REPORT MERCOSUR

2000 - 2001

Juan José Taccone and Uziel Nogueira (editors)

Integration and Regional Programs Department
Institute for the Integration of Latin America and the Caribbean - INTAL

INTER-AMERICAN DEVELOPMENT BANK
MERCOSUR Report N° 7

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Institute for the Integration of Latin America and the Caribbean IDB - INTAL
Esmeralda 130, 16th and 17th Floors C1035 ABB. Buenos Aires, Argentina
tel 54 114 320-1871 fax 54 114 320-1872
E-mail: INT/INL@iadb.org. http://www.iadb.org/intal

Printed in Argentina

IDB - INTAL
MERCOSUR Report
Buenos Aires, 2001. 88 pages.
Report Nº 7. 2000-2001

I.S.B.N. 950-738-121-X

US$ 15,00

Cover design-Editing:
Alicia Pinotti
Assistance:
Susana Filippa

The Subregional Integration Reports Series, which includes the MERCOSUR Report, 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 subregion as a whole. Likewise, in order to promote MERCOSUR within and beyond the subregion, information dissemination oriented towards the international community is fostered through the publication of this report in English, as well as in Portuguese and Spanish, the two official languages of the process.

Report N° 7 covers the second semester of 2000 and the first of 2001 and has been prepared by Dr. João Bosco M. Machado, professor at *Instituto de Economía de la Universidad Federal de Rio de Janeiro (UFRJ)* and reasearcher at *Fundación Centro de Estudios de Comercio Exterior (FUNCEX*); with the assistance of Mr. Ricardo A. Markwald, FUNCEX Director, Rio de Janeiro, Brazil.

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

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

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EXECUTIVE SUMMARY

Impasses in MERCOSUR

MERCOSUR has become less operational, despite government claims that it will continue to play a leading role in the international insertion strategies of its member countries for some years. The current crisis is clearly far from over. It is important to note that the enormous difficulties that MERCOSUR faces stem not only from changes to the conditions of competition triggered by the devaluation of the Brazilian currency and the fragility of the Argentine economy. A number of more important issues and impasses undoubtedly have come into play to threaten the future of the integration process.

The impasse clearly has a political dimension that can be defined in simple terms: for Brazil and Argentina, MERCOSUR is not the only possible strategy for putting their economies on the world stage. As long as MERCOSUR is perceived as a genuine "state policy", both countries will continue to consider alternative (nut not necessarily coincident), options and strategies. At times of crisis these alternatives obviously become clearer and more concrete. It would, however, be naïve to believe that the alternatives arise merely from conjunctural differences of opinion. On the contrary, the emergence of alternatives to the subregional integration project is the consequence of more permanent structural factors, such as a country's size, the nature of its productive structure and, ultimately, its history.

Brazil has at least two relatively concrete alternatives: first, autonomous insertion in the international economy; and second, to promote a strategic alliance with its neighbors in order to consolidate its leadership in the region and secure a greater role on the world stage. The latter is conditional on the following factors: (i) this leadership should take account of an area larger than MERCOSUR, preferably including all of South America; (ii) the costs of exercising this leadership should be low; and (iii) Brazil should preserve a reasonable degree of foreign policy autonomy.

The option of autonomous insertion reflects a vision of the national interest that has always been present in the country's foreign policy objectives. In short, Brazil has always believed that the size of its population, the vastness of its territory, the complexity of its industrial structure and the scale of its gross domestic product (GDP) give it the right to play a leading role on the world stage.

The strategy of promoting Brazil's leadership in South America should also be viewed as an alternative to subregional integration. MERCOSUR can (and should) be consistent with this process, but it clearly entails different challenges and actions. This alternative implies that MERCOSUR is a necessary but insufficient mechanism, since without the participation of the other South American countries the incentives to deepen subregional integration are weak. Hence this is not a matter of an incremental foreign policy strategy centered on a "hard core" that advances on the basis of concentric circles. The outer circle determines the inner one, not *vice-versa*. This is why there is little motivation to consolidate this core and why there is a preference to exercise a more informal leadership with low costs and few rules or institutions.

Argentina, like Brazil, also views autonomous insertion in the world economy as an alternative strategy. In this case the strategy is similar to that adopted by Chile, whose much narrower industrial base is three or four times smaller than Argentina's: (i) to reduce import costs; (ii) to promote specialization in a small group of sectors; (iii) to explore market niches that are intensive in skilled labor; (iv) to sign free trade agreements with as many partners as possible; and (v) to maintain preferential access to the Brazilian market in order to boost the country's attractiveness and increase foreign direct investment.

If Brazil's strategy of autonomous insertion can be called into question for being overly confident of the country's real prospects, Argentina's can be accused of the opposite: the country underestimates the potential of its economy, casting doubt on its capacity to ensure equilibrium in its external accounts and to promote full employment.

The impasse also has an institutional dimension, an area in which MERCOSUR undoubtedly suffers a deficit. There is consensus, and little controversy, about this. However, there is disagreement about the problem's relevance, its impact on the future of MERCOSUR, which partners would benefit and which would suffer, and what solutions should be sought.

There are three main problems: (i) the norms approved by MERCOSUR institutions cannot be defined as community law in the strict sense, but only as international law in the classical sense. They must therefore be transposed into national law through procedures established by the constitutional or legal norms in force in each member country; (ii) MERCOSUR lacks an efficient dispute settlement mechanism and a juridical body with the capacity to interpret and apply the agreements; and (iii) the bodies created by MERCOSUR are all inter-governmental and are therefore by nature political. Hence political and technical issues are both negotiated in a similar manner, with the former obviously influencing settlement of the latter.

According to specialists in this field, one of the most serious problems is the essentially political nature of MERCOSUR's institutions and the absence of permanent technical bodies. MERCOSUR institutions consist of officials (who are not necessarily permanent) appointed by their governments. Interaction in the decision-making bodies occurs *a posteriori*, after each country has decided what is in its national interest. Each government therefore arrives at the negotiating table to defend its particular interest, which can be incompatible with those of the customs union. This affects the strategic vision, since there is no one to defend the common (that is, MERCOSUR) interest.

The legal and institutional deficit is cause for concern since it spurs conflicts, exacerbates uncertainty and delays the resolution of problems. Paraguay and Uruguay claim that the lack of norms or the predominance of "lax" rules tends to favor the larger members because they have greater capacity to impose or postpone the resolution of conflicts. These larger members, particularly Brazil, criticize the existing system of consensus-based decisions because it encourages the fiction that the partners are equal and thus gives the smaller countries too much power. There is, however, reluctance to discuss any proposal for resolving certain issues by qualified majority, since this would raise the thorny and supposedly insoluble question of how to distribute voting power among the member states.

Despite these observations, it is clear that there is room for modifying aspects of MERCOSUR's current institutional and legal framework. Of particular note among the suggestions already made are: (i) creating technical committees; (ii) establishing a more independent Court of Arbitration with a greater stability of membership, or a juridical body to interpret agreements, respond to consultations and guide the national courts in applying the law stemming from MERCOSUR norms; (iii) setting deadlines or introducing fast track procedures for transposing norms into national legislation; and (iv) setting up a common body to safeguard competition.

These changes, and many others that have been suggested, could be implemented relatively fast and would greatly improve the quality of MERCOSUR's institutions. Most of these do not even touch on the question of supra-nationality, but little emphasis has been placed on the institutional debate.

It is hard to believe that MERCOSUR will be able to make progress unless its institutions are strengthened, but initiatives to this effect will not prosper unless the members embrace an effective strategic commitment to the integration process. Hence MERCOSUR's institutional deficit might not be the main cause of the impasse but one of its most revealing symptoms.

Macroeconomic Trends

Current short-term prospects for the world economy are pessimistic. The virtuous circle evident during much of the 1990s, characterized by sustained productivity increases, high investment in technology, easy access to foreign financing and rising stock markets, has been reversed. Although there are still no signs of a hard landing for the US economy, the downturn in US output appears to have led to a reduction in world output, accompanied by a sharp fall in trade flows.

The only positive aspect of the current international situation worth highlighting is the low inflation apparent in most regions of the world. Given that present conditions stem from a contraction of output caused by a demand shock, there is room for implementing active monetary policies such as those adopted by the US monetary authorities. The growth of domestic demand in countries currently experiencing a fall in domestic output is fundamental, especially at a time when the world economy lacks a buyer of last resort – a role played by the US economy until a few months ago.

The 1999-2001 period will be viewed as one of the worst in MERCOSUR's history. Battered by Brazil's external crisis (which began at the end of 1998 and ended with the devaluation of the currency at the beginning of 1999) and by the Argentine crisis (which deteriorated at the end of 2000), the 1999-2001 period was marked by a sharp deterioration in the subregion's macroeconomic indicators.

Conditions in the subregion deteriorated as a result of a number of negative factors: (i) the devaluation in Brazil, which led to a significant change in the conditions of intra-bloc competitiveness; (ii) a reduction in the terms of trade, which reduced, albeit to differing degrees, the exports of the four MERCOSUR countries; and (iii) an increase in the perception of risk in financing emerging markets, which led to higher costs and reduced the supply of external resources available to the countries of the region.

Subregional inter-dependencies have worked over the last three years, but only in a negative sense The expansion of economic output and the growth of imports in MERCOSUR's main economy brought few, if any, benefits to the other members. Brazil's devaluation in 1999 and Argentina's crisis at the end of 2000 negatively affected the other countries of the subregion, since those circumstances increased uncertainty and pessimism, exacerbated the problems associated with external financing, and forced neighboring countries to adopt more restrictive policies. This had adverse effects on growth in the subregion.

Trade and Foreign Direct Investment

The Asian crisis gave rise to a change in MERCOSUR's foreign trade outlook. Between 1997 and 2000 the subregion's deficit with the rest of the world was reversed. More precisely its trade deficit, which reached US$ 16.05 billion in 1997, became a slight surplus of just over US$ 100 million in 2000. This adjustment sprang from a US$ 12 billion fall in imports, with exports increasing by US$ 4.1 billion in the same period.

The adjustment could have safeguarded intra-subregional trade. This is what happened in 1998 and 2000, when MERCOSUR first reduced and then eliminated its deficit with the rest of the world, while intra-bloc trade remained stable or even increased. In 1999, however, the fall in MERCOSUR's external deficit was followed by a reduction in intra-zone flows, which has yet to be completely reversed.

Intra-regional trade fell largely because of changes in intra-bloc competitiveness, provoked by Brazil's devaluation at the start of 1999. The impact was not merely circumstantial, since its effects were long-lasting. Data on intra-subregional trade for the first half of 2001 confirm this trend: trade between MERCOSUR members remains stagnant, while extra-regional trade is growing in both directions.

The most notable event in the first half of 2001 was the growth of Brazilian imports, especially from outside the subregion (16.1%), while demand for intra-regional products increased at a much lower rate (3.7%).

Prospects for subregional trade in 2001 are not promising. Trade flows between the member countries will remain stagnant or, more probably, will fall.

Preliminary data for foreign direct investment (FDI) in 2000 confirm a significant change in FDI flows following the 1997 Asian crisis. There is evidence of a growing concentration of foreign investment in industrialized countries over the last three years. Developing countries' share of FDI therefore fell by half, relative to their share in the mid-1990s.

In 2000 Latin America, not Asia, was responsible for the developing world's smaller share of FDI flows. The decline in foreign investment in Latin America centered on Argentina and Chile, where the process of mergers and acquisitions was particularly intense in 1999.

The region's attractiveness as a destination for FDI stems largely from the active participation of foreign investors in the privatization of public assets in the MERCOSUR countries, and from the frequent restructuring and ownership changes of recently privatized firms and services. Given the waning of privatization programs and the gradual stabilization of asset restructuring, it is unsurprising that the subregion has experienced a decline in FDI flows.

In this respect, financing the current account deficits of the MERCOSUR countries will be difficult. Until two years ago FDI flows easily covered these deficits. In Brazil, for example, projections for the next two years suggest that FDI will not cover more than 65% of the deficit.

In the near future, truly significant inflows of FDI should be not the cause but the consequence of a turnaround in the subregion's prospects.

The Internal Negotiating Agenda

In the last year there has been little progress on consolidating the customs union, despite the efforts of negotiators to define the MERCOSUR relaunch agenda at the end of 1999. Conditions deteriorated in the middle of the first half of 2001, as the Argentine crisis deepened and the Brazilian devaluation accelerated. Integration was undermined after MERCOSUR's two largest members failed to set minimum macroeconomic convergence criteria. Since then, a number of measures adopted unilaterally by the two countries have paralyzed the customs union's "rules of the game". Changes that members made independently to the common external tariff (CET), and the re-introduction of intra-subregional tariffs (which reverse MERCOSUR preferences), have seriously compromised the credibility of the subregional integration process.

In the second half of 2000, before the onset of the Argentine crisis and the acceleration of the Brazilian devaluation, the Argentine government proposed a 10% reduction in the CET for capital goods, in order to boost economic growth. This reduction covered machinery and equipment, some vehicles, and petrochemical and telecommunication products, all of which are produced in the subregion solely by Brazil.

As part of a package to reactivate the economy, in March 2001 the Argentine government carried out an extensive review of its import tariffs. The changes affected some 2,700 tariff items. To escape recession, Argentina called for increases in custom tariffs for consumer goods and the elimination of aliquots for capital goods in order to open up opportunities for new investment in the country.

Another measure implemented by Argentina in the middle of the first half of the year entailed the elimination of subregional preferences and the re-introduction of trade barriers between Argentina and its MERCOSUR partners. Through Resolution 258/01, the Argentine government applied discounts on import tariffs for capital and telecommunication goods from extra-MERCOSUR countries.

Despite Brazilian government protests against these measures, the worsening of the Argentine crisis led Brazil to soften its confrontational stance. This meant accepting the measures adopted by the Argentine government and thus delaying resolution of contentious issues, so as not to endanger the unity of MERCOSUR in the short term.

In July 2001 Paraguay also decided to eliminate some intra-MERCOSUR trade preferences and applied a 10% customs tariff on the intra-bloc import of 352 products. The measure will be in force until December 2002 and, according to the Paraguayan government, it seeks to protect local industry from low-cost imports following Brazil's devaluation and the export incentives introduced by Argentina.

To the same end, in July 2001 the Uruguayan government decided to increase its import tariffs by three percentage points, including for MERCOSUR members. The Uruguayan authorities argued that this was a "defensive measure" designed to offset the exchange rate changes introduced by the Argentine government. Uruguay adopted another two measures: the introduction of import controls on textiles and footwear, and the establishment of a minimum price for edible oils from Argentina.

In the midst of the Argentine crisis, Brazil and the other MERCOSUR members agreed to allow Argentina to maintain import tariff aliquots different from those of the CET until 31 December 2001. Although its impact cannot yet be accurately gauged, the agreement was the means whereby the members preserved the CET and, at the same time, gave Argentina temporary freedom to operate with different tariffs.

Following negotiations in the Common Market Council (CMC), MERCOSUR created a high-level technical group to review the CET (CMC Decision N° 5/01). The group agreed to reduce the CET by one percentage point as of January 2002, rather than the 2.5 points referred to in CMC Decision N° 67/00. The countries had already agreed to reduce the CET by half a point at the MERCOSUR Summit in Florianópolis in December 2000. Tariffs would thus remain 1.5 percentage points higher than in 1997, when Argentina proposed (and the other MERCOSUR members agreed to) a three percentage point increase in the import tariff aliquots. According to the negotiators, the CET remains fundamental to consolidating the customs union. This is why the CMC approved the creation of a technical group to analyze the consistency and spread of the current CET tariff structure, so as to adapt it better to the goals of integration.

The studies that form part of the MERCOSUR relaunch program were examined at the CMC meeting in Asunción in June 2001. The CMC agreed to modify the deadlines for some of the studies in the program, such as: (i) reform of the dispute settlement system; (ii) identification and elimination of barriers that affect intra-subregional trade; (iii) the creation of common disciplines for analyzing MERCOSUR anti-dumping processes and drawing up a proposal for the gradual elimination of anti-dumping measures and intra-zone countervailing duties; and (iv) the introduction of a MERCOSUR harmonized consumer price index (H-CPI), which will form part of the agenda of macroeconomic policy coordination.

In July 2001 the CMC approved the Framework Agreement on the Environment in MERCOSUR. The significance of the environmental issue in deepening the integration process, involving a view of sustainable development as a directive for exploiting the subregion's natural resources, led the negotiators to note the need for a specific juridical framework with a view to regulating actions on environmental protection and to facilitating cooperation between the member countries in this field

On 30 June 2000 Argentina and Brazil concluded negotiations on the common automotive policy, in force from 1 August 2000 to 31 December 2005. The agreement covers trade in automobiles, light commercial vehicles of up to 1.5 tonnes, chassis with engines, trailers, semi-trailers, bodywork, agricultural and road machinery, and automotive parts for production and for the spares market.

The bilateral trade in new vehicles will be tariff-free as long as trade remains balanced. Argentine-Brazilian trade will be monitored quarterly and measured on an overall basis – that is, for all the products covered in the agreement, assessed in US dollars. The agreement includes provision for the emergence of growing trade imbalances between the two countries as long as certain limits are respected: 3% in 2000, 5% in 2001, 7.5% in 2002 and 10% in 2003. The acceptable deficits for 2004 and 2005 will be fixed later. Tariffs will be imposed on imports that exceed the authorized deficit in line with the following rule: (i) 70% of the CET for all types of vehicles, and (ii) 75% of the CET for parts.

The agreement set the minimum regional content requirement (of parts) at 60% for the product to be tariff-free in bilateral transactions. New models manufactured in the subregion must have a minimum regional content of 40% in the first year, 50% in the second, and must submit to the general rule in the third. In the case of Argentina, light vehicles (automobiles and light commercial vehicles) will have 30% minimum regional content, while other types of vehicles will have 25% until 2005.

The CET for the automotive sector was fixed at the following levels:

Vehicles (automobiles, light commercial, buses and trucks)	35%;
Agricultural and road machinery	14%;
Vehicle parts	14%, 16% and 18%;
Parts for agricultural and road machinery	8%;
Parts for production, not manufactured in MERCOSUR and subject to periodic revision	2%.

Once the agreement was finalized, its implementation suffered serious obstacles because Brazil disagreed with the method used by Argentina to calculate the local content index. Brazil objected to parts of Argentine government Decree 660 (which regulates the agreement), notably the point on interpreting the "super-local content". According to the Brazilian authorities' interpretation, the 30% of local Argentine content should be calculated on the basis of the final cost of parts used in the vehicles, not part by part as defined by the Argentine decree. By adopting its own interpretation, Argentina increased the local content to 40%, and to 50% in some cases. The government increased the local content of vehicles made in Argentina in order to favor the local parts industry. However, the plants in the two countries claimed that parts manufacturers would not have the capacity to meet demand for local content of more than 30% and, if they did, the cost of vehicles produced in Argentina would rise significantly.

During the Florianópolis meeting in December 2000, the CMG adopted a new negotiating mandate so that the regime initially agreed between Argentina and Brazil could also include Paraguay and Uruguay. Completed in February 2001, the negotiations for the creation of the new common automotive regime confirmed the 35% tariff level for imports into Argentina and Brazil of passenger vehicles and light commercial vehicles from third countries.

Three months after the new MERCOSUR automotive regime was approved, Argentina demanded changes to the current automotive regime in order to modify the parameters fixed for the system of compensation trade in vehicles and parts with Brazil. Because of the recession in the domestic market and the low level of imports, Argentina exceeded the negotiated disequilibrium level and thus lost the opportunity to increase its exports to Brazil. By mid-year, Argentina's surplus in automotive trade had already exceeded the 30% of the total value of bilateral trade.

In practice, Argentina is seeking to modify the system of compensation trade and to bring forward the full liberalization of the automotive sector from January 2004 to January 2006. Brazil agrees in principle with this request as long as Argentina accepts other changes to the automotive regime, such as modification of the criteria for calculating the local content index.

Argentina also wants to reduce the CET for automobiles from 35% to 25%, and to eliminate the import tariff on trucks, tractors and agricultural machinery. The countries had until 6 July 2001 to propose adjustments to the regime. All these proposals should be examined by 1 September 2001. However, Brazil's decision to suspend the negotiations might compromise the original timetable.

Paraguay adhered to MERCOSUR's common automotive regime in July 2001. In line with the agreed rules, Paraguay's schedule for reducing imports of used cars (up to seven years old) lasts until 2006. The age of the imported vehicles will fall annually to three years in 2005. From the following year Paraguay will not be able to import used cars.

A 23% aliquot was set in the case of Uruguay. Since the Uruguayan automotive industry is based on the assembly of CKDs (Completely Knocked Down), the aliquot for the import of autoparts was fixed at 2%. The local content index for vehicles manufactured in Uruguay has been set at 50%, lower than the 60% negotiated for Argentina and Brazil – that is, tariff-free intra-subregional trade in automobiles is conditional on compliance with these regional content requirements. The tariff-free status of intra-subregional trade was also based on the operation of a monitoring system for bilateral trade balances that was negotiated between Argentina and Brazil in 2000. The level of disequilibrium allowed in bilateral trade in 2000 was increased from 5% to 10.5%. Trade that exceeds this value will be subject to an aliquot of 70% of the 35% CET.

A review of all non-tariff barriers on intra-subregional trade was carried out by the negotiators and discussed by the CMG in October 2000. Eighty-two measures that restrict intra-bloc trade were identified, most of them applied by Argentina and Brazil. These measures consist mainly of technical regulations, phytosanitary measures, fiscal and financial restrictions, judicial decisions, the operation of legal monopolies, countries' failure to transpose subregional norms, and administrative and customs procedures. The review aims to formalize a common proposal to restrict or eliminate the use of non-tariff barriers in intra-subregional trade. Argentina presented 28 cases in which measures adopted by its neighbors affected its sales to the subregional market. Of this total, 18 are measures imposed by Brazil. Brazil presented 17 cases, of which 12 originate in Argentina. Paraguay presented 31 cases and Uruguay 23.

The External Negotiating Agenda

In the last year, the economic downturn in the two largest MERCOSUR countries, especially Argentina, has increased dissatisfaction with subregional integration. The unilateral changes to the CET effected by Argentina, Paraguay and Uruguay for a broad range of products in the first half of 2001 weakened MERCOSUR as a customs union. The crisis has undermined the identity of the customs union, which in turn has damaged MERCOSUR's ability to sustain a strong and consistent negotiating position in the various initiatives of its external agenda. The fact that the integration process has become less operational has also revealed the willingness of some MERCOSUR countries to negotiate bilaterally with the United States.

The current stage of negotiations for the Free Trade Area of the Americas (FTAA), the recent acceleration of negotiations with the European Union (EU), and the prospect that a new multilateral trade round will be launched in Qatar in November 2001 make it all the more important that MERCOSUR's agenda give priority to enhancing coordination of the bloc's negotiation position in external negotiations, at least in the short term. The negotiations with Latin American countries and groupings (Chile, Mexico and the Andean Community) are also important in that regard.

The Sixth Meeting of Trade Ministers of the FTAA in Buenos Aires in April 2001 concluded the second stage of negotiations for hemispheric integration. At the meeting, the negotiating groups each presented the ministers with a summary of their chapters. On the eve of the Buenos Aires Ministerial there seemed to be a significant risk that that the FTAA negotiations were going to become deadlocked, and hence the outcome of the meeting was relatively positive. This was reflected in the Final Declaration, which addressed the different interests at stake and lessened the number of disagreements that threatened to paralyze the process.

The Buenos Aires Ministerial Declaration reaffirmed the principles behind the FTAA negotiations, such as the single undertaking and the coexistence of bilateral and subregional agreements. It also confirmed that the negotiations would end in 2005. It was further agreed that the negotiating groups dealing with market access issues should define the methodology of the tariff negotiations by1 April 2002. This should enable the market access negotiations to begin on 15 May 2002 with the establishment of a tariff reduction schedule.

The FTAA talks are making gradual and continuous progress on setting up a hemispheric free trade area. Many issues remain to be resolved, however, such as the extent of the commitments, issues and disciplines, agreement on asymmetries, and the implementation calendar. It is thus not clear whether the convergence of interests between the negotiating parties will continue as it has done hereto. If the talks fail to make satisfactory progress, the United States might resort to bilateral agreements with Latin American countries. The fact that the US administration has yet to secure Trade Promotion Authority (TPA) gives force to the bilateral alternative. In this context MERCOSUR reactivated the Rose Garden Agreement, signed with the United States in June 1991, in order to examine the possibility of initiating bilateral talks on a 4+1 basis.

The MERCOSUR-EU talks began in April 2000 but little (and only preliminary) progress has been made in the four rounds so far. The negotiations gained new momentum in March 2001 following the agreement that talks on tariffs and services would begin as soon as possible after 1 July 2001. In July 2001 the EU presented an offer on tariffs, as well as negotiating texts on trade in goods, services and public procurement.

In that round, MERCOSUR and the EU reached a consensus on various issues relevant to the negotiations on tariffs and non-tariff measures. Many disagreements nonetheless persist, such as the conditioning of the EU's offer on standstill and rollback clauses, and the reciprocity of concessions granted by MERCOSUR. With regard to the tariff reduction timetable, the EU is proposing four categories of across the board tariff cuts (immediate, four years, seven years and ten years), and another category whose reduction schedule is yet to be defined. Some products were excluded from the offer, but these are subject to the concession of tariff quotas or to specific negotiations.

The EU's tariff offer to MERCOSUR is relatively modest, especially on market access for agricultural products and processed agricultural goods. The main problems in the EU's offer on agricultural goods are: (i) the exclusion from the offer of agricultural products and processed agricultural goods that are important to MERCOSUR exports; (ii) the distinction between the treatment given to *ad valorem* tariffs and specific duties; reductions are limited to the former, which are less important than the latter as a protection mechanism for European agricultural and agro-industrial production; (iii) the introduction of a product category for which tariffs will be reduced but for which there are no clear rules governing the cuts; and (iv) the continued use of an entry price mechanism, even when products have reduced *ad valorem* tariffs.

With respect to the LAIA negotiations, since MERCOSUR adopted the common external tariff in January 1995 it has been necessary to renegotiate *en bloc* the old bilateral agreements signed by the countries, with a view to establishing a common policy on tariff preferences. After 30 June 2001 talks on a free trade agreement between MERCOSUR and the Andean Community (CAN) returned to a "4+4" format, and should be completed by 31 December 2001. Brazil sought to speed up the bilateral talks in an effort to ensure access to markets in which Mexico has benefits. MERCOSUR and the CAN resumed bloc-to-bloc negotiations in April 2001 to set a timetable for presenting proposals on a free trade agreement. The trade liberalization program proposed by the MERCOSUR countries envisages the creation of a free trade area in 10 years through progressive and automatic tariff reductions applicable to tariffs in force at the time the agreement is signed.

The "4+1" negotiations between MERCOSUR and Mexico resumed in 1998, making viable the preferential agreements signed with Paraguay, Argentina and Uruguay in the LAIA framework. Negotiations for a trade agreement between Brazil and Mexico had been under way for almost two years when the deadline expired (30 June 2001) for the MERCOSUR member countries to sign separate bilateral agreements. The divergence of interests made it difficult to conclude a bilateral accord, despite the new Mexican government's willingness to negotiate with Brazil and then with MERCOSUR. The dialogue resumed in February 2001 and it is expected that in the coming months the discussions in the automotive sector will be expanded to the "4+1" format. At present, negotiations on a Mexico-MERCOSUR preferential trade agreement are at a standstill and should only resume in 2002 because of commitment to other negotiations on MERCOSUR's external agenda.

Chile's accession to the Treaty of Asunción was again among the main items on the subregion's external agenda in the context of MERCOSUR's relaunch in June 2000. In November 2000, however, Chile announced that it would start free trade negotiations with the United States, thereby practically paralyzing the MERCOSUR-Chile talks. In addition to MERCOSUR's reticence about the tariff preference negotiations between Chile and the United States, the current constraints on closer bilateral relations remain significant, especially as regards the two sides' tariff policies. Although a new deadline has not been set for concluding talks on Chile's accession to MERCOSUR, both parties have a key interest in ensuring that the negotiations move in that direction, and that the right conditions are created for macroeconomic convergence and for deepening the existing bilateral free trade agreement.

