



2003 - 2004

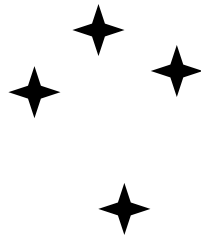
Juan José Taccone and Uziel Nogueira (editors)



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

INTER-AMERICAN DEVELOPMENT BANK
MERCOSUR Report N° 9





REPORT

MERCOSUR

2003 - 2004

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Printed in Argentina

Institute for the Integration of Latin America and the Caribbean IDB - INTAL
MERCOSUR Report 9
1^a ed. - Buenos Aires: BID-INTAL, 2004.
118 p.; 28 x 21 cm.

ISBN 950-738-XXX-X

1. Mercosur I. Título
CDD 338.9

Editing:
Susana Filippa

The MERCOSUR Reports Series represents an effort by INTAL to promote knowledge and the spread of information on the dynamic process of integration underway in Latin America and the Caribbean. As part of this integrationist trend, since the signing of the Treaty of Asunción in 1991 the Southern Common Market has been a test case for assessing the achievements and challenges of this ambitious initiative.

In publishing this annual report, INTAL aims to facilitate access to information for a broad readership interested in MERCOSUR from the public and private sectors, as well as among the subregion's general public. It seeks also to go beyond the interest that the process arouses at the subregional level by making the report available to an international audience through this version in English, as well as in Spanish and Portuguese, the official languages of the process.

Report N° 9, covering 2003 and the first half of 2004, was prepared by Dr. João Bosco Mesquita Machado, Deputy Director of the Institute of Economics at the Universidade Federal de Rio de Janeiro (UFRJ), with the collaboration of Mr. Regis Bonelli, Consultant to the IPEA, and Ms. Simona Saisse, Consultant to the National Confederation of Industry. Ms. Renata Razo and Ms. Cristina Pessoa also collaborated in the preparation of different parts of the report.

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

In order to meet the expectations raised by the publication of previous reports, readers are invited to send their comments and/or suggestions for the purposes of improving the scope or focus of these publications in the future.

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EXECUTIVE SUMMARY

The period beginning in the first half of 2003 opened a window of opportunity for MERCOSUR's internal agenda. Convergence among the member countries' exchange rate policies, the resumption of economic growth in the subregion, and the assumption of power on the part of heads of state who are explicitly favorable to the bloc created an auspicious environment for intra-MERCOSUR understanding. The Asunción Summit in June 2003 revealed a new level of ambition in the integration project, and its outcomes amounted to an effort to recover the group's internal negotiating agenda.

Most issues on the agenda have moved forward to a greater or lesser degree in the past 18 months. A work program for the 2004-2006 period was approved. This establishes targets and deadlines for complying with the various issues on the agenda. Macroeconomic coordination has come to be seen as important. The liberalization of services trade made progress with the conclusion of the Fourth Round of Negotiations on Specific Compromises in the Area of Services.

Progress was also evident in the agreement among the member countries to grant the MERCOSUR Visa. The MERCOSUR Protocol on Government Procurement was also approved in December. This is a corollary to the work of the *Ad Hoc* Group, which since 1997 has been devising a subregional instrument to eliminate discrimination against member countries in the areas of goods and services procurement on the part of any member.

From the standpoint of the institutional structure, the main sign of progress was the entry into force on January 1, 2003 of the Protocol of Olivos, which covers dispute settlement. Its main innovation is the creation of a Permanent Review Tribunal, which offers greater legal security to the dispute settlement system and ensures a review of rulings, thereby facilitating an accumulation of experience that enables disputes to be handled more expeditiously.

Progress was modest, however, in two crucial areas: the common external tariff (CET) and trade defense. As regards the CET, the deadline given to the High-Level Group (created in 2001) to submit its proposals on the consistency and dispersal of tariffs was extended to November 2004. At the same time, approval was given to the Regime Governing Capital Goods Originating Outside MERCOSUR. This will take effect on January 1, 2006.

The shortage of agreed instruments in the area of intra-MERCOSUR trade defense and the unilateral adoption of protectionist measures remained the most striking signs of MERCOSUR's incipience as a customs union. The most recent example of this was Argentina's announcement, on the eve of the Puerto Iguazú Summit, that it would raise tariffs and increase customs barriers to restrict imports of domestic appliances from Brazil.

As a result, the Puerto Iguazú Summit in July took place in a less favorable context than had been expected. Little structural progress was made and the negotiations dissipated in short-term arrangements that sought to avert the trade restrictions imposed by Argentina. The Brazilian government realizes that the crisis between Brazil and Argentina is a structural problem. Hence Brazil's government hopes, in the period when it holds the *pro tempore* presidency of MERCOSUR, to pursue economic integration by motivating the distribution of productive chains among the countries.

Matters related to immediate economic conditions no longer pose an obstacle to progress on the internal agenda. Nonetheless, it should not be forgotten that the agenda must be very carefully assessed in the light of the goals of integration. One potentially successful strategy to deepen MERCOSUR integration might

be to reflect the priorities of the national economic agendas, such as boosting exports and employment. The external agenda has shown itself to be incapable of playing that role.

The negotiations in which MERCOSUR is involved for the Free Trade Area of the Americas (FTAA) and with the European Union (EU) made little progress. In fact, both sets of negotiations are practically paralyzed: MERCOSUR has found it difficult to secure concessions on agriculture and its offers have been of limited scope, not only in terms of access to goods markets but also in other areas of interest, such as services and government procurement. The fact that progress in these negotiations has been made conditional on the outcome of the Doha Round also hinders the US and EU adoption of more flexible positions in the talks with MERCOSUR. Nevertheless, efforts continue to be made to expand the network of bilateral and plurilateral agreements, both in the Americas and with strategic partners such as South Africa, China and India. As a result of these initiatives, MERCOSUR finally concluded an agreement with the Andean Community (CAN), while Mexico and Peru joined the group as associate members.

Trade, investment and the free movement of people among the member countries remain hindered, if not blocked, by physical barriers. In South America the most important initiative to unite forces so as to upgrade and integrate regional infrastructure began in 2000, with the Initiative for the Integration of Regional Infrastructure in South America (IIRSA).

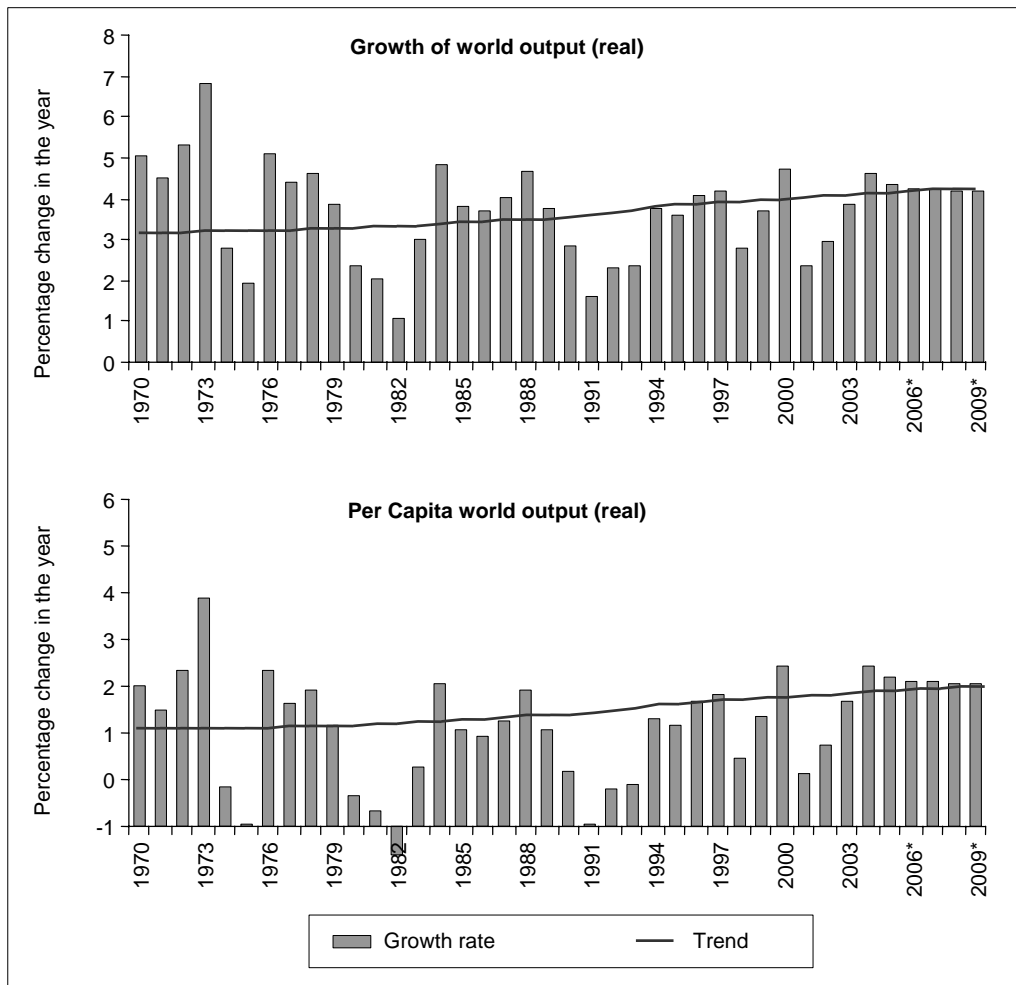
MERCOSUR sees IIRSA as a chance to accelerate subregional integration, and its work program for 2004-2006 gives priority to projects of interest to the member countries, to the setting up of a MERCOSUR Special Fund for infrastructure, and to devising a program of investment in physical infrastructure.

CHAPTER I. THE MACROECONOMIC CONTEXT

A. The World Economy: Trends and Prospects

The world economic recovery that began in 2002 strengthened in 2003. Industrial output grew markedly and world trade increased. The recovery was underpinned and driven by the growth of fixed investment, which was positive in almost all regions. In the second half of 2003, world GDP grew by 6%, the highest rate since 1999. Figure I.1 shows the growth rates of world output from 1970 to date, and includes a projection to 2009. It also shows trends in world per capita output for the same period.

FIGURE I.1
WORLD OUTPUT, TOTAL AND PER CAPITA (1970-2009*)



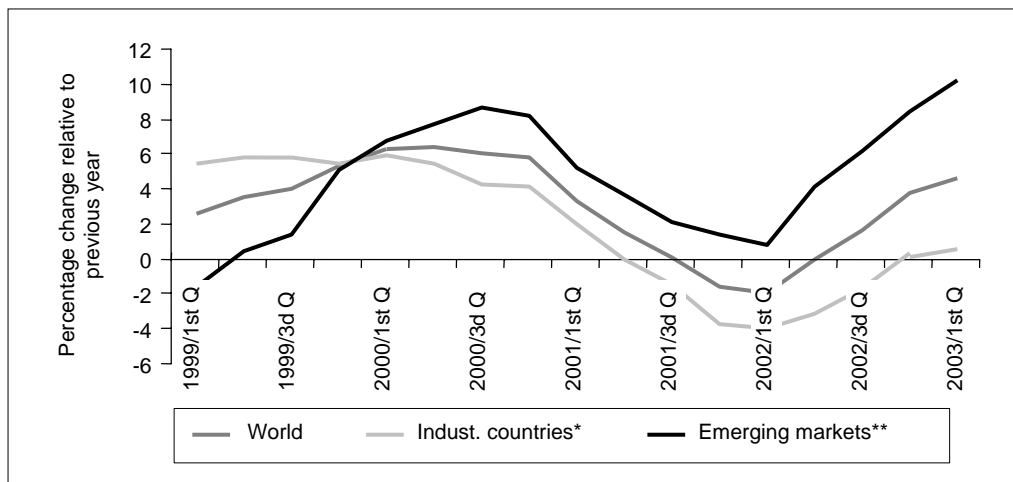
Note: * Projections.

Source: "World Economic Outlook 2003 – Advancing Structural Reforms", IMF.

Various analysts and institutions indicate that growth will be even higher in 2004 (a slowdown is expected for 2005)¹ in view of the macroeconomic performance of the main countries in the first half of 2004. Nonetheless, it should be noted that several elements of uncertainty could impinge on future developments, especially those related to geopolitical risks such as terrorist attacks and trends in international oil prices. To these factors should be added the risk of lower growth in China, as well as the effects of an increase in the US interest rate. All these matters will be touched upon more than once throughout this report.

World investment resumed high levels throughout 2003 (and continued to do so at the beginning of 2004), similar to those evident during the previous cycle's boom in 2000, before the recession of 2001 and part of 2002. This sprang, in particular, from the performance of emerging countries, especially China, India and the countries of East and Southeast Asia.

FIGURE I.2
WORLD INVESTMENT, 1st QUARTER 1999-4th QUARTER 2003



Notes: * Australia, Canada, Denmark, United States, Eurozone countries, Japan, New Zealand, United Kingdom, Sweden and Switzerland.

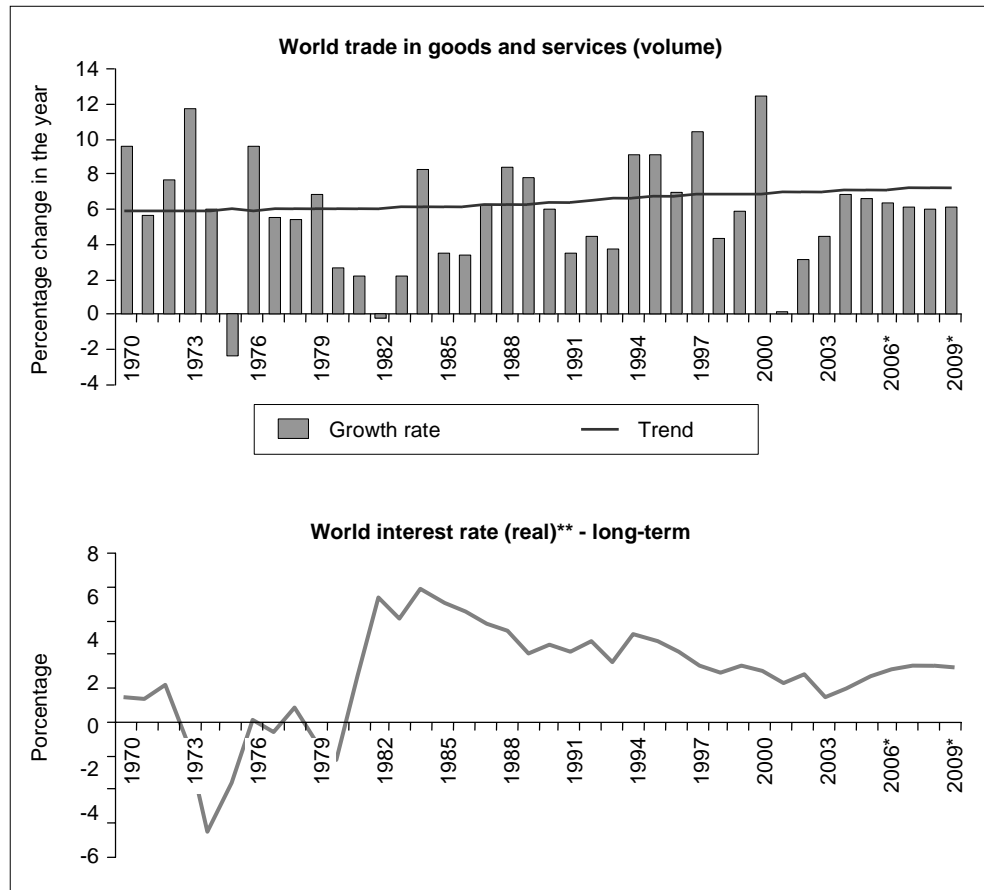
** South Africa, Argentina, Brazil, Bulgaria, Chile, China, Colombia, Czech Republic, Estonia, Hong Kong SAR, Hungary, India, Indonesia, Israel, South Korea, Latvia, Lithuania, Malaysia, Pakistan, Peru, Philippines, Poland, Rumania, Russia, Singapore, Slovak Republic, Slovenia, Taiwan, Thailand, Turkey, Ukraine and Venezuela.

Source: "World Economic Outlook 2003 – Advancing Structural Reforms", IMF.

Two key variables underlie the excellent performance of the world economy in 2002: world trade and international interest rates. The figure below shows, in the upper panel, long-term trends in the growth of the volume of world trade in goods and services between 1970 and 2003, as well as a projection to 2009. Growth was about 4% in 2003, followed by (expected) growth of 6% in 2004. The lower panel shows the marked fall in long-term real interest rates up to 2003, and a projection of a slight increase from 2004 onwards. These projections reveal that interest rates should not approach the levels prevailing before the recession of the early-1990s.

¹ *The Economist* magazine's weekly survey indicates forecasts of 1.8% for GDP in the Eurozone in 2004 (2.0% in 2005), 4.6% for the United States, (3.6% in 2005), 4.4% for Japan (2.2% in 2005) and 3.2% for the United Kingdom (2.7% in 2005).

**FIGURE I.3
WORLD TRADE AND WORLD INTEREST RATES, 1970-2009***



Notes: * Projections.

** Real world interest rate: government bonds weighted by average GDP in the last 10 years minus the inflation rates of the United States, Japan, Germany, France, Italy, the United Kingdom and Canada.

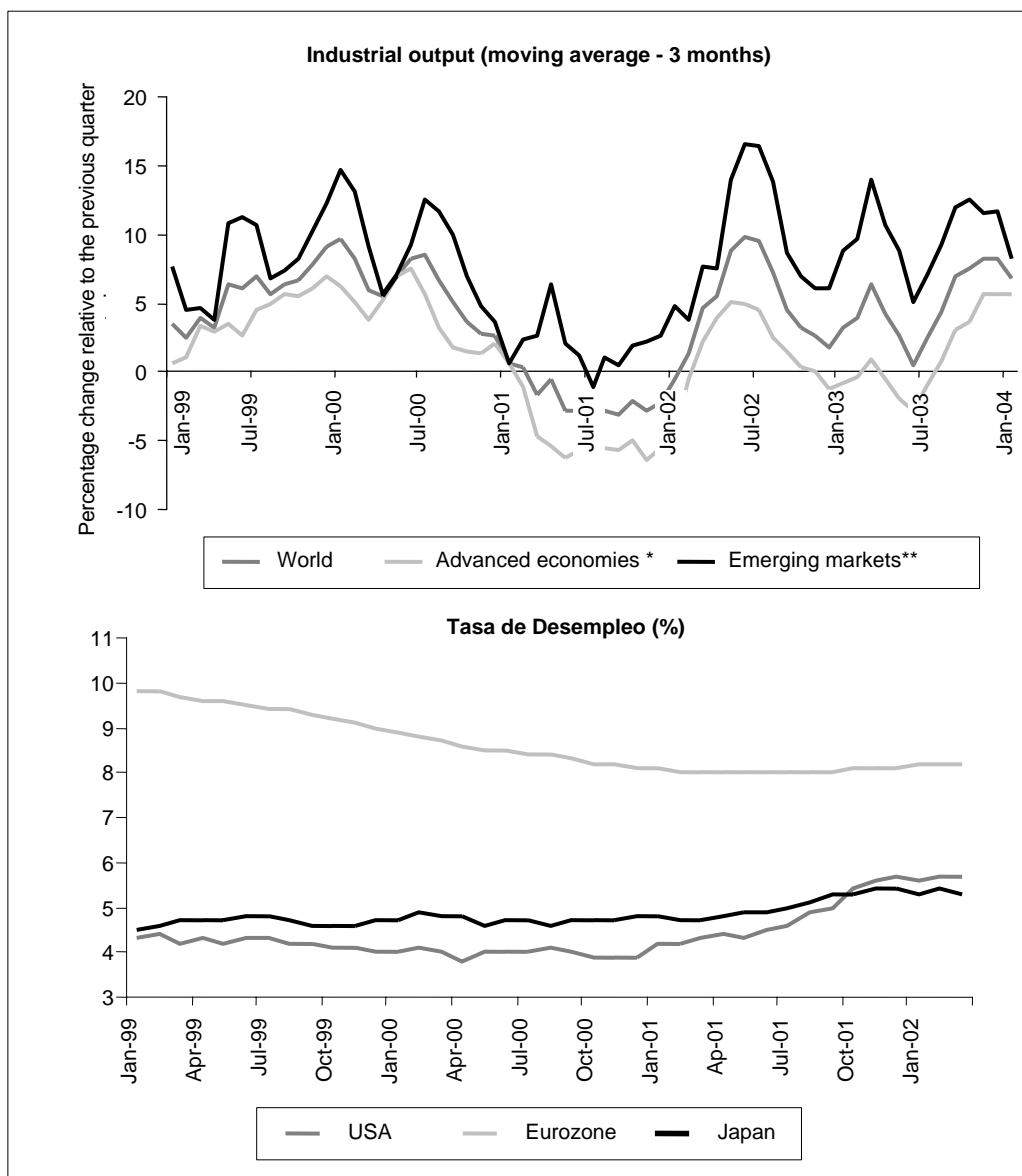
Source: "World Economic Outlook 2003 – Advancing Structural Reforms", IMF.

Another striking feature of recent growth is that it happened in a context of substantially stable and historically very low prices. Even in the developing countries, recent trends in consumer prices have been highly favorable, with inflation falling on average. The medium-term prospects are also quite positive.

Inflation was controlled in 2003, with few exceptions. In the most advanced economies the average was 1.8% and IMF projections suggest that the rate will remain moderate, a reflection of the still-weak labor market in many countries and sharp competition for external and internal markets. Inflation was also controlled in the emerging markets and developing countries in 2003, albeit at levels higher than those evident in other countries.

Additionally, unemployment remained relatively low in historical terms and was equivalent to other stages of recovery. This is evident in the following figure, which also shows recent industrial production.

FIGURE I.4
INDUSTRIAL OUTPUT, JANUARY 1999-JANUARY 2000, AND UNEMPLOYMENT, %
 (January 1999 - March 2004)



Notes: * Australia, Canada, Denmark, United States, Eurozone countries, Japan, New Zealand, United Kingdom, Sweden and Switzerland.

** Argentina, Brazil, Bulgaria, Chile, China, Colombia, Czech Republic, Estonia, Hong Kong, Hungary, India, Indonesia, Israel, South Korea, Latvia, Lithuania, Malaysia, Pakistan, Peru, Philippines, Poland, Rumania, Russia, Singapore, Slovak Republic, Slovenia, Taiwan, Thailand, Turkey, Ukraine and Venezuela.

Source: "World Economic Outlook 2003 – Advancing Structural Reforms", IMF.

Although the recovery was global, its source and speed varied substantially from region to region. The recovery was faster in emerging Asia and the United States while in the Eurozone, where consumption remains weak and some important indicators are unfavorable, recovery is not yet fully consolidated. Table A.1 in the statistical annex illustrates this point, revealing the GDP growth rates for a group of selected countries in 2002 and 2003, as well as the prospects for 2004-2005.

The exchange market also changed in 2003, persisting with the trend begun in 2002 (and even earlier for various currencies). Trends in the main international currencies in 2003 were dominated by the depreciation of the US dollar, a reflection of the US current account deficit. From its mid-2002 high, the dollar fell by almost 20 percentage points in real terms relative to the main international currencies. The dollar fell almost 30% against the euro in the period between June 2001 and December 2003. In mid-2004 there were signs that the depreciation had begun to stimulate US exports.

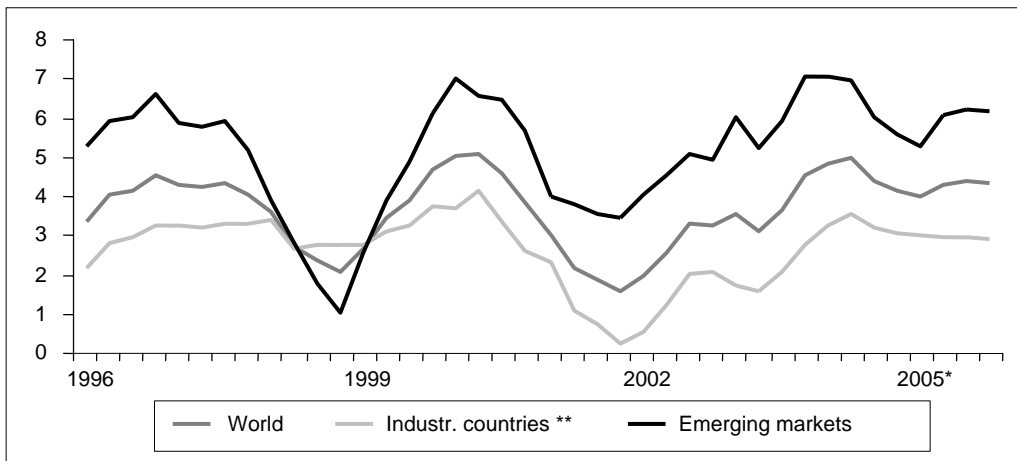
Clearly, the effects of the depreciation were not spread evenly among countries and regions. The most marked decline was against the currencies of other advanced economies, including the Eurozone and Japan. The effects were less apparent against emerging country currencies. The dollar fell against the currencies of transition economies and emerging Asia, while its value increased against Latin American currencies. Projections in the international money markets are markedly difficult, but it is hard to imagine (though there are some contrary opinions) that the US dollar could fall much below present levels.²

The depreciation of the dollar, combined with the recovery of the world economy, gave rise to an increase in the prices of various commodities, especially oil. The price per barrel rose substantially as a result of higher than expected demand (especially in the United States and China) because of low stocks, the delay in the recovery of Iraqi production, and speculative movements.

B. The Global Recovery

After a period of uncertainty and attempts at recovery, in the second half of 2003 the United States entered a stage of growth underpinned by an expansionist monetary and fiscal strategy and the stabilization of geopolitical conditions. Real GDP grew by an annual 8.5% in the third quarter and 4% in the last quarter. The growth was driven by private consumption, which in turn was stimulated by the fall in taxes and cuts in interest rates, the rise in investment attendant on increased returns, and attractive financing conditions. Notwithstanding this positive scenario, the labor market remained contracted relative to the country's historical performance.

FIGURE I.5
REAL GDP, % VARIATION RELATIVE TO THE FOUR PREVIOUS QUARTERS
BY GROUPS OF COUNTRIES



Notes: * IMF projections. * Australia, Canada, Denmark, United States, Eurozone, Japan, New Zealand, United Kingdom, Sweden and Switzerland.

Source: "World Economic Outlook 2003 - Advancing Structural Reforms", IMF.

² In early June 2004, Professor K. Rogoff offered this opinion in an interview with the Brazilian magazine *Veja*.

As mentioned, the outlook is that the US economy will continue to grow strongly up to the end of 2004. There is, nonetheless, a need for a sustainable fiscal policy, since the expansionist policy pursued in 2003 contributed to the deterioration in the US accounts, which in the medium term could excessively affect the global economy.

Recovery is still much slower in the Eurozone. The weak growth of real GDP in 2003 (1.5% in the first quarter and 1.4% in the final quarter) was the result of greater external demand. The dynamism of world trade underpinned European exports despite the high value of the euro. Consumption growth, however, was weak. Inflation remained stable at slightly below 2% and is expected to fall in the next two years. This favorable scenario of price stability suggests that growth could be stimulated by a softer monetary policy.

Inflation has varied substantially among the Eurozone countries since the adoption of the single currency in 1999. The nominal interest rate common to all those countries gives rise to different real rates among them. Moreover, there is a significant variation in real domestic demand among them. Domestic demand is expanding in Spain, for example, while in Germany it is stagnant.

For 2004 the IMF is projecting growth in Denmark, Norway, Sweden and Switzerland, driven by the increase in global demand. In the other countries domestic demand will be weaker because of poor labor market conditions. For the region as a whole, recovery is linked to external demand, since it makes it more vulnerable to exchange rate shifts and the recovery of each individual member country (their main trading partners).

In contrast to the Eurozone countries, macroeconomic conditions in the United Kingdom are solid, the result of an appropriate counter-cyclical monetary policy, an expansionist fiscal policy and the structural flexibility attained through the reforms effected in the last 20 years in the labor, production and financial arenas.

In Japan, economic growth is surpassing expectations. This is the result of: (i) strong external demand for Japanese goods, (especially from China), despite the appreciation of the yen; (ii) growing investment driven by the increased rate of return; and (iii) the rise in domestic consumption. The question today is whether the growth of the Japanese economy will persist or whether, as in previous recoveries, the increase will be followed by a sharp fall in the growth rate. Some changes in the past year suggest that the growth could be sustained, including:

- Improved private sector performance caused by the increased returns and the decline in debt. This improvement was evident only in large exporting firms; small enterprises fared less well.
- The banking system has improved as a result of the appreciation of banks' shares. Nonetheless, the sector's modest profitability remains a matter of concern for the country.
- The lessening of deflationary pressures. Putting an end to deflation is one of the Japanese government's main targets.

Although the changes mentioned amount to a first step in the direction of sustainable growth, there is a need for reform in the financial and corporate sectors if the growth trend is to continue.

Emerging markets and developing countries in most regions also experienced growth in the past year. Prominent among this group is emerging Asia. With its substantially competitive interest rates and successful macroeconomic policies, and with the recovery of the technology sector, the region grew by 7.2% in 2003 (the highest rate since the crisis of 1997-1998) and accounted for half of world growth. Its economic output triggered the recovery in the second half of 2003, driven by domestic demand and exports. Consumption and tourism grew significantly (especially in the countries that had been affected by SARS), supported by an adjustment-oriented monetary policy and a rise in consumer credit. In China, unlike the other countries of the region, investment grew rapidly.

Exports were driven by: (i) the recovery of the global economy; (ii) the increased demand for high-technology goods; and (iii) currency depreciation relative to the US dollar. Imports also grew as a result of the increase in domestic demand and the rise in exports. Thus these countries experienced no significant change in their trade surpluses. Inflation rose slightly, caused by the increase in commodity prices, but remained low.

The IMF expects the countries of the region to continue to grow fast in 2004. The growth of the credit market could cause some disequilibria in the financial sector, which would lead some countries to gradually adopt a more restrictive monetary policy. Additionally, the IMF stresses that structural reforms will be necessary to sustain growth based on a rise in demand.

Because of the swift increase in exports and investment, China grew strongly in 2003. This underpinned the growth of other countries in the region and beyond it. Although investment has been one of the main pillars of this growth, it was also a source of much concern for the Chinese government: the meteoric growth of investment in some sectors and the rise in input prices. More restrictive policies that are consistent with sustainable growth are needed to minimize this risk and avoid adjustments in some sectors.

India's GDP has also exceeded expectations as a result of cyclical and structural factors. The structural factors include: (i) the delayed effect of economic liberalization in the manufacturing sector during the 1990s; (ii) the recent opening of the external sector; (iii) the effect of investments in infrastructure; and (iv) corporate restructuring in recent years. The cyclical and temporary factors include the effect of rains on agricultural output, the impact of low interest rates on consumption and the real estate credit market, and the recovery of the world economy. In Pakistan, the growth of the economy facilitated fiscal consolidation. The government managed to hasten structural reforms and modernize institutions, essential steps for the purposes of sustainable growth and poverty-reduction.

All the economies of the ASEAN-4 group grew in 2003. There was a strong recovery in Thailand, but inflation remained low. Output also recovered sharply in Malaysia, and both inflation and unemployment were modest. Indonesia experienced moderate growth, driven by private consumption. Inflation declined, and the fiscal consolidation plans proved to be quite appropriate. In the Philippines, 2003 was a year of marked uncertainty, especially in light of the expectations related to the elections of May 2004. Most important, according to the IMF, is that fiscal conditions remained stable and monetary policy was contractionary, and thus the depreciation of the currency did not endanger the country's inflation target.

In Asia's newly industrialized economies (NIEs), which were most affected by SARS, recovery was based on liquid exports. Maintenance of a macroeconomic policy to support domestic demand would probably underpin the recovery, making possible higher interest rates. Singapore's macroeconomic support policies aided its recovery. In Hong Kong, the focal point of SARS, private consumption underlay the recovery of 2003; inflation began to fall and the government made fiscal consolidation its priority for 2004.

In Latin America, especially Brazil, growth was quite modest last year. The recession of 2002 (except in Brazil) was followed by a modest rise in real GDP in 2003. That growth was driven by external demand arising from the depreciation of Latin American currencies, by a resumption of internal demand (nourished by the decline in interest rates), and by the new-found credibility of government policies. The rise in exports also helped improve the current account.

Despite the improved economic performance, unemployment remained high, as did rates of inequality and poverty, circumstances that contributed to a rise in social tensions.

Since the governments of the region have maintained a restrictive monetary policy in an effort to control the (generally high) public debt, they are hampered in their ability to tackle the social problems that lead to higher public spending. This problem is more apparent in the short term. In the long term, it is hoped that the efforts made to reduce the debt will bring social benefits. This would help lessen uncertainty and

thus social tensions (the Argentine experience showed that crises in the financial sector can lead to quite drastic social tensions), and would make fiscal policy more flexible. The latter would then be better placed to tackle a future economic downturn, since resources would be made available for infrastructure, education and social security.

There is no short-term solution for social problems or for the matter of public debt. The policies to be adopted will depend on each country's particular circumstances. The recovery of 2004 was based on the strength of domestic demand, higher commodity prices, and the global recovery.

Prominent among the emerging markets are those that in the coming years will join the European Union (EU) and the Commonwealth of Independent States (CIS). Of the 10 countries in the former group, Turkey had one of the highest growth rates in 2003. The improvement in financial market conditions had a very positive impact on the region's economic output. Real GDP grew by about 6%, driven by investment and private consumption. Inflationary pressures were substantially low, a circumstance related to the appreciation of the local currency. The external position was well-managed. Nonetheless, there is a risk that the increase in oil prices and concerns arising from geopolitical events (terrorist attacks) will have a negative effect on the country's current account into 2004.

Among the other countries of this group, the Slovak Republic grew by 4.2%, driven by exports. In Bulgaria and Romania, growth sprang from the expansion of the credit market. In Slovenia, domestic demand strengthened, but GDP growth was modest because of the low dynamism of the external sector.

All the economies of the ASEAN-4 group grew in 2003. In almost all of them, growth was consolidated by rising oil prices, by increasing wages (and then by consumption) because of competitive exchange rates, and in some cases by a somewhat unexpected growth in investment.

C. Trends in Foreign Direct Investment (FDI)

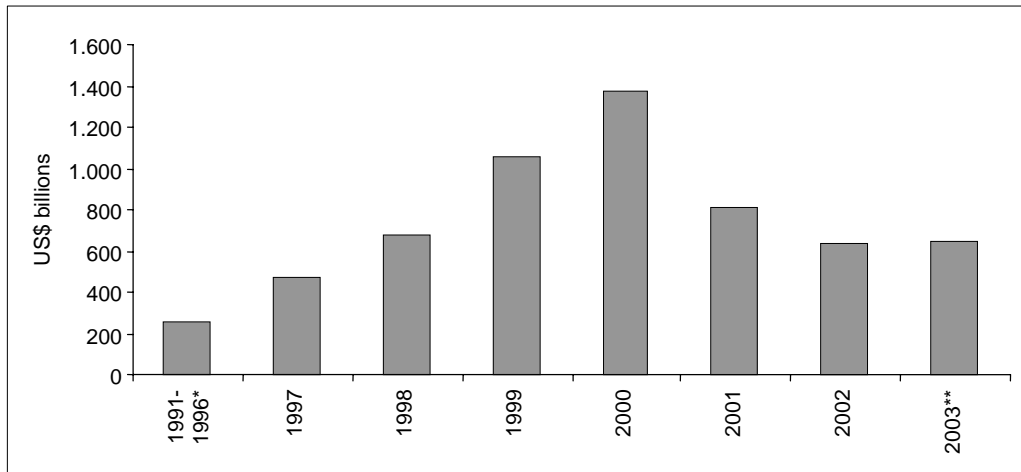
Having reached annual average rates of about US\$ 251 billion in the period 1991-1996, global FDI flows grew substantially until 2000, when they stood at almost US\$ 1.4 trillion. Thereafter, there was a significant decline in the next two years. This process is evident in Figure I.6 and Table I.1.

The main cause of this decline was the slower growth of the developed economies in 2001-2002, followed by the Asian and Russian crises in the second half of 1997 and 1998, respectively, the decline in the asset prices of companies linked to the "new economy", the September 2001 terrorist attacks in the United States (which were almost simultaneous to the fall in stocks), and the accounting scandals in Enron and other companies. That decline seemed to be curbed in 2003. FDI stabilized in practically all regions and stood at practically the same level as in 2002.

Latin America, however, is an exception. There, the situation was even worse. FDI flows peaked in 1999 and thereafter the trend was significantly negative. According to UNCTAD estimates, FDI flows fell from about US\$ 88 billion in 1999 to US\$ 37 billion in 2003.

UNCTAD (see below) expects FDI to enter a new growth phase as of this year. This optimistic expectation covers almost all regions, but the scale will be different in each. In general, the most recent projections of specialist analysts suggest that FDI will mainly grow in manufacturing sectors. The beneficiary industries should be: (i) food and beverages; (ii) automobiles and other transport equipment; (iii) electrical and electronic products; and (iv) machinery and equipment.

FIGURE I.6
FOREIGN DIRECT INVESTMENT INFLOWS - WORLD, 1991/2003



Notes: * Preliminary data.

** Annual averages.

Source: UNCTAD, "World Investment Report 2003" and "Global FDI Decline Bottoms Out in 2003".

