distortionary practices and their impact on competitiveness at the sub-regional level.⁵⁴ For their part, Paraguay and Uruguay agreed that a list should be drawn up for the whole range of incentives in the sub-region, but expressed doubts about whether common discipline was necessary.

An agreement was finally reached to address investment incentives at the MERCOSUR level.⁵⁵ This was an important advance, since the issue featured as part of a community norm for the first time. However, the application of the corresponding disciplines was agreed as part of a range of trade-related issues (such as drawback and other special import regimes) on which differing progress has been made. The CMC therefore instructed the CMG to prepare a proposal on common disciplines in the use of investment, production and export incentives that distort resource-allocation at the sub-regional level.

The member states agreed to draw up a complete list of incentives currently in force before 15 December 2000. On that basis the CMG would prepare a proposal on the common application of disciplines before 31 March 2001. This would then be sent for consideration to the CMC meeting in mid-2001.

E. Unfair Practices and the Protection of Competition

Acknowledgement of the importance of a MERCOSUR norm in anti-trust matters stems from the experience of the two largest member states, which for some years have had such a regulation for trade within their own borders. The expanded market is now the new setting for business development, and it is in this context that governments must focus their efforts to guarantee clean and transparent competition.

In 1996, the CMC approved the Protection of Competition Protocol, which covers issues such as restrictive behavior and practices, abuse of a dominant position, the sanctions regime, and the bodies and procedures for the application of sanctions. Argentina expected that the instrument would include specific commitments on state aid in order to guarantee the transparency of government intervention and to prevent this aid from negatively affecting competition. Brazil, for its part, only agreed to consider common norms on this particular issue, and only for two years after the protocol's entry into force. A similar timeframe was agreed for examining the treatment of company mergers and concentrations.

Only Paraguay has thus far approved the protocol, while Brazil is in the process of promulgating it. The protocol cannot enter into force unless at least two countries have ratified it.

The protocol is not only an important anti-trust instrument, but also has implications for intra-zone trade since it penalizes actions such as predatory price practices (artificially low prices that displace competitors) or distortions in sub-regional trade arising from state aid for production and exports.

⁵⁴ This issue will be examined more closely in the next section.

⁵⁵ In their meeting in April, the CMG coordinators decided to create Working Sub-group N° 12, which would specifically examine investment subsidies in the sub-regional context.

The Protection of Competition Protocol could thus limit the effects of national public policies that affect competitiveness, and counter unfair trade practices between the member countries. The Decision that approved the Protocol in 1996 makes it possible to investigate complaints of dumping in intra-zone trade according to national legislation until 31/12/2000.

With respect to this latter point, Brazil is seeking to ensure that anti-dumping and anti-subsidy policies in intra-zone trade are eliminated within the agreed deadline. Brazil has thus proposed that implementation of the protocol be speeded up and the two-year deadline brought forward so that the issue of state support can be covered. It also proposed that the legal basis for analyzing this issue be completed by the end of 2000.

According to the Brazilian foreign minister, "... anti-dumping mechanisms are a way of restricting trade. This is why we want Argentina to apply a more transparent instrument that is not a black box used in an arbitrary way...".⁵⁶

As noted above, Argentina (the main user of anti-dumping mechanisms in intra-zone trade) has made the elimination of these mechanisms conditional on the eradication of the various incentives in the countries of the sub-region, most notably in Brazil. Argentine Economy Minister José Luis Machinea has said that: "the anti-dumping mechanism is a tool for protecting a country from the unfair competition created by export subsidies. These lower one country's prices in sales to its neighbor...The mechanism can therefore only disappear if these state policies are also eliminated...".(*Ambito Financiero*, 26 April 2000).

In negotiations during the first half of 2000, the member countries agreed on further joint analysis of means to protect competition, protection against unfair practices in intra-zone trade and state aid. The purpose is to identify the appropriate instruments for consolidating a genuine and competitive common market. At last April's bilateral meeting, the two countries therefore decided that in a first phase (to last until 15 August 2000) they would examine the progress made thus far at the sub-regional level, prevailing national laws and possible options. Timeframes and mechanisms to regulate and/or eliminate intra-zone anti-dumping measures would be established in a second phase, and the Protection of Competition Protocol would be adapted to the requirements attendant on MERCOSUR's current status.

The CMC meeting of June 2000 decided to instruct the CMG to draw up a proposal on how to bring discipline to the investigation and application of anti-dumping measures and countervailing duties in intra-zone trade. This work should be concluded before 30 November 2000, so that a proposal can be presented to the CMC meeting at the end of the year. It was also agreed to ask the MERCOSUR Trade Commission to draw up a proposal that defines the applicable instruments, with a view to the gradual elimination of anti-dumping measures and countervailing duties in intra-zone trade. These tasks should be concluded before 30 June 2001, and sent to the CMG for consideration before 31 December 2001.

Finally, the CMC called for an institutional and regulatory framework to be designed that would counter unfair trade practices (dumping and subsidies) in imports from third countries. It is worth noting that although MERCOSUR has common instruments in this respect, it still has to define and regulate the quadripartite decision-making process and examine the possibility of applying these bloc-wide trade protection measures, whenever possible, on behalf of one or more member states and not the bloc as a whole.

⁵⁶ Statement by Luiz Lampreia to *Gazeta Mercantil*, 18 April 2000.

F. The Negotiation of Services

The Treaty of Asunción makes reference to the fact that the common market entails not only the free circulation of goods but also of services and production factors. During the 1991-1994 transition period, it was impossible to start negotiations on this issue because there were marked differences in the degree to which the four member states had opened their markets.

An *Ad Hoc* Group, set up in 1995 to examine the issue, was to draft a Framework Agreement on Trade in Services. It is worth noting that the inclusion of liberalization of trade in services on the FTAA negotiating agenda encouraged attention to it at the sub-regional level. Once goods could circulate freely the opening of the services markets became a priority on the agenda to MERCOSUR.

The Protocol of Montevideo, signed in December 1997, committed the member states to liberalize sub-regional trade in services within ten years of the entry into force of the Protocol. The Protocol provided for annual negotiating rounds to integrate the various sectors in sub-regional free trade by means of positive sectoral and horizontal lists.

Each member state's initial list of specific commitments (which were fixed in 1998), and the sectoral provisions on land and water transport, the movement of service-providing physical persons, air transport and financial services, were based on the commitments agreed by the member states with the WTO – although with some minor improvements, such as Brazil's inclusion of information services.

Nevertheless, these moves to liberalize MERCOSUR's services market have not been put into practice, since the Protocol is yet to be approved by the parliaments of the member countries. The negotiations are also being hampered by each country's varying degrees of liberalization. Argentina has agreed in the WTO a greater degree of opening of its services market in the WTO than its other partners, from which the other countries of the sub-region already benefit. This initial asymmetry therefore implies that Argentina's neighbors must initially make a greater effort if the sub-regional talks are to advance.

This issue can only be resolved politically through negotiations, since the services issue is part of a delicate overall balance involving a significant number of other agreements.

During the first round of talks in 1999 there was no significant progress on deepening the initial commitments. Brazil, Paraguay and Uruguay presented their commitments on telecommunications, while Argentina offered to improve access to its insurance sector and to construction and engineering services. The CMG sent these offers to the CMC in November 1999, and called a second round of talks for 2000.

The issue has been part of MERCOSUR' relaunch this year. At the request of the CMC, the Services Group reviewed the lists pertaining to the first round, as well as the methodology and liberalization measures to be adopted for each sector in the second round. The CMC meeting in June 2000 approved the results of the First Round of Negotiations on Specific Commitments.

The CMG meeting of that same month approved the methodological and technical aspects of creating the conditions for the start of the second round of negotiations.

G. The Public Procurement System

The construction of a Customs Union must include some kind of common treatment of public sector procurement. Discrimination in favor of national suppliers (to the detriment of sub-regional competitors)

spawns inequalities in the conditions of competition within the expanded market. This is incompatible with the idea and objective of the integration process.

Another priority on MERCOSUR's relaunch is the negotiation of a Public Procurement Agreement.⁵⁷ The aim is to commit the member states to end all forms of discrimination in the tendering processes that the public bodies of the member countries carry out to buy goods or contract services.

The agreement also includes preference rules for sub-regional companies competing in international tenders. MERCOSUR-based firms would be given a preferential 3% price margin over extra-zone competitors.

The relevant *Ad Hoc* Group has been working since December 1997 to design a MERCOSUR regime that includes provisions on scope, national treatment and rules and procedures to foster transparency. However, these activities have not as yet been formalized in a quadripartite agreement. The original deadline for completing the negotiations, December 1998, had to be extended to 30 June 2000.

The existence of different public procurement regimes in the member states has hampered harmonization at the sub-regional level. Over and above the agreements reached on non-discriminatory treatment and the banning of performance requirements, questions still to be resolved include Protocol's scope (that is, if sub-regional regulations on procurement cover purchases made at different levels of the public administration in each country), whether concessions are included in the regime, tariff treatment, and other matters concerning the qualification requirements for suppliers.

Significant progress was made in the *Ad Hoc* Group in the first half of 2000, particularly on drawing up a register of suppliers, tariff treatment, and other pending issues. Other questions are yet to be resolved, including the scope of the protocol and minimum thresholds. The latter refers to the minimum values at which governments buy goods and contract services in order to be covered by the Protocol, and the number and importance of public bodies – according to the level of procurement – which will be subject to these regulations.

Talks held in recent months have reaffirmed the resolve of the member states to complete the negotiations on the Normative Framework of the Common Market Group before the end of Argentina's presidency. A draft agreement has been completed (after two years), but it has not yet been approved because the corresponding annexes are not ready. Without these, the agreement cannot enter into force. Negotiation of these annexes (which should happen in the second half of 2000) is vital to the effective implementation of the agreement, since they define which public bodies, goods, services and public works will be covered by the protocol.

There was no consensus on whether to include concessions in the protocol. A significant share of public works projects and the privatization of various services are effected via this measure. Argentina has repeatedly proposed that concessions be included in the normative framework in order to ensure that sub-regional companies are not discriminated against, and that processes are transparent. The other member countries, however, have opposed the inclusion of concessions in the Protocol, arguing that these cannot be defined as contributions from the member states.

At its last meeting, and following the suggestion of the *Ad Hoc* Group on Public Procurement, the CMG created an *Ad Hoc* Group on Concessions to devise a specific juridical framework.

⁵⁷ According to estimates by Brazil's Ministry of Foreign Affairs, MERCOSUR public procurement totals some US\$ 20 billion a year, of which US\$ 15 billion corresponds to Brazil, US\$ 3 billion to Argentina and US\$ 2 billion to Paraguay and Uruguay.

H. Transposition into National Legislation of MERCOSUR Norms

The Treaty of Asunción only gave the Common Market Council and the Common Market Group the authority to take decisions and make resolutions on matters that aimed to foster the integration process.

This proved to be a weak base by which to bind countries to resolutions and decisions approved at the sub-regional level. Special attention was given to the issue at Ouro Preto, where it was agreed that all norms in the protocol, including international mechanisms and acts passed by bodies with normative capacity, were obligatory and binding for member states, which had to incorporate them into internal juridical codes.

It was also agreed that quadripartite decisions must be published in MERCOSUR's Official Bulletin, and a mechanism was set up to allow these norms to enter into force simultaneously in the four member countries.

Since Ouro Preto, the transposition of norms by the member countries has faced numerous difficulties, including the incompatibility between norms devised by MERCOSUR's technical fora and the regulations in force at the national level. The transposition into national legislation of MERCOSUR norms has therefore been hampered by administrative, technical and political barriers.

According to MERCOSUR's Administrative Secretariat, 1,024 regulations (162 CMC decisions, 763 CMG and 99 MTC directives) have been approved at the sub-regional level in recent years that had to be transposed into national legislation. However, the Uruguayan government estimates that only 50% of these MERCOSUR norms have been transposed.

In the first half of 2000, as part of the negotiations to relaunch the integration process, the member countries agreed on the immediate need to transpose those MERCOSUR norms already approved. They also decided to introduce technical criteria for establishing norms that do not require transposition (either because they are related to MERCOSUR's internal organization or because there is already a national norm similar to the quadripartite one) and mechanisms that reinforce the commitments already made on this issue.

The June 2000 meeting of the CMC formalized an agreement whereby norms issued by MERCOSUR bodies do not require internal measures for their transposition when the countries jointly acknowledge that the norm deals with questions relating to the internal running of MERCOSUR or when its provisions are already covered by national legislation.

With respect to the norms already approved, it was agreed that the National Coordinators should confirm or correct the information available in MERCOSUR's Administrative Secretariat regarding which norms have been transposed. The National Coordinators will send an official communication to the Secretariat by 30 September 2000, identifying the MERCOSUR norm and the national norm that incorporates it. It was also decided that the member states should identify which norms were not transposed into national legislation because they concern issues related to the internal running of the integration process.

MAIN OBSTACLES AND RESTRICTIONS TO INTRA-ZONE FREE TRADE

Requests Presented by the Member States to June/July 2000

Issue	Affected Products or Sectors	Plaintiff	Defendant
Additional mobile tariffs on intra-zone imports	Sugar	Brazil	Argentina
Labeling requirements with compulsory certification	Footwear and paper	Brazil	Argentina
Non-automatic import licenses	Footwear and paper	Brazil	Argentina
Participation of private bodies in customs verification	Various products	Brazil	Argentina
Customs verification by "Purple Channel"	Various products	Brazil and Uruguay	Argentina
Anti-dumping/anti-subsidy duties that have been applied and/or are under study	poultry, wild sow, cold-rolled plates, aluminum cables, saws, <i>garrafas</i> and fiber optic cables	Brazil	Argentina
Intra-zone export duties	raw hide and oleaginous seeds	Brazil	Argentina
Restrictive regime for containers and border traffic	various products	Paraguay	Argentina
Customs verification by "Red Channel"	various products	Paraguay	Argentina
Labeling requirements and specific duties	textiles and footwear	Uruguay	Argentina
Specific security measures	iron and steel and electronic products	Uruguay and Paraguay	Argentina
Sanitary and veterinary obstacles and barriers (SENASA)	citrus fruit and live pigs	Uruguay	Argentina
Sanitary requirements for authorizing frozen exports	fowl meat	Brazil	Argentina
Erosion of MERCOSUR preferences by Special Regimes (REI)	aluminum, iron and steel and tires	Brazil	Argentina
Obligation to combine with national production for consumption	natural gas	Argentina	Brazil
Non-automatic import licenses (DECEX 37/97, 7/98 and 23/98)	various products	Argentina and Uruguay	Brazil
Non-eligibility to use social programs	powdered milk	Argentina	Brazil
Non-compliance with the transposition of registration commitments	medicines	Argentina	Brazil
Non-compliance with agreements on risk registration and revaluation	agro-chemicals and fertilizers	Argentina	Brazil
Investigation on dumping under study	powdered and long-life milk	Argentina and Uruguay	Brazil
Demand for sight payment of imports	rice and maize	Argentina and Uruguay	Brazil
Technical regulations for safety inspections	weapons and munitions	Argentina	Brazil
Incomplete transposition of technical MERCOSUR regulations	wines	Argentina	Brazil
Access problems relating to juridical decisions	genetically modified maize and rice	Argentina and Uruguay	Brazil
Demands for special phytosanitary analysis	Rice	Argentina	Brazil
States-level tax discrimination against imported products	railway material, cattle on the hoof and long-life milk	Argentina	Brazil
Special sanitary requirements	Potato	Argentina	Brazil and Uruguay
Minimum specific import duties	maté and UHT milk	Argentina, Brazil and Uruguay	Paraguay
Discriminatory tax treatment for national production	unleaded naphtha and beer	Argentina	Paraguay
Compulsory technical norms	iron and steel products	Brazil	Paraguay
Minimum import prices	Sugar	Brazil	Paraguay and Uruguay
Non-automatic import licenses	crude oil and derivatives	Argentina	Uruguay
Technical barriers higher than international ones	water ices	Argentina	Uruguay
Tax discrimination against imports	cigarettes, beers and concentrated juices	Argentina and Brazil	Uruguay
Loss of MERCOSUR tariff preferences because of special regulations	natural gas and steel pipes	Argentina	Uruguay

Source: Prepared by the author, based on Brazilian and Argentine newspaper reports and business information

CHAPTER IV. DEVELOPMENTS ON MERCOSUR'S EXTERNAL AGENDA

In the context of MERCOSUR's severe internal difficulties throughout last year, and the particular turbulence in the areas of trade and international finance provoked by the outbreak of the Asian-Russian crisis and its subsequent effects on Latin America, international negotiations entered a phase of stagnation, indefiniteness and (in some cases) withdrawal from or non-fulfillment of agreed timetables and objectives.