Integration and the Development of Physical Infrastructure

Since MERCOSUR was founded the member countries have seen a significant increase in intra-zone trade, mainly because of the elimination of tariff and non-tariff barriers. It is worth noting, however, that although trade integration between the MERCOSUR countries has made significant progress in the last 10 years, trade and investment flows with the other South American countries are still relatively modest. A recent IDB document suggests that the low economic dynamism of the South American countries stems partly from the physical barriers to greater integration between the different national markets.

The fact that MERCOSUR participates in various trade liberalization initiatives in the continent underlines the need to develop the subregion's comparative advantages by combining the bloc's competitive strengths with those of the other countries of South America. This would not only help foster economic links between the MERCOSUR countries, but also between the latter and the other South American countries, which would enhance the subregion's competitive insertion. In this context the development and integration of MERCOSUR's physical infrastructure with that of the other countries of the continent, in conjunction with the elimination of existing bottlenecks in transport, telecommunications and electricity infrastructure in the various countries, are factors of crucial importance. The South American governments should consider them when they devise and implement future integration initiatives and, therefore, when they formulate national public policies.

Isolated efforts, however, are insufficient in themselves. Various analyses by international organizations and specialists suggest that the development and integration of physical infrastructure in MERCOSUR, and in South America as a whole, requires a concerted inter-governmental effort, which in turn entails identifying joint activities on the basis of a strategy that clearly defines how to cooperate and plan regionally for the purposes of exploiting a continental infrastructure network. In this regard it is imperative to seek joint solutions that can create and maintain channels of integration between the continent's economies. This can de done by means of mechanisms that help identify the region's main economic corridors, and that allow investment projects in infrastructure to be conducted in such way that these corridors are fostered as real hubs of economic development.

The importance of integrating and developing physical infrastructure for the purposes of creating an enlarged economic area in South America was highlighted by the leaders of the subregion in the Brasilia Declaration of September 2000. On that occasion the presidents deemed it a priority to identify public works of bilateral and subregional interest, and they underlined the need to appeal to sources of finance in the public and private sectors, as well as among multilateral financial institutions. The latter include the Inter-American Development Bank (IDB), the Andean Finance Corporation (CAF), the Financial Fund for the Development of the River Plate Basin (FONPLATA) and the World Bank. They also recognized the importance of the IDB initiative to draw up what later became the "Action Plan for the Integration of Regional Infrastructure in South America". This makes proposals for broadening and modernizing the region's infrastructure over ten years, especially in the areas of energy, transport and telecommunications, with the aim of establishing integration and development hubs in the region.

In the field of transport, priority was given to creating multi-modal networks to provide improved linkages between land, river, maritime and air transport. In the energy sector, integration and complementarity in the use of existing resources, especially in the areas of natural gas and electricity, will be a core element of closer links between the countries of the region; on that basis the barriers raised by current restrictions and regulations in the sector will be eliminated, and the commitment to environmental protection will be met. As regards the development of the telecommunications sector, stress was placed on the importance of establishing logistical systems and of attending to society's growing demand for information. In parallel, the presidents reaffirmed their pledge to give political priority to national, bilateral or subregional initiatives that are now being implemented.

CHAPTER I. IMPASSE IN MERCOSUR

In the last three years the MERCOSUR integration process has experienced its most serious crisis. The changes to Brazil's exchange rate in January 1999 and the deterioration of the Argentine economy in the first half of 2001 raised serious obstacles to the implementation of MERCOSUR's relaunch agenda and cast doubt on the long-term sustainability of integration. The outlook involves a complex interplay between the lack of macroeconomic convergence, difficulties in attaining microeconomic policy harmonization, and institutional weakness.

The deterioration in international conditions exacerbated the crisis. The subregion was affected by the Brazilian devaluation and the Argentine recession, while several other negative factors harmed the performance of all the members: the concentration of the international supply of credit; the simultaneous contraction of economic activity in the other Latin American countries; the fall in international commodities prices; and the slowdown in world trade.

Two years after the onset of the crisis, macroeconomic conditions in the subregion are weak, mainly because of the poor state of the Argentine economy, the acceleration of the Brazilian devaluations, and the economic stagnation of the smaller countries. Despite government claims that MERCOSUR should continue to take the lead in its members' international insertion strategies, the truth is that the integration process is becoming less operational. It is clear that the current crisis is far from over. It is also important to note that MERCOSUR's enormous difficulties stem not only from changes to the conditions of competition brought on by the devaluation of the Brazilian currency, nor from the economic situation in Argentina. A variety of more significant questions and impasses have come into play to threaten the future of the integration project. These factors should be examined carefully.

A. Political and Economic Questions

The impasse clearly has a political dimension that can be defined in simple terms: for Brazil and Argentina, MERCOSUR is not the only possible strategy for putting their economies on the world stage. As long as MERCOSUR is perceived as a genuine "state policy", both countries will continue to consider alternative (not necessarily coincident), options and strategies. At times of crisis these alternatives obviously become clearer and more concrete. It would, however, be naïve to believe that the alternatives arise merely from conjunctural differences of opinion. On the contrary, the emergence of alternatives to the subregional integration project is the consequence of more permanent structural factors, such as a country's size, the nature of its productive structure and, ultimately, its history (García Peluffo [2000]).

BRAZIL

Brazil has at least two relatively concrete alternatives: first, autonomous insertion in the international economy (more skeptical observers have dubbed this option the "lonely runner" strategy); and second, to promote a strategic alliance with its neighbors with the aim of consolidating its leadership in the region and ensuring a greater role on the world stage. The latter is conditional on the following factors: (i) this leadership should take account of an area larger than MERCOSUR, preferably including all of South America; (ii) the costs of exercising this leadership should be low; and (iii) Brazil should preserve a reasonable degree of foreign policy autonomy.

The option of autonomous insertion reflects a vision of the national interest that has always been present in the country's foreign policy objectives. In short, Brazil has always believed that the size of its population, the vastness of its territory, the complexity of its industrial structure and the scale of its gross domestic product (GDP) give it the right to play a leading role on the world stage, albeit as a "lonely runner". This is not wholly presumptuous for the world's ninth largest economy (World Bank [2000]), which has the kind of highly diversified trade relations that make it a true global trader. Hence Brazil, together with India, Russia and Indonesia, is defined as a "pivot" country – a regional power with its own specific weight on the world stage.

The strategy of promoting Brazil's leadership in South America should also be viewed as an alternative to subregional integration. MERCOSUR can (and should) be consistent with this process, but it clearly entails different challenges and actions. This alternative implies that MERCOSUR is a necessary but insufficient mechanism, since without the participation of the other South American countries the incentives to deepen subregional integration are weak. Hence this is not a matter of an incremental foreign policy strategy centered on a "hard core" that advances on the basis of concentric circles. The outer circle determines the inner one, not *vice-versa*. This is why there is little motivation to consolidate this core and why there is a preference to exercise a more informal leadership with low costs and few rules or institutions. It is also evident that Brazil would prefer to introduce policies to enlarge rather than deepen the customs union.

The factors that will condition this second alternative can easily be gauged from the figures below:

BRAZIL'S RELATIVE POSITION IN SOUTH AMERICA

South American countries	Population		Area		GDP		GDP (PPP)		GDP per capita (PPP)	
	(10^6 pop.)	Index	(10^3 Km^2)	Index	(US\$ 10^9)	Index	(US\$ 10^9)	Index	(US$)	Index
BRAZIL	**165.9**	**100**	**8,547**	**100**	**767.6**	**100**	**1,070**	**100**	**6,460**	**100**
Rest of MERCOSUR (A)	*44.6*	*27*	*3,364*	*39*	*319.5*	*42*	*475*	*44*	*10,628*	*164*
Argentina	36.1	22	2,780	32	290.3	38	424	40	11,728	182
Uruguay	3.3	2	177	2	20.0	3	28	3	8,541	132
Paraguay	5.2	3	407	5	9.2	1	23	2	4,312	67
MERCOSUR Associates (B)	*22.7*	*14*	*1,856*	*22*	*81.9*	*11*	*144*	*14*	*6,314*	*98*
Chile	14.8	9	757	9	73.9	10	126	12	8,507	132
Bolivia	7.9	5	1,099	13	8.0	1	18	2	2,205	34
Andean Community (C)	*101.0*	*61*	*3,620*	*42*	*261.7*	*34*	*513*	*48*	*5,067*	*78*
Colombia	40.8	25	1,139	13	100.7	13	239	22	5,861	91
Venezuela	23.2	14	912	11	82.1	11	133	12	5,706	88
Peru	24.8	15	1,285	15	60.5	8	104	10	4,180	65
Ecuador	12.2	7	284	3	18.4	2	37	4	3,003	47
Subtotal (A+B+C)	**168.3**	**101**	**8,840**	**103**	**663.1**	**86**	**1,132**	**106**	**6,709**	**104**

Note: 1998 data.
Source: *World Development Indicators* (World Bank [2000]).

In aggregate terms, for example, Brazil's MERCOSUR partners have the equivalent of barely 27% of its territory, 39% of its population and 44% of its GDP; they also account for just 16% of Brazilian trade. From Brazil's viewpoint these asymmetries are an undeniable barrier to deepening subregional integration, particularly in those issues that might constrain the country's sovereignty.

The inclusion of the other South American countries in this comparison alters the picture, but Brazil's weight is still equal to that of the nine countries as a whole. Brazil's trade with the CAN and with MERCOSUR's associate members is relatively modest: South America's total share of Brazilian trade is slightly above 22%.

Brazil's reluctance to incur the costs of a more formal leadership role, either in MERCOSUR or in the broader context of South America as a whole, can be better understood by comparing per capita GDP: Brazil's is much lower than that of Argentina, Uruguay and Chile, and not much higher than that of Colombia and Venezuela. In this respect Brazil surpasses only Bolivia, Ecuador, Peru and Paraguay. Its income distribution, however, is worse than some of these latter countries.

The fact that Brazil's foreign policy simultaneously contemplates alternative strategies for insertion in the world economy is rooted in the ill-defined and ambiguous nature of the country's economic and trade relations with its MERCOSUR partners. Of particular note is Brazil's unilateralism, reflected in the fact that its economic policy instruments rarely take account of the impact of its domestic policy on the economies of its subregional partners. Brazil's natural leadership of the bloc thus rests on the assumption that the other partners should passively adapt their policies to Brazilian activism (Lavagna [1999]). Hence there is no clear perception of the limits to be respected when exercising such leadership – that it be neither hegemonic nor the consequence of coercion. Otherwise it risks becoming incompatible with the promotion of a strategic alliance (Hirst [2000]).

Another factor is the lack of a community vision, defined as a genuine concern that MERCOSUR will effectively contribute to the industrial development of the other subregional partners. This concern was evident in the stage prior to MERCOSUR's formal founding (1985-1990), but it subsided in the 1990s. The explicit aim behind the negotiation of the first bilateral agreements between Brazil and Argentina was undoubtedly to promote intra-industrial specialization and complementarity in the context of reasonably balanced and symmetrical trade. The idea was to avoid inter-industrial specialization between the countries. For Argentina this was the only acceptable basis for an integration agreement with Brazil, since both the government and the business sector rejected any project that would make the country a mere supplier of agricultural raw materials or industrial commodities.[1]

The notion that the country's subregional partners could specialize in the production of primary products with low value added, and that they could be markets for Brazil's industrial output, is still present in many of Brazil's attitudes. Lavagna [1999] notes that Argentina has no interest in such a proposal, since if Argentina chose to pursue insertion in the world economy solely on the basis of exploiting its static advantages its target would be not only the Brazilian market but the world.

Motta Veiga [1999b] notes that one of the ideas behind Brazilian foreign policy is the development of national industry. This is why Brazil does not support integration based on liberal policies. He argues, however, that Brazil is also reluctant to support integration based on policies that promote the industrial development of the subregion as a whole, since its own industrialization strategy is exclusively national and not community-based. This explains its aggressively competitive stance in the area of policies to attract foreign investment; its lack of interest in the idea of a regional bank to finance development projects in MERCOSUR; its opposition to the establishment of *maquilas* in Paraguay; and its position on the crisis in the first half of 1999, when it refused to negotiate with Argentina any type of formal measure, even temporary, to soften the effects of the sharp change in competitive conditions after the devaluation of the real.

In short, unilateralism, the lack of a community vision and an unwillingness to incur the costs of exercising leadership reflects Brazil's continued refusal to view MERCOSUR as the definitive option.

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1 Campbell, *et al* [1999] highlight the principles behind these agreements: *"...from the start it was agreed that the integration process would advance on the basis of integrated, selected and multi-speed projects. This would generate industrial and trade complementarity in different productive segments and minimize the destructive effects on one of the two economies, and promote specialization in both of them in specific niches or lines of production within the same sector of activity. The aim was not only to improve productive performance in the two economies (based on intra-regional complementarity and the exploitation of economies of scale), but also to promote a balanced expansion in bilateral trade in the context of strong external financial restrictions* (pp. 82-83).

ARGENTINA

Argentina, like Brazil, also views autonomous insertion in the world economy as an alternative strategy. In this case the strategy is similar to that adopted by Chile, whose much narrower industrial base is three or four times smaller than Argentina's: (i) to reduce import costs; (ii) to promote specialization in a small group of sectors; (iii) to explore market niches that are intensive in skilled labor; (iv) to sign free trade agreements with as many partners as possible; and (v) to maintain preferential access to the Brazilian market in order to boost the country's attractiveness and increase foreign direct investment.

If Brazil's strategy of autonomous insertion can be called into question for being overly confident of the country's real prospects, Argentina's can be accused of the opposite: the country underestimates the potential of its economy, casting doubt on its capacity to ensure equilibrium in its external accounts and to promote full employment (Lavagna [1999]).

A Chilean-style strategy has been debated frequently in Argentina, and has gained momentum each time a conflict arises with Brazil. This is precisely what happened in 1993, when the bilateral trade balance was significantly in Brazil's favor and the negotiations on a common external tariff were showing little sign of progress, mainly because of protectionist demands from several of Brazil's industrial sectors. The issue resurfaced in 1995 when Brazil set up its own automotive regime. This was in line with the system in force in Argentina since the start of the decade but was incompatible with the rules of the recent Treaty of Ouro Preto. Soon afterwards Brazil granted fiscal incentives to foreign assembly firms that relocated to the north-east of the country, again re-igniting the debate on Brazil's lack of trustworthiness and the advantages of reforming the integration process. Since mid-1998, when the scale of the Brazilian crisis became evident, the idea of transforming MERCOSUR into a mere free trade area has been discussed openly in Argentina. Scaling down the subregional integration project would enable Argentina to regain control of its trade policy, to promote a new round of tariff reductions, to sign trade agreements with new partners and, in short, to opt for a strategy similar to Chile's.

From a political standpoint this alternative would mean formalizing Argentina's triangular relationship with the United States and Brazil: the former as the main political ally and the latter as the leading market.[2]

By considering an alternative strategy to MERCOSUR, Argentina has exacerbated the conflicts and irritated Brazil. But this irritation has been caused more by the political urgency of the alternative Argentine project than by the country's "split personality" on economic matters. In fact, the strategic dependence of one partner on an extra-South American power is more threatening to Brazil than a weakening of its preferences in the Argentine market. Hence the proposal to downgrade MERCOSUR to a free trade area has also been advocated by some sectors of Brazilian public opinion. Even more controversial was Argentina's decision to negotiate its extra-NATO ally status without prior consultation and, at the same time, its refusal to support Brazil's aspiration to a permanent seat on the UN Security Council.

The change of government in Argentina in 1999 raised Brazilian expectations that the new administration would modify the country's alignment with the United States. The new administration, however, made only modest changes to Argentine foreign policy. The country's financial weakness and its high

[2] This strategy was recently explained by Escude [1998] in the following terms: *"The alliance with the United States has three functions: to eliminate the obstacles to Argentina's development caused by futile political conflicts over decades; to dissuade the potential 'adventurism' of some Chilean military sectors, without having to waste resources on purchasing weapons, and to limit Brazil's expectations, once the Argentine-US alliance clearly shows that Argentina is unwilling to confront the United States with Third World utopias disassociated from the immediate interests of the MERCOSUR countries. In turn, the alliance with Brazil also has three objectives: to promote deep subregional economic integration, which is essential for Argentina's economic development; to place limits on the alliance with the United States, showing clearly that Argentina will not tolerate any attempt by the United States to intervene in Brazil's internal matters (for example, with the argument that Argentina will promote the defense of the Amazon's ecological system); and, again, to dissuade the potential 'adventurism' of certain Chilean military sectors.*

dependence on international capital markets have undoubtedly reduced its bargaining leverage. Despite some disquiet, Argentina seems likely to continue to pursue a bandwagoning policy with regard to the United States (Tokatlián [2000]).

PARAGUAY AND URUGUAY

For the purposes of their international insertion, Paraguay and Uruguay lack clear economic alternatives to the MERCOSUR project. The bloc's consolidation is therefore a priority of both countries' foreign policies. The relationship with the larger members is more than a simple option, since it is an "inevitable" step in the process of projecting their economies on the world stage (Bizzozero and Abreu [2000]).

However, there have been an increasing number of conflicts involving the smaller MERCOSUR members. These tensions largely reflect Paraguay's and Uruguay's discomfort with the principle of reciprocity that regulates the four members' participation in MERCOSUR. Having signed the Treaty of Asunción, the smaller countries had to formally renounce the principle of differentiated treatment as the fundamental basis for the integration process. They also had to accept the model of negotiations embodied in the agreements previously signed by Argentina and Brazil, which was based on the reciprocity of rights and duties. By way of compensation, Paraguay and Uruguay benefited from equal status in MERCOSUR's decision-making and administrative bodies, and from the use of consensus (rather than a system based on qualified voting) as the criterion for decision-making. In practice, therefore, the smaller members have used their veto power in the decision-making sphere to guarantee specific or temporary differentiated treatment and to limit the recurrent unilateralism of the larger members. In short, many of the tensions involving Paraguay and Uruguay have been caused by the negotiating process. The fact that these conflicts have recurred is to some extent natural and inevitable, given the lack of a permanent system to guarantee more favorable treatment for the relatively less developed economies.

The intensification of some recent conflicts has been caused by factors more directly associated with the crisis in MERCOSUR. The decline in intra-subregional trade has had a particularly sharp impact on the smaller partners, particularly because Argentina and Brazil have increasingly imposed non-tariff barriers on their exports. This situation has been exacerbated by the changes to the conditions of intra-bloc competitiveness brought on by the persistent devaluation of the Brazilian currency. The smaller countries' disquiet has become increasingly explicit and, therefore, worrying.

B. Legal and Institutional Questions

MERCOSUR suffers from a juridical and institutional deficit. There is consensus, and little controversy, about this. However, there is profound disagreement about the problem's relevance, its impact on the future of MERCOSUR, which partners would benefit and which would suffer, and what solutions should be sought. It is therefore useful briefly to examine these questions.

There are three main problems: (i) the norms approved by MERCOSUR institutions cannot be defined as community law in the strict sense, but only as international law in the classical sense. They must therefore be transposed into national law through procedures established by the constitutional or legal norms in force in each member country; (ii) MERCOSUR lacks an efficient dispute settlement mechanism and a juridical body with the capacity to interpret and apply the agreements; and (iii) the bodies created by MERCOSUR are all inter-governmental and are therefore by nature political. Hence political and technical issues are both negotiated in a similar manner, with the former obviously influencing settlement of the latter (Redrado [1999]).

As regards MERCOSUR's juridical status in the member countries, it is worth noting the sharp asymmetries between the partners. Argentina, for example, recognizes international treaties as superior to national laws and even constitutional norms.[3] Paraguay also recognizes a supra-national juridical order, albeit in a more restricted form, since international norms are subject to approval by the Supreme Court (Jimenez [1997]). There is greater uncertainty about the juridical status of integration law in Brazil and Uruguay, since in these two countries "*international treaties do not prevail over the constitution, nor over infra-constitutional internal law, nor are they equal to national law and can be modified by it*" (Abreu Dallari [1997]). In concrete terms, this means that a national law approved by the Brazilian or Uruguayan legislatures can at any point overturn what was agreed in the Treaty of Asunción.

In 1995 there was an attempt in Brazil to introduce a constitutional measure similar to that in Argentina, but the proposal was overwhelmingly defeated in Congress.[4] The political consequences of this are undeniable, since it illustrates Brazil's resistance to proposals that limit its sovereignty. It is unsurprising that Argentine observers believe that the current situation makes it difficult to apply the reciprocity of rights and duties enshrined in the Treaty of Asunción (De la Balze [2000]).

Because of the need to transpose norms into the national legal systems of the member countries, the decisions adopted by MERCOSUR institutions do not have immediate legal force. This prompts asymmetrical or confused situations when a norm is transposed in one country but not in another. The process of transposing norms is also extremely slow and depends solely on the good will of the member countries.[5] For this reason the weakness of MERCOSUR's legal order has been ascribed to the fact that the member states have intentionally chosen not to subject themselves to rigid legal obligations that might limit their maneuvering room (Gonzalez [1999]).

With respect to the dispute settlement system, MERCOSUR introduced reasonably complex procedures in which conflicts are initially examined by the inter-governmental institutions and, if no agreement is reached, are submitted to an *ad hoc* Court of Arbitration. The member states thus avoided the need to create a supranational Court of Justice or a permanent Court of Arbitration.

This system has been heavily criticized. First, several analysts claim the system discourages the use of formal mechanisms and encourages political solutions to conflicts, since disputes must previously be examined by inter-governmental bodies. The resolution of trade conflicts via diplomacy has a negative impact, since all disputes come to be deemed vital to the continuation of the subregional project (Redrado [2000]). Second, the *ad hoc* nature of the Court of Arbitration runs counter to the development of a jurisprudence, since the turnover of its membership eliminates the moral force of its own precedents (Gonzalez [1999]). Third, since the court is not permanent there is no juridical institution that can interpret and apply the agreements or respond to consultations.

The members have discussed the creation of a permanent court for at least two years but this has been resisted, especially by Brazil. Paradoxically, the MERCOSUR members unquestioningly accept the World Trade Organization's (WTO) dispute settlement system, which regulates trade relations with other partners, but they refuse to introduce a similar mechanism to resolve their own disputes despite sharing a common project (Torrent [2000]).

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3 The principle was enshrined in the 1994 constitutional reform (Art. 75 of the present Constitution).

4 The proposal presented by a deputy from Rio Grande del Sul needed 293 votes in favor, but was defeated. It received 168 votes in favor, 144 against and 7 abstentions (Abreu Dallari [1997]).

5 Between 1995 and 1998, the Common Market Group (CMG) issued 280 resolutions, but by the end of 1998 only 88 had been effectively transposed by the four countries (Redrado [1999]).

According to specialists in this field, one of the most serious problems is the essentially political nature of MERCOSUR's institutions and the absence of permanent technical bodies. MERCOSUR institutions consist of officials (who are not necessarily permanent) appointed by their governments. These act on instructions from their superiors, since naturally the hierarchy that exists in the areas of government to which they belong is preserved. Interaction in the decision-making bodies occurs *a posteriori*, after each country has decided what is in its national interest. Each government therefore arrives at the negotiating table to defend its particular interest, which can be incompatible with those of the customs union (Gonzalez [1999]). This affects the strategic vision, since there is no one to defend the common (that is, MERCOSUR) interest. Independent technical institutions should be set up, comprising officials of MERCOSUR and not the member states, whose sole function is to promote policies geared to completing the customs union. Naturally these institutions would only make proposals, but they would be of crucial importance.

The legal and institutional deficit is cause for concern since it spurs conflicts, exacerbates uncertainty and delays the resolution of problems. Paraguay, Uruguay and even Argentina argue that the current juridical-institutional framework undermines investor confidence in the countries where they place their resources. This situation favors the largest market, Brazil. The lack of norms or the predominance of "lax" norms also tends to favor Brazil, because it has greater capacity to impose or postpone the resolution of conflicts.

The Brazilians, however, criticize the existing system of consensus-based decisions since it encourages the fiction that the partners are equal and thus gives the smaller countries too much power (Baptista [1999]).[6] Brazil nevertheless refuses to discuss any proposal that would introduce qualified majority voting, because this would raise the thorny and supposedly insoluble question of how to distribute voting power among the member states. In fact, given MERCOSUR's current membership (just four members) and the size asymmetries among its members, it is difficult to discern a system for distributing voting power that would be acceptable to Brazil and that would also preserve the political identity of the other members.

Despite these observations, it is clear that there is room for modifying aspects of MERCOSUR's current institutional and legal framework. Of particular note among the suggestions already made are: (i) creating technical committees; (ii) establishing a more independent Court of Arbitration with a greater stability of membership, or a juridical body to interpret agreements, respond to consultations and guide the national courts in applying the law stemming from MERCOSUR norms; (iii) setting deadlines or introducing fast track procedures for transposing norms into national legislation; and (iv) setting up a common body to safeguard competition.

These changes, and many others that have been suggested, could be implemented relatively fast and would greatly improve the quality of MERCOSUR's institutions. Most of these do not even touch on the question of supra-nationality, but little emphasis has been placed on the institutional debate.

It is hard to believe that MERCOSUR will be able to make progress unless its institutions are strengthened, but initiatives to this effect will not prosper unless the members embrace an effective strategic commitment to the integration process. Hence MERCOSUR's institutional deficit might not be the main cause of the impasse but one of its most revealing symptoms.

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6 It should be noted that consensus is not synonymous with unanimity. Consensus allows abstentions but not negative votes.

CHAPTER II. MACREOECONOMIC TRENDS

A. The International Environment

Despite the Asian crisis, the Russian moratorium and the recurrent episodes of instability in emerging markets, the world economy expanded significantly in the second half of the 1990s. Between 1996 and 2000 world output rose by 3.8% a year, and at a faster rate towards the end of that period. In 2000 it grew by 4.8%, while the volume of world trade expanded by an impressive 13.4%, more than double the 1999 rate.

The vigorous growth of the US economy was undoubtedly what drove the accelerated expansion of the world economy in this period. In the 1996-1999 period US output increased by a constant 4.3% a year, and by 5% towards the end of the decade. Since mid-2000, however, there have been numerous warnings of a slowdown in the US economy. In the first half of this year real US output increased by an annualized 5.3%, far higher than any optimistic estimate of potential GDP growth. On the other hand excessive family indebtedness and the persistent appreciation of the dollar contributed to a worrying increase in the current account deficit (over than 4% of GDP). The risk of inflation was undeniable and there were increased fears of a collapse in investor confidence in the rest of the world, thereby threatening investment flows that finance the increasing external imbalance of the US economy. In these circumstances the Federal Reserve opted for three increases in short-term interest rates in an effort to cool economic growth. Growth fell suddenly and GDP increased by less than an annualized 2% in the last two quarters of the year.

The reversal in US activity was sharper and deeper than anticipated. The coincidence of a series of shocks, especially the increase in oil prices and lower profit expectations in the high technology sectors, undermined consumer and business confidence, thereby weakening demand. The index of industrial production fell continuously between October 2000 and July 2001, the longest run of negative rates since 1982.

The changed outlook prompted a radical shift in US monetary policy, and between January and August 2001 the Federal Reserve made seven successive cuts in short-term interest rates. Lower oil prices (which had been falling since the end of 2000) and favorable inflation rates enabled the Federal Reserve to reduce interest rates quickly, from 6.5% to 3.5% in only eight months.

Despite the looser monetary policy there is still little sign of a recovery, although data on family consumption and housing construction point to a modest rebound. Various indicators on future economic activity also suggest that the economy has been recovering since July. However, manufacturing output and the stock market are still falling, while idle capacity in important industrial sectors is increasing.

Despite this mixed picture, growth forecasts for the US economy in 2001 have not been revised in the last five months. Most forecasters continue to project GDP growth of 1.5%-1.7%, similar to the baseline scenarios issued by the multilateral organizations in March and April 2001. Paradoxically, the forecasts for world output and trade have changed significantly in recent months. Current 2001 estimates for these two indicators are much more pessimistic, and are in line with an outlook that was based until recently on the assumption that the US recession would be much more severe.