As to the services sector, FDI flows are expected to grow in the subsectors of: transport, banking and insurance, and tourism. The main recipients of FDI in 2004 will be China and India, followed by the United States, Thailand, Poland, the Czech Republic, Mexico, Malaysia, the United Kingdom, Singapore and South Korea. Competition for FDI projects is quite sharp, and a large number of countries are making increasing efforts to attract such investment.

Investment flows were dominated by flows to and among the developed economies. Although FDI trends were similar in the developing countries, it is plain that the advanced economies accounted for the bulk of global flows. The latter countries accounted for 61.5% of global FDI flows in the period 1991-1996, while in 2000 they accounted for 81.5%. It is estimated that they accounted for 72.2% of the total in 2003. Note that the countries of Central and Eastern Europe are relatively unimportant in terms of global FDI flows: they accounted for barely 1.9% of the total in 2000, and for 4.7% in 2003 (UNCTAD [2004a], [2004b]).

TABLE I.1
REGIONAL DISTRIBUTION OF GLOBAL FOREIGN DIRECT INVESTMENT INFLOWS
FOREIGN DIRECT INVESTMENT INFLOWS - WORLD
(US\$ billions)

	1991-1996*	1997	1998	1999	2000	2001	2002	2003 (1)
World total	251.4	475.6	678	1058.7	1375.7	809.6	640.1	647.3
Developed countries	154.6	269.7	472.3	824.6	1120.5	589.4	460.3	467
<i>Western Europe</i>	91	139.3	263	496.2	709.9	400.8	384.4	345.8
<i>European Union</i>	87.6	127.9	249.9	475.5	683.9	389.4	374.4	341.8
Germany	4.8	12.2	24.6	55.8	203.1	33.9	38	36.4
France	18.4	23.2	31	46.5	43.3	55.2	51.5	36.3
United Kingdom	16.5	33.2	74.3	84.2	130.4	62	24.9	23.9
Other countries of Western Europe	3.4	11.4	13.1	20.7	26	11.4	10	4
<i>North America</i>	53.4	114.9	197.2	308.1	380.8	172.8	50.6	97.7
Canada	6.6	11.5	22.8	24.7	66.8	28.8	20.6	11.1
United States	46.8	103.4	174.4	283.4	314	144	30	86.6
<i>Other developed countries</i>	10.2	15.5	12	20.3	29.9	15.8	25.3	23.5
Japan	0.9	3.2	3.2	12.7	8.3	6.2	9.3	7.5
Developing countries	88.6	186.9	183.3	208.9	228.8	195.2	151	149.9
<i>Latin America and the Caribbean</i>	24.2	67	74	87.9	78.1	69.5	44.9	36.5
<i>Africa</i>	4.6	10.7	8.9	12.2	8.5	18.8	11	14.4
<i>Asia-Pacific</i>	59.4	109.1	100	108.5	142.1	106.8	95	99
China	25.5	44.2	43.8	40.3	40.8	46.8	52.7	57
Central and Eastern Europe	8.2	19	22.5	25.1	26.4	25	28.7	30.3

Notes: ⁽¹⁾ Preliminary data.

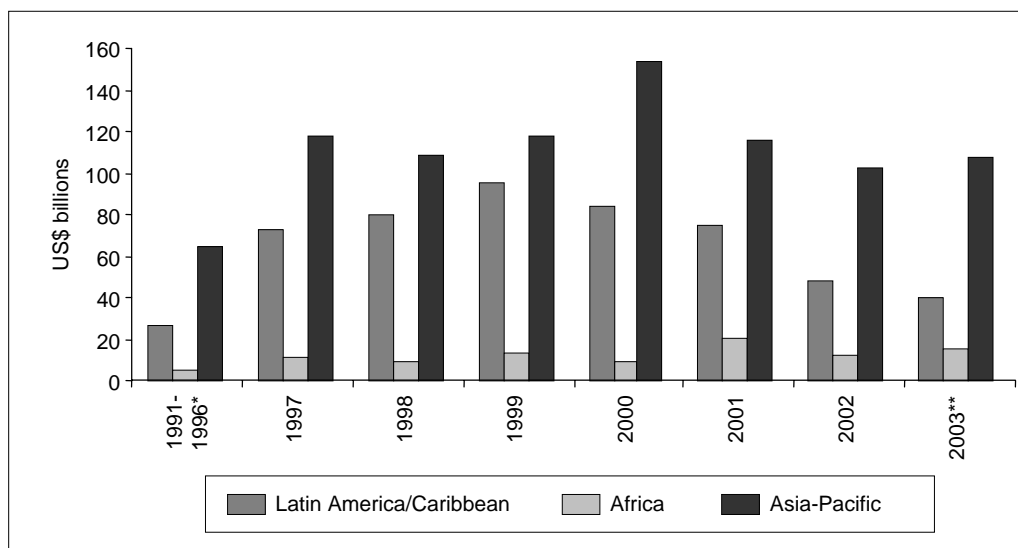
** Annual averages.

Source: UNCTAD, "World Investment Report 2003" and "Global FDI Decline Bottoms Out in 2003".

Emerging economies

The most recent data indicate that FDI flows to the emerging countries continued to fall in 2003. The decline, however, was less than in previous years, and largely reflects the fall in investment to Brazil and to those countries acceding to the EU. There follows a brief summary of FDI performance by region. The aim is to establish a backdrop for a more detailed analysis of the countries of Latin America in general, and MERCOSUR in particular.

FIGURE I.7
LIQUID FDI INFLOWS – DEVELOPING COUNTRIES, 1991/2003
 (US\$ billions)



Source: UNCTAD, "World Investment Report 2003" and "Global FDI Decline Bottoms Out in 2003".

Western Asia and the Pacific

In 2003, FDI flows to this region remained high at about US\$ 99 billion, a little more than the US\$ 95 billion recorded in 2002. In the latter year the region was the target of about 63% of direct investment in developing countries, a share that rose to 66% in 2003. To a large extent, this stemmed from the good performance of China, where FDI flows continue to rise strongly: the country now accounts for 58% of all FDI going to emerging economies in Asia.

South Asia

In 2003, India was among the five leading recipients of FDI, with flow amounting to US\$ 4.1 billion. The increase in FDI reflected the lessening of restrictions on investment in the automobile, banking and telecommunications sectors.

According to Global Development Finance (IMF [2004b]), FDI to South Asia will grow from US\$ 5 billion in 2003 to more than US\$ 7 billion in 2005, as long as India's reform program continues to develop and to attract direct investment in services companies.

Europe and Central Asia

FDI flows to this region fell substantially last year. It is estimated that the total was US\$ 26 billion, as against US\$ 33 billion in 2002. The final negotiations on privatization were held in 2003, and the process ended in most countries of the region. Despite that, Russia experienced a slight increase in FDI, devoted mainly to the oil and gas sectors.

There are favorable expectations that FDI to this region will recover, including flows to Russia and Turkey. Flows are also expected to increase in the Czech Republic, Hungary, and Poland. The target sector will be services.

Latin America and the Caribbean

As mentioned earlier, among the developing economies, Latin America and the Caribbean experienced the sharpest decline in FDI flows. In 2003, FDI in the region reached about US\$ 36.5 billion, a fall of 19% relative to 2002. In the latter year flows were already substantially depressed relative to the US\$ 70 billion recorded in 2001 and the US\$ 78 billion in 2000. The decline evident in Brazil stemmed from a series of factors, chiefly: (i) the end of the stage of privatizations of 1998-1999 in the telecommunications and electrical sectors; (ii) contagion from the Argentine crisis in 2001; and (iii) no less important, doubts among international investors about the future economic policy of the government-elect at the end of 2002, which took office on January 1, 2003. In Mexico there was a 15% decline. In Chile, by contrast, FDI grew by more than US\$ 1 billion, a reflection of the economic recovery in 2003 and a very solid institutional foundation. In Argentina, flows stabilized at low levels because of the country's deep economic crisis, which prominently featured a moratorium on external debt payments (see below).

The ECLAC report [2004a] on FDI in Latin America highlights the following regional trends (see also the table below):

- (i) In Mexico and the Caribbean, FDI stemmed from transnational enterprises' use of an efficiency-seeking strategy to conquer other markets by integrating local production platforms with their regional or international production systems. The new patterns of competition in various industries motivated the companies to seek production locations offering lower costs and preferential geographic positions to export on a large scale. Thus the companies strove for an internationalization that enabled them to maintain a competitive regional and global position.
- (ii) In South America, FDI was effected mainly through transnational enterprises using strategies to seek raw materials and services markets, especially the subsectors of telecommunications, energy, infrastructure, and finance, particularly in the MERCOSUR countries and Chile. Central factors in this process were the deregulation and liberalization of activities, privatization programs, and an active strategy on the part of new international operators.

Since the 1990s, FDI to the region has been moving from the manufacturing sector to the services sector. That change is one of the reasons for the decline in investment evident in recent years. In contrast to the global trend, it is expected that in the coming years FDI to the region will be channeled towards the natural resources sectors, such as mining, oil and agriculture. In the services sector, investment is likely to be devoted to hotels, restaurants, and tourism in general. According to UNCTAD, the primary sector has less potential than the others. Hence the prospects for Latin America, unlike those of other regions, are not particularly encouraging over the long term.

TABLE I.2
LATIN AMERICA – SECTORAL DISTRIBUTION OF FDI, 1996-2003
(US\$ millions)

	1996	1997	1998	1999	2000	2001	2002	2003	Cumulative	%
Mexico										
Primary	116	140	71	210	282	38	209	25	1,090	1
Manufactures	4,719	7,306	5 123	8,985	9,309	5,854	5,435	4,532	51,262	48
Services	2,887	4,715	3 048	3,971	6,858	20,677	7,615	4,875	54,646	51
Brazil *										
Primary	111	457	143	846	1,299	1,494	637	1,482	6,469	4
Manufactures	1,740	2,036	2,767	7,003	5,088	7,000	7,620	4,480	37,734	24
Services	5,814	12,817	20,362	20,140	24,139	12,547	10,499	6,940	113,258	72
Argentina										
Primary	1,728	177	1,324	17,845	2,736	898	1,225		25,934	43
Manufactures	2,776	3,308	1,147	1,950	1,487	49	596		11,314	19
Services	2,096	4,888	3,648	3,153	4,749	1,261	-1,036		18,759	31
Other	350	788	1,173	1,038	1,445	-42	-9		4,743	8
Chile										
Primary	1,090	1,758	2,523	1,388	363	975	2,002		10,492	28
Manufactures	917	627	530	828	240	754	209		4,339	11
Services	2,829	2,833	2,981	6,983	2,419	3,053	1,166		22,912	61
Colombia **										
Primary	866	696	110	-73	27	1,020	837	483	3,966	19
Manufactures	731	514	785	505	514	236	285	140	3,710	18
Services	1,515	4,354	1,934	1,019	1,758	1,244	851	312	12,987	63
Ecuador										
Primary	307	562	769	605	681	1,139	1,078	5,141		85
Manufactures	24	45	30	8	10	59	56	232		4
Services	169	117	70	36	28	132	141	693		11

Note: * Brazil and Mexico, values for the whole year. ** Colombia, values from January to June.

Source: ECLAC [2004a].

Despite the decline in FDI flows, the presence of transnational companies in the region remains significant, and the process of transnationalization remains strongly evident in the regional economy. According to the ECLAC report [ECLAC, 2004], transnational companies were responsible for 39% of sales in the region's 500 biggest firms, 55% of the sales of the 100 biggest manufacturing companies, 38% of the sales of the 100 leading services firms, 52% of exports of the 200 main exporters, and 37% of the assets of the 100 biggest banks.

D. The Latin American Economy

Following a mediocre performance in 2001 and 2002, Latin America resumed growth in 2003 (of about 1.5%).³ Among the MERCOSUR countries in particular, only Argentina performed well following the disastrous period of 1999-2002, when the country's GDP fell by an accumulated 18.3%. As well as Brazil, Mexico – the region's second most important economy – also performed very modestly in 2003: Mexican GDP grew by 1.2% while Brazilian output fell by 0.2%. The other countries associated with MERCOSUR performed far below the regional average (see Table I.3 below). We will return to this point later.

The low growth rates of the Latin American countries are in stark contrast to those posted by developing countries as a whole in 2003. Apart from Argentina, no country even approached the average of developing economies (5.6% in 2003). Note, moreover, that the growth of the other developing countries, as well as the recovery of the world economy, was essential for the recovery of the Latin American economy. The low growth recorded in the region was driven by exports. Exports to China, alone, for example, grew by 40.4% in the first 10 months of 2003 (BNDES [2004]).

Latin America's per capita GDP remained reasonably stable between 2002 and 2003. An indicator of the seriousness of the crisis in the region is the value of aggregate per capita GDP, which is still below 1997 levels. Despite the (albeit modest) growth, there was virtually no change in the rate of unemployment. The latter remains very high, about 10.7% in 2003. ECLAC projects recovery of the regional economy and the start of a new growth cycle. Even so, the projected performance (see Table I.3) is poorer than that of all the other regions analyzed.

As mentioned in the previous section of this report, the region's macroeconomic performance also suffered the direct influence on FDI inflows: the latter was responsible for the less satisfactory performance at the world level in 2003, with a fall of 19%. That is, Latin America and the Caribbean was the only region to experience a prolonged decline in such investment. Between the periods 1990-1994 and 1995-1999, annual average FDI inflows practically quadrupled. Thereafter they began to fall, with an accumulated decline of some 40% between 1999 and 2003.

³ Preliminary results collected and analyzed by ECLAC [2004].

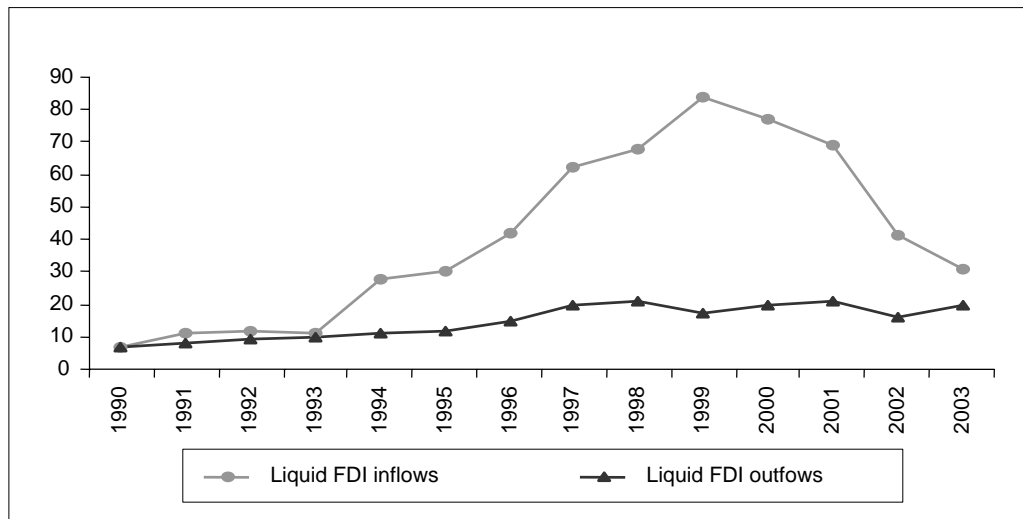
TABLE I.3
REAL GDP GROWTH RATE, 1999-2003 AND FORECAST 2004-2005
 (%)

	1999	2000	2001	2002	2003	2004*	2005*
Developing countries	4.0	5.7	4.1	4.6	5.0	5.6	5.7
Africa	2.8	3.0	3.7	3.1	3.7	3.8	3.6
Latin America and the Caribbean	0.5	3.8	0.7	-0.1	1.5	4.3	3.6
Argentina	-3.4	-0.8	-4.4	-10.8	8.4	6.7	3.3
Bolivia	0.3	2.3	1.3	2.8	2.0	3.9	4.8
Brazil	1.0	4.0	1.4	1.9	-0.2	3.3	3.5
Chile	-0.7	4.4	3.1	2.1	3.1	4.8	5.0
Colombia	-3.8	2.2	1.4	1.7	3.3	3.6	3.7
Ecuador	-7.9	2.3	6.0	3.4	2.0	4.3	2.3
Mexico	3.7	6.8	-0.4	0.9	1.2	3.2	3.6
Paraguay	-0.1	-0.6	2.4	-3.0	-1.0	2.4	-
Peru	0.9	3.0	0.2	4.9	4.0	3.7	3.7
Uruguay	-3.4	-1.9	-3.4	-10.8	-2.5	5.5	4.0
Venezuela	-5.8	3.8	2.9	-8.4	-8.9	9.2	4.8
Dominican Republic	7.8	7.3	2.7	4.2	2.5	0.5	-
Asia-Pacific	6.1	6.7	5.8	6.4	6.4	6.7	6.8
China	7.1	8.0	7.3	8.0	9.1	8.0	7.7
India	6.7	5.4	4.1	5.0	7.0	7.0	7.2
Central and Eastern Europe	2.3	3.9	3.1	3.0	3.4	5.0	5.4
Russia	6.3	10.0	5.0	4.3	7.3	5.9	5.6

Note: * Projections: average of the tables of projections from ECLAC, IMF and Merrill Lynch.

Source: Sinopse Internacional BNDES - April 2004.

FIGURE I.8
LATIN AMERICA: FDI INFLOWS AND OUTFLOWS
 (US\$ billions)



Source: ECLAC [2004a].

The decline in FDI was not uniform among the Latin American countries. South America was the most affected region, and even more so MERCOSUR, as is evident in the table below.

TABLE I.4
LIQUID FDI INFLOWS,* 1990-2003
(US\$ millions)

	1990-1994 (a)	1995-1999 (a)	2000	2001	2002	2003 (b)
Mexico	5,430	11,398	16,449	26,569	14,435	10,731
Central America	575	2,067	1,964	2,017	1,354	1,742
Costa Rica	222	481	409	454	662	466
El Salvador	12	282	173	250	208	140
Guatemala	88	213	230	456	110	104
Honduras	41	120	282	195	143	216
Nicaragua	20	194	267	150	174	241
Panama	192	777	603	513	57	576
Caribbean	840	1,949	2,014	2,420	2,710	2,466
Jamaica	124	285	468	614	481	500
Dominican Republic	171	594	953	1,079	961	700
Trinidad and Tobago	270	550	472	685	737	700
Other	274	519	121	42	531	566
South America	8,930	45,534	57,716	38,528	26,480	21,527
Chile	1,207	5,401	4,860	4,200	1,888	2,982
MERCOSUR	4,880	30,188	43,590	25,039	17,496	11,397
Argentina	3,027	10,599	10,418	2 166	775	1 103
Brazil	1,703	19,240	32,779	22,457	16,566	10,144
Paraguay	99	185	119	95	-22	19
Uruguay	51	164	274	320	177	131
Andean Community	2,843	9,945	9,266	9,289	7,096	7,148
Bolivia	85	711	736	706	677	357
Colombia	818	2,796	2,299	2,500	1,974	1,291
Ecuador	303	639	720	1,330	1,275	1,637
Peru	801	2,350	810	1,070	2,391	1,332
Venezuela	836	3,449	4,701	3,683	779	2,531

Notes: * Liquid inflows correspond to FDI inflows net of capital outflows in the form of remittances by foreign firms. For this reason they differ from those represented in Section I.B.

(a) * Annual average.

(b) Estimated.

Source: "Foreign Direct Investment in Latin America and the Caribbean", ECLAC [2004].

A positive result in 2003 was the performance of Latin America's world trade, which benefited substantially from the devaluations in Argentina and Brazil. Table I.5 highlights this matter, presenting the growth rates of exports and imports of (non-factor) goods and services in that year. The factors that made the greatest contribution were:

a) *The recovery of world demand*: the recovery of international output after the mild recession of 2001 and 2002; this has still not ended. It is expected that the main countries will continue to import at a high rate. It is also probable that the markets of Latin America and the Caribbean will become more stable, which should contribute further to the growth of regional exports. As result of the acceleration of international demand, Latin American exports to the United States, the EU, Japan and Latin America itself recovered in 2003 from the low level apparent in 2002. As regards exports to other regions, China is to be highlighted. In 2003 China was Brazil's second main trade partner, just behind the United States. The main increases in the volume and value of exports were secured by the MERCOSUR countries and stemmed largely from the growth of sales of soya, vegetable oils, flours, coffee, wheat, cotton, and other agricultural products. As in MERCOSUR, throughout Latin America the recovery of exports was largely due to agricultural and fisheries products, followed by the mining and oil sectors.

TABLE I.5
GROWTH RATE OF EXPORTS AND IMPORTS IN 2003 (%)

	Exports		Imports	
	Goods	Services	Goods	Services
Latin America and the Caribbean	8.3	6.6	3.1	3.3
Chile	14.8	21.3	13.9	13.3
MERCOSUR	18.9	13.2	10.2	8.5
Argentina	14.3	29.6	54.4	15.9
Brazil	21.1	9.8	2.2	6.7
Paraguay	11.9	2.5	9.2	10.8
Uruguay	18.2	0.4	11.7	-5.6
Andean Community	5.4	-2.9	-2.4	-2.4
Bolivia	20.1	23.5	-8.9	14.8
Colombia	9.9	-3.5	9.8	-0.7
Ecuador	19.4	-8.4	1.2	2.8
Peru	17.1	2.6	10.8	3.5
Venezuela	-3.4	-10.4	-21.4	-11.9
Mexico	2.9	-0.3	1.4	2.3
CACM	9.9	5.7	7.5	4.9
Costa Rica	16.6	9.5	11.1	6.8
El Salvador	4.8	5.4	10.4	1.8
Guatemala	6.1	2.9	2.4	3.9
Honduras	7.7	-0.7	9.3	7.8
Nicaragua	1.4	5.4	-0.8	3.8
Caribbean	9.4	5.2	-1.2	-6.6
Dominican Republic	6.0	16.7	-7.0	16.7

Source: ECLAC [2004a], based on the values of each country's balance of payments.

b) *The recovery of intra-regional economic areas*: closer relations between Latin American subregions and the extension of economic integration to other socio-economic areas of the region, such as the agreement between the Andean Community and MERCOSUR, helped consolidate intra-regional trade.

c) *The improvement in external financing conditions*: better conditions in the international financial markets, both in terms of capital flows and financing conditions, have provided significant alleviation compared to the negative impact on the region's balance of payments in 2002. Thus highly indebted countries, such as Brazil and Mexico, saw their sovereign risk reduced. Foreign investors, seeking greater stability, are focusing on the region, drawn by low international interest rates, the reduction of sovereign risk in various Latin American countries, and the low price of shares in emerging markets. The composition of investors in debt paper diversified: private sector banks have now been joined by other financial institutions, such as pension funds managers, as well as private investors. Hence the issues profiles have improved substantially as regards terms and costs.

d) *Increase in financial flows*: as a result of the foregoing, it is estimated that in 2003 Latin America and the Caribbean received about US\$ 40 billion from bond issues in Brazil, Chile, Colombia, Mexico, Uruguay and Venezuela. The increase in capital inflows in the form of the issue of bonds and shares has offset the stagnation of FDI.

e) *Devaluation of Latin American currencies*: the devaluation of some Latin American currencies helped increase exports. Those countries in which the exchange rate fell most relative to the dollar were: Jamaica (13%), Mexico (9%), Dominican Republic (25%), and Venezuela (21%). In Jamaica and the Dominican Republic the depreciation reflected the fragility of the fiscal accounts, and in Venezuela it was caused by the general strike that paralyzed the country in February 2003. The devaluation of the Mexican peso allowed some sectors, which have suffered significantly from the growth of Chinese exports to the United States, to recover a little of their competitiveness. In the other countries of the region, appreciation of the exchange rate, which began to harm export performance in the first half of 2003, was offset by the depreciation of the dollar against the euro and the yen. To some extent this aided exporters in MERCOSUR, Chile and the Andean Community, as well as the region's dollarized economies (Ecuador, El Salvador and Panama).

CHAPTER II. THE REGIONAL MACROECONOMIC CONTEXT OF THE MERCOSUR COUNTRIES: RECENT PERFORMANCE AND PROSPECTS

This chapter analyses the macroeconomic context of the region's economies, highlighting the main developments in the recent past with a focus on 2003, as well as a short-term prospects for the four MERCOSUR economies. The analysis reveals a substantial improvement in the region's macroeconomic conditions, despite the slight fall in Brazilian GDP in 2003. Similarly, the prospects for 2004 are promising for Argentina and Brazil, although doubts remain about whether growth will persist in subsequent years. The doubts are largely associated with the recovery of fixed investment spending in general, and on infrastructure in particular. Second, they are linked to the continuation of the phase of strong external demand for the member countries' export commodities, given the probable trends in the main western economies, Japan, China and India. For the smaller members, Paraguay and Uruguay, the prospects are closely related to those of the larger members.

A. Argentina

Retrospective

The Argentine economy made substantial progress in 2003, allowing the country to overcome the most acute phase of the macroeconomic instability associated with the economic and financial crisis of 2001-2002, which was probably the most severe in Argentine history. The implementation of the structured economic program in the second half of 2002 increased the level of confidence, boosted output, and facilitated the strengthening of the financial variables. These new conditions made possible the implementation of important measures, such as the lifting of restrictions on bank deposits, relaxation of exchange controls, and the initiation of monetary reunification through the issuing of quasi-currencies. Nonetheless, the moratorium on the external debt has thus far remained a difficult economic problem.

The election of a new president in April 2003 strengthened the macroeconomics trends inherited from the program implemented the previous year. However, the government's economic and social goals (sustainable growth, job-creation, and reducing poverty and inequality) have still not been reached. The present Argentine government proposes to make the social and infrastructural changes needed to foster enduring and equitable growth with low inflation, while simultaneously lessening the country's vulnerability to external shocks and thereby enhancing the solidity of public finances. Moreover, it plans to take steps to put the banking system on a more solid footing so as to substantially increase the level of credit in the economy. These are clearly complex goals, and are hard to attain in the short term.

Table II.1 illustrates the performance of the main macroeconomic variables in the period between 1994 and 2003. Figure II.1 prompts the conclusion that the economic recovery of 2003 was gradual and consecutive to the downturn of 2002. In the second half of 2003 the growth rate was 8.7%, the highest recorded since 1997, and growth is expected to continue to be high in 2004.

TABLE II.1
ARGENTINA: GDP, UNEMPLOYMENT, INFLATION, GOVERNMENT DEFICIT
EXCHANGE RATE AND FOREIGN TRADE, 1994-2003

Years	Growth of GDP (%)	Unemp. rate (%)	Inflation CPI (%)	Exchange rate (US\$)	Fiscal deficit (% GDP)	Exports (US\$ millions)	Imports (US\$ millions)	Balance (US\$ millions)
1994	5.84	11.45				15,787	21,544	-5,757
1995	-2.85	17.4	1.6	0.918		20,963	20,122	842
1996	5.53	17.2	0.1	1.000	1.95	23,809	23,761	48
1997	8.11	14.9	0.3	1.000	1.48	26,431	30,450	-4,019
1998	3.85	12.8	0.7	1.000	1.36	26,442	31,405	-4,963
1999	-3.39	14.2	-1.8	1.000	1.70	23,333	25,508	-2,176
2000	-0.79	15.1	-2.4	1.000	2.40	26,409	25,243	1,167
2001	-4.41	17.4	-1.4	1.000	3.20	26,655	20,311	6,344
2002	-10.89	19.4	40.8**	3.085	1.50	25,709	8,991	16,718
2003	10.82*	14.5	3.6**	2.950	n.a.	26,967*	12,310*	14,605*

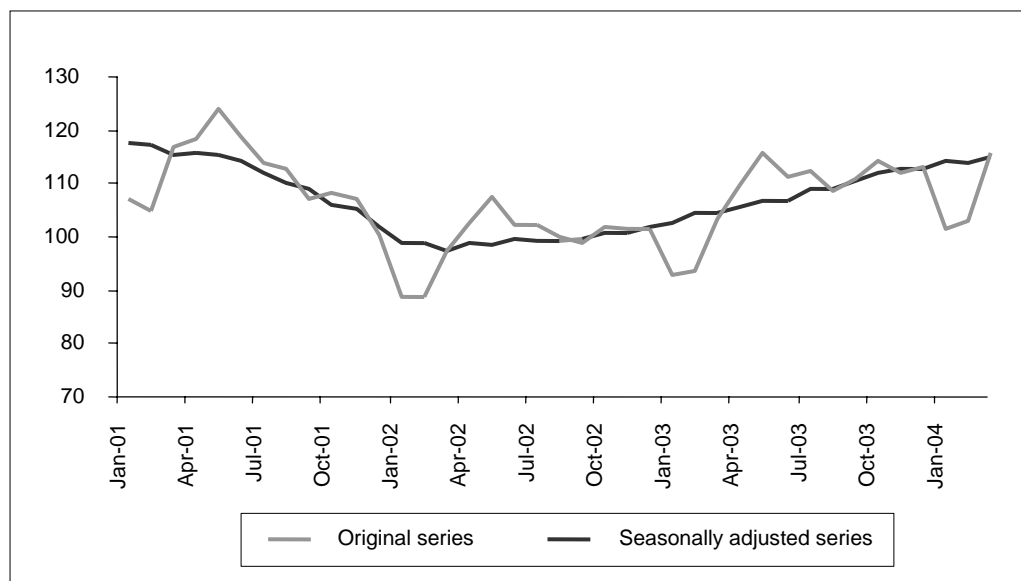
Notes: * Preliminary.

** Accumulated 12 months.

Source: INDEC.

Inflation, which reached 41% in 2002 (the result of the abrupt end of the fixed exchange rate regime and the Convertibility Law), fell to a modest 3.6% in 2003. Preliminary data, not included in the table, indicate that for the first time in the last 10 years the primary consolidated surplus exceeds 2% of GDP and that the current account surplus remained at a high level in 2003.

FIGURE II.1
ARGENTINA: REAL GDP INDICES, JANUARY 2001-APRIL 2004
 (Base: 2000 = 100)

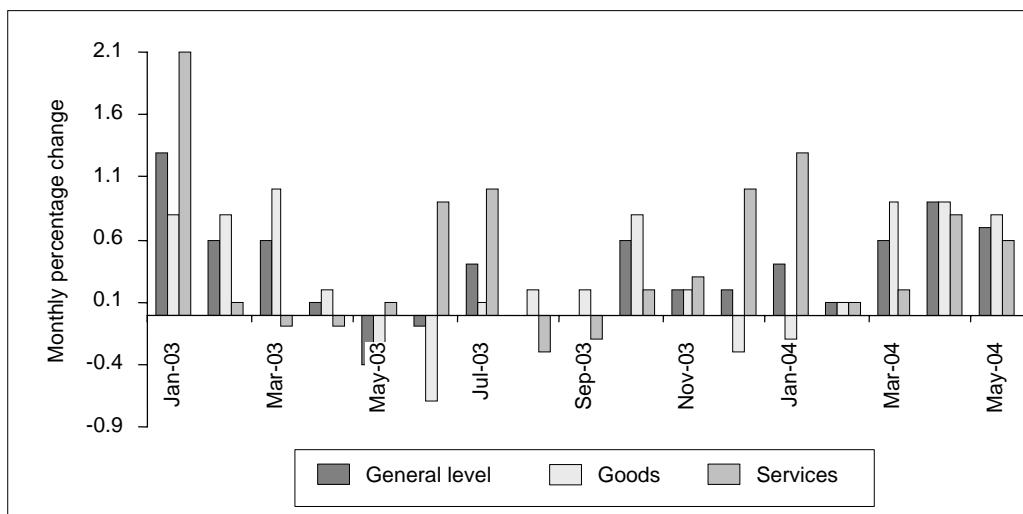


Source: INDEC.

As to aggregate demand for goods and services, the most significant increase was in gross fixed capital formation (+ 38.1% in 2003) and private consumption (+ 8.1%). Exports and government consumption posted the lowest percentages in the same period, respectively reaching 6.4% and 1.5%. As regards the supply of goods and services, of note was the growth of the construction sector (34.3%) and manufacturing industry (15.8%). Note that the growth rates of 2003 and 2004 seem high because the basis for comparison (2001 and 2002) were years of low growth. The continuation of this growth beyond 2004 is a matter to which we will return later.

As mentioned earlier, progress on the output front was matched by the stabilization of inflation in 2003. Inflation in the year was characterized by gradual deceleration in the rate of price increases, such that prices stabilized by the end of the year at rates relatively lower than those of 2002.

FIGURE II.2
ARGENTINA: CONSUMER PRICE INDEX, MONTHLY VARIATION:
JANUARY 2003-MAY 2004
 (%)



Source: Instituto Nacional de Estadística y Censos – INDEC.

Consumer prices grew by an accumulated 1.1% in the first quarter of 2004, which can be annualized at 4.6% (Figure II.2). Given these price trends, it is estimated that by the end of 2004 inflation will be somewhat higher than that recorded at the end of 2003. That increase will stem mainly from: (i) the adjustment of relative prices in some sectors, which at present are able to recover the margin lost during the most acute period of the past recession; (ii) the government's raising of tariffs in some public service sectors; and (iii) pressure on costs arising from the increase in international prices of raw materials exports.

As to external trade, in 2003 the surplus was very close to that evident in 2002, when the trade balance was at a record high.⁴ Exports increased by 14.3% relative to the previous year, and totaled US\$ 27 billion. That total was the result of an increase in prices that was higher than the amounts exported. This superb export performance sprang from the increase in sales of agricultural goods and raw materials, which rose by 23% and 22% respectively. Exports of fuels and energy grew by an annual 13%, while sales of industrial manufactures rose by barely 1%. This relatively modest performance is partly attributable to the stagnation of the Brazilian economy in 2003, Brazil being one of the leading destinations for Argentine exports.

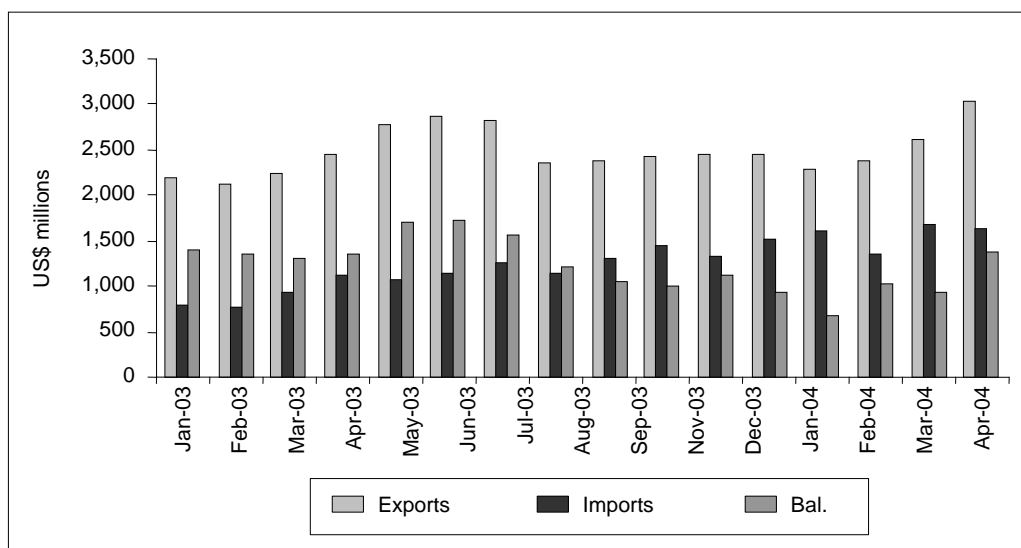
⁴ As far as MERCOSUR is concerned the result was a deficit, as we shall see.

The performance of goods imports was outstanding in 2003, driven by the recovery of the domestic economy. Those imports totaled US\$ 12 billion and grew by 33% relative to 2002. It is worth noting that despite this increase, in 2003 imports were about 40% below those recorded in 2001. The most prominent sector for imports was the capital goods sector, as well as intermediate inputs, with annualized growth rates of about 93% and 43% respectively. Imports of consumer goods also grew significantly, by 54% relative to the previous year. As a result of these developments, by the end of 2003 the trade surplus stood at \$15.6 billion, which was \$1.2 million below the level recorded in 2002.

It is expected that a positive performance of exports will be consolidated in 2004. These optimistic expectations are based on: (i) bullish projections for Argentina’s main markets, mainly Brazil and the countries of Asia; (ii) the increase in the competitiveness of local output; and (iii) the favorable prospects for international commodity prices. Similarly, the recovery of imports is expected to be maintained as a result of the resumption of domestic demand.

The available data on foreign trade in 2004 show an increase in total exports relative to the same period of the previous year (Figure II.3). The leader in this regard is the agricultural sector.