Circumstances were made yet more complex from the end of 1999 by the failure to launch a new round of multilateral negotiations in the WTO at Seattle, and by the emergence in the main developed countries of new groups and recalcitrant forces that were resistant to market opening and to the effects of economic globalization. Hence the major players in the world economy had little incentive to push for progress in the complex and unprecedented exercise of North-South negotiations.⁵⁸

Beyond the significant advances made with regard to the possibility of Chile's full integration in the Customs Union, little progress was made on MERCOSUR's external agenda in this period. Most of the external negotiations remained in the area of the formal and "diplomatic" treatment of the various issues on the agenda, the conclusion of some relatively important trade agreements, and the preservation of established routines. In this light, the challenges and prospects of the coming period are as important as they are uncertain, since most of the timetables already agreed upon assume decisive measures and irreversible steps in the next two years.

Additionally, the four countries face the new and unprecedented challenges arising from the decisions taken by the MERCOSUR presidents at their June 2000 summit in Buenos Aires to push for an ambitious agenda of trade negotiations with Mexico, the Andean Community countries and South Africa, and to fix a strict time limit (June 2001) for reaching or extending individual agreements with third countries that are members of the LAIA.⁵⁹ Those challenges are great in view of the serious difficulties, evident in earlier failed negotiations, of defining a common MERCOSUR position to balance out and harmonize the sometimes divergent interests of the four partners.⁶⁰

In this connection, it is interesting to review recent developments connected to the status of the various issues on MERCOSUR's external agenda.

A. FTAA Negotiations Continue without Fast Track

Following the decade's most complicated year, the Third Meeting of the FTAA's Trade Negotiations Committee (TNC) and the Fifth Meeting of hemisphere's trade ministers was held in Toronto, Canada, at the beginning of November 1999. This meeting, during which Canada handed over the chair to Argentina, ended the stage of exchanging information, establishing databases, methodologies and procedures, and approving business facilitation measures. The countries embarked on the stage of defining negotiating norms, disciplines and tariff reduction schedules.

⁵⁸ Despite this, it should be pointed out that there are some exceptions to these "rules", such as the European Union's trade agreements with South Africa and Mexico, or the culmination of China's negotiations with the EU and the United States with regard to its accession to the WTO.

⁵⁹ It is interesting to note in this regard that at the Buenos Aires Summit of June 2000, Chile had informally expressed its interest in participating in the negotiations with the Andean Community countries from the MERCOSUR desk. The Andean states finally decided that in practice this would be an additional obstacle to the talks.

⁶⁰ It is worth noting that while Argentina sought to re-start negotiations with the Andean countries and Mexico with the aim of regulating preferential trade relations, Brazil's explicit aim was to establish a free trade area.

The concrete substance of the negotiating round that began with this gathering was one of the most controversial issues. The host country insisted on the presentation of a preliminary, consolidated, indicative scheme whose criteria were the object of severe criticism. In this regard, MERCOSUR argued that it was still too early to approve it, since it would condition future endeavors.

Some countries, including Chile and the United States, insisted on the need to agree on specific instructions for the negotiating groups on market access and agriculture. This was interpreted by other countries as an effort to “bring forward” agreements on tariff reduction. A general formula was reached, establishing that the groups concerned with market access should discuss mechanisms and procedures in their respective areas.

The Andean Community countries expressly argued that the agreement should include provisions on special and differentiated treatment, a matter that spurred intense debate. It was agreed that the TNC should examine how the issue of differences in size and development levels should be dealt with in other fora, and that it should inform the ministers of the results of that examination.

The countries agreed that each of the groups should prepare a draft of their respective chapters, which will be submitted to the TNC before the April 2001 ministerial meeting in Buenos Aires. The drafts will include issues on which consensus has been reached, as well as those on which the countries still diverge (which will be included “in brackets”). The groups concerned with market access issues will start discussions on mechanisms and negotiating procedures in their respective areas.

The TNC, chaired by Argentina until April 2001, will bring together the draft texts of the different groups and draw up a report for the ministers. This will include the areas requiring special guidelines for the purposes of ensuring optimal fulfillment of the agreed mandates. The report will cover the outcome of discussions on the general structure of the agreement (general and institutional aspects), as well as how differences in size and development levels among the countries should be addressed.

A start was made on identifying business facilitation measures with the approval of an initial list of 18 measures, including customs procedures (8 measures) and administrative transparency (10 measures). The TNC is responsible for supervising the implementation of these measures, for giving technical assistance to their implementation (particularly in the less developed countries), and for identifying and recommending any additional measures that might be considered helpful.

As regards the WTO negotiations, the delegations reaffirmed their support for the (then still possible) launch of a new round. Discussion of the message to be sent to the Secretary General of the WTO was an issue that prompted substantial controversy. The Caribbean countries did not accept that the message should only include the agricultural issue, and the Andean countries insisted on the complex issue of special and differentiated treatment (although without making concrete proposals in that respect).

The message from the ministers concluded with a call for the multilateral negotiations to have a balanced and wide-ranging agenda that includes the elimination of subsidies to agricultural exports and a ban on their reintroduction in any form; commitment to fulfillment of the obligations assumed in the Uruguay Round Agricultural Agreement; and implementation of additional disciplines to neutralize other practices that distort agricultural trade.

As regards the sensitive issue of “the interests of developing countries”, it was agreed to ask the WTO to pay greater attention to effecting the principle of special and differentiated treatment, as well as other provisions related to such countries.

Later, in mid-April 2000, the Fifth Meeting of the TNC (vice-ministerial level) was held in Guatemala under Argentine chairmanship. The meeting analyzed progress in the discussions within the nine negotiating groups, specialized committees and advisory groups, and approved the agenda of meetings and

work programs designed to ensure that the first drafts are ready before April 2001. The meeting also considered a document presented by the chair and another from the Tripartite Committee (OAS/IDB/ECLAC) on other experiences of dealing with different sizes and development levels among countries in various integration processes. In that regard, and given the issue's eminently "horizontal" nature, it was agreed that it be included in each of the negotiating groups, in the discussions of the TNC and other *ad hoc* working groups. The TNC is responsible for permanent follow-up on the matter, but there is currently no general mandate on it.

One of the most politically important moves at this meeting was the attempt by the United States and Canada to put issues that are directly or indirectly related to labor standards and environmental protection on the agenda, and in the drafts of the various working groups (especially that on investment). These issues had been peripheral to the hemispheric negotiations, largely because of the overt opposition of the Latin American countries, which saw the initiative as an attempt to impose another obstacle to access to the US market. Most countries firmly rejected this proposal but the debate is not completely finished, and it is likely that such arguments will be made again within the various negotiating groups in the coming months.

As regards business facilitation, a report was considered by the *Ad Hoc* Group of Customs Experts on progress in this area, and implementation of the first series of measures on transparency was taken as finished. With respect to the identification of facilitation measures other than those agreed in the July 1999 meeting of the TNC in Cochabamba,⁶¹ a timetable was agreed (finishing at the end of May 2000) to simplify the list of 233 proposals presented by the countries and the Business Forum. On that basis the chair is preparing a new list of proposals in this area, to be examined in the Barbados meeting of the TNC in September 2000.

In sum, apart from the "uncertainty effect" arising from the lack of progress made in securing fast track authority from the US Congress, the hemispheric negotiations have acquired their own momentum. Throughout last year significant progress was made in defining the agendas of each of the groups. The next ministerial meeting, to be held in Buenos Aires in April 2001, could therefore signify a qualitative leap in negotiating the FTAA – given the progress made in the various working groups and the probable political conditions at that time (the most important of which will undoubtedly be a new president in the United States).

In this respect, President Clinton's message to Congress in early May 2000 pointed out that the "silence" of the US government on the negotiation of the FTAA, after his failure to secure fast track authority in the winter of 1998 (before the presidential summit in Santiago), should not be interpreted by the countries of the region as a sign of less interest or a lack of US commitment to the issue.

Clinton expressed his optimism for the future of the negotiations, pointing out that "there are no differences between [presidential candidates] Al Gore and George Bush." At the beginning of June 2000, however, there was some journalistic contention between US and Brazilian officials on the issue. The US commerce secretary attributed doubts about fulfillment of the agreed timetables to the fact that "Brazil does not make the efforts it should" to foster the creation of a hemispheric bloc. Brazilian Foreign Minister Luiz Lampreia mentioned the need to reach internal and external consensus in order to proceed with an extremely complex negotiation. In that connection, he pointed out that "in democratic societies, entrepreneurs, workers and consumers must be listened to, and must be sure of the economic advantages that would stem from their country's inclusion in the bloc" (*Jornal do Brasil*, 8/6/00).

⁶¹ It is worth noting the criteria that define the proposed measures as part of business facilitation: that they are not part of issues to be negotiated in other groups; that they do not entail changes to national laws; and that they do not imply attachment to extra-hemispheric international agreements.

B. The Difficult Negotiations with Chile in ECA 35

After several years of strong growth, trade between Chile and the MERCOSUR countries fell sharply in 1999. MERCOSUR exports to Chile declined by 6% and imports by 12%, reflecting the severe contraction of output on both sides and the significant fall in the prices of most traded products. After solid recovery in Chile from the end of 1999 onwards, and an improvement in MERCOSUR's general conditions, clear positive trends were evident in the first months of 2000: Argentine and Brazilian sales to Chile grew by 20-30%.

In the area of international negotiations, and in the framework of the MERCOSUR-Chile agreement (Economic Complementarity Agreement N° 35), throughout last year significant progress was made on implementing a new dispute resolution mechanism with instruments that surpass those established within MERCOSUR by the Protocol of Brasilia.⁶²

There was virtually no progress last year on deepening bilateral preferences, a matter on which negotiations should have begun in October 1998, according to the original commitments of 1995. In this regard it should be noted that the continuity of the unilateral tariff reductions that Chile has been effecting since early 1999 (which establish annual cuts of 1%, to reach an average level of 6% in 2003) undermines the trade benefits that the MERCOSUR countries could secure from additional preferences with Chile, thus sharply diminishing their interest in negotiating new reciprocal concessions in this area.

As regards sectoral issues, in the period under analysis there were two significant developments. The first of these was the claim by Argentina against Chile in the framework of the dispute settlement mechanism originally established in ECA 35. This centered on the tariff treatment accorded to vegetable oils mixtures. The other was Chile's imposition of WTO safeguard clauses on a series of agricultural products.

With respect to the former issue, at the end of March 1999 Chile's National Customs Service reclassified vegetable oils mixtures in a such way that these ceased to pay the preferential duty of 3.7% (corresponding to a 63% preference over the MFN tariff for heading 15.17.90) and were included in the heading applied to the mixture's main ingredient. The resulting tariff was thus 10% *ad valorem*, to which must be added the duty arising from the application of the price band system. (The latter did not affect oils mixtures but it did affect pure oils, and with the fall in international prices it led to increasing tariff protection). The effective tariff was therefore at a level of about 40-45% *ad valorem*.

A couple of weeks later, in response to the action of Chile's customs authorities, Argentina conducted the corresponding consultations provided for in the dispute settlement system of ECA 35. This mechanism (Additional Protocol N° 21) provided for arbitration, through which the parties pledge to resolve disputes by "direct negotiations that are conducive to a mutually satisfactory solution". In the case of MERCOSUR those negotiations were conducted by the CMG's National Coordinators, and in Chile's case by the foreign ministry's General Directorate for International Economic Relations (DIRECON). In light of the strictly technical bases of Chile's position, in December 1999 the Administrative Commission of ECA 35 decided to convoke a group of experts in customs classification issues that would issue a non-binding ruling on the measure's validity. The advisory group comprised Milton Cevallos Rodríguez of Ecuador, the expert designated by both sides to chair the group; Augusto Aninat del Solar, the representative of Chile; and Juan José Sortheix, Argentina's expert. The group had thirty days from its

⁶² The new mechanism has a prior process of bilateral negotiation, after which the matter passes to the Administrative Commission and finally reaches the arbitration stage. Simultaneously, and keeping in mind the experience acquired in MERCOSUR, some elements were added that did not feature in the Protocol of Brasilia. These included a chance for the parties to analyze (and refute when necessary) the rules of procedure fixed by each *ad hoc* tribunal.

first meeting in early April to reach its conclusions, over which the accord's Administrative Commission would have final approval.

In early May 2000 the *ad hoc* group of experts ruled in favor of Argentina,⁶³ recommending that the National Customs Service should not effect the tariff reclassification of such products. Hence, in the May meeting of the Administrative Commission of ECA 35, Chile pledged to accept the verdict and to take steps to comply with it⁶⁴ by changing the earlier customs ruling.⁶⁵ In mid-June 2000 the Chilean foreign ministry formally annulled customs decision 18/99. The tariff on imports of oil mixtures from the MERCOSUR countries and Bolivia was set at 3.7% *ad valorem*, rather than the 45-50% under the earlier classification.

As regards the second issue, at the end of September 1999 the Chilean treasury began an investigation into the application of WTO safeguard measures on imports of vegetable oils and other products included in the price band system. In November, provisional safeguards were established for wheat, wheat flour, sugar and edible vegetable oils,⁶⁶ equivalent to the difference between the *ad valorem* tariff resulting from the application of the price band (from which the MERCOSUR countries had been excluded) and the level consolidated at the WTO.

At the end of January 2000, a decree published in the Official Bulletin established definitive safeguard clauses for one year (extendible for a further year) for imports of the aforementioned products from any source. Chile thus tried to "regularize" its situation in the WTO, since (as a result of the bands mechanism) the prevailing tariffs on those products substantially exceeded the levels consolidated at the WTO (reaching 61% for raw oils and 70% for refined oils, against the maximum of 31.5% allowed by Chile's WTO commitments).

These measures had a particular effect on Argentine exports to Chile of all the items mentioned⁶⁷ (and on Bolivian exports of soya oils, although Bolivia recently won some compensation in the framework of ECA 22). They were received with undisguised distaste by Argentine officials, who questioned the Chilean government's grounds for taking such measures and threatened to make a formal complaint to the WTO.

In view of the difficulties arising from the change in government, the departure of the officials responsible for the matter, and the sensitivity of the issue for some regions of the country, the new Chilean authorities argued that the norm sprang from the complex circumstances of its farmers after the crisis of international prices in 1998-1999: projections for 2000 included a 34% decline in the area of wheat under cultivation, an 80% drop in sugar production, and a 54% fall in the output of vegetable oils.

Finally, between the end of June and the beginning of July 2000, the issue of Chile's full accession to MERCOSUR again occupied the center of the sub-region's political stage. The optimistic declarations made by senior officials of both blocs (particularly those by Presidents Lagos and Cardoso during the

⁶³ It should be pointed out that some days earlier, the (binding) arbitration tribunal sought by Bolivia against Chile in the LAIA framework, in connection with the issue of the tariff reclassification of vegetable oils mixtures, ruled in favor of Bolivia.

⁶⁴ Since the same issue also affected Bolivia, another group of experts was set up in the framework of ECA 22 (Chile-Bolivia agreement). Before the Argentine case, this ruled in favor of Bolivia. It is worth noting that, unlike the mechanism of ECA 35, the verdict of the technical group in this case was mandatory.

⁶⁵ At the time of writing, this measure had still not been put into effect.

⁶⁶ The first two products mentioned are in a particularly sensitive sector of the Chilean economy. ECA 35 established a long timetable of tariff convergence that contemplated the granting of preferences in the fourteenth year.

⁶⁷ To 1999, Argentina accounted for 100% of Chilean imports of soya oils and sunflower, 26% of wheat imports, and 82% of wheat flour imports.

former's recent visit to Brazil) have suggested that Chile might become a full member before the end of 2000, on the basis of an undefined tariff convergence scheme, the swift transposition of MERCOSUR norms, and an additional Protocol to the Treaty of Asunción.

Notwithstanding the undoubted juridical and technical complexity of this undertaking, and the many obstacles that it will face (particularly in the agricultural and automotive sectors, in which the two sides' policies are clearly incompatible) it is plain that Chilean accession would make an enormous political and economic contribution to MERCOSUR's relaunch.

C. MERCOSUR-Andean Community: Modest Progress, Uncertain Prospects

The April 1998 signing in Buenos Aires of the Framework Agreement for the creation of a free trade area between MERCOSUR and the Andean Community seemed to open the way to the realization of the "old" Brazilian yearning for a trade bloc covering the whole of South America. This could help balance (at least partly) the United States' greater bargaining leverage in the FTAA. However, the serious difficulties facing negotiations between the two groups in the second half of 1998 (which repeatedly hampered compliance with the original schedules for multilateralizing and broadening the preferences) curbed progress on the planned negotiation of a free trade area under the 4 + 4 format. According to initial agreements, this should have entered into force at the beginning of 2000.