Prospects for the world economy have been revised downward because of the disappointing performance in other industrialized countries, mainly the European Union and Japan, and because of the unexpected fall in the growth rates of important emerging countries, such as Mexico, Brazil, Argentina and Singapore.

In 2000 the EU posted its best performance of the decade, with GDP expanding by some 3.4%. Forecasts suggested that output in the euro zone would fall in 2001 because of two likely effects of the US downturn on the EU economy: (i) the slowdown in world trade; and (ii) lower profits in an important sector of EU firms with US subsidiaries. However, it was believed that GDP would not fall by more than 1%, to 2.4%-2.7%, since more than 60% of EU trade is intra-bloc and therefore the member countries are less exposed than other regions to fluctuations in world commerce. It was also thought that high domestic consumer levels would remain stable because of increases in real wages, low inflation and planned tax cuts.

The first half results for 2001, however, do not support these forecasts. Growth in Germany, Italy and the Netherlands was either zero or negative in the second quarter of the year, and German GDP registered an accumulated 12 month variation of only 1%. Unlike the Federal Reserve, the European Central Bank has been cautious, and even excessively conservative, in reducing interest rates only once from 4.75% to 4.5%. Estimates for 2001 have therefore been revised more than once, and the EU's real GDP is currently forecast to increase between 1.7% (JP Morgan) and 2% (IMF).

Growth forecasts for Japan and the emerging economies, notably those in Latin America, have been revised even more drastically. The Japanese economy has been marked by high company and government indebtedness, the fragility of the financial system, and a worrying increase in unemployment. In contrast to Europe, the fall in US external demand has had an inevitable impact on Japan because of the substantial bilateral trade ties. Another significant aspect of these forecasts is the expected contraction of information technology companies, which should also negatively affect other Asian economies. The decline in economic output is proving more severe than anticipated. Earlier forecasts for 2001 pointed to a slight increase in Japanese GDP, but these have been revised to a negative variation of between -0.2% (IMF) and -0.6% (JP Morgan and ING Barings).

Finally, forecasts for the main emerging economies of Latin America have also been revised downwards. In this case the changes have been dramatic. Until May both ECLAC and the IMF were forecasting growth of 3.8% for the region, while the latest projections point to an increase of around 1.8% (ECLAC).

PROSPECTS FOR THE WORLD ECONOMY

Variation Rates (%)

	Estimate		Projected	
	1999	2000	2001 May	2001 August (1)
World output	*3.5*	*4.8*	*3.2*	*2.8*
Advanced economies	3.4	4.1	1.9	
United States	4.2	5.0	1.5	1.5
European Union	2.6	3.4	2.4	2.0
Japan	0.8	1.7	0.6	-0.2
Asian NICs	7.9	8.2	3.8	---
Developing countries	3.8	5.8	5.0	---
Western Hemisphere	0.2	4.1	3.7	1.8
Volume of World Trade	*5.6*	*13.4*	*6.7*	*4.0*
Commodities				
Oil	37.5	56.9	-9.6	---
Non-oil	-7.1	1.8	0.5	---
Libor (in %)	*5.5*	*6.7*	*4.5*	---

Notes: (1) Preliminary IMF and ELAC data (August, 2001).

Source: IMF [2001].

Mexico grew by an exceptional 6.9% in 2000, and both its exports and imports expanded dramatically (20% relative to 1999). Since 87% of Mexican exports go to the US market it was obvious that such GDP growth was unsustainable. The overvaluation of the peso and the overheating of the economy also pointed to an inevitable slowdown in domestic activity. Initial ECLAC forecasts suggested that the GDP growth in 2001 would be less than half that of 2000 and that trade growth would slow significantly. However, the results for the first half of 2001 – zero growth relative to the same period of 2000 – show an even more modest increase in GDP of under 1%. The region's poor economic performance has also been affected by the worsening of the Argentine crisis and by Brazil's significantly lower growth expectations economy. (See Section C).

In short, current perspectives for the world economy are rather pessimistic. The virtuous circle evident during much of the 1990s, characterized by sustained productivity increases, high investment in technology, easy access to foreign financing and rising stock markets, has been reversed. Although there are still no signs of a hard landing for the US economy, the downturn in US output appears to have led to a reduction in world output, accompanied by a sharp fall in trade flows. If trade expands by 3%-4%, in line with current forecasts, world trade will have virtually stagnated. If this occurs, commodity prices are unlikely to rise. This will have a severe impact on developing countries.

The only positive aspect of the current international situation worth highlighting is the low inflation apparent in most regions of the world. Given that present conditions stem from a contraction of output caused by a demand shock, there is room for implementing active monetary policies such as those adopted by the US monetary authorities. The growth of domestic demand in countries currently experiencing a fall in domestic output is fundamental, especially at a time when the world economy lacks a buyer of last resort – a role played by the US economy until a few months ago.

B. The Subregional Panorama

The 1999-2001 period will be viewed as one of the worst in MERCOSUR's history. Battered by Brazil's external crisis (which began at the end of 1998 and ended with the devaluation of the currency at the beginning of 1999) and by the Argentine crisis (which deteriorated at the end of 2000), the 1999-2001 period was marked by a sharp deterioration in the subregion's macroeconomic indicators.

If current forecasts suggesting that Argentina and Uruguay will evolve negatively in 2001 are borne out, 1999-2001 will be characterized as a truly recessionary period. Paraguay is likely to stagnate, and in 2001 per capita GDP will fall for the sixth successive year. Brazil will be the only one of the four members to have performed positively by the end of the triennium. However, the expected slowdown in output in 2001 will confirm the persistent difficulty that Brazil faces in achieving sustained growth and in overcoming the current phase, which is characterized by short stop and go cycles. Unfavorable trends in the subregion will continue till half of 2002. Even if the Argentine crisis has a favorable outcome, international conditions will curb more optimistic expectations of subregional output before the second semester of next year.

Growth is not the only macroeconomic indicator that is deteriorating. Fiscal imbalances have also worsened, in some cases because of the adoption of expansive public spending policies aimed at softening the impact of the recession. There are, however, other more significant factors: first, the shrinking of the tax base and the consequent fall in the tax take caused by the cyclical contraction of output; and second, the increase in the cost and volume of the public debt because of higher domestic interest rates and/or the acceleration of devaluation.

MERCOSUR: SELECTED MACROECONOMIC INDICATORS

1998-2000 Period

Indicators		Argentina			Brazil			Paraguay			Uruguay		
		1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000
GDP-Total	(% annual)	3.9	-3.4	-0.5	0.2	0.8	4.5	-0.4	0.5	-0.4	4.5	-2.8	-1,3
CPI	(% Dec-Dec)	0.7	-1.8	-0.8	1.7	8.9	6.0	14.6	5.5	8.6	8.6	4.2	5,0
Public Debt (-)	(% of GDP)	-1.4	-1.7	-2.4	-8.2	-10.3	-4.5	-1.0	-3.6	-4.4	-0.9	-4.0	-3,9
Exp. (goods)	(US$ 10^9 fob)	26.44	23.33	26.30	51.14	48.01	55.09	3.55	2.68	2.37	2.83	2.29	2,38
Imp. (goods)	(US$ 10^9 fob)	29.56	24.10	23.76	57.71	49.27	55.78	3.94	3.04	2.91	3.60	3.19	3,31
Trade Balance	(US$ 10^9 fob)	-3.06	-0.77	2.54	-6.57	-1.26	-0.69	-0.39	-0.36	-0.54	-0.77	-0.90	-0,93
Current Ac. Deficit (-)	(% of GDP)	-4,9	-4.4	-3.3	-4.3	-4.8	-4.1	-1.9	-1.1	-4.2	-2.1	-2.5	-3.0

Source: MECON (Argentina); BACEN (Brazil); BCP (Paraguay); BCU (Uruguay).

Inflation remains relatively low in the four MERCOSUR countries, but the downward trend in the consumer price index has been interrupted in Brazil, Paraguay and Uruguay. This development, evident in 1999 and 2000, does not yet mark a reversal of the trend but apparently stems from the rise in fuel prices or the temporary effect of devaluation on prices. The latter circumstance, however, could be repeated again in 2001.

Trade flows trends too have been unfavorable. In 1999 there was a fall in both the imports and exports of the four MERCOSUR countries. In 2000 Argentine and Paraguayan imports continued to decline, while those of Brazil and Uruguay recovered only partially and remained below 1998 levels. As regards exports, Brazil was the only country to exceed 1998 levels in 2000. Current account deficits remains at uncomfortable levels, varying between 3% and 4% of GDP.

Conditions in the subregion deteriorated as a result of a number of negative factors: (i) the devaluation in Brazil, which led to a significant change in the conditions of intra-bloc competitiveness; (ii) a reduction in the terms of trade, which reduced, albeit to differing degrees, the exports of the four MERCOSUR countries; and (iii) an increase in risk perceptions in financing emerging markets, which led to higher costs and reduced the supply of external resources available to the countries of the region.

The negative impact of the devaluation of the real on subregional exports is undeniable. The evidence is clear, especially in a comparison of Brazil’s intra- and extra-bloc imports before and after the devaluation. The comparison shows that not only was the decline in subregional imports more pronounced, but their recovery has been slower. In 2000 Brazilian extra-bloc imports had almost returned to 1998 levels, while aggregate imports from its trade partners were 17% lower.

Brazilian imports from Paraguay and Uruguay declined for various reasons, not only because of the devaluation. The change in the conditions of competitiveness was also decisive. It should be noted that the partial recovery of Argentine exports to Brazil is largely explained by the rise in fuel prices, since in 2000 other exports remained stagnant at the low levels of 1999. The results for the first half of 2001 underline the persistence of this phenomenon: Brazil’s extra-zone imports increased by more than 16% relative to the same period of the previous year, while its aggregate purchases from the countries of the subregion expanded by less than 4%. It seems obvious, therefore, that the devaluation sharply constrained Brazil’s capacity to stimulate growth in its trade partners.

BRAZIL: TRENDS IN IMPORTS FROM MERCOSUR AND THE REST OF THE WORLD

Period: 1996-2000

(Base index 1996 = 100)

Year	Brazilian Imports					
	Argentina		Paraguay	Uruguay	MERCOSUR	Rest of the World
	Total	Excluding oil				
1996	100.0	100.0	100.0	100.0	100.0	100.0
1997	118.0	122.2	93.7	102.5	114.6	111.7
1998	117.9	131.5	63.6	110.4	113.6	107.2
1999	85.4	92.2	47.0	68.5	80.9	94.3
2000	100.6	95.8	63.6	63.7	93.9	106.5

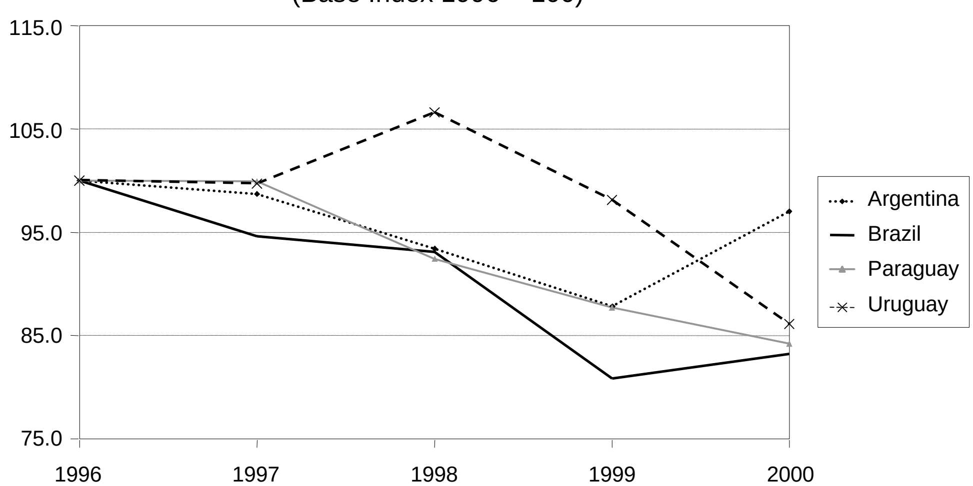
Source: SECEX/MDIC.

The deterioration in the terms of trade also merits attention. This varied in intensity and pace in the different countries, but all of them were affected. Because oil prices rose in 2000, Argentina's terms of trade improved significantly and the country, which is an important source of fuel for Brazil, partially reversed the downward trend evident since 1997. Conversely, the other MERCOSUR countries are net oil importers and thus experienced a renewed fall in their terms of trade that year. The situation could reverse itself in 2001, since oil prices have again declined. However, the terms of trade are unlikely to improve significantly for any of the countries of the subregion in view of the poor prospects for world trade growth in 2001.

MERCOSUR: TRENDS IN THE TERMS OF TRADE

Period: 1996-2000

(Base Index 1996 = 100)



Source: INDEC (Argentina), FUNCEX (Brazil) and ECLAC.

The third determinant of subregional conditions is the contraction and instability of flows of external financing. The risk perception inherent in emerging markets increased with the 1997 Asian crisis and was exacerbated the following year by the Russian moratorium. International banks thereafter reduced their exposure in emerging countries and became more selective in their lending. Bond market volatility also increased significantly at the end of 1999, partly because of stock market fluctuations. Financing to emerging countries recovered somewhat in 2000, but forecasts suggest they will fall by more than 20% in the first half of 2001. According to IMF forecasts, this decline will sharpen even further during the rest of the year.

RESOURCE FLOWS TO EMERGING MARKETS

Period: First Half 2000-2001

(In US$ billions)

	2000	2001	Var. (%)
Total Issues	*115.7*	*90.0*	*-22.2*
Bonds	49.9	53.8	7.8
Shares	20.5	7.9	-61.5
Syndicated loans	45.3	28.3	-37.5

Source: IMF.

The emerging markets have not been equally affected by the fall in external resources. Russia and Mexico, for example, have faced no great difficulties in maintaining satisfactory levels, but the same cannot be said of other emerging markets in Latin America, especially Argentina.

In short, subregional conditions are not promising. Subregional inter-dependencies have worked over the last three years, but only in a negative sense. The expansion of economic output and the growth of imports in MERCOSUR's main economy brought few, if any, benefits to the other members. Brazil's devaluation in 1999 and Argentina's crisis at the end of 2000 negatively affected the other countries of the subregion, since those circumstances increased uncertainty and pessimism, exacerbated the problems associated with external financing, and forced neighboring countries to adopt more restrictive policies. This had adverse effects on growth in the subregion.

C. Recent Economic Trends in the Member States

ARGENTINA

The Argentine economy continues to suffer a serious and prolonged recession. The downturn began in the last quarter of 1998 as a result of a combination of negative external shocks. As stated above, these simultaneously affected the macroeconomy of the four MERCOSUR countries.

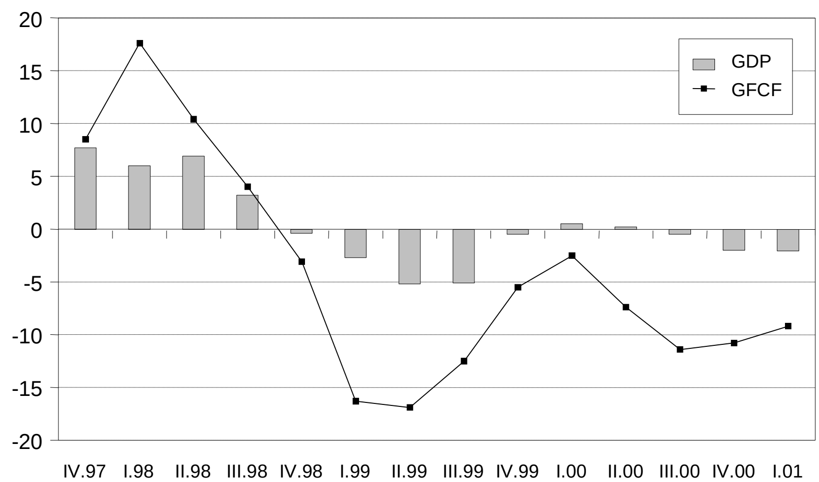
The factors that triggered the current recession were: (i) the deterioration of the terms of trade, which in Argentina began in mid-1997 and deepened in the following two years; (ii) the strengthening of the US dollar, which serves as an anchor to Argentina's "convertibility" system; (iii) the Brazilian devaluation at the start of 1999, which significantly changed the conditions of intra-bloc competitiveness and undermined Argentina's manufacturing exports; and (iv) the increase in the risk perception in financing emerging markets, a process that was sparked by the Asian crisis and exacerbated by the Russian moratorium. In tandem with the increase in sovereign risk, the hikes in short-term US interest rates after mid-1999 heightened the cost of external financing in emerging markets, including Argentina.

The succession of adverse shocks to the Argentine economy led to a deterioration in the competitiveness of sectors producing tradable goods (not offset by an increase in productivity), and to an rise in domestic interest rates. However, the persistence of the crisis might stem from the limits imposed by the currency board system on the use of economic policy instruments to soften the impact of this series of negative shocks. In an economy free from the restrictions of a currency board, these impacts could have been offset by a devaluation of the nominal exchange rate, although at the cost of higher domestic inflation. The adjustment of the Argentine economy to the new external environment proved much more costly. The fall in prices led to an unfortunate process of deflation. This, in turn, spurred a prolonged contraction of GDP, a fall in investment and a growth in unemployment. The decline in output was accompanied by significant fiscal deterioration, largely attributable to the pro-cyclical nature of the tax base.

ARGENTINA: QUARTERLY TRENDS IN GDP AND GFCF

Period: IV-1997 - I/2001

(% compared to same period of the previous year)



Note: GFCF: Gross Fixed Capital Formation
Source: MECON.

The economic measures taken to overcome the crisis and stimulate economic growth have basically had three aims: (i) to offset the increasing difficulties of access to voluntary external financing by appealing to financial assistance programs with the support and participation of the IMF, and through debt swap operations to reduce the country's demand for external resources in the short and medium terms; (ii) to promote the balance of public finances by severely controlling public spending and/or new taxes in order to increase the tax take; (iii) to improve the competitiveness of the industrial sector by making the most of the limited scope to adopt fiscal incentives, and even modifying the exchange rate system in force since 1991.

The main measures introduced to tackle the difficulties in access to external financing were the financial assistance operation ("armoring"), introduced in December 2000, and the partial swap of debt securities, announced in June 2001. The former, structured as a three-year program, involves resources totaling US$ 40 billion, with a high concentration of short-term disbursement. The "armoring" operation sought to allay mounting fears that Argentina would renege on its external obligations and thus enable the country to return to the international capital markets without having to pay excessive financial costs. The measure had only momentary success, since in February 2001 the country risk again increased following publication of the fiscal accounts. The results of the partial swap of debt securities were more satisfactory. Their nominal value reached US$ 28.1 billion and involved the issue of five new 7-30 year securities with average rates of 15.3%, 0.35 percentage points higher than the average paid for the securities. The debt stock increased by US$ 2.3 billion and the average maturity date was extended by 2.8 years. The swap reduced the financial needs of the public sector by US$ 16 billion until the end of 2005, with the relief concentrated in 2002-2003.

The measures implemented to reduce the public sector imbalance went through various phases. At the end of 1999 the newly elected government approved a fiscal package based mainly on measures to increase the tax take. By mid-2000 government initiatives began to emphasize public spending cuts, particularly the reduction of the public payroll. After March 2001 the new economic team approved a series of measures to adjust the public accounts, especially the following: (i) the introduction of a financial transactions tax (FTT), with a general aliquot of 0.6% on current account bank movements and the two-fold aim of tax increasing collection and combating evasion; (ii) an increase in the rate of employers' welfare contributions; (iii) the elimination of value added tax (VAT) exemptions on public transport; and (iv) the reduction of welfare spending.

A number of measures were also introduced to boost competitiveness in the industrial sector, including: (i) the introduction of subsidized credit; (ii) the elimination of aliquots on the import of capital goods from extra-MERCOSUR countries; (iii) an increase in tariff protection for extra-MERCOSUR consumer goods in the electrical-electronic sector; and (iv) the selective elimination of the tax on the minimum wage and on the interest on business loans (selective, since it was restricted to specific industrial sectors).

The main measure to stimulate competitiveness in the tradable sector, however, was the introduction of a trade compensation mechanism whereby exporters receive an additional amount in pesos for every dollar exported, while importers pay a surcharge in pesos for every dollar imported. This additional charge (the *convergence factor*) is set daily by the Central Bank on the basis of the difference between the value of the peso in dollars and a simple arithmetic average between the euro (expressed in dollars) and the dollar. The adoption of this new mechanism was made possible by a modification introduced as part of the convertibility plan and approved under the extended convertibility law. Under this new measure, the value of the peso is calculated by a simple arithmetic average between the euro and the dollar the day after the parity of the two currencies was set. The convergence factor therefore envisages a new parity, but limits its reach to the restricted area of commercial transactions abroad.

The convergence factor excludes the export of fuel and was introduced at the same time as the reduction in "drawback", a tax refund mechanism that benefits extra-regional sales to varying degrees depending on the type of product exported. The liquid effect of the convergence factor and the reduction in drawback was therefore different for exports and imports. The new mechanism only benefited exports that previously did not qualify for drawback, especially exports to MERCOSUR countries. As for imports, the convergence factor operated in practice as a generalized increase of the import tax for all products with an aliquot of under 27%. The convergence factor did not benefit all products with a higher rate, since the 35% ceiling has been respected (determined by the tariff value agreed by Argentina in the WTO).

When the convergence factor was introduced the euro was worth 86 US cents. There was thus an implicit difference of some 8% in the new mechanism. It should be noted, however, that the appreciation of the euro reduces the convergence factor, and its effect is zero when the dollar and euro are at par.

Despite the broad range of measures adopted between the end of 2000 and mid-2001, Argentine risk remained high in July and August, fluctuating at levels above 1,400 bps. The growing climate of mistrust, and concerns about a default, also led to a fall in bank deposits and a contraction in official international reserves. The government and the IMF finally agreed on a new financial assistance package in the last week of August. The most recent package is worth US$ 8 billion, US$ 5 billion of which will be used to strengthen the Central Bank's international reserves while US$ 3 billion is for improving the maturity profile of the public debt. This should guarantee the principal when old debt securities are swapped for new ones. Debt swaps will again be voluntary, but are likely to involve significant reductions in the repurchase of old securities and an extension of maturity dates. The government's most important commitments to the IMF will be to follow a policy of fiscal balance (monitored monthly), and to modify the tax coparticipation system by eliminating the minimum resource transfer guarantee for lower government levels.

The recent agreement with the IMF points to the only viable and realistic solution: a reduction in the public debt. This way out of the crisis, implicitly acknowledged in the IMF agreement, could begin to be negotiated with foreign creditors immediately after the October legislative elections.

Projections for the Argentine economy in 2001 are disappointing, even if the prospect of a dramatic unfolding of the current crisis in the rest of the year is discounted. GDP will again fall and is likely to be more negative than the year before. The public deficit, measured in relation to GDP, will be in disequilibrium as in 2000, although the trade balance will be positive and the current account deficit is likely to narrow. These projections reflect the significant decline in imports and poor export performance.

ARGENTINA: FORECASTS FOR 2001

Indicators		2000	2001
GDP	(% annual var.)	-0.5	-1.6
Exports (FOB)	(% annual var.)	-1.4	2.8
Imports (CIF)	(% annual var.)	-1.2	-6.3
Inflation	(% Dec.-Dec. var.)	-0.8	-2.0
Fiscal deficit	(% of GDP)	-2.4	-2.3

Source: *Latin American Consensus Forecasts* (August, 2001).

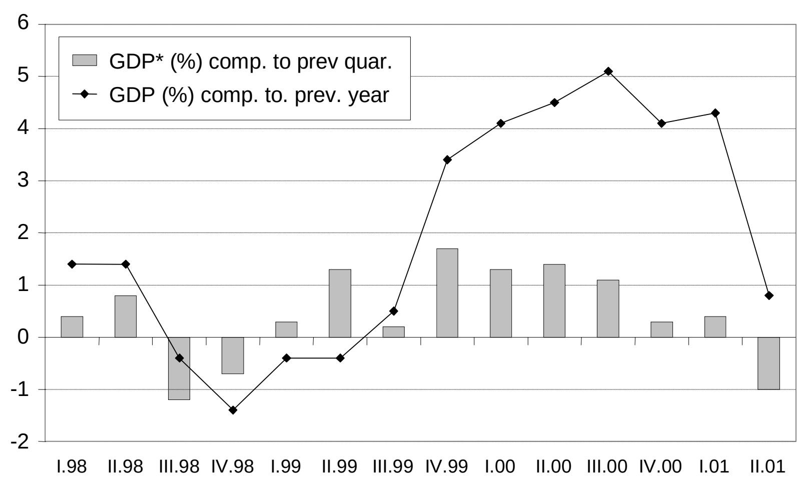
BRAZIL

In the last two years Brazil has been, paradoxically, the MERCOSUR economy that has suffered least from its own crisis. In 1999 Brazil's GDP expanded by a modest 0.8%, while Argentina and Uruguay were in recession and Paraguay stagnated. The contrast was even greater in 2000, when Brazil grew by a significant 4.5% while all the other members of the bloc recorded a decline in output.

Analysis of Brazil's non-seasonally adjusted real output shows that the economy only contracted in the last two quarters of 1998, compared to the immediately preceding period. After the 1999 devaluation, output recovered quickly and, at the end of that year, the Brazilian economy began an expansionary cycle that lasted until the first quarter of 2001.

BRAZIL: TRENDS IN QUARTERLY GDP

Period: I/1998 - II/2001



Note: (*) non-seasonally adjusted data.
Source: IBGE.

All the macroeconomic variables developed positively in 2000. Industrial production expanded at a faster rate than at any other time in the last five years, and unemployment fell for the first time since 1995. Accumulated inflation reached 5.9%, slightly below the Central Bank's average inflation target (6%). Even more significantly, in order to meet this target the bank did not once have to reverse the downward trend in basic economic interest rates, which fell from 19% to 15.5% in 2000. Brazil also met all the targets agreed with the IMF on the public sector primary surplus, which reached 3.5% of GDP in 2000.

Only the trade balance failed to meet expectations completely. Exports, which had declined in 1999, recorded satisfactory growth of slightly below 15%. However, imports were fostered by the intense pace of output and grew at a similar rate (13.2%), such that the trade balance was negative for the sixth consecutive year. The deficit was not particularly significant (less than US$ 1 billion) but that was not the result expected after an approximately 25% devaluation of the real exchange rate.

At the end of 2000, the forecasts for Brazil's economic performance in 2001 were frankly optimistic. External conditions prompted some apprehension, but it was expected that the slowdown in the US economy would be reasonably short and moderate. The continuation of the recession in Argentina spurred disquiet, but the successful conclusion of the international financial assistance program ("armoring"), announced in December 2000, helped dissipate expectations of an imminent worsening of the Argentine crisis. Consequently, projections for the Brazilian economy suggested a continuation of the expansionary cycle that had begun in mid-1999.

The outlook, however, changed radically at the end of the first quarter of 2001, when expectations were drastically reversed and there was a concomitant impact on the exchange market. In barely three months the nominal exchange rate was devalued by 10%. Two factors explain this unexpected turnaround of expectations: (i) the sudden deterioration of the crisis in Argentina, with the traumatic replacement of the economic team and an upsurge of political and social tension; and (ii) the awareness that the downturn in the world economy would be more intense and longer than initially envisaged.

Instability was also reflected in more volatile price indices, while core inflation began to rise. This aroused concern that the variation in the exchange rate might be transferred to prices. In March, therefore, after various fruitless attempts to calm the exchange markets by offering foreign exchange and securities indexed to the exchange rate, the Central Bank decided on the first rise in interest rates, reversing the downward trend evident since mid-1999. This decision served to confirm the change in macroeconomic conditions. In May, finally, came the surprising disclosure that the country was on the edge of a serious energy crisis, and that tackling the situation would demand severe energy rationing.

Trends in the main macroeconomic indicators confirm the worsening short-term outlook for the Brazilian economy. For the first time since the end of 1998, real output in the second quarter of 2001 (non-seasonally adjusted) was negative relative to the preceding quarter. In June, accumulated industrial output over twelve months also recorded a slight fall (-1.4%). These data partly reflect the 20% reduction in electricity use that entered into force in June.