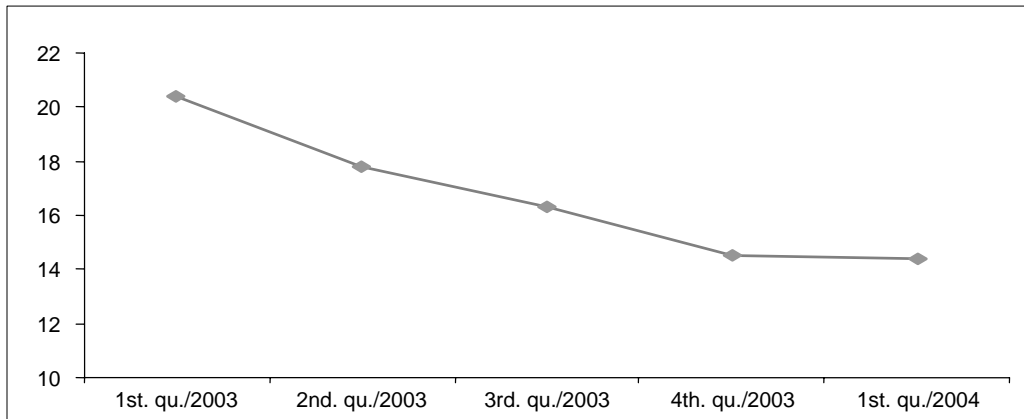
FIGURE II.3
ARGENTINA: TRADE BALANCE – JANUARY 2003-APRIL 2004
(In US\$ millions)



Source: INDEC.

As regards the labor market, the last household survey revealed a swift decline in unemployment throughout 2003, although joblessness remains at high levels (see Figure II.4). At the end of 2003, the unemployment rate was about 14.5%, while in the final quarter of 2002 it stood at 20.9% of the economically active population.

FIGURE II.4
UNEMPLOYMENT RATE – 1st QUARTER 2003-1st QUARTER 2004



Source: INDEC.

The indicators suggest that Argentina's unemployment rate is beginning to fall, supported by the recovery of output. That recovery, in turn, reflects changes in relative prices related to the new macroeconomic regime established since the end of convertibility.

Intra-MERCOSUR foreign trade: Argentina-MERCOSUR transactions

Argentine imports recovered in 2003 following a very poor performance during the preceding year of crisis. Imports were far below the \$7.9 billion posted in 1998 but the trend is towards recovery, a circumstance related to the increase in output. The following table shows Argentina's imports from MERCOSUR; the subsequent table shows Argentina's exports to the other countries of the region.⁵

As might be expected, imports from Brazil are prominent. These accounted for 91% of Argentina's total imports from MERCOSUR in 2003. Nonetheless, they amount to about half the imports that Argentina took from Brazil in 1998. The economic recovery of 2003 was responsible for the strong increase in imports that year.

TABLE II.2
ARGENTINE IMPORTS FROM MERCOSUR
(US\$ millions)

Country of origin	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Brazil	4,287.5	4,174.4	5,325.2	6,897.5	7,054.7	5,598.9	6,478.5	5,277.6	2,518.4	3,702.7
Paraguay	71.6	139.8	181.3	319.6	347.6	304.1	294.9	303.0	255.5	253.2
Uruguay	424.7	279.3	293.8	371.0	528.0	395.8	425.9	328.4	122.4	131.0
Total	4,783.8	4,593.5	5,800.3	7,588.1	7,930.3	6,298.8	7,199.3	5,909.0	2,896.3	4,086.9

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

Despite the devaluation of the Argentine peso, the recovery of exports has been quite slow. To a large extent this is because of the modest performance of Brazilian output since 2000. In 2003, Argentina's exports were a little less than half of those recorded in 1997-1998.

⁵ The data in the tables on intra-MERCOSUR trade are not necessarily equal to the totals because of classification differences between the information sources (FOB versus CIF and so on).

TABLE II.3
ARGENTINE EXPORTS TO MERCOSUR
(US\$ millions)

Destination country	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Brazil	3,656.3	5,510.9	6,619.9	8,107.3	7,924.4	5,689.3	6,991.4	6,311.3	4,838.0	3,818.3
Paraguay	497.7	631.6	581.4	621.2	621.9	563.2	592.2	496.7	341.9	349.6
Uruguay	649.6	654.2	717.1	835.3	843.3	818.6	818.3	768.5	543.0	444.3
Total	4,803.6	6,796.7	7,918.4	9,563.8	9,389.6	7,071.1	8,401.9	7,576.5	5,722.9	4,612.2

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

Consequently, the trade balances, which are shown below, clearly reveal the deterioration in Argentina's external accounts with the other members of MERCOSUR. This is because of difficulties with the other members, especially the contentious questions involving Brazil, which were made concrete in mid-2004. In this regard, the declining trade surpluses in 2003 were followed by deficit in the first half of 2004. Note the disproportionate weight of the balance with Uruguay in the last year.

TABLE II.4
ARGENTINA'S TRADE BALANCE WITH THE OTHER MERCOSUR MEMBER COUNTRIES
(US\$ millions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Brazil	-631.2	1,336.5	1,294.7	1,209.8	869.7	90.4	512.9	1,033.7	2,319.6	115.6
Paraguay	426.1	491.8	400.1	301.6	274.3	259.1	297.3	193.7	86.4	96.4
Uruguay	224.9	374.9	423.3	464.3	315.3	422.8	392.4	440.1	420.6	313.3
Total	19.8	2,203.2	2,118.1	1,975.7	1,459.3	772.3	1,202.6	1,667.5	2,826.6	525.3

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

Prospects

The Argentine economy's level of aggregate output in the first quarter of 2004 (about 10.5%) supports projections of GDP growth of about 8% for the year. There are, however, two sets of difficulties on the horizon. The first of these is surely the most important in 2004: developments in the international context and domestic conditions. Each of these matters will be discussed in greater detail below.

As to the international context, the threats are in four principal areas and one secondary area. The main threats are: (i) the increase in US interest rates; (ii) the growth of China and India; (iii) developments in commodity prices; and (iv) the outlook for the other MERCOSUR countries: especially Brazil. The secondary threat is: (v) the collapse of the real estate market in various advanced economies, especially the United States, the United Kingdom, and some countries of the EU.

- (i) The United States' expansionary monetary policy, put in place in 2001 and still in operation at the beginning of 2004, was only possible because of a fortuitous conjunction of a sharp increase in productivity and low inflation. The low rate of return on federal bonds persisted for a long period in an effort to stimulate growth despite the fiscal deficit and the disequilibrium in the external accounts, evident in a very high ratio (about 5%) between the current account deficit and GDP (the same level as the fiscal result). Nonetheless, the rise in interest rates at the end of June 2004 was more modest than had been expected since the beginning of the year, when the first signs of rising inflation became apparent in the United States. This is partly because the recovery of the economy in the first of 2004

was less intense than expected, and partly because inflation is lower than had previously been feared. Consequently, the markets reacted positively to the Federal Reserve's decision to raise rates moderately. Present circumstances entail fewer risks for the emerging economies in the event of a possible increase in US rates.

- (ii) China's decades-long dynamizing role in international trade, the result of an intensive process of growth (which accelerated following the economic reforms), is well-known. Analysts have argued, however, that China is likely to face difficulties in the near future. Those difficulties are three-fold. First is the fragility of China's financial sector, which could give rise to recession, especially during the recovery period in which the country's economy now finds itself. Second is the value of China's currency, the yuan. China is subject to international pressure (especially in the United States) to increase its value, especially in light of the country's huge international reserves.⁶ Third is what could happen if there is a decline in inflows of FDI, which have amounted to about US \$40-50 billion since 1997, or about 5% of China's GDP. Note, however, that the impact of a possible and abrupt decline in FDI inflows would not have the same effect as in other countries because of the very high level of international reserves and the rate of domestic savings. Nonetheless, there is a risk associated with a possible fall in the productivity of capital. With a high rate of savings (35%-40% of GDP), China's economy has been able to grow at 8% a year thanks to the increase in the productivity of capital, which could decline with the relative growth in housing construction (given China's real estate boom of recent years). India's economy has also performed very positively. This has had a dynamizing effect on the world economy since the beginning of the 1990s. The performance is characterized by growing foreign trade, a feature that breaks with an old characteristic of the Indian economy, which was its low level of commercial openness.
- (iii) The prices of the main non-oil commodities, which experienced strong upward pressure in 2003, simply offset the losses (in dollars) of the preceding decades. Those prices' extreme volatility, however, suggest that the upward pressure might not persist. Indeed, in mid-2004 there are indications that the prices of various commodities are below those of 2003 (soya and soya byproducts, for example), despite the rise apparent between mid-2003 and March 2004. By end-2004, the trend in commodity prices, on average, is downward. Oil is a case apart because of the significant geopolitical implications (Iraq, Iran) and domestic disturbances in various countries (Venezuela and Indonesia) which shape trends in supply. Increased international demand triggered by global growth in 2003, especially in China, also kept prices high. Obviously, the end of the conflicts and the waning of the attendant uncertainty, as well as a decline in the (very high) growth rate of the global economy, will put downward pressure on prices.
- (iv) The growth prospects for Brazil and the other member countries of MERCOSUR will be analyzed in specific sections. It can be said here, however, that Brazil's performance in 2004 was substantially better than its recent average. There are good prospects that this will continue in future as long as certain conditions are met. In this regard, the effects of Brazil's growth on the Argentine economy will continue to be felt in the medium term, as long as it is possible to overcome certain obstacles in the trade negotiations that hamper the full operation of MERCOSUR. Chapter Four returns to this matter.

B. Brazil

Advent and early moves of the Lula government: continuity and change

In much of 2002, Brazil's economy suffered from concerns that the left-wing coalition led by the Workers' Party (*Partido dos Trabalhadores*, PT) would win the presidential elections (in two rounds: October 3 and November 15). As the polls confirmed suspicions that most of the electorate would choose representatives of the PT (something that became clearer in April-May 2002), international flows to Brazil (especially

⁶ These reserves, however, are being used, as in Asian countries, to finance the deficits in the US current account.

loans and financing) began to decline. The situation became critical at the end of that year and the start of 2003, when even the international financing of foreign trade was affected. The country risk broke records, despite the fact that the Central Bank sharply increased domestic interest rates and fostered changes in the debt profile by shortening terms and issuing bonds indexed in US dollars.

From April 2002 onward, the devaluation was brutal: the real-dollar rate fell from 2.2:1 to 4:1 in October. The deterioration of the macroeconomic environment, increasingly characterized by uncertainty and by concerns as to whether contracts would be met, was the trend of the year. Capital flight increased enormously in this period. The issuing of the "Letter to Brazilians" by Lula, presidential candidate in 2002 (when his election was assured, according to the polls), calmed economic actors as to the fulfillment of existing contracts, the risk of a default, and the danger of compulsive enlargement of the internal debt. To some extent this helped reduce the level of uncertainty. With Fernando Henrique Cardoso still in the presidency, Brazil concluded an emergency agreement with the international monetary fund (IMF), whereby it submitted itself to rigid targets in the areas of spending, reducing inflation, and securing a primary surplus as a way of demonstrating its commitment to controlling the public accounts (seeking to gain credibility). The country thereby secured a loan to strengthen its very low level of international reserves. The new resources and the support of the IMF for the plan that was then drawn up were unable to curb the decline in external capital flows to Brazil.

Notwithstanding the doubts, the new government, which took office on January 1, 2003, maintained the same macroeconomic policy. This rested on a three pillars: a floating exchange rate, inflation targets, and an increase in the primary surplus as had been agreed by the previous administration with the IMF. The result, in the early quarters, was a moderate recession, accompanied by strong pressure on the part of many of the PT's main political allies that the government change the "economic model". Orthodoxy, however, worked. From the third quarter of 2003 onwards, as noted below, the economy began to show signs of recovery that would persist in 2004.

At the start of 2003, it was clear that the sharp devaluation of 2002 would affect domestic prices. The prices of tradables began to rise at the start of the same year, a phenomenon that swiftly became apparent in wholesale prices. The increase in consumer prices was less sharp and appeared later. Nonetheless, it was clear that the inflation target for 2003 would be surpassed. The reaction of the Central Bank to the acceleration of inflation was a rise in the basic interest rate (the so-called "SELIC" rate) at the start of the year.

The increase in inflation measured by consumer prices (which entailed a decline in the real purchasing power of household income because of the difficulty of raising wages in the same proportion as the increase in prices) associated with the rise in interest rates first led to a decline in real aggregate income and then in consumption. At the same time, the recession brought about a decline in private investment. Since public investment was at a very low level because of the need to generate primary surpluses, the entire burden of maintaining aggregate demand fell on liquid exports. The devaluation and the domestic recession stimulated exports. Nonetheless, this was not enough to obviate the 0.2% decline in GDP during 2003 relative to 2002.

The increase in unemployment was one of the most obvious effects. Another, in terms of performance, was a stagnation of aggregate demand despite the sharp increase in exports, driven by devaluation and the greater importance of new trade partners in a strong growth phase, such as China and India. Thus, after moderate growth of 1.9% in 2002, Brazil's GDP fell by about 0.2% in 2003.

As in the past, therefore, control of inflation again fell on monetary policy, and fiscal policy played a secondary role in terms of reducing fiscal pressure.

An assessment of the new government in its first 18 months in office is therefore positive from the point of view of macroeconomic management. Prominent among the structural transformations and reforms deemed necessary to overcome the constraints on the country's sustainable growth are the reforms to the social security and tax systems. The effects of these, however, are only partial because they were approved by the Congress at the end of the year amid intense discussions and concessions. Additionally, there are

doubts about some of the proposed measures, such as the 11% tax on public sector pensioners, a matter still pending resolution in the federal Supreme Court in June 2004. Hence the need to readdress these reforms in future with the intention of deepening them.

Changes to the social security system were undoubtedly an advance over those made during the administration of Cardoso, whose reform in this area (also partial) was approved only with difficulty and was confined to the private sector. The 2003 reforms, however, targeted the public sector. The aim was to reduce the privileges of its specific system of social security. Relative to the original project, however, there have been many concessions. Among others, the reform did not touch the general system and, as regards financing, the distribution system was basically unchanged. There was no move towards a capitalization system, which is more secure from an actuarial perspective. Apart from that, it did not touch careers in the legislative and judicial branches, where the highest salaries are concentrated and which are wholly in opposition to any reform effort. The structural disequilibrium in the social security system therefore persists.

Retrospective

Table II.5 below shows the performance of Brazil's main microeconomic variables from 1994 to 2003 in a manner similar to that used for Argentina. In the final years shown, the data attest to the developments presented above.

Obviously, as mentioned earlier, macroeconomic performance was not uniform throughout 2003. This is evident in Figure II.5, which shows trends in quarterly GDP, seasonally adjusted, for the years between 1999 and 2004 (first quarter only). Note that the Brazilian economy exhibited two short-term cycles in those years. The first, which began at the start of 1999, lasted until the first quarter of 2001 and was brought to an end by the energy crisis.⁷ In its first cycle, real GDP grew at an annual rate of 3.8%. In the second mini-cycle, between the fourth quarter of 2001 and the fourth quarter of 2002, real GDP again grew by 3.8%. Following the recession in the first half of 2003, related to the monetary shock imposed by the new government, real GDP began to grow again, now at an annualized rate of 4.9% (until the first quarter of 2004). In both cases, the performance of GDP was a mild reflection of that of industry (IPEA [2004] p. VII-VIII).

TABLE II.5
BRAZIL: GDP, UNEMPLOYMENT, INFLATION, FISCAL DEFICIT, EXCHANGE RATE,
AND FOREIGN TRADE, 1994-2003

Years	GDP (%change)	Unemp. rate (%)	Inflation CPI (%)	Exchange rate (R\$/US\$)	Fiscal deficit (% GDP)	Exports (US \$ millions)	Imports (US\$ millions)	Balance (US\$ millions)
1994	5.85	5.1			26.97	43,545	33,079	10,466
1995	4.22	4.6	22.0	0.918	7.27	46,506	49,970	-3,464
1996	2.66	5.4	9.1	1.005	5.87	47,747	53,286	-5,539
1997	3.27	5.7	4.3	1.078	6.07	52,993	59,741	-6,748
1998	0.13	7.6	2.5	1.160	7.47	51,140	57,744	-6,604
1999	0.79	7.6	8.4	1.815	5.76	48,011	49,273	-1,262
2000	4.36	7.1	5.3	1.830	3.63	55,086	55,797	-711
2001	1.31	6.2	9.4	2.351	3.58	58,222	55,573	2,649
2002	1.93	7.14/10.5*	14.74**	2.921	4.59	60,360	47,233	13,127
2003	-0.20	12.3*	16.36**	3.078	5.22	73,084	48,260	24,825

Notes: * New employment survey, results are not comparable with the previous series.

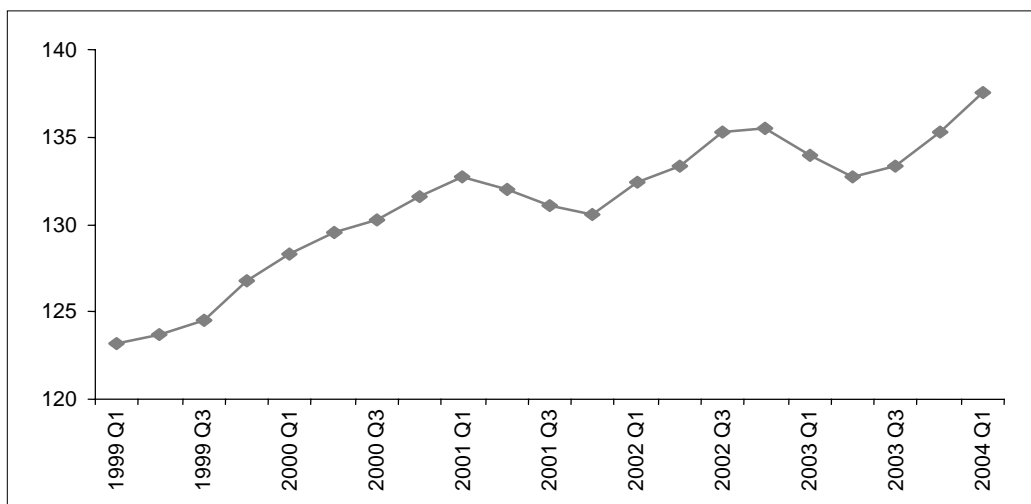
** 12 months accumulated relative to the preceding 12 months.

Source: IBGE and Central Bank.

⁷ The text follows that of the IPEA (Boletín de Coyuntura, June 2004).

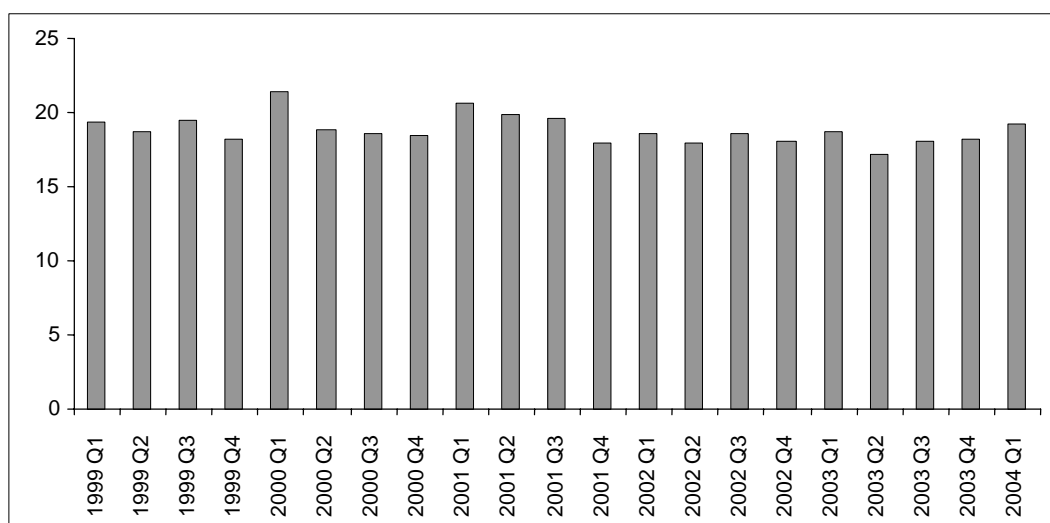
Thus it is clear that most of the recent adjustment took place in the first two quarters of 2003. The industrial and construction sectors, which are more sensitive to a rise in interest rates, have suffered the most (see the figures below). In the second half of 2003 the economy began to show clearer signs of recovery, a process that lasted until 2004 and that raised positive expectations among many economic actors. As Figure II.6 shows, however, the recovery has rested only partly on capital formation. Indeed, almost without exception in recent years, the rate of investment has been below 20%, although there have been signs of recovery since the second quarter of 2003. The most dynamic element of the main economic aggregates is the growth of exports, followed by the increase in private consumption (Figure II.7).

FIGURE II.5
BRAZIL: SEASONALLY ADJUSTED QUARTERLY GDP, 1st QUARTER 1999-4th QUARTER 2004
 (1990=100)



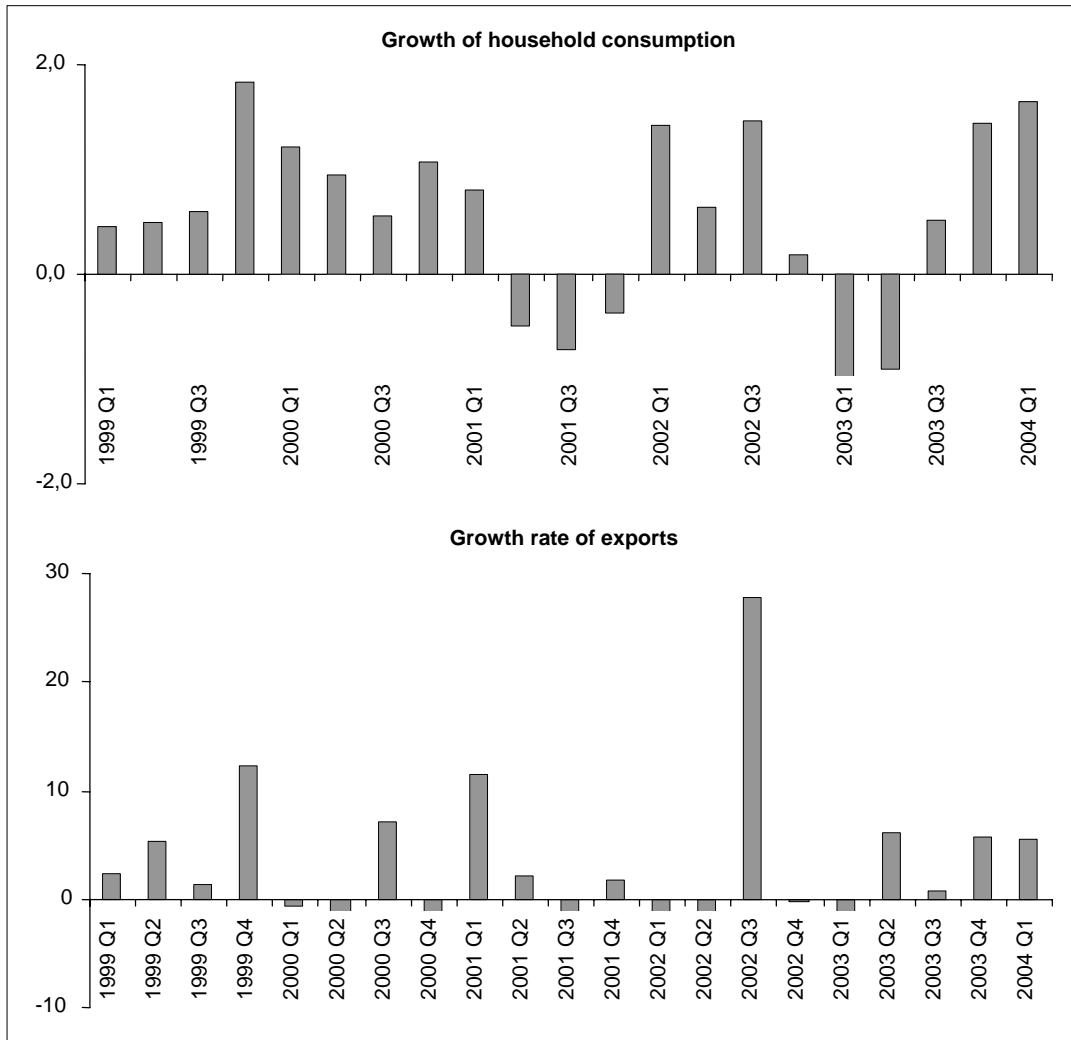
Source: IBGE, Department of National Accounts and IPEA [2004].

FIGURE II.6
BRAZIL: QUARTERLY RATE OF INVESTMENT, 1st QUARTER 1999-1st QUARTER 2004
 (At current prices)



Source: IBGE, Department of National Accounts.

FIGURE II.7
BRAZIL: GROWTH OF HOUSEHOLD CONSUMPTION AND EXPORTS OF GOODS
AND SERVICES BY QUARTER
 (% , using seasonally adjusted series)



Source: IBGE, Department of National Accounts.

Intra-MERCOSUR foreign trade: Brazil-MERCOSUR transactions

Table II.6 shows the trends in Brazilian imports from the other MERCOSUR countries. Note the sharp contraction following the change to exchange rate regime in 1999, and again in 2002 and 2003 as a result of the devaluation in the first year and the recession in the second.

TABLE II.6
BRAZILIAN IMPORTS FROM MERCOSUR
(US\$ millions)

Country of origin	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Argentina	3,660.0	5,581.0	6,784.0	8,033.0	8,035.0	5,815.0	6,843.0	6,207.0	4,745.0	4,673.2
Paraguay	352.0	514.0	551.0	518.0	350.0	260.0	351.0	302.0	383.0	474.8
Uruguay	569.0	737.0	933.0	966.0	1,043.0	645.0	601.0	500.0	484.0	537.9
Total	4,581.0	6,832.0	8,268.0	9,517.0	9,428.0	6,720.0	7,795.0	7,009.0	5,612.0	5,685.9

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

On the export side, it is plain that there was a substantial decline after 1997-1998, despite the devaluation of 1999. This indicates that Brazil chose to adjust its trade with MERCOSUR (read: Argentina) after the devaluation, seeking to avoid causing undue damage to the bloc. The recovery in 2003 was linked to the recovery of output in Argentina as of that year.

TABLE II.7
BRAZILIAN EXPORTS TO MERCOSUR
(US\$ millions)

Destination country	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Argentina	4,136.0	4,041.0	5,171.0	6,767.0	6,746.0	5,362.0	6,233.0	5,002.0	2,343.0	4,561.1
Paraguay	1,053.0	1,300.0	1,325.0	1,405.0	1,249.0	744.0	829.0	720.0	557.0	707.2
Uruguay	732.0	812.0	812.0	871.0	881.0	671.0	670.0	641.0	412.0	403.5
Total	5,921.0	6,153.0	7,308.0	9,043.0	8,876.0	6,777.0	7,732.0	6,363.0	3,312.0	5,671.9

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

As a consequence, Brazil's trade balances with the other members have fluctuated, and deficits have predominated. In the 1994-2003 period, the only year in which there was a surplus was 1994. In some years (2002, for instance) Brazil posted a significant deficit with Argentina. As regards other countries (that is, apart from MERCOSUR members), there was a surplus of US\$ 15.4 billion. Clear, once again, was the willingness to collaborate with MERCOSUR by maintaining the deficit with the other members. By 2003 there was some equilibrium in the balances with the other countries, largely because of the narrowing of the deficit with Argentina.

TABLE II.8
BRAZIL'S TRADE BALANCE WITH MERCOSUR (LAST 12 MONTHS)
(US\$ millions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Argentina	476.0	-1,540.0	-1,613.0	-1,266.0	-1,289.0	-453.0	-610.0	-1,205.0	-2,402.0	-112.1
Paraguay	701.0	786.0	774.0	887.0	899.0	484.0	478.0	418.0	174.0	232.4
Uruguay	163.0	75.0	-121.0	-95.0	-162.0	26.0	69.0	141.0	-72.0	-134.4
Total	1,340.0	-679.0	-960.0	-474.0	-552.0	57.0	-63.0	-646.0	-2,300.0	-14.0

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

Foreign trade by destination country and region, and by category of goods use⁸

Following the modification of the exchange rate regime and the consequent devaluation in January 1999, Brazil's exports were extraordinarily dynamic. Apart from that, as is evident in the following table, there has been a significant diversification of markets. The last column of the table gives an index of structural shift that is nothing more than the differences in the percentages exported by countries (or blocs, or regions) by category of use of the exported goods.

Starting with the total at the end of the table it is plain that the composition in terms of categories of use has changed relatively little, despite the substantial dynamism of exports (which rose from US\$ 48 to US\$ 73 billion in the 1999-2003 period. Fuels gained most in relative share, increasing from 1% to 4.5% of total exports. The share of intermediate goods fell from 64% to a still significant 60.7%.

Distribution by destination country reveals marked changes, implying substantial market diversification. Without question, the main actor is China, whose share grew from 1.4% of total exports in 1999 to 6.2% in 2003. In second place are the countries of the Americas (except MERCOSUR and the United States), whose share rose from 10.7% to 13.9%.

The losses are concentrated in the following blocs/countries/regions: MERCOSUR, whose share fell from 14.1% to 7.8% of total exports (it would have been worse had it not been for the recovery in 2003 relative to 2002), reflecting a decline in absolute value from US\$ 6.8 billion to US\$ 5.7 billion; the EU (from 28.6% to 24.8%); and Japan (4.6% to 3.2%).

TABLE II.9
EXPORTS BY CATEGORY OF USE, BY DESTINATION, 1999-2003
(US\$ millions FOB and %)

Selected countries/blocs	1999	% total	2000	2001	2002	2003	% total	Structural change (%)
MERCOSUR	6,778	14.1	7,733	6,364	3,311	5,672	7.8	-6.4
Capital goods	1,256	2.6	1,490	954	312	967	1.3	-1.3
Intermediate goods	3,711	7.7	3,995	3,440	2,243	3,350	4.6	-3.1
Consumer durables	666	1.4	912	646	188	657	0.9	-0.5
Consumer non-durables	1,098	2.3	1,261	1,193	508	655	0.9	-1.4
Fuel	47	0.1	75	131	59	43	0.1	0.0
United States	10,675	22.2	13,181	14,190	15,354	16,692	22.8	0.6
Capital goods	1,980	4.1	3,094	3,976	4,146	3,606	4.9	0.8
Intermediate goods	6,256	13.0	6,698	6,094	6,877	7,809	10.7	-2.3
Consumer durables	446	0.9	769	1,017	1,171	1,175	1.6	0.7
Consumer non-durables	1,765	3.7	2,119	2,085	2,280	2,499	3.4	-0.3
Fuel	228	0.5	499	1,019	881	1,604	2.2	1.7

⁸ The tables in this section were kindly prepared and provided by Dr. Henry Pourchet of FUNCEX, Rio de Janeiro.

TABLE II.9 (continued)

Selected countries/blocs	1999	% total	2000	2001	2002	2003	% total	Structural change (%)
European Union	13,736	28.6	14,784	14,865	15,113	18,102	24.8	-3.8
Capital goods	982	2.0	1,504	1,138	665	819	1.1	-0.9
Intermediate goods	9,841	20.5	10,610	10,878	11,189	13,156	18.0	-2.5
Consumer durables	650	1.4	506	323	289	383	0.5	-0.8
Consumer non-durables	2,240	4.7	2,097	2,337	2,542	3,186	4.4	-0.3
Fuel	23	0.0	67	189	428	560	0.8	0.7
Japan	2,193	4.6	2,472	1,986	2,098	2,311	3.2	-1.4
Capital goods	25	0.1	196	25	37	43	0.1	0.0
Intermediate goods	1,810	3.8	1,971	1,608	1,642	1,835	2.5	-1.3
Consumer durables	1	0.0	2	2	2	2	0.0	0.0
Consumer non-durables	335	0.7	294	334	391	411	0.6	-0.1
Fuel	22	0.0	10	18	26	19	0.0	0.0
China	676	1.4	1,085	1,902	2,520	4,533	6.2	4.8
Capital goods	15	0.0	61	128	56	70	0.1	0.1
Intermediate goods	641	1.3	962	1,617	2,400	4,376	6.0	4.7
Consumer durables	0	0.0	3	88	34	13	0.0	0.0
Consumer non-durables	19	0.0	23	29	31	50	0.1	0.0
Fuel	0	0.0	36	40	0	24	0.0	0.0
Russia	746	1.6	423	1,103	1,252	1,500	2.1	0.5%
Capital goods	0	0.0	2	5	8	29	0.0	0.0
Intermediate goods	642	1.3	316	743	583	785	1.1	-0.3
Consumer durables	0	0.0	1	2	4	5	0.0	0.0
Consumer non-durables	103	0.2	103	353	658	680	0.9	0.7
Fuel	0	0.0	0	0	0	0	0.0	0.0
Rest of the Americas (1)	5,128	10.7	6,674	7,525	8,889	10,182	13.9	3.3%
Capital goods	937	2.0	1,053	1,102	1,205	1,366	1.9	-0.1
Intermediate goods	2,940	6.1	3,672	3,892	4,496	4,860	6.6	0.5
Consumer durables	524	1.1	1,048	1,290	1,614	1,968	2.7	1.6
Consumer non-durables	676	1.4	768	937	1,053	1,175	1.6	0.2
Fuel	51	0.1	132	304	521	812	1.1	1.0
Rest of Asia	2,863	6.0	2,767	3,061	4,173	4,833	6.6	0.6
Capital goods	70	0.1	62	75	183	216	0.3	0.1
Intermediate goods	2,229	4.6	2,321	2,507	2,900	3,505	4.8	0.2
Consumer durables	13	0.0	28	17	50	34	0.0	0.0
Consumer non-durables	528	1.1	340	406	418	555	0.8	-0.3
Fuel	22	0.0	15	56	621	523	0.7	0.7

TABLE II.9 (continued)

Selected countries/blocs	1999	% total	2000	2001	2002	2003	% total	Structural change (%)
Rest of Europe (2)	559	1.2	956	924	913	1,145	1.6	0.4
Capital goods	9	0.0	195	193	168	47	0.1	0.0
Intermediate goods	450	0.9	651	609	600	853	1.2	0.2
Consumer durables	19	0.0	12	10	9	10	0.0	0.0
Consumer non-durables	81	0.2	97	112	134	232	0.3	0.1
Fuel	1	0.0	1	1	3	3	0.0	0.0
Africa	1,336	2.8	1,347	1,988	2,362	2,860	3.9	1.1
Capital goods	114	0.2	168	251	231	272	0.4	0.1
Intermediate goods	707	1.5	739	882	1,076	1,453	2.0	0.5
Consumer durables	50	0.1	60	68	69	127	0.2	0.1
Consumer non-durables	459	1.0	353	692	777	866	1.2	0.2
Fuel	7	0.0	26	96	208	141	0.2	0.2
Oceania	269	0.6	375	275	292	349	0.5	-0.1
Capital goods	23	0.0	50	45	80	80	0.1	0.1
Intermediate goods	137	0.3	121	99	139	192	0.3	0.0
Consumer durables	3	0.0	3	8	18	16	0.0	0.0
Consumer non-durables	105	0.2	201	122	52	61	0.1	-0.1
Fuel	0	0.0	0	0	3	0	0.0	0.0
Other countries	3,052	6.4	3,288	4,040	4,084	4,906	6.7	0.4
Capital goods	245	0.5	340	192	216	177	0.2	-0.3
Intermediate goods	1,382	2.9	1,356	1,511	1,578	2,153	2.9	0.1
Consumer durables	21	0.0	19	26	32	51	0.1	0.0
Consumer non-durables	1,343	2.8	1,503	1,997	1,906	2,314	3.2	0.4
Fuel	60	0.1	70	314	352	211	0.3	0.2
Total	48,011	100.0	55,086	58,223	60,362	73,084	100.0	0.0
Capital goods	5,657	11.8	8,216	8,084	7,309	7,694	10.5	-1.26
Intermediate goods	30,747	64.0	33,413	33,880	35,723	44,328	60.7	-3.39
Consumer durables	2,394	5.0	3,363	3,497	3,479	4,439	6.1	1.09
Consumer non-durables	8,751	18.2	9,161	10,595	10,749	12,683	17.4	-0.87
Fuel	462	1.0	932	2,166	3,102	3,940	5.4	4.43

Notes: (1) Including Mexico and Canada.

(2) Eastern Europe.

Source: Secex/Mdic. Prepared by FUNCEX.

Table II.10 shows similar information for imports. The changes in composition gave rise to a sharp increase in the share of intermediate goods (56.5% to 62.5%) and fuels (9.8% to 13.4%). The losses were concentrated in capital goods, whose share fell drastically: from 20.5% to just 14.8% in the 1999-2003 period.

As to the distribution by countries/blocs/regions, the changes have been as marked as in the case of exports. The EU and the United States lost share as the leading suppliers of Brazil (respectively, their shares fell from 30.5% to 23.8%, and from 26.3% to 19.%), MERCOSUR's share fell from 13.7% to 11.8%. The gains were concentrated on China (+2.7%), other Asian countries and Africa (in the latter case, centered on fuels imports).