Against the background of the serious political and economic difficulties facing MERCOSUR in the first quarter of 1999 as a result of the sudden change to Brazil's exchange parity, in March of that year the Brazilian government unilaterally decided to abandon the stagnant negotiations between the blocs (which had made minimal progress in eight rounds). Brazil invited the Andean countries to negotiate a fixed preferences accord under the 1 + 4 format, with the idea that this could help unblock and re-channel the inter-bloc talks.⁶⁸

Brazil's decision was initially interpreted by some officials and analysts in the sub-region as reflecting some loss of Brazilian interest in MERCOSUR.⁶⁹ In August 1999, Brazil and the Andean countries finally concluded a two-year partial scope agreement that covered a significant number of new tariff lines, establishing an explicit commitment to strive for the negotiation of a free trade area between the two groups (as established in the 1998 Framework Agreement).⁷⁰

In this context, and after several months of inactivity and uncertainty, the new phase of negotiations between Argentina and the Andean countries began in Buenos Aires at the end of October. The talks took the old MERCOSUR-Andean Community negotiating scheme as a point of reference. The negotiators therefore tried to make initial progress in negotiating the traditionally traded goods and included new tariff lines in the schedule of products to benefit from preferences, on the basis of the situation prevailing at the time that the inter-bloc negotiations were suspended in March 1999.⁷¹

⁶⁸ It should be recalled that before the breakdown in negotiations, the central problem was the parties' refusal to multilateralize certain levels of preferences, as well as the internal conflicts in several Andean countries (especially Colombia and Ecuador). The negotiation was thus self-restricted to a small number of tariff items comprising the historically traded goods plus a few new products, since the initial criterion was reformulated to include only those products that enjoyed a certain minimum level of trade.

⁶⁹ In this regard, Itamaraty officials stated that the interests of the MERCOSUR countries in these negotiations were very different, which repeatedly blocked progress. The other MERCOSUR governments did not react favorably. On the contrary, Argentine officials did not hide their objection to Brazil's decision, and the Uruguayan foreign ministry sent a letter formally expressing its disagreement on the matter.

⁷⁰ For a detailed analysis of the substance, scope and implications of the agreement between Brazil and the Andean countries, see Centro de Economía Internacional [November 1999].

⁷¹ It should be noted that from this moment, Argentina, Paraguay and Uruguay were renewing their "old" preferences on a quarterly basis, pending the signing of a new agreement.

The second round of negotiations was held in mid-February 2000, followed by new meetings in March that finally led to the initialing of the final agreement at the beginning of May. In the text of the understanding (which was finally formalized in mid-July, and which will be in force for two years after 1 August 2000), the countries reaffirmed their intention of continuing negotiations for an Economic Complementarity Agreement between the Andean Community and MERCOSUR members, with a view to creating a free trade area between the two sub-regional groups.

In parallel, there was explicit agreement on the validity of the norms established in LAIA Res. 70 on safeguards, including a dispute settlement system that establishes three negotiating institutions: reciprocal consultations and direct negotiations, the activities of the Administrative Commission, and the final intervention of an *ad hoc* group of experts. Once the dispute has been analyzed, the group will communicate its conclusions and recommendations to the Administrative Commission, which will issue a definitive ruling and ensure compliance.

The agreement maintains the market access conditions for products that enjoy preferences under the existing bilateral accords, although several bilateral preferences will persist; observations (items with preferences that do not include all the articles within them); and asymmetric preferences. Ecuador was deemed to be a country of lesser relative economic development, and was therefore granted greater preferences than the other Andean Community countries for its special list of requests.

In general terms, the relative level of the preferences agreed was not particularly significant, most of them being around 30% to 50%. Similarly, as regards the absolute quantity of beneficiary tariff items, there was little inclusion of new items relative to the earlier agreements.

Of the 2,052 tariff lines in the schedule of preferences granted by Argentina, 1,330 (65%) respected the overall “1 + 4” format. As for the Community, of the 1,512 lines that comprise the total preferences granted, 774 (51%) conform to that format. A high percentage of the 2,600 negotiated lines was based on the notion of reciprocity: Argentina granted preferences to Colombia for 1,740 lines, to Ecuador for 1,710, to Peru for 1,604, and to Venezuela for 1,498. In turn, it received preferences for 1,229 lines from Colombia, 1,150 from Ecuador, 1,065 from Peru and 969 from Venezuela.

The limited scope of these numbers contrasts sharply with those in the partial preferences accord between Brazil and the Andean countries in mid-1999, wherein the region’s biggest economy granted preferences on 6,476 products and received tariff benefits from the Andean countries on 5,523 goods.

A more precise analysis of the preferences granted and received shows that Argentina gave more preferences than it received. In terms of traded values, however, it won export preferences worth US \$510 million (50% of its sales), while the Andean Community received preferences worth US \$280 million. Most of the preferences won by Argentina correspond to the agro-industrial sector (particularly the oils sector), while in the industrial sector the concessions were greater than the tariff benefits.

Since the aim of the agreement was to lay the groundwork for the negotiation of a MERCOSUR-Andean Community free trade area, the accord stipulates that it is temporary. It will be in force until 15 August 2001, in line with the expiry of the Brazil-Andean Community accord, and will expire immediately if there is agreement before that date to conclude a more wide-ranging agreement under the “4 + 4” format.

In parallel, negotiations are under way between Uruguay and the Andean countries for an agreement similar to that reached by Argentina and Brazil. Nonetheless, the two sides recently agreed on a temporary extension of the prevailing agreements (“historical patrimony”) until the end of June 2000. Paraguay made no great progress on this matter last year, and the future agenda remains unclear.

While there are still no agreed schedules for restarting negotiations between the blocs, the two bilateral agreements (with Brazil and Argentina) leave open the possibility of reaching August 2001 with a free trade area under the 4 + 4 format.⁷² The difficulties and barriers to be overcome before that can happen, however, are not minor. Several factors are at play in that regard. Substantial divergences of commercial interest are evident within both blocs. As happened during the successive negotiating rounds in 1998 and the start of 1999, this severely hampers the definition of rules and common criteria for negotiating with the other side.

Hence, for Brazil, Mexico's increasing commercial penetration of Colombia and Venezuela (via the G-3) in recent years has been a source of growing concern for its automotive and auto parts sector. For Argentina, the existing difficulties of access to the Andean markets in sectors such as oils, meat and cereals seem to be a significant focus of conflict. Similarly, some sectors in Argentina, Paraguay and Uruguay would see their preferences eroded if the large Brazilian market were to be opened up to the Andean countries – another element to keep in mind with regard to the nature of the negotiations between the blocs.

It is plain that the political (and commercial) factors that prompted the signing of the framework agreement of Buenos Aires in 1998 are as pertinent today (or more so) than they were then. It is no minor matter that in recent years the Andean Community countries have become significant recipients of Argentine and Brazilian investment capital. At the same time, it should be noted that if the value of bilateral commerce is still low, this opens the way to a sharp increase in trade in the coming years.

More generally, the “premium” of “South Americanist” integration has been enhanced by the apparent failure or stagnation of the WTO negotiations and the greater imminence of the final phase of the FTAA negotiations. In the next half year, MERCOSUR will formally propose the re-initiation of bloc-to-bloc negotiations with the Andean Community, with a view to establishing a free trade area by 2001. That will be crucial to a clearer and more defined outlook for the future of this complex exercise.⁷³

D. Negotiations with the European Union: Between Diplomacy and Skepticism

Politically, the most salient and relevant development in negotiations between the European Union and MERCOSUR the last year was the biregional summit of heads of state and government held in Rio de Janeiro in late June 1999. That gathering, which paradoxically originated in an initiative by French President Jacques Chirac, was about to founder on several occasions because, until the last moment, the European Commission faced serious difficulties in agreeing on its mandate for the most sensitive issues in the negotiations.⁷⁴

In the months prior to the meeting, the Argentine government maintained the uncompromising posture that the document approved at the Summit should reaffirm both sides' explicit commitment to the creation of a free trade area that fully covered the conflictive agricultural sector. This spurred the “reserved”

⁷² It is worth pointing out that in the bilateral meetings in Buenos Aires at the beginning of May 2000, Argentina and Brazil made explicit their intention of concluding the bloc's negotiations with the Andean Community countries and Mexico before 31/12/02. The MERCOSUR relaunch agenda (April 2000), stresses the objective of “jointly negotiating with third countries or groups of countries (...) and establishing an end-date for unilateral negotiations.”

⁷³ In this regard, CMC decision 32/00 established that if there is no agreement between the blocs, the prevailing LAIA preferences will certainly expire in June 2003.

⁷⁴ It is to be stressed that, contrary to what happened in the negotiations with MERCOSUR, by mid-March and after five years of negotiations, Mexico and the EU concluded a free trade agreement (the first that Europe has reached with a Latin American country). It will enter into force on 1 July 2000. The EU commits itself to suspend, from the accord's entry into force, 82% of the tariffs on Mexican industrial goods and to eliminate the remaining 18% in stages by 2003. Mexico will cut its tariffs on European products by 47% in 2001; another 5% in 2003; and the remaining 48% gradually between 2005 and 2007. The European Union will have preferential access to the vehicle market through the reduction of export taxes on its car exports. These will fall from 20% to 16.7% and will be eliminated in 2003. Liberalization of agricultural products will take place in four phases over the next seven years.

mission of a senior Itamaraty official to Brussels and other European capitals, in an effort to bring the two sides closer together and obviate what was seen as a serious obstacle to the success of the summit.

Several meetings of European commissioners and ministers during the German presidency (the first half of 1999) failed to agree on the substance and scope of the European mandate for the negotiations – particularly as regards the sensitive agricultural issue, an area in which France and Ireland were openly opposed to any strategy that might undermine the bases of the Common Agrarian Policy. However, the General Affairs Council of foreign ministers, meeting in Luxemburg at the end of June 1999, agreed on a “reasonable” document. This proposed that the negotiations should initially address non-tariff matters, leaving the discussion of tariff issues, market access and agriculture until mid-2001,⁷⁵ since the WTO negotiations would by then have produced specific commitments in these areas.

In June 1999 the meeting of MERCOSUR’s Common Market Council in Asunción stressed that the negotiations had three aims: the single undertaking criterion; a fixed date for the start (2000) and end (2005) of the negotiations; the inclusion of all sectors in the talks and the overall concept of balance in the negotiations.

Amid fears that the meeting would founder or be nothing more than a “family photo”, the Rio Summit’s final communiqué⁷⁶ expressly omitted to make any concrete reference to the final aim (which had been explicit in the framework agreement of 1995) of establishing a free trade area between the two blocs. It limited the aims of the negotiations to the less resolute and somewhat diffuse objective of promoting the growth and diversification of trade by means of reciprocal liberalization, with the ultimate purpose of forming an Interregional Association.⁷⁷

No deadline was fixed for ending the negotiations. The European delegation deemed it impossible to stipulate in the documents that the negotiations could end in 2002, when the second EU–Latin America /Caribbean summit will be held. The date will depend on the outcome of the Millennium Round and the FTAA negotiations.

The two sides agreed to hold the first meeting of the Interregional Cooperation Council in November 1999 in Brussels, when the negotiations formally began. They devised and exchanged proposals on the structure, methodology and calendar of the negotiations, and agreed to set up a Biregional Negotiating Committee to be responsible for taking the process forward.

At the end of February 2000 the two sides held a ministerial meeting in Vilamoura, Portugal, where they agreed to effect mechanisms to facilitate the participation of the various civil society actors in the negotiations. At the beginning of April 2000 the first meeting of the Biregional Negotiating Committee was held in Buenos Aires. The general guidelines and the structure of the groups were defined, and the two sides exchanged their initial lists of requests for information to update the “snapshot” of inter-bloc relations undertaken in mid-1997. Nevertheless, the substantial differences between the two sides as regards the issues to be negotiated was reflected in their inability to agree on a joint final document.

⁷⁵ This conclusion was a compromise solution between the French desire to postpone the start of the negotiations on these issues until mid-2003, and the desire of the German presidency to begin such talks in December 2000, so that they could be concluded in light of the outcome of the Millennium Round.

⁷⁶ For a more detailed analysis of the substance and implications of this summit, see INTAL [1998-1999].

⁷⁷ In parallel, a MERCOSUR-Europe Business Forum (MEBF) was set up, consisting of entrepreneurs of both blocs. It aims to coordinate the dialogue between business people of the two regions so as to identify barriers to goods, services and investment, and to make recommendations for their elimination. This forum met for the first time in Rio de Janeiro in February 1999 and will hold a new meeting in Buenos Aires in September 2000.

As agreed in the Rio Summit, the work program contemplated an initial stage focused on negotiating the non-tariff barriers to trade. From July 2001 such talks will include the methodology and timetable for negotiating the liberalization of goods and services.

At the Buenos Aires meeting, the negotiators began formally to set up three working groups on the following issues: (i) trade in goods, to cover phytosanitary and technical matters, antidumping norms, rules of origin and customs procedures; (ii) trade in services, to cover investment and intellectual property; and (iii) unfair competition, consumer protection, trade disciplines, public markets and dispute settlement. They agreed that the next meeting in Brussels would determine other technical working groups. According to Guy Legras, chief of the European Delegation and Director of External Relations at the Commission, these would cover other commercial and technical issues, as well as agriculture.”

The document stipulates that the talks will aim for a single undertaking. The two sides agreed that no sector would be excluded from the negotiations but that account will be taken of sensitive sectors on both sides, while respecting WTO rules. There was significant disagreement toward the end of the meeting, when the MERCOSUR countries asked that the more than sensitive issue of export subsidies be included as one of the aims of the inter-bloc cooperation in the WTO.⁷⁸ Legras tried to indicate the differences between European and US policy on this issue, pointing out that while the EU had resolved the previous year (at the Berlin Summit) to freeze the budget devoted to agricultural support, corresponding expenditure in the United States was increasing sharply.

The meeting was also the venue for the signing of the draft agreements on equivalence of sanitary and phytosanitary certification (by mutual recognition) between Argentina and the European Union. It was thought that the final version could be signed before the end of the year, making agricultural trade between the two blocs more fluid and stable.

The agenda of the Committee’s second meeting was also defined, and that gathering was held in mid-June 2000 in Brussels. It addressed the exchange of information on non-tariff barriers and technical norms in biregional trade, in line with the distribution of work agreed in April in Buenos Aires. Despite this, and notwithstanding the fact that this initial stage of the negotiations expressly excluded market access issues until mid-2001, the main MERCOSUR spokespersons at the meeting repeatedly expressed their skepticism for the future of the exercise, particularly as regards the EU’s real willingness make substantive concessions on agriculture. According to press statements by Argentina’s deputy foreign minister after the meeting: “in October or November we will have the third meeting, and if more progress is not made than till now there will be no fourth meeting”.

Ambassador Botafogo also conveyed his skepticism for the future of the negotiations, stating at the end of June 2000 that “they are not willing to negotiate a free trade area with MERCOSUR. I do not think they are willing to negotiate something balanced” (*Gazeta Mercantil*, 25/6/00).

Progress has been made in recent years on designing and setting up the necessary institutional mechanisms for the agreement, and political relations between the two sides are currently excellent. Despite this, however, the trade negotiations remain in the “known” realm of rhetoric and angry declarations on the agricultural issue and subsidies from MERCOSUR, and Europe’s interest in devising more advanced norms on intellectual property, competition policy and public procurement.

⁷⁸ Some weeks before this meeting Argentine Economy Minister José Luis Machinea had participated in the debate by declaring to the French press that was “a little tired of seeing how Argentina imports French cheese while it cannot export its dairy products.”

Hence, unlike what is happening in the FTAA, the negotiations with the EU have no clear and defined goals as to their scope and final objectives, and no date has been fixed for their conclusion. The talks continue on the informal basis that they will end in parallel with the negotiations of the hemispheric agreement (2005).

The stagnation of the WTO negotiations after the failure of Seattle, the EU's need to concentrate all its political and negotiating efforts on the complex agenda of enlargement, and (especially) the absence of movement on fast track and the start of the "hot" stage of the FTAA talks are not pushing the Europeans to adopt a more defined and determined posture on the future of its commercial and economic negotiations with MERCOSUR. Hence those talks continue to evolve in the sphere of formalisms, of "wait and see", and of a lack of definition as to their format, scope and deadlines.⁷⁹

E. MERCOSUR-Mexico: The Eve of a New Era?

Mid-1998 saw the failure of efforts to secure a 4 + 1 agreement between MERCOSUR and Mexico. In October, therefore, the Argentine government agreed with Mexico the renewal of a new partial preferences agreement for two years (including compensation from Mexico for the damage caused by its accession to NAFTA). Brazilian negotiators did not hide their objection to what they considered a "lack of negotiating solidarity" on the part of their partner.