Energy rationing affected the level of industrial production. Some models designed to assess the impact of energy restrictions on output levels predicted a fall of up to two percentage points of GDP relative to the prior trend. The same models suggested that the proper operation of a secondary market, facilitating inter-sectoral energy transfers, could reduce the scale of that impact by 60%. Hence government efforts have concentrated on organizing that market.

As regards inflation, in July the price index governing the Central Bank's inflation target recorded an accumulated variation of slightly more than 7% in twelve months. For 2001 the central inflation target set by the National Monetary Council is 4%, but the prevailing monetary regime envisages a variation of up to two percentage points from that goal. If that margin is exceeded, the Central Bank must explain why the goal was unmet; this procedure could begin in 2001.

The target for the public sector primary surplus was raised from 3.0% to 3.35% of GDP following the recent renewal of the agreement with the IMF, since there were no great doubts about the target being met and the government has displayed fiscal rigor and discipline. It is noteworthy in this regard that the primary fiscal result is immune to exchange rate variations, as well as to interest rate hikes, since it contemplates non-financial revenue and spending over which the government has reasonably tight control. That is not true of the nominal public deficit or the public sector liquid debt. In fact, the raising of base rates from 15.25% to 19% during the year, as well as a more than 25% devaluation of the nominal exchange rate since the start of 2001, had a devastating impact on those two indicators. The total public sector liquid debt rose from 49.3% of GDP at the end of 2000 to 51.3% in June 2001, while the nominal public sector deficit increased from 4.5% of output to 5.4% in the same period.

The heavy burden attendant on the impact of the rise in interest rates and the exchange rate on the public sector debt and deficit underlines some of the dilemmas facing economic policy-making in 2001. Such dilemmas concerned the best way of administering the fluctuating exchange rate/inflation target regime in a context of severe uncertainty and unfavorable expectations. Given the persistent increase in the exchange rate, with the consequent threat to meeting the inflation target because of the predictable transfer of exchange variations to prices, the position of the monetary authority shifted as its diagnosis changed. Initially, the belief was that the increase in the exchange rate basically responded to speculative pressures. That interpretation suggested that the worsening of external conditions would promote a self-sustained increase in hedging on the part of debtors in foreign currency, importers and/or non-resident shareholders, without any evidence of an actual deterioration in the economic fundamentals. On the basis of this hypothesis, the Central Bank frequently intervened in the foreign exchange market to sell foreign currency and increase the placement of exchange rate-indexed securities. The inefficiency of these interventions served to reinforce the conviction that the changes in external conditions and the energy crisis had affected the economic fundamentals, making the upward movement of the exchange rate unavoidable. The Central Bank limited its interventions in the foreign currency market but kept interest rates at a higher level to attenuate the spread of the exchange rate shock, thereby attempting to calibrate an inflation rate that was not far from the upper target.

At the beginning of August, the Brazilian government took the initiative to conclude a new agreement with the IMF for a loan of US$ 15 billion. The new program will be in force until the end of the current administration in December 2002. The agreement sought to lessen the contagion effect of the Argentine crisis and to ensure greater security during the next electoral period. The fiscal targets set out in the agreement are more severe than those in previous accords, but the inflation rate envisaged for 2001 is higher than that set by the National Monetary Council. The agreement with the IMF fixes the inflation target at 5.8%, with an upper limit of 7.8%. Additionally, the minimum level of the Central Bank's liquid reserves will be below that established in the previous agreement, thus increasing the monetary authority's maneuvering room in the event of future interventions in the foreign exchange market. In short, the government committed itself to greater fiscal adjustment but in return it received significant backing for its economic policy, and in the coming months it will secure resources to partly offset the likely fall in voluntary capital flows.

According to the projections below, Brazil's economic outlook for 2001 includes a significant slowdown in real output, a modest and balanced growth of exports and imports, a significant increase in the nominal deficit and, finally, a slight rise in the inflation rate.

BRAZIL: FORECASTS FOR 2001

Indicators		2000	2001
GDP	(% annual var.)	4.5	1.8
Exports (FOB)	(% annual var.)	14.7	5.5
Imports (FOB)	(% annual var.)	13.2	5.6
Inflation rate	(% var. Dec. - Dec.)	6.0	6.3
Fiscal deficit (Nominal result)	(% of GDP)	-4.5	-6.4

PARAGUAY

Trends in the Paraguayan economy in the second half of the 1990s were particularly unsatisfactory. The economy is virtually stagnant. In the period 1995-1998, Paraguay suffered a serious banking crisis that led to a sharp contraction of credit to the private sector, accompanied by a rise in real interest rates. In view of such factors, private investment has fallen successively over the past six years. The terms of trade, in turn, began to deteriorate in the second half of 1997, falling almost 16% between 1998 and 2000. Finally, in the period 1999-2000, the Paraguayan economy was negatively affected by three other events: (i) the Argentine recession, which has persisted since 1998; (ii) the devaluation of the Brazilian currency at the beginning of 1999; and (iii) poor weather that caused an appreciable fall in agricultural production last year.

In 2000, real output declined by 0.4%, giving rise to the fifth consecutive fall in per capita GDP. The external sector experienced a simultaneous fall in exports and imports, an increase in the trade deficit, and a sharp deterioration of the current account balance, which expanded from -1.1% to -4.2% of GDP.

The downward trend in trade flows began in 1995. Since then, exports have fallen by more than 40% and imports have declined by almost 35%. The subregional crisis and the deterioration of trade relations only partly explain these developments. In addition to these factors, the fall in the volume of trade conforms to the increase in customs controls imposed by neighboring countries, mainly Brazil, which are trying to limit informal trade and triangulation operations. In 2000, re-exports fell by 30%. This has recurred for several years, explaining the simultaneous decline of imports and exports.

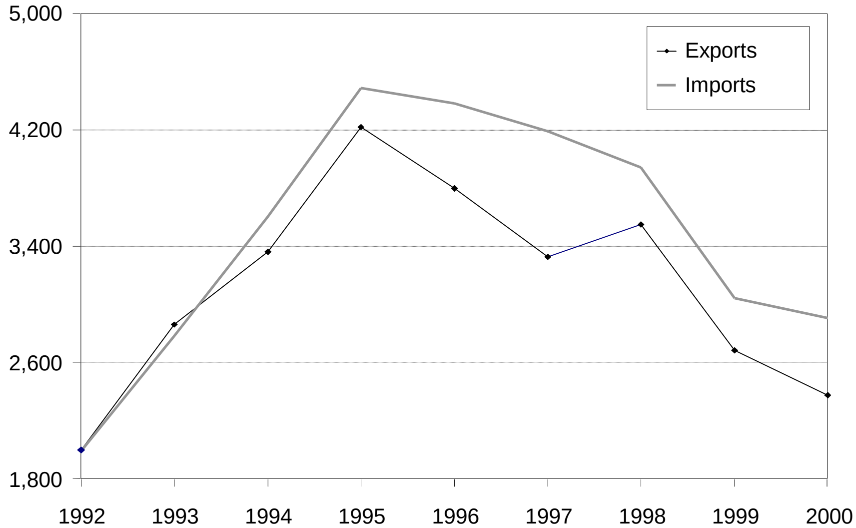
Inflation underwent a downward trend in the 1990s. This was interrupted only in 1998, when the nominal exchange rate was devalued by about 24%, thereby contaminating the inflation indices. The following year, however, the consumer price index rose only modestly and the inflation rate stabilized at 5.5%, the lowest in the decade. In 2000 it climbed again as a result of the rise in oil prices, the increase in the minimum wage and mounting utilities tariffs. The consumer price index ended 2000 with an accumulated increase of 8.6%, and the recent program agreed with the IMF envisages the preservation of the inflation rate at that same level for 2001. That year, however, is expected to see additional increases in utilities tariffs and the imposition of VAT on transport and personal services, as well as a faster devaluation of the exchange rate. These factors will make it difficult to meet the target.

Public finances also deteriorated rapidly in the second half of the 1990s. In 1998 the public deficit reached 3.6% of GDP. It rose further in 1999 to stand at 4.4% of output. The public sector’s growing imbalance stems from a fall in the tax take and the growth of spending, which in turn springs from the increase in transfers (including subsidies), and investment in infrastructure.

PARAGUAY: TRENDS IN TOTAL EXPORTS AND IMPORTS

Period 1992-2000

Data in US$ millions (FOB)



Source: Central Bank of Paraguay.

For 2001 the program recently agreed with the IMF envisages GDP growth of over 2%, a sharp fall in the current account deficit, a stable inflation rate and a marked decline in the public sector deficit, which should fall to 2% of GDP. Expectations of a reversal of output levels, as well as significant export growth, are based on optimistic forecasts for agricultural production. Some crops with a significant share of the export mix are expected to increase by between 20% and 50%, such as cotton, soya and corn. In turn, the narrowing of the public deficit will stem from the rise in the tax take, fostered by the increase in the aliquot of the selective tax on fuels, the widening of the VAT base, and smaller fiscal incentives to favor products for re-export. The IMF program envisages a drastic contraction of public spending, equivalent to two percentage points of GDP, by lowering expenditure on the civil service in line with the budget law approved by the legislature, and through lower interest payments on the foreign debt in line with the fall of international rates.

The preliminary results for the first half of 2001 suggest that some of the projections in the agreement with the IMF will not materialize. Agricultural production has developed positively, but growth has been less than expected and industrial output is falling. At the same time, the figures for the trade balance in the first half of 2001 (which are limited to recorded trade), are disappointing: exports grew moderately (3.5%), while imports increased at a substantially higher rate (12%). Brazilian statistics, in turn, point to a fall of over to 20% in imports from Paraguay in the first half of 2001, suggesting that unrecorded exports have developed unfavorably. Trends in prices, however, have been good. In July, the rate of accumulated inflation for 2001 stood at 4%, while the variation of the price index in the last twelve months was 6.9%.

Hence the projections are of a less optimistic scenario for 2001 than was envisaged in the agreement with the IMF.

PARAGUAY: FORECASTS FOR 2001

Indicators		2000	2001
GDP	(% annual var.)	-0.4	1.2
Exports (FOB)	(% annual var.)	-11.5	4.0
Imports (FOB)	(% annual var.)	-4.5	8.0
Inflation rate	(% var. Dec. – Dec.)	8.6	7.5
Fiscal deficit	(% of GDP)	-4.4	-2.8

URUGUAY

From the start of the 1990s and until 1998, Uruguay's economic performance was quite satisfactory, indeed better than that of other MERCOSUR countries. In the period 1991-1998, real output grew by 4.4% a year and fell only in 1995, very largely because of the severe impact of the Mexican crisis on the Argentine economy. That episode underscores the keen sensitivity of the local economy to recurrent fluctuations in Argentine output. This is explained not only by the intensity of trade flows, including tourism services, but also by the financial interdependence of the two economies. On this occasion, however, the contraction of economic activity was not particularly intense and ended soon. After falling by 1.4% in 1995, real output swiftly recovered, increasing at an average rate of over 5% in the following three years.

At the end of 1998, however, the growth of the Uruguayan economy was abruptly interrupted. This time the recession was not only sharper but also more persistent. GDP fell in both 1999 and 2000, declining by 2.4% in the former year and 1.3% in the latter, with no sign of improvement.

Figures for non-seasonally adjusted real quarterly output show that the Uruguayan economy slowed down in the last quarter of 1998, coinciding with the onset of the recession in Argentina and the worsening of Brazil's external crisis.

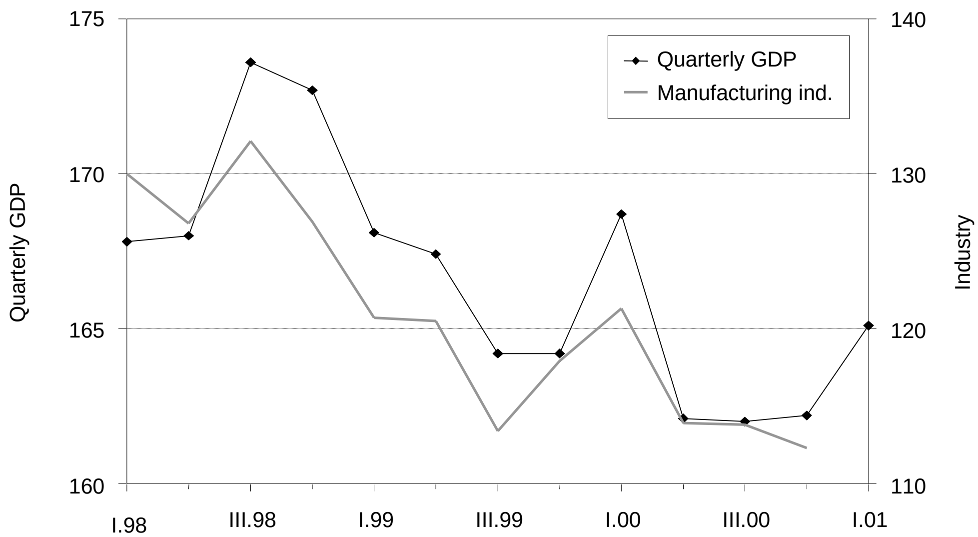
The decline in output was sharper in 1999 because of the Brazilian devaluation. After a modest recovery in the first quarter of 2000 output again fell; it was stagnant throughout the last nine months of the year. Preliminary data for the first quarter of 2001 show a mild recovery, indicating the possibility of a slight revival of economic activity. However, the worsening subregional context curbs any more optimistic expectations: a new contraction in output is the most likely scenario for 2001.

The multiplicity of adverse shocks attendant on the deterioration of international and subregional conditions largely explains the unfavorable performance of the Uruguayan economy in the last two years. In 2000, the main negative influences were: (i) the rise in the oil price, which increased 50% relative to the average of the preceding year and which helped exacerbate the worsening of the terms of trade evident since 1999; (ii) the increase of about 1.5 percentage points in international interest rates; (iii) the persistent weakening of the euro, which was devalued by an average of 13%, against the US dollar; and (iv) the continuation of the Argentine recession.

The only two potentially favorable developments for Uruguay's economic performance in 2000 were the marked expansion of the volume of international trade (13.4%), driven mainly by the demand for imports in the United States and the Asian countries, and the appreciable recovery of the Brazilian economy. The latter grew by 4.5% in 2000 and there was a notable increase in imports (over 13%). However, the vigor of external demand did not extend to Uruguayan exports, whose performance was mediocre and which grew by only 2.6% in 2000. Exports to the United States, China and Japan increased very substantially, by an average of 35% relative to 1999, but their aggregate share of Uruguayan exports is not particularly important, at less than 15%. The growth of demand in Brazil did not help Uruguay, whose exports to the Brazilian market fell by 4.8% in 2000. It is to be noted in this regard that Uruguayan sales to Brazil had already recorded an accumulated fall of about 45% relative to the peak of 1998, and that Brazil's share of Uruguayan exports declined from 33% to 23% in barely two years.

URUGUAY: TRENDS IN QUARTERLY GDP AND IN THE OUTPUT OF MANUFACTURING INDUSTRY

Non-seasonally adjusted data (Base: 1983 average = 100)



Source: BCU - Central Bank of Uruguay.

The devaluation of the real reduced the competitiveness of Uruguayan products in the Brazilian market; the Argentine recession negatively affected tourism receipts and unfavorably influenced the investment decisions of local entrepreneurs; and the non-tariff restrictions imposed by Brazil and Argentina on the sales of some products that are important to Uruguay's export basket – such as rice, dairy goods and others – were the main negative influences on the subregional situation and explain Uruguay's growing unease with MERCOSUR's two main partners in the most recent period.

The worsening of external conditions was abetted by two chance events that damaged agricultural production, which fell by 2.7% in 2000. First, a drought affected the 1999-2000 crop and contributed to the contraction of domestic output. Second, an outbreak of foot and mouth disease demanded a mass vaccination program and the culling of animals in the affected areas. The upward trend in livestock production was interrupted and Uruguay lost its certification as "a country free of foot and mouth disease without vaccination", which will affect its export performance in the coming years.

The recession affected the rate of unemployment, which increased from 11.3%, in 1999 to 13.6% in 2000. That situation is not expected to be reversed. On the contrary, in the last half of 2000, as well as in the early months of 2001, the unemployment rate has been above 14%. The downward trend in inflation evident in recent years was also interrupted and in 2000 the consumer price index increased by 5%, almost one percentage point above the inflation rate for 1999. This was conditioned by the rise in oil prices and the pace of exchange devaluation, which was preset at 7.5% a year (and hence above the inflation rate). In a context of depressed agricultural prices and a contraction of domestic demand, exchange policy gave primacy to promoting some competitiveness gains to the benefit of the tradable sector, although at the cost of a slight increase in the inflation rate.

Besides the commitment to stability and to boosting external competitiveness, the program of the new government (which took office in March 2000) sought to cut the public deficit. This had increased dramatically in the previous year, rising from 0.9% of GDP in 1998 to 4.0% in 1999. The widening deficit, which peaked at 4.7% of GDP in May 2000, stemmed from the counter-cyclical fiscal policy adopted in 1999. The policy was reversed and public spending was cut significantly. Partly because of the decline in the tax take, however, there was only a marginal narrowing of the fiscal deficit in 2000.

Against this background, the prospects for 2001 are unfavorable. The fall in oil prices and in international interest rates are positive developments, but they are insufficient to offset the impact of the slowdown in world trade and the generalized decline in output in developed countries. The subregional context, in turn, is marked by the continuing deterioration of the Argentine crisis and the drastic reduction of growth forecasts for Brazil, which will entail a cooling of external demand. At the same time, curbs on public spending, the high rate of unemployment and pessimistic business expectations will curtail internal demand.

The macroeconomic indicators for the early months of 200 – on real quarterly output, the physical production of manufacturing industry and trends in trade flows[7] – tend to confirm the pessimistic scenario indicated in the following projections.

URUGUAY: FORECASTS FOR 2001

Indicators		**2000**	**2001**
GDP	(% annual var.)	-1.3	-1.0
Exports (FOB)	(% annual var.)	2.6	-4.0
Imports (CIF)	(% annual var.)	3.2	-8.0
Inflation rate	(% var. Dec-Dec.)	5.0	6.0
Fiscal deficit	(% of GDP)	-3.9	4.0

[7] The data up to May 2001 indicate that exports fell by 1.1% while imports declined by more than 7%.

MAIN MACROECONOMIC INDICATORS OF MERCOSUR

		ARGENTINA					BRAZIL					PARAGUAY					URUGUAY				
		1996	1997	1998	1999	2000	1996	1997	1998	1999	2000	1996	1997	1998	1999	2000	1996	1997	1998	1999	2000
Output																					
GDP - Total	(US$ billions)	272.2	292.9	298.9	283.3	285.0	775.5	807.8	787.5	529.4	595.9	9.6	9.6	8.6	7.7	6.9	20.5	21.7	22.4	20.9	20.1
GDP - Total	(% annual var.)	5.5	8.1	3.9	-3.4	-0.5	2.7	3.3	0.2	0.8	4.5	1.3	2.6	-0.4	0.5	-0.4	5.6	5.0	4.5	-2.8	-1.3
Industrial production	(% annual var.)	7.2	11.9	-0.1	-9.7	-1.5	1.7	3.9	-2.1	-0.7	6.5	-2.2	-0.2	1.0	0.0	1.0	4.8	5.6	5.5	-8.6	0.8
Gross fixed capital formation	(% of GDP)	18.1	19.4	19.9	17.9	16.0	20.2	20.4	19.7	18.0	18.6	22.8	22.0	21.1	20.3	20.3	14.0	14.4	15.2	14.5	13.2
Unemployment rate	(%)	17.2	14.9	12.8	14.2	15.1	5.4	5.7	7.6	7.6	7.1	8.2	7.1	14.3	16.0	17.7	11.9	11.5	10.1	11.3	13.6
Prices and Exchange Rate																					
CPI	(% var. Dec-Dec)	0.1	0.3	0.7	- 1.8	- 0.8	9.6	5.2	1.7	8.9	6.0	8.2	6.2	14.6	5.5	8.6	24.3	15.2	8.6	4.2	5.0
Nominal exchange rate	(% var. Dec-Dec)	0.0	0.0	0.0	0.0	0.0	7.1	7.4	8.2	48.0	9.3	6.7	8.7	23.8	16.7	6.5	22.7	15.1	8.2	7.6	7.3
Terms of trade	(1995 = 100)	107.8	106.5	100.7	94.8	104.6	101.0	106.8	104.6	94.4	91.5	100.0	99.9	92.4	87.7	84.2	96.7	96.4	103.1	94.9	86.2
Public Sector and Interest Rate																					
Public sector deficit (-)	(% of GDP)	-1.9	-1.5	-1.4	-1.7	-2.4	-5.9	-6.1	-8.2	-10.3	-4.5	-0.8	-1.3	-1.0	-3.6	-4.4	-1.6	-1.4	-0.9	-4.0	-3.9
Passive interest rate	(% a year)	7.4	7.0	7.6	8.0	8.3	26.4	24.3	28.0	26.0	17.2	17.2	13.0	15.3	16.6	15.6	28.1	19.6	15.1	14.2	12.1
External Sector (1)																					
Goods exports (FOB)	(% annual var.)	13.6	9.9	0.0	-11.8	12.7	2.7	11.0	-3.5	-6.1	14.7	-10.0	-12.4	6.6	-24.4	-11.5	14.0	14.1	1.3	-19.0	3.9
Goods imports (FOB)	(% annual var.)	18.5	28.1	3.5	-18.4	-1.4	6.8	12.0	-3.3	-14.7	13.2	-2.3	-4.4	-6.0	-22.8	-4.5	15.6	11.5	3.0	-11.5	4.0
Goods exports (FOB)	(US$ billions)	24.0	26.4	26.4	23.3	26.3	47.7	53.0	51.1	48.0	55.1	3.8	3.3	3.5	2.7	2.4	2.4	2.8	2.8	2.3	2.4
Goods imports (FOB)	(US$ billions)	22.3	28.6	29.6	24.1	23.8	53.3	59.7	57.7	49.3	55.8	4.4	4.2	3.9	3.0	2.9	3.1	3.5	3.6	3.2	3.3
Trade balance (FOB-FOB)	(US$ billions)	1.8	-2.1	-3.1	-0.8	2.5	-5.6	-6.7	-6.6	-1.3	-0.7	-0.6	-0.9	-0.4	-0.4	-0.5	-0.7	-0.7	-0.8	-0.9	-0.9
Current account balance	(US$ billions)	-6.9	-12.4	-14.7	-12.4	-9.4	-23.5	-30.8	-33.4	-25.4	-24.6	-0.4	-0.7	-0.2	-0.1	-0.3	-0.2	-0.3	-0.5	-0.5	-0.6
Current account deficit	(% of GDP)	-2.5	-4.2	-4.9	-4.4	-3.3	-3.0	-3.8	-4.3	-4.8	-4.2	-3.7	-6.8	-1.9	-1.1	-4.2	-1.1	-1.4	-2.1	-2.5	-3.0
Foreign direct investment	(US$ billions)	6.9	9.2	7.3	24.2	11.2	11.3	17.9	26.0	26.9	30.5	0.1	0.2	0.3	0.1	0.1	0.1	0.1	0.2	0.2	0.2
Total gross external debt	(US$ billions)	110.7	125.1	141.9	146.0	147.2	179.9	200.0	241.6	241.5	236.2	1.6	1.7	1.8	2.4	2.5	4.7	4.7	5.2	5.2	5.8
International reserves	(US$ billions)	19.3	24.3	26.5	27.8	26.5	60.1	52.2	44.6	36.3	33.0	1.1	0.8	0.9	1.0	0.7	1.9	2.1	2.4	2.4	2.6

Notes: (1) balance of payments data.
Paraguayan trade flows include re-exports and unrecorded exports and imports.
The foreign debt of Uruguay corresponds to the debt of the public sector.

Source: MERCOSUR Secretariat, Argentina's Ministry of the Economy; Central Banks of Argentina, Brazil, Uruguay and Paraguay; IPEA, (Brazil) and ECLAC.

CHAPTER III. TRADE AND FOREIGN DIRECT INVESTMENT

A. Recent Trends in MERCOSUR's External Trade

The regional context

The Asian crisis changed the outlook for MERCOSUR's external trade. Analysis of the overall data reveals this clearly, since between 1997 and 2000 the subregion's trade deficit with the rest of the world was nil. More precisely, the bloc's trade deficit, which stood at US$ 16.05 billion in 1997, was transformed into a modest surplus of a little more than US$ 100 million in 2000. The burden of adjustment fell onto imports, which declined by US$ 12 billion, while exports increased by US$ 4.1 billion in the same period.

The adjustment process might have safeguarded intra-subregional trade. In fact, this is what happened in 1998 and 2000, when MERCOSUR managed to reduce and then eliminate its deficit with the rest of the world, while intra-bloc trade remained stable (1998) or even grew (2000). However, in 1999 the narrowing of MERCOSUR's external deficit was accompanied by a dramatic fall in intra-zone flows, which has still not been entirely reversed.

INTRA- AND EXTRA-MERCOSUR TRADE
Period: 1991-2000
(US$ millions)

		1991	1993	1995	1996	1997	1998	1999	2000	Growth (annual %) 1997/00	Growth (annual %) 1999/00
Exports											
Total	(US$ 10^6)	45,891	54,122	70,402	74,998	82,342	81,323	74,320	86,461	1.6	16.3
Intra-MERCOSUR	(US$ 10^6)	5,103	10,026	14,384	17,038	20,053	20,351	15,163	17,709	-4.1	16.8
	(%)	*11.1*	*18.5*	*20.4*	*22.7*	*24.4*	*25.0*	*20.4*	*20.5*		
Extra-MERCOSUR	(US$ 10^6)	40,788	44,095	56,019	57,960	62,289	60,972	59,158	68,752	3.3	16.2
Imports											
Total	(US$ 10^6)	34,264	48,079	75,311	83,217	98,392	95,395	79,801	86,323	-4.3	8.2
Intra-MERCOSUR	(US$ 10^6)	5,247	9,429	14,093	17,092	20,546	20,437	15,418	17,603	-5.0	14.2
	(%)	*15.3*	*19.6*	*18.7*	*20.5*	*20.9*	*21.4*	*19.3*	*20.4*		
Extra-MERCOSUR	(US$ 10^6)	29,017	38,650	61,218	66,124	77,846	74,958	64,383	68,720	-4.1	6.7
Trade											
Total	(US$ 10^6)	80,155	102,201	145,713	158,215	180,734	176,718	154,121	172,784	-1.5	12.1
Intra-MERCOSUR	*(%)*	*12.9*	*19.0*	*19.5*	*21.6*	*22.5*	*23.1*	*19.8*	*20.4*		
Trade Balance											
Extra-MERCOSUR	(US$ 10^6)	11,627	6,043	-4,909	-8,219	-16,050	-14,072	-5,481	138		

Source: IDB (Data: 1991 to 1999). INDEC, SECEX, BCP, BCU and ECLAC (Data: 2000).

The foregoing developments might prompt the conclusion that the change in the conditions of intra-bloc competitiveness that was induced by the Brazilian devaluation contributed crucially to the slowdown in intra-zone trade. That did not have merely incidental consequences, since the effects were enduring. The increase in trade flows in 2000, however, runs somewhat counter to that conclusion. As the previous chapter indicated, the recovery of intra-bloc trade in that year owed more to the growth of Argentine fuels exports to Brazil.

The data on intra-subregional trade in the first half of 2001 give grounds for pessimism. Trade between the MERCOSUR countries stagnated, while extra-zone trade grew in both directions.