TABLE II.10
IMPORTS BY CATEGORY OF USE, BY COUNTRY OF ORIGIN, 1999-2003
(US\$ millions FOB and %)

Selected countries/blocs	1999	% total	2000	2001	2002	2003	% total	Structural change (%)
MERCOSUR	6,719	13.7	7,796	7,010	5,615	5,686	11.8	-1.9
Capital goods	534	1.1	678	696	445	321	0.7	-0.4
Intermediate goods	3,281	6.7	3,679	3,381	3,032	3,380	7.0	0.3
Consumer durables	769	1.6	728	896	407	255	0.5	-1.0
Consumer non-durables	1,459	3.0	1,201	926	864	851	1.8	-1.2
Fuel	676	1.4	1,510	1,111	867	879	1.8	0.4
UNITED STATES	11,727	23.8	12,864	12,894	10,285	9,564	19.8	-4.0
Capital goods	3,033	6.2	3,099	3,424	3,006	2,237	4.6	-1.5
Intermediate goods	7,711	15.7	8,904	8,661	6,580	6,620	13.7	-2.0
Consumer durables	138	0.3	158	148	104	94	0.2	-0.1
Consumer non-durables	677	1.4	528	448	433	498	1.0	-0.3
Fuel	168	0.3	175	213	163	114	0.2	-0.1
European Union	14,987	30.5	14,048	14,822	13,069	12,687	26.3	-4.2
Capital goods	4,484	9.1	3,497	3,915	3,127	2,459	5.1	-4.0
Intermediate goods	8,599	17.5	8,799	9,275	8,298	8,512	17.6	0.2
Consumer durables	537	1.1	434	374	342	363	0.8	-0.3
Consumer non-durables	1,143	2.3	1,110	1,112	1,015	985	2.0	-0.3
Fuel	224	0.5	208	146	287	368	0.8	0.3
Japan	2,576	5.2	2,960	3,064	2,347	2,521	5.2	0.0
Capital goods	709	1.4	660	903	653	662	1.4	-0.1
Intermediate goods	1,638	3.3	2,093	1,952	1,549	1,738	3.6	0.3
Consumer durables	174	0.4	158	168	106	82	0.2	-0.2
Consumer non-durables	55	0.1	49	40	40	38	0.1	0.0
Fuel	0	0.0	0	0	0	0	0.0	0.0

TABLE II.10 (continued)

Selected countries/blocs	1999	% total	2000	2001	2002	2003	% total	Structural change (%)
China	865	1.8	1,222	1,328	1,554	2,148	4.5	2.7
Capital goods	140	0.3	188	216	208	280	0.6	0.3
Intermediate goods	476	1.0	779	824	1,046	1,566	3.2	2.3
Consumer durables	70	0.1	64	69	73	90	0.2	0.0
Consumer non-durables	179	0.4	191	215	202	208	0.4	0.1
Fuel	0	0.0	0	4	24	4	0.0	0.0
Russia	315	0.6	571	464	428	555	1.2	0.5
Capital goods	0	0.0	1	1	1	1	0.0	0.0
Intermediate goods	308	0.6	545	437	363	543	1.1	0.5
Consumer durables	0	0.0	0	0	0	0	0.0	0.0
Consumer non-durables	7	0.0	14	13	4	5	0.0	0.0
Fuel	0	0.0	11	13	60	5	0.0	0.0
Rest of the Americas (1)	3,917	8.0	5,192	4,165	3,588	3,517	7.3	-0.7
Capital goods	277	0.6	341	375	285	171	0.4	-0.2
Intermediate goods	2,049	4.2	2,649	2,366	1,980	2,275	4.7	0.6
Consumer durables	32	0.1	51	111	81	53	0.1	0.0
Consumer non-durables	477	1.0	420	404	367	332	0.7	-0.3
Fuel	1,082	2.2	1,730	910	876	685	1.4	-0.8
Rest of Asia	3,034	6.2	4,412	4,533	4,095	4,255	8.8	2.7
Capital goods	559	1.1	804	785	564	632	1.3	0.2
Intermediate goods	2,125	4.3	3,070	3,028	2,901	3,116	6.5	2.1
Consumer durables	121	0.2	143	123	75	66	0.1	-0.1
Consumer non-durables	224	0.5	209	222	201	191	0.4	-0.1
Fuel	5	0.0	185	375	354	249	0.5	0.5
Rest of Europe (2)	1,111	2.3	1,228	1,374	1,299	1,506	3.1	0.9
Capital goods	236	0.5	209	296	249	221	0.5	0.0
Intermediate goods	592	1.2	642	621	727	953	2.0	0.8
Consumer durables	18	0.0	17	17	22	16	0.0	0.0
Consumer non-durables	253	0.5	317	316	239	250	0.5	0.0
Fuel	13	0.0	42	123	62	66	0.1	0.1
Africa	2,222	4.5	2,908	3,325	2,687	3,254	6.7	2.2
Capital goods	9	0.0	4	5	4	3	0.0	0.0
Intermediate goods	403	0.8	474	487	396	513	1.1	0.2
Consumer durables	1	0.0	0	1	0	1	0.0	0.0
Consumer non-durables	19	0.0	20	11	9	14	0.0	0.0
Fuel	1,789	3.6	2,410	2,822	2,278	2,724	5.6	2.0

TABLE II.10 (continued)

Selected countries/blocs	1999	% total	2000	2001	2002	2003	% total	Structural change (%)
Oceania	292	0.6	334	301	247	316	0.7	0.1
Capital goods	20	0.0	18	19	10	15	0.0	0.0
Intermediate goods	222	0.5	254	244	204	247	0.5	0.1
Consumer durables	22	0.0	17	14	4	12	0.0	0.0
Consumer non-durables	28	0.1	26	24	29	13	0.0	0.0
Fuel	0	0.0	20	0	0	29	0.1	0.1
Other countries	1,445	2.9	2,249	2,300	2,018	2,251	4.7	1.7
Capital goods	96	0.2	178	241	116	149	0.3	0.1
Intermediate goods	421	0.9	539	606	589	696	1.4	0.6
Consumer durables	7	0.0	114	80	32	30	0.1	0.0
Consumer non-durables	58	0.1	52	52	46	42	0.1	0.0
Fuel	863	1.8	1,366	1,321	1,235	1,334	2.8	1.0
Total	49,210	100.0	55,783	55,582	47,232	48,260	100.0	0.0
Capital goods	10,098	20.5	9,678	10,876	8,667	7,152	14.8	-5.7
Intermediate goods	27,825	56.5	32,426	31,882	27,665	30,158	62.5	5.9
Consumer durables	1,888	3.8	1,886	2,002	1,245	1,061	2.2	-1.6
Consumer non-durables	4,579	9.3	4,136	3,781	3,449	3,428	7.1	-2.2
Fuel	4,821	9.8	7,657	7,040	6,206	6,460	13.4	3.6
	49,210	100.0	55,783	55,582	47,232	48,260	100.0	0.0

Notes: (1) Including Mexico and Canada.

(2) Eastern Europe.

Source: Secex/Mdic. Prepared by FUNCEX.

As a result of the foregoing developments, there has also been a substantial change in the trade balances with blocs/countries/regions. The table below summarizes data in a manner analogous to those above, revealing the contributions to the creation of the balances (negative in 1999 and 2000) between 1999 and 2003. It is interesting to note that the United States and the EU accounted for 50% of Brazil's trade surplus in 2003, followed by the Americas (27%), other countries (11%), China (10%), Russia (4%) and the rest of Asia. The other contributions are either very small or negative (Japan, the rest of Europe, Africa and MERCOSUR). Although Brazil is a global trader, the weight of the trading giants of the United States and the EU in the creation of the trade balance should not be minimized, whatever external trade strategy is pursued.

TABLE II.11
BRAZIL: TRADE BALANCE BY DESTINATION REGION AND CATEGORY OF GOODS USE
(US\$ millions FOB)

Selected countries/blocs	1999	Contrib./ balance (%)	2000	2001	2002	2003	Contrib./ balance (%)
MERCOSUR	59	-4.9	-63	-646	-2304	-14	-0.1
Capital goods	721	-60.2	812	258	-133	646	2.6
Intermediate goods	430	-35.8	316	59	-788	-29	-0.1
Consumer durables	-103	8.6	183	-250	-219	402	1.6
Consumer non-durables	-361	30.1	60	267	-356	-197	-0.8
Fuel	-628	52.4	-1,434	-980	-808	-836	-3.4
United States	-1,052	87.7	316	1,296	5,069	7,128	28.7
Capital goods	-1,053	87.8	-5	552	1,140	1,369	5.5
Intermediate goods	-1,455	121.4	-2,205	-2,567	297	1,189	4.8
Consumer durables	308	-25.7	611	868	1,067	1,081	4.4
Consumer non-durables	1,088	-90.7	1,592	1,637	1,847	2,000	8.1
Fuel	61	-5.0	324	806	718	1,490	6.0
European Union	-1,251	104.4	736	43	2,045	5415	21.8
Capital goods	-3,503	292.2	-1,994	-2,777	-2,462	-1,640	-6.6
Intermediate goods	1,243	-103.6	1,811	1,603	2,891	4,644	18.7
Consumer durables	114	-9.5	72	-51	-53	20	0.1
Consumer non-durables	1,097	-91.5	988	1,225	1,527	2,201	8.9
Fuel	-202	16.8	-141	43	142	191	0.8
Japan	-383	32.0	-487	-1,078	-249	-210	-0.9
Capital goods	-684	57.0	-464	-878	-616	-618	-2.5
Intermediate goods	171	-14.3	-123	-344	93	97	0.4
Consumer durables	-173	14.4	-156	-166	-104	-80	-0.3
Consumer non-durables	280	-23.3	245	294	351	372	1.5
Fuel	22	-1.8	10	17	26	19	0.1
China	-189	15.8	-137	574	966	2,385	9.6
Capital goods	-125	10.4	-127	-88	-152	-209	-0.8
Intermediate goods	165	-13.8	184	793	1354	2,810	11.3
Consumer durables	-69	5.8	-61	19	-39	-77	-0.3
Consumer non-durables	-161	13.4	-168	-186	-171	-158	-0.6
Fuel	0	0.0	36	35	-24	20	0.1
Russia	431	-36.0	-148	638	825	945	3.8
Capital goods	0	0.0	2	4	8	28	0.1
Intermediate goods	335	-27.9	-228	306	220	243	0.9
Consumer durables	0	0.0	1	2	3	5	0.0
Consumer non-durables	96	-8.0	89	340	654	675	2.7
Fuel	0	0.0	-11	-13	-60	-5	0.0

TABLE II.11 (continued)

Selected countries/blocs	1999	Contrib./ balance	2000	2001	2002	2003	Contrib./ balance (%)
Rest of the Americas (1)	1,211	-101.0	1,482	3,359	5,300	6,665	26.9
Capital goods	660	-55.0	712	726	921	1,195	4.8
Intermediate goods	891	-74.3	1,023	1,527	2,516	2,585	10.4
Consumer durables	493	-41.1	997	1,180	1,533	1,916	7.7
Consumer non-durables	199	-16.6	348	533	686	843	3.4
Fuel	-1,030	85.9	-1,598	-606	-355	127	0.5
Rest of Asia	-171	14.2	-1,645	-1,472	78	578	2.3
Capital goods	-489	40.8	-742	-710	-380	-416	-1.7
Intermediate goods	104	-8.7	-749	-521	0	389	1.6
Consumer durables	-108	9.0	-115	-106	-24	-32	-0.1
Consumer non-durables	304	-25.4	131	184	216	364	1.5
Fuel	17	-1.4	-170	-319	266	274	1.1
Rest of Europe (2)	-553	46.1	-271	-450	-385	-362	-1.5
Capital goods	-227	19.0	-14	-104	-81	-175	-0.7
Intermediate goods	-142	11.8	9	-12	-128	-100	-0.4
Consumer durables	1	-0.1	-5	-7	-13	-7	0.0
Consumer non-durables	-172	14.3	-220	-204	-105	-18	-0.1
Fuel	-13	1.1	-41	-123	-59	-63	-0.3
Africa	-886	73.9	-1,561	-1,337	-324	-393	-1.6
Capital goods	105	-8.8	164	246	227	270	1.1
Intermediate goods	304	-25.3	265	395	681	941	3.8
Consumer durables	48	-4.0	60	67	69	126	0.5
Consumer non-durables	439	-36.7	334	681	769	852	3.4
Fuel	-1783	148.7	-2,384	-2,726	-2,070	-2,582	-10.4
Oceania	-22	1.9	41	-26	45	33	0.1
Capital goods	4	-0.3	32	26	70	65	0.3
Intermediate goods	-85	7.0	-133	-145	-65	-55	-0.2
Consumer durables	-19	1.6	-14	-6	14	5	0.0
Consumer non-durables	77	-6.5	175	99	23	48	0.2
Fuel	0	0.0	-19	0	3	-29	-0.1
Other countries	1,607	-134.0	1039	1,739	2,066	2,654	10.7
Capital goods	149	-12.4	162	-49	100	28	0.1
Intermediate goods	962	-80.2	817	905	989	1457	5.9
Consumer durables	14	-1.2	-95	-54	0	20	0.1
Consumer non-durables	1,285	-107.2	1,452	1,945	1,860	2,272	9.1
Fuel	-803	67.0	-1,296	-1,008	-883	-1,123	-4.5
Total	-1,199	100.0	-698	2641	13,130	24,825	100.0

Notes: (1) Including Mexico and Canada.

(2) Eastern Europe.

Source: Secex/Mdic. Prepared by FUNCEX.

Prospects

The brief turbulence of the second quarter of 2004 (especially in May), which stemmed from a devaluation of the real by almost 10%⁹ and brought about a deterioration in Brazil's indicators, is eloquent testimony to the fact that the Brazilian economy, despite its robustness, is vulnerable to events beyond the country's control. Aside from the economic policy options, this has marked effects on the prospects for 2004 and subsequent years.

Despite the unequivocal signs of positive fiscal and monetary performance, and of determined adhesion to a floating exchange rate, any threat of deterioration on the external front (here in tandem with fears of a sudden rise in US interest rates and the effects on the financing of Brazil's external accounts)¹⁰ has a marked impact on Brazil's risk indicators. One result of that is an increase in the cost of loans, devaluation (in part determined by hedging associated with uncertainty), inflation nurtured by the new exchange rate and a worsening of the public accounts because of: (i) the increase in the cost of that part of the government's debt that is denominated in dollars (currently about 15% and falling; it was 34% at the end of 2002); (ii) the need to keep interest rates fairly high so as to attract foreign capital while simultaneously obviating the additional resurgence of domestic demand. The sequence closes with the market reaction to the deterioration of domestic conditions, and sometimes that leads to an increase in the risk indicators.

Another view sees negative expectations being aroused by the frequent signals given by the government. Various factors are involved here, especially: (i) the nature of the regulatory framework in various sectors; (ii) retention of the prevailing economic policy; (iii) definition of the role of the state in the growth process; and (iv) the stability of the rules of the game. It is plain that the two explanations complement and nurture each other.

Despite the turbulence, the Brazilian economy can be deemed robust and, in mid-2004, output was clearly recovering. Inflation was under control (although above the average level of the band set by the Central Bank in 2004; not the upper limit of the band). Urban unemployment was falling; employment and wages were rising; there was a strong trade balance;¹¹ and there was also a current account surplus (about 1.5% of GDP in mid-year). The monetary authorities reaffirmed their aim of maintaining the primary surplus in 2005 as a means of stressing the commitment to fiscal responsibility and helping reduce the debt-GDP ratio. The latter stood at 56% in mid-2004, with a slight downward trend.

As a result, growth for 2004 should be about 4%. Inflation should be about 7% (at the end of the year, but with a downward trend). The public sector borrowing requirement should stand at about 3% of GDP. The public sector's liquid debt is declining. Exports will stand at about US\$ 85 billion and imports at some US\$ 56 billion. The current account balance will be of the order of US\$ 5-6 billion (as against US\$ 4 billion in 2003). The foregoing circumstances suggest that external vulnerability will decline in 2004.

From the institutional viewpoint, however, the acceleration of growth and its continuation beyond 2004 will depend on structural changes and a new development agenda resting on three pillars: fiscal austerity (fundamental to reducing the public debt-GDP ratio); floating exchange rate (to sustain high trade balances

⁹ The exchange rate, which was about R\$ 2.9/US\$ at the end of April, swiftly became R\$ 3/3/US\$ in less than a month. In mid-July 2004, despite the stabilization, the rate was about R\$ 3.05-3.10/US\$. The risk premium rose from a little less than 600 basis points to 740 in the same period.

¹⁰ Added to the fear of additional rises in oil prices.

¹¹ The external debt-goods exports ratio, which had been about 4.0 at the start of 1999, was 2.2 in mid-2002 (the lowest level since the start of the 1980s; see IPEA [2004] p. IX).

and reduce the country-risk); and inflation targets (to guarantee that inflation is duly monitored and thus obviate the danger that price changes might spin out of control).

Faster growth also depends, from the perspective of aggregate supply and demand, on the prospects for investment and its effects on potential output growth. Since investment decisions are long-term, investment depends crucially on policies and indicators providing evidence that issues such as the following are being addressed and resolved: (i) the definition of the regulatory framework, especially as regards investment in infrastructure; (ii) a tax reform that cuts taxes on production without compromising the primary deficit; (iii) a labor reform that lowers employers' labor costs, facilitates the formalization of labor relations¹² and expedites hiring and firing; and (iv) a reform of the social security system so as to alleviate the state of the growing burden associated with longer life expectancy and less formal employment, thereby contributing to balance in the public accounts.

Two features of the international context, in particular, cannot be ignored: from the viewpoint of trade, since Brazil has reached an historic milestone inasmuch as its goods exports are close to the significant rate of 15% of GDP: and from the viewpoint of financing, given the need to secure external resources at a competitive cost so as to sustain foreign transactions.

C. Paraguay

Retrospective

In 2003 the Paraguayan economy improved substantially relative to 2002. The main macroeconomic variables stabilized, albeit at levels that still cause concern. Various productive sectors performed positively, especially the primary sector.

GDP rose by 2.1%, largely because of the positive performance of the agricultural sector, which grew by 12%. The non-agricultural sectors contracted by 2.3%. Table II.12 shows the trends in the main macroeconomic variables and Figure II.7 shows trends in the main sectors. The following points are noteworthy: (i) the significant increase in the import component between the start of 2000 and the start of 2003; (ii) the favorable performance of foodstuffs, beverages, tobacco, textiles and leather; (iii) the relatively less favorable performance of the mineral extraction and timber sectors.

Although the performance in 2003 was quite positive (especially compared to the decline of 2002), it is still not enough to signal a process of economic growth in view of the annual 2.3% increase in the population. Structural reforms are essential if growth is to be sustainable and less dependent on the agricultural sector.

¹² A noteworthy aspect of contemporary Brazil is the low proportion of workers without an employment booklet. It is estimated that over half of total employment consists of informal work.

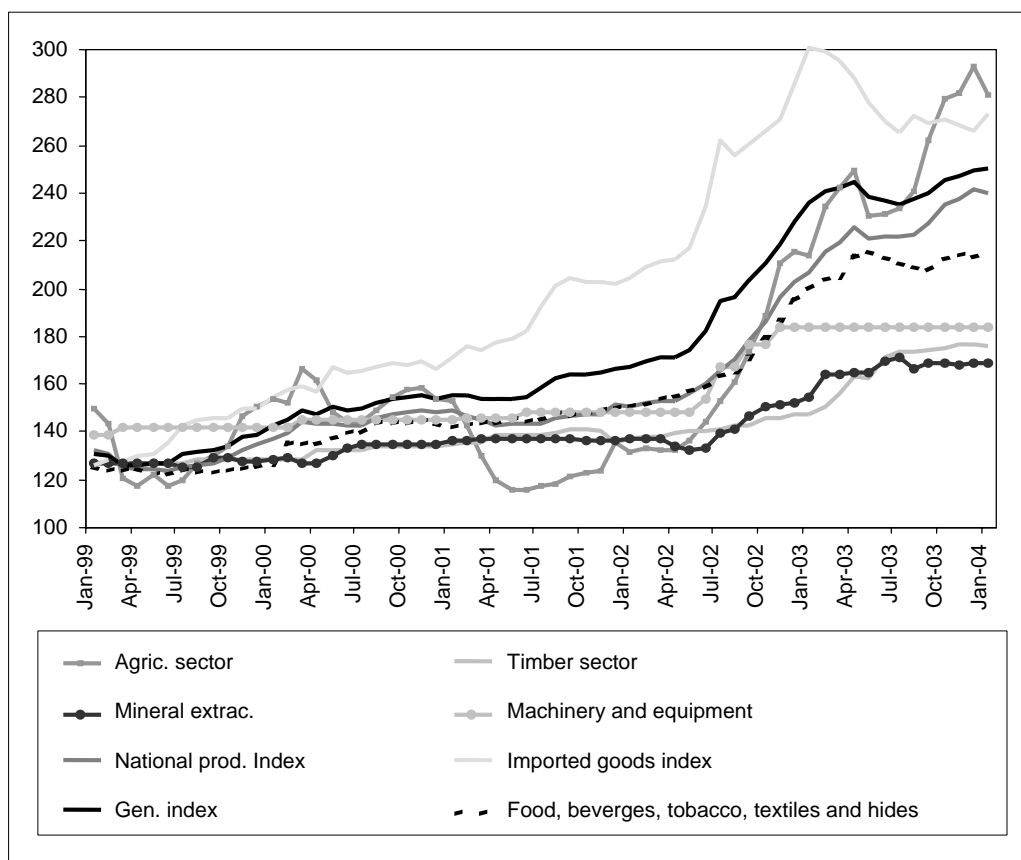
TABLE II.12
PARAGUAY: GDP, UNEMPLOYMENT, EXCHANGE RATE AND FOREIGN TRADE

Years	GDP (% change)	Unemp. rate (%)	Inflation CPI (%)	Exchange rate (US\$)	Exports (US\$ millions)	Imports (US\$ millions)	Balance (US\$ millions)
1994	3.70	4.4			817	2,142	-1,325
1995	5.50	5.6	10.5	1,971	919	2,782	-1,863
1996	0.40	8.2	8.2	2,067	1,044	2,851	-1,807
1997	3.00	7.1	6.2	2,187	1,143	3,126	-1,983
1998	0.60	13.9	14.6	2,755	1,002	2,377	-1,375
1999	-1.50	16.6	5.5	3,135	741	1,711	-971
2000	-3.30	17.0	8.6	3,502	871	2,039	-1,168
2001	2.10	n.a.	8.5	4,129	990	1,989	-999
2002	-1.50	n.a.	14.66*	5,767	950	1,510	-560
2003	2.10	n.a.	9.3*	6,457	1,289	1,878	-590

Notes: * Accumulated 12 months.

Source: Central Bank of Paraguay.

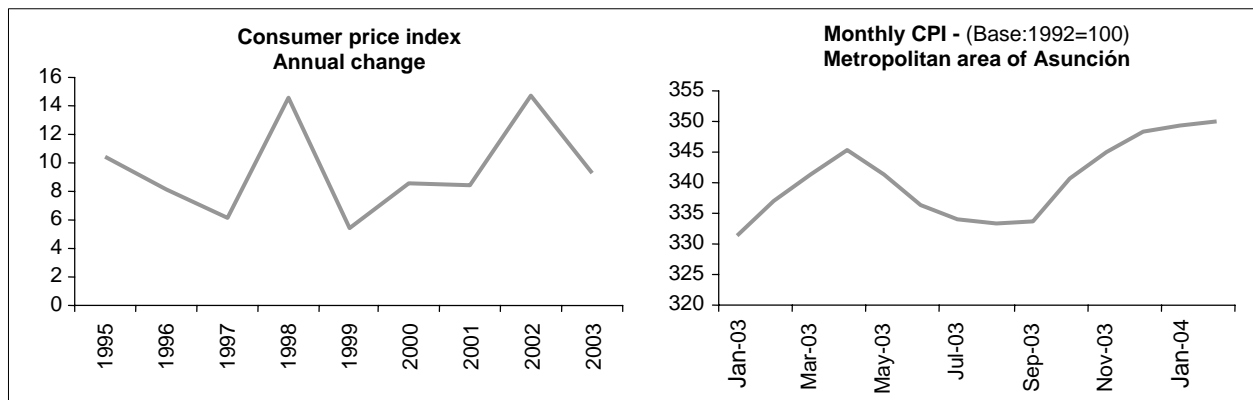
FIGURE II.7
PARAGUAY: TRENDS IN GDP, JANUARY 1999 – JANUARY 2004
(Base: Dec. 95 = 100)



Source: Central Bank of Paraguay - Department of National Accounts and Internal Market.

The stability of the exchange rate and the fall in prices (mainly between April and August; see below), the recovery of the population's confidence in the banking sector and a more auspicious climate for the agricultural sector were the leading domestic factors behind growth in 2003. That growth, however, would have been lower were it not for: (i) an improved macroeconomic performance and greater stability among the MERCOSUR economies; (ii) a significant increase in international prices for soya and cotton; and (iii) international interest rates below the Paraguayan rate.

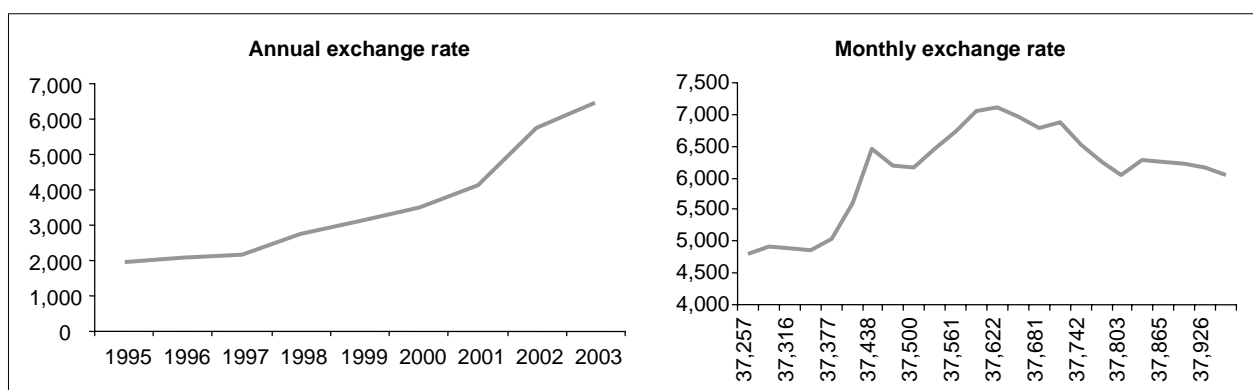
FIGURE II.8
CONSUMER PRICE INDICES – ANNUAL CHANGE (1995-2003) AND MONTHLY INDEX
 (January 2003-January 2004)



Source: Central Bank of Paraguay - Department of National Accounts and Internal Market.

As to inflation, the Paraguayan economy began 2003 with a sharp rise in prices, which peaked at a 21% monthly rate in April. The rate subsequently fell, and inflation ceased to be an immediate concern for the Central Bank: after the first four months the rate was negative for four consecutive months, and hence the year ended with a rate of 9.3%. That rate is well below the estimates made at the start of the year, and the 14.7% recorded in 2002. One of the main reasons for price stabilization was the appreciation of the currency relative to the US dollar (about -11%).

FIGURE II.9
PARAGUAY: ANNUAL EXCHANGE RATE (1995-2000) AND MONTHLY RATE
 (January 2002-January 2004)



Source: Central Bank of Paraguay - Department of National Accounts and Internal Market.

Currency appreciation mainly affected tradable goods prices. Inflation was not significant in the second half of 2003 but note that the modest variation was caused by the increase in the prices of oil-based fuels and meat.

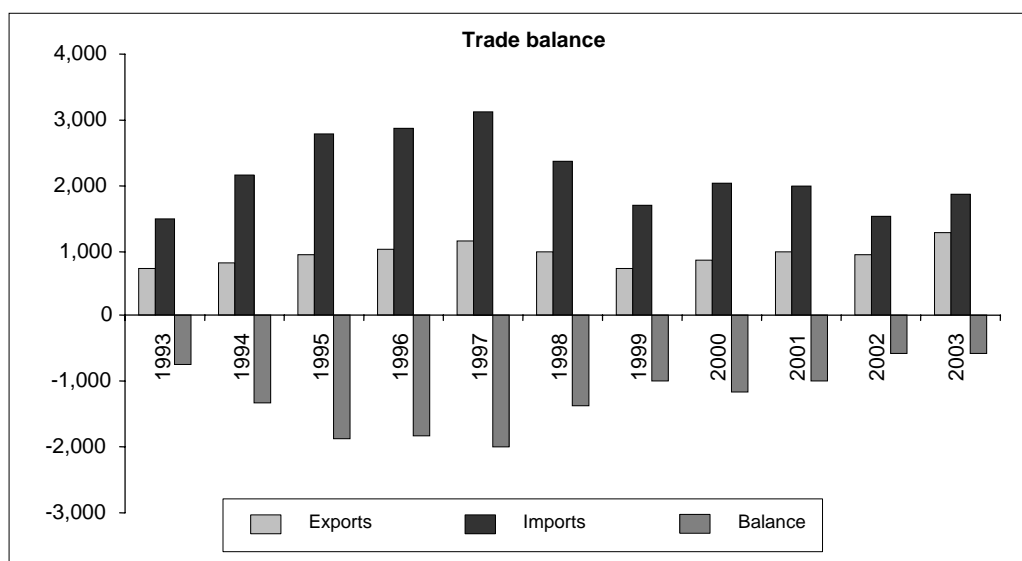
External sector

In 2003, the Central Bank’s liquid international reserves (LIR) grew by more than US\$ 300 million as a result of the liquidity sales of the financial system and the public sector to the Bank; the growth of the Reserve Requirement Deposits associated with deposits in foreign currency; the increase in the public sector’s current account balance in foreign currency; and the fact that the flow of resources from binational entities in which Paraguay participates as a partner were higher than external debt payments.

Preliminary data for the end of 2003 indicate that the LIR reached US\$ 960 million. This is the highest level since 1999, when the Chinese credit of US\$ 400 million was disbursed. Other factors that helped raise the LIR include:

- the pressure of the lower interest rate on the local market as a result of the depreciation of the US dollar in the global market;
- the stability of the region, largely stemming from macroeconomic improvements in MERCOSUR (especially Argentina and Brazil);
- the financial system’s greater credibility, which has had a positive impact on the exchange rate and thereby allowed the Central bank to reduce its interventions as a source of dollars for the local exchange market.

FIGURE II.10
PARAGUAY: EXPORTS, IMPORTS AND TRADE BALANCE, 1993-2003
(In US\$ millions)



Source: Central Bank of Paraguay.

As regards trade, 2003 was a good year for exports, which grew after several years of stagnation. Growth sprang mainly from the increase in the production of soya (+54%) and cotton (+67%). Imports also grew in 2003, largely because of the recovery of domestic demand.

With regard to the commercial competitiveness of MERCOSUR's main members, it should be noted that Paraguay's position improved in 2003. The national currency depreciated by 15% against the Brazilian real and by 7% against the Argentine peso.

Intra-MERCOSUR foreign trade: Paraguay-MERCOSUR transactions

The semi-stagnation of the Paraguayan economy is reflected in the relative stability of its imports from MERCOSUR during recent years. There was some recovery in 2003, in comparison to 2002, of imports from Brazil and Argentina. The export situation is similar, although at consistently lower levels than imports (see the tables below).

TABLE II.13
PARAGUAYAN IMPORTS FROM MERCOSUR
(US\$ millions)

Country of origin	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Argentina	308.0	491.2	386.6	641.0	460.5	312.0	512.6	478.7	310.5	436.6
Brazil	555.0	644.8	847.7	961.5	785.6	493.4	503.5	563.4	477.6	605.0
Uruguay	28.6	33.9	52.2	62.6	77.2	69.8	75.0	69.3	58.3	59.1
Total	891.6	1,169.9	1,286.5	1,665.1	1,323.3	875.2	1,091.1	1,111.4	846.4	1,100.8

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

TABLE II.14
PARAGUAYAN EXPORTS TO MERCOSUR
(US\$ millions)

Destination country	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Argentina	69.2	83.2	90.0	101.3	155.7	53.1	93.6	60.8	34.5	66.9
Brazil	298.9	410.7	516.7	460.9	347.6	235.0	336.6	277.8	353.2	438.3
Uruguay	9.2	34.0	48.7	22.2	20.8	19.1	123.0	180.0	165.1	257.2
Total	377.3	527.9	655.4	584.4	524.1	307.2	553.2	518.6	552.8	762.4

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

As a result, Paraguay consistently posts trade deficits. Note, however, that the deficits have tended to fall since 1997. The exception is the last year in the table, when Paraguay's output level recovered modestly.

TABLE II.15
PARAGUAY'S TRADE BALANCE WITH MERCOSUR (LAST 12 MONTHS)
(US\$ millions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Argentina	-238.8	-408.0	-296.6	-539.7	-304.8	-258.9	-419.0	-417.9	-276.0	-369.7
Brazil	-256.1	-234.1	-331.0	-500.6	-438.0	-258.4	-166.9	-285.6	-124.4	-166.7
Uruguay	-19.4	0.1	-3.5	-40.4	-56.4	-50.7	48.0	110.7	106.8	198.0
Total	-514.3	-642.0	-631.1	-1,080.7	-799.2	-568.0	-537.9	-592.8	-293.6	-338.4

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

Prospects

At the beginning of 2003, then, the Paraguayan economy experienced a slight recovery, in large part because of the world economy's resumption of growth and the improvement in the region's economies, especially that of Argentina. Additionally, the positive performance of the agricultural sector and a more favorable political scenario also aided the country's (albeit modest) growth.

In the early months of 2004, the rate of general output continued to rise. It is estimated, however, that this phase of growth will only last if measures are taken to resolve the basic structural problems that constrain Paraguay's growth. Those problems are the main focus of the new government, especially the deterioration in public finances and the fragility of the financial system.

The prospects are good that the agricultural sector will remain the main source of growth. Soya and cotton production, driven by an increase in international prices for these commodities, will be the main engine of economic growth in Paraguay.

The trade balance was slightly positive in 2004, given the favorable performance of exports at the start of the year – especially soya, meat and cotton – and the slight increase in imports that stemmed from the higher oil price.

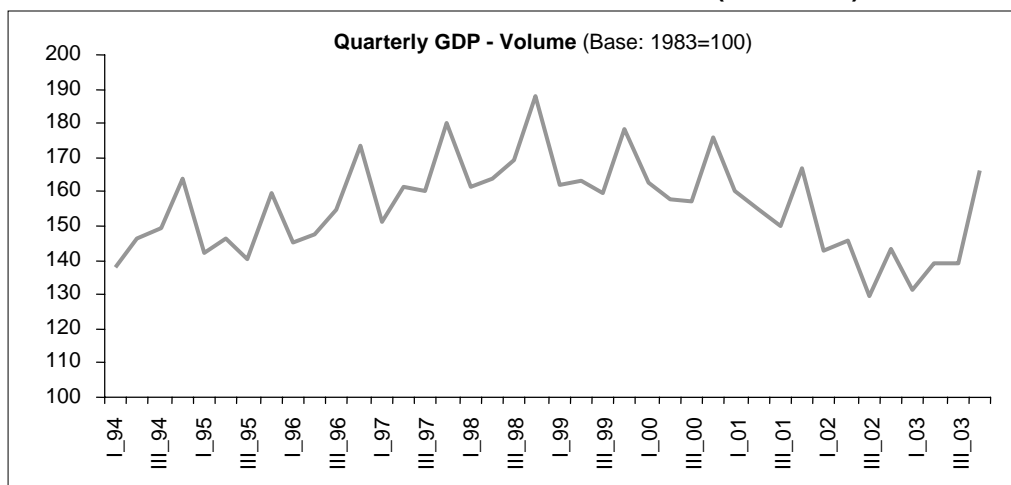
The recovery of the domestic market will be less marked than that of the external market. The projection for growth in 2004 is about 3%, which is higher than in 2003.

D. Uruguay

Retrospective

The Uruguayan economy experienced a modest recovery in 2003. Seasonally adjusted GDP grew by 5.5% in the first half of the year, with growth of 2.2% in the first quarter and 3.3% in the second. In the fourth quarter, seasonally adjusted GDP was 3% higher than in the third quarter. Thus, by year's end, GDP had grown 2.5% relative to 2002 (see trends in quarterly GDP in the table below). Table II.16 summarizes Uruguay's main macroeconomic variables in the period between 1994 and 2003.

FIGURE II.11
URUGUAY: TRENDS IN QUARTERLY GDP (1994-2003)



Source: Central Bank of Uruguay.

The recovery in Uruguay followed a deep recession that lasted for four years (1999-2002), when the country went through the worst financial crisis in its history. Fiscal conditions were extremely delicate. The factors that aided the recovery of the Uruguayan economy in 2003 include: a more favorable international context; the change in relative prices; the stabilization of the banking system; the improvement in financial indicators; and the greater confidence of economic actors.

The recovery was largely driven by the increase in exports, especially to extra-regional markets. The rapid growth of exports of goods and services sprang from the increase in Uruguay's competitiveness and a more favorable international context than in the previous years, when Uruguay was struck by external shocks. This higher global growth translated into better prices for export products. Additionally, the recovery of the countries of the region supported the tourism industry, while the lowering of the country risk also helped cut the cost of external financing significantly.

TABLE II.16
URUGUAY: GDP, UNEMPLOYMENT, INFLATION,
EXCHANGE RATE AND FOREIGN TRADE

Years	GDP (% change)	Unemp. rate (%)	Inflation CPI (%)	Exchange rate (%) (per US\$)	Exports (US\$ millions)	Imports (US\$ millions)	Balance (US\$ millions)
1994		9.1			1,913	2,600	-686
1995	-1.40	10.3	35.2	6.349	2,106	2,686	-580
1996	5.60	11.9	24.3	7.972	2,397	3,123	-726
1997	5.00	11.5	15.2	9.445	2,726	3,489	-763
1998	4.50	10.1	8.6	10.473	2,769	3,577	-809
1999	-2.80	11.3	4.2	11.339	2,237	3,160	-923
2000	-1.40	13.6	5.0	12.100	2,294	3,276	-982
2001	-5.00	15.2	3.7	13.319	2,060	2,880	-820
2002	-10.80	16.7	25.9**	27.220	1,847	1,854	-7
2003	2.2*	16.9	10.2**	28.393	2,008	2,065	-57

Notes: * Preliminary.