Despite this, from mid-1999 onwards Brazilian foreign ministry officials (with the vigorous backing of the automotive sector's chambers of commerce) decided to renew negotiations with Mexico, focusing on the possibility of integration in the automotive sector. At the end of April 2000 the two sides announced that they had reached an agreement establishing a ceiling of 40,000 units a year in the first year and 50,000 in the second. Brazil's intra-quota tariffs will thus fall from the current 35% to 8%, while Mexico's will fall from 23% to 8%. Entrepreneurs from both countries hope to triple vehicle trade (a third of total trade between Latin America's two biggest economies), which in 1999 totaled US \$435 million.

One of the issues that sparked the greatest difficulties (and which almost stymied the talks at some points) concerned rules of origin for automobiles. This was largely because of Brazil's fear that agreement with an automotive power such as Mexico would entail access to its market for vehicles assembled in Mexico with a large proportion of parts and inputs from the United States, or from some East Asian countries.

Several negotiating rounds have been held, concentrating exclusively on dispute settlement, intellectual property and safeguard mechanisms, but no significant progress has yet been made on the possible future signing of a partial but broad preferences accord like that in force until December 1998. So far, agreement has only been reached on 30-40% of the items to be negotiated⁸⁰ (a total of some 1,400 items). The two sides have repeatedly expressed their interest in concluding the accord swiftly, with a view to subsequently resuming negotiations with MERCOSUR under the 4 + 1 format (*La Prensa*, 21/2/2000).

At the end of December 1999, Uruguay and Mexico publicly announced the conclusion of a new and ambitious economic complementarity agreement (ECA 5), subject to ratification by their parliaments. This extends the elimination of tariff duties on a significant number of items. The accord goes far beyond the standards that are normal in such initiatives, establishing overall, provisional and bilateral safeguard clauses, a dispute settlement mechanism and laxer rules of origin than those of MERCOSUR (which in practice makes it incompatible with the bloc's internal agreements).

⁷⁹ In this sense, in his stopover in Brasilia before going to the Buenos Aires meeting, the head of the European delegation, Pascal Lamy, told the press that all changes to the agricultural policies of the EU would be discussed in the WTO negotiations.

⁸⁰ While Mexico seeks vainly to secure preferences for the electronic sector, Brazil seeks to include meats and fine leather goods.

Mexico granted Uruguay 100% preferences (tariff zero) on approximately 89% (6,200 tariff items) of its imports from Uruguay, while the latter did so for about 70% of its purchases from Mexico (4,980 items). The two sides also agreed to eliminate tariff restrictions (with a few exceptions). The accord will be in force indefinitely, although both countries explicitly expressed their willingness to participate in an eventual commercial understanding between MERCOSUR and Mexico.

Despite the declared political will of both sides to move toward a broader and more inclusive trade agreement, it is only potentially likely that this will materialize, at least at the moment. Nevertheless, Mexico's newly-elected President Vicente Fox has stated his interest in closer political and commercial links with MERCOSUR, and MERCOSUR's Common Market Council has resolved to push again for the negotiation of a free trade area with Mexico under the 4 + 1 format. These developments seem to offer new possibilities in this complex area.

CHAPTER V. CONSTRUCTING THE INSTITUTIONAL ARCHITECTURE OF THE CUSTOMS UNION

A. General Issues in Debate

The need to change MERCOSUR's juridical-institutional structure has prompted numerous debates and controversies in the past five years, both between analysts and officials, and between specialists in integration law. The countries rejected any initiative that could lead, directly or indirectly, to the emergence of some supranational bureaucracy in the Brussels mould. This posture contrasted with the difficulties provoked by the apparent absence of juridical-institutional mechanisms that could quickly and efficiently resolve frequent problems or disputes that arose from some members' flawed application of MERCOSUR regulations.

In this regard, and aside from the complex economic and commercial circumstances of the MERCOSUR countries throughout 1999 and so far this year, substantial progress was made in this period on the functioning of the dispute settlement mechanisms established by the Protocol of Ouro Preto (which incorporated the Protocol of Brasilia⁸¹ of 1991 as a starting point for such purposes). Argentina appealed to the arbitration mechanism on two occasions in 1999 (with different outcomes) when it believed its rights and interests were being affected by Brazil. The first case concerned non-automatic licenses for intra-sub-regional trade, and the second related to domestic subsidies for pig meat. In 2000 the Brazilian government successfully appealed to the dispute settlement mechanism against Argentina's application of WTO safeguards against its exports of cotton fabric.⁸²

In general terms, and beyond their concrete results, the establishment of the mechanisms agreed in the Protocol of Brasilia-Ouro Preto has been welcomed by most of the sub-region's officials, jurists and analysts. But this has not ended the debate on the creation of a more general institutional structure for MERCOSUR. On the contrary, it has triggered new discussion and expressions of opinion in various spheres.

Some analysts have pointed out that the existing juridical institutions work in such a way that it is possible to resort to them much more often to solve new and old disputes. Other specialists have stressed that the indirect system established by the Protocol of Brasilia (wherein only the member states have the legitimacy to participate as an originating agent in an arbitration) politicizes the claims made by individuals. These are eventually "mixed up" in the negotiations between countries, in which a legitimate sectoral request can be used (or sacrificed) as a bargaining chip by the countries in the interests of some "greater good". The tribunal would thus have a secondary role in the construction of MERCOSUR, and its original mandate of safeguarding compliance with the agreed rules would be sidelined.

Some Argentine officials ascribed some of the sub-region's commercial problems last year to the inadequate state of MERCOSUR's juridical instruments. Others have stressed the significant constraints involved in using juridical mechanisms at the current stage of the integration process.⁸³

⁸¹ Which establishes, in short, an initial process of negotiation and information exchange between the governments of those involved in the dispute. This is followed by the arbitration stage, for which an *ad hoc* tribunal is instituted.

⁸² At the time of writing, several disputes were in the pre-arbitration stage: Argentina's case against Brazil for the incomplete transposition of MERCOSUR regulations on phytosanitary (agro-chemical) products, and for non-transposition of the registration of pharmaceutical products; Argentina's case against Uruguay for subsidies to wool; Brazil's claim against Argentina for the mid-1999 imposition of non-automatic licenses for footwear imports and for the conflict arising from Law 24.822, which prohibits the reduction of the intra-zone tariffs on sugar (for more on the state of bilateral negotiations in this area, see Chapter II of this Report); and Brazil's case against Paraguay for the imposition of minimum specific duties on intra-zone trade.

⁸³ Because in those mechanisms "decisions are taken from the viewpoint of norms, disregarding the partners' economic structures. They thus affect the member states without the decisions being heeded. MERCOSUR has many questions to resolve before habitual appeals can be made to the tribunal". *Clarín*, 9/4/00.

Another source of debate in recent months has been the issue of supranationality. In early April, as it has done in various international fora over recent years, Brazil reiterated its opposition to participation in any artificial structure whose resolutions could affect its national laws. This, according to Brazil, would be a violation of the constitution. Ambassador José Botafogo told the Argentine press in early April that “we are willing to improve the dispute resolution system, but that does not mean accepting supranational courts.” (*Clarín*, 9/4/2000)

In this regard, the judges’ degree of stability is another point under discussion between jurists and specialists in international law. Advocates of a permanent tribunal stress the advantages of greater speed in resolving cases, and the prospect of attaining greater homogeneity in the criteria of interpretation. Those who favor an *ad hoc* system of tribunals stress the limitations of general knowledge and the need for each case to involve specialists in the specific issue in dispute.

Aside from the debates and exchanges of opinion, the two main partners have made significant progress on two significant questions in recent months. Brazil quickly rejected the initial Argentine proposal to move toward the creation of a permanent arbitration tribunal.⁸⁴ A compromise solution has nevertheless been reached. This consists of a mechanism to give greater stability to judges, which it is hoped will translate into more uniform criteria for rulings and the gradual creation of a MERCOSUR “jurisprudence”. To that end, the countries have agreed to draw up a joint initial list of eight or nine candidate-experts, from which two judges will be selected to sit on the tribunal for two to three years.

There is agreement about the need to supplement the Protocol of Brasilia with a mechanism that facilitates follow-up on compliance with the rulings and the scope of their measures. Hence, on the basis of the recently approved Additional Protocol to ECA 35 on dispute resolution, an institution will be created to review the rulings. Its main aim will be to regulate the application of retaliatory measures when some ruling of the arbitration tribunal goes unheeded by a member country.

In line with its traditional strategy of avoiding the delegation of authority to non-governmental bodies, and with the idea of establishing an effective mechanism for the swift and uniform interpretation of norms in unforeseen or unusual circumstances, at the Buenos Aires meeting of the national coordinators in April 2000 Brazil proposed granting the Common Market Council the authority “to clarify, when necessary, the scope of the arbitration rulings, or to adopt summary decisions in certain cases on the basis of existing rulings.”

In this regard, and mindful of the specific peculiarities of juridical issues, Dec. CMC 25/00 of late-June 2000 resolved to ask the GMC to present a proposal on these issues before 10 December 2000. Beyond such progress, however, there is still a need to address the deficiencies and problems made evident by the difficulties facing individuals in the current legal framework when they wish to make a claim against an individual in another country, or against a member state. At the moment, these matters depend wholly on the changing political will of their respective authorities and governments to pursue the issue (or on the capacity of the various sectors to lobby for that end).

Beyond individual controversies and claims, however, it is plain that the juridical institutions cannot and should not fill negotiating vacuums, nor tackle the pending issues on the integration agenda. Similarly, and irrespective of how they could be improved, the judges can only rule on what is already agreed and not on issues in which the countries have yet to conclude firm agreements – as is the case of sugar, bringing discipline to the systems of investment incentives, or the applicability of antidumping regulations to intra-zone trade. In this sense, seeking to solve MERCOSUR’s deficiencies and structural problems by juridical means or through arbitration (as some analysts have repeatedly argued amid the sub-regional crisis) is simply an illusion, one that could bog down the integration process.

⁸⁴ “Brazil believes that it is unnecessary; today we have a mechanism that is wholly compatible with international organizations and we do not see any reason to change it ... although we admit that it could be improved” Statements by Foreign minister Lampreia to BAE, 23/4/00.

B. Juridical Voids and Trade Disputes: The Problem of the “Umbrella”

Amid the severe recession in the four MERCOSUR economies in 1999, the center of the political stage was occupied by business protests and pressure on the government to tackle what was perceived in Argentina as the displacement of the domestic market by imported competition, particularly Brazilian.

The issue of applying the trade relief instruments foreseen in the Treaty of Montevideo (LAIA) and the WTO to intra-zone commerce spurred several heated debates among specialists, entrepreneurs and governments. The Argentine government's use of the safeguard mechanism provided for in LAIA Res. 70 in late-July 1999 prompted an angry diplomatic protest from Brazil and a threat to resort to the principle of “an eye for an eye”. This led to what has probably been the most serious incident in the history of the integration process.⁸⁵

The imminence of Argentina's presidential succession severely limited the maneuvering room and field of vision of the officials responsible for conducting the negotiations. The member countries could only agree on an imprecise and indefinite “system for monitoring the evolution of trade flows, to identify possible imbalances”. The alternative of encouraging inter-company agreements on temporary and voluntary trade restraints (with the “sponsorship” of the governments) seemed to be a useful and reasonable instrument for dissipating tensions and responding to complex circumstances.

Such agreements are not a panacea for the problems attendant on the chronic differences in competitiveness between Argentina and Brazil in some productive sectors (particularly paper, the iron and steel industry, and footwear). They did, however, “buy time” before the new authorities took office and the sub-regional recession had finally passed, thus spawning more favorable conditions in which to seek more lasting solutions.

Business accords were reached in the paper and footwear sectors at the end of September 1999, and Argentina imposed antidumping measures in some branches of the steel sector, as well as safeguards in textiles. The new authorities elected in October therefore suggested to their Brazilian counterparts that there was a need for some kind of “umbrella” mechanism to serve as juridical basis for integral solutions in the eight productive sectors⁸⁶ that were defined, *a priori*, as commercially sensitive.

Practical experience showed that while there could be a reasonable degree of compliance with such voluntary agreements in sectors that had few players (such as paper, or iron and steel), it was very hard to reach a compromise (or, when such compromises were reached, they were not fully observed) in the more dispersed productive branches like textiles, chicken and footwear. The governments were willing to persuade their business sectors that it would be helpful to agree with their peers in the sub-region, but the absence of a legal instrument to uphold such accords in institutional terms sidelined them from the prevailing multilateral norms. That absence also inhibited the customs and commercial authorities from enforcing the agreements, while leaving them vulnerable to a private legal suit or a case in the Commission for the Protection of Competition (whose Article 1 prohibits “the limitation or restriction of market competition by means of an agreement to reduce trading to a limited quantity of goods”) for collusive or anticompetitive practices.⁸⁷

⁸⁵ For more on this issue, see Chapter II of this Report.

⁸⁶ These are rice, chickens, pigs, sugar, footwear, textiles, paper and steel – to which are added (at a second level) potatoes, honey, garlic and onions.

⁸⁷ Argentina initially seemed to encourage excessive expectations of the use of the judicial mechanism for resolving sectoral disputes. At the end of March 2000 Argentina's deputy foreign minister told the press that “what we are trying to do is to get together the entrepreneurs of the sectors involved in the dispute. We would be merely a host or witness.” Thus, when “there is agreement in the private part, everything is arranged”. As to those cases in which the parties are unable to reach an agreement, the disputes would be resolved “through the rulings of the MERCOSUR Tribunal.”

The Argentine chamber of commerce representing transnational companies in the footwear sector (Capcica) stated in mid-April 2000 that the sectoral agreements “are expressly forbidden by the WTO, by MERCOSUR legislation and by Argentina’s Law for the Protection of Competition” (*El Cronista*, 13/4/00). Weeks later it said that the fact that “the government takes pains to enact legislation that allows it to ensure the implementation of these banned practices is hard to qualify” (*El Cronista*, 2/5/00).

In March and April 2000 the Argentine negotiators tried to reach agreement with their Brazilian counterparts on an additional Protocol to the Treaty of Asunción that could address the existing legal void in the matter. They sought a more general program to facilitate the reconversion and specialization of sensitive sectors.⁸⁸

Officials in Argentina’s economy ministry declared the need to institutionalize government intervention in the sectoral agreements at the MERCOSUR level, so as to guarantee compliance with them.⁸⁹ Brazilian foreign ministry negotiators emphatically rejected this possibility.⁹⁰

The Brazilians repeatedly stated their political willingness to seek political, non-automatic procedures for understanding on a limited set of productive sectors, “there is no justification for such a complicated and institutional investment as the revision of Ouro Preto for problems that might not exist tomorrow” (José Botafogo, BAE, 2/5/00). They insisted on the temporary nature of the problem, and on the need to use the sectoral agreements to create reconversion and/or restructuring schemes that facilitate open and unrestricted competition once the agreed period of transition has ended: “comparative advantages cannot be eternally managed” (Statement of José Botafogo to *Gazeta Mercantil Latinoamericana*, 5-11 March 2000).

C. The Three Rulings of MERCOSUR’s Arbitration Tribunal: Analysis and General Comments

First Ruling: Claim by Argentina against Brazil for non-automatic import licenses

Non-automatic licenses for the import of several products (including dairy goods, fruits, fuels, chemical products and mechanical apparatus) were imposed by Brazil’s department of foreign trade in December 1997, and later expanded by the resolutions of the health and agriculture ministries in October 1998. This caused serious difficulties between the MERCOSUR partners in the second half of 1998. The Rio presidential summit in December of that year agreed on a political means of resolving such disputes, and the Brazilian government had pledged that such measures would not in practice block the entry of products from the other member countries. This, however, remained a precarious and temporary solution, subject to the whims of political and commercial circumstance or to future interpretations by new officials.

From the outset Argentina argued in MERCOSUR’s various institutions that such dispositions were incompatible with the pre-existing commitments to dismantle non-tariff barriers and allow the free circulation of goods throughout the enlarged market. Given Brazil’s refusal to formally comply with such regulations on intra-zone trade, at the start of 1998 the Argentine government appealed to the dispute settlement mechanism

⁸⁸ Although the WTO agreements contemplate sectoral agreements on voluntary restraint in the areas of prices and trade volumes in sensitive sectors, there is an express prohibition on the application of fines or other forms of public intervention for non-compliance.

⁸⁹ According to Debora Giorgi: “Now we can only monitor trade. The idea is to be able to intervene when the agreement is distorting”. BAE, 7/4/00

⁹⁰ At the end of April 2000 Minister Machinea told the Argentine press that thought was being given to “establishing an institutional framework for the sectoral agreements. These will be temporary and controlled by both states, which will ensure their execution”. Brazil’s Deputy Foreign Minister Luiz Felipe Seixas Correia stated that “Brazil will only allow agreements between entrepreneurs” and that the country “will in no way allow intervention by governments” (BAE, 23/4/00).

established by the Protocol of Brasilia.⁹¹ That instituted the system whereby the member countries or individuals (through their governments) can take legal action when they believe that their interests are affected by non-compliance with, or the incorrect application of, the regulations arising from the integration process.