MERCOSUR: INTRA- AND EXTRA-MERCOSUR TRADE
Period: First Half of 2001
(US$ millions)

	Intra-MERCOSUR			Extra-MERCOSUR			TOTAL		
	1st. half. / 00	1st. half. / 01	Var. (%)	1st. half. / 00	1st. half. / 01	Var. (%)	1st. half. / 00	1st. half. / 01	Var. (%)
Exports									
MERCOSUR	*8,405.8*	*8,243.9*	*-1.9*	*32,395.7*	*35,718.0*	*10.3*	*40,801.5*	*43,961.9*	*7.7*
Argentina	3,986.1	3,963.0	-0.6	9,053.9	9,492.0	4.8	13,040.0	13,455.0	3.2
Brazil	3,607.2	3,579.1	-0.8	22,545.8	25,348.0	12.4	26,153.0	28,927.1	10.6
Paraguay	309.3	245.9	-20.5	169.0	249.2	47.5	478.3	495.1	3.5
Uruguay	503.2	455.9	-9.4	627.0	628.8	0.3	1,130.2	1,084.7	-4.0
Imports									
MERCOSUR	*8,257.8*	*8,414.4*	*1.9*	*31,849.8*	*34,570.8*	*8.5*	*40,107.6*	*42,985.2*	*7.2*
Argentina (CIF)	3,362.8	3,393.0	0.9	8,812.2	8,062.0	-8.5	12,175.0	11,455.0	-5.9
Brazil (FOB)	3,674.0	3,809.3	3.7	21,694.9	25,187.9	16.1	25,368.9	28,997.2	14.3
Paraguay	505.6	566.9	12.1	428.9	482.2	12.4	934.5	1,049.1	12.3
Uruguay (FOB)	715.4	645.2	-9.8	913.8	838.7	-8.2	1,629.2	1,483.9	-8.9

Note: Data for Paraguay correspond to recorded trade.
Sources: INDEC (Argentina); SECEX/MDIC (Brazil); BCP (Paraguay); BCU (Uruguay).

The most important development is the growth of imports in Brazil, where the expansion of extra-subregional purchases was very marked (16.1%) while the demand for intra-zone products grew at a much lower rate (3.7%).

Hence the prospects for subregional commerce in 2001 are not encouraging. Trade between the member countries will remain stagnant or, more probably, will decline.

External trade trends in the MERCOSUR countries

In the first half of 2001, Argentina's trade surplus more than doubled, rising from US$ 865 million to exactly US$ 2 billion. This is significant, although it was only possible because while exports were practically stagnant, imports fell. This circumstance could persist until the end of the year and the surprises, if there are any, could be negative. Pessimism is justified because the decline in imports is intensifying while the growth of exports is not particularly significant and cannot be sustained over the coming months. In contrast to what happened in the previous two years, demand in the Brazilian market – which was largely responsible for the growth of Argentine industrial exports evident in the first half of 2001 – could fall drastically in the second half of the year, thus making Argentina's export performance even more fragile. In this regard the forecasts in the preceding section, which projected a 2.8% increase in exports and a 6.3% fall in imports, can be deemed fairly optimistic.

Of the MERCOSUR countries, Brazil had the highest growth rates of exports and imports in the first half of 2001. The country was able to offset the stagnation of intra-zone flows with very significant increases in extra-subregional flows. Undoubtedly the most surprising development was how little the devaluation of the real affected that performance. On the export side, growth was led by the marked increase in overseas sales of primary products, solely the result of the expansion of the physical volumes shipped. Exports of manufactures, which are concentrated in the depressed Latin American market, were substantially more modest. The rise in the exchange rate also had little influence on the import side, since the growth fostered by the growth of domestic output was very significant (14.7%).

A slowdown in flows in both directions is expected. Deteriorating external conditions combine with the energy crisis, the waning of domestic output and, in the case of exports, the seasonal fall in shipments of agricultural products during the second half of the year, as well as a very sharp decline in sales to Argentina. The impact of the energy crisis on the external sector is ambiguous: on the one hand, imports are directly affected by the fall in internal demand for electronic products and, indirectly, by the overall decline in output. On the other hand, exports are constrained by energy rationing: this is the case for some electro-intensive sectors that account for a reasonable share of overseas sales, such as non-ferrous metallurgy and the iron and steel industry. Nevertheless, some significant industrial export segments (cellulose, aircraft) consume relatively little energy. It is estimated that over 40% of Brazilian industrial exports originate in sectors that are not particularly intensive in energy use, which suggests that the main impact of the energy crisis will be to reduce imports. The forecasts for the trade balance reflect that outcome and it would be unsurprising if, rather than a deficit, the year-end trade balance were to be slightly in surplus.

The trends and prospects of external trade in MERCOSUR's two smaller economies are not encouraging. The expectation of a significant increase in Paraguayan exports, springing from very optimistic forecasts of the crops of some agricultural products that account for a significant share of total sales, has not materialized. Exports to MERCOSUR continue to fall sharply, while extra-zone sales have increased significantly. In this regard the net outcome is disappointing, since total exports grew by only 3.5%, in the first half of 2001. Import growth of over 12% in the first six months of the year is surprising, given that the economy was stagnant. Note that imports of capital goods fell and that the increase in imports has basically centered on foodstuffs and fuels. These data, however, are restricted to recorded trade, which was in deficit throughout the entire 1990s.

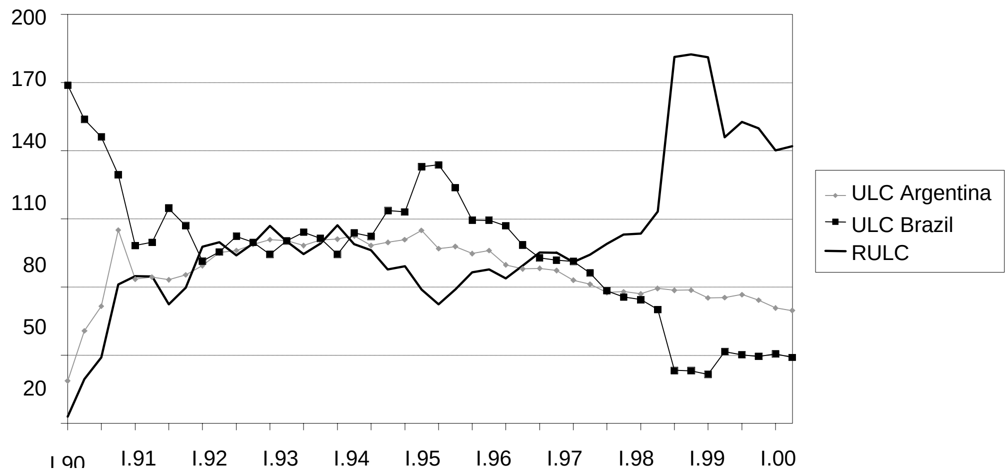
In Uruguay too, trade deficits are the rule, but in this case they are partially offset by net income from tourism services. The deficit should narrow in 2001. The forecasts point to a simultaneous fall in exports and imports, with a marked decline in the latter. These projections reproduce the trends evident in the first half of the year and do not contemplate any reversal. This is a realistic scenario because output will remain depressed, thereby contributing to the fall in imports, while the outlook for exports is no more encouraging. Sales of many of the main export products have fallen, or income from them is stagnant; this is the case of meat, textiles, chemical products and transport equipment. Finally, it should be stressed that about 45% of Uruguayan exports go to MERCOSUR, which nourishes skepticism about a possible improvement in the country's overseas sales.

B. Industrial Competitiveness in Argentina and Brazil

A recent study by Lucángeli [2001] considers unit labor costs (ULC) in Brazil and Argentina in the 1990s, as well as relative unit labor costs (RULC) in the two countries. This indicator has some advantages over other measures of competitiveness, mainly because it serves to distinguish variations in unit labor costs in two components: variations in the exchange rate-wage ratio and variations in labor productivity.

The graph below shows the development of unit labor costs in both countries and the relative competitiveness index, defined as ULC^A/ULC^B, such that a rise in the index points to a loss of competitiveness on the part of the Argentine economy.

ARGENTINA AND BRAZIL: UNIT LABOR COSTS (ULC) AND RELATIVE UNIT LABOR COSTS (RULC)
Period 1990-2000



Source: Lucángeli [2001].

Note that unit labor costs in Argentina and Brazil have developed in a quite similar fashion. Both rise in the period immediately following the implementation of each country's stabilization plan, but fall almost simultaneously from the second half of 1995 onwards. Nevertheless, the increase in ULC^A after the Convertibility Plan (I/1991) is less intense than that experienced by ULC^B after the Real Plan (II/1994). The fall in ULC^B from the second half of 1995 was quite sharp, and intensified significantly after the devaluation of the Brazilian currency in 1999.

Fluctuations in unit labor costs basically reflect wage trends in dollars in each country, which rise in the post-stabilization phase and later fall. Lucángeli [2001] nevertheless stresses that the growth rate of labor productivity in Brazil is not only more uniform than in Argentina but also higher. The sharp fall in ULC^B from mid-1995 onwards to some degree reflects Brazil's better performance.

The development of the RULC shows that Brazil's competitiveness improvements preceded the 1999 devaluation. The RULC rose persistently between mid-1995 and the start of 1999, when the real was devalued and Brazil's relative competitiveness climbed significantly. The subsequent appreciation of the Brazilian currency again raised wages in dollars in Brazil, and the improvement in competitiveness suffered a significant decline in 2000. In this regard, the Brazilian devaluation in the first half of 2001 helped bring relative competitiveness back to the same peak value recorded in mid-1999.

C. Trends in Foreign Direct Investment

The global context

Preliminary estimates of foreign direct investment (FDI) flows for 2000 confirm that there was a significant change in the pattern of such flows after the 1997 Asian crisis. In the last three years foreign investment has been increasingly concentrated in the industrialized countries, such that the share of FDI received by developing countries (DCs) fell to less than half of their share in the mid-1990s. This happened again in 2000, when flows to the developed world grew by 21% while those to DCs increased by only 8%. However, this time the Latin American countries and not the Asian countries are responsible for the DCs' loss of share in FDI flows. Note in this regard that flows to Latin America and Caribbean fell by 22%, while foreign investment in the Asian countries rose by 44%. Partly as a result of this development, the latter region regained its primacy as the leading recipient of FDI flows among DCs.

FLOWS OF FOREIGN DIRECT INVESTMENT (FDI)
Period: 1994-2000
(US$ billions)

	1988-1993		1994		1995		1996		1997		1998		1999		2000	
	Value	(%)	Value	(%)	Value	(%)	Value	(%)	Value	(%)	Value	(%)	Value	(%)	Value	(%)
World	**191**	**100.0**	**257**	**100.0**	**331**	**100.0**	**385**	**100.0**	**478**	**100.0**	**693**	**100.0**	**1.075**	**100.0**	**1.271**	**100.0**
DCs	*47*	*24.6*	*106*	*41.2*	*113*	*34.1*	*152*	*39.5*	*187*	*39.1*	*188*	*27.1*	*222*	*20.7*	*240*	*18.9*
Lat. Am./Caribbean	13	6.8	31	12.0	33	9.9	52	13.5	73	15.3	83	11.9	110	10.2	86	6.8
Asia	30	15.7	68	26.5	74	22.3	93	24.1	102	21.3	95	13.7	98	9.1	141	11.1
Africa	3	1.6	6	2.3	6	1.8	6	1.6	11	2.3	8	1.2	10	1.0	9	0.7
Other	1	0.5	1	0.4	0	0.1	1	0.3	1	0.2	2	0.3	4	0.4	6	0.5
Memo: Latin America / DCs		27.6		29.2		29.2		34.2		39.0		44.1		49.5		35.8

Source: UNCTAD, *UNCTAD Press Releases* - 2001 (PR 14, PR 18 and PR 19); UNCTAD, *World Investment Report* - 2000 (2000).

The fall in foreign investment in Latin America was concentrated in Argentina and Chile, where the process of mergers and acquisitions was particularly intense in 1999. In fact, the privatization of public assets in the countries of the Southern Cone was followed by frequent restructurings and changes in the stock control of companies and services transferred to private hands. Foreign investors were actively involved in this process, which largely explains the region's attractiveness as a recipient of FDI flows. As privatization programs waned and as processes of asset restructuring stabilized, the decline in foreign investment flows to the region was to some extent expected.

UNCTAD forecasts for trends in global FDI flows in 2001 suggest that they might contract. If this comes to pass, it will interrupt the cycle of growth begun in 1991, the longest in the last 30 years. In the first months of 2001 Latin America in general, and the countries of the Southern Cone in particular, should again see a downturn in FDI flows. However, this forecast cannot be extrapolated over the medium term. There are still profitable opportunities and projects for foreign investment. Nevertheless, in the short term the waning of privatization, coupled to Latin America's modest growth prospects, posits a somewhat discouraging scenario that will be characterized by a lesser contribution of FDI flows to the region's external financing.

Recent trends in FDI in MERCOSUR

In 2000, FDI flows to MERCOSUR fell by almost 20% relative to the previous year. It should be noted that growth in the five-year period 1994-1999 was very impressive, with risk capital inflows growing by more than 50% a year. The high volume of FDI flows in 1999 was strongly influenced by the Spanish firm Repsol's acquisition of the privatized Argentine oil company YPF, an operation that involved over US$ 13 billion. Hence the decline in 2000 is not surprising.

MERCOSUR: FLOWS OF FOREIGN DIRECT INVESTMENT (FDI)
Period: 1994-2000
(US $millions)

	1988-1993		1994		1995		1996		1997		1998		1999		2000	
	Value	(%)	Value	(%)	Value	(%)	Value	(%)	Value	(%)	Value	(%)	Value	(%)	Value	(%)
MERCOSUR	*3,914*	*100.0*	*6,516*	*100.0*	*11,392*	*100.0*	*17,726*	*100.0*	*28,266*	*100.0*	*36,252*	*100.0*	*55,813*	*100.0*	*44,845*	*100.0*
Argentina	2,266	57.9	3,635	55.8	5,609	49.2	6,949	39.2	9,162	32.4	7,281	20.1	24,147	43.3	11,152	24.9
Brazil	1,534	39.2	2,590	39.7	5,479	48.1	10,496	59.2	18,761	66.4	28,480	78.6	31,372	56.2	33,403	74.5
Paraguay	63	1.6	137	2.1	147	1.3	144	0.8	230	0.8	336	0.9	65	0.1	119	0.2
Uruguay	51	1.3	154	2.4	157	1.4	137	0.8	113	0.4	155	0.4	229	0.4	171	0.4
Memo:																
MERCOSUR / Latin America		29.8		21.0		34.5		34.1		38.7		43.7		50.7		52.1

Source: MECON (Argentina); Central Banks of Brazil, Paraguay and Uruguay; *World Investment Report* - 2000 (2000).

The importance of privatizations and, in particular, the subsequent process of asset restructuring as factors attracting foreign investment, also explain the recent decline in the already small share of Paraguay and Uruguay as recipients of FDI in MERCOSUR. Both are open economies from the commercial and financial standpoint, but to date there has been little structural reform and privatization of public companies in the two countries. Hence their small share (below 1%) of FDI flows to MERCOSUR.

In the last two years, mergers and acquisitions (M&A) have been central to the region's FDI inflows.[8] The ECLAC database aptly reflects this means of investment, discriminating between privatization, concessions and tenders for public companies or services, and the acquisition of private firms. Foreign investors have been involved in both cases.

The database records operations valued at over US$ 100 million, which is why – except for a single operation involving Uruguayan resources – the figures refer exclusively to transactions with Argentine or Brazilian companies. Almost US$ 66 billion was involved in M&A operations in Brazil and Argentina in 1999-2000, of which just 15% was related to public sector assets. Among the latter, the most significant operations were the following: (i) the purchase by Spain's Repsol of the share of YPF still in the hands of the Argentine public sector; (ii) the sale of BANESPA, a Brazilian state bank, to Banco Santander Central Hispano as part of the process of consolidating Spanish investment in the region's financial sector; (iii) the privatization of various state Brazilian companies engaged in electricity distribution, involving US and,

[8] Note that investment effected by this means is not directly comparable with the FDI flows, as recorded in the balance of payments data. M&As frequently include the purchase of assets partially financed with resources acquired in local capital markets. Moreover, the amounts involved in these transactions are gauged by the overall value of the operations, independent of the payments schedule. Despite the methodological differences, M&As are a reasonable indicator for monitoring trends in FDI flows in an economy.

again, Spanish capital; and (iv) the concession of telecommunications services in Argentina, involving French, US, Italian and Spanish capital.

ARGENTINA AND BRAZIL: PRIVATIZATIONS, TENDERS AND ACQUISITIONS INVOLVING FOREIGN INVESTORS
Period: 1999-2000
(US$ millions)

Sector	Argentina	Brazil
Privatizations and tenders:	**3,299**	**6,728**
Primary sector	*2,011*	*260*
Oil and gas	2,011	260
Services	*1,288*	*6,468*
Water	439	692
Telecommunications	849	155
Electricity	---	2,071
Financial services	---	3,550
Acquisitions:	**27,618**	**28,193**
Primary sector	*13,424*	*766*
Mineral extraction	---	766
Oil and gas	13,424	---
Manufactures	*1,210*	*3,275*
Food and beverages	835	1,237
Other manufactures	375	2,038
Services	*12,984*	*24,152*
Telecommunications	6,203	16,802
Financial services	2,621	1,780
Electricity	586	3,058
Other services	3,574	3,232
TOTAL	**30,917**	**34,921**
Memo: Share (%) in Latin America and the Caribbean	28.9	32.7

Note: Operations with a value of over US$ 100 million.
Source: ECLAC [2001].

As with public assets, the acquisition of private companies was sharply concentrated in the primary and services sectors. There were very few transactions in the manufacturing sector. The main operation in the primary sector was that mentioned above – the acquisition of the Argentine oil company YPF. In the services sector the most important transactions were in the area of telecommunications, with the purchase by Spain’s Telefónica of shares in companies in both countries, part of a mega-operation (“Operation Verónica”) that also involved Peru.

Despite the foregoing, the M&A operations of companies in the subregion will wane. This forecast is based on two factors: (i) on the one hand, the processes of restructuring and the shift in stock control of the previously privatized companies and services are stabilizing, because the repositioning of the main international players in their respective areas has already taken place; (ii) the high degree of internationalization already attained among companies in the services sector, mainly in Argentina, suggests that what has been an important source of external resources in recent years is about to diminish (CEPAL [2001]). In Argentina, mining is the sector most likely to attract FDI flows in the near future. In Brazil, the services sector will continue to attract significant external flows, including "non-traditional" areas such as the Internet.

Doubts arise about the manufacturing sector because the wave of investments in the automotive sector, which was very marked in the 1990s, has still not faded – as the most recent figures from the Central Bank make plain. However, this process is being curtailed. The chemical sector assumed the leadership in the last biennium, but the crisis facing the countries of the subregion precludes a more optimistic short-term forecast. In 2001, for example, FDI flows are projected to reach about US$ 18 billion, 45% below the level of the previous year.

In short, it will become difficult to finance the current account deficits of the MERCOSUR countries. Until two years ago FDI flows amply covered these. In Brazil, for example, forecasts for the next biennium envisage that the contribution of FDI flows will not surpass 65% of the current account deficit in that period. In the near future, therefore, investment inflows on a truly significant scale could probably become not so much the cause as the consequence of a turnaround in the subregion's prospects.

D. Intra-industrial Trade in MERCOSUR

Intra-industrial trade is defined as the simultaneous export and import of goods in the same industry. More precisely, intra-industrial trade represents the value of exports of a certain industry that is exactly offset by the same industry's imports. In general, such trade is characteristic of a pattern of mature exchange between two economies, since it is based on the specialization that is spurred by productivity gains arising from economies of scale, and on the differentiation of products within a specific industry. Additionally, intra-industrial trade has lower adjustment costs for the economies in question, the range of products increases to the benefit of consumers, and there are greater opportunities to take part in international trade.

Trends in intra-industrial trade (IIT) between Brazil and Argentina in the 1990s, measured by the Grubel and Lloyd index (GL),[9] were calculated on the basis of the three-digit classification of the SITC (Standard International Trade Classification), Second Revision. The calculation of the GL index was limited to SITC sections 5 (Chemical Products), 6 (manufactures classified according to the type of material), 7 (Machines and Transport Equipment) and 8 (Various Manufactured Articles).

Analysis of the data for these four sections prompts the following observations: (i) the number of positions (three-digit SITC) in which intra-industrial trade occurs rose from an average of 150 in the first half of the 1990s to an average of 159 in the period 1995-2000; (ii) the volume of trade in these positions rose quickly between 1990 and 1997, when it peaked at US$ 10.1 billion, but fell in 1999 and recovered partially in 2000; and (iii) the number of positions in which the GL index is >0.5 was surprisingly high in 1991-1992 but fell drastically in 1993 and rose again in 1995. From 1995 onward, half of the positions in which there was intra-industrial trade had a GL index above 0.5.

[9] The intensity of intra-industrial trade can be estimated using the index proposed by Grubel and Lloyd, which measures the share of such trade in bilateral flows, disaggregated sectorally. The index varies between 0 and 1, assuming the latter value when all trade is intra-industrial. The index is zero when all trade is inter-industrial – that is, when trade is between sectors of different industries. Values above 0.5 evidence the presence of intra-industrial trade.

TRENDS IN INTRA-INDUSTRIAL TRADE BETWEEN BRAZIL AND ARGENTINA
Period: 1990-2000

SITC		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
5	N° of 3-digit SITC with IIT	30	30	30	31	30	32	31	31	30	33	32
	N° of 3-digit SITC with GL > 0.5	17	20	18	16	15	19	29	19	19	25	28
	Vol. of trade in [US$ 10^6]	294	369	457	546	718	1,021	1,164	1,323	1,389	1,294	1,488
6	N° of 3-digit SITC with IIT	46	47	43	46	45	47	50	49	50	49	49
	N° of 3-digit SITC with GL > 0.5	15	15	5	5	9	18	19	22	19	15	15
	Vol. of trade in [US$ 10^6]	286	613	949	1,047	1,201	1,409	1,683	1,725	1,774	1,486	1,625
7	N° of 3-digit SITC with IIT	49	47	47	45	48	50	49	47	48	48	47
	N° of 3-digit SITC with GL > 0.5	24	27	15	14	14	24	21	23	25	25	25
	Vol. of trade in [US$ 10^6]	347	792	1,782	2,253	2,672	3,018	4,135	6,164	6,376	3,916	4,398
8	N° of 3-digit SITC with IIT	25	27	28	28	29	30	30	30	31	30	29
	N° of 3-digit SITC with GL > 0.5	8	14	6	2	5	16	14	12	14	9	9
	Vol. of trade in [US$ 10^6]	43	92	183	235	276	365	435	523	552	497	614
Total	N° of 3-digit SITC with IIT	150	151	148	152	152	159	160	157	159	160	157
	N° of 3-digit SITC with GL > 0.5	64	79	44	37	43	77	83	76	77	74	77
	Vol. of trade in [US$ 10^6]	970	1,866	3,371	4,081	4,867	5,813	7,417	9,811	10,091	7,193	8,125

Source: Basic data of SECEX/MDIC.

Disaggregation by sections reveals some contrasts that are worth highlighting: (i) trade in machines and transport equipment (section 7) contracted dramatically after 1999 but the same was not true of chemical products (section 5) or various manufactured articles (section 8), which peaked in 2000; (ii) the number of positions with a GL index of >0.5 fell after 1999 in sections 6 and 8, but grew appreciably in section 5 and remained constant in section 7. The distinct conduct is reflected in trends in the GL index, as reflected in the following table:

TRENDS IN INTRA-INDUSTRIAL TRADE (GRUBEL AND LLOYD INDEX)
Period: 1990-2000

SITC	Description	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Trade in 2000 (%)
5	Chemicals and similar products	0.64	0.65	0.61	0.46	0.50	0.57	0.62	0.59	0.66	0.74	0.71	18.3
6	Manufactures, by type of material	0.38	0.28	0.17	0.22	0.27	0.42	0.46	0.44	0.40	0.38	0.35	20.1
7	Machines and transport equipment	0.62	0.57	0.41	0.58	0.65	0.73	0.66	0.69	0.65	0.69	0.66	54.1
8	Various manufactured articles	0.40	0.64	0.36	0.29	0.33	0.60	0.62	0.63	0.53	0.38	0.33	7.5
	Total SITC 5-8												**100.0**

Note: The GL index was calculated on the basis of disaggregation to three digits of the SITC Rev.2 and weighted according to the trade volume.

Source: Basic data of SECEX/MDIC (Brazil).

Finally, the three-digit SITC with a GL index of >0.5 in the biennium 1999-2000 were distinguished according to the following criteria: (i) *high consolidated pattern*: those whose GL index was continuously >0.75 from 1997 onwards; (ii) *normal consolidated pattern*: those whose GL index was permanently >0.5 from 1997 onwards, but not included in the previous category; and (iii) *recent pattern*: those whose GL index was >0.5 in the biennium 1999-2000, but not in 1997-1998. The main conclusion to be drawn from the above table is that consolidated intra-industrial trade seems to be strongly associated with the presence of transnational companies, not only in the automotive sector but also in chemical, petrochemical and pharmaceutical products.

ARGENTINA AND BRAZIL: PATTERNS OF INTRA-INDUSTRIAL TRADE

SITC	Description	Consolidated pattern		Recent pattern (3)
		High (1)	Normal (2)	
5	Chemical and similar products	Medicines Plastic sheets Plastics, primary forms	Hydrocarbons Styrene polymers	Polyesters Alcohol and Phenol
6	Manufactures, according type of material	Threads and special fabrics Artificial fabrics	Textile threads Tires	Iron and steel bars Iron and steel sheets
7	Machines and transport equipment	Combustion engines Cargo vehicles	Automobiles Vehicle parts and accessories	Machinery and electrical apparatus Pumps, except for liquids
8	Various manufactured articles	---	Photographic articles Plastic articles	Control instruments Measuring instruments

Notes: (1) GL index >0.75 in 1997-1998-1999-2000.
(2) GL index >0.50 in 1997-1998-1999-2000.
(3) GL index >0.50 in 1999-2000.

CHAPTER IV. THE INTERNAL NEGOTIATING AGENDA

Little progress has been made in the past year in furthering implementation of the customs union, despite the efforts made by the negotiators in defining the agenda to relaunch MERCOSUR at the end of 1999. This situation began to deteriorate from mid-2001 onwards with the worsening of the Argentine crisis and the acceleration of the devaluation in Brazil. The impossibility of guaranteeing minimum convergence in macroeconomic performance between MERCOSUR's two main countries heightened the risk that the process would fragment. Consequently, thereafter a series of measures adopted unilaterally by the two countries blocked the customs union's "rules of the game". Changes to the common external tariff (CET) that the partners pursued in isolation, as well as the re-imposition of tariffs on intra-subregional trade (which are a reversal of MERCOSUR preferences), significantly compromised the credibility of the subregional integration process.

In the second half of 2000, before the onset of the Argentine crisis and the acceleration of the Brazilian devaluation, the Argentine government proposed a 10% reduction in the CET for capital goods, in order to boost economic growth. This reduction covered machinery and equipment, some vehicles, and petrochemical and telecommunication products, all of which are produced in the subregion solely by Brazil.

In March 2001, as part of the economic reactivation package, the Argentine government undertook an extensive review of its import tariffs. The changes affected about 2,700 tariff items, distributed as follows: (i) 866 products, most of them (862) capital goods and the other four in the sector of fittings for medicines and prefabricated constructions, had their aliquots reduced to zero; (ii) 1,240 final consumer goods, including clothing and textile articles had their aliquots raised to 35%; (iii) 273 products, including prepared foodstuffs, photographic products, paints and varnishes had their aliquots increased to a level of between 20% and 26.6%; and (iv) 291 products in the textiles sector had their aliquots raised to 30%.

The scope of the Argentine measure surprised the Brazilian government, since the list of products with a zero import aliquot included information technology goods and telecommunications products, which are usually classified as consumer goods and not as capital goods. Brazil's main concern was cellular telephones, ink jet printers and computers. The reduction to zero of the import rate for these products would mean that Brazil lost its preference margin relative to foreign competitors in the subregion. According to estimates by Brazilian producers, the reduction of the import aliquot for such products could entail annual losses of about US$ 300 million in exports to Argentina. However, in the first week of April 2000 bilateral negotiations at the ministerial level led to an agreement in which the Argentine government agreed to remove information technology and telecommunications goods from the list of products with a zero import rate.

Overcoming the recession in Argentina will require increases in tariffs on consumer goods, combined with the elimination of the tax on capital goods as a means of creating opportunities for new investment.