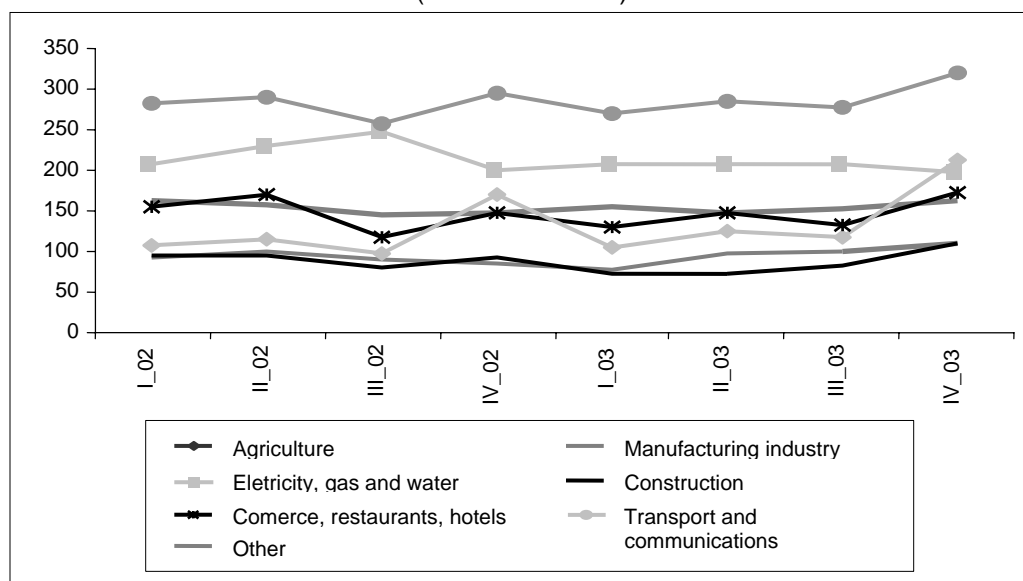
** Accumulated 12 months. Source: Central Bank of Uruguay.

Moreover, the stabilization of the financial system facilitated the activity of export companies, which began to enjoy easier access to credit lines in banking operations. The banks became less restrictive in providing credit, and interest rates fell gradually.

Domestic consumption had fallen significantly in 2002 because of the financial crisis, but in 2003 it began to show signs of recovery. Domestic consumption demand was gradually impelled by the recovery of credit to the private sector, albeit at a slower rate than exports.

Investment, which was also sharply affected by the crisis of 2002, was the final component of aggregate demand to recover. Overall, there was less macroeconomic uncertainty than in 2002. Hence the country risk fell substantially, and all the financial variables were less volatile. Thus there was a recovery in investment, especially in the infrastructure and agriculture sectors.

FIGURE II.12
URUGUAY: QUARTERLY GDP BY ECONOMIC ACTIVITY (1st quarter 2002- 4th quarter 2003)
 (Base: 1983=100)



Source: Central Bank of Uruguay.

The period between the end of 2002 and the beginning of 2003 was a recessive phase for the Brazilian economy; in the second half of 2003 the level of output fell by an annualized 1.4%. This was offset, however, by the strong recovery of the Argentine economy (GDP grew by 7.6% and private consumption by 6.9% in the same period). On the other hand, the Argentine and Brazilian exchange rates appreciated by 15% and 20% respectively in the first six months of the year, which helped improve the competitiveness of Uruguayan products in the region. Moreover, a modest depreciation of the Uruguayan currency, together with the recovery of international prices for its main export products, helped boost exports. Another factor conducive to the growth of the economy in 2003 was the increase in agricultural output and its catalyzing effect on commercial intermediation, cargo transport and port activity.

The greater competitiveness (both within the region and outside) favored sectors producing tradable goods and those services most directly linked to them. Hence those sectors received greater benefits, guaranteeing a better position in the external sector and initiating a process, albeit incipient, of import-substitution.

TABLE II.17
URUGUAY: OUTPUT GROWTH BY SECTOR
 (%)

Economic activity	Change	
	Jan-Dec 2003/Jan.-Dec. 2002	Oct.-Dec 2003/July-Sep. 2003
Agriculture	14.4	6.1
Manufacturing industry	4.6	2.9
Electricity, gas and water	-7.6	2.5
Construction	-7.1	11.4
Commerce, restaurants and hotels	-0.9	3.7
Transport and communications	2.8	1.0
Other	1.1	2.0
GDP	2.5	3.0

Source: Central Bank of Uruguay.

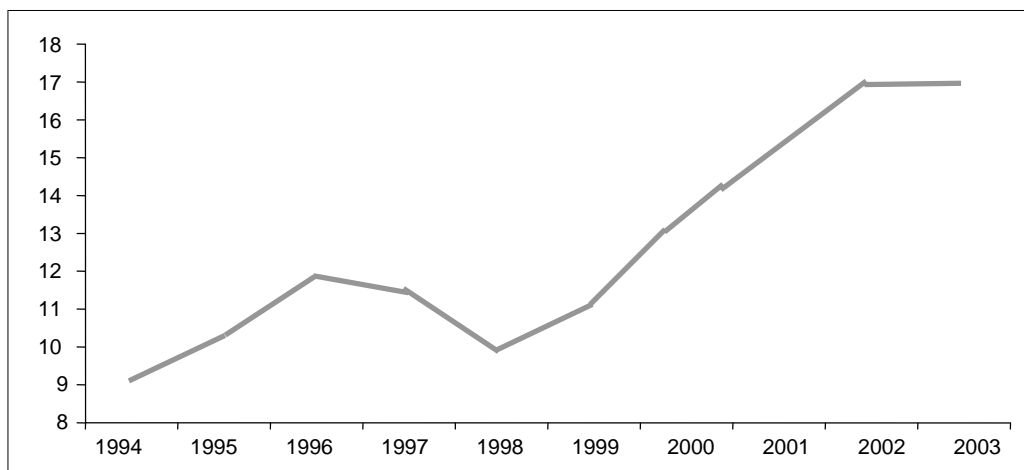
Production of oil seeds, especially soya and sunflower, reached record levels, driven by trends in international prices and the region's favorable environment. The refrigeration industry is beginning to recover the external market lost because of the outbreak of foot and mouth disease. Meat exports thus began to grow, especially because of higher sales to Canada, the United States and Argentina. The textile sector made gains from the increase in international wool prices. Nonetheless, the growth of exports from the sector could be harmed in the short term because of the low level of stocks. Some sectors of industry, whose export performance was good in the 1990s (such as milk, tobacco and the transport material sector) have still not recovered.

Labor market

Given a more favorable context, labor market indicators began to give positive signals, although in terms of annual averages 2003 has only been the same as the previous year. The economic recovery was accompanied by a 5.5% growth in employment and a decline in the rate of unemployment to 15.4% in the last quarter of 2003 (against a rate of 18.5% evident in the same period of 2002). The decline in the unemployment rate stemmed from the reduction in the labor supply and the increase in employment.

There was little uniformity in labor demand across sectors. In general terms, the sectors that most contributed to the growth of output – manufacturing industry, agriculture, and transport – were also those that created new jobs. The more favorable conditions in the labor market were reflected not only in the number of new jobs but also in the stabilization of real wages.

FIGURE II.13
URUGUAY: UNEMPLOYMENT RATE, 1994-2003
(%)

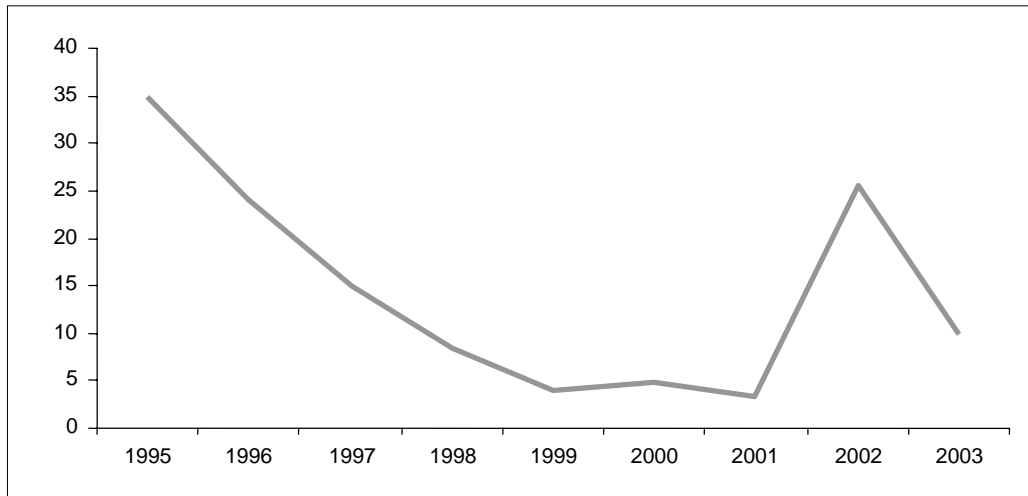


Source: MERCOSUR Secretariat [2004].

Inflation

Inflation in the second quarter of 2003 was the lowest since the country decided to maintain a more stable exchange rate (for more details, see the following section). The somewhat contracted domestic demand and expectations of lower inflation are fundamental to an explanation of inflation's downward trend in the first half of the year. In the third quarter, however, there was a slight rise in prices, explained by a change in relative prices. The products whose prices increased most were: meat (because of supply constraints and the overcoming of the foot and mouth disease crisis) and fuels. Nonetheless, inflation remained below the Central Bank's projections.

FIGURE II.14
URUGUAY: CONSUMER PRICE INDEX, 1995-2003
 (%)



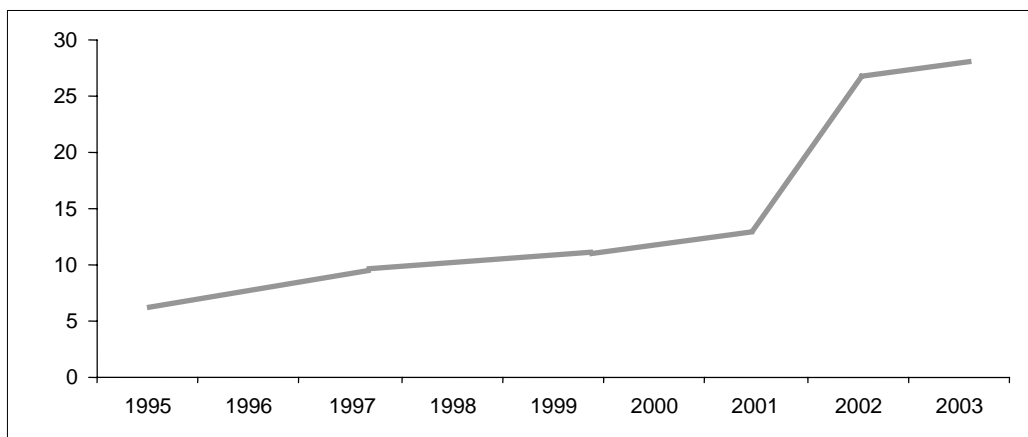
Source: MERCOSUR Secretariat [2004].

Exchange rate

The Uruguayan exchange rate remained reasonably stable in 2003, which helped substantially to control inflation. According to the Central Bank of Uruguay, the exchange rate is close to the equilibrium value because of the satisfactory ratio between internal spending and relative output and productivity.

In the first of 2003, the competitiveness of the Uruguayan economy was higher than in 2002. That circumstance stemmed from a significant fall in the average dollar price of Uruguayan products and the increase in international dollar prices. It is expected that there will be a slight appreciation of the exchange rate in the coming years because of the recovery in private spending and the increase in productivity.

FIGURE II.15
URUGUAY: EXCHANGE RATE DEVELOPMENTS, 1995-2003
 (Pesos/US\$)

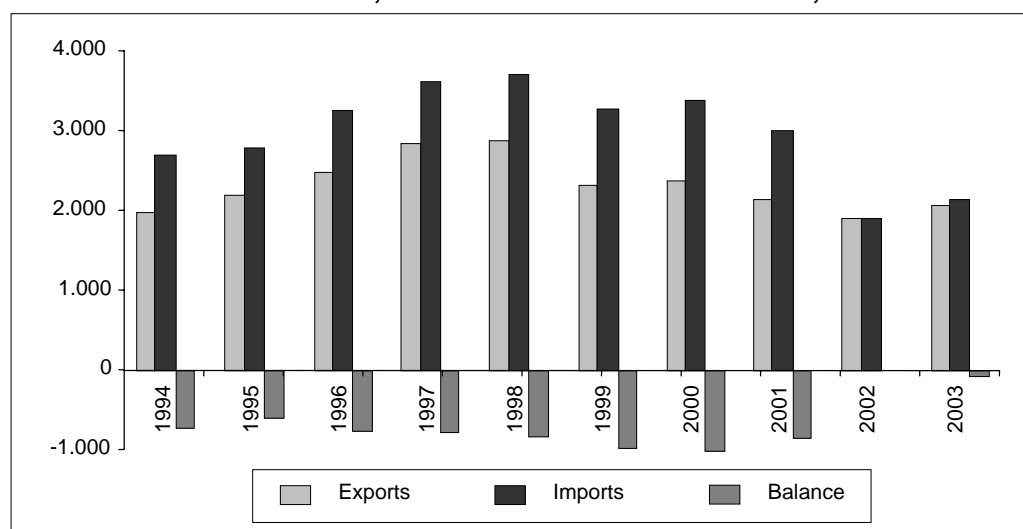


Source: MERCOSUR Secretariat [2004].

Foreign trade

As mentioned earlier, Uruguay's economic recovery is based on the increase in exports, which in turn was driven by a more competitive exchange rate and by the recovery of the international market (especially Argentina). Imports recovered more slowly than exports. This, however, is normal and to be expected at the start of a recovery phase in a country that has recently emerged from a financial crisis: private consumption increases gradually, thus constraining the growth of imports.

FIGURE II.16
URUGUAY: EXPORTS, IMPORTS AND TRADE BALANCE, 1994-2003



Source: Central Bank of Uruguay.

Intra-MERCOSUR foreign trade: Uruguay-MERCOSUR transactions

Uruguay's trade performance in MERCOSUR is recorded in the following three tables in a manner similar to that used for the other member countries. As with the others, import flows are consistent with changes in the output level, especially with the recovery in 2003. Argentina's importance as a trade partner is plain.

TABLE II.18
URUGUAYAN IMPORTS FROM MERCOSUR
(US\$ million)

Country of origin	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 (to Nov.)	2003
Argentina	652.6	608.5	690.8	790.8	839.4	795.6	836.1	706.0	540.6	479.0	572.6
Brazil	709.7	698.6	745.5	802.1	793.4	651.7	666.6	626.0	389.6	384.2	458.8
Paraguay	8.6	13.6	25.3	23.7	16.6	14.4	15.3	18.1	13.6	8.9	10.7
Total	1,370.9	1,320.7	1,461.6	1,616.6	1,649.4	1,461.7	1,518.0	1,350.1	943.8	872.4	1,042.1

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

Nonetheless, this is not true for exports, most of which go to Brazil. Moreover, the local endowment of factors is such that Uruguay systematically has a lower volume of exports than imports.

TABLE II.19
URUGUAYAN EXPORTS TO MERCOSUR
(US\$ million)

Destination country	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 (to Nov.)
Argentina	382.3	267.1	271.7	354.3	513.2	368.6	410.7	316.5	113.0	139.0
Brazil	492.5	700.0	831.0	940.2	935.2	557.3	530.1	439.2	433.8	429.7
Paraguay	24.1	24.9	49.4	60.7	83.8	81.0	82.1	82.9	61.9	42.9
Total	898.9	992.0	1,152.1	1,355.2	1,532.2	1,006.9	1,022.9	838.6	608.7	611.7

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

In this regard, there is a clearer accumulation of trade deficits with the other partners, despite the improvement in the last two years. Note also that the trade balance with all the member countries reveals that there is an equilibrium between imports and exports in 2002-2003. Thus the customs union served to accommodate the Uruguayan economy, allowing the country to accumulate deficits with the other members during the years in which its external accounts were adjusted.

TABLE II.20
URUGUAY'S TRADE BALANCE WITH MERCOSUR (LAST 12 MONTHS)
(US\$ million)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 (to Nov.)
Argentina	-270,3	-341,4	-419,1	-436,5	-326,2	-427,0	-425,4	-389,5	-427,6	-340,0
Paraguay	-217,2	1,4	85,5	138,1	141,8	-94,4	-136,5	-186,8	44,2	45,5
Uruguay	15,5	11,3	24,1	37,0	67,2	66,6	66,8	64,8	48,3	34,0
Total	-472,0	-328,7	-309,5	-261,4	-117,2	-454,8	-495,1	-511,5	-335,1	-260,7

Source: MERCOSUR Secretariat [2004] and central banks: Argentina, Brazil, Paraguay and Uruguay.

Prospects

The recovery that began in 2003 continued at the start of 2004 and, according to ECLAC projections, will last until the end of the year. ECLAC forecasts that GDP will grow by about 7.5% in 2004. After four years of recession the Uruguayan economy has a high level of idle capacity, which will allow it to attain high growth rates without the need for large-scale investment during the initial phase of recovery.

As regards the labor market, expectations are also positive. In the early months of 2004 unemployment fell to 14% (in 2002 it was 20%). As to the external sector, the underpinning of Uruguay's economic recovery, it is expected that exports will grow by 14% in 2004 and imports by 9%. This should allow the country to generate a small surplus.

In sectoral terms, agriculture leads the recovery, driven by the increase in international prices for its main products. The positive prospects for this sector are based on the growth of the land area under cultivation and the volume of production of soya and other oilseeds. As to the internal market, which until recently had grown relatively slowly, a recovery is expected. This will be based on the increased output of some parts of manufacturing industry, such as chemical products, leather and textiles, which have been recovering since the third quarter of 2003 and have expanded well in 2004.

CHAPTER III. MERCOSUR: EXTERNAL SECTOR AND INTERNATIONAL TRADE

This chapter analyzes in greater detail recent trends in foreign trade and the main components of MERCOSUR's balance of payments. It is important to note that the sometimes erratic performance of trade among the countries of the region in the past in large part reflects their lack of macroeconomic policy harmonization.¹³ Indeed, it is hard to imagine that the customs union will operate more harmoniously while the member countries have such asymmetrical economic policies and macroeconomic performances, as mentioned in the preceding chapter.

In that regard, note the huge adjustment in the external accounts undertaken in 2002-2003 by the group's main members (and even before that, in Brazil's case). Moreover, the chapter shows that exports changed markedly in terms of countries (of origin) and (destination) regions. The most salient outcome was the dramatic fall in the significance of intra-MERCOSUR imports up to 2002. A recovery was evident after 2003. Nonetheless, intra-MERCOSUR exports are still far from the levels of the late-1990s – which in this respect can be seen as the golden age of intra-MERCOSUR trade.

That said, the following five sections analyze MERCOSUR trade flows, the main components of the balance of payments, and the composition of exports in recent years. Emphasis is placed on the structure of imports and exports according to the goods' country of origin and destination, the sectoral trade balances posted by the members in intra-MERCOSUR trade, and the changes apparent in recent years. In analyzing the latter it is important to keep in mind the role of the sectoral agreements among the members, which make it difficult to see trends in the balances as an indicator of comparative advantages.

A. Trade

Despite the macroeconomic instability suffered by the countries of the region in practically every one of the last five years, regional trade developed quite favorably in 2002-2003, as is clear from the table below.

In 2003, MERCOSUR exports grew by no less than 18.9%, driven by the performance of the biggest countries, Brazil (+21.1%) and Argentina (+14.3%).¹⁴ The performance was substantially better than that of Latin America as a whole, whose exports grew by 8.3% in 2003. From the data in the table it can be deduced that, apart from MERCOSUR, the exports of the rest of Latin America grew from US\$ 256.5 billion to US\$ 268.2 billion, or by just 4.5%.

The positive export performance in 2003 was influenced by product prices (average unit values) and the quantities exported, circumstances that led to a reversal of the results posted in the two previous years. This is shown by the table below, which reveals the improvement in export prices in the past year.

¹³ This also explains the recurrent difficulties between Argentina and Brazil arising from frequent devaluations that prompt abrupt changes in the intensity of the flows, as in 1999 and in the more recent period.

¹⁴ Chapter II analyzes the member countries' foreign trade performance.

TABLE III.1
LATIN AMERICA AND MERCOSUR: TRENDS IN GOODS TRADE, 2002-2003
(US\$ millions and % growth rates)

	Exports			Imports			Balance	
	2002	2003	2003-2002	2002	2003	2003-2002	2002	2003
Latin America and the Caribbean	346,416	375,009	8.3%	322,780	333,262	3.2%	23,637	41,747
MERCOSUR	89,878	106,841	18.90	59,727	65,797	10.20	30,151	41,045
Argentina	25,709	29,375	14.30	8,473	13,083	10.20	17,236	16,292
Brazil	60,362	73,084	21.10	47,219	48,260	2.20	13,143	24,825
Paraguay	1,884	2,109	11.90	2,162	2,362	9.20	-278	-254
Uruguay	1,923	2,273	18.20	1,873	2,092	11.70	50	182

Source: ECLAC [2004b].

The data in the next table prompt the following conclusions: (i) in 2001 the increase in the value of MERCOSUR exports was wholly the result of the increase in the volumes exported by Argentina and Brazil, since the exports of the other two members contracted (as did those of Latin America as a whole); (ii) in 2002, all of the growth in export values stemmed from Brazil's performance; (iii) export prices were unfavorable for all countries, a repetition of what had happened in 2001, as usually occurs in periods of international recession; (iv) in 2003, by contrast, export prices grew in all the countries of the region as a result of the recovery of the international economy; and (v) nonetheless, most of the increased value came from the growth of the amount exported (except for Argentina).

TABLE III.2
LATIN AMERICA AND MERCOSUR: TRENDS IN EXPORTS, INDICES OF VALUE, VOLUME AND UNIT VALUE, 2001-2003
(In % growth rates)

	2001			2002			2003		
	Volume	Unit value	Value	Volume	Unit value	Value	Volume	Unit value	Value
Latin America and the Caribbean	1.7	-6.1	-4.5	1.4	-0.3	1.1	5.1	3.2	8.3
MERCOSUR	7.3	-3.3	3.8	6.3	-4.5	1.5	13.3	5.6	18.9
Argentina	4.1	-3.5	0.5	-0.01	-3.0	-3.1	5.2	8.6	14.3
Brazil	9.0	-3.0	5.7	9.1	-5.0	3.7	15.3	5.0	21.1
Paraguay	-16.0	-3.4	-19.1	0.0	0.0	0.0	7.6	4.0	11.9
Uruguay	-7.3	-3.0	-10.1	-9.4	-1.0	-10.3	12.6	5.0	18.2

Source: ECLAC [2004b].

Imports were also markedly dynamic. They grew by 10.2% in 2003, largely because of Argentina – since Brazil's imports grew by just 2.2% in the year as a result of the mild recession in the first year of the Lula government. Consequently, the MERCOSUR countries' trade surplus grew substantially, from US\$ 30 million to US\$ 40 million between 2002 and 2003 (a 37% increase). Again, this was largely a result of Brazil's performance. Practically all the increase in the trade surplus in 2003 stemmed from developments in Brazil.¹⁵

¹⁵ It is interesting to note that despite the huge trade surpluses that have marked Brazil's trade balance since 2002, the exchange rate has not been re-valued accordingly. The current account balance has also been positive, albeit to a lesser extent. One possible explanation of this is that the extension of the debt terms has not been comprehensive. In other words, part of the balance has been used to cancel debts previously contracted with foreign creditors.

B. Transfers, Factor Earnings and Current Account Balances

Table III.3 summarizes the other items, as well as the current account balance between 2001 and 2003. It is well known that MERCOSUR's balance of non-factor goods and services, like that of Latin America and the Caribbean, was in deficit until 2001, apart from Argentina in that same year. In 2002, however, that situation was reversed in all the countries in the table, apart from Paraguay: of the US\$ 26 billion change between 2001 and 2002, US\$ 12 billion is accounted for by Argentina and US\$ 13 billion by Brazil. The adjustment in the account was heightened in 2003, again apart from Paraguay. This is the sharpest dimension of the adjustment made in the balance of payments by the countries of the region since the turn of the decade.

The table also reveals the modest significance of transfers in the balance of payments for the MERCOSUR countries (except for Brazil), compared to the other countries of Latin America and the Caribbean. In 2003, for example, of the US\$ 33.5 billion in transfers received by the region (19 countries), only US\$ 3.7 billion went to the MERCOSUR countries (and US\$ 2.9 billion of those went to Brazil).

As was to be expected, the balances in the services accounts (mainly interest on the external debt) were sharply negative in all the years covered by the table. For MERCOSUR as a whole, however, there was relative consistency in the period 2001-2003. Note that every year the MERCOSUR members pay almost half the total of the countries of Latin America (19 countries).¹⁶

As a result of the foregoing, the current account balance turned positive in 2002 (\$ 2.3 billion), substantially reversing the negative total of about US\$ 28 billion in 2001. The adjustment was sharp in all countries, although in Brazil the current account was still US\$ 7.7 billion in deficit in 2002. The adjustment was consolidated in 2003 when even Brazil posted a surplus of about US\$ 4 billion, which accounted for about a third of MERCOSUR's total balance. In the latter year the countries of the region financed about US\$ 12 billion abroad.

Note, moreover, that the adjustment does not cover all 19 countries of Latin America. The region's current account balance remained sharply negative in 2003 (about US\$ 7 billion), although it was substantially below that of 2002 (about US\$ 15.5 billion).¹⁷

¹⁶ It is not clear how the Argentine moratorium is being treated in these results. Thus the data should be treated with caution, especially in the last year shown in the table.

¹⁷ These results are obtained by subtracting the MERCOSUR balance from that for Latin America as a whole.

TABLE III.3
LATIN AMERICA AND MERCOSUR: COMPOSITION OF THE CURRENT ACCOUNT, 2001-2003
(US\$ millions)

	Trade balance of non-factor goods and services			Current transfers			Factor income account balance			Current account balance		
	2001	2002	2003	2001	2002	2003	2001	2002	2003	2001	2002	2003
Latin America and the Caribbean	-25,123	6,339	25,523	26,982	30,126	35,916	-56,804	-53,124	-58,640	-54,945	-16,659	2,799
Latin America (19 countries)	-22,953	9,105	27,908	24,938	27,898	33,512	-54,830	-50,869	-56,113	-52,845	-13,886	5,307
MERCOSUR	-2,581	23,743	34,745	2,264	3,151	3,678	27,622	24,619	26,296	-27,939	2,275	12,127
Argentina	3,432	15,548	14,746	432	576	620	-7,770	-6,498	-7,425	-3,906	9,627	7,941
Brazil	-5,108	8,105	19,737	1,638	2,390	2,867	-19,743	-18,190	-18,552	-23,213	-7,695	4,051
Paraguay	-457	-83	-81	167	116	115	16	59	25	-275	92	59
Uruguay	-447	172	344	27	69	76	-125	10	-244	-545	251	76

Source: ECLAC [2004b].

C. Trends in MERCOSUR Exports by Technological Intensity and Dynamism¹⁸

Analysis of MERCOSUR exports by technological intensity and dynamism between 1997 and 2002 reveals several interesting issues. One is that the conclusions vary depending on the destination market for exports.

Table III.4 shows the value of intra-MERCOSUR exports from 1997 to 2002. The fall in export values within the bloc is marked: the fall was from about US\$ 20 billion at the end of the 1990s (average 1997-1998) to about half of that by 2002.¹⁹ The decline was in all categories of technological intensity, especially the middle-high category.²⁰ As to dynamism, the fall only preserved (albeit not unduly) products in decline – precisely those that are less interesting from the viewpoint of the dynamism of foreign trade.

This performance is in large part a consequence of the events that followed adoption of the floating exchange rate in Brazil in January 1999, and its impact on the other MERCOSUR countries. The restrictions imposed by the other countries on Brazilian exports – especially by Argentina – explain the poor performance of intra-MERCOSUR exports, which should have been stimulated by the customs union.

¹⁸ The material in this section was taken from Pinto da Matta [2004].

¹⁹ The data in the previous chapter suggest that this situation was partially reversed between 2002 and 2003. Intra-MERCOSUR exports grew by about 15% in the latter year to US\$ 11.7 billion – still far below the US\$ 20 billion of 1997-1998. All of the increase stems from the growth of Brazilian exports to Argentina, one source of the difficult negotiations in mid-2004.

²⁰ With respect to this classification, see Pinto da Matta [2004], which discusses the OECD methodology used.

TABLE III.4
MERCOSUR: INTRA-MERCOSUR EXPORTS BY TECHNOLOGICAL INTENSITY AND DYNAMISM
(In US\$ millions)

	1997	1998	1999	2000	2001	2002
Total MERCOSUR	20,504	20,278	15,095	17,671	15,107	10,132
Low	5,515	5,636	4,269	4,622	3,913	2,450
Medium-low	2,959	2,618	2,270	2,619	2,425	1,904
Medium-high	7,709	7,880	5,064	5,628	4,860	2,956
High	651	624	791	1,150	784	425
Non-industrialized	3,670	3,519	2,701	3,652	3,125	2,397
Very dynamic	1,863	1,282	1,462	2,707	2,068	887
Dynamic	1,855	1,995	1,586	1,895	1,653	1,052
Intermediate	5,238	4,682	3,280	3,629	3,123	1,856
In regression	3,854	4,216	2,965	3,655	3,403	2,157
In decline	7,694	8,102	5,801	5,781	4,857	4,179

Source: Tables A. 14 and A. 15 in Pinto da Matta [2004].

Nonetheless, the performance of other exports was very different, even though 2003 is not considered (data are unavailable in the database used in that section). The table below shows the value of intra-MERCOSUR and total exports from 1997 to 2002 by technological intensity and dynamism. It reveals that, despite practically no growth between 2001 and 2002, the level of exports at the start of this century surpasses that of the end of the 1990s – in contrast to what happened with intra-MERCOSUR exports.

TABLE III.5
MERCOSUR EXPORTS BY TECHNOLOGICAL INTENSITY AND DYNAMISM, 1997-2002
(US\$ millions)

	1997	1998	1999	2000	2001	2002
Total	83,287	81,337	74,322	84,863	87,880	88,883
Low	33,891	32,276	30,004	31,045	32,083	34,180
Medium-low	9,567	8,630	8,557	10,382	10,506	10,764
Medium-high	15,506	16,118	12,970	15,156	14,829	14,632
High	2,810	3,448	4,269	7,120	7,195	6,167
Non-industrialized	21,479	20,839	18,500	21,137	23,245	23,116
Very dynamic	5,296	5,178	6,520	11,224	12,500	10,050
Dynamic	6,514	6,740	6,909	8,665	8,447	8,121
Intermediate	14,211	13,937	12,452	15,295	14,870	15,443
In regression	15,757	15,107	13,595	16,126	17,143	17,182
In decline	41,486	40,345	34,821	33,524	34,893	38,059

Note: (*) The totals are not equal to the sum of the columns because non-classified products are not included.

Source: Pinto da Matta [2004].

The data in the two tables above show that extra-MERCOSUR exports grew from US\$ 62.8 billion in 1997 to US\$ 78.8 billion in 2002. As we have seen, in 2003 they grew even more. There has been market diversification over time, while intra-MERCOSUR exports have lost relative importance as this decade has progressed.

Apart from that, analysis of total or intra-MERCOSUR exports shows that their structure and the changes in their composition over time are different. To corroborate this, it is important to note in the table below the composition of intra- and extra-MERCOSUR exports by technological intensity and dynamism in 1997 and 2002.

Examination of the table prompts the conclusion that, as regards exports' technological intensity: (i) exports of low- and medium-technology goods are substantially more important in trader with the rest of the world than among the members of the common market; (ii) the relative share among the members, however, grew slightly between 1997 and 2002 (from 41.3% to 43%) and fell in the case of the other destination countries (from 55.7% to 51.6%); (iii) exports of non-industrial goods grew among the members (17.9% to 23.7% of total exports) and fell in extra-MERCOSUR exports (from 28.4% to 23.6% between 1997 and 2002); (iv) from the foregoing it can be concluded that high- and medium-high technology exports fell among the members and grew in exports to the rest of the world.

TABLE III.6
TOTAL, INTRA-MERCOSUR AND EXTRA-MERCOSUR EXPORTS BY TECHNOLOGICAL INTENSITY
AND DYNAMISM, 1997 AND 2002
(%)*

MERCOSUR: Composition of exports (%)				
	Intra-MERCOSUR		Extra-MERCOSUR	
	1997	2002	1997	2002
Technological intensity				
Low	26.9	24.2	45.2	40.3
Medium-low	14.4	18.8	10.5	11.3
Medium-high	37.6	29.2	12.4	14.8
High	3.2	4.2	3.4	7.3
Non-industrialized	17.9	23.7	28.4	26.3
Dynamism				
Very dynamic	9.1	8.8	5.5	11.6
Dynamic	9.0	10.4	7.4	9.0
Intermediate	25.5	18.3	14.3	17.3
In regression	18.8	21.3	19.0	19.1
In decline	37.5	41.2	53.8	43.0

Note: (*) The percentages are not equal to 100% because non-classified products are not included.

Source: Pinto da Matta [2004].

The analysis of the dynamism of exports complements the foregoing. The table shows that the "very dynamic" products (those trading internationally at much higher rates than the average for goods) more than doubled their share between 1997 and 2002 (5.5% to 11.6%), while in intra-MERCOSUR trade their share fell slightly (9.1% to 8.8%). In the "dynamic" goods, by contrast, there was a modest increase in share between those two years for both groups of destination countries.

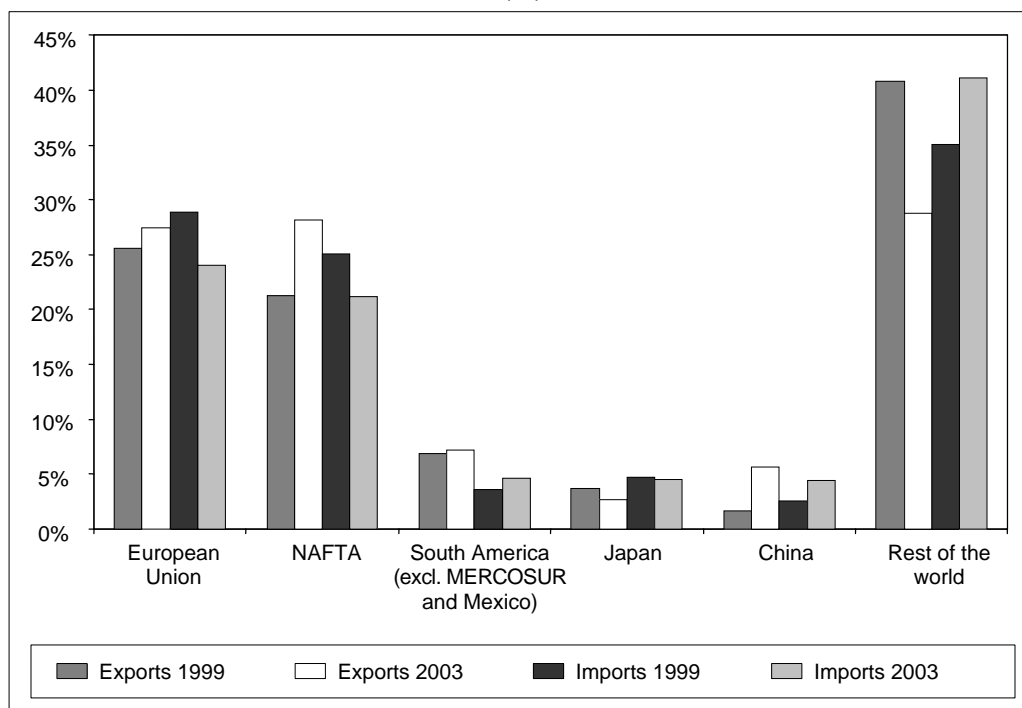
Perhaps the most striking aspect of the table concerns products "in decline" – those in which international trade is decreasing. In this case there is a slight increase in intra-MERCOSUR exports and a sharp fall in exports to the rest of the world.

D. MERCOSUR's Foreign Trade by Destination and Origin of Exports and Imports

Figure III.1 shows the structure of MERCOSUR's exports and imports in 1999 and 2003²¹ by the main blocs, countries and regions of origin and destination. There is a clear increase in the concentration of exports in the EU and NAFTA, and the greater importance of China is plain. The flipside is the lesser importance of Japan and the "rest of the world". The other countries of Latin America (except Mexico) maintained their share in total exports at about 7% between 1999 and 2003.

For imports, the changes are different. Between 1999 and 2003 the EU and NAFTA lost share as suppliers to MERCOSUR. China, and especially the other countries, gained share. To a large extent these changes reflect the performance of Brazil, as analyzed in Chapter II.

FIGURE III.1
COMPOSITION OF MERCOSUR'S EXPORTS AND IMPORTS
BY DESTINATION AND ORIGIN, 1999 AND 2003
 (%)



Source: MERCOSUR Secretariat [2004].