The claim went through the institutions stipulated in the protocol (the Trade Commission and the Common Market Group) without a satisfactory solution being reached throughout 1998. Argentina therefore asked for an arbitration tribunal to be set up. This was to handle the claim known as “Communications N° 37 of 17/12/97 and N° 2/98 of 20/2/98 of the operations department of foreign trade, DECEX, of the Secretariat of foreign trade, SECEX: application of restrictive measures to reciprocal trade.”

In February 1999, for the first time in MERCOSUR’s history, an arbitration tribunal was instituted. It consisted of a tripartite jury consisting of three specialists in the matter at hand (a Brazilian, an Argentine and an Uruguayan), who studied the case and heeded the presentations and allegations of the parties. At the end of April 1999 it issued a unanimous and mandatory verdict that could not be appealed against.

In its presentation to the tribunal, Argentina disputed the two communiqués (and DECEX communiqué 23/98, which eliminated the list of products annexed to communiqué N° 37/97 and remitted them to the SISCOMEX computer system), arguing that through them Brazil had established and consolidated a system of “non-automatic import licenses” and “automatic import licenses subject to special conditions or procedures”, which of itself constituted a restriction on intra-zone trade, caused Argentine exporters uncertainty and insecurity, and consequently degraded conditions of access to the Brazilian market.

Argentina added that the changes in access conditions affected twenty chapters of the Tariff Nomenclature, corresponding to Argentina’s main exports to Brazil. It further charged that the need to apply to SISCOMEX, in order to know the treatment given to each product, robbed the mechanism of transparency and allowed the Brazilian government to modify its import requirements at any time by simply changing the computerized records. It argued that all this violated the commitment to eliminate non-tariff barriers (NTBs) embodied in the Treaty of Asunción, and contravened the obligation to retain only until 31/12/94 the measures listed in the Complementary Notes to ECA 18, in which Brazil had declared the import guides that were then replaced by the licenses. Argentina further argued that the constant increase in chapters and products under the system of non-automatic licenses since 1997 violated the commitment in Council Decision 3/94 not to place any new restrictions on reciprocal trade.

Brazil responded that the system of licenses made the import regime flexible and transparent, and conformed to internationally accepted criteria; that there was no category of “non-automatic licenses subject to conditions”, since there were only automatic licenses subject to certain controls (such as health controls). These were in effect before communiqué N° 37/97 and were allowed in MERCOSUR by virtue of the exceptions contemplated in Article 50 of the Treaty of Montevideo of 1980.

⁹¹ On 17 December 1991, a few months after the signing of the Treaty of Asunción, Argentina, Brazil, Paraguay and Uruguay signed the Protocol of Brasilia on Dispute Settlement in MERCOSUR. This Protocol has been used in several disputes between the member states, but it had never reached the arbitration stage that the Protocol itself provided for until the arbitration tribunal was convoked to rule on Argentina’s case against Brazil. The case was prompted by the latter’s demand for prior import licenses. The *ad hoc* arbitration tribunal’s first ruling on this dispute was announced on 28 April 1999.

Brazil insisted that the figures showed that trade had not been affected, and that the change to the system had not caused damage to Argentine exporters; that the Treaty of Asunción was a framework agreement with mostly programmatic dispositions that depend for their implementation on the gradual adoption of commitments; that in 1994 the countries had agreed to redefine the objectives, and since the common market had not been established there was no commitment to eliminate NTBs, including those declared in the Complementary Notes to ECA 18.

Brazil argued that a distinction should be made between measures and NTBs, the former being harmonized in MERCOSUR; and that the “stand still” commitment meant giving national and most favored nation treatment to imports from MERCOSUR, a commitment that was complied with by giving them the same treatment as that given to imports from third countries; that the norm did not entail a ban on imposing new restrictions; and that, in any case, the restrictive effect of the measures adopted by Brazil should be proven by their effects on trade flows.

In its ruling the tribunal established:

- (i) that MERCOSUR’s trade liberalization program comprises both the elimination of tariffs and non-tariff restrictions, and for that reason the contracting parties are obliged to comply with both aspects on the same date.
- (ii) that deferment of the creation of the common market (relative to what was originally stated in the Treaty of Asunción) does not remove the obligation to eliminate tariffs and NTBs. Non-automatic import licenses (NIL) are thus only compatible with MERCOSUR regulations as long as they relate to “values of a non-commercial nature”, such as “the life and health of people, animals and vegetables, national security, the preservation of artistic heritage, nuclear questions or public morality” (as established in Article 50 of the LAIA Treaty of 1980).
- (iii) In that regard, the tribunal stated that measures linked to those values can persist beyond the date that the trade liberalization program ends, on the basis of two criteria: (a) that only those measures expressly devoted to protect those values, having no impact on trade, are compatible with MERCOSUR; and (b) that the process of harmonizing those measures should continue. The exceptional measures allowed by the Treaty of Montevideo should thus remain similar to the exceptions to the tariff elimination program which, in MERCOSUR, is permitted in sectors such as sugar and vehicles.
- (iv) Applying these interpretations to Brazil’s import license regime (resolutions) the tribunal concluded that the process of dismantling tariffs in intra-zone trade (the adaptation regime which, according to Ouro Preto, was to end on 31/12/98 for the two bigger MERCOSUR countries and 31/12/99 for Paraguay and Uruguay) is inconsistent with some members’ use of non-automatic licensing mechanisms for intra-zone trade.
- (v) The ruling indicated that the obligation to eliminate NTBs to intra-zone trade covers barriers that predated the Treaty of Asunción and those established later, be these new or previous barriers that had been re-established. In conclusion, the tribunal’s verdict stated that the Brazilian government had until the end of 1999 to dismantle the regime.

This ruling was particularly important. It was the first time that such a trade dispute had been resolved within the institutional framework and rules of the Customs Union and, consequently, without appealing to the political realm. Although its trade implications have not been especially important (as mentioned earlier, Brazil had already pledged to find a political solution to the issue that sparked the dispute) it should be noted that the countries “entrusted” an independent institution (whose rulings were mandatory) with the resolution of a trade conflict. The ruling thus established a juridical precedent that favored the spirit of sub-regional free trade.

Second Ruling: Claim by Argentina against Brazil for subsidies to pig meat production

Since mid-1995, Argentine pork producers had expressed their concern about and disagreement with what they perceived as an unfair competitive practice by their Brazilian counterparts. The latter, aided by various kinds of fiscal and financial mechanisms, receive substantial state subsidies that harm establishments in Argentina. In this context, and against the background of the crisis prompted by the devaluation of the real and of the favorable reception of the tribunal’s first ruling in Argentina at the beginning of April 2000, the objection to subsidies for the production and export of pig meats (which had long since been lodged by Argentina against Brazil with MERCOSUR’s Trade Commission) finally entered the arbitration stage.

In its presentation, Argentina condemned as subsidies four internal regimes applied by Brazil that affect the price at which pig meat is exported. Those four were: the Companhia Nacional do Abastecimento (CONAB) system of public corn stocks; PROEX’s loans to promote exports; advances on exchange contracts (Adiantamentos de Contrato de Câmbio, ACC) and advances on export contracts (Adiantamentos de Contratos de Exportação, ACE); and the drawback of PIS/PASEP and COFINS social contributions as a Presumed Credit of the IPI (Tax on Industrialized Products).

(i) As regards the CONAB system, Argentina maintained that the intervention of this official body in the purchase, storage and sale of corn (which constitutes 50% of the cost of pig meat production) artificially stabilizes the price of the input (especially in inter-harvest periods), thus neutralizing increases in international prices. The Argentines argued that the mechanism isolates Brazilian pig meat producers from the volatility of corn prices and creates an incentive that affects exports.

(ii) As for PROEX, Argentina argued that it constitutes a financial incentive prohibited by the MERCOSUR agreements because it equalizes rates in order to cover (with resources from the national treasury) the difference between the international rate and that allowed by the Central Bank, and because it finances exports by discounting exports titles on credit.

(iii) With respect to the ACC and ACE mechanisms (financial instruments agreed between export companies and Brazilian commercial banks), Argentina alleged that the interest rates applied in these schemes benefit from fiscal and monetary exemptions. It also pointed out that the elimination of obligatory exchange in ACC and ACE operations is an incentive for the banks to grant credits to exporters under those mechanisms; and that, given the difference between their interest rates and those of the market, exporters benefit from arbitrage, thus creating additional incentives prohibited by MERCOSUR norms.

(iv) As to the rebate of social taxes to the private sector (PIS, Programas de Integração Social; PASEP, Programa de Formação do Patrimônio do Servidor Público; and COFINS, Contribuição para o financiamento da seguridade social) through an alleged credit in the payment of the tax on industrialized products, Argentina maintained that, according to MERCOSUR norms, social contributions cannot be returned to the exporter. It argued that the fixed percentage returned through this mechanism exceeds the amounts that those contributions represent in the case of production that does not require several processing stages, as is the case of pig meats.

The Brazilians asked that the Argentine claim be considered unfounded, on the basis of the following arguments.

- (i) The CONAB system of public stocks does not seek to benefit pig breeders but those producing corn and other cereals (by ensuring purchase of the product and supply to the market). It added that the practice of agricultural price support is consistent with WTO norms and that therefore the country is not violating Dec. N° 10/94 (since that disposition is programmatic and has no fixed period for its implementation).
- (ii) As to PROEX, the Brazilian jurists pointed out resolution 93/99 provides for the prohibition to apply it in its two forms (equalization of rates and export financing) for foreign sales of consumer goods to MERCOSUR, and that before that resolution PROEX was not used for intra-zone exports of those goods.
- (iii) Regarding the ACC and ACE, Brazil argued that these mechanisms are not credit operations but anticipate the price of foreign currency purchases by banks, and that they are carried out in the private sphere without public intervention.
- (iv) With respect to the Presumed Credit of the IPI, Brazil stated that it should not be included in the dispute because it was not part of the initial object of the claim. It said that PIS/PASEP and COFINS are indirect taxes for the Brazilian juridical system and, therefore, repayable according to WTO norms and to Dec. N° 10/94. The presumed credit was only a debit/credit entry that was not a refund above the payment made.

The tribunal's ruling initially said matters not handled in previous stages could not be added to the documents of presentation and response appearing before it. The dispute was therefore limited to three matters arising from the claim before the Trade Commission concerning the existence or otherwise of subsidies. It thus resolved not to analyze the question of the Presumed Credit of the IPI because it was not presented formally in such a claim. On the basis of WTO rules, the tribunal pointed out that proving the existence of a subsidy requires three elements: a financial contribution from the government, the existence of a benefit, and specificity.

As regards the system of corn stocks (CONAB), the tribunal indicated that the system is general and seeks to guarantee the purchase of cereal from the producer in order to ensure supply and to regulate the stability of the domestic price. Hence, if it implies some state intervention, this had a degree of generality that completely transcends the production and export of pig meat; it thereby lacks specificity. Consequently, it does not violate WTO rules on subsidies.

According to the ruling, the regime of public corn stocks does not violate MERCOSUR regulations, since Dec. N° 10/94 requires implementation and cannot be invoked as a direct source of rights and obligations. On these grounds the Argentine claim on corn stocks was not allowed.

As to PROEX, the tribunal understood that Brazil meets the Argentine claim because at the beginning of 1999 Brazil decided to disallow the future use of this mechanism in any of its forms for exports of consumer goods to MERCOSUR.

With respect to the advance on exchange contracts (ACC) and the advance on export contracts (ACE), the tribunal found that it was necessary to analyze if the tax exemptions or reductions disputed by Argentina were export incentives covered by Dec. N° 10/94, and to take into consideration that this MERCOSUR Decision refers to the pertinent specifications of the GATT/WTO. Both classifications refer to state financing, which is not the case for the ACC and the ACE, establishing a principle whereby the subsidy is determined by the extent to which the interest rates applied differ from those accepted internationally in equivalent operations.

The tribunal considered if the ACC and ACE instruments have had a restrictive and discriminatory effect; if they amount to unfair competition in violation of MERCOSUR regulations; and if they cause damage or threat of damage to individuals. It concluded that there is no evidence that these financial instruments (with the tax benefits mentioned) cause damage. In light of this, the tribunal disallowed Argentina's claim on those mechanisms.

In this context, and using Article 22 of the Protocol of Brasilia, Argentina submitted a request for clarification covering six points. The tribunal's response essentially ratified the original grounds of the ruling, and offered some additional considerations:

- regarding the mechanisms ACC and ACE, it declared that the subsidy configuration depends on the interest rates effectively applied;
- it confirmed that Article 11 of Dec. N° 10/94 (other applicable sectoral, regional or tax incentives to production/export activity) requires implementation and does not directly generate rights and obligations. It stated that this does not mean that it lacks all value; it should be linked to negotiations between the member states designed to reach an agreement on common instruments in the matter, so as not to frustrate the objectives of the Treaty of Asunción.

Third ruling: Claim by Brazil against Argentina for the ATC-WTO safeguard for cotton fabrics

Several of Argentina's various productive sectors faced severe difficulties as a result of the international crisis of 1997-1998, the Brazilian devaluation of January 1999 and, consequently, the sharp fall in internal demand. At the end of July 1999, therefore, the Argentine government prepared the three-year application of quotas for imports of cotton fabrics from Brazil, Pakistan and China, in line with the stipulations in the WTO Agreement on Textiles and Clothing.

The Brazilian government reacted very vigorously to this measure, questioning not only its bases but also the very applicability of a restrictive WTO norm to intra-subregional trade. This incident was the starting point for a large-scale conflict between the two main MERCOSUR countries (which led to an unforeseen personal visit by the Argentine president to Brasilia); it was not resolved until March 2000. Brazil questioned the technical validity of the Argentine measure in the WTO's supervisory body on textiles (which recommended that Argentina lift the measure) and expressed its intention of continuing until a panel was set up. This promoted initiation of the dispute settlement system instituted by the Protocol of Brasilia. The dispute passed through the ordinary institutions with no great change, and in February it moved to the arbitration stage.

Brazil initially alleged in its presentation to the tribunal that, according to the commitments assumed by the parties in MERCOSUR (CMC Dec. 5/94), intra-zone safeguards could only be applied until the Customs Union began (31/12/94), and after that date they were proscribed as an instrument of commercial defense for intra-MERCOSUR trade. It argued that the safeguard not only violated the regulations mentioned and the very aim of adapting to free sub-regional trade, but that it was impossible to conceive of a Customs Union in which there were internal safeguards systems. In that sense, textiles products should be fully integrated into the intra-zone free trade established by MERCOSUR.

Brazil asked the tribunal to declare the incompatibility of MERCOSUR norms with safeguards of any kind, and claimed that the Argentine government should be told to revoke Res. MEOySP 861/99 immediately.

Argentina argued that the ban on applying intra-zone safeguards after 31/12/99 referred only to preferential safeguards, but this did not mean that all safeguards are forbidden. It claimed that there was a legal void that should eventually be filled (for the textile sector) by the rules provided for in the WTO Agreement on Textiles and Clothing (ATC) until MERCOSUR had devised some measure in this area.

Argentina also alleged that although Annex 4 of the Treaty of Asunción regulated the application of safeguards in intra-zone trade, Dec. CMC 7 and 8/94 allowed safeguards for products subject to exception regimes and originating in free zones. Argentina believed that such norms modified that annex and took primacy over the Treaty of Asunción.

Argentina stressed that textile products have a special treatment in MERCOSUR. It pointed out that (as with sugar and cars) there was still no common trade policy on textiles, since technical committee 10 should have ruled on the issue in light of the two sides' WTO commitments but never did so. Argentina added that Brazil, having earlier specified that the object of the controversy was Res. MEOySP 861/99, had exceeded the remit of the tribunal by requesting the elimination of all safeguards in reciprocal trade.

Argentina argued that safeguards are not necessarily incompatible with Customs Unions because the dispositions governing them (Article XXIV of the GATT-WTO) refer to "the greater part of trade" and not to all trade between the partners.

In this light, on 10 March 10 2000 the arbitration tribunal met and issued its unanimous ruling, on the following bases:

- (i) The arbitration tribunal declared itself competent to decide the dispute based on Article 19 of the Protocol of Brasilia.
- (ii) The judges stated that the reports from the WTO's supervisory body on textiles were not relevant for the dispute, since the question to be settled was whether the safeguards applied to textiles are allowed or prohibited in MERCOSUR, thus rejecting the Brazilian argument that referred to presentations made to that body.
- (iii) The tribunal discounted Argentina's observation that Brazil had exceeded the terms of the claim, since the object of the dispute was determined by the complete substance of the documents of presentation and response.
- (iv) The ruling analyzed the stages of MERCOSUR's development (transition period, adaptation regime and its expiry for Argentina and Brazil on 1/1/99), stating that at the point when Argentina adopted

Res. MEOySP 861/99 there was free trade between the two countries and the application of safeguard measures in reciprocal trade was prohibited.