Another measure implemented by Argentina in the middle of the first half of 2001 entailed, in practice, the elimination of the subregional preference and the reestablishment of barriers to trade between Argentina and its MERCOSUR partners. Through Resolution 258/01, the Argentine government decided to apply discounts to the import tariffs on capital goods and telecommunications products from non-MERCOSUR countries. In practice, the measure only gives exporters from third countries the right to the refund of the "convergence factor" established by Argentina for foreign trade operations. This means that products imported from third countries pay the CET, but they receive a discount corresponding to the exchange rate variation of the peso equivalent to the average rate between the dollar and the euro of about 8%. Hence Resolution 258/01 discriminates in favor of Argentine imports from third countries, which ultimately means a reduction in the preference margins for products manufactured in the subregion. According to the list published in Argentina's Official Bulletin, the discounts are valid for 548 products, of which 407 are information technology and telecommunications goods, 82 are transport equipment (specifically automobiles, agricultural machinery, trucks and tractors) and the other 59 are capital goods.

In view of this measure Brazil decided to suspend bilateral conversations on the new automotive regime and the CET review program, negotiating issues that are of interest to Argentina. In an official note, the Brazilian government stressed that Argentina has a surplus in its bilateral trade with Brazil and threatened to suspend imports of Argentine wheat and petroleum. The Argentine government indicated that it would not reverse the measures since they are essential to cutting the cost of investment, and hence to reactivating the Argentine economy.

Studies by the Brazilian government and business associations show that the measures will affect between US$ 600 million and US$ 1 billion in exports of transport equipment, information technology goods and telecommunications products as a result of the loss of preference stemming from the application of Resolution 258.

Despite the Brazilian government's statements against the Argentine measures, the worsening of the crisis in Argentina encouraged Brazil to renounce confrontation. This entailed accepting the measures recently adopted by Argentina, thereby postponing the resolution of contentious issues so as not to endanger MERCOSUR's unity in the short term.

In July 2001, Paraguay also decided to eliminate some intra-MERCOSUR trade preferences and began to apply a tariff of 10% on imports of 352 products from other countries of the subregion. The measure will last until December 2002 and, according to the Paraguayan government, seeks to protect local industry from low-priced imports – the result of the devaluation in Brazil and of the export incentives introduced by Argentina. The Common Market Council (CMC) endorsed the Paraguayan measure and authorized the country to apply, exceptionally and for a temporary period, tariffs on imports originating in MERCOSUR. Nevertheless, these changes cannot exceed 5% of the tariff schedule.

The *Unión Industrial Paraguaya* defended the protective measures, but this position was criticized by entrepreneurs associated with the Paraguayan Chamber of Commerce. In practice the measure revives the rescinded adaptation regime that, in the case of the smaller countries, was in effect until 1997. The measure consists of a list of protected products: clothing, dairy goods, cigarettes, furniture, construction materials, packaging, beverages, sausages, canned vegetables and edible oils.

Similarly, the Uruguayan government decided in July 2001 to increase its import tariffs by three percentage points, including those applicable to the MERCOSUR members. Uruguay argued that this is a "defensive measure" to tackle the shifts in the Argentine exchange rate. Uruguay also adopted another two measures: import control on textiles and footwear, and a minimum price for oils from Argentina.

This series of measures amounted to a scaling down of MERCOSUR to a free trade area. More than that, in fact, in some cases the measures re-create obstacles to intra-zone trade that had been eliminated from 1995 onwards. In the case of Argentina, all the indications are that some senior members of the government, especially those associated with the Economy Ministry, want to transform MERCOSUR into a free trade area, which would allow the country to negotiate new trade agreements independently. In particular, and like Chile, the country would be able to establish a direct dialogue with the US government with a view to a bilateral free trade accord.

Amid the worsening of the Argentine crisis, Brazil and the other MERCOSUR partners concluded an agreement authorizing Argentina to retain, until 31 December 2002, import tax aliquots different from those of the CET. Although the effects of this measure cannot yet be accurately gauged, the agreement allowed the partners to preserve the CET while simultaneously giving Argentina temporary freedom to operate with different tariffs.

A. Revision of the Common External Tariff

As a result of negotiations in the CMC, MERCOSUR created a high-level technical group to revise the CET (Decision CMC N° 5/01). It was decided that the CET would be reduced by one percentage point as of January 2002, in contrast to the 2.5 percentage points referred to in Decision CMC N° 67/00. During the MERCOSUR Summit in Florianópolis in December 2000, the countries had already decided to reduce the CET by half a percentage point. The tariffs will therefore remain one and a half percentage points higher than in 1997, when Argentina proposed (and the other MERCOSUR partners accepted) a three percentage-point increase in the import tax aliquot.

Together with the publication of the new CET in December 2000, the Brazilian government published a ministerial resolution consisting of a new list of about 400 articles that will be included in the ex-tariff list for two years, comprising capital goods with no domestic input that pay an import tariff of 4%. For some products on Brazil's list of exceptions, the timetable for convergence with the CET was changed: dairy goods, whose import aliquot should fall to 16% in 2001, retained tariffs of 27%. The tariff on wine was retained at 27% instead of the 20% previously envisaged.

There is a relative consensus between the bigger countries that the common external tariff requires structural revision. During the whole of the first half of 2001, Argentina advocated the immediate elimination of the CET on information technology and telecommunications goods. However, a more marked change in the CET was deferred and it will only be discussed in the second half of the year in the technical group responsible for proposing modifications to the tariff.

In Brazilian ministries at least two schools of thought advocate different ways of revising of the CET. The first group, comprising technical officials of the Treasury, favor greater trade liberalization because the significant devaluation of the real appreciably raised the levels of protection for industry. The second and more cautious group in the Ministry of Development, Trade and Industry argues that the revision of tariffs, although necessary, should respect the logic of productive chains and the competitiveness forums. The Ministry of Development also wants to retain the levels of protection for the components industry as a means of offsetting the local industry's lack of competitiveness, which is compromised by the high tax burden on domestic production. The latter group seemed to triumph with its call for an immediate cut in the import tax on information technology and telecommunications goods from 14% to 2%, and a reduction of that on cellular telephones from 28% to 16%. In negotiations mediated by President Cardoso, it was decided not to reduce the import tariff on information technology and telecommunications goods, at least until the end of 2001. It is worth recalling that the MERCOSUR agreement envisaged the gradual reduction of these tariffs during the next five years – that is, until 2006. The Ministry of Agriculture also has a more protectionist position, especially when it presented and secured approval, in the meeting of MERCOSUR Ministers in July 2001, of a proposal to raise the CET on imports of subsidized agricultural products. To implement these increases the maximum CET limit of 20% on agricultural products was eliminated, which offers room to increase tariffs to 35%, the maximum level consolidated in the WTO.

The puncturing of the CET, the reestablishment of tariffs in intra-MERCOSUR trade and the shifts in exchange rate policy recently pursued by Argentina (and in 1999 by Brazil) significantly altered economic agents' perception of MERCOSUR's operability as a customs union. A recent survey of Argentine executives conducted by the *Instituto de Altos Estudios*, which is linked to the *Escuela de Administración y Negocios* of the *Universidad Austral*, revealed that 62% of them favor MERCOSUR's transformation into a free trade area. Since the Brazilian devaluation in January 1999 there has been a growing feeling among Argentine entrepreneurs that over the long term the devaluation undermined the competitiveness of Argentine products.

The perception among negotiators is that the CET remains fundamental to consolidating the customs union. It was on this premise that the CMC approved the creation of the technical group to analyze the consistency and dispersal of the CET's current tariff structure, so as to adapt it better to the goals of integration.

B. The Relaunch Agenda and the Completion of the Customs Union

The CMC meeting of June 2001 in Asunción assessed the studies conducted as part of the program to relaunch MERCOSUR. The CMC deemed it necessary to alter the deadlines for completing some of the undertakings in the program.

As regards the *dispute settlement system*, the CMC agreed to extend the deadline to 31 November 2001, so that the Senior Level Group could complete its work. Among the proposals for improving the dispute settlement system, Paraguay and Uruguay advocated the establishment of a permanent tribunal and of consultative opinions. A consolidated project still could not be defined. There was consensus on reducing, from three to two, the stages of the process contemplated in the Brasilia Protocol. There was a suggestion to eliminate assessment of the dispute by the GMC. This comes between the first stage, which envisages direct negotiations between the parties, and the third stage, which specifically concerns the establishment of *ad hoc* arbitration tribunals. The suggestion was accepted. Other changes to the project of completing the system, as presented by Argentina, Brazil and Paraguay in the Florianópolis Summit, were: (i) the creation of a specific list of third arbiters so as to confer greater quality and uniformity on the arbitration rulings; (ii) the introduction of a court of appeal with five referees; (iii) the introduction of stipulations on the post-ruling phase (the period of implementation of the ruling) to define the levels of compensation and the forms of retaliation. As a contribution to the continuation of the undertakings, the Brazilian delegation presented the document "Bases for Completing the Dispute Settlement System". In the opinion of the negotiators, one of the biggest obstacles to the current system is the absence of a common trade policy in important sectors, as well as the lack of subregional legislation. This hinders completion of the system in as much as juridical voids impede the performance of the referees in various concrete cases.

With regard to *market access*, the GMC will follow up on the mater of how to address the barriers to intra-subregional trade that were identified in a report completed by the negotiators in 2000. With respect to phytosanitary barriers, the Committee on Animal and Vegetable Health, together with the Committee of Directors of Customs Services, held their first meeting. Before 15 November 2001 they will propose measures to dismantle barriers to intra-zone trade and to facilitate trade in their respective areas of competence. The CMC also approved the MERCOSUR Action Program to Combat the International Trade in Illicit Goods, the aim of which is to facilitate the adoption of measures to communicate and transmit data between the information systems of the countries' customs services. Priority will be given to information on customs transit, as well as on export and import regimes. These measures will enable the introduction of new methods for surveillance, inspection and control in customs so as to prevent and combat the cross-border movement of illicit goods.

In the area of *trade remedies and competition*, work continues on drawing up a proposal for the gradual elimination of intra-zone anti-dumping measures and countervailing duties. The negotiators' main concern is the possible adverse consequences of the removal of these measures for conditions of competition in the customs union. In this regard, possible means of applying a common policy on safeguarding competition will be geared to minimizing the adverse effects triggered by the elimination of the use of instruments against unfair practices in intra-zone trade. Part of the activities of CT5 is the comparative analysis of trade remedy and competition policies in the various countries, taking account of their plans and goals, as well as the corrective measures envisaged in each specific piece of legislation.

In this regard, common disciplines are being negotiated for judging anti-dumping processes in MERCOSUR. The new rules will confer greater transparency on the procedure and thus enhance the ability of accused companies to mount a defense, since consultation between countries will be obligatory whenever the process involves unfair practices that affect the market in a neighboring country. Among other things, the partners agreed: (i) to cut from five years to three the maximum period in which the anti-dumping duty is in force; (ii) that the damage justifying the imposition of the duty should be identified in the same period as the unfair practice; that is, the criterion of concomitance obliges the affected companies to demonstrate a causal link between the dumping and the damage. Establishment of a common discipline for using mechanisms against unfair trade practices in MERCOSUR was proposed some years ago by Brazil, but Argentina always opposed a change to its own criteria for analyzing anti-dumping processes. Instead of establishing a duty that offsets the damage caused by the unfair practice (in line with WTO rules), the Argentine government set a minimum import price that leads to a broadening of the margin of protection to the local producer.

As part of the activities of agenda for *macroeconomic policy coordination*, economists at the statistical institutes of Argentina, Brazil, Paraguay and Uruguay, with the cooperation of the corresponding bodies in the associate members (Bolivia and Chile), are drawing up a harmonized consumer price index (H-CPI) for MERCOSUR. The effort involves the establishment of uniform technical criteria and standards to assess prices in the six countries. In line with the technical criteria already defined, setting the price index will require that the statistical institutes obtain an average of the prices recorded in the lowest level of the basic basket. On the basis of the average prices or relative prices at this level, the respective weighting will be applied so that the indices of the upper levels can be drawn up. As regards the scope of the consumer price index, this will refer to the demographic groups, regions, products and points of sale with which the index is related. Hence the index should cover, within all the variables to be measured, trends in the prices of goods and services that the reference population acquires in the region in which the selected points of sale are located. The proposal is that the H-CPI should be drawn up periodically from 2001 onwards. An experimental index, which is not yet fully harmonized, will be presented in the second half of 2001. The basket of products whose prices are to be obtained in that first stage would not be a particularly extensive list of goods, given the difficulties facing the statistical institutes in devising a set of representative goods and in determining differences in forms of payment for specific services in the different countries.

In the financial area, in June 2001 the Common Market Group (CMG) approved the Resolution of WSG N° 4 (Financial Affairs), which obliges the member countries to adapt their financial systems to the rules of transparency recommended in the Basle Agreement.

In July 2001 the CMC approved the *Framework Agreement on the Environment in MERCOSUR*. The significance of the environmental issue in deepening the integration process, involving a view of sustainable development as a directive for exploiting the subregion's natural resources, led the negotiators to note the need for a specific juridical framework with a view to regulating actions on environmental protection and to facilitating cooperation between the member countries in this field. Approval of this new juridical framework implies: (i) a commitment to comply with those international agreements on environmental issues of which the MERCOSUR countries are signatories; (ii) the possibility of exchanging information, presenting joint communications or adopting a common policy on environmental protection, the conservation of natural resources, and the promotion of sustainable development; (iii) furthering analysis of the subregion's environmental problems with the participation of competent national bodies and of civil society organizations as a basis for defining and implementing specific working rules and methods geared to the sustainable management of natural resources, improved environmental planning, and the development of environmentally sustainable productive activities.

In the field of *technical norms*, the MERCOSUR Standardization Association (MSA) has approved almost 370 common norms for the subregion. These represent a consensus between governments, producers and consumers on the requirements, as well as the technical and presentational characteristics, that various products should fulfill. The steel sector has the greatest number of common norms: 173. Another 103 projects are under way in the MSA and its work plan envisages the implementation of 730 more subregional norms before the end of 2002. The biggest problem with the MSA-approved norms is their transposition by the countries. Of all the norms established by the regional organization, barely 35% have been transposed in all the MERCOSUR countries.

C. The Common Automotive Regime

On 30 June 2000 Argentina and Brazil concluded negotiations on the common automotive policy, in force from 1 August 2000 to 31 December 2005. The agreement covers trade in automobiles, light commercial vehicles of up to 1.5 tonnes, chassis with engines, trailers, semi-trailers, bodywork, agricultural machines, road machines and automotive parts for production and for the spares market.

Bilateral trade in new vehicles is tariff-free when such trade is balanced. Monitoring the trade flows between Argentina and Brazil will be undertaken on a quarterly basis and will be measured in overall terms – that is, it will cover all the products included in the agreement and the appraisal will be in US dollars. The agreement includes provision for growing trade imbalances between the two countries as long as certain levels are respected: 3% in 2000, 5% in 2001, 7.5% in 2002 and 10% in 2003. The acceptable deficit for 2004 and 2005 will be set later. Imports that exceed the authorized deficit will levied a tax in line with the following rule: (i) 70% of the CET for all types of vehicles; and (ii) 75% of the CET for parts.

The agreement set the minimum regional content requirement (of parts) at 60% for the product to be tariff-free in bilateral transactions. New models manufactured in the subregion must have a minimum regional content of 40% in the first year, 50% in the second, and must submit to the general rule in the third. In the case of Argentina, light vehicles (automobiles and light commercial vehicles) will have a 30% minimum regional content, while other types of vehicles will have 25% until 2005.

The CET was set at following levels:

Vehicles (automobiles, light commercial vehicles, buses and trucks)	35%;
Agricultural and road machinery	14%;
Vehicle parts	14%, 16% and 18%;
Parts for agricultural and road machinery	8%;
Parts for production, not manufactured in MERCOSUR and included on a list that will be revised periodically	2%.

A CET convergence calendar was also established, covering finished products and parts for which each country's tariffs are different. In the case of Argentina, parts for production will have their aliquots fixed at

7.5%, 8.5% and 9.5% in 2000. In 2001, Argentina will set aliquots of 8%, 9% and 10%, depending on the type of product. These percentages will be increased gradually until they reach the CET level of 14%, 16% and 18% in 2006. These aliquots will converge to 14%, 16% and 18% in 2006. At the outset, buses, trucks, chassis with engines, trailers, semi-trailers and bodywork have aliquots of 18% or 25%, depending on the product, and will gradually converge toward 35% in 2006. In the case of Brazil, parts for production have their aliquots set at 9.1%, 10.4% and 11.7% for 2000, and at 9.9%, 11% and 13% for 2001. These aliquots will also converge gradually to the negotiated tariff graduations of 14%, 16% and 18% in 2006. Agricultural and road machinery have their aliquots set at 18% and will reach the CET level of 14% in 2001.

Additionally, the Automotive Committee was set up with responsibility for monitoring the agreement and for making periodic assessments. Before the agreement expires there will be an overall assessment of it, with the aim of suggesting possible adjustments and of ensuring an orderly transition towards bilateral free trade.

Once the negotiations were concluded, implementation of the automotive agreement faced serious difficulties because Brazil disagreed with the method used by Argentina to calculate the local content index. Argentine government Decree 660, which regulates application of the agreement, was contested by Brazil in the point on interpretation of the so-called “super-local content”. The Brazilian authorities’ interpretation was that 30% of Argentine local content should be appraised on the basis of the final cost of the parts used in the vehicles, not part by part as the government defined it in the decree. In making this interpretation, the Argentine decree expanded the local content to 40% and even to 50% in some cases. This decision to raise the local content of vehicles manufactured in Argentina sought to benefit the local parts industry. However, the plants in the two countries argued that the parts makers would lack the capacity to meet a demand for local content above 30% or, if they could, they would do so at the cost of significantly increasing the price of vehicles produced in Argentina.

The private sector maintained that there were distortions in the agreement that could undermine subregional integration in the automotive sector, and that the accord was to some extent a reversal of the degree of bilateral trade liberalization already attained in the recent past. Representatives of MERCOSUR automotive companies, and of the Association of Brazilian Companies for MERCOSUR Integration (Adebim), have favored the introduction of changes to the bilateral agreement. The main suggestions for revising the accord are: (i) maintaining the balanced trade clause only for automobiles, and thereby allowing the immediate adoption of free trade in vehicle parts, agricultural and road machinery, bodywork, chassis and trailers; (ii) changing the interpretation of the local content of parts in automobiles such that components imported from other MERCOSUR countries can be considered in the 30% of national parts.

During the Florianópolis meeting in December 2000, the CMG adopted a new negotiating mandate so that the regime initially agreed between Argentina and Brazil could also include Paraguay and Uruguay. Completed in February 2001, the negotiations for the creation of the new common automotive regime confirmed the 35% tariff level for imports into Argentina and Brazil of passenger vehicles and light commercial vehicles from third countries. Paraguay did not sign the agreement at that time but pledged to work towards accession, which happened in July 2001. In the case of Uruguay, the aliquot was set at 23%. Since in Uruguay the automotive industry is based on the assembly of CKDs, the aliquot for imports of parts was set at 2%. The nationalization index for vehicles produced in Uruguay will be 50%, below the 60% negotiated for Argentina and Brazil. In other words, tax-free intra-subregional trade in automobiles depends on meeting these regional content requirements. Moreover, the non-levying of taxes in intra-subregional transactions was also based on a system of monitoring bilateral trade balances already negotiated between Argentina and

Brazil in 2000. The imbalance tolerated in bilateral trade for 2001 was expanded from 5% to 10.5%; trade that surpasses this will pay an aliquot corresponding to 70% of the 35% CET.[10]

Three months after the approval of the new MERCOSUR automotive regime, Argentina sought to modify it by altering the parameters set for the system of compensation trade in cars and parts with Brazil. The problem is that because of the recession in the domestic market and the low level of imports, Argentina surpassed the level of negotiated imbalance and thus lost the chance to expand exports to Brazil. By mid-year, Argentina's surplus in the automotive trade had surpassed the 30% of the total value of bilateral commerce.

In practice, Argentina wants to alter the system of compensation trade and to bring forward from January 2006 to January 2004 the establishment of free full trade in the automotive sector. Brazil agrees with this in principle, as long as Argentina accepts other changes in the automotive regime, such as modification of the criteria used to calculate the nationalization index. As already mentioned, since the measure fixing a super-local content of 30% for automobiles manufactured in Argentina was implemented, the Brazilian government and manufacturers in the subregion have advocated a change in the criterion on the grounds that its application undermines the competitiveness of cars produced in Argentina. On the one hand, this criterion is perceived as a mechanism for establishing a market for the Argentine parts industry; on the other, the decree establishing the part by part approach to a determination of the 30% minimum of national components for automobiles manufactured in the country could raise production costs and thereby diminish the synergies arising from the complementarity between the two countries' productive structures. This would make it less viable to transform MERCOSUR into an integrated platform for the production and export of vehicles. In practice, measuring local content part by part means increasing the nationalization index of vehicles from 30% to 48%.

Nevertheless, what has actually happened as a result of the Brazilian devaluation of January 1999 is a transfer of vehicles and parts production from Argentina to Brazil. Fiat, for example, transferred the entire production of its Palio model to the Betim factory, retaining only production of the Siena model in Argentina. In the case of the parts industry, in 2000 alone 16 companies closed their factories in Argentina and reopened them in Brazil.

Argentina also wants to reduce the CET for automobiles from 35% to 25%, and to eliminate the tax on imports of trucks, tractors and agricultural machines. The countries had until 6 July 2001 to make proposals for adjustments to the regime. All proposals related to the revision of the common automotive regime will be analyzed by 1 September 2001, but Brazil's suspension of the negotiations compromises the prospects of meeting the original schedule.

Paraguay adhered to MERCOSUR's common automotive regime in July 2001. In line with the agreed rules, Paraguay's schedule for reducing imports of used cars (up to seven years old) lasts until 2006. The age of the imported vehicles will fall annually to three years in 2005. From the following year Paraguay will not be able to import used cars. Additionally, quotas have been defined for automobile exports with a zero tariff from Paraguay to MERCOSUR countries. Although Paraguay does not manufacture automobiles, the quotas should act as an incentive to investment in the country. In 2001 Paraguay will be able to export up to 10,000 units; up to 12,000 in 2002; up to 14,000 in 2003; 16,000 in 2004; 18,000 in 2005; and 20,000 in 2006. Quotas were also set to Paraguayan parts exports to Argentina and Brazil; these can be up to US$ 35 million in 2005 and 2006.

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[10] The limit of disequilibria in the sectoral trade balance is growing. In other words, in practice each country's annual imports can surpass 10.5% of exports in 2001, 16% in 2002 and 22.2% in 2003.

D. Barriers to Intra-subregional Trade

In May 2001 the Argentine government issued Resolutions N° 2004 and 2008 fixing minimum reference prices for imports of several foreign products, including those from the MERCOSUR countries. Among the products covered by the two resolutions are footwear, washing machines, cookers, bicycles, textiles, dairy goods, household appliances and others. According to the Brazilian government the minimum prices are very high, which makes the Argentine measure an obstacle to the export of products manufactured in Brazil. The Argentine government, in turn, alleges that the measure seeks solely to avoiding under-invoicing in imports and, consequently, tax evasion. During the Twentieth Meeting of the CMC in Asunción the Brazilian government made a request for consultation, questioning the Argentine measure.

The discovery of cases of foot and mouth disease in Argentina's northeast provinces during the second half of 2000 forced the Brazilian government to suspend imports of Argentine livestock in August 2000. With the emergence of new centers of the illness in February 2001 in the provinces of Entre Ríos, Formosa and Corrientes, the Brazilian government also decided to suspend imports of beef on the bone from Argentina. Even with the establishment of eight phytosanitary control posts to disinfect people and vehicles at the borders between these Argentine provinces and the state of Rio Grande do Sul, the disease reached the cattle breeding grounds in the livestock regions next to the border with Argentina. Consequently, the cattle had to be vaccinated and the state of the Rio Grande do Sul lost its status as a region free of foot and mouth without vaccination. The disease also affected cattle and pigs in the Uruguayan department of Artigas. The Uruguayan government set up an exclusion area in the region and decided to sacrifice 5,700 animals. The country had had no cases of foot and mouth since 1990 and since 1994 it had held a certificate from the International Office of Epizootics as a "country free of foot and mouth disease without vaccination". Meat accounts for 25% of Uruguay's exports and brings in an annual income of about US$ 500 million. In its June 2001 meeting the CMC laid down a series of joint activities and permanent coordination to combat foot and mouth in the MERCOSUR countries.

In mid-2001, rice producers in Rio Grande do Sul benefited from two decisions by the Federal Regional Tribunal of Porto Alegre, which banned the entry of Argentine and Uruguayan products into the Brazilian market. On the basis of an appeal lodged by the Attorney General of the Union, Brazil's Supreme Court revoked the decision of the state body and allowed rice to enter from neighboring countries. Despite the fact that the measure has been revoked, Argentine and Uruguayan producers allege that they continue to face difficulties in exporting rice to Brazil since the Brazilian government requires a prior license to import the product. In November 2001, the Federation of the Associations of Rice Producers in Rio Grande do Sul counterattacked by presenting the Ministry of Development, Industry and External Trade with a series of documents to support the opening of an anti-dumping investigation against rice producers in Argentina and Uruguay. Despite the allegation that producers in the neighboring countries were causing harm to local production by dumping, rice production in Rio Grande do Sul was practically unaffected in 2000 and there was even a 1.5% reduction in the area under cultivation.

As regards Brazil's refusal to automatically grant import licenses, a practice followed by the country's customs authorities since 1997, it should be noted that Brazil is not complying with the unanimous ruling of the MERCOSUR Arbitration Tribunal of 28 April 1999, which obliges the country to eliminate the use of such licenses to control imports. The Brazilian authorities argue that the absence of automaticity in conceding import licenses is a legitimate mechanism to control imports, specifically in the case of agricultural products and those that might affect public health. In the document that led to the lifting of the barriers to intra-subregional trade, which was completed by the negotiators in October 2000, the Argentine and Uruguayan representatives included the measure as one of Brazil's trade practices that most affected their exports.

As part of the activities on MERCOSUR's relaunch agenda, in February 2001 Argentina and Brazil discussed the list of pending trade issues that for several years have affected bilateral commerce in sugar, poultry, footwear, milk and tobacco. Argentina's sugar imports face a 20% import tariff. Imports from MERCOSUR countries are levied an 18% aliquot. Imported sugar also pays an "additional duty" determined on the basis of the average international rates of the last four years. In September 2000, the Argentine government issued a ministerial resolution that made the import tariff on sugar applicable for another five years, and that extended from four to eight years the period used for calculating the "additional duty".[11] The decree protecting local producer ceased to be in force in December 2000. The Argentine Congress had already voted for a measure extending the protection indefinitely, but the Executive vetoed it and decided to replace it with the ministerial resolution that grants the Executive the right to alter the regime without congressional approval.

The imposition of import tariffs on sugar from Brazil was also retained on the grounds that the sector benefits from Brazilian government subsidies to alcohol producers. Despite the extension of the period for levying the import tariff and the additional duty to 2005, the Argentine government announced that from that year onwards it will seek gradually to reduce the barriers to imports of Brazilian sugar. The most recent initiative to end this sectoral conflict was a Brazilian proposal, put forward in a meeting with representatives of the Argentine government in February 2001, to provide Argentine producers in the north of the country with the technology to produce anhydrous alcohol based on sugar cane. The Argentine sugar sector has 150,000 hectares under cultivation and employs about 55,000 people. Efforts have been made for over five years to resolve the conflict over the bilateral sugar trade.

In the case of poultry, the Argentine government imposes surcharges on imports of Brazilian poultry. In August 2000 the Brazilian government decided to appeal to MERCOSUR's dispute settlement body against an anti-dumping measure imposed by Argentina in July on Brazilian poultry exports. Argentine poultry producers favoring this measure argue that between 1999 and 2000 about 12 poultry companies closed in Argentina. Since 1997 the two countries have been discussing an agreement to establish export quotas for Brazilian sales in Argentina. Brazil exports about 50,000 tonnes of poultry a year to Argentina, and these sales account for some 10% of local consumption.