²¹ The 2003 data are preliminary because for some countries (Argentina and Uruguay) they were estimated on the basis of the accumulation between January and October. See the table with data on origin in the statistical annex.

E. Sectoral Trade Balances of the Member Countries

It is also interesting to analyze the comparative, static and dynamic advantages revealed by the intra-MERCOSUR trade balances (and their development over time). The original tables cover the period 1991-2003 (Brazil), 1991-2002 (Argentina and Uruguay) and 1991-2001 (Paraguay). These tables show the annual exports and imports of the members of the customs union by product category, according to the harmonized system. Analysis of the trade balances makes it possible to draw up a table of intra-MERCOSUR balances. (see Table III.7).

TABLE III.7
STRUCTURE OF INTRA-MERCOSUR TRADE BALANCES* ACCORDING TO THE HARMONIZED
SYSTEM, BY COUNTRY, 2002 (%)*****
 Structure of the trade balance, 2003 (%)

Sections	Description	Brazil	Argentina	Uruguay	Paraguay
I.	Live animals and products of animal origin	13.2	6.0	-25.9	0,8
II.	Vegetable products	55.2	32.0	-19.4	-31,8
III.	Fats and oils	3.2	3.0	2.5	-5,0
IV.	Foodstuffs, beverages and tobacco	0.4	5.0	12.4	10,7
V.	Mineral products	31.0	29.0	42.5	39,3
VI.	Products of the chemical or allied industries	-10.7	-1.0	25.0	30,0
VII	Plastics and articles thereof	4.7	6.0	3.8	11,0
VIII	Hides and skins (except footwear)	1.6	3.0	9.1	-1,4
IX	Wood, charcoal and articles thereof	0.4	0	3.0	-3,1
X	Wood pulp, paper and paperboard	-3.1	-1.0	3.0	10,5
XI	Textiles and textile articles	-0.6	0	10.5	-4,0
XII	Footwear, artificial flowers and others	-1.5	0	1.8	1,4
XIII	Plaster, cement, asbestos, mica, ceramics and glassware	-2.2	-1.0	5.7	2,9
XIV	Precious stones and metals, coins and others	0.0	0	0.0	0,0
XV	Base metals and articles thereof	-4.0	-1.0	8.7	10,1
XVI	Machinery, appliances and electrical material	-5.7	2.0	18.2	18,7
XVII	Transport equipment	19.4	18.0	-5.3	6,8
XVIII	Optical, precision, surgical watchmaking and musical instruments	0.1	0	0.8	1,1
XIX	Arms, munitions and others	-0.1	0	0.0	0,0
XX	Miscellaneous products	-1.3	0	3.6	2,1
XXI	Works of art and antiques	0.0	0	0.0	0,0
General total		100,0	100.0	100.0	100.0

Notes: * For Brazil, Paraguay and Uruguay, the interpretation should keep in mind that the balances were negative in 2002.

** Paraguay, 2001.

*** The totals are not exactly equal to the sum of the parts because special transactions are not included in the percentages.

Source: MERCOSUR Secretariat [2004].

Brazil's trade balances with Argentina in 2002²² reveal a concentration in a relatively small number of sectors, as follows:²³ (i) products of the chemical or allied industries; (ii) base metals and products thereof; (iii) machinery, appliances and electrical material; (iv) wood pulp, paper and paperboard. Heavily prevalent, indicating a dependence on imports, are vegetable products (55.2%), mineral products (31.0%) and transport material (19.4%).²⁴

In Argentina's case, its positive trade balance is concentrated in the following sectors: (i) vegetable products; (ii) mineral products; (iii) transport equipment. The fact that there are few negative values in the table indicates that most of the sectors were in surplus in 2002, a circumstance that reflects Brazil's continuing to make purchases from its partners in the region.

As to Paraguay, which had a trade deficit in 2001, note the vegetable products sector, in which the country had its biggest surplus. In other cases there are wide deficits, which to some extent reflects Paraguay's factor endowment. Among them are: (i) mineral products; (ii) products of the chemical or allied industries; (iii) machinery, appliances and electrical material.

Uruguay, whose trade balance with the other members as a whole is also negative, posts positive balances in sectors related to primary production, such as the first two in the table.

There follow some additional conclusions related to the analysis of changes in the goods trade balances by product category according to the harmonized system (Table III.8). Note from the following table that Uruguay's trade balance was the only one to decline between the years under consideration (by US\$ 65 million).

The table indicates that a substantial part of the improvement in Brazil's trade balance with the other MERCOSUR countries originated in the balance of exports over imports in a small number of sectors: transport material, followed by live animals and products of animal origin, and mineral products. Argentina is different. Prominent here are: machinery, appliances and electrical material, plastics and plastic products, precious stones and metals, base metals and products thereof. Uruguay, whose balance deteriorated between 1997 and 2002, exhibits significant structural variations, as indicated in the table. Finally, in Paraguay, where the deficit narrowed between 1997 and 2001, most of the improvement was in the foodstuffs, beverages and tobacco sector (52.3% of the change in the trade balance). The biggest and most positive contributions came from electrical material and transport; in both cases the deficit narrowed.

It is worth noting that these conclusions are preliminary because of the huge instability of the external sector in the countries of the region in the period analyzed. Nonetheless, the analysis seems to be useful because it highlights the broad features of intra-MERCOSUR trade in this troublesome period.

²² We have chosen 2002 for two reasons: first for the purposes of comparison with Argentina, since 2002 is the last year for which Argentina data are available; and second because the Brazilian deficit with MERCOSUR in 2003 was insignificant (US\$ 14 million), as we saw in Chapter II. This gives rise to very high values for the percentage shares in the table.

²³ Note that the total balance is negative and therefore the negative percentages reveal an excess of exports over imports.

²⁴ Strictly speaking, the products indicated are typically the result of bilateral negotiations between Argentina and Brazil – such as wheat, oil and automotive products.

TABLE III.8
STRUCTURE OF INTRA-MERCOSUR TRADE BALANCES* ACCORDING TO THE HARMONIZED
SYSTEM, BY COUNTRY, 1997 AND 2003**
 (% variation in the trade balances)***

Sections	Description	Brazil	Argentina	Uruguay	Paraguay
I.	Live animals and products of animal origin	100.8	-17.0	269.2	-1,3
II.	Vegetable products	13.6	-30.0	256.6	7,8
III.	Fats and oils	21.3	-6.0	-1.7	-3,0
IV.	Foodstuffs, beverages and tobacco	-58.3	-18.0	-81.3	52,3
V.	Mineral products	63.6	-21.0	40.4	7,8
VI.	Products of the chemical or allied industries	-24.6	16.0	-26.6	-0,4
VII	Plastics and articles thereof	-65.4	50.0	-44.9	8,5
VIII	Hides and skins (except footwear)	11.3	-4.0	28.7	-0,3
IX	Wood, charcoal and articles thereof	-3.7	4.0	-23.5	-6,2
X	Wood pulp, paper and paperboard	-14.5	13.0	-21.6	-3,0
XI	Textiles and textile articles	98.0	-9.0	171.4	-9,9
XII	Footwear, artificial flowers and others	14.5	-1.0	-0.8	-0,7
XIII	Plaster, cement, asbestos, mica, ceramics and glassware	-11.3	4.0	0.2	2,0
XIV	Precious stones and metals, coins and others	-0.9	29.0	-0.9	-1,9
XV	Base metals and articles thereof	-93.8	23.0	-75.3	6,6
XVI	Machinery, appliances and electrical material	-52.2	67.0	-133.6	17,5
XVII	Transport equipment	115.4	-7.0	-248.8	22,5
XVIII	Optical, precision, surgical watchmaking and musical instruments	-7.7	3.0	-6.1	0,4
XIX	Arms, munitions and others	-1.1	0	-1.0	1,0
XX	Miscellaneous products	-4.5	4.0	-0.4	0,5
XXI	Works of art and antiques	0.0	0	0.3	0,0
General total		100,0	100.0	100.0	100.0

Notes: * For Argentina the interpretation is contrary to that for the other countries because of the negative change in the trade balance.

** Uruguay, 1997-2002; Paraguay, 1997-2001.

*** The totals are not exactly equal to the sum of the columns because special transactions are not included in the percentages.

Source: MERCOSUR Secretariat [2004].

CHAPTER IV. DEVELOPMENTS ON THE INTERNAL AGENDA

A. Return to a Leading Role

The period beginning in the first half of 2003 opened a window of opportunity for MERCOSUR's internal agenda. Convergence among the member countries' exchange rate policies, the resumption of economic growth in the subregion, and the assumption of power on the part of heads of state who are explicitly favorable to the bloc created an auspicious environment for intra-MERCOSUR understanding. The Asunción Summit in June 2003 revealed a new level of ambition in the integration project and its outcomes amounted to an effort to recover the group's internal negotiating agenda. That agenda, frozen by the succession of crises during the four previous years, is crucial to the reconstruction of the integration model on credible and sustainable foundations.

Most issues on the agenda have moved forward to a greater or lesser degree in the past 18 months. At Brazil's initiative, a work program for the 2004-2006 period was presented and approved. This establishes targets and deadlines for complying with the various issues on the agenda. Re-addressed, among other issues, were the following: common trade defense, elimination of antidumping and countervailing duties in intra-MERCOSUR trade, strengthening a common discipline on incentives, the harmonization of macroeconomic indicators and reinforcing the bloc's institutional structure. All of these matters came with proposals that should (in most cases) be concluded in 2004.

Macroeconomic coordination has gained in importance, especially because of the more recent awareness that overcoming crises and bringing the Argentine and Brazilian economies closer are necessary but insufficient conditions for the avoidance of disputes arising from structural problems. In the first half of 2003 the main point of progress in this field was the decision of the Macroeconomic Monitoring Group (MMG) on the treatment of public companies in each country's fiscal statistics and the proposal for a common methodology for calculating core inflation, as well as the discussion of the possibility of harmonizing monetary aggregates.

The harmonization of services trade in MERCOSUR made progress in 2003 with the conclusion of the Fourth Round of Negotiations on Specific Commitments in Services. The negotiations were undertaken in line with Article 19 of the Montevideo Protocol on Trade in Services, which establishes that the member countries will engage in annual negotiations so as to complete, within ten years of its entry into force, the Program on the Liberalization of Services Trade in MERCOSUR.

Another advance in this area was the agreement to issue a MERCOSUR Visa. According to the Agreement on Residence for Nationals of the MERCOSUR Member Countries, immigrants from one country of the region who acquire a temporary or permanent residence visa in another MERCOSUR country will receive the same treatment as the country's nationals, including in the labor field. At the same time, the member countries concluded the Agreement on Regulating the Migration of MERCOSUR Citizens. This makes it possible to regularize immigrants without their having to return to their countries of origin.

December saw the approval of the Protocol on MERCOSUR Government Procurement, a corollary to the work of the *Ad Hoc* Group. Since 1997 the group has been devising a subregional instrument to eliminate discrimination among the member countries that affects any of them in the area of government procurement of goods and services. The presidential summit considered the protocol as crucial to deepening the customs union, although its signing does not mean that efforts at liberalization in this field will cease.

As regards MERCOSUR's institutional structure, the main step forward was the entry into force, on January 1, 2004, of the Protocol of Olivos on dispute settlement. This was signed in February 2002 because of the

need to enhance the dispute settlement mechanisms established in the 1991 Brasilia Protocol. Its main novelty is the creation of a Permanent Review Tribunal, which offers greater juridical security to the dispute settlement system by ensuring review of the rulings and allowing an accumulation of experience that will help streamline dispute settlement.

Progress was modest, however, in two crucial areas: the common external tariff (CET) and trade defense. As regards the CET, the deadline given to the High-Level Group (created in 2001) to submit its proposals on the consistency and dispersal of tariffs was extended to November 2004. In the meantime, the exceptions to the CET remained in place through successive deferments of the dates originally agreed for their suspension. At the same time, approval was given to the Regime Governing Capital Goods Originating Outside MERCOSUR. This will take effect on January 1, 2006. The regime will entail national lists and a common list of capital goods that are not produced in the region. All the lists will have a 0% import aliquot until January 1, 2008, at which point the benefit will be applied solely to the common list. Additionally, Decision 33/03 set December 31, 2005 as the final deadline for the Common Market Group's (CMG) approval of a Common Regime on Information Technology and Telecommunications Goods.

The shortage of agreed instruments in the area of intra-MERCOSUR trade defense and the unilateral adoption of protectionist measures remained the most striking signs of MERCOSUR's incipience as a customs union. The most recent example of this is Argentina's announcement, on the eve of the Puerto Iguazú Summit, that it would raise tariffs and increase customs barriers to restrict imports of domestic appliances from Brazil.

As a result, the Puerto Iguazú Summit in July took place in a less favorable context than had been expected. Little structural progress was made and the negotiations dissipated in short-term arrangements that sought to avert the trade restrictions imposed by Argentina.

The challenges to integration remain very substantial. Despite the recovery of economic growth, representatives of Argentina's private sector argue that Brazil's industrial and export support mechanisms distort competition in MERCOSUR. The dispute makes it clear that, in a context of economic integration, internal policies – such as industrial support strategies – cannot be implemented unilaterally without prior discussion or negotiation with partners in the integration process.

Brazil, recognizing the problem as structural, took a conciliatory position. Hence Brazil's government hopes, in the period when it exercises the *pro tempore* presidency of MERCOSUR, to motivate the distribution of productive chains among the countries and review MERCOSUR's financing mechanisms so as to avoid disparities in access to credit, which these days is limited in Argentina. Nonetheless, Brazil remain opposed to the adoption of automatic triggers as a means of compensating for the disequilibrium in sectoral trade.

MERCOSUR's internal agenda needs not only to be unfrozen but also reviewed organically, and in line with certain criteria. Various recent initiatives brought together experts to consider the agenda. One such was a conference sponsored by the IDB in Rio de Janeiro in June 2003. Another initiative was the reflections of the MERCOSUR Secretariat in its First Biannual Report. Both initiatives have various points in common.

There was broad consensus about two matters in particular: the need to overcome the bloc's institutional deficit and to build the customs union. MERCOSUR's low institutional profile was adequate when the main issues were commercial or tariff-related. That arrangement, however, has proven insufficient to tackle more complex matters. The inter-governmental foundations and policy that predominate in all levels of MERCOSUR's operations expands the sectoralist outlook with which government negotiators tackle integration issues. Additionally, the costs incurred by the member countries in following the inter-

governmental model are significant, and probably higher than those they would incur if they adopted an efficient supranational model.

The second issue is the need to resolve the dilemma between the free trade area and the customs union. As an intermediate stage in the transition towards deeper integration, a customs union has the advantage of being more transparent and involving lower operational costs than a free trade area. Moreover, it is more important for attracting foreign investment and for MERCOSUR's external agenda. Abandonment of the customs union would be a setback with a substantial impact on the credibility of the member countries as regards their adherence to rules and contracts. Continued progress must therefore be a crucial point on MERCOSUR's external agenda.

Matters related to immediate economic conditions no longer pose an obstacle to progress on the internal agenda. Nonetheless, it should not be forgotten that the agenda must be very carefully assessed in the light of the goals of integration. One potentially successful strategy to deepen MERCOSUR integration might be to reflect the priorities of the national economic agendas, such as boosting exports and employment. The external agenda has shown itself to be incapable of playing that role.

B. Status Report on the Main Issues

The common external tariff

Review of the CET became important after the member countries' ratification of their commitment to the customs union, of which the CET is the most emblematic element. The many exceptions to the CET since it entered into force in 1995, and the crisis in trade relations between the countries of the region (especially after the changes to the exchange rates in Argentina and Brazil) undermined the credibility of the customs union and significantly lessened the support of public and private actors for its application.

The summit meetings of recent years formally moved away from the risk of a backwards step in this area. The June 2003 summit was particularly important in this regard, since it was the first to take place after the new governments took office in the region's main economies: Argentina and Brazil. The general assessment of that meeting was that MERCOSUR needed to be strengthened and deepened "by enhancing the existing instruments and by considering new issues on the negotiating agenda in the political, social, cultural and other fields" (Act 01/03). The presidents' declaration stressed that MERCOSUR should allow some indispensable flexibility so as not to harm productive processes, and it acknowledged the need to deal explicitly with the member countries' development asymmetries, since this is one of MERCOSUR's main problems.

To a large extent, MERCOSUR's difficulties in consolidating a broad CET lie in the disregard for local economic diversity and in the predominance of policy variables that (with few exceptions) led to the replication of Brazil's customs structure and (to a lesser extent) Argentina's. Since Brazil's productive base is very broad, in general terms the adoption of that structure entailed a reduction in the other member countries' real protection (Rios [2003]).

There are numerous exceptions to the application of the CET. From the outset, capital goods, as well as information technology and communications goods, were treated as exceptions. Moreover, each country could present national lists of exceptions for sensitive products. The domestic regimes for the vehicle industry were preserved. Finally, various binational tariff preference accords among the MERCOSUR member countries and other countries of Latin America, negotiated in the ALADI framework, were also preserved. These too comprised exceptions to the CET.

Apart from the exceptions stemming from structural factors, the economic crises faced by the countries of the region, especially in the last two years of the 1990s, led to new perforations of the CET – although in most cases these were adopted unilaterally. The precursor of this process was the "statistical tax" imposed by Argentina in addition to the CET. The high point was in 2001, when Argentina reduced its tariffs on capital goods to zero and raised the rate on various consumer goods to 35%, with a view to preserving the convertibility regime that was formally abandoned in January of the following year.

As a reaction to the excess of perforations and in view of the need for the region to present lists of offers in the FTAA and EU negotiations, in June 2001 the Common Market Group created a High-Level Group to review the CET structure and to analyze the coherence and dispersal of the tariff structure. The group's main task was to examine the nominal and real perforations stemming from the prevailing structure and to submit proposals for change to the CMG before November 2001. Capital goods, as well as information technology and communications goods and agricultural products, were to be the object of special studies.

The worsening of the Argentine crisis entailed obvious difficulties for compliance with the original timeframe for revision of the CET. The subsequent convergence of exchange rate regimes and the recovery of economic growth in the region raised expectations of consistent progress. Such hopes were dashed, however, reflecting the persistence of difficulties in tackling MERCOSUR's structural problems.

The deadline for the High-Level Group to present its proposals on the consistency and dispersal of the CET was extended three times. The final extension, granted in Decision 10/03, set a new deadline of November 30, 2004. That date was confirmed later in the MERCOSUR Work Program 2004-2006, which was approved in December 2003.

The exceptions to the CET meanwhile persisted, thanks to the successive deferments of the dates originally agreed for their suspension. Decision 02/03 in June 2003 extended the period for Argentine exceptions for capital goods until December 31, 2003 and gave Paraguay and Uruguay the same prerogative. In December 2003 that deadline, like that for the end of national exception regimes, was extended to December 31, 2005 (Decision 34/03). The same decision authorized Paraguay and Uruguay to retain the 2% aliquot on all extra-MERCOSUR capital goods imports. Decision 31/03 extended until December 31, 2005 the member countries' retention of more than 100 exceptions to the CET. Paraguay and Uruguay were allowed to raise the number of exceptions to 150 and 125, respectively, and the lists could be maintained to 2010 (Paraguay, in addition, could retain the 399 exceptions for which provision was made in Decision 07/94).

Nonetheless, there was some progress on establishing common MERCOSUR sectoral policies. Decision 34/03 approved the Regime Governing Capital Goods Originating Outside MERCOSUR. This will take effect on January 1, 2006. The regime will entail national lists and a common list of capital goods that are not produced in the region. All the lists will have a 0% import aliquot until January 1, 2008, at which point the benefit will be applied solely to the common list. Decision 33/03 set December 31, 2005 as the final deadline for the CMG's approval of a Common Regime on Information Technology and Telecommunications Goods. That same decision authorized Paraguay and Uruguay to maintain a 2% aliquot for extra-MERCOSUR imports of such goods until December 31, 2010 and allowed the negotiation of a list to which a 0% aliquot would be applied until December 31, 2005.

Macroeconomic coordination

The matter of macroeconomic coordination gained importance on MERCOSUR's internal agenda. The grave asymmetry in the exchange rate policies of Argentina and Brazil having been resolved, conditions seemed right to consider the establishment of common fiscal and monetary targets. Nevertheless, it became clear that, although internal interests took primacy over those of the group at times of crisis (with

the abandonment of the common targets, for example), the passing of the crisis and the greater proximity of Brazilian and Argentine economic policies were not enough to avert disputes arising from differences in economic performance. On the eve of the Puerto Iguazú Summit, Argentina announced that it would raise tariffs and increase customs barriers to restrict imports of domestic appliances from Brazil. This is a clear example of the inadequate understanding of what the macroeconomic coordination agenda should be. The latter should not be confined, as now, solely to the harmonization of economic indicators and the simple exchange of statistics.

Macroeconomic coordination seeks to ensure economic stability in the MERCOSUR countries, obviating ruptures that can cause spurious gains and losses of competitiveness among them. To that end, in March 2002 the member countries agreed to set common targets for the fiscal balance, public debt and price variations. The Macroeconomic Monitoring Group (MMG) was set up to harmonize statistics. At the July 2002 summit in Buenos Aires the presidents stressed the strategic nature of macroeconomic coordination because of its value as an instrument of external credibility.

In its ordinary meeting in December 2002 the Common Market Council (CMC) recommended to the Meeting of Ministers of the Economy and Central Bank Presidents (MMECBP) that it ask the MMG for an assessment of the possibility of including new indicators in the process of macroeconomic coordination. The participants in the MMECBP reaffirmed their commitment to fiscal discipline and the targets set in the Declaration of Florianópolis on December 15, 2000. They decided to take the maximum inflation target for 2006 to 5% and recommended to the MMG the adoption of an *ex-ante* system of monitoring convergence towards the targets.

In the first half of 2003 the main point of progress in this field was the decision of the MMG on the treatment of public companies in each country's fiscal statistics, and the proposal for a common methodology for calculating core inflation, as well as a discussion of the possibility of harmonizing monetary aggregates.

Macroeconomic coordination featured among the priorities of the MERCOSUR Work Program 2004-2006, approved by Decision 26/03. In that regard the following matters should be resolved by the end of 2004:

- completion of the harmonization of macroeconomic indicators, including monetary aggregates;
- transposing the agreed targets into the countries' domestic policies;
- permanent monitoring of the degree of compliance with the agreed targets, and making the results public; and
- giving the MMG a stronger institutional structure and a clearer hierarchy.

Adjustment Targets and Trajectories in the Declaration of Florianópolis

1. Flow fiscal variable

Indicator: Variation of the consolidated public sector fiscal debt (financing needs as measured by the below-the-line criterion).

Target: Maximum 3% of GDP for all countries as of 2002.

Adaptation: Maximum 3.5% of GDP for Brazil in 2002 and 2003.

2. Stock fiscal variable.

Indicator: Quarterly average of the ratio of the consolidated public sector liquid debt (less the international reserves) and nominal GDP.

Target: Maximum 40% of GDP for all countries as of 2010.

Adaptation: From 2005 onwards, taking as a base the average of the years 2002-2004, a downward trend for the successive quarterly averages applicable to those countries whose debt stands at more than 40% of GDP.

3. Inflation

Indicator: Annual change between the points of each year of the consumer price index or equivalent.

Target: Maximum of 5% as of 2006.

Adaptation: Each country will seek an annual reduction by a quarter of the difference between 2002 inflation and the maximum target of 5%.

Negotiations on services

The harmonization of services trade in MERCOSUR made progress in 2003 with the conclusion of the Fourth Round of Negotiations on Specific Commitments in Services. The negotiations were undertaken in line with Article 19 of the Montevideo Protocol on Trade in Services, which establishes that the member countries will engage in annual negotiations so as to complete, within ten years of its entry into force, the Program on the Liberalization of Services Trade in MERCOSUR.

The CMC's Decision 22/03, which approved the member countries' lists of specific commitments, brought the fourth round to an end. Consequently, the countries consolidated their regulatory frameworks on market access and national treatment. The commitments are important because they establish minimum levels for future concessions. The decision should be transposed into national legislation in line with each member country's internal procedures. The need for transposition makes the progress relative. The Montevideo Protocol has still not been incorporated into domestic law except in Argentina, despite the explicit commitment of Brazil, Paraguay and Uruguay not to stint in their efforts to expedite its approval in their national congresses.

The Montevideo Protocol is based on GATS norms so as to wholly liberalize services trade among the MERCOSUR countries. One difficulty in this area is that the MERCOSUR countries' GATS commitments are somewhat different from each other. Of the four member countries, Argentina was the only one to commit itself to the highest degree of openness. This was in contrast to Brazil's position (forty-seventh ordinary meeting of the CMG).

The MERCOSUR Visa, a corollary to the liberalization of services, was finally agreed upon by the member countries in the December 2002 summit. According to the Agreement on Residence for Nationals of the MERCOSUR Member Countries, immigrants from one country of the region who acquire a temporary or permanent residence visa in another MERCOSUR country will receive the same treatment as the country's nationals, including in the labor field. At the same time the member countries concluded the Agreement on Regulating the Migration of MERCOSUR Citizens. This makes it possible to regularize immigrants without their having to return to their countries of origin.

The signing of these agreements is a step forward. The free circulation of people among the MERCOSUR countries is essential for the establishment of a common market. The agreements facilitate the movement of physical persons supplying services and firms' hiring of citizens of other nationalities. The institutional progress, however, still has not led to concrete results because the agreements have to be ratified by the national parliaments. The still-difficult situation of the labor markets in the MERCOSUR countries is, to a greater or lesser extent, a significant obstacle to such ratification in the short term.

The MERCOSUR Visa

Since the beginning of 2002 the GMC has been discussing a simplified visa for the movement of people among the MERCOSUR countries. The goal was to reduce the bureaucratic procedures for the entry into and residence in the recipient country of citizens of other member countries, and to allow them to undertake paid activities such as the provision of services. One aim is to avoid bureaucratic demands such as proof of economic need for proportionality between national and foreign workers (for example, the "two thirds" rule Brazil). Despite the lack of initial consensus, the discussions proceeded relatively fast. The main points of the Residence Agreement are presented below. One of the most important matters is the guarantee of labor and social security rights for immigrants holding a residence visa. A possible agreement on reciprocity in this matter is pending analysis.

Request

Nationals of one of the MERCOSUR member countries who want to live in the territory of another member country can do so legally by making a request. That request must be made in the consulate of the recipient country if the individual in question has not yet entered the country, or to the immigration authorities if the individual is already in the other member country. An important detail is that the request can be made (and granted) even in those cases in which the petitioner's situation is irregular in the recipient country. He or she will not be subject to fines or other administrative sanctions.

Temporary and permanent residence

Temporary residence will be for up to two years and can be granted through the prior presentation of documentation such as a civil records and certificates proving that the individual has no criminal background. The procedures for verifying the authenticity of the documents are simplified. Temporary residence can become permanent residence by means of a request made 90 days before the expiry of the former.

General rules and immigrants' rights

Individuals who obtain residency in line with the provisions of the agreement will have the right to enter leave move within and stay freely in the recipient country, as well as to undertake any activity, either through self-employment or employment by third persons, on the same terms as nationals of the recipient country and in line with the legal norms of that country.

If they have a residency visa, the nationals of the member countries and their families will have the same civil, social, cultural and economic rights and freedoms as the nationals of the recipient country, in particular the right to work and to engage in all legal activity. They will receive treatment that is no less favorable than that received by the nationals of the recipient country in all matters related to the application of labor legislation, especially as regards wages, working conditions and social security.

The agreement also makes provision for the right of family reunion for family members of a non-MERCOSUR nationality, and to transfer resources and rights to immigrants' children.

Government procurement

The MERCOSUR Protocol on Government Procurement was also approved in the December 2003 summit. Decision 40/03 stemmed from the work of the *Ad Hoc* Group, which since 1997 has been devising a subregional instrument to eliminate discriminations against member countries in the areas of goods procurement and services concessions on the part of any member. The presidential summit considered the protocol as crucial to deepening the customs union, although its signing does not mean that efforts at liberalization in this field will cease. The member countries pledged to engage in negotiations in successive rounds so as to complement the liberalization of MERCOSUR's procurement markets and expand the protocol's scope of application.

The protocol made provision for the main points of contention that arose during the agreement's negotiation. It will be applied to all levels of government - federal, state and municipal. It is an ambitious measure given the autonomy of local governments in federal systems such as Brazil. Companies located in the member countries are given treatment equal to that afforded to national firms as regards their participation in public tenders. Additionally, offers from MERCOSUR countries will have preference over third countries.

The protocol's main features are:

- Scope of application. It is applied to public tenders of federal and subnational bodies for the acquisition of goods and services, including public works, in line with predefined lists, indicated bodies and reserves, and specified limits.
- National treatment. Each member country will treat products and services from other MERCOSUR members no less favorably than it does its own goods, services and public works, and its own suppliers and service providers.
- Intra-MERCOSUR preference. Goods, services and public works from the MERCOSUR countries will have the right to preference over those from outside MERCOSUR in tenders. This preference will be effected through the opportunity that MERCOSUR countries have to enter a bid that is equal to the best offer, as long as the price difference is not above 3%. In the event of a draw, MERCOSUR suppliers will have priority over those from other countries. In the event of a draw between MERCOSUR

countries, a new price offer will be requested. If the draw persists, the winner will be decided by public lottery.

- Entry into force. The protocol will enter into force for the first two countries that ratify it 30 days after the second instrument of ratification is deposited. This has not yet happened. For the others, the protocol will enter into force 30 days after the deposit of the corresponding instruments of ratification.

Trade defense

Ideally, a customs union should have a common trade defense policy towards third countries, while intra-bloc trade relations should be regulated by a single policy to uphold competition, as happens among companies in the same country. As Rios [2003] notes, however, "establishing a free trade area that includes economies with such asymmetrical productive structures as Argentina, Brazil, Paraguay and Uruguay is a difficult undertaking. If the integration process unfolds in the context of diverging macroeconomic policies (significant exchange rate variations that abruptly change the conditions of competitiveness between the countries, in tandem with a lack of agreed mechanisms to overcome circumstantial sectoral difficulties), the environment is very propitious for the adoption of unilateral *ad hoc* measures as a means of dealing with the pressures of sectoral lobbies.

Recent events make plain that the convergence of macroeconomic policies is a necessary but insufficient precondition for the formulation and implementation of a policy of trade defense that is consistent with the concept of a customs union. One explanation of this, according to Rios [2003] is the modest degree of commitment on the part of the member countries' national bureaucracies to comply with agreed rules, and the low level of pro-integrationist thinking in the formulation of new policies.

Argentina's decision showed that despite the new government's repeated declarations of support for MERCOSUR, practices for securing concessions remain unchanged. In the technical and preparatory meetings before the summit, the Argentine representatives advocated the creation of an automatic mechanism ("trigger") that would come into effect whenever the difference in GDP growth or the exchange rate to the dollar between two countries surpassed a pre-set level. This would allow the affected country or countries to impose trade restrictions. This idea was rejected by Brazil, but the country partly agreed to Argentina's position with the creation of a bilateral trade monitoring group to promote occasional interventions in sensitive areas.

Argentina's reaction reveals that the partial solution was unsatisfactory. Although protectionist measures have not been applied immediately – in the hope that the private sectors can reach a "voluntary" agreement – all the signs are that domestic appliances among white and brown goods will be added to the list of disputes among the countries, which already include trade in sugar, poultry, footwear and textiles, among others.

The customs union agenda in the MERCOSUR Relaunch in 2000 included the investigation and application of antidumping measures and countervailing duties in intra-MERCOSUR trade. Decision 28/00 instructed the CMG to draw up a proposal for regulating these measures and for gradually eliminating them. In 2002, in an effort to discipline this area of intra-MERCOSUR trade, the CMC decided to adopt (in the MERCOSUR framework) the WTO's Agreements on Antidumping and Countervailing Duties. The proposal for the gradual elimination of these measures still has not been presented.

In June 2003, Decision 10/03 extended the deadline for the CMG to submit the proposal to November 30, 2004. The MERCOSUR Work Program 2004-2006, approved in December 2003, stipulated that the CMC should define the mechanisms and conditions conducive to the elimination of intra-MERCOSUR trade

defense instruments as of 2006. The CMC must also determine the changes to the Protocol on the Defense of Competition and present a program for its entry into force as of 2005, including trade in services.

During the Puerto Iguazú Summit, Brazil and Argentina agreed to hold a ministerial meeting in an effort to coordinate their industrial policies and narrow the scope for trade disputes. Despite its more flexible position, Brazil remained opposed to the use of a "trigger" leading to the imposition of trade safeguards. This episode reveals that MERCOSUR still lacks an effective dispute settlement mechanism.

Disciplining trade with extra-MERCOSUR countries has consisted of analyzing draft common regulations on protection against antidumping and subsidies. The MERCOSUR Work Program 2004-2006 stipulates that the regulations should be completed before the end of 2004. The Common Regulation on Safeguards should enter into force during 2004.

Argentina's Restrictions on Imports of Domestic Appliances from Brazil

On July 1, 2004, two days before the start of the MERCOSUR summit, the Argentine Economy Minister, Roberto Lavagna, and the Secretary of Industry, Alberto Dumont, announced that the entry into the country of freezers, cookers and washing machines from Brazil would depend on the granting of non-automatic import licenses and a 21% tax would be imposed on imports of televisions from the free zone of Manaus.

Minister Lavagna justified this unilateral decision on the grounds that it was necessary to protect local industry and a time when, because of immediate economic conditions, the entry of Brazilian products would hamper industrial recovery and would compromise job-creation in Argentina. The measures were taken after the failure of Argentine producers to secure voluntary restrictions on Brazilian exports in the Bilateral Trade Monitoring Committee.

The restrictions surprised Brazilian authorities and intensified feelings within the local private sector. The president of the National Association of Manufacturers of Domestic Appliances, Paolo Saab, stated that the private sector had exhausted all possibilities of negotiation and that if the situation persisted the Association would take the necessary measures (*Valor Económico*, July 6, 2004).

During the summit meeting, it was agreed that Argentina would not put the restrictions in place without first engaging in negotiations to resolve the problem between the governments and private sectors. The meetings were held within 10 days of the summit and addressed each product separately. For freezers, a working group was set up and given 60 days to establish the scale of the Argentine market; Brazil would then have 50% of it. A quota of 42,370 units was set for Brazilian exports in the period between July 19 and September 19. In the case of cookers, Brazilian exports would be limited to 90,000 units in 2004 and 47,500 in the first half of 2005.

There was no agreement on washing machines. The Argentine government then complied with its commitment to the local private sector and effected the demand for non-automatic licenses. This demand, prior to the import of washing machines, entered into effect on July 23 and will be used to adapt the level of imports to the level demanded by Argentine producers (50,000 units to the end of 2004). This measure could expedite the imposition of barriers to the entry of Brazilian products since it refers not only to domestic appliances but can also be applied to other products.

The value of Brazilian exports of domestic Appliances to Argentina and grew very significantly in 2003. That circumstance, however, is wholly explained by a very low base of comparison (2002). As Table IV.1 shows, with the exception of refrigerators, Brazilian exports of domestic appliances in 2003 were still substantially below the annual averages recorded in 1997 and 2001.

TABLE IV.1
BRAZILIAN EXPORTS TO ARGENTINA
(US\$ millions FOB)

	Cooking and heating equipment		Refrigerator-freezers		Domestic compression refrigerators		Washing machines/up to 10kg	
	Value	Growth %	Value	Growth %	Value	Growth %	Value	Growth %
1997	13,332		9,620		12,383		16,735	
1998	12,761	-4	8,269	-14	14,712	19	14,832	-11
1999	13,663	7	7,926	-4	17,100	16	26,037	76
2000	19,528	43	13,765	74	12,020	-30	28,526	10
2001	19,788	1	15,594	13	12,404	3	20,861	-27
2002	1,754	-91	3,128	-80	2,618	-79	2,796	-87
2003	8,770	400	35,742	1,043	7,561	189	15,444	452

Source: MDIC.

Institutional structure

As regards MERCOSUR's institutional structure, the main step forward was the entry into force, on January 1, 2004, of the Protocol of Olivos on dispute settlement. This was signed in February 2002 because of the need to enhance the dispute settlement mechanisms established in the 1991 Brasilia Protocol. Its entry into force in January was made possible by its transposition by Brazil, the last member country to ratify it.

Its main innovation is the creation of a Permanent Review Tribunal. This is a second level in the dispute settlement process. The first remains the *ad hoc* tribunals formed especially for specific cases. In the event of divergence between the rulings issued by these tribunals, any of the parties involved in the dispute can resort to the Permanent Tribunal (PO, Article 17, 1).

The Permanent Review Tribunal offers greater legal security to the dispute settlement system and ensures a review of rulings, thereby facilitating an accumulation of experience that enables disputes to be handled more expeditiously. In the *ad hoc* tribunals, that accumulation of experience was compromised because the tribunals dissolved after the end of the dispute that had led to their being formed.

The consultative opinions, introduced by the implementing regulation of the Protocol of Olivos, comprise an important tool to standardize the interpretation of MERCOSUR law. The consultations can be elevated by the member countries' supreme courts with national jurisdiction to the Permanent Review Tribunal on all matters related to the legal interpretation of MERCOSUR law. This mechanism still depends on an implementing regulation on the part of the member countries' supreme courts.