- (v) It rejected the alleged existence of a legal void. On the contrary, it pointed out that there is a MERCOSUR norm that has explicitly prohibited the application of intra-zone safeguards since 1/1/95 (Annex IV of the Treaty of Asunción).
- (vi) As to the application of safeguards in a Customs Union, and specifically in MERCOSUR, the tribunal concluded that this is possible provided the safeguards conform to an explicit norm of the system that authorizes or provides for it.
- (vii) The tribunal examined MERCOSUR regulations on the textile sector and agreed with Argentina that they include provisions on intra-zone trade. It concluded, however, that the regulations do not contemplate special treatment for textiles that would allow unilateral safeguards to be viewed as licit in the absence of a norm expressly agreed between the member states. It thus showed that although the norms dictated by the Common Market Group, the Common Market Council and the Technical Committees reflect the members' special interest in this sector, the tribunal itself always tended to reduce trade barriers.
- (viii) As regards the link between the ATC and MERCOSUR, the tribunal did not deem it necessary to pronounce on the precedence of the former over the latter, because in general it concluded that there is a MERCOSUR norm regulating safeguards against other member states, and that there is thus no legal void that would make it necessary to appeal to other norms of international law, such as those of the WTO.

On these bases, the tribunal pointed out in its ruling that Articles 1 and 5 of Annex IV of the Treaty of Asunción clearly stipulate a general prohibition on the application of safeguards in intra-zone trade. This can only be obviated by means of a specific MERCOSUR norm if the contracting parties deem it useful. In that sense it found no dispositions that explicitly allow the application of safeguards to intra-zone imports of textile products.

The judges thus concluded that Brazil's claim was sound. Res. MEOySP 861/99 of Argentina's economy ministry was judged to be incompatible with Annex IV of the Treaty of Asunción and with the prevailing MERCOSUR regulations. It should therefore be revoked by Argentina in a period not to exceed 15 days.

Finally, after presenting a request for clarification (prompted, according to the press, by a desire to "win time" so as to allow negotiation of some sectoral agreement between the two countries' private sectors, which never happened) and after asking the Brazilian government to withdraw its presentation to the WTO, the economy ministry's Res. 265/00 of 13/4/00 removed the effect of the safeguard measure on Brazilian products. This amounted to full acceptance of the tribunal's decision – despite the angry complaints of some business sectors, which threatened the Argentine government with legal action against the industry secretariat in the common justice system.

CHAPTER VI. REVIEWING MERCOSUR'S RELAUNCH AGENDA AN INVENTORY OF PENDING ISSUES OR THE START OF A NEW STAGE?

A. The General Debate on the Relaunch

From mid-1997 onwards, as a result of various factors largely born of the complex international financial situation and of changes in the economic circumstances of the countries of the sub-region, MERCOSUR was gradually losing the negotiating dynamism that had characterized it since its creation.

Hence, despite the efforts of the member states in the last three years to improve the free trade area and the (incomplete) Customs Union, the agreements reached have been limited and, in large measure, have been of little substance or practical application.

In this context, exploiting the natural momentum stemming from the change of authorities in Argentina and Uruguay, and the generally favorable outlook of the MERCOSUR economies in late-1999, this year the governments of the sub-region have begun to push for a new phase of integration with what is termed the "relaunch of MERCOSUR."

The start of 2000 thus seemed to indicate the beginning of a new upgrading of MERCOSUR. Since the first meeting between member states' officials, the issue of the relaunch has become part of the negotiating agenda, although with a scope and implications that remain somewhat unclear. For some Argentine officials, the relaunch meant giving the process the political substance that it had in its initial stage (1986-1987).⁹² For others it meant giving MERCOSUR mechanisms to manage trade and coordinate policies, with a view to making the integration process more sustainable.

For Brazil, the relaunch seemed to mean increasing the scope of business and launching (among other initiatives) a joint infrastructure plan. Similarly, Brazil opposed the "defensive" and "managed" approach that Argentina appeared to favor.

As talks were held in early 2000 about what it would mean to "relaunch" MERCOSUR, business and political leaders (particularly in Argentina) publicly emphasized the sectoral tensions and trade conflicts that were dominating bilateral relations.

The Brazilian government did not hide its disapproval of Argentine opposition to the integration process, but attributed the difficulties to Argentina's internal political and economic circumstances. The various attempts to give a new political thrust to MERCOSUR collided with feelings of conflict and mutual distrust between the member states, which were accentuated by the devaluation of the real.

However, the tensions that had characterized bilateral relations during the latter part of 1999 and the beginning of 2000 were lessened toward the end of the first quarter of 2000 by the agreement in principle on the automotive regime; Argentina's commitment to remove the textiles safeguards (thereby accepting

⁹² "The essentially political spirit of 1986 seems to have been diluted in the integration of this sub-region, Alfonsín, Sarney and their collaborators thought of politics. With an intensity never repeated they saw that integration was a question of the future viability of Argentina and Brazil, in which economics would undoubtedly play an important role but not the only one, and not even the most important...." (Oscar Raúl Cardoso, *Clarín*, 25/3/2000).

the ruling of the arbitration tribunal); the resolution of some market access problems; and the fact that the two countries' private sectors reached some understanding.⁹³

It seemed as if the relaunch agenda was being clarified, starting with agreements reached during the meeting of coordinators of the Common Market Group at the beginning of April, and the bilateral summit of Argentine and Brazilian ministers at the end of the month. Politicians, business people and opinion formers in Argentina made many public statements about the issues to be included in the work program, and about the format and objectives of the negotiating agenda. The substance of the relaunch, however, was increasingly assimilated into the list of actions pending from the previous administration, to which was added the qualitative leap represented by the inclusion of certain explicit commitments on macroeconomic coordination.

As was to be expected, important agenda issues included revision of the common external tariff and the elimination of various perforations; the need to complete and implement existing agreements on trade disciplines (rules of origin, policies of protection against unfair trade practices, temporary admission and drawback, etc.); effective means of addressing public policies that distort competitiveness and the location of investment; and real progress in negotiating services and public procurement. In addition, questions about the institutional environment, dispute settlement and the transposition of MERCOSUR regulations, as well as the perennial problems of external negotiations, were also included.

However, the agenda made no explicit and formal mention of the sectoral agreements and commitments, nor of "escape" or emergency clauses. Also unresolved was the implementation of a sub-regional infrastructure plan during the Brazilian presidency in the second half of the year, which could improve the supply of general services and invigorate internal sub-regional demand.

With respect to the latter issue, President Cardoso announced during the May 2000 meeting of the World Economic Forum in Brazil that the next summit of South American presidents – to be held in Brazil in August – would propose a regional physical integration project that would spur a new cycle of regional development.⁹⁴

Aside from these agreements in principle, and to the quasi-euphoria induced by the apparent conclusion of the automotive negotiations, rising international interest rates and the deteriorating world financial situation in May and June (circumstances that raised questions about the Argentine economic outlook) appeared to push sub-regional negotiations into second place. Moreover, the political difficulties involved in implementing a complex new fiscal adjustment in Argentina reduced the chances of the country committing to a relaunch agenda in the short term.

Equally discouraging was the Brazilian government's unexpected reopening of several points of the automotive sector agreement reached in late-March, and renewed pressure to include on the new sub-regional agenda an explicit commitment to liberalize the sugar trade before the end of the Argentine presidency (coupled to Brazil's traditional demand that Argentina eliminate intra-zone antidumping). In addition, attainment of some type of accord was hindered by Argentina's call for Brazil to explain the battery of incentives in its economy, and to agree on some mechanism that ensured greater joint discipline in the future (conditioning the elimination of intra-zone antidumping on the disappearance of these distortions).

⁹³ For more on this issue, see Chapter II of this Report.

⁹⁴ In press statements, Cardoso said: "I am convinced that it is possible to do in Latin America what Juscelino Kubitschek did with the Brazilian interior". The reference was to the man who governed Brazil between 1956 and 1961, and who developed the interior of the country by means of major public works projects.

The end of that half year seemed to confirm that MERCOSUR had not overcome the internal difficulties which at the beginning of 2000 had conspired against the “exploitation” of the political impetus and the favorable international situation. This was despite the substantial efforts to complete the automotive agreement, and some progress on macroeconomic policy coordination.

It was in these difficult circumstances that the meetings of the Common Market Group and the Council of Ministers were held in Buenos Aires at the end of June 2000. Those gatherings gave rise to new political momentum and a flexible and pragmatic approach in the two main partners, which finally allowed an outcome that would have been hard to imagine earlier.

As a corollary of the meetings, agreement was reached on a more than reasonable program for relaunching MERCOSUR. It should be kept in mind, however, that the program negotiated is more programmatic than real. Beyond its invaluable political significance as the starting point of a new phase in the integration process, its core is an ambitious plan of pending tasks and activities over the coming months.

Many of the questions that, *a priori*, seemed short-term priorities (such as the removal of defects in the free trade area, drawback, or perforations of the common external tariff) were finally deferred. In some cases there were commitments to neutralize their negative effects on sub-regional trade in five years. In contrast, complex and sensitive questions such as defining goals for macroeconomic coordination were given deadlines that will be difficult to meet in practice.

Real and substantive results included ordering and clarifying the pending agenda, elucidating the different visions of the countries on specific issues, and explicitly outlining the trade off of possible negotiations. These are significant outcomes in light of the limitations imposed by developments in the last two years, and the negative impact of those developments (pessimism, uncertainty, a loss of “mystique”) on the vision and perception of the integration process in various sectors of the MERCOSUR countries.

It will soon be known if the relaunch program finally produces a new La Leñas Timetable of 1992 (ambitious but excessively willful, and therefore subject to only partial fulfillment) or a realistic, reasonable and feasible work program. By the end of 2000 many of the dates and objectives established should already be met.

It will then be clear if the MERCOSUR countries were able to creatively use the necessary (but insufficient) political will, added to technical work, intellectual effort and decision-making endeavor, in the interests of reaching a strategic agreement. Such an agreement, although it has medium- and long-term benefits, often obliges each of the countries to make complex concessions now, and to relinquish some degree of freedom in formulating their domestic policies.

B. Macroeconomic Coordination: A Simple Heading or an Imperative Need?

Article 1 of the Treaty of Asunción stated that the coordination of macroeconomic policies was a central element in the construction of MERCOSUR. It therefore established that this should be sought gradually, in convergence with tariff reduction programs and the elimination of non-tariff barriers during the transition period that finished at the end of 1994.

The MERCOSUR Action Plan 2000 of late-1996 reiterated the importance of this issue as an integral component of the Customs Union, and of the process of deepening integration.

Despite this, the exercises in coordination undertaken in these years have been insubstantial, and have generally had scant practical results. The periodic meetings of the economy ministers and presidents of the central banks, as well as the meetings of the Common Market Council, have been part of such exercises. They have not had a decisive influence on the countries' macroeconomic conduct, but they have enhanced each member's knowledge of the performance and problem of the others, as well as their interactions.

During the first half of the 1990s, the international economic/financial context and convergence in the general alignment of Argentine and Brazilian domestic policies helped mask the lack of explicit coordination. The changes in international economic trends that began with the Asian crisis, however, highlighted MERCOSUR's deficits in terms of macroeconomic agreements.

The Asian crisis, with its impact on emerging economies and particularly the Brazilian devaluation, was a reminder that macroeconomic stability is a necessary condition for MERCOSUR's economic and institutional development.

On this premise (which is hard to refute) many observers, analysts and even governments tended to associate/confuse the sub-region's economic difficulties with the absence of formal mechanisms for macroeconomic coordination.

Consequently, there was an upsurge of opinion, commentary and suggestions that a move toward commitments of regional self-discipline was a functional and efficient tool (available to the member states) to deal with events as wide and diverse as the Asian crisis, domestic policy asymmetries, the need to "differ" in attitudes to other regions or to avoid a devaluation of the Brazilian currency, etc.

The proposal for a single regional currency, made by President Menem at the end of 1997, is part of such thinking and perhaps provided the spark for many later initiatives. In 1997-1998, the idea of taking the long road to macroeconomic coordination (implicit in the proposal for the single currency) had few advocates in the sub-regional market, but after the Brazilian devaluation it won broad and generalized support.

One example occurred in June 1999, when the Common Market Council instructed the economy ministers and presidents of the central banks to create a high-level working group that was to propose effective alternatives for macroeconomic coordination at the sub-regional level.

Similarly, statements by President Cardoso highlighting the need for a "mini-Maastricht" in MERCOSUR (whose initial spark was to be a commitment to joint fiscal responsibility) clearly expressed the Brazilian government's desire to move forward with negotiation of an issue that thereto had seemed to be of interest only to Argentina and the other partners.

At the same time, the CMC of mid-1999 created an *Ad Hoc* Follow-up Group on Economic and Commercial Conditions, to monitor the economic behavior of the various countries and the impact of that conduct on trade flows.

After the presidential succession, and in the context of the bloc's relaunch, the issue of macroeconomic coordination has become a priority on the MERCOSUR relaunch agenda since the start of 2000. The Buenos Aires Declaration, signed by the Argentine and Brazilian ministers of foreign affairs, defense and economy at the end of April 2000, reveals the progress made in analyzing statistics on fiscal matters, debt and prices, and in detecting existing differences. The aim is to devise a common methodology that makes the data from the two countries comparable.

On that occasion, the two governments convoked their Paraguayan and Uruguayan counterparts (and expressed their intention of inviting Bolivia and Chile) to participate in the commitments adopted in this field. They decided to build, before September 2000, a series of indicators in the areas of fiscal matters, public debt and prices (with data up to June), in order to provide basic information fostering macroeconomic convergence and coordination.

The indicators chosen for this first stage were:

- Nominal fiscal result of the national government ⁹⁵
- Primary fiscal result of the national government
- Variation in the consolidated net debt of the public sector, excluding consolidation of debts
- Net debt of the national government
- Consolidated net debt of the public sector ⁹⁶
- Index of consumer prices

The member countries pledged to establish, in March 2001, the goals for these indicators. Special attention is to be paid to fiscal solvency and price stability, for which purpose a Bilateral Macroeconomic Monitoring Group was placed in charge of the follow-up.

In the same meeting the Argentine and Brazilian ministers maintained that the existence of different exchange regimes is incompatible with a strategy geared to macroeconomic coordination, as long as there are fiscal policies that ensure fiscal solvency and monetary policies that guarantee price stability.

In the June 2000 meeting of the CMC, the four countries jointly reaffirmed their commitment to fix common objectives in the areas of macroeconomics and financial services. They also restated the idea of establishing goals in the areas of fiscal matters, public debt and prices, as well as their respective convergence schedules, in March 2001. They agreed on the regular publication of fiscal indicators from September 2000 onwards, beginning with data for 1999 and the first half of 2000.

Finally, they created a Macroeconomic Monitoring Group under the aegis of the meeting of economy ministers and presidents of central banks, to assess the consistency of the statistics and to follow up the chosen indicators.

C. The Challenges of Macroeconomic Coordination

The internal consolidation of MERCOSUR (and of the set of economic interrelations present within it), as well as the changing international context, suggest that in this new stage it would be helpful to embark on the delicate path of policy coordination.

⁹⁵ National government includes the central administration, the social security system, the decentralized bodies, the national state companies and the central bank.

⁹⁶ Also includes the assets and liabilities of the provinces and municipalities, as well as their companies.

In this regard, three issues could block greater macroeconomic coordination in the sub-region. The first is the different sizes of the MERCOSUR member states, which could trigger different responses to the option of adopting greater commitments. In other words, the small countries have much more motivation to coordinate than the bigger members.

Secondly, the countries have a low level of opening, which could “naturally” lead their authorities to question coordination if external trade in general, and sub-regional trade in particular, remains a small portion of their output. Finally, the historical instability of the member countries is, objectively, a source of uncertainty about the possible degree of compliance with any sub-regional commitments that might be assumed.