Until July 2000 Brazilian footwear exports were subject to quantitative restrictions that placed a ceiling of 4.4 million pairs on sales to Argentina every six months. In 2000, Argentina imported 18.9 million pairs of shoes, worth US$ 123.7 million. Brazil accounts for about 80% of Argentina's footwear imports. The proposal under discussion is to create and implement projects to integrate productive chains, possibly involving partnerships between companies in the two countries. Because of the difficulties of access to the Argentine market, some Brazilian companies are looking into the possibility of establishing production units in Argentina.

In the case of trade in milk and its by-products, Brazil is analyzing an anti-dumping procedure against Argentine exports of dairy goods. The Brazilian government had asked for mediation by the WTO's dispute settlement system so as to secure a final resolution of the matter. There were also suspicions that subsidized powdered milk from New Zealand was entering the Brazilian market via triangulation, by means of imports through Argentina and Uruguay. The Argentine and Brazilian governments reached agreement in February 2001. Representatives of the two countries' dairy industries concluded an accord that set a minimum price of US$ 1,900/t for the sale of this product in Brazil, or otherwise the levying of

[11] In practice, with the new rules the additional duty increased from US$ 240 to US$ 300 as of January 2000, since the international price of the product has tended to fall since 1997.

an 11% surcharge on its international price if this falls below the minimum fixed price. In 2000 Argentina exported US$ 225 million of dairy goods to Brazil, 25% below the previous year's exports.

As regards inputs for the cigarettes industry, a technical group will be set up to analyze a Brazilian tax that affects tobacco exports to Paraguay and Uruguay. Brazil's partners want to end the 150% rate on tobacco, paper and cigarette filters that has been in effect since mid-2000.

In October 2000, the Argentine government set a 25% customs tariff for a model of bicycle produced in Uruguay on the grounds that the product did not meet MERCOSUR rules of origin. Representatives of the Argentine industry accused the Uruguayan company Motociclo of selling bicycles manufactured in China as if they were locally produced. Motociclo sued the Argentine association of bicycle manufacturers for libel. It alleged that INTI (*Instituto Nacional de Tecnología Industrial*), the Argentine institution that certifies quality, had already inspected the factory and had decided that the product met MERCOSUR's origin requirements. Motociclo says that its bicycles contain 75% national inputs, with 25% of the inputs imported from China. The factory has the capacity to produce 330,000 bicycles a year and employs 450 workers. Until the first half of 2000, Motociclo bicycles accounted for 25% of total sales in the Argentine market.

In May 2001, the Brazilian government decided to extend to the MERCOSUR countries the levying of a tariff on leather exports. Argentine tanners fear that this measure, combined with an increase in the international demand for leather and a fall in the number of livestock, will cause a leather shortage in the local market. Brazil advocates a common policy in the sector, to include eliminating the tariff in intra-subregional trade, reducing from 8% to 4% the CET on wet blue leather, and harmonizing export taxes.

The negotiators produced a report on all the non-tariff barriers affecting intra-subregional trade, which was discussed in the CMG in October 2000. Some 82 restrictions on intra-bloc trade were identified, most of them applied by Argentina and Brazil. These mainly consist of technical regulations, phytosanitary measures, fiscal and financial restrictions, judicial decisions, legal monopolies, the countries' failure to transpose subregional regulations into national legislation, and administrative and customs procedures. The aim of the report is to formalize a joint proposal fostering the restriction or elimination of non-tariff barriers in intra-subregional trade.

Argentina presented 28 cases in which the measures adopted by its neighbors affect Argentine sales in the subregional market. Of this total, 18 are measures imposed by Brazil. Brazil presented 17 cases, of which 12 originate in Argentina. Paraguay presented 31 cases and Uruguay 23.

CHAPTER V. THE EXTERNAL NEGOTIATING AGENDA

In the last year, the economic downturn in the two largest MERCOSUR countries, especially Argentina, has increased dissatisfaction with subregional integration. The unilateral changes to the CET effected by Argentina, Paraguay and Uruguay for a broad range of products in the first half of 2001 weakened MERCOSUR as a customs union. The crisis has undermined the identity of the customs union, which in turn has damaged MERCOSUR's ability to sustain a strong and consistent negotiating position in the various initiatives of its external agenda. The fact that the integration process has become less operational has also revealed the willingness of some MERCOSUR countries to negotiate bilaterally with the United States.

The current stage of negotiations for the Free Trade Area of the Americas (FTAA), the recent acceleration of negotiations with the European Union, and the prospect that a new multilateral trade round will be launched in Qatar in November 2000 make it all the more important that MERCOSUR's agenda give priority to enhancing coordination of the bloc's negotiation position in external negotiations, at least in the short term. The negotiations with Latin American countries and groupings (Chile, Mexico and the Andean Community) are also important in that regard.

The Free Trade Area of the Americas

The Sixth Meeting of Trade Ministers of the FTAA in Buenos Aires in April 2001 concluded the second stage of negotiations for hemispheric integration. In the 18 months preceding that meeting, all negotiating groups sought to comply with the negotiating mandate to emerge from the Toronto Ministerial Meeting, and each presented the ministers with a draft of their chapters. At the same time, the implementation process for the agreed business facilitation measures was expedited.[12]

During this period, the negotiating positions of the countries and subregional groups became more explicit. MERCOSUR´s proposal for the FTAA negotiations, strongly influenced by the interests of Brazilian industry, was marked by caution in areas such as industrial tariffs, safeguards, TRIMs and TRIPs, and by an aggressive position on agriculture – the only area where the proposal is WTO-plus. In addition, MERCOSUR has made it clear that it will not negotiate unless issues such as agricultural liberalization and anti-dumping disciplines are part of the negotiating agenda. The United States, meanwhile, combines aggressiveness on issues that are of interest to national exporters and investors with caution in domestically sensitive areas, such as agriculture and anti-dumping. Washington is also proposing the inclusion of environmental and labor issues on the agenda, a reflection of the importance of these questions in securing domestic consensus in favor of the FTAA.

At the January 2001 meeting of the Trade Negotiations Committee (TNC) in Lima, Peru, the diverging interests of MERCOSUR and the United States on the treatment of anti-dumping disciplines became clear, causing an impasse in the talks. Additionally, although the new Republican administration in the United States has reaffirmed the FTAA as a priority in trade relations with other countries of the Americas, it has also made clear that if faced with possible difficulties in the hemispheric negotiations it might resort to bilateral agreements as a means of advancing its negotiating agenda in the Hemisphere.[13]

On the eve of the Buenos Aires Ministerial there seemed to be a significant risk that the FTAA negotiations were going to become deadlocked, and hence the outcome of the meeting was relatively

[12] The United States is the only country that has fully implemented the eight customs-related business facilitation measures.

[13] The start of bilateral trade negotiations with Chile in November 2000, and several Latin American countries' frequent statements in favor of such negotiations, appear to make this a viable alternative.

positive. This was reflected in the Final Declaration, which addressed the different interests at stake and lessened the number of disagreements that threatened to paralyze the process.

The Buenos Aires Ministerial Declaration reaffirms the principles guiding the FTAA negotiations, such as that of a single undertaking ("nothing is agreed until everything is agreed") and the coexistence of bilateral and subregional agreements to the extent that the rights and duties under these agreements are not covered by or do not exceed the rights and obligations of the FTAA. The main decision of the ministerial meeting was to fix 2005 as the deadline for concluding the negotiations. The decision was confirmed by the Heads of State and Government at the Third Summit of the Americas in Quebec on 20-22 April 2001. This followed recommendations from the Ministers that guidelines be established to ensure that the FTAA negotiations are concluded no later than January 2005, so that the agreement can enter into force as soon as possible thereafter and no later than December of that year. It was also decided that the negotiating groups dealing with market access issues (Market Access, Agriculture, Services, Investment and Government Procurement Groups) should define the methods and modalities of the tariff negotiation before 1 April 2002. This should enable market access negotiations, including discussions of the tariff liberalization schedules, to begin no later than 15 May 2002.[14]

The mandates and guidelines given by Trade Ministers to the Negotiating Groups called on the latter "to intensify efforts to resolve existing divergences and reach consensus, with a view to eliminating the brackets from draft texts to the maximum extent possible, to work on consolidating texts on the basis of the specific instructions (for each chapter), and to submit to the TNC a new version of chapters on their respective areas no later than eight weeks before" the next Ministerial meeting. This will be held in Ecuador before 31 October 2002. The TNC will be responsible for ensuring that the groups dealing with market access issues (Market Access, Investment, Services and Government Procurement) begin such negotiations no later than 15 May 2002. At least three TNC meetings will be held in the next eighteen months and the TNC must produce a second version of the draft FTAA Agreement – including the chapters of each Negotiating Group and those related to general and institutional issues – for submission to the next Ministerial Meeting.

Annex I of the Ministerial Declaration contains the ministerial instructions given to the Negotiating Groups:

Market Access. By 1 April 2002, the Group should present to the TNC: (a) recommendations on the methods and modalities for tariff negotiations so that negotiations can begin no later than 15 May 2002; (b) a timetable and modalities for establishing FTAA rules of origin, also in order to initiate negotiations no later than 15 May 2002; (c) a preliminary inventory of non-tariff measures in order to establish a methodology, including a schedule where appropriate, for the elimination, reduction, definition, further definition, further disciplining and/or prevention of non-tariff barriers; and (d) a report on the progress made in negotiations for a safeguards regime applicable to the goods of the Hemisphere. Prior to that, and by 1 November 2001, the Hemispheric Database should be fully operational.

Agriculture. Market Access negotiations should start by 15 May 2002. Before that, by 1 April of that year, the Group should present to the TNC: (a) recommendations on the methods and modalities for tariff negotiations; (b) recommendations on the scope and methodology for eliminating export subsidies affecting trade in agricultural products in the Hemisphere; (c) recommendations on the types of measures and the methodology for the development of disciplines to be adopted for the treatment of all the practices that distort trade in agricultural products, including those that have an equivalent effect to agricultural

[14] With the establishment of deadlines for concluding the negotiations, proposals for bringing forward the calendar to enable the agreement to enter into force before the end of 2005 lost force. These proposals had negatively affected the negotiating environment from the second half of 2000 onward.

export subsidies; (d) a preliminary inventory of non-tariff measures in order to establish a methodology, including a schedule where appropriate, for the elimination, reduction, definition, further definition, further disciplining and/or prevention of non-tariff barriers; and (e) based on the establishment of a process of notification and counter-notification of sanitary and phytosanitary measures, recommendations on the treatment to be adopted in order to prevent these measures from becoming unjustified obstacles to trade in the Hemisphere.

The mandate conferred by the ministers on the Agriculture Group is very broad. It includes tariffs, non-tariff barriers, sanitary and phytosanitary measures, export subsidies and trade distorting practices that have an equivalent effect to export subsidies. As regards the latter two issues, however, the mandate is less incisive and clear with regard to how the negotiations should proceed after 1 April 2002. This reflects US and Canadian resistance to committing themselves, in this negotiating forum, to the establishment of disciplines in areas such as agricultural export subsidies and domestic support measures for this sector.

Subsidies, Antidumping and Countervailing Duties. The mandate for this negotiating group reflects, on the one hand, US resistance to discussing its anti-dumping legislation and, on the other, pressure from various countries, among them the MERCOSUR countries, for the FTAA to perfect the multilateral agreement applicable in this area. The Group was instructed to intensify its efforts to identify options for deepening existing disciplines on subsidies in the WTO Agreement on Subsidies and Countervailing Measures, and for applying laws on anti-dumping duties. By 1 April 2002 the Group is to submit to the TNC recommendations for deepening disciplines on subsidies, and also recommendations for the methodology to be used to “improve the rules and procedures for the operation and enforcement of anti-dumping laws and countervailing duties, so as not to create unjustified obstacles to free trade within the Hemisphere”. Both recommendations will be evaluated by the TNC during its first meeting thereafter.

Investment, Services and Government Procurement. Important in this regard is the fixing of 1 April 2002 as the deadline for submission to the TNC of recommendations by each group on the modalities and procedures for negotiations, such that the market access negotiations can also begin by 15 May 2002. With respect to the Government Procurement Group, the deadline of 1 April 2002 has also been set for identifying “the scope and details of the statistical information that countries should make available” for exchange among themselves and to support the negotiations.

The instructions given to the Competition Policy and Dispute Settlement Groups are generic and do not include the establishment of dates or deadlines for achieving results.

In addition to the mandates and guidelines defined for the different negotiating groups, and the establishment of deadlines for the conclusion of the negotiations and the entry into force of the Agreement, the Declaration includes some important elements that reflect the consensus reached recently in areas where agreement has been difficult.

First, the Declaration includes labor and environmental questions, maintaining that “one of the FTAA´s general objectives is to strive to make trade liberalization and environmental policies mutually supportive, taking into account work undertaken by the World Trade Organization (WTO) and other international organizations, and to further secure, in accordance with our respective laws and regulations, the observance and promotion of worker rights, renewing our commitment to the observance of internationally recognized core labor standards, and acknowledging that the International Labour Organization (ILO) is the competent body to set and deal with those core labor standards”. These considerations represent a compromise solution between the parties, in that they allow the inclusion of labor and environmental issues in the FTAA negotiations but take as a reference the norms and principles established by the ILO or the laws and procedures of the parties. This precludes the creation, through the Hemispheric Agreement, of specific rules in an area where conflicts are frequent.

A second point to be highlighted is the attention given to the "differences in the level and size of the economies" of the Hemisphere, in contrast to the low level of priority thereto attributed to this question by the main players of the FTAA and on the negotiating agenda. With the support of the Consultative Group on Smaller Economies and the Tripartite Committee (IDB, ECLAC and OAS), the TNC shall formulate, no later than 1 November 2001, "guidelines or directives on ways of applying the treatment of the differences in the levels of development and size of economies".

A third important agreement reached during the meeting was a commitment to transparency in the negotiations. The Ministers decided to publish the draft Agreement in its current version, in the four official languages, following the Summit of the Americas in Quebec. The results reached in the negotiations will be disseminated after each Hemispheric Summit. Vice-ministers, moreover, were instructed to include more information on the process on the official FTAA website. This decision partly responds to private sector demands throughout the region. It is worth noting, however, that the Declaration does not call for the dissemination of the results of the Negotiating Group meetings. The latter would be of great importance to the private sector in its attempts to adequately follow-up on the negotiations, bearing in mind that the Summit meetings are only held once every two years.

Finally, a decision was taken to establish a Technical Committee on Institutional Aspects within the structure of the FTAA negotiations, with the aim of developing the general structure of the Agreement and of considering issues such as institutional mechanisms, transparency and general rules applicable to all chapters and areas of the Agreement.

Consequently, following the Quebec Summit of April 2001, the FTAA negotiating process seems to be making gradual and continuous progress on setting up a hemispheric free trade area. In a recent article, Bouzas and Svarzman [2001] argued that one of the main results of the FTAA negotiations so far has been "the absence of significant discontinuities and the capacity to further the agenda on the basis of gradualism", allowing negotiating positions to be moderated by pragmatism and fostering the search for compromise solutions. This is particularly important in view of the fact that the initial context for the FTAA talks was one of divergent interests, agendas and perceptions among the main participants, and that there were a number of incentives for non-cooperative behavior.

Many issues remain to be negotiated and agreed upon, including "the scope of the commitments, the treatment of the issues and disciplines, how to address the asymmetries, and the implementation schedules", according to Bouzas and Svarzman. Hence it is not clear whether the convergence of interests between the negotiating parties will continue as it has done hereto. If the talks fail to make satisfactory progress, the United States might resort to bilateral agreements with Latin American countries. The fact that the US administration has yet to secure Trade Promotion Authority (TPA) gives force to the bilateral alternative in its integration strategy.

In this respect, during the Twentieth Meeting of the Common Market Council (CMC) in June 2001, MERCOSUR reactivated the Rose Garden Agreement, an accord with the United States signed in June 1991 "with the objective of examining the possibility of initiating bilateral negotiations in the 4+1 format aimed at improved market access conditions". This decision responded to the interests of Argentina and Uruguay, which had expressed a desire to negotiate bilateral agreements with the United States as a result of the difficulties facing the bloc in recent months.

MERCOSUR-European Union

Negotiations between MERCOSUR and the EU began in April 2000 in the EU-MERCOSUR Biregional Negotiations Committee (BNC). The BNC was created at the end of 1999 and entrusted with conducting biregional talks aimed at the conclusion of an Interregional Association Agreement. Negotiations have proceeded somewhat timidly and only preliminary progress was made during the first four rounds, in which discussions centered on broad issues such as political dialogue, cooperation and trade issues.

MERCOSUR´s interests in the negotiations with the EU focus on the liberalization of agricultural trade, and the reduction of subsidies that distort production and international trade in this sector. However, these are issues that the Europeans will negotiate fully only in multilateral fora. In this regard the failure of the WTO multilateral negotiating round in Seattle in November 1999 entailed the postponement of any effort to tackle such issues in bilateral relations between the two blocs, and the weakening of incentives to negotiate a preferential trade agreement.

The negotiations also respond to important political interests. In principle, both MERCOSUR and the EU are concerned that the FTAA will materialize, since many perceive it as a decisive step towards consolidating a US zone of influence in the entire Hemisphere.

During the Fourth Meeting of the BNC in March 2001, the two sides agreed that negotiations on tariffs and services should start as soon as possible, no later than 1 July 2001, and that the pace of negotiations should be accelerated to that end. At the Asuncion Summit of June 2001, MERCOSUR's CMC, in its Decision No. 08/01 ("Negotiations with Third Parties"), also pronounced its desire to accelerate the talks with the EU.

Given the importance of addressing the various issues related to agricultural trade, and not only the tariff questions of market access, MERCOSUR called for negotiations to begin with a profound discussion of the methods and modalities of the negotiations, following the model adopted in the FTAA negotiations. The EU, in turn, argued that the negotiations should be based on a practical discussion, organized according to the chapters of the future agreement. This means that discussions on the methods and modalities of the tariff negotiations would be simultaneous to those on market access conditions. The desire to move beyond the phase of methods and modalities is a clear expression of the EU's interest in accelerating the negotiations ahead of the FTAA talks, since in the hemispheric negotiations that phase will not be concluded before April 2002.

At the Fifth Meeting of the BNC in Montevideo on 2-6 July 2001, MERCOSUR expected the EU to formulate an offer covering trade in goods, services, government procurement and business facilitation measures in the areas of customs and electronic commerce, as it had previously announced. The Europeans did in fact present their proposal, which mainly includes an offer in the tariff area and negotiating texts on trade in goods, services and government procurement. Specific proposals on the elimination of non-tariff barriers, and on business facilitation measures, would be presented in a subsequent phase of the negotiations. The parties also discussed a draft text on the institutional framework of the future Association Agreement. In addition, it was agreed that MERCOSUR would present its negotiating offer before the Sixth BNC Meeting, which will be held before 31 October 2001.

At the end of the Fifth BNC Meeting, MERCOSUR and the EU had reached consensus on various issues relevant to the talks on tariffs and non-tariff measures. The two sides agreed that the whole tariff schedule would be subject to negotiation, taking a reference tariff[15] as the basis for discussions on tariff reductions, and a base tariff[16] for the application of the preferences following the conclusion of the negotiations. It

[15] For the EU, the reference tariff will be the one applied on 1 July 2001 (or, alternatively, the Most Favored Nation – MFN – tariff, still subject to definition). For MERCOSUR, it will be the CET adopted by CMC Decision No. 22/94. The MERCOSUR proposal adds the subsequent modifications introduced to the CET in line with the bloc´s rules.

[16] For the EU; the base tariff will be the one in force (or the MFN tariff) on the date of the conclusion of the negotiations. On this point, the EU has agreed to introduce the changes to the CET agreed by MERCOSUR after 1994 as long as these changes do not result in higher tariffs than those established by CMC Decision No. 22/94. When such changes result in lower tariffs, they should be considered.

was also agreed that the reference period for determining the trade data that will serve as the basis for the negotiations would be the three-year period 1998-2000. Moreover, a substantial part of trade should be totally liberalized within a ten-year period. The negotiations will be based on the nomenclature of the 1996 Harmonized System and its respective revisions, and both tariff and non-tariff issues will be considered in order to ensure effective market access.

There are, however, countless points of divergence in the interests of the parties involved. In the area of goods trade, the EU has conditioned its offer on an agreement regarding standstill and rollback clauses for the tariff levels applied by each party. This implies a commitment not to raise reciprocal tariffs once the tariff negotiations start, and a restriction on MERCOSUR´s freedom to conduct trade policy. From this viewpoint, the clauses mentioned above are quite rigid and conditional, particularly in view of the recent modifications to the CET effected by the members of MERCOSUR (especially Argentina) and MERCOSUR's recent decision to revise its CET structure. MERCOSUR believes that the standstill and rollback clauses should form part of the negotiating process, and should not be a technical prerequisite to that process.

The tariff reduction proposed by the EU, and possible improvements in its offer, are conditional on reciprocal concessions by MERCOSUR, including strict reciprocity in concessions on textiles and footwear. The EU does not accept as a basic principle that it should assume larger trade liberalization obligations in an initial phase because of the "broad differences existing in the level of economic development" between the two blocs, as is recommended by MERCOSUR. This European position contrasts with that adopted in negotiations with Mexico and South Africa, where the proposal for goods trade envisages different liberalization schedules based on the principle of "asymmetric reciprocity". In the negotiations with MERCOSUR, in contrast, the exceptions to the treatment of tariff and duty elimination exclusively benefit the EU in the areas of agricultural, processed agricultural and fisheries products, as will be shown below.

With respect to the tariff reduction schedules, the EU proposes that they be applied equally to industrial, fisheries, agricultural and processed agricultural products. Europe also wants the tariff reduction to be across the board, with both parties meeting the same deadlines. The products are classified in categories according to the EU's proposed treatment:

(a) products subject to total tariff elimination:
   - Category A: immediate elimination;
   - Category B: across the board elimination in 4 years;
   - Category C: across the board elimination in 7 years; and
   - Category D: across the board elimination in 10 years.

(b) Category E: products (processed agricultural and fisheries) for which the method of liberalization has not yet been defined;

(c) Products excluded from the offer but subject to tariff quota concessions (various agricultural, agro-industrial and fisheries products) or to specific negotiations (wines).[17]

Although the tariff reduction schedule is the same for agricultural, processed agricultural and industrial products, the European offer is more restricted in the area of agriculture. For the industrial sectors, where Europe has comparative advantages, the offer covers the total tariff schedule and envisages the complete (or almost complete) elimination of customs duties in predefined time periods. For the agricultural and

[17] Tariffs on wine and distilled beverages were not included in the offer. Their gradual tariff reduction will be undertaken under a specific agreement which will include questions of intellectual property (the protection of denomination of origin, as well as geographic indications and traditional expressions, among others).

agro-industry sectors, where MERCOSUR products are more competitive, the proposal focuses on the elimination of *ad valorem* tariffs, which constitute a less important barrier to MERCOSUR exports compared to other mechanisms, such as specific tariffs, entry prices, etc. The European proposal does not contemplate complete tariff liberalization for certain sensitive products, which are currently subject to specific tariffs and/or entry prices. For these products, which are important to the exports of MERCOSUR members (cereals, rice, olive oil, dairy products, meats, eggs and poultry, tobacco, sugar) and for the processed fruit and vegetable sectors, the European proposal envisages greater liberalization through quotas subject to preferential tariff treatment. It is important to note that the EU proposal is quite clear in establishing that the reduction is applicable only to the *ad valorem* part of the tariff.

In contrast, the MERCOSUR position on tariff cuts is that in the negotiations on reduction, the equivalent *ad valorem* tariff should be taken as the reference, whatever form the tariff assumes in each of the structures (specific tariffs, mixed, or others). For the EU, the equivalent *ad valorem* tariff would only be considered when the opposite is not specified. This entails the retention of the tariff structure currently in force in Europe, which includes precisely those distortions that MERCOSUR would like to eliminate through negotiations.

The European proposal presented in Montevideo also covers other subjects which, while not referring to market access conditions, are equally important. In the areas of services and government procurement, the EU presented negotiating texts, although no liberalization offer has been formulated. The text proposed for the services sector follows the General Agreement on Trade in Services (GATS) model, since it includes commercial presence - Mode 3-supply.[18] Moreover, the proposal is not clear in terms of the methodology of liberalization to be adopted: positive lists as in the GATS, or negative lists as in NAFTA. The proposal explicitly excludes audiovisual services, maritime cabotage and national and international transport services from the agreement. In the European view, an Agreement on Trade in Services would not cover domestic subsidies. In addition, the proposal calls for differentiated and specific treatment for telecommunications, financial and maritime transport services.

In the area of government procurement the European proposal is ambitious. In principle it includes all goods, services and public works, and applies to public bodies at the central and sub-central level, although it allows for the inclusion of exceptions in the course of the negotiations. The clause on national treatment rejects discrimination between suppliers from each region on the basis of origin criteria that refer to the firm's capital or the source (country of production) of the goods and services provided. Moreover, the proposal prohibits national preferences and margins in qualifying and selecting suppliers of goods and services, in the evaluation of proposals, and in the concession of contracts. A series of articles refer to the government procurement procedures to be adopted in order to ensure transparency and non-discrimination among suppliers from both regions. As regards the technical specifications of the procurement process, the proposal recommends that these be based on performance criteria, not on descriptive characteristics or design, and that they be grounded in international norms whenever these are available.

As regards trade remedy laws, the proposal refers to the General Agreement on Trade and Tariffs (GATT) agreement on anti-dumping and countervailing measures, but for safeguards it envisages bilateral consultation and negotiation on the application of the mechanism.

In sum, the tariff offer presented by the EU to MERCOSUR in the fifth round of negotiations in July 2001 in Montevideo is quite modest, particularly on market access for agricultural and processed agricultural goods. It is clear that the limitation in the document's coverage reflects a negotiating strategy arising above all from a negotiating mandate that is restrictive in areas that would affect implementation of the Common Agricultural Policy.

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18 In the NAFTA model, this is treated as investment.

In the area of agriculture, therefore, the main problems in the EU offer are: (i) the exclusion of agricultural and processed agricultural products that are important to MERCOSUR exports; (ii) different treatments for *ad valorem* tariffs and specific duties, with tariff reductions limited to the former – which are less relevant than the latter as mechanisms for the protection of European agricultural and agro-industrial products; (iii) the introduction of a category of products slated for tariff reduction but for which the rules of reduction are not explicit; and (iv) the maintenance of the entry price mechanism even when products have reduced *ad valorem* tariffs.

In addition, the European proposal does not address important issues in the MERCOSUR document on the methods and modalities of tariff negotiations. For MERCOSUR it is fundamental, if the distortions and asymmetries affecting biregional commerce are to be eliminated, that the talks lead to the establishment of disciplines on tariff graduation, tariff peaks, entry prices, quotas or other forms of limitation, export subsidies, measures with the equivalent effect of domestic support measures, and the non-use of the special safeguard clause for agriculture.

It is important to point out that MERCOSUR is negotiating preferential trade agreements simultaneously with its main partners, the EU and the United States (the latter in the FTAA talks). Hence the need for MERCOSUR to maintain a consistent negotiating strategy in the various initiatives on its current external agenda (given that the liberalization offers proposed and accepted in one forum will influence the demands and offers in others), and for it to define what will be negotiated only at the multilateral level.

C. MERCOSUR - Andean Community

Since the adoption of MERCOSUR's common external tariff in January 1995 it has been necessary to renegotiate, *en bloc*, the bilateral agreements previously concluded by the countries within the LAIA framework in order to build a common policy on tariff preferences. The renegotiation of the agreements between the MERCOSUR countries and those of the Andean Community of Nations (CAN) – Colombia, Ecuador, Peru and Venezuela[19] – began at the end of 1996 under the "4+4" format. Given the difficulties in the negotiations both within MERCOSUR and between the two subregions, it proved impossible to conclude the agreement under this format, and the MERCOSUR countries therefore opted to conduct the talks under a "1+4" scheme.

In this context, in August 1999 Brazil and the CAN signed a fixed preferences agreement in the LAIA framework. This accord, Economic Complementarity Agreement N° 39 (ECA N° 39), was the first step in the creation of a free trade area between MERCOSUR and the CAN. In June 2000, to the same end, the CAN and Argentina signed ECA Nº 48. Agreements between Uruguay and Paraguay and the CAN are pending.