The Protocol of Olivos has been in effect for only a short period and thus its effectiveness in settling intra-MERCOSUR disputes cannot be assessed. Note that the arbitration procedure contemplated in the Protocol of Olivos still does not amount to a permanent dispute settlement system as mentioned in point 3 of Article III of the Treaty of Asunción. Article 53 of the protocol makes explicit provision for a review of the current system "before the end of the process of convergence of the common external tariff". According to CMC Decision 07/94, this process should end on January 1, 2006. This means that MERCOSUR must shortly begin to undertake the studies needed to fill the gaps in, and correct the weaknesses of, the current system.

One of those weaknesses is the prevalence of the thinking behind the arbitration mechanism. According to the MERCOSUR Secretariat, "justice by arbitration does not avert the plurality of applicable rights ... which can stem from a minimalist application of MERCOSUR rules" (MERCOSUR Secretariat, 2004).

The Secretariat suggests that the current mechanism should be replaced by another of a juridical nature, whose decisions would be binding on national judges. This is a risky proposal because MERCOSUR, since its founding, has avoided the creation of supranational institutions in a context in which the commitment of national actors to integration still seems to be insufficient to allow such subordination.

Another mechanism that should be superseded by a permanent dispute settlement system is the forum included in the Protocol of Olivos. Article 1 of the Protocol establishes that if the dispute can be submitted to the MERCOSUR dispute settlement system and to the WTO, the plaintiff country should opt for one of those mechanisms, whereupon the other is automatically and definitively precluded. This is not compatible with a full integration process, since the forum option allows for the review of MERCOSUR law by independent international organizations.

The provisions for dealing with complaints lodged by individuals are also weak, since the Protocol of Olivos, like the Brasilia Protocol, renders them subject to the control of the National Sections of the GMC. A dispute settlement system that is confined to "state-against-state" claims is not consistent with the dynamic of an integration process such as MERCOSUR's, since political interests tend to prevail in such claims.

From the institutional perspective, too, mention should be made of the change in the nature of MERCOSUR's Administrative Secretariat. Since it was created, the Administrative Secretariat has gradually expanded its functions. By virtue of Decision 30/02 it was slowly transformed into a technical secretariat on the grounds that "the current needs of the integration process demand institutional progress that makes possible the formation of a technical advisory body, one that can undertake actions with a joint outlook and help the consolidation of MERCOSUR". In item 1 of Annex 1 of the same Decision, the member countries stipulated that the goal of the Secretariat's Technical Advisory Section is to "contribute to the creation of an arena for joint reflection on the development and consolidation of the integration process". In line with these new functions, the Secretariat published its first biannual report in July 2004, entitled "A Focus for the Regional Integration Process". It is an open question if the shortage of resources for the Secretariat will limit the scope of the initiative to transform it into a full technical body.

The Internal Agenda and the 2004-2006 Work Program

In June 2003 in the first summit after the assumption of office by the new governments in Argentina and Brazil, the Brazilian government presented "Objetivo 2006", a work program geared to the consolidation of the customs union and the promotion of the common market. The program was approved with modifications by CMC Decision 26/03 in December of that year.

The program was divided into blocks (economic-commercial, social and institutional), and a new integration agenda is included issues related to cooperation on science and technology and progress on physical and energy integration. The social dimension gained importance since it had become plain that it is crucial to increase the participation of civil society in integration matters. Prominent among the activities of this block, because of their importance to the creation of the common market, are those related to the movement of labor and the promotion of workers' rights.

Above all, the work program covers MERCOSUR's internal agenda. It seeks to move forward objectively (by setting deadlines in defining authorities) in the elimination of the main obstacles to the consolidation of the customs union and the common market in the subregion. The main activities of the program are summarized below.

Economic-commercial block

CET

- In the first half of 2004 the MERCOSUR Secretariat will draw up a proposal on mechanisms to eliminate the double levying of the CET and to resolve the matter of the distribution of customs revenue.
- To complete, before 2006, analysis of exceptions to the CET and the negotiation of common rules to find the ways and timeframes for tackling this matter.
- To identify, in the first half of 2004, the priority sectors for the establishment of special, joint import regimes.

Customs matters, intra-MERCOSUR trade

- In the first half of 2004, the CCM will identify the basic conceptual aspects of the MERCOSUR Customs Code that need to be defined by the CMG.
- Before the end of 2004, to continue to simplify and harmonize intra-MERCOSUR customs procedures.
- In the first half of 2004, to establish a mechanism for the free movement within MERCOSUR of a group of products that are unquestionably the result of regional production.
- During 2004, to draw up a rule that allows for the accumulation of productive processes in MERCOSUR, that makes provision for the treatment to be given to imports that originate within MERCOSUR and in extra-MERCOSUR sources, as well as other matters involved in this issue.

The defense of trade and competition

- Conclusion of the common regulations for the application of antidumping and countervailing duties before the end of 2004.
- Entry into force of the common regulation of safeguards in 2004.
- The CMC must determine the changes to be made to the Protocol on the Defense of Competition and submit the program with a view to its entry into force in 2005. Services trade will also be considered in this context.
- The CMC must define the mechanisms and conditions for the elimination of trade defense instruments as of 2006.

Productive integration

- To continue with the undertakings of the Program of the Forum on Wood and Furniture, and in 2004 to develop other fora in those sectors identified as priorities.
- In 2004, to analyze the implementation of financing instruments to support projects to emerge from the Competitiveness Fora.

Structural funds

During 2004, to promote the studies needed for the establishment of structural funds in MERCOSUR, designed to raise the competitiveness of the smaller partners and of the less developed regions.

Border integration

- To ensure the implementation of flexible mechanisms for the development of border areas in the integration process, including trade in services between MERCOSUR's border cities.

Joint promotion of extra-MERCOSUR exports

- To continue with joint trade missions, such as those to South Africa and Mexico, with a view to identifying new markets in the framework of the REPCCM. There should be at least one trade mission a year.

Assessment of the conformity of products and technical regulations

- To make further progress in 2004 in the conclusion of agreements on mutual recognition and mechanisms to assess the conformity of groups of products or sectors with MERCOSUR norms that are already harmonized. The aim is to avoid the duplication of verification and certification procedures.

Discipline on incentives

- To define additional disciplines applicable to incentives for production, investment and exports, conditioning all levels of government to gradually limit the use of incentives that distort the allocation of resources, competition conditions and the operation of the MERCOSUR enlarged market; or, to allow the adoption of measures that eliminate or offset distortionary effects as of 2006.

Tax harmonization

- In the first half of 2004, promote meetings of tax specialists to tackle the issue of the member countries' indirect taxes on intra-MERCOSUR trade flows.

Business facilitation

- Before July 2004, to identify the mechanisms needed to facilitate the establishment and development of business activities in MERCOSUR in the areas of establishing companies, business visas, the harmonization of the sums demanded of investors and the establishment of MERCOSUR companies, among other things, so as to institute feasible instruments in these fields in the first half of 2005.

Government procurement

- Continue with pending activities for the effective implementation of the Protocol on MERCOSUR Government Procurement.

Social block

Participation of civil society

- To foster a broader participation on the part of civil society, mindful of the proposal submitted by the Economic and Social Consultative Forum (FCES) on October 3, 2003.

Movement of labor and the promotion of workers' rights

- In 2004, to assess the inter-relation of the various agreements signed or under negotiation on the free movement of citizens of the member states, with a view to analyzing the possibility of consolidating them into a single document, without prejudice to the approval of the instruments already negotiated on movement of people.
- To take the necessary steps at the highest level to put into effect the Agreement on Residency for MERCOSUR Nationals and the Agreement on the Regularization of Migration for MERCOSUR citizens before the end of 2004.
- Before the end of 2004, to submit proposals geared to promoting workers' rights in MERCOSUR.
- To assess the degree of application of compliance with the Socio-Labor Declaration in the member countries (Article 20, point e).

Education for MERCOSUR

- To further the negotiations for the mutual recognition of professional qualifications in the member countries, thereby allowing the movement of professionals and the performance of their activities, and to engage in cooperation programs with a view to improving educational levels in MERCOSUR.

Institutional block

MERCOSUR Parliament

- In 2004, to consider the Joint Parliamentary Commission's proposal on the establishment of a MERCOSUR Parliament, considering as a first stage the Inter-institutional Agreement signed by the CMC and the Commission.

Institutional strengthening

- In 2004, complete the work on the implementing regulation of the Protocol of Olivos.
- To set up the MERCOSUR Permanent Review Tribunal, providing it with the necessary infrastructure and resources for it to exercise its functions.
- To strengthen the participation of the private sector in the MERCOSUR integration process.
- Before the end of 2004, to complete the transformation of the MERCOSUR Secretariat into the Technical Secretariat.

C. The Puerto Iguazú Summit

The events that preceded the presidential meeting of MERCOSUR heads of state on July 8 and 9 in Puerto Iguazú, Argentina, cast a shadow on the climate of optimism that had prevailed in the negotiations during 2003. The convergence of exchange rate policies among the member countries, the recovery of economic growth in the region, and the assumption of power on the part of heads of state who were explicitly favorable to the bloc had created a climate that was auspicious for intra-MERCOSUR understanding. This was apparent, for example, in the effort to readdress MERCOSUR's internal negotiating agenda.

Argentina's announcement that it would adopt unilateral measures to restrict imports of domestic appliances from Brazil was the tip of the iceberg. Other sectors, such as producers of pigmeat, poultry, textiles, footwear, automobiles and agricultural machinery, also announced their intention of pressuring the Argentine government to seek new concessions. Those events prompt two conclusions. The first is that the "goodwill" of the heads of state does not necessarily reflect a national consensus that is sufficiently broad to withstand the political pressure of sectoral lobbies. In an economic integration process, it is essential that the countries involved foster their comparative advantages, a circumstance that always leads to changes in the productive structure and to localized losses. Hence the need to build a consensus, so as to obviate the danger that the reaction of those who lose might prevail over the gains for society as a whole.

The second conclusion is that MERCOSUR still lacks appropriate instruments to tackle the structural problems attendant on the economic asymmetries among the countries of the region. The succession of crises affecting Argentina and Brazil in the second half of the last decade diverted the focus of the discussions towards immediate problems, such as those arising from sudden and pronounced changes in exchange rates. The good news is that once adverse economic circumstances had been overcome, attention focused once more on the internal agenda, where the possibility of permanent progress on integration resides.

In the joint declaration of the Puerto Iguazú Summit, the Presidents of the member countries restated the importance of furthering macroeconomic coordination with a view to consolidating MERCOSUR as an economically stable area. They reiterated the need to ratify and promote the entry into force of the Montevideo Protocol on Trade in Services. The liberalization of services trade was particularly prominent. The Presidents pledged to identify and eliminate the measures that do not need legislative treatment and that restrict access or discriminate against service providers in the MERCOSUR countries.

The decisions approved in the twenty-sixth meeting of the CMC reflected fulfillment of the Work Program 2004-2006, although less progress was made than had been thought possible before the meeting. In particular, there was no decision on the problem of the double levying of the CET. The Council confined itself to taking note of the preparation of a preliminary study by the MERCOSUR Secretariat that included different scenarios for resolving this problem and for the distribution of customs revenue.

The double levying of the CET is an aberration. The importer pays the tax when a good enters from abroad and is obliged to pay it again if that good is transported from one MERCOSUR country to another. The Secretariat's study includes different strategic options for resolving the matter, and offers various alternatives with different degrees of ambition.

One important aspect of the meeting was approval of Decision 22/04 "Entry into Force and Application of the Rules Issued by MERCOSUR Decision-Making Bodies" that do not require legislative approval. Approval of this decision should enable a more streamlined application of MERCOSUR regulations.

By Decision 17/04, the CMC approved the creation of the Special Fund for Dispute Settlement contemplated in Article 36 of the Protocol of Olivos. The fund will be managed by the MERCOSUR Secretariat and will be used to meet the costs and fees incurred by the activities of the judges in the *Ad Hoc* Arbitration Tribunals

and the Permanent Review Tribunal. At the same time the CMC approved Decision 26/04, which designates the judges of the Permanent Review Tribunal, and instructs the GMC to analyze the possibility of paying the Tribunal's members on a monthly basis. These decisions complete the main mechanisms for the entry into force of the dispute-settlement system foreseen in the Protocol of Olivos.

D. The Internal Agenda: What has Been Defined and What Needs to be Reconsidered

The last two years have presented both challenges and opportunities to MERCOSUR. The opportunities emerged from the convergence of the member countries' exchange-rate policies, from the recovery of economic growth in the region, and from the election of new governments whose discourse was more favorable toward MERCOSUR than had been their predecessors. In the first summit held in this new context, in June 2003, the heads of state of the MERCOSUR countries reaffirmed their commitment to the ideal of a common market in the region. Following the economic crisis that struck Argentina and Brazil, and that led to MERCOSUR's most serious identity crisis since the signing of the Treaty of Asunción, the return to the original integration model on the part of the new Argentine and Brazilian governments was seen as a promising sign. Equally positive for the future of the bloc was the explicit acknowledgement of the need to tackle the existing development asymmetries among the member countries with due flexibility.

That acknowledgement allowed MERCOSUR's internal agenda to be unfrozen. At Brazil's initiative, a work program for the 2004-2006 period was presented and approved. This establishes targets and deadlines for complying with the various issues on the agenda. Common trade defense, the elimination of antidumping and countervailing duties in intra-MERCOSUR trade, the application of a common discipline on incentives, the harmonization of microeconomic indicators and the strengthening of MERCOSUR's institutional structure were issues placed on the agenda with proposals for action, much of which should be completed before the end of 2004.

Recent events reveal that the integration process still faces significant challenges. Despite the return to economic growth, or because of it, representatives of Argentina's private sector have argued that Brazil's mechanisms to support industry and exports spuriously distort competition within MERCOSUR and justify the adoption of protectionist measures. The dispute makes it clear that, in a context of economic integration, internal policies – such as industrial support strategies – cannot be implemented unilaterally without prior discussion or negotiation with partners in the integration process. This is particularly true when the differences in industrial productivity are so clear.

Brazil has taken a conciliatory position. In press statements, Foreign Minister Celso Amorim has indicated that Brazil does not want an economic war with Argentina and will be patient in resolving bilateral trade tensions (*Valor Económico*, July 15, 2004). Nonetheless, if protectionist pressures lead to the usual solutions of limiting exports, this could be a setback in the construction of the customs union.

Despite the official positions, belief in the benefits of integration among the MERCOSUR countries still seems to be insufficient. This makes the local governments particularly vulnerable to pressure from sectors they feel themselves to be at risk. Recent episodes seem to have had a positive outcome in the sense that there has been a more appropriate and consequent reflection on the main obstacles to integration; without such reflection, MERCOSUR would lose even less backing from regional society.

The Brazilian government realizes that the crisis between Brazil and Argentina is a structural problem. Hence Brazil's government hopes, during the period in which it holds the *pro tempore* presidency of MERCOSUR, to pursue economic integration by motivating the distribution of productive chains among the countries. Brazil, for example, acknowledges the need to review MERCOSUR's financing mechanisms so as to avert the disparity in access to credit, which these days is very limited in Argentina.

According to the adviser on international relations of the Brazilian presidency, Marco Aurelio Garcia, the Brazilian government has three priorities: strengthening MERCOSUR's structures; accelerating the ministerial meetings in the search for economic integration, especially with Argentina; and revising the financing instruments. With regard to this latter point, the options under study are the creation of a BNDES for MERCOSUR, the reactivation of the Fund for the Development of the River Plate Basin (FONPLATA), and joining the Andean Finance Corporation (CAF) (*Valor Económico*, July 16, 2004).

Building the new agenda

Beyond the government sphere, there have been several notable initiatives to rethink MERCOSUR. One of these was the conference entitled "MERCOSUR: In Search of a New Agenda", which was held in Rio de Janeiro in June 2003 with the sponsorship of the IDB. The conference report summarizes the reflections and suggestions of several of the specialists who took part.

According to the report (Crawley, [2004]), the determinants of MERCOSUR's new agenda are essentially three-fold: the regional and extra-regional environment; the attitude of subregional elites towards the strategies adopted to ensure their countries' international insertion; and MERCOSUR's past experience. As regards this latter issue, particularly important are the various intra-MERCOSUR trade disputes and the deficiencies of the institutions established to mediate them; the devastating impact of excessive fluctuations of exchange rate among the member countries; and structural characteristics such as asymmetries of size.

The message to emerge from this background is that in order to deepen the MERCOSUR integration process, the future agenda should concentrate on three groups of essential elements:

- the elimination of the main non-tariff barriers, institutional agreements, and the systems needed to make rules;
- construction of a common view of what MERCOSUR is and where it is going;
- exchange rate matters, microeconomic coordination and the formulation of a common trade policy.

There was broad consensus about two matters in particular: the need to overcome the bloc's institutional deficit and to institute the customs union. The institutional deficit stems from MERCOSUR's origins. The member countries took this option for various reasons, including the negative experience of Latin American integration institutions, budgetary constraints on the financing of supranational organizations, and the belief that the size asymmetries among the economies involved was a structural obstacle to the creation of supranational institutions, since such an endeavor could entail an unequal constraint on the sovereignty of the member countries.

MERCOSUR's low institutional profile was adequate when the main issues were commercial or tariff-related. The integration process unfolded on the basis of a program of widespread tariff-reduction that operated automatically, based on pre-established percentage cuts. This minimal institutional structure proved itself inadequate to address more complex matters. The inter-governmental foundations and policy that predominates in all levels of MERCOSUR's operations expand the sectoralist outlook with which government negotiators tackle integration issues. Aside from that, the costs incurred by the member countries as a result of the prevalence of the inter-governmental model are significant, and probably higher than would be incurred if the countries were to adopt an efficient supranational model (MERCOSUR Secretariat [2004]).

The second issue is the need to resolve the dilemma between the free trade area and the customs union. As an intermediate stage in the transition towards deeper integration, a customs union has the advantage of being more transparent and having lower operational costs than a free trade area, and it is more attractive

for foreign investment and for the bloc's external agenda. Abandonment of the customs union would be a backward step, and would have a substantial negative effect on the member countries' credibility in terms of their adherence to rules and contracts. Insisting on progress in the customs union, therefore, is a crucial point on MERCOSUR's agenda.

The MERCOSUR Secretariat, invested with technical functions and with the mission to identify deficiencies, gaps and difficulties, as well as to propose courses of action, has recommended the adoption of a schedule geared to prohibiting any direct or indirect mechanism that leads to quantitative restrictions on goods traded among the partners. According to the Secretariat's first biannual report, "it is unreasonable that import tariffs are reduced and that the members are allowed to replace them with instruments that create a greater distortion of trade". The Secretariat's suggestions, which do not reflect the exclusive interest of any member country, aim to deepen the customs union and reduce the frequency of disputes within MERCOSUR. The elimination of trade barriers within the bloc extends investment and growth opportunities to all the countries of the region with the division of the stages of the production chains. The main suggestions are as follows.

Suggestions of the MERCOSUR Secretariat*

- (i) Devise a calendar to eliminate non-tariff barriers among the partners.
- (ii) Prohibit any direct or indirect quotas mechanism for the partners' products.
- (iii) Eliminate official incentives for exports from one MERCOSUR country to another.
- (iv) Extend free trade in sugar and automobiles.
- (v) Eliminate the double levying of the CET.
- (vi) Establish a schedule to eliminate rules of origin in trade among the member countries.
- (vii) Adopt gradual measures to unify the member countries' monetary policies, culminating with the adoption of a single MERCOSUR currency.
- (viii) Create a virtual development bank and MERCOSUR, through the association of the national development banks.
- (ix) Use part of the import tariffs to set up a fund to help finance the development of the smaller countries.

* Taken from the First Biannual Report of the MERCOSUR Secretariat: "Un foco para el proceso de integración regional".

In sum, according to Rio [2003], " the decline in the external and internal credibility of MERCOSUR is a result of the past is chosen by the partners to tackle the unfavorable internal and international conditions of recent years. The excessive flexibility lesson differences, the lack of action on the agenda to deepen the bloc, and the absence of assured view of the role of integration for the development strategies of the four member countries are factors that have distorted the original project". A successful strategy to deepen MERCOSUR integration should reflect the priorities of the national economic agendas, such as increasing exports and employment. The external agenda, which provides MERCOSUR's main source of cohesion, has proved itself inadequate to deepen integration.

CHAPTER V. TRENDS ON THE EXTERNAL AGENDA

The negotiations in which MERCOSUR is involved for the FTAA and with the EU made little progress. In fact, both sets of negotiations are practically paralyzed: MERCOSUR has found it difficult to secure concessions on agriculture, and its offers have been of limited scope, not only in terms of access to goods markets but also in other areas of interest, such as services and government procurement. The fact that progress in these negotiations has been made conditional on the outcome of the Doha Round also hinders the US and EU adoption of more flexible positions in the talks with MERCOSUR. Nevertheless, efforts continue to be made to expand the network of bilateral and plurilateral agreements, both in the Americas and with strategic partners such as South Africa, China and India. As a result of these initiatives, MERCOSUR finally concluded its agreement with the Andean Community (CAN), while Mexico and Peru joined the group as associate members.

A. The FTAA Negotiations

The eighth meeting of trade ministers of the Americas in Miami in November 2003 determined that the FTAA initiative would lead to a "light" or "à la carte" agreement. The final declaration drawn up by the negotiators presents a proposal for a two-level FTAA: the first stage defines a broad agreement that establishes the rights and obligations of the participating countries; in the second stage, the countries will negotiate a network of plurilateral agreements between groups of two or more countries willing to accept deeper commitments in specific areas. In reality, this means that the countries can assume different levels of commitments in the FTAA. According to the ministers, therefore, one possible line of action henceforth is that those countries undertake plurilateral negotiations in the FTAA, defining individual obligations in specific areas. The idea is that the negotiations should lead to a balanced agreement that takes account of the differences in size and development levels among the countries of the Western Hemisphere by means of various provisions and mechanisms.

This progress, however, does not mean that the 34 participating countries will meet the January 2005 deadline for instituting the free trade area, although the Miami ministerial declaration had reaffirmed the commitment of all countries to complete the FTAA negotiations successfully by that date. In practice, that deadline proved to be technically unfeasible. The trade ministers' final declaration at the end of that meeting established only a general framework defining the parties' rights and obligations, which means that in the negotiators' jargon the "substantive negotiations" have not even begun. At that time there was a clear perception that any attempt to approve a document with more precise proposals on the substance of the negotiations could lead to a new impasse in the talks.

Thus the meeting of the Trade Negotiations Committee (TNC) in Puebla in the first week of February made plain that there were differences on the basic substance of the accords. There was no consensus on the set of products that would be subject to negotiation. MERCOSUR advocated the inclusion of 100% of the tariff schedule in the negotiations, which entailed consideration of all products in the tariff-reduction calendar. The United States and other countries from the G-14 (including Canada, Mexico, Costa Rica and Chile) proposed negotiating market access for only a "substantial part" of the tariff schedule, which represents somewhere between 80% and 90% of the goods that could be traded among the countries. Moreover, the US negotiators suggested that the degree of opening in the goods market should be conditional on concessions that the others were willing to make in areas such as services, intellectual property and investment.

Other differences involved the following matters: (i) the prospect of including additional provisions on basic rights and obligations once the FTAA entered into force, a rule advocated by the G-14 but contrary to the MERCOSUR position; (ii) the negotiation of special agricultural safeguards in the event of changes in import prices or volumes, without having to demonstrate harm, as in the Chile-United States trade

agreement but opposed by the G-14; this mechanism is deemed unacceptable by the MERCOSUR countries; (iii) the US desire for rising quotas for goods traded through this instrument, rather than the gradual reduction of tariffs – a position that met with resistance from the MERCOSUR countries.

Agriculture remains the main cause of the current impasse in the negotiations. While the United States seems little willing to eliminate agricultural subsidies or seems ready to negotiate compensation for the use of domestic agricultural support measures, the US negotiators suggest that the other countries should secure easier access to the US market for agricultural goods if they are willing to implement agreements on intellectual property, investment and government procurement. This is precisely the kind of conditioning that the MERCOSUR representatives have opposed. They resist the conditioning of market opening on the elimination of barriers and the adoption of policies on investment, government procurement and intellectual property that are consistent with US interests. The MERCOSUR governments are only willing to accept new rules in these areas through the WTO.

Brazil's private sector, however, represented by the Brazilian Business Coalition, has pressured the government to review this position in exchange for the easier access for Brazilian goods promised by the US negotiators. The positioning of some members of the Brazilian government reveals their complete skepticism towards the prospect that the Americans will become more generous in opening their market to MERCOSUR agricultural goods. With reference to the terms of the trade agreements that the United States has recently concluded with Australia and the Central American countries (members of the CACM), the then-Ambassador of Brazil in Washington, Rubens Barbosa, stated unambiguously that " ... there is no hypothesis that concessions on industrial goods, services or rules and disciplines of interest to the United States can be rewarded with real opening of the US agricultural market in areas that interest us most ...". This is to judge by the precedent of the agreements negotiated by the United States with the Australians and the Central Americans, involving products such as sugar, meat and dairy goods.

In line with the TNC declaration, throughout the first half of 2004 several delegations engaged in informal consultations with a view to devising guidelines for the FTAA negotiating groups. The aim was to draw up a common and balanced set of rights and obligations applicable to all countries, as well as procedures for the plurilateral negotiations among countries that want to liberalize, and additional disciplines in the FTAA, all of this consistent with the Miami ministerial declaration.

Some delegations asked for more time to continue informal consultations. In view of the complexity of this endeavor and the evident goodwill, the TNC's co-chairs viewed the proposal positively. After the mini-meeting among the negotiators in Buenos Aires in the first week of March, it was decided to postpone to April 22-23 the new meeting of the TNC originally scheduled for March 18-19 in Puebla. Again, the lack of progress in the agricultural negotiations led to an impasse that placed the MERCOSUR countries and the United States on opposite sides. The US government indicated its willingness to eliminate agricultural export subsidies as long as it retained the right to grant them again if countries were to import commodities from countries or regions that subsidize their producers. The MERCOSUR representatives were skeptical about this proposal.

The vice-ministerial meeting in Buenos Aires in the first week of June highlighted the deepening of the impasse between Brazil and the United States, the co-chairs of the negotiations. The United States, which until then was willing in principle to accept zero tariffs on agricultural products from the countries of the region within ten years, indicated that some agricultural goods should be excluded from the agreement. That is, the US negotiators sought to create a special basket of products on which tariffs would never be completely eliminated.

Another obstacle to the negotiations arose in July, when Peter Allegeir, the Deputy US Trade Representative, announced that thenceforth the US priority would be the negotiation of an agricultural agreement in the

WTO. Only then would the country return to the FTAA negotiations on the matter. This position led to the *de facto* paralyzation of the Western Hemisphere talks. The MERCOSUR negotiators considered the regional talks to be at a standstill because of the US attempt to exclude some products from agricultural liberalization in the FTAA, and because of the US effort to make the discussion on intellectual property rules conditional on concessions in areas of interest to the countries of the region. In this context it was hard for the substantive talks to resume before the US elections.

B. The MERCOSUR-European Union Negotiations

MERCOSUR-EU relations are currently based on the Inter-regional Framework Cooperation Agreement that entered into force on July 1, 1999. Its main aim was to prepare the negotiations for an Inter-regional Association Agreement that would create a free trade area between the two blocs.²⁵

That accord is very important for both, since the EU is MERCOSUR's main trade partner in terms of both exports and imports. Between 1980 and 2002, Europe's imports from MERCOSUR grew by an annual average of 5.3%, while EU exports to the region increased by 5.2% a year. In 2002, EU-MERCOSUR trade accounted for 2.4% of the former's total imports and 1.8% of its exports. In the same year MERCOSUR ranked second as a source of EU imports and fifth as an export destination. It bears repeating that about half of all MERCOSUR exports to the EU comprise agricultural and agro-industrial products. In 2002 they represented 16.04% of EU imports in those sectors.

Despite the political interest in concluding an inter-regional agreement (as reaffirmed on several occasions by the MERCOSUR foreign ministers and the European trade commissioner), since 2001 the negotiations have moved very slowly. The two sides first exchanged liberalization offers on goods in June 2001. Both proposals were deemed unsatisfactory. In particular, the MERCOSUR negotiators regarded the European proposal as especially modest for agricultural goods. This was precisely the area in which MERCOSUR had most interest, because of the importance of such products in the composition of the region's exports to Europe. In practice, these were constrained by a variety of protectionist measures – from subsidies for various kinds of crops to health restrictions designed expressly to exclude goods from large, non-EU producers.

As a result of MERCOSUR's dissatisfaction with the European proposal, in October 2001 MERCOSUR made an even more modest counter-proposal that sprang mainly from Argentina's extremely defensive position at that time.

Later, at the ninth meeting of the Biregional Negotiations Committee (BNC) in Brussels on March 17-21, 2003, significant progress was made. This was particularly true in the area of market access for goods, the result of a substantial improvement in the proposal made by MERCOSUR, which facilitated the creation of a solid basis for the subsequent discussions. In other areas, such as services and investment, government procurement, dispute settlement and e-commerce, there was also progress in the consolidation of the texts, although differences between the parties persisted. At the same time, the participating countries also discussed the preparation of an Action Plan for Business Facilitation.

As regards the initial offer on market access for goods presented by MERCOSUR in October 2001 scarcely 39.2% of the products, accounting for 32% of MERCOSUR's imports from the EU, were included among

²⁵ The agreement between MERCOSUR and the EU differs from that being negotiated in the FTAA, since it also includes scientific and technological exchange and the expansion of political understanding. This is because inter-regional integration seeks to cover, as well as trade relations, political and cooperation links between the two regions. Because of this broader object, the EU has become the main source of resources for MERCOSUR. Funds dispersed by the EU for regional and bilateral cooperation with MERCOSUR in the 2000-2006 period amount to about 250 million euros.

the products, divided into five "baskets" with defined treatment and a tariff-reduction schedule that was to be completed in a maximum of 10 years. In 2003, the revised offer included, in the five "baskets", 85.5% of the products, accounting for 83.5% of MERCOSUR's imports from the EU (Table V.1).

The widening of the MERCOSUR offer stemmed largely from the inclusion, in the basket of products with more conservative tariff-reduction schedule (Basket E), of a large number of tariff items for which no treatment had been defined in the first offer. In all, the total number of items in the basket rose from 116 to 2,752, an increase of 2,636 items. There was also an increase in the number of products included in the category of tariff-elimination within eight years, with one year's grace period. This comprised Basket C. The number of items in this category rose from 610 in the initial offer to 1,395 in the new offer, an increase of 785 items.

Nonetheless, MERCOSUR's offer remained quite conservative, both as regards its internal composition and in terms of the proposed calendar for tariff-reduction. This is because in MERCOSUR's revised offer, only 551 items (accounting to 10% of imports from the EU) would be subject to complete and immediate tariff-reduction, while the tariffs on 1,598 items (8.4% of imports) would be cut by 50% in two years. Of the others, 14,508 items (64.4% of imports) would have a two-year grace period from the agreement's entry into force, and between eight and 10 years for wholesale tariff-elimination; 1,393 items (17.2%) would simply be excluded from the tariff-reduction calendar.

TABLE V.1
DEVELOPMENTS IN MERCOSUR'S OFFER TO THE EU
(in US\$ millions FOB)

Baskets ⁽³⁾	Offer in October 2001 ⁽¹⁾			Offer in March 2003 ⁽²⁾			Offer in April 2004 ⁽²⁾			Offer in May 2004 ⁽²⁾		
	No. items	MS imp. 1998/2000	%	No. items	MS imp. 1998/2000	%	No. items	MS imp. 1998/2000	%	No. items	MS imp. 1998/2000	%
A	551	1,900	8	551	2,246	10	655	2,535	11	657	2,535	11
B	1,109	1,110	5	1,598	1,900	8	1,778	2,458	11	1,800	2,460	11
C	610	542	2	1,395	821	4	1,381	822	4	1,433	1,135	5
D	1,305	3,590	16	1,923	4,199	19	1,878	4,305	19	1,976	4,456	19
E	116	186	1	2,752	9,488	42	2,644	8,928	39	2,905	9,295	41
Subtotal	3,691	7,328	32	8,259	18,653	83	8,336	19,047	83	8,771	19,880	87
PF ⁽⁴⁾	--	--	--	--	--	--	--	--	--	78	244	1
S. (NO)	5,719	15,607	68	1,393	3,889	17	1,394	3,876	17	881	2,800	12
Total	9,410	22,935	100	9,652	22,542	100	9,730	22,924	100	9,730	22,924	100

Notes: (1) Offer of products and values imported in the Mercosur common nomenclature (MCN) 2001.

(2) Offer of products and values in the NCM 2003.

(3) In 2001 and 2003, the baskets used the following timeframes: A - immediate; B - eight years; C, D and E - 10 years; NO - not offered. In 2004 the baskets were changed to: A - immediate; B - two years; C - 8 years; D and E - 10 years; S - sensitive, basket not indicated.

(4) PF: products subject to a 20% fixed preference.

Source: Confederación Nacional de la Industria (CNI), May 2004.

In this context, the EU requested better access conditions and, in the area of goods, had three clearly-defined aims: (i) to reduce the number of products with no defined treatment in the MERCOSUR offer;²⁶ (ii) to change the composition of the baskets of products, transferring items originally included in the categories with longer deadlines to those with shorter timeframes; and (iii) to modify the tariff-reduction schedule proposed by MERCOSUR with the aim of accelerating the entire liberalization process.

In parallel, the EU also presented improvements to its initial offer of June 2001. In addition to adding 1,235 products to the offer of 2003, bringing all the items to 10,400, the EU included 385 of them in the category of immediate tariff-reduction. Since these included a series of products that have significant weight in MERCOSUR's exports to the EU, in the European offer there was a substantial rise in products subject to immediate tariff-reduction: from 48.8% of EU imports from MERCOSUR, in the new offer this category came to represent 61.7% of such imports. Nonetheless, for the MERCOSUR negotiators the new European proposal for trade liberalization was still substantially short of what they hoped for, given that 375 products of the total of 385 new inclusions in the basket of items subject to immediate tariff-reduction already entered the EU without paying import taxes. In terms of additional liberalization, the increase in the number of products subject to immediate tariff-reduction has practically no effect.

In the revised EU proposal, 748 items were included in the category without defined treatment in terms of tariff-reduction, which brought the total of such products from 195 in 2001 to 963 in 2003. This is equivalent to 9.3% of the tariff items or, seen in another way, to 6.8% of European imports from MERCOSUR.

In sum, the trade negotiations between MERCOSUR and the EU in 2003 were marked by progress in the total number of products considered for tariff-reduction, according to the offers presented by the two sides. Nonetheless, in both cases, the offers evinced a high degree of conservatism, with substantially lengthy deadlines for complete tariff-elimination.

Four rounds of negotiations were planned for 2004, two in Buenos Aires (March and June) and two in Brussels (April and July), as well as two ministerial meetings. The first of these was held in Mexico in May, and the second in Brussels in October. The aim is to conclude the Association Agreement between MERCOSUR and the EU and to make possible the implementation of an inter-regional free trade area beginning in October of the same year.

During the twelfth meeting of the BNC in March in Buenos Aires, further progress was made on political and cooperation matters as established in the agreement. Progress was also made on trade issues. The chapters on technical barriers to trade competition and customs matters were finalized.

In the area of market access, however, the negotiations continue to pose problems for both sides. At the Guadalajara Summit, which took place at the end of May 2004 in Mexico, the MERCOSUR negotiators considered that the new European offer (which made provision for opening in a period of 10 years for 87% of agricultural goods trade) fell far short of what the South American countries wanted.²⁷ As regards trade in poultry, for example, MERCOSUR sought an export volume of 250,000 tonnes a year; Europe offered a quota of 37,500 tonnes. As for wheat, MERCOSUR sought to export a million tonnes a year; the Europeans offered only 100,000 tonnes (Table V.2).

²⁶ Brazil was the main target of this demand, since about a quarter of European exports to Brazil lacked defined treatment in MERCOSUR's revised offer, as against only 16.1% of exports from the bloc as a whole.

²⁷ The volume of quotas offered by the EU, as well as being far below the level desired by MERCOSUR, would also have failed to generate real gains in trade for the MERCOSUR countries, only greater margins for agricultural products. This is because, for most products, the EU confined itself to offering quotas for volumes that MERCOSUR already exports to Europe, despite the high tariffs imposed on quantities that exceed the volume established in the quotas. Hence there is a tendency for the producers who export within the quotas to have greater benefits by virtue of the reduction in tariffs.

TABLE V.2
VOLUME AND VALUE OF THE QUOTAS OFFERED AND REQUESTED IN THE NEGOTIATIONS
BETWEEN MERCOSUR AND THE EU FOR SELECTED AGRICULTURAL PRODUCTS

Products	Quantities (in 1000 tonnes)			Value (in US\$ millions)		
	EU offer 1st stage	EU offer 2nd stage	MERCOSUR request	EU offer 1st stage	EU offer 2nd stage	MERCOSUR request
Poultry	37.5	37.5	250.0	35.7	35.7	238.1
Pigmeat	6	5	40.0	7.4	6.2	49.5
Cattle meat	50	50	315.0	90.2	90.2	568.3
Ethanol	500	500	2.400.0	139.3	139.3	668.6
Sugar	-	-	1.800.0	-	-	308.9
Corn	400	300	4.000.0	37.9	28.5	379.4
Wheat	100	100	1.000.0	13.5	13.5	135.0
Rice	20	20	150.0	5.8	5.8	43.7
Powdered milk	6.5	6.5	34.0	6.0	6.0	31.5
Butter	2	2	20.0	2.6	2.6	26.5
Bananas	30	-	60.0	4.2	-	8.4
Mutton and lamb	-	-	10.0	-	-	25.6
Cheeses	10	10	60.0	21.0	21.0	126.0
Garlic	5	5	20.0	3.9	3.9	15.6

Source: Instituto de Estudios del Comercio y Negociaciones Internacionales (ICONE). Taken from *Gazeta Mercantil*.