Notwithstanding the validity of the reasons stated, and aside from the events of 1999, it is possible to discern some justification for thinking about formal rules of macroeconomic coordination:

- strong macroeconomic “spillovers” induced by integration mean that the demand for macroeconomic coordination exceeds what could be explained by current trade volumes;
- MERCOSUR’s characteristics, unlike other integration processes, mean that there is still a low level of economic interdependence between the countries. Despite this, they did not hesitate to make commitments on trade liberalization at the beginning of the decade, when the benefits were, (*a priori* and given the low level of trade) diffuse. In the Treaty of Asunción and in later MERCOSUR negotiations, the differences in size and the low level of interdependence between the countries were not crucial obstacles to the adoption of commitments on issues such as trade disciplines, the common external tariff, and intra-zone free trade;
- the “strategic” convergence of the stabilization plans under way in the main countries make possible and credible the adoption of joint objectives in macroeconomic issues. There is some agreement in the two main MERCOSUR countries about the “public benefits” of an orderly handling of the public accounts and low inflation, and about the problems that stem from public indebtedness, etc.;
- MERCOSUR’s favorable long-term prospects and sub-regional stability make it increasingly possible to exploit the complementarities between the economies,. This in turn implies new alternatives for investment location; the countries thus often seem to be competing for new projects. The “struggle” for investment has clear macroeconomic implications that can negatively affect the performance of monetary and fiscal variables. This suggests an area of potential coordination with the aim of establishing a consistent framework for decisions about the location of capital, such that the efforts at stabilization are not affected;
- the authorities’ search for “compromise technologies”: a sub-regional institutional arrangement could help strengthen some actions by subjecting them to the approval of other countries. In this case, agreeing on policies would be related to securing external “support “ or a “lock in” that positively influences expectations of some of the aims of macroeconomic conduct.

These considerations suggest that MERCOSUR’s current circumstances require a search for ways of mutually adapting macroeconomic policies. Increasing commercial interrelation and, in particular, greater “Brazil-Argentina interdependence”, make the issue of policy coordination more relevant by the day.

The fact that the two main partners now have different exchange regimes should not be seen as an insurmountable obstacle to a strategy of macroeconomic coordination (in the 1960s and 1970s, when

Germany had a free exchange system, France and Britain retained exchange controls and restrictions but then began to plan the current convergence). Objectively, however, it is hardly debatable that maintaining these differences over time is incompatible with the objective of coordinating and effecting common disciplines in the main economic variables.

The European experience is also eloquent here. It is enough to recall the large number of European initiatives throughout the years that sought to coordinate the various exchange parities, an exercise that culminated in the introduction of the euro.

Apart from these observations, the agreement in MERCOSUR during the past months to define a series of indicators and their respective goals of macroeconomic discipline, and to move toward greater harmony in national fiscal policies, will make a decisive contribution to the consolidation and deepening of the Customs Union over the medium term. The fate of the integration process will undoubtedly depend on the progress made in this area.

DECISIONS, TASKS AND TIMETABLES ON THE RELAUNCH AGENDA

Dec. CMC	Issue	Task or Responsibility	Deadline
22/00	Market access	List of NTBs	30 July 2000
		Actions to eliminate NTBs	15 November 2000
23/00	Transposition of harmonized norms	Drawing up a presentation of the transposition of norms	30 September 2000
24/00	Institutional strengthening of the MERCOSUR secretariat	Proposal on institutional strengthening	10 December 2000
25/00	Improving three dispute settlement system	Integral proposal on improving the Protocol of Brasilia	10 December 2000
26/00	Analysis of the structure of the CMG and the CMC	Internal consultations and proposals on adaptation to the relaunch agenda	10 December 2000
27/00	Common external tariff	Proposal on a common regime for capital goods not produced in the region	15 December 2000
		Proposals on the revision of the CET	30 September 2000
		Addressing the double perception of the CET	31 December 2000 (preliminary work)
28/00	Commercial defense and protection of competition	Proposal on bringing discipline to Investigations and the application of antidumping measures and countervailing duties	30 November 2000
		Proposal for the gradual elimination of antidumping norms and countervailing duties in intra-zone trade	Completion by 30 June 2001 Submission to CMG: 31 December 2001
29/00	Commercial defense and protection of competition	Proposal for a common regulation on defense against third country dumping and subsidies	15 December 2000
30/00	Macroeconomic coordination	Drawing up harmonized statistics	Publication starting in September 2000
		Fixing goals for fiscal matters, debt and prices, with their convergence process	March 2001
31/00	Incentives to investment, to production and exports (free zones, temporary admission and other special regimes)	Report and exchange of information	15 December 2000
		Proposal on common disciplines	31 March 2001
		Regulation of incentives for special customs regimes for imports (free zones, temporary admission)	15 December 2000
32/00	External relations	Commitment to negotiate trade preferences as a bloc	As of 30 June 2001
		Re-start negotiations with the Andean Community	31 December 2001

Source: *Pro Tempore* Secretariat and Intelligence Trade Report.

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ANNEX

THE EU-MERCOSUR NEGOTIATIONS

1. BACKGROUND

The framework agreement between the European Union (EU) and the Southern Common Market (*Mercado Común del Sur*, MERCOSUR) was signed on 12 December 1995. Its aim was to prepare the ground for the negotiation of an association agreement between the two blocs. This accord would cover the whole spectrum of inter-regional relations – that is, trade, politics and cooperation. Despite pressure from within the EU during the negotiation of the framework agreement, the oft-stated aim of the European Commission to give special attention to MERCOSUR increased expectations that the agreement would be signed within a relatively short space of time. The framework accord would shape relations only until there was agreement on implementing the biregional association.

The EU's desire to strengthen relations with MERCOSUR was both political and economic. From a European perspective, several factors have worked in favor of an association with the bloc.

- First, the consolidation of democratic systems in the MERCOSUR countries has increased the potential benefits for the EU of a deepening of relations between the two blocs. The political dialogue (long established between the two regions) made evident the convergence of interests and perceptions that went beyond the mere bilateral. The alternative of coordination at the multilateral level made it necessary to establish new mechanisms to channel the dialogue between the two blocs.
- Second, advances in the MERCOSUR integration process, following the decision to create a Customs Union, qualitatively increased the region's attractiveness, mainly because of its potential for development. The possibility of including new members, such as Bolivia and Chile, made the bloc more attractive to the EU, since at the time MERCOSUR had a population of 200 million, a gross domestic product (GDP) of more than US\$ 600 billion, and was the fourth largest economic bloc in the world. Because the EU was MERCOSUR's largest trade partner (with a 26.2% share of the MERCOSUR market in 1992) its interest in the sub-region was further boosted by the 10% annual increase in MERCOSUR trade between 1988 and 1994. According to a Communication from the European Commission to the Council and the European Parliament on 10 November 1994, failure to sign an association agreement with MERCOSUR would have highly negative consequences for Europe's position in Latin America.

When the two sides signed the framework agreement they decided to carry out a detailed analysis of their trade links (known as the "snapshot") as a step prior to the start of the association negotiations. This analysis included an examination of trade flows, bilateral relations and legislation related to areas covered by the biregional relationship. As expected, the preparatory studies were concluded in 1998. Differences within the EU about how to include the agricultural issue on the negotiating agenda delayed approval of the mandate needed to start the negotiations.

2. DIFFICULTIES IN SECURING A NEGOTIATING MANDATE

The European desire to strengthen relations with MERCOSUR on the basis of economic and political considerations ran into certain difficulties. Although most EU institutions acknowledged the importance of

the EU's trade relations with MERCOSUR (as shown by the various preparatory documents), approval of a negotiating mandate proved controversial.

The difficulties in securing the negotiating mandate reflect the problems the EU has in balancing the interests of its members and in formulating a common position. The negotiating mandate was requested in 1998, but differences of opinion in the General Affairs Council (which brings together the EU's foreign ministers) meant that a decision on the issue was repeatedly delayed.

In particular, MERCOSUR's request for wide-ranging negotiations that included talks on liberalization (without excluding any sector) was rejected by several European countries. France and Ireland, which because of their agricultural interests were strongly committed to the European policy of subsidies, opposed the inclusion of agriculture in the negotiations. The United Kingdom, for its part, preferred to link the MERCOSUR negotiations to the free trade talks taking place within the World Trade Organization (WTO) and await the results of the Seattle round before signing any trade agreement. The EU's argument for differential treatment for the agricultural sector was indirectly strengthened by the environment created by expectations of how agriculture would be treated in the new WTO round.

The Council was divided on the signing of an association agreement with MERCOSUR. The United Kingdom, Ireland and France opposed approval of a mandate to negotiate a free trade area (FTA). These countries preferred a more flexible formula that did not specifically mention an FTA, thus allowing the parties to make progress on liberalization issues, but at a slower pace. Other countries, such as Germany (which at the time held the Presidency of the Council) and Spain, however, favored starting talks on an FTA immediately.

After an unsuccessful meeting on 30-31 May 1999, when an agreement could not be reached, the Council decided to postpone any decision on the matter until the summit of EU heads of state and government in Cologne (Germany) on 3-4 June. Although a definitive statement on the issue was expected during the summit, the document finally released made no reference to the MERCOSUR negotiations, much to the surprise of some observers. Faced with the prospect of going to the EU-Latin America/Caribbean Summit (scheduled to be held on 28-29 June) empty-handed, the EU decided to hold a meeting of the Council on 21 June with a view to reaching an agreement.

A compromise solution was finally reached at the 21 June meeting, whereby the Commission was authorized to start talks immediately with MERCOSUR and Chile on non-tariff matters, while negotiations on tariff-related issues were postponed until July 2001. The mandate was thus approved just before the Rio Summit. Although it was based on more strict criteria than originally hoped for by the MERCOSUR countries, it was well received by its members, since it at least opened a formal negotiating channel through which the different positions of the two blocs could be discussed.

The joint statement by the representatives of MERCOSUR/Chile and the EU did not explicitly mention the intention of establishing an FTA, but instead made a vague reference to trade liberalization. The two sides nevertheless viewed this statement as an important political first step, since it marked the start of the negotiations. The joint statement set the first meeting of the Cooperation Council for November 1999, with the aim of agreeing the methodology, structure and the timetable of the talks, according to proposals put forward by MERCOSUR and the EU.

3. THE AGREEMENT ON THE METHODOLOGY, STRUCTURE AND TIMETABLE OF THE NEGOTIATIONS

In the first meeting of the Cooperation Council, held in Brussels on 24 November 1999 and attended by the foreign ministers of both blocs, the EU and MERCOSUR discussed each others' proposals on the

structure, methodology and timetable of the negotiations. The two sides approved a prior commitment on the procedural aspects of the talks.

Structure

In relation to the structure of the talks, the two sides agreed to establish a centralized scheme organized along the following lines:

- A *Biregional Negotiations Committee* would be set up jointly by the EU and MERCOSUR. This would be responsible for the general management of the negotiating process and directly responsible for the trade talks.
- Reporting directly to the Committee, a *Cooperation Sub-committee* would be established, with responsibility for the negotiations on inter-regional cooperation.
- Several *Working Groups* can also be established as and when the Committee should need them. These would be responsible for the technical aspects of the negotiation and would report directly to the Biregional Negotiations Committee.
- Two *Coordinating Secretariats*, made up of representatives of the European Commission and the MERCOSUR Presidency respectively, would be responsible for the administrative coordination of the negotiations, the preparation and organization of summit meetings, and the distribution of all official documentation produced for the talks.

Methodology

As regards the methodology, it was agreed that the talks should be conducted as a single undertaking. Although the negotiations will be held separately in working groups, any actions resulting from these will be carried out as part of a single and indivisible overall project. This will enable both sides to secure satisfactory results in all, rather than only some, of the sectors included in the negotiations. With this strategy, however, there is a risk that the negotiations could be delayed if agreement proves difficult in some of the sectors under discussion.

The Biregional Negotiations Committee will be responsible for the trade talks, and the Cooperation Sub-Committee for the negotiations on cooperation-related issues. The Biregional Negotiations Committee will ensure consistency between the two bodies, and will decide their timetable and work program as well as that of any Working Group it decides to establish. Meetings of the Committee will take place alternately in one of the MERCOSUR countries and in Brussels, except when there is consensus that the venue should be changed. It was also stressed that the talks should be as open and transparent as possible, ensuring optimal contact between the various negotiating bodies and between these and civil society. This desire for transparency must be based on a policy of fluid communication, not only of the results of the negotiations, but also of the whole negotiation process.

Timetable

The Biregional Negotiations Committee meets three times a year. The first of these meetings took place between the EU and MERCOSUR in Buenos Aires on 6-7 April 2000, and between the EU and Chile on 10-11 April in Santiago. These meetings sought to establish a general framework for the negotiations and the Working Groups that should be set up. The second meeting took place on 13-16 June 2000 in Brussels, and the third is scheduled for November in Brazil. The Cooperation Sub-Committee will establish its own schedule of meetings. It has thus far met twice, in parallel to the meetings of the Negotiations Committee. The Working Group meetings will also be held in parallel to those of the Committee. The members of these groups can maintain unofficial contacts between meetings when the need arises.

The main point of disagreement arose over the date on which the tariff negotiations should begin. While MERCOSUR and Chile claimed that both tariff and non-tariff issues should be negotiated simultaneously and immediately, the EU sought to adhere closely to the terms of the negotiating mandate. This stipulated that although non-tariff issues could be discussed immediately, talks on tariff-related matters could only begin in July 2001. At MERCOSUR's insistence, however, discussion of this issue was postponed until the first meeting of the Negotiations Committee. The issue therefore remained unresolved until the start of the first round of negotiations.

4. THE BUENOS AIRES MEETING

The Biregional Negotiations Committee first met on 6-7 April in Buenos Aires, and the parallel negotiations with Chile took place on 10-11 April in Santiago. A first attempt to examine the political, cooperation and trade aspects of the talks was made at the Buenos Aires meeting. The meeting (which was preceded by one of the Joint Cooperation Committee, which discussed in general terms the future guidelines for inter-regional cooperation) examined the options for setting up the Working Groups.

The establishment of the Working Groups was a controversial issue, since MERCOSUR favored creating one specifically for agriculture, while the EU preferred not to debate the question so closely. At the proposal of the EU (based on its talks with Mexico) it was finally agreed to set up three Working Groups:

- one covering goods trade and market access rules, including sanitary and phytosanitary regulations, customs procedures, import licenses, rules of origin and quality control;
- another responsible for investment, services and capital movements, as well as patents and intellectual property rights; and
- a third group for competition issues (including anti-dumping measures), trade-related dispute settlement and public procurement systems.

The general negotiating guidelines and the specific rules regarding the three main areas of the biregional association agreement (political dialogue, biregional cooperation and trade) are reflected in a document that reaffirms many of the points already noted in previous documents, such as the Rio Communiqué, the Vilamoura ministerial meeting and the 1995 framework agreement. The document also includes several new issues that are important for the talks:

- The two sides agreed that the negotiations should entail certain rights and obligations for both blocs that go beyond what was agreed in the framework agreement.
- The negotiations should be comprehensive and balanced, so that the outcome proves satisfactory to both sides.
- With respect to the political dialogue, the Negotiating Committee will prepare the political chapter of the agreement. This should deepen and broaden the agenda and mechanisms that have been established since the signing of the framework accord.
- In terms of cooperation, the two sides agreed to improve the scope of existing agreements and make these compatible with the objectives of the association. For example, it was agreed that technical cooperation should seek to adapt MERCOSUR to the future demands of an association with the EU.

It was further agreed that the tariff negotiations (the most difficult issue in the talks) would only begin in July 2001. This met the EU demand that the negotiating mandate be respected. This delay in treating tariff issues is not so important if viewed in a comparative context. The timetable is similar to that adopted for the EU-Mexico talks, in which tariffs were not examined until the third round of negotiations. It is also worth noting that despite the European preclusion of tariff issues until 2001, the possibility of informally exchanging opinions on the issue before that date was not excluded.

5. THE SECOND ROUND OF NEGOTIATIONS

The second meeting of the Biregional Negotiations Committee, and the first meeting of the three technical Groups created in Buenos Aires, took place on 13-16 June in Brussels. The meeting, which was not so prominently advertised as the first, began with an introduction outlining the positions of the two blocs by Guy Legras and Horacio Chighizola, the heads of the European and MERCOSUR delegations. The negotiators then analyzed the information presented by the delegations on the issues identified as priorities by both blocs in the first meeting. The EU made a presentation on Europe's common agricultural policy (CAP), while the MERCOSUR delegates reviewed the current situation of the MERCOSUR integration process, with particular emphasis on services and public procurement.

Political dialogue

The two sides agreed to prepare and exchange texts on the political chapter of the association agreement during the third meeting in November. In particular, MERCOSUR insisted on the need for a meeting of experts to draft a preliminary version of the legal framework of the future political dialogue.

MERCOSUR also proposed a meeting of senior officials to jointly analyze the proposals presented by the bloc at the EU-MERCOSUR ministerial meeting in Vilamoura on 4 February. MERCOSUR presented the European ministers with a statement and an action plan on political cooperation. This identified the areas in which inter-regional cooperation should be applied, and what action should be taken.