Since 30 June 2001, therefore, negotiations for a free trade agreement between the MERCOSUR and the CAN countries have returned to the "4+4" format; they will be concluded before 31 December 2001.[20] This is because a meeting of the Common Market Council in July 2000 – which sought to address the relaunching of MERCOSUR – decided that no new preferential agreements would be signed and that no new trade preferences would be agreed in the prevailing LAIA agreements.

In view of that decision, Brazil endeavored to hasten bilateral negotiations with the CAN in an effort to guarantee access to markets in which Mexico has benefits.[21] Brazil and the countries of the Andean

[19] Bolivia does not participate in this agreement because it has already concluded a free trade agreement with MERCOSUR, ECA N° 36.

[20] If it is impossible to conclude these negotiations, the preferences in force will be maintained only until 30 June 2003.

[21] Mexico, Colombia and Venezuela have signed the Free Trade Agreement of the Group of Three, in force since 1 January 1995.

Community, except Bolivia, held the first meeting of the Administrative Commission of Economic Complementarity Agreement N° 39 in July 2000 in Lima. Two resolutions were approved. Resolution 001/2000 approved the regulations of the agreement's Administrative Commission, while Resolution 002/2000 endorsed the deepening of the preference margins between Brazil and Peru for iron manganese, iron nickel, and cathodes and cathode sections. For the first two articles Brazil was to receive a 60% and 40% preference margin, respectively. For the third article Brazil granted an 81% margin. To intensify trade flows, the two sides exchanged preliminary lists of new products, as well as of goods that would be conducive to deepening the preference margins in ECA N° 39.

During the second meeting on 18-20 October 2000 in Brasilia, Brazil, Colombia, Venezuela, Ecuador and Peru reached understandings on expanding the preference margins on products already benefiting from the accord, and decided to include new products. These understandings gave rise to a list of 472 tariff items, of which 348 are of interest to the CAN, 81 of interest to Brazil, and 43 are of joint interest.

In the bloc-to-bloc context, MERCOSUR and the CAN returned to the negotiations in April 2001 with the aim of establishing the rules and schedule for talks on a free trade agreement. The main outcome of the meeting, which was held in Asunción, was the fixing of dates for the negotiations. According to the schedule, MERCOSUR had to submit a draft text on the substance and methodology of future tariff negotiations before the end of May 2001. Thereafter, the CAN would have a month to submit a counterproposal so that the negotiations could culminate in the signing of an inter-subregional free trade agreement before 31 December 2001.

Delaying the schedule, MERCOSUR presented its proposal for an economic complementarity agreement with the CAN in June 2001. In general terms, the MERCOSUR countries proposed a program of trade liberalization that would lead to a free trade area in 10 years, by means of progressive and automatic reductions in the tariffs prevailing at the time of the signing of the accord. As regards the timetable to be applied to what is known as the "historical patrimony" of commercial relations (LAIA agreements currently in force), preferences would be determined by two different timetables: one for Argentina and Brazil and another for the other countries, with no "equalization" or "multilateralization" of preferences. For sensitive products, which "will number as few as possible", MERCOSUR proposes a maximum tariff reduction schedule of 15 years, and suggests making it possible to fix a maximum five-year period during which the corresponding tariff cuts would not be applied. Within the fixed schedules, moreover, the parties can reduce tariffs at the pace they deem appropriate.

The next round of negotiations between MERCOSUR and the CAN will be held on 22-24 August 2001 in Montevideo, in the headquarters of the MERCOSUR's Administrative Secretariat. This meeting will discuss the document presented by MERCOSUR and the Andean counterproposal, and will pay particular attention to the rules governing negotiations on dispute settlement, safeguards, rules of origin, and sanitary and phytosanitary measures.

D. MERCOSUR - Mexico

"4+1" negotiations between MERCOSUR and Mexico on a free trade agreement to replace the current bilateral agreements in LAIA framework began in 1996. In 1998 the dialogue was reinitiated after having languished for almost two years, thereby making viable the LAIA preferential trade agreements with Paraguay,[22] Argentina and Uruguay.

Mexico and Argentina have already concluded an economic complementarity agreement (ECA N° 06), and in March 2001 they signed three protocols to expand bilateral tariff advantages, to include norms on

22 In December 2000 Paraguay and Mexico agreed to extend the tariff preferences until 31 December 2001.

the preservation of preferences, technical norms, sanitary measures and some specific rules of origin, and to grant preferential treatment to products in the automotive sector. Negotiations between the two countries also made progress on establishing a joint dispute settlement system when they signed the thirteenth additional protocol. Mexico did not ratify these protocols, however, because of the tariff measures later adopted by Argentina.

With respect to the negotiations between Mexico and Uruguay, the economic complementarity agreement (ECA N° 05) signed at the end of 1999 entered into force in March 2001. The two countries made significant changes to the substance of the agreement concluded in the LAIA framework (in force since 1986), with the signing of a modifying protocol and an additional protocol. The former expands and deepens the negotiated preferences in order to foster trade and investment flows. The latter establishes a dispute settlement mechanism that will come into operation whenever disputes arise over the interpretation, application or failure to comply with the stipulations of the agreement. In specific lists for each country, the accord's tariff reduction program notes the products to be freely traded and indicates the respective preference margins to be provided. Mexico immediately grants Uruguay a 100% preference margin (that is, a zero tariff) on about 89% (6,200 articles) of the whole tariff schedule, while Uruguay grants free access to 72% of its imports from Mexico (4,980 articles).

For Uruguay, therefore, the broadening of ECA N° 05 entailed liberalizing more than 90% of the tariff schedule and applying more modern norms and disciplines on market access, rules of origin, customs procedures, safeguard clauses, unfair trade practices, and technical and phytosanitary norms. ECA Nº 05 features a dispute settlement mechanism, and the two sides agreed to include an agreement for the reciprocal promotion and protection of investments.

Negotiations for a trade agreement between Brazil and Mexico[23] were under way almost two years ago when the period expired for MERCOSUR member countries to negotiate separate bilateral agreements (30 June 2001). Divergent interests made it difficult to conclude a bilateral agreement. According to Mexico's chief trade negotiator, speaking in the FTAA meeting of January 2001, this was despite the willingness of the new Mexican government to negotiate with Brazil and then with MERCOSUR.

The bilateral negotiations were interrupted in December 2000 after the sixth round of negotiations because the Brazilian government deemed the Mexican proposals to be unsatisfactory, especially as regards the three alternative lists of Mexican requests in the area of electronics and Mexico's call for better Brazilian offers in the areas of chemicals and synthetic fibers. Brazil decided to wait until the new Mexican government was fully in place before re-assessing the negotiations and relaunching the talks. They began again in February 2001. The two negotiating rounds that followed were inconclusive, largely the result of matters that arose in the areas of chemicals and agricultural products. With the appointment of the new Mexican negotiator it is expected that the talks will continue, although it is not clear when new rounds will be held.

However, in March 2001 the two countries concluded negotiations involving about 110 tariff positions in the autoparts and tires sectors. These negotiations were formalized in the LAIA General Secretariat as the Eighth Additional Protocol to Economic Complementarity Agreement N° 09. In the coming months it is expected that the talks in the automotive sector will be expanded to the "4+1" format , so as to include all the MERCOSUR countries and Mexico.

Negotiation of a preferential trade agreement between MERCOSUR and Mexico are now at a standstill and will only restart in 2002, given the commitments MERCOSUR has made in other negotiations on its

[23] It should be recalled that trade relations between Brazil and Mexico have not featured tariff preferences since December 1997, when the old bilateral trade accord – LAIA Partial Scope Agreement N° 09 – expired. For the purposes of the agreement, the across the board 20% preference margins will be retained, as negotiated in the old Regional Tariff Preference Agreement (RTPA).

external agenda. There is an interest in concluding the negotiations between Mexico and MERCOSUR "as fast as possible", and to that end 2003 has been set as the final deadline.

E. MERCOSUR - Chile

Chile's accession to the Treaty of Asunción was again among the main items on the subregion's external agenda in the context of MERCOSUR's relaunch in June 2000. Government representatives from the MERCOSUR countries and Chile had agreed that the preparatory negotiations to draw up a draft Decision would be completed by the end of that year. Such a Decision would formalize Chile's full accession, which was to be approved in the Nineteenth Summit of MERCOSUR Presidents in December 2000 in Florianópolis. The period of actual negotiations would then last until the first half of 2002.

In November 2000, Chile announced that it would begin negotiations for a free trade agreement with the United States. This announcement brought the talks between MERCOSUR and Chile to a virtual standstill. In December, at the Florianópolis meeting, the only decisions referring to Chile concerned the CMC's approval of the Meeting of MERCOSUR Social Development Ministers and Authorities. Such approval stemmed from the importance of enlarging and deepening the social development dimension of regional integration in the Forum for Political Consultation and Coordination of MERCOSUR, Bolivia and Chile, and from the significance of MERCOSUR's associate members (Chile and Bolivia) taking part in macroeconomic coordination.

In addition to MERCOSUR's reticence about the tariff preference negotiations between Chile and the United States, the current constraints on closer bilateral relations remain significant, especially in terms of the two sides' tariff policies. In various meetings the Chilean government has expressed an interest in further integration with MERCOSUR, although it clearly and repeatedly maintains that the country's full accession must entail the convergence of the latter's tariff structure to Chile's low tariffs, as well as Chile's retention of its foreign policy autonomy. In other words, Chile will not adopt a common external tariff.[24]

Although no new deadline has been agreed for concluding the negotiations on Chile's accession, both sides have a key interest in ensuring that the negotiations move in that direction. To that end, therefore, both want to create the right conditions by means of macroeconomic convergence, deepening the existing bilateral free trade agreement (ECA N° 35),[25] wide-ranging negotiations on other matters of common interest such as services and investment, and participation in forums for political consultation and institutional strengthening, especially upgrading the dispute settlement mechanism.

For Chile, MERCOSUR is a strategic project in as much as it is more than a trade agreement. It embraces social policies and educational and cultural issues, as well as infrastructural integration for the development of the Southern Cone.

The negotiations for Chile's full accession to MERCOSUR should culminate in the adoption of a Protocol of Adhesion to the Treaty of Asunción, including its ancillary protocols, and an Additional Protocol to LAIA Cooperation Agreement N° 18, which defined the methodology for convergence towards intra-MERCOSUR free trade.

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[24] Despite Chile's reiterated interest in intensifying its integration with MERCOSUR, the treatment of sensitive products is an obstacle to the negotiations, as shown by the recent Chilean measure to increase the import aliquot on Brazilian sugar from 31.5% to 98%, on the grounds that imports of Brazilian sugar at lower prices would damage the local industry.

[25] Through Additional Protocol N° 25 to ECA N° 35, Chile and Paraguay extended until 31 December 2001 the tariff treatment granted to autoparts in reciprocal bilateral trade.

CHAPTER VI. INTEGRATION AND PHYSICAL INFRASTRUCTURE DEVELOPMENT

Since MERCOSUR was founded, intra-zone commerce has increased significantly, driven above all by the dismantling of tariff barriers and the elimination of other obstacles to trade. However, it should be noted that although trade integration between the MERCOSUR countries has made substantial progress in the last ten years, flows of trade and investment are still relatively small relative to transactions between the countries of the subregion and other South American economies. A recent IDB publication suggests that South America's low level of economic dynamism stems partly from the physical obstacles to greater integration between the various national markets (IDB [2000]).

The fact that MERCOSUR participates in various trade liberalization initiatives in the continent underlines the need to develop the subregion's comparative advantages by combining the bloc's competitive strengths with those of the other countries of South America. This would not only help foster economic links between the MERCOSUR countries, but also between the latter and the other South American countries, which would enhance the subregion's competitive insertion. In this context the development and integration of MERCOSUR's physical infrastructure with that of the other countries of the continent, in conjunction with the elimination of existing bottlenecks in transport, telecommunications and electricity infrastructure in the various countries, are factors of crucial importance. The South American governments should consider them when they devise and implement future integration initiatives and, therefore, when they formulate national public policies.

Isolated efforts, however, are insufficient in themselves. Various analyses by international organizations and specialists suggest that the development and integration of physical infrastructure in MERCOSUR, and in South America as a whole, requires a concerted inter-governmental effort, which in turn entails identifying joint activities on the basis of a strategy that clearly defines how to cooperate and plan regionally for the purposes of exploiting a continental infrastructure network. In this regard it is imperative to seek joint solutions that can create and maintain channels of integration between the continent's economies. This can be done by means of mechanisms that help identify the region's main economic corridors,[26] and that allow investment projects in infrastructure to be conducted in such way that these corridors are fostered as real hubs of economic development.

The importance of integrating and developing physical infrastructure for the purposes of creating an enlarged economic area in South America was highlighted by the leaders of the subregion in the Brasilia Declaration of September 2000. On that occasion the presidents deemed it a priority to identify public works of bilateral and subregional interest, and they underlined the need to appeal to sources of finance in the public and private sectors, as well as among multilateral financial institutions. The latter include the Inter-American Development Bank (IDB), the Andean Finance Corporation (CAF), the Financial Fund for the Development of the River Plate Basin (FONPLATA) and the World Bank. They also recognized the importance of the IDB initiative to draw up what later became the "Action Plan for the Integration of Regional Infrastructure in South America". This makes proposals for broadening and modernizing the region's infrastructure over ten years – especially in the areas of energy, transport and telecommunications – with the aim of establishing integration and development hubs in the region.

In the field of transport, priority was given to creating multi-modal networks to provide improved linkages between land, river, maritime and air transport. These networks should facilitate the movement of people,

[26] The corridors consist of the stretches where the movement of goods, people, information and energy has been consolidated. At the regional level, as these corridors favor the economic and social development of the areas that they cross, they can become integration and development hubs and can contribute to the organization of territorial space.

cargo and vehicles, thereby fostering trade and investment in the region.[27] In the energy sector, integration and complementarity in the use of existing resources, especially in the areas of natural gas and electricity, will be a core element of closer links between the countries of the region. On that basis the barriers raised by current restrictions and regulations in the sector will be eliminated, and the commitment to environmental protection will be met. As regards the development of the telecommunications sector, stress was placed on the importance of establishing logistical systems and of attending to society's growing demand for information. In parallel, the presidents reaffirmed their pledge to give political priority to national, bilateral or subregional initiatives that are now being implemented.

Drawn up by the IDB, the CAF and FONPLATA, the final version of the "Action Plan for the Integration of Regional Infrastructure" was presented to the Meeting of the South American Ministers of Transport, Telecommunications and Energy in Montevideo in December 2000. The plan is based on the concept of integration and development hubs, complemented by the development of the "necessary sectoral processes to optimize the competitiveness and sustainability of the logistics chain". Additionally, efforts will concentrate on at least three areas: the coordination of planning and investment; making regulatory and institutional factors compatible and harmonizing them; and innovative mechanisms for public and private financing. Among the basic guidelines of this strategic plan, the following aims are prominent:

(i) to design a more integral vision of infrastructure;

(ii) to frame the projects within a strategic planning process founded on the identification of regional integration and development hubs.

(iii) to reform and modernize the regulatory and institutional systems that govern the use of national infrastructure;

(iv) to harmonize policies, plans and regulatory and institutional frameworks among governments;

(v) to develop new regional mechanisms for programming, implementing and managing projects;

(vi) to adapt financial schemes to the specific risk configuration of each project;

(vii) to take careful account of the projects' environmental and social dimensions, and to seek to improve the quality of life and the opportunities of local populations in regional integration hubs.

The document recommends that six criteria be used for selecting and assigning priority to the hubs: (i) the geographical coverage of countries and regions; (ii) current trade flows; (iii) potential trade flows; (iv) the volume of recent, current and imminent investment in the hubs' areas of influence; (v) the private sector's interest and level of involvement; and (vi) the projects' degree of environmental and social sustainability. Additionally, the plan identifies twelve integration and development hubs[28]. Six sectoral integration processes were also identified: (i) multimodal transport operating systems; (ii) air transport operating systems; (iii) facilitating border crossings; (iv) harmonization of regulatory policies, as well as those on interconnection, broadcast spectrum, technical standards and promoting widespread Internet use.; (v)

[27] Other important sources of information on the planning and implementation of projects to expand and modernize the region's physical infrastructure were: "Red de Transportes y el Inventario de Proyectos Prioritarios para la Integración de América del Sur", study approved by the Conference of Ministers of Transport, Communications and Public Works of South America; the "Plan Maestro de Transportes y su Infraestructura para América del Sur", a document drawn up by the LAIA in the framework of the Conference of Ministers of Transport, Communications and Public Works of South America; the activities of the Multilateral Working Group Work on Bioceanic Land Corridors; and a project in the context of the Treaty of the River Plate Basin and the Amazon Cooperation Treaty, which seeks to integrate transport networks.

[28] MERCOSUR-Chile hub, Andean hub, Brazil-Bolivia-Paraguay-Peru-Chile inter-oceanic hub, Venezuela-Brazil-Guyana-Surinam hub, Multimodal Orinoco-Amazon-River Plate hub, Multimodal Amazon hub, Atlantic maritime hub, Pacific maritime hub, Neuquén-Concepción hub, Porto Alegre-Jujuy-Antofagasta hub, Bolivia-Paraguay-Brazil hub and Peru-Brazil hub.

instruments for financing regional physical integration projects; and (vi) the legal frameworks of regional energy markets.

The Action Plan approved in Montevideo also envisages the creation of an Executive Steering Committee (ESC) of senior representatives, designated by the governments. This Committee will devise proposals for improving initiatives in the implementation phase, and will suggest policy guidelines on the integration and development hubs in the areas of coordinating investment plans and of regulatory, institutional and financing frameworks based on the prior analysis of technical proposals from the Executive Technical Groups (ETGs). These endeavors began in April 2001 during the First Meeting of the Executive Steering Committee in Santa Cruz de la Sierra, Bolivia. At that meeting the ministers agreed on the creation of the working groups for 2001, which are to be organized on the basis of the hubs axes deemed priorities in the Action Plan. The ESC and the technical groups have the technical and financial assistance of a Technical Coordinating Committee (TCC) comprising the IDB, the CAF and FONPLATA.

Below, in general terms, are the main physical problems of infrastructure and the difficulties associated with the institutional and regulatory arrangements in the countries of the region. These were highlighted in the IDB study, published in December of 2000 and entitled *A New Impulse to the Integration of Regional Infrastructure in South America*.

A. The Transport System

The MERCOSUR-Chile hub has the highest trade flows in South America.[29] It includes multiple infrastructure facilities with multimodal linkages between large urban centers such as São Paulo, Buenos Aires, Montevideo and Santiago. Of all the possible modes of transport, land transport is the most widely used for trade between the countries of the Southern Cone. It accounts for about 30% of total goods transported in the region, both in terms of volume and value. In the 1996-1998 period, total intra-zone trade amounted to approximately 20 million tonnes on average a year, of which 6.5 million tonnes were transported by road.

The biggest volume of trade in the region, in physical and value added terms, is between Brazil and Argentina. Brazil is Argentina's main trade partner, followed by Chile. Of the total goods traded between the countries, which led to the MERCOSUR corridor, maritime trade accounts for 49% of the cargo volume, followed by road (30%), river (15%), railways (3%) and air (2%). Land transport in the subregion is marked by the progressive segmentation of the market, because of the growing number of small or family companies, as well as countless autonomous firms.

In 2000, progress on most of the public works on the MERCOSUR corridor was less than planned because resources were not released on time nor in the necessary amounts, which not only affected fulfillment of the physical targets for the year but also compromised the projects' future development. According to the assessment report of Brazil's Ministry of Planning, Budget and Administration, regularizing the flow of resources is the main recommendation for such programs as the Transport Corridors in the MERCOSUR Corridor, such that progress can be made on the physical implementation of the projects and of the planned services. The report also indicates the main results for 2000: (i) doubling the MERCOSUR highway in the stretches between São Paulo, Paraná and Florianópolis with the completion of the stretch in the state of Paraná (except Contorno Leste de Curitiba), and of 95% of the stretch in the state of Santa Catarina; (ii) completion of the projects and the environmental studies for doubling the highway in the Florianópolis-Osorio stretch; and (iii) the resolution of judicial conflicts and the consequent launch of a new tender to restart construction at Rio Grande port in 2001.

[29] According to the IDB [2000], 18 million tonnes moved along this hub in 1998, of which 8 million comprised the transport of oil via pipelines and 10 million were transported by truck.

More generally, the main infrastructural problems of land transport in the region are as follows:

(i) existing natural barriers such as the Andes mountain range, the Amazon forest and the Orinoco basin;

(ii) insufficient capacity in the main hubs carrying much of the flows of goods and people. The most serious road capacity problems are in the "MERCOSUR corridor", where international flows (trucks, buses and private passenger vehicles) add to an increasing level of local traffic. In the stretch that crosses the Andes mountains the conditions are even more precarious, especially in winter, because of snowfalls.

(iii) the deterioration of roads and the lack of maintenance, together with mountainous terrain, hamper vehicle traffic and thus increase freight costs.

With respect to the railways, the region's existing network has suffered chronic problems of financing and management since the last decade. It is poorly preserved, which constrains the use of trains large enough to exploit the economies of railways to the full. The privatization of rail services in recent years was unable to overcome the deficiencies of the infrastructure in view of the significant amount of investment needed. The main problems caused by the poor state of the rail networks are restrictions on trains' cargo capacity, speed limits, gauge differences between countries, and the lack of multi-modal links.

In the case of air transport, the volume of cargo transported between the countries of the region is low, in contrast to the growing flows of passengers. Nevertheless, the share of regional flows is relatively small compared with the air transport of cargo and passengers to the rest of the world, and with domestic transport within the countries. The capacity problems evident in several airports is one of the main problems of air transport, as well as the low quality of services and the lack of equipment to guarantee operational safety.

As regards river transport, its economic importance stems mainly from its logistical role, particularly in terms of marketing of agricultural produce, given its capacity to reduce transport costs substantially and to offer a greater competitive advantage to MERCOSUR products. However, the unreliability and under-use of the river network, as well as the lack of support to navigation and the absence of multimodal connections with land transport, are the main physical problems of river infrastructure and limit its potential use. Conveying cargo through waterways is the most economic alternative for low value added goods in large volumes, such as agricultural products, minerals and fertilizers. The Paraguay-Paraná waterway is the most important hub of river integration between Brazil, Bolivia, Paraguay, Argentina and Uruguay, and was organized in a such way as to exploit the natural advantages of a navigable network more than 2,500 km long. This waterway mainly transports cereals, oils, minerals and fuels. A third of the traffic consists of movements between the countries of the area, and the rest comprises the countries' exports or imports. In this hub there are also three binational hydroelectricity stations, as well as high tension lines, through which the main electricity flows are transmitted between the countries.

In the case of Brazil, a little over half of the 42,000 kilometers of the country's river system that can be used for transporting cargo is being exploited by commercial navigation. The system of internal waterways accounts for only 1% of all cargo transported in the country, while highways account for almost 62%. It is to be noted that the development of this waterways system is compatible with the current development strategy in the Amazon and the center-west region, by inter-linking several modes of transport with a view to channeling cargo from the interior of the country to the Pacific and Atlantic Oceans.

The following chart summarizes the main problems of transport infrastructure in the Southern Cone countries, in terms of both their physical characteristics and their regulatory and institutional arrangements.

MAIN PROBLEMS OF TRANSPORT INFRASTRUCTURE

Highways	➢ Problems of insufficient capacity in some stretches ➢ Natural barriers ➢ Road safety problems
Rail network	➢ Restrictions on the operation of high-capacity trains ➢ Gauge differences ➢ Lack of multimodal links ➢ Speed restrictions
Airports	➢ Problems of insufficient capacity in some terminals ➢ Lack of equipment to guarantee operational reliability and safety
Ports and navigable routes	➢ Lack of support to navigation ➢ Lack of connections to land transport

Despite the progress made in the 1990s, several problems continue to hinder transport and negatively affect costs (see the following table). As regards land transport in particular, the main obstacles are: (i) cargo reserve regimes that reduce the sector's operational efficiency; (ii) delays and extra costs caused by customs inspections of goods at border crossings; and (iii) the lack of harmonization between various national regulations. Rail transport also faces problems related to border delays and difficulties of interconnection with other forms of transport. In this sector, however, the presence of a few private operators facilitates the integration of services. In the MERCOSUR hub, for example, the same company is the concessionaire of rail services in southern Brazil and in northeastern and central Argentina, which makes it easier to introduce new services. With respect to river and maritime transport, the main regulatory restriction is cargo reserves, while in air transport the problems stem mainly from market reserves in the sector, which constrain the improvement of service supply in passenger transport.

MAIN PROBLEMS IN THE REGULATORY FRAMEWORKS FOR TRANSPORT

Land transport	➢ Cargo reserves make transshipment necessary ➢ Delays and substantial costs at border crossings ➢ Tax asymmetries ➢ Different qualification requirements
Rail transport	➢ Delays at borders crossings ➢ Difficulties in exchanging rolling stock
Air transport	➢ Market reserves
River and maritime navigation	➢ Cargo reserves ➢ Safety regulations that impose excessive costs

B. The Energy Sector

In recent years the energy sector has been one of the main stimuli to economic integration, especially in the Southern Cone, since structural reform and the privatization of public companies fostered the development of the internal electricity market. Nevertheless, many countries still lack an enhanced perception of the importance of devising a strategy to integrate national markets in the sector. Consequently, most of the electricity inter-connections between the countries of the region spring from bilateral agreements that involve the construction of connections and energy supply, which entails the use of a specific operator for each interconnection.

Regional projects allow economies of scale to be exploited and better use to be made of national resources, thereby facilitating major projects such as the Brazil-Bolivia gas pipeline and electrical interconnections that are only economically viable when they involve two or more countries and lead to the construction of true regional energy markets.[30] In the case of electricity, in particular, the development of regional markets will facilitate better use of the existing interconnections through the trade in secondary energy. It will also increase the reliability of national systems by broadening the available resource base at the regional level. However, to realize the full potential of interconnections it is first necessary to harmonize technical norms and standards in the various countries, since there are still marked structural asymmetries to be overcome.

According to technical studies by the Regional Electrical Integration Commission (CIER), the main physical problems of energy infrastructure concern their size, in view of the real and potential demand for electricity in the region and its potential for integration. A similar conclusion holds true for the sub-sectors of natural gas and petroleum, despite their peculiarities.

Hydroelectricity accounts for more than 80% of the total energy supply of most countries in South America. The high dependence on this energy source increases the vulnerability of the energy matrix and makes it necessary to have large surplus reserves to meet demand in drier periods. On the demand side, three countries account for three quarters of electricity consumption in South America: Brazil (more than 50%), and Venezuela and Argentina (25% in total).

The growing participation of the private sector in the energy sector, in particular in distribution facilities, requires a reformulation of relations between governments and the private sector in the whole investment process, from the assessment phase through financing to the construction and operation of the facilities. Governments also need to coordinate greater integrated planning and execution of regional investment among themselves.

[30] Two initiatives are important in the construction of regional energy markets. The first concerns a July 2001 visit to Brazil of a high-level Argentine government mission, comprising the Ministers of Infrastructure and Foreign Relations, which offered 650 MW of electricity (in addition to the 2,000 MW already under contract to the Compañía *de Interconexión Energética*), using a conversion station in Garabi, in the Brazilian state of Rio Grande do Sul. This additional offer involves 150 MW that could be transmitted immediately and 500 MW more in the short term. The latter would depend on laying down a 16-kilometer transmission line from the Yacyretá hydroelectric plant to the substation in Ayolas, Paraguay. The Paraguayan government has IDB financing to build the transmission line at a cost of about US$ 10 million. At present, Brazil's main difficulty in purchasing energy from the other MERCOSUR countries is the technical matter of the quality of the transmission lines – especially in Paraguay, where the lines have a low transmission capacity. The second initiative also involves Argentina, which is discussing with Brazil a project to build a thermoelectric station using natural gas in Misiones province. The 3,000 MW that the station could produce would be sold to Brazil by means of a line that would transmit the energy from the border area close to Foz de Iguazú to Embu-Guazú in the São Paulo metropolitan area.

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