Cooperation

In line with what was agreed during the first round of negotiations, only one of the sub-groups (financial and technical cooperation) held a meeting on this occasion. The sub-group examined in detail the changes that an association agreement between the two blocs would have on cooperation policy. This required current inter-regional cooperation trends to change dramatically, so as to reflect the new environment that an agreement of this magnitude would imply.

Three priority areas were identified in terms of future technical and financial cooperation:

1. **Modernization of the public administration:** Cooperation should focus on adapting the administration of both regions to the new circumstances of an association. Particularly in MERCOSUR's case, cooperation should help improve the organizational efficiency of the bloc. In this respect, the EU's experience might prove useful. A number of measures could be adopted as a first step, including EU technical assistance for MERCOSUR's various bodies, and the exchange of information.
2. **Institutional cooperation:** Deepening the MERCOSUR integration process was identified as the main aim of institutional cooperation. The goal of measures in this area should be to promote close cooperation between the various EU and MERCOSUR bodies. In this respect, cooperation should continue with MERCOSUR's Administrative Secretariat, the Mixed Parliamentary Commission, and MERCOSUR's Economic and Social Consultative Forum. The regular exchange of information, technical assistance and training were identified as some of the measures that should be introduced in this respect.
3. **Regional cooperation:** The two blocs identified as fundamental the use of the available instruments for promoting cooperation in MERCOSUR, and between the bloc and the other Latin American countries, in order to strengthen the regional integration process. A number of areas were identified as important, including the promotion of trade and investment in the region, the development of regional cooperation on the environment, the development of a regional communications infrastructure, and support for initiatives on regional development and urban and rural planning.

Trade negotiations

The three sub-groups established in Buenos Aires held their first meeting in Brussels. This first meeting discussed general aspects of each sub-group's area of responsibility, in an effort to understand the respective trade regimes. The delegations exchanged information on various issues, such as the CAP, EU enlargement, Chile's and Bolivia's accession to MERCOSUR, and the bilateral trade agreements signed between each of the blocs. The two sides agreed to continue this process, since the information exchanged in the period before the meeting could not be properly analyzed and processed by the sub-groups, and because a need for new information emerged during the meeting,

MERCOSUR presented its proposal on the specific objectives of the trade talks. The EU is to analyze this proposal and present its own before the next meeting in November. The EU presented to the MERCOSUR delegation a list with those issues identified as non-tariff trade barriers. MERCOSUR had to provide the necessary information in this respect by the end of July. The Groups also fixed the agenda for the next round of negotiations, which will mainly consist of further exchanges of information, the definition of specific objectives on trade liberalization, and the identification of non-tariff trade barriers.

The immediate schedule is as follows:

- Each bloc's list of experts will be exchanged by the end of June, to facilitate both sides' information requirements;
- each bloc has until 31 July to present the information requirements identified during the second round of negotiations, analyze the information already sent, and prepare a series of questions on the information provided; and
- the two sides have until 30 September to hand over the information needed to respond to the questions. The EU should also submit a proposal on the specific commercial objectives of the negotiations.

6. THE CHALLENGES OF AN ASSOCIATION

The EU's difficulties in winning approval for the negotiating mandate for a trade liberalization agreement with MERCOSUR, and divergence in the Biregional Negotiations Committee on the structure and scope of the negotiations, revealed the differences of opinion between the EU and MERCOSUR about the reach of such an association agreement. Although there is a clear commitment on both sides to deepen and broaden relations, several items on their respective agendas expose the different sets of interests at play in these negotiations. Both sides' room for maneuver will be influenced by (in the case of Europe) reform of the CAP, the accession of the Eastern European countries, and the coordination of a common foreign and security policy (CFSP); and (in the case of MERCOSUR) by internal conditions in the integration process and the prospects for enlargement.

The agricultural question. Agriculture is probably the most difficult issue in the negotiations. According to the European agricultural lobby, an FTA with MERCOSUR would threaten the CAP by allowing access to more competitive South American goods, most notably agricultural and fishery products that account for around half of MERCOSUR's exports and in which the EU (unlike in other sectors) has a substantial trade deficit. Opponents of quickly negotiating a trade deal with MERCOSUR argue that a liberalization accord would cost an extra 5.3-14.3 billion euros per year in compensation for EU farmers affected by the competition.

As regards agricultural trade between the EU and MERCOSUR, it is worth noting that:

- Only 14% of total MERCOSUR exports to the EU is considered sensitive, and barely 2% would have a negative impact on the EU in terms of market share.
- MERCOSUR is an important extra-EU supplier of certain goods. In 1998, it accounted for 66.7% of extra-EU imports of fresh and frozen beef, 51.4% of fruit juice, 43.4% of maize (unground), 47.7% of animal feed and 41.6% of oil-bearing seeds and fruits.
- The signing of any trade agreement implies that long transition periods must be considered, so as to prepare the internal market for greater competitiveness. This would limit the effects of an agreement.

Regardless of whether a liberalization agreement is signed, it is important to note that the CAP's share in the total EU budget is falling. There is increasing pressure in the EU to eliminate distortions in the agricultural market and instead to increase direct subsidies to producers. The CAP now accounts for 48% of the EU budget, significantly less than the 70% recorded in the 1980s. This figure is expected to fall

even further in future with the application of criteria set out in Agenda 2000, which restates the need to lower intervention prices for commodities such as cereals, meat and sugar.

Despite the long-term trend toward reducing the CAP's importance on the European political agenda, the EU has made clear its intention to continue to protect farmers' interests. The EU's willingness to reform the CAP, however, helps explain its interest in maintaining a more cautious position towards liberalizing agriculture, so as not to exacerbate underlying conflict.

EU enlargement. Another issue that continues to feature prominently on the EU's internal agenda, and which has an indirect impact on MERCOSUR, are the negotiations with prospective new EU members. The negotiations with Cyprus, Estonia, Hungary, Poland, the Czech Republic and Slovenia, which began on 30 March 1998, mean that the EU will have to adapt its institutional structure to accommodate new members. A number of issues that still need to be addressed, such as the weighting of votes in the Council of Ministers or the number of Commission members, are strongly debated both within and outside the EU's institutions.

The accession of these countries will also have an impact on the CAP, since agriculture accounts for a significant part of their output. As part of the pre-accession program, these countries will, for example, receive specific economic assistance for their agricultural sectors. The SAPARD program (Special Accession Programme for Agriculture and Rural Development) will distribute 520 million euros per year to Bulgaria, the Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Rumania, Slovenia and Slovakia. It is thus reasonable to assume that in future there will be more EU countries in favor of continuing with the CAP.

Common foreign and security policy. An agreement with MERCOSUR and Chile will be a test of the EU's ability to formulate a coherent common position on a foreign policy issue, and to redefine its role as a global player. It remains to be seen whether the specific interests of those sectors that wish to postpone the negotiations on particularly controversial issues, such as agriculture, can be reconciled with those that favor speedier negotiations to open up potentially lucrative markets for European sectors, such as manufacturing and services. If the EU is able to do so, it will be better placed to become a single, cohesive international actor. The EU's ability to reconcile the different positions of its Member States on the sub-region will therefore represent an important challenge for the CFSP. However, recent internal differences in the European bureaucracy over responsibility for foreign policy reveal certain difficulties of coordination.

Progress in the integration process. Despite the clear progress that MERCOSUR has made on integration, many criticize the bloc for being merely an incomplete Customs Union with aspirations to being a common market. The unresolved trade problems between the main MERCOSUR members reveal how far there is to go. Last year's disputes between Argentina and Brazil highlighted institutional deficiencies and the lack of effective mechanisms to resolve such conflict. Similarly, Paraguay's and Uruguay's difficulties in accepting a common automotive regime, once the two main members signed an agreement on 23 March, disclose the problems associated with completing the Customs Union.

These examples reveal MERCOSUR's difficulties in harmonizing the interests of all its members and in presenting itself to the international community as a solid and coherent actor. Its ability to make progress on the various technical and basic aspects of integration will largely shape the EU's perception of the bloc as an attractive trade partner. In particular, its ability to present a solid and technically sound defense of its position will have a decisive impact on the outcome of the negotiations.

7. PROSPECTS FOR AN AGREEMENT

Given the number of factors that thus far have determined the various positions adopted by the two blocs on the scale and scope of liberalization, it is reasonable to assume that the EU-MERCOSUR/Chile talks will continue to be complicated, since there is little evidence that these factors are likely to change substantially in the short term. Any radical change in the positions of the negotiators that might significantly speed up the talks would imply a fundamental shift in their respective foreign policies. It could be argued, however, that the interest that both sides have so far shown in moving the talks forward bodes well for the eventual signing of some liberalization accord. Neither the processes under way in MERCOSUR, nor those that might significantly affect the EU's priorities in the near future, are likely to alter the current pace of the negotiations.

It is reasonable to assume, however, that for these same reasons the reciprocal interests that until now have motivated each side to negotiate will continue to favor the deepening of biregional relations. The fact that the talks are now in progress, despite a relatively unfavorable climate marred by a series of conflicts that have unbalanced MERCOSUR's internal conditions, is a positive sign. Despite the differences of interest between them, the two sides have increasingly demonstrated the political will to make a qualitative leap in the relationship that unites them. This will help the negotiations move forward.

Several factors might have a particular effect on the current negotiations. These include Latin America's general economic performance, the success of European investment in MERCOSUR, and the development of constituencies in favor of liberalization and MERCOSUR integration:

The **prospects of a recovery in economic growth** in the region this year will increase the significance of a strategic alliance with MERCOSUR in sectors such as banking, telecommunications, energy and services. It is estimated that the MERCOSUR countries and Chile will grow by more than 3% this year, with further growth expected in 2001. These emerging markets will therefore continue to be attractive for European investors, since growth is likely to have a positive impact on the profits of companies operating in the region, especially since lower exchange rate risks will boost foreign investment. Greater market stability might also improve the prospects for exporters. This could increase the incentives for European companies operating in the bloc to redistribute their production geographically, and for those that are not to examine the existing business opportunities more closely. If these trends persist, the case in favor of an agreement between the two blocs will be indirectly strengthened in the medium term.

- With respect to **investment**, recent data revealing the attractiveness of the MERCOSUR countries for foreign investors indicate that the trend of recent years is likely to continue. According to provisional figures from the Economic Commission for Latin America and the Caribbean (ECLAC), Brazil was the main Latin American destination for foreign direct investment (FDI), attracting a total of \$31 billion in 1999. Argentina, with \$21 billion in FDI, moved into second place ahead of Mexico, mainly because of the sale of the Argentine oil company Yacimientos Petrolíferos Fiscales (YPF) to Spain's Repsol for over \$13 billion, as well as several mergers and acquisitions involving mostly Spanish firms. According to ECLAC, the bloc as a whole attracted as much as \$52.2 billion, representing almost 70% of FDI in the member countries of the Latin American Integration Association (LAIA). Future privatizations in the banking, energy and telecommunications sectors in Argentina (Banco Nación, Banco Hipotecario Nacional) and Brazil (Banespa, Cemar) will provide further investment opportunities for European companies.
- Two factors will be critical for the development of **constituencies in favor of liberalization**: the role of the private sector in the two blocs and the consolidation of strategic intra-bloc alliances that could boost the position of sectors in favor of a far-reaching negotiation. The MERCOSUR-EU Business

Forum (MEBF) is an example of how civil society can interact in favor of trade liberalization. The Forum meetings have revealed that a broad spectrum of companies favor liberalization in all sectors, and that biregional trade relations would be placed on a firmer footing with the signing of a free trade agreement. The Forum's main aim is to encourage progress in the EU-MERCOSUR negotiations, as well as to promote a stable investment environment, easier market access, and liberalization in the services sector. The real impact of the MEBF, however, will depend on its ability to contribute to specific aspects of the negotiating agenda with well-founded arguments. The input of the various working groups established by the Forum to examine those issues that it considers important to biregional relations could be a valuable contribution in this regard.

- Whether MERCOSUR is able to coordinate positions on the negotiations will depend on progress made in **consolidating the South American bloc**. MERCOSUR (which last year faced one of its most critical periods as a result of the trade conflicts between Argentina and Brazil) will have to demonstrate its ability to present a solid and coherent stance in its negotiations with the EU. This will become easier as the bloc consolidates internally, and as it becomes an increasingly important reference point for the region as a whole. In terms of MERCOSUR's consolidation, a positive development was the signing of an agreement on 23 March 1999 between Argentina and Brazil on the automotive regime, traditionally one of the most conflictive sectors in bilateral relations. However, the fact that this agreement was not accepted by all the members at the last summit in Buenos Aires on 30 June highlights the fact that the integration process is very dependent on the political will of its members. Similarly, although the prospects for enlarging MERCOSUR via Chile's accession will increase its relative weight in an association agreement, discussion of the measures needed to achieve this during the last presidential summit show that there is still much to do.

For the EU, recent trends in biregional trade could be a cause for concern, and could provide impetus for the negotiation of an agreement:

- Although the EU has increased its share of MERCOSUR imports in value terms, its percentage share has remained virtually static (rising from 27% in 1994 to 27.6% in 1998) while in relative terms it has actually lost market share (the United States' share rose from 20.3% to 21.6% during the same period). Europe's share of MERCOSUR imports is likely to have fallen in sectors such as foodstuffs, machinery, transport and information technology goods, plastics and chemical products. Progress in the negotiations with the United States on the FTAA could be of strategic importance.
- Although MERCOSUR's imports from the EU have risen steadily, this has been at a slower rate than the growth of intra-bloc imports. Between 1994 and 1998, imports from Europe rose by an annual average of 13.2%, compared to 15% for intra-bloc purchases.

As for the EU, some important precedents favor negotiation of an association agreement with MERCOSUR, such as the experience of its trade relations with Mexico. The entry into force of the North American Free Trade Agreement (NAFTA), and the ensuing decline in Europe's share of the Mexican import market, made it necessary for the EU to negotiate a trade agreement that would help it recover its share and focus on a strategy to penetrate the US market. But the negotiations with Mexico were far less conflictive, since inter-regional trade is less sensitive; hence this does not invalidate Europe's reticence in signing a similar agreement with MERCOSUR. The EU-Mexican negotiations, however, could serve as a point of reference for the two sides on how to secure a balanced agreement that includes areas of common interest, thereby helping both regions to reach a mutually beneficial agreement.

In light of these considerations, it is fair to predict that progress in the negotiations is likely to be slow. The pace of the talks is conditioned by the flexibility of the negotiators on both sides and their capacity to apply the knowledge they have acquired from previous negotiations. To the extent that they can exploit opportunities to make progress in less controversial areas, the pace of the talks could gather speed. The EU-Mexico FTA is an important precedent. The negotiators will probably have to take into account some of the agreements reached between the EU and Mexico, such as the two-phase liberalization of EU industrial imports to Mexico, or the partial liberalization (62%) of agriculture within a 10-year time frame.

Any future agreement is likely to include a lengthy transition for sensitive sectors. EU negotiators acknowledge the need to protect agricultural interests and to avoid the large-scale damage that an agreement with MERCOSUR would cause. This almost certainly means that there will be transition periods that are sufficiently long to enable those sectors to adapt to the conditions induced by imports from MERCOSUR. It is also likely that some kind of exception will be negotiated for the most sensitive sectors, and that in general some safeguard will be introduced to allow the opening to be reversed if it can be proved that the affected sectors are being damaged.

MERCOSUR is likely to attempt to keep its tariffs relatively high for those products considered sensitive, and in which European competition could threaten national production. MERCOSUR might also favor some kind of “umbrella” for sensitive products in the services or industrial sector. It is especially likely that Brazil will demand such measures, since the country is particularly keen to protect its manufacturing industry, which accounts for a large part of its exports and thus has a higher level of protection than the other members of the group.

Factors such as MERCOSUR’s interest in liberalizing the agricultural sector, and the difficulties this entails for the EU, will undoubtedly determine the dynamism and fluidity of the negotiations. It is also plain that a number of arguments favor conclusion of the process. Even if these considerations result in lengthy and complicated negotiations, it seems reasonable to assume that the talks can be concluded in five years. This will be more likely if there is a more direct competition between the EU-MERCOSUR negotiations and other alternative regional liberalization processes such as the FTAA. The degree of liberalization that is finally agreed upon will depend on the negotiators’ ability to resist pressures to restrict liberalization, and on the extent to which long-term strategic concerns about improving business opportunities can outweigh short-term interests.

The signing of an FTA between the EU and MERCOSUR is a challenge for both blocs. To negotiate an association agreement, the two sides will have to overcome a series of structural and conjunctural difficulties and accept the challenge of establishing a qualitatively different form of biregional relations. An EU-MERCOSUR free trade agreement, however, will have effects beyond the biregional level. It will also have a significant impact on the foundations of the global system, since the two blocs will be more closely united on political, economic and cooperation issues that transcend the limits of their biregional relationship.