Moreover, the new European offer was regarded as a backward step from the previous position, especially as regards agricultural offers. This is because the Europeans offered a two-stage scheme for the liberalization of agricultural trade. The first of these would begin with the signing of the agreement (50%); the second would depend on the conclusions of the Doha Round (50%).²⁸

In the following meeting in July in Brussels, the Europeans presented a new offer. In this, the liberalization of agricultural trade increased to 60% in the first stage, staggered over a period of 10 years, a circumstance that caused substantial frustration for the MERCOSUR delegates.²⁹ The result was an impasse that led the MERCOSUR representatives to ask for the meeting to be suspended. For them, the quotas offered by the EU were still far below the levels that MERCOSUR already exports to Europe. Moreover, the MERCOSUR representatives did not agree to the implementation of the agreement in two stages, since it is impossible to know when or how much the Europeans would concede once the WTO negotiations had been completed. With regard to agricultural products, the MERCOSUR negotiators upheld the possibility of selling sugar to the EU, a matter that is not even being considered by the Europeans. They also seek greater advantages for agro-industrial products, especially those that include sugar, milk and cacao. As to industrialized products, MERCOSUR wants to export more vehicles to Europe.

²⁸ Some analysts estimate that the potential gains from the European offer on access for agricultural and agro-industrial goods would be, at a maximum, US\$ 720 million in the two stages, while MERCOSUR's requests amount to about US\$ 2.6 billion. In the first stage, following the entry into force of the free trade agreement, the benefit for MERCOSUR would be about US\$ 368 million. In the second stage, which is conditional on the conclusion of the Doha Round, the benefit could be expanded by a further US\$ 352 million. Consequently, the gains ensured by the negotiations, those from the first stage, amounts to a very small part of MERCOSUR's current exports of agricultural and agro-industrial products. This prospect of limited gains became a source of frustration for several representatives of MERCOSUR industry, since industrial goods are inserted almost entirely in the liberalization schedules presented by MERCOSUR and thus the latter's offer is not conditional on a second stage.

²⁹ The distribution across 10 years, for example, would mean Brazil would export less than a container of meat a year to Europe.

The EU was also unhappy with the way the negotiations proceeded, since it expected MERCOSUR to make a significant improvement in its offer, especially the offer on industrialized goods and in particular in the footwear, textiles, vehicle parts, and ferrous and non-ferrous metals sectors. Other differences were related to the desire of the Europeans to take part in maritime transport among the MERCOSUR countries, to require identification of origin for certain products, such as cheeses and alcoholic beverages, and to secure total preference to take part in tenders for government procurement. This last point raised a significant obstacle in the negotiations. It faced resistance mainly from the Brazilian government, which was reluctant to grant national treatment to European companies in its tenders. The MERCOSUR countries, in turn, only accepted to grant this facility to those companies that were already installed in the region.

In the area of services, the Europeans envisaged the possibility of selling cross-border services without the need for the company to be established in the country in which it would be providing the service. Another crucial point in this area is directly related to the labor market. The EU argued for the inclusion of "professional services", which would allow the transfer of skilled labor from Europe to the affiliates of European companies located in MERCOSUR. Some of the MERCOSUR governments believed that this would aggravate the unemployment problem in the region. The Europeans also focused on those sectors considered strategic or sensitive, such as mining (including the extraction of oil and gas), financial services, telecommunications, environmental services (including water and sewerage), cabotage and fisheries.

In view of the EU's refusal to improve its offer, MERCOSUR declined to improve its own, which made provision for the elimination of tariffs on 87.8% of the tariff schedule (see Table V.1). Despite that, Brazil hinted at the possibility of offering easier access in the agricultural area in exchange for the opening of those sectors. In this case, however, there was resistance from Argentina. Moreover, so as not to compromise the negotiating calendar entirely, in the July meeting in Brussels the two sides agreed that the MERCOSUR delegates would submit to their governments what had been presented. In the same meeting it was decided that all the offers made to that point would be put on paper, including the conditions, and that those documents would be exchanged in a new meeting to be held in Brasilia between August 9 and 13.³⁰ At that meeting, as well as seeking to reach an understanding on agricultural trade, the two sides tackled the issues that were deemed most important for the Europeans: market access for non-agricultural products, services and government procurement.

Since then, the EU has insisted on the possibility of compensating the MERCOSUR countries by raising the import quotas for certain agricultural products in areas deemed sensitive, as well as other advantages, so as to lessen the effects of the subsidies granted to European producers. This would entail short-term benefits for MERCOSUR. The latter, in exchange, revealed itself to be equally willing to improve its list of offers, increasing to 9,400 (90%) the number of items that European exporters could sell without paying tariffs in a 10-year reduction program. Additionally, MERCOSUR insisted on the adoption of a system of quotas for the import of products from industrial sectors that are important to the Europeans, for example: automobiles, and vehicle parts, wines, information technology and telecommunications products, and capital goods. This quota proposal, however, like the European proposal, would also be divided into two stages. A part of those sectors would only be liberalized when the EU submitted the second part of its offer, which was conditional on the conclusion of the Doha Round. This attitude on the part of MERCOSUR is a clear response to the European insistence on offering only quotas on agricultural products, rather than engaging in a gradual reduction of tariffs.

In this context, a significant divergence that remains to be resolved is the European aim of excluding from the agreement the drawback operations undertaken by the MERCOSUR countries. The EU argues that this system constitutes an incentive to exports and hampers fulfillment of the rules of origin. Thus the products

³⁰ This meeting ended with a new postponement in the negotiations (until September) since the terms previously agreed were not fulfilled.

that use drawback would not benefit from the reduction of imports tariffs to be conceded by the EU. This demand faced resistance from MERCOSUR, and especially from the private sector, because of the importance of the drawback system for the MERCOSUR countries.³¹

Another pending question concerns the schedule for tariff-reduction. The EU exerted pressure for the adoption of its system, which contemplates the continuous reduction of tariffs with the products divided into four baskets: A (immediate opening); B (four years); C (seven years); and D (ten years). MERCOSUR offers five baskets: A (immediate); B (two years); C (eight years), D (ten years, with a one-year grace period) and E (ten years, with a two-year grace period) (Table V.3). The EU proposal also contemplated the possibility that some sectors – pharmaceuticals, steel, construction equipment, agricultural machinery, furniture and toys – would have the tariffs eliminated immediately on both sides. MERCOSUR regarded this as impossible because many of those sectors are considered sensitive, especially by Brazil.

TABLE V.3
SCHEDULE OF TARIFF-REDUCTION BY BASKETS,
ACCORDING TO MERCOSUR'S OFFER TO THE EU IN 2004

Basket	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
A	100%										
B	50%	50%	100%								
C	11%	22%	33%	44%	55%	66%	77%	88%	100%		
D		10%	15%	25%	30%	40%	50%	60%	70%	85%	100%
E			10%	15%	25%	35%	45%	55%	70%	85%	100%

Source: Confederación Nacional de la Industria (CNI), May 2004.

As regards the agricultural negotiations, a series of doubts make it difficult to analyze the EU offer. Among these is the issue of export subsidies in the agricultural sector, a matter that has still not been addressed in the negotiations. There is also a doubt about the tariffs to be adopted for products on which the EU is only offering quotas, such as meats or alcohol. In this regard, Brazil prefers tariff exemptions, while the Europeans have proposed the adoption of half of the consolidated tariffs in the WTO. For some products, such as chocolate and candies, the difficulties are even greater since the scale of the quotas has not yet been defined.

The Europeans are also unsatisfied with MERCOSUR's refusal to liberalize the participation of European suppliers in government procurement. They also insist on ensuring a list of commitments, mainly from Argentina and Brazil, so as to guarantee that European investors have stability in the rules and are treated in the same manner as national industry.³²

Finally, it is worth noting that despite the successive impasses and difficulties in the negotiations for a MERCOSUR-EU free trade area, the negotiators of both sides continue to reiterate their intention to bring the agreement into force at the beginning of 2005. They also reiterate that there is political will to reach an agreement that is not "light" but significant.

³¹ In the case of Brazil, for example, drawback is used by various sectors, such as the automotive, aeronautical and domestic appliance sectors. Between January and May 2004 this regime benefited 30% of Brazilian exports.

³² Although the Europeans claim to understand MERCOSUR's argument about the need to preserve a political space for the rules of industrial policy that benefit national investors, they insist on transparent, stable and non-discriminatory rules for European companies already established in countries of the region. Nonetheless, as was indicated by the Brazilian Foreign Minister, Celso Amorim, the difficulties of guaranteeing this include the fact that to grant some of the guarantees demanded by the Europeans would require legal and constitutional changes. Investment in Brazil's financial sector, for example, is constitutionally dependent on the authorization of the president.

C. The MERCOSUR-Andean Community Negotiations

The negotiations between MERCOSUR and the Andean community (CAN), comprising Colombia, Ecuador, Venezuela, Peru and Bolivia, began in 1995 at the initiative of MERCOSUR. The latter was interested in negotiating items of what is termed the "historical patrimony", so as to avoid gaps when the two sides began to operate as customs unions.³³ As the negotiations advanced they moved towards a broader aim, which culminated in mid-1996 with an agreement to create a free trade area on the basis of bloc-to-bloc negotiations.³⁴

In the following months, successive rounds of talks were held without concrete results. There was no outcome until April 1998, when representatives of both groups signed a framework agreement for the creation of a free trade area between MERCOSUR and the CAN. This was to come into force on January 1, 2000. MERCOSUR and the CAN thereby laid the foundations for an enlarged economic area with an estimated population of 35 million and a GDP of more than US\$ 900 billion.

To reach this goal they agreed on a two-stage negotiating process. The first would entail the conclusion of a fixed tariff preferences agreement on the basis of the historical patrimony of the Latin American Integration Association (ALADI). New products could be added and the agreement's entry into force was planned for October 1, 1998. It would replace the existing partial scope bilateral agreements between the MERCOSUR and CAN countries signed in the ALADI framework. The second stage would consist of negotiating a true free trade accord in the period October 1, 1998 to December 31, 1999. This agreement would cover the products contemplated in the tariff preferences accord mentioned earlier, as well as the other items in the tariff schedule, and would come into force on January 1, 2000.

None of these deadlines was met, for several reasons. These include the progressive withdrawal of capital from the region following the 1998 Russian crisis and the Asian crisis. These episodes slowed both integration initiatives and gave rise to a context, in the late-1990s, that was inauspicious for trade liberalization. Thus it was even harder to overcome the main differences evident in the bloc-to-bloc negotiations. Within the blocs, the CAN faced difficulties in establishing a CET because of differences between Bolivia and Peru, on the one hand (which were favorable to opening) and Colombia, Ecuador and Venezuela on the other. The latter were less favorable because they are relatively more industrialized and thus feared that an agreement with MERCOSUR would affect their sales to relatively less developed CAN countries.

MERCOSUR also faced internal problems, in this case stemming from the Brazilian devaluation in 1999 and the prolonged Argentine crisis of 1999-2002. Brazil, moreover, was interested in moving the negotiations forward, even unilaterally, so as to recover its share of the Colombian and Venezuelan markets. Brazil had lost share to Mexican goods as a result of the creation of the G-3, comprising Mexico, Colombia and

³³ The "historical patrimony" covers the goods subject to the mutual, bilateral and partial scope tariff preferences granted in the ALADI framework by all the governments of the blocs.

³⁴ The negotiations between MERCOSUR and the CAN amount to more than a simple free trade agreement. The goal is more than commercial, since the negotiations cover a series of activities geared to development, complementarity and cooperation in various fields of mutual interest. It was foreseen that the trade liberalization measures would be accompanied by the establishment of a juridical and institutional framework for economic and physical cooperation that would facilitate the free movement of goods and services and the full use of productive factors; a regulatory framework to promote mutual investment; measures to stimulate economic, energy-related, scientific and technological complementarity between the countries of the region; and an understanding to move forward in the coordination of positions in a hemispheric and multilateral negotiations. Additionally, at least at the beginning, the negotiations also sought to cover services, intellectual property, investment and government procurement.

Venezuela. Demands for protection surged in this inauspicious context, and the differences between MERCOSUR and the CAN became almost irreconcilable.³⁵

To overcome the impasse, Brazil suggested changing the negotiating scheme so as to enable the Andean countries as a whole to negotiate separately with each of the MERCOSUR countries. As a result of this change, and on the basis of the preliminary understandings, Brazil continued to negotiate with the CAN. The talks led to the signing, on August 16, 1999, of Partial Scope and Economic Complementarity Agreement No. 39. This was to be in effect for two years, a timeframe that was later extended. In 1999, too, Argentina and the CAN began negotiations for a preferential accord similar to that between the CAN and Brazil. Following several meetings, on June 29, 2000, Partial Scope and Economic Complementarity Agreement No. 48 was signed by Argentina, Colombia, Ecuador, Peru and Venezuela. This second agreement was originally intended to be in force for a year but, as happened in the Brazilian case, the timeframe was later extended. In their turn, the other members of MERCOSUR, Paraguay and Uruguay, concluded tariff preferences agreements with the Andean countries.

This progress enabled the start of the second phase of understandings between MERCOSUR and the CAN, as of April 2001, with the aim of establishing a free trade area between the two blocs. Once again, however, the negotiations did not move as fast as expected, for two reasons in particular. The first of these was the inability of the negotiators to overcome differences regarding the liberalization program for sensitive products and for those included in the historical patrimony. The second was the continuing financial crises in both blocs.

The main differences over the liberalization program stemmed from MERCOSUR's stated desire to reduce tariffs at a faster rate than the CAN wanted. The latter wanted tariffs on some products, especially agricultural goods, to be reduced over a period of 18 years, while MERCOSUR would not accept more than 15. Another issue of debate concerned differences in the policies governing access to the automotive sector, which made it almost impossible for MERCOSUR to import automotive goods from the Andean countries. As to rules of origin, MERCOSUR wanted 60% regional content while the CAN argued for 40%. Finally, the CAN also wanted to set up a dispute settlement mechanism in tandem with the trade negotiations, while MERCOSUR preferred this to happen after the accord was concluded.

The discouraging outlook for the negotiations at the end of 2001 and the start of 2002 began to change for two main reasons. The first concerned the CAN's fears that the Andean integration scheme would be weakened in the hemispheric agreement. This enabled the member countries to reach a consensus on the CET in mid-2002. The second was related to the settlement of the main disputes involving the MERCOSUR members. Paradoxically, despite the substantial economic harm caused by the collapse of the Argentina economy, both domestically and regionally, the crisis promoted an abrupt end to the exchange rate asymmetry with Brazil, which had been one of the main points of bilateral conflict. Simultaneously, this circumstance enabled the other members of the bloc to make some progress, thereby curbing the regional crisis.

In this context the foreign ministers of the CAN and MERCOSUR countries met in Montevideo in August 2003. Their purpose was to assess the status of the inter-group negotiations with a view to concluding a free trade accord in line with the terms of Economic Complementarity Agreement No. 56. They agreed to hold two monthly meetings so as to facilitate the conclusion of the negotiations before the end of 2003. At the

³⁵ The main dispute between the blocs centered on the following matters: (i) the temporary or permanent nature of the exceptions since the CAN wanted permanent exceptions while MERCOSUR preferred temporary exceptions or prolonged tariffs-reduction calendars for sensitive products; (ii) from the MERCOSUR viewpoint, the list of sensitive products subject to more prolonged tariff-reduction schedules was very expensive, since it covered 2,700 items in the case of the CAN as against 1,400 in the case of MERCOSUR; and (iii) the desire on the part of the countries of the CAN for special and differentiated treatment on the grounds that the lower-level of relative economic development affects the pace of liberalization as well as the distribution of the potential costs and benefits among the countries participating in the process.

same time they exchanged lists of products subject to immediate tariff-reduction, as well as lists of improved requests containing the offers presented.

Finally, on December 16, 2003, after eight long and arduous years of negotiations, the four MERCOSUR countries and three CAN countries (Colombia, Ecuador and Venezuela) signed Economic Complementarity Agreement No. 59 in the ALADI framework. This made provision for the establishment of a biregional free trade area as of July 1, 2004.³⁶ It is worth noting, moreover, that the negotiations were not confined to the expansion of goods trade among the member countries, but also sought to prepare the ground for the harmonious development of the different economies through discussion of a series of complementary measures. These included the Initiative for the Integration of Regional Infrastructure in South America (IIRSA). The latter's goal is the construction of large-scale integration and development axes in the region (IIRSA is discussed in more detail in Chapter VI).

The agreement established a schedule of gradual tariff-reduction for products traded in the region. When it enters into force (originally scheduled for July 1, 2004) 80% of the trade will be tariff-free³⁷ and the other 20% (sensitive products) will be liberalized in up to ten years if the goods are deemed sensitive by both blocs. MERCOSUR's sensitive products include textiles and paper; Ecuador, Colombia and Venezuela stressed agricultural goods such as wheat and soya, as well as automobiles. For a set of 185 products (at the eight-digit level in the 1996 ALADI nomenclature (NALADISA), there would be a reduction only of those tariffs contemplated in one of the annexes to the agreement. Those tariffs would range from 15% to 20%. They include milk by-products, rice and various kinds of oils.

Another feature of the agreement concerns the inclusion of the tariff preferences and other conditions of access previously negotiated among the signatories of the ALADI partial scope accords. In this regard, the tariff preferences and other access conditions agreed prior to the signing of the present accord would apply, as long as such preferences and conditions are more favorable than those established in the present agreement.

In addition, special treatment was given to the region's relatively less developed economies, which managed to negotiate tariff-reduction schedules that took account of the asymmetries among the participating countries, both in terms of deadlines and the pace of tariff-reduction for all tariff items. Nevertheless, some important issues, such as intellectual property, investment and government procurement, are pending since there is no agreement on these matters.

As regards rules of origin, there was agreement that exports to MERCOSUR should comprise 50% regional content during the first seven years; this would rise to 55% in the eighth year. Exports from MERCOSUR will, in turn, will comprise 60% regional content.

Many analysts believe that a free trade bloc in South America will give the countries of the region greater bargaining power with the United States in the FTAA negotiations. Other observers believe that MERCOSUR's agreement with the CAN is undoubtedly a step forward, but that it does not necessarily entail a strengthening of MERCOSUR's position in the final stage of the FTAA negotiations because all

³⁶ Peru and Bolivia opted for different and separate negotiations since they both had already concluded free-trade agreements with MERCOSUR. Peru's agreement with MERCOSUR dates from August 25, 2003 (ECA 58). Bolivia's dates from December 17, 1996 (ECA 36). Bolivia takes part in the negotiations between the CAN and MERCOSUR with a view to making ECA 36 compatible with the new agreements under negotiation.

³⁷ The timeframe for general tariff-reduction are 10 years for the Andean countries, Paraguay and Uruguay, and six years for Argentina and Brazil. The products subject to those timeframes will be at a minimum 70% for the CAN and 85% for MERCOSUR, as regards the imports of both blocs; and 80% and 90%, respectively, in terms of the number of items in the tariff schedule. In the case of country-to-country trade, the import percentages will be a minimum of 60%. Additionally, there will be the lowest number of levels of initial tariff-reduction so as to safeguard the asymmetries of the existing preferences. These stand at 10%, 15% and 35% for the Andean countries, Paraguay and Uruguay, and at 30% and 45% for Argentina and Brazil.

of the CAN countries – apart from Venezuela – have a clear interest in concluding an agreement with the United States. Trade between the CAN and MERCOSUR is not particularly high, and is marked by a substantial surplus for the MERCOSUR countries. The US market is much more attractive for the Andean countries than the MERCOSUR market. Moreover, an agreement with the United States would allow them to consolidate the advantages granted unilaterally by the US government through the Andean Trade Preferences Act (ATPA), preferences that have to be renewed periodically by the US Congress.

D. The MERCOSUR-South Africa Negotiations

The first initiatives geared towards closer relations between MERCOSUR and South Africa arose in 1996, at the initiative of then-President Nelson Mandela. At that time there was a proposal that South Africa should become an associate member of MERCOSUR. This development received relatively little attention from the MERCOSUR countries; their governments, and especially that of Brazil, were then giving priority to relations with developed countries. Nevertheless, in the two following years the negotiations between MERCOSUR and South Africa made some progress. This led to the signing of a tariff preference agreement in 1998 and, more importantly, to the December 2000 conclusion of a framework agreement for the establishment of a free trade area.

In the next two years there was practically no progress in relations between MERCOSUR and South Africa.³⁸ The reasons for the stagnation, despite the shared political agenda, are attributable to: (i) instability in South Africa; (ii) the internal problems of the MERCOSUR countries, triggered by the Argentine crisis; and (iii) the priority given to other bilateral agreements by both parties' foreign policy establishments.

From 2003 onwards, relations between MERCOSUR and South Africa (a market that, despite its inequalities, has about 44 million inhabitants and serves as an export base for a significant part of the continent) regained momentum. This change originated in the turnaround in foreign policy undertaken by the Brazilian government. During the presidency of Luiz Inácio Lula da Silva, Brazil has made unprecedented efforts to integrate South America, both in terms of strengthening economic and political relations with other developing countries so as to exploit commercial and investment opportunities, and of building a joint anti-hegemonic position around globalization. The aim was to increase the bargaining power of the periphery countries in the WTO negotiations and in talks in other multilateral organizations.³⁹

It was in this new context that the strategic association with South Africa began to take shape, thanks to the fact that the latter country, as well as being a leading economic partner of MERCOSUR in Africa, is also part of the group of emerging countries that seek to coordinate and harmonize their interests in a multipolar world system. They also endeavor to deepen and expand economic cooperation and trade

³⁸ Amid the crisis of inter-bloc trade, an initiative related to South Africa in this period merits attention. This is in an unprecedented initiative for the MERCOSUR countries. In June 2002 a trade mission comprising more than 100 entrepreneurs from the four countries travelled to South Africa. This was the first time that they had joined together to organize a trip for the purpose of the joint promotion of their products abroad, in an attempt to overcome the mutual ignorance between the South Americans and Africa's biggest economy. Rather than an isolated initiative, this trip was one of the high points on MERCOSUR's agenda, which had made little progress in the area of trade promotion.

³⁹ Another initiative led by the Brazilian government as part of its strategy to strengthen trade links among developing countries and thus aid their greater integration in world trade, led to the creation of the Group of Three (G3), comprising Brazil, India and South Africa. The aim of the G3 is to intensify trilateral cooperation, stimulate South-South trade, and harmonize positions in international fora. Although this is an incipient project, it aims to cover all the countries of MERCOSUR and of the Southern African Customs Union. The economic, political and even military potential of the G3 is beginning to attract the attention of other countries, such as Russia, which follow the negotiations with particular interest.

among themselves. These trade relations are increasingly seen as an alternative to the traditional South-North routes.⁴⁰

South Africa had become a member of the Southern African Customs Union (SACU), a customs area that also includes Namibia, Botswana, Lesotho and Swaziland. Hence the need, in the recent process of intensifying trade relations between South Africa and MERCOSUR, for the negotiations to cover the other members of the SACU, because of South Africa's commitments to its partners. That circumstance introduced some turbulence to the ongoing negotiations, because now there was a need to reach agreement between two blocs. Nonetheless, it has been possible to move forward in establishing closer trade relations, including the negotiation of an automotive agreement, because the Brazilian government has a particular interest in securing greater openness in Africa for the automobiles and other vehicles manufactured in Brazil. Hence it was planned that during the July 2004 MERCOSUR summit, the two sides would sign a fixed tariff preferences agreement, the first step in the process of concluding a free trade agreement. The two blocs are estimated to comprise a market of US\$ 800 billion.

South Africa is the SACU's most developed country, and has the highest level of trade with MERCOSUR because of its substantial industrial base in the metallurgy, mechanical, transport material (especially railway equipment) and electro-electronic sectors. Apart from that, it has a strong mining industry because of its reserves of iron, gold, platinum and diamonds. Of all the products exported by MERCOSUR to South Africa, about 75% consist of manufactured goods, notably vehicle parts, chassis and bodywork, automobiles, vehicle engines, tractors, soya oil, pumps and compressors, polymers and cargo vehicles. As to basic and semi-manufactured products, the most important are poultry meat, iron and iron concentrates, as well as hides and skins. With respect to MERCOSUR's imports from South Africa, about half consist of manufactured goods although the highest percentage is accounted for by coal, followed by platinum. Also worth noting are iron alloy, aluminum bars, vehicle engines, gasoline, insecticides and herbicides.

Another auspicious circumstance for closer trade relations between MERCOSUR and South Africa, apart from the desire to intensify political relations and expand trade, lies in the prospect of establishing joint ventures between companies of both sides, given the relatively unexploited potential of the opportunities offered by the regional market.

E. The MERCOSUR-Peru Negotiations

On August 25, 2003, Peru became an associate member of MERCOSUR through the formalization of a free trade agreement known as Economic Complementarity Agreement No. 58 MERCOSUR-Peru. Peru thus became the third Latin American country to become an associate member, together with Bolivia and Chile, which had done so in 1996. For the MERCOSUR countries, this understanding was an important step forward in the creation of an ambitious free trade area among the countries of South America. It was hoped that this would help drive forward the negotiation of similar agreements with the other members of the Andean Community (Colombia, Ecuador and Venezuela), processes that had been marked by difficulties.⁴¹

⁴⁰ Although South-South trade represents less than 10% of the world total, it has grown rapidly. According to UNCTAD, exports to developing countries now amount to more than 40% of those countries' exports and the trend is upward in both absolute and relative terms. On one hand this is because several developing countries, especially in Asia, have experienced vigorous economic growth. On the other hand, is because the population of those countries should increase from the present 4.8 billion to about 5.6 billion in 2010, while the population of the developed countries should stagnate at about 1.2 billion.

⁴¹ In view of the imminence of the FTAA, the Brazilian government has worked vigorously to create a South American economic area that would facilitate new trade flows in the shortest timeframe possible. Hence Brazil has treated the negotiations between MERCOSUR and the Andean countries as a priority issue and has exerted a great deal of pressure for the trade agreements between them to be concluded as soon as possible. More than once, Brazilian Foreign Minister Celso Amorim has spoken of the importance of deepening the regional commitments to tariff-reduction as soon as possible, as a means of lessening (or making it easier to manage) the effects of the erosion of regional preferences on intra-regional trade flows as a result of the entry into force of the FTAA..

It is worth mentioning that the "4+1" economic complementarity agreement between MERCOSUR and Peru differs from the accords signed by MERCOSUR with Chile and Bolivia. In this case, free trade between the parties makes provision for the asymmetries and sensitivities of the less developed economies in the process. Without that, it would have been difficult to evade the impasses that arose during the negotiations.⁴² The document makes provision for two different rates of gradually reducing import tariffs in trade between Peru and MERCOSUR. In the case of Peru's trade with Paraguay and Uruguay, the pace would be faster. In the country's trade with Argentina and Brazil, tariffs would be reduced more slowly.

Another peculiarity of the MERCOSUR-Peru agreement is that it includes a safeguard mechanism in the form of tariff quotas or a heightened rise in tariffs in the event of an abrupt increase of imports into Peru of a series of about 300 agricultural products from Argentina or Brazil. The justification for this measure is that Peru is not a significant competitor in the agricultural area, in contrast to circumstances between the MERCOSUR countries, and its social problems could worsen if there were to be a significant increase in agricultural imports. The safeguard mechanism, however, cannot be applied automatically. It must follow the regular procedures for such measures, such as the need to demonstrate harm to local sectors as a result of the increase in imports.

Brazil's free zone in Manaus was also excluded from the MERCOSUR-Peru agreement because Peruvian business sectors were opposed to its inclusion. They believed that it would place national production at a disadvantage. Another Peruvian demand prompted the imposition of rules of origin to curb imports of textile products made with Asian raw material.

Despite these peculiarities, the MERCOSUR-Peru agreement makes provision for the reduction of tariffs on about 85% of the items traded between the parties within a period of 10 years. The other 15%, in sensitive areas, will be liberalized over 13 years for Uruguay and Paraguay and over 15 years for Argentina and Brazil.

The first stage of understandings between Peru and MERCOSUR began in September 1994, when MERCOSUR presented Peru with a timetable for future negotiations that covered the following points: (i) the extension until December 31, 1995 of the bilateral agreements with each of the MERCOSUR member countries; and (ii) conclusion of the renegotiation of the historical patrimony before December 31, 1996, so as to facilitate the later conclusion of agreements geared towards the establishment of a free trade area within 10 years. The second stage of negotiations began in the first half of 1996, after MERCOSUR's Common Market Group decided to conclude economic complementarity agreements with the other members of ALADI on a "4+1" basis. Argentina, which then held MERCOSUR's *pro tempore* presidency, formally invited the Peruvian government to begin talks on this matter. This led to a series of negotiating rounds.

Throughout this period the negotiations reached an impasse on several occasions. The most sensitive points concerned obstacles to the Peruvian market for agricultural products, especially rice and dairy goods; the establishment of sanitary and phytosanitary measures for animal products from Peru; and the refusal of the Peruvian government to allow the entry of products from the Manaus free zone. Peru's trade deficit, especially with Brazil, was also a matter of concern for the Peruvian negotiators, since the country wanted to sell more foodstuffs and other basic consumer goods to MERCOSUR. In order to reach an understanding, the two sides decided to include in the agreement a series of "evolutionary clauses" to make possible the future negotiation of matters on which there was no consensus, including key issues such as rules of origin and free zones.⁴³

⁴² It is interesting to note that during the signing of the agreement, Peruvian Foreign Minister Allan Wagner stated that, despite the agreement with MERCOSUR, the basic aim of Peru's foreign policy in the short term would be to establish closer relations with the United States and to conclude free trade agreement with that country. On the same occasion, Peruvian President Alejandro Toledo confirmed that Peru's priority consists of accelerating the negotiations with the United States, Mexico, the European Union and in the WTO, while Peru's "bet" on Brazil and MERCOSUR is in the medium and long term.

⁴³ For this reason the MERCOSUR-Peru agreement contemplates 10 annexes with issues that are still under discussion. These include goods that are free of taxes in the territory of the member countries, sanitary and phytosanitary measures, rules of origin, subsidies, safeguard mechanisms, dispute settlement, and technical rules and regulations.

F. The MERCOSUR-India Negotiations

On June 17, 2003, the MERCOSUR countries and India signed a framework agreement with the aim of promoting bilateral trade and of creating the conditions and mechanisms necessary for the negotiation of a free trade area consistent with the rules and disciplines of the WTO.⁴⁴ It was the first agreement of this type that MERCOSUR had signed with a country outside of Latin America. India's main attraction is that it has a market of more than 1 billion inhabitants.

The first step towards this goal was the commitment to negotiate a partial scope fixed preferences agreement through which the two sides would grant effective access to their markets by means of mutual tariff concessions. The framework agreement also made plain that MERCOSUR and India would engage in periodic negotiations geared to expanding the scope of the preferences agreement. That understanding was entrusted to a Negotiating Committee, comprising the members of MERCOSUR's Common Market Group and India's Trade Secretariat.⁴⁵

Within a short period, in meetings that followed the signing of the framework accord, the two sides reached agreement on the implementation of the fixed tariff preferences and the establishment of trade disciplines between MERCOSUR and India. To these ends they concluded a preferential trade agreement, the first step in the creation of a bilateral free trade area. This second agreement, signed on January 21, 2004, set a deadline of 120 days for the countries to negotiate the definitive list of products that would benefit from tariff preferences. This was expected to cover about 1,700 items.⁴⁶ MERCOSUR presented a list of more than 900 products for access to the Indian market, mostly agricultural and manufactured goods that are subject to in average *ad valorem* tariff of 33.1%; the modal tariff is 30% and the maximum tariffs are 150%. India sought access for more than 500 products, especially vehicle parts, chemical products, pharmaceutical goods and textiles.

It is worth noting that from the perspective of the representatives of the signatories of the agreement on market access, this is the first step in strengthening trade between developing countries as a real alternative to trade with more powerful economies.⁴⁷ Nonetheless, some negotiations on tariffs are expected to be hard, especially in those industrial categories in which India is very competitive, such as pharmaceutical products and tires.

⁴⁴ The framework agreement will be in force for three years and can be automatically extended for the same period should the parties so desire.

⁴⁵ The powers of the Negotiating Committee include the following: (i) to promote the exchange of information on tariffs applied by each party, both as regards bilateral trade and trade with third countries, as well as their respective trade policies; (ii) exchange information on market access, tariff and non-tariff measures, sanitary and phytosanitary measures, technical norms, rules of origin, safeguard measures, antidumping and countervailing duties, special customs regimes and dispute settlement; (iii) to identify and propose measures that make possible the expansion of bilateral trade; and (iv) to establish the criteria and bases for the negotiation and agreement of a free trade area between the parties.

⁴⁶ At the same time, Brazil separately concluded with India bilateral cooperation agreements in the areas of space development, the promotion of tourism, and artistic-cultural exchange. The two sides also furthered understandings on the short-term conclusion of agreements in the areas of agriculture, science and technology, education, health, food security, and agricultural development.

⁴⁷ Worth mentioning in this context is the recent agreement between Brazil, India and South Africa to create the G3 with a view to challenging the current geography of world trade. Given these three countries' shared perceptions of matters of interest to developing countries, they decided to join forces by means of a strategic alliance with a view to strengthening their positions in talks with rich countries. In 2003 the group led the pressure on developed countries to slowly withdraw the subsidies they grant to agricultural products during the failed WTO meeting in Cancun, Mexico.

**Main Points of the Preferential Trade Agreement between
MERCOSUR and India, January 25, 2004**

- The tariff preferences will be applied to all customs duties prevailing in each signatory at the moment when the product in question is imported.
- The customs duty includes duties and levies on any kind of tax related to the import of the good, with the exception of: (i) internal taxes or other levies imposed in conformity with Article III of the GATT Agreement 1994; (ii) antidumping or countervailing duties in line with Articles VI and XVI of the GATT Agreement 1994 and the WTO Agreement on Subsidies and Countervailing Measures; and (iii) other duties or taxes imposed in conformity with Article VIII of the GATT Agreement 1994 and understandings on the interpretation of Article II: 1(b) of the GATT Agreement 1994.
- Unless stipulated in the present agreement or in the GATT Agreement 1994, the parties cannot apply non-tariff restrictions (understood as any administrative, financial, exchange-related or other measure whereby a party unilaterally impedes or hampers reciprocal trade) to the trade in products contained in the annexes to the present agreement.
- In matters of taxes, duties and other internal levies, products originating in the territory of any other parties will enjoy in the territory of the other parties the same treatment as applied to national products, in line with the stipulations of Article III of the GATT Agreement 1994.
- As regards customs valuation, the parties will be governed by Article VII of the GATT Agreement 1994 and by the WTO Agreement on the Application of Article VII of the GATT Agreement 1994.
- The parties retain their rights and obligations to apply its safeguard measures as stipulated in Article XIX of the GATT Agreement 1994, in the Agreement on the Implementation of Article VI of the GATT Agreement 1994, and in the WTO Agreement on Subsidies and Countervailing Measures.
- In the application of antidumping and countervailing measures, the parties will be governed by their respective legislation, which should be consistent with what is stipulated in Articles VI and XVI of the GATT Agreement 1994, with the Agreement on the Implementation of Article VI of the GATT Agreement 1994, and with the WTO Agreement on Subsidies and Countervailing Measures.
- In the area of technical barriers to trade, the parties will respect the rights and obligations established in the WTO Agreement on Technical Barriers to Trade.
- In matters of sanitary and phytosanitary measures, the parties will have the rights and obligations established by the WTO Agreement on Sanitary and Phytosanitary Measures.
- The agreement will remain in force until the entry into effect of the agreement for the creation of a free trade area between MERCOSUR and India. Nonetheless, any of the parties can abrogate it giving a minimum of 60 days notice. Once the abrogation is formalized, the rights and obligations of the abrogating party shall cease, with the exception of obligations related to tariff preferences, which must remain in force for a period of a year.

During the second round of negotiations between MERCOSUR and India at the beginning of March 2004 in Buenos Aires, the countries exchanged an initial offer on more than 200 products and negotiated the preferential levels to be mutually granted. They also assumed a commitment to continue enlarging their lists in the coming months. As regards the texts on trade disciplines, they completed the chapters on safeguards and dispute-settlement, and made significant progress on rules of origin. The aim of the next negotiating rounds is to complete the negotiations before the end of 2004.⁴⁸

⁴⁸ The preferential trade agreement has five annexes. The first establishes the products on which MERCOSUR grants tariff preferences to India, while those granted by India to MERCOSUR are outlined in the second. Annex III presents the rules of origin to be followed to secure tariff preferences on the products listed in Annexes I and II. Annex IV contains provisions on the implementation of safeguard measures on imported products that are subject to the tariff preferences established in Annexes I and II. Annex V contains the provisions on the settlement of disputes that might arise from the application, interpretation on non-compliance with the terms of the present agreement by any of the parties.

G. The MERCOSUR-Mexico Negotiations

During the twenty-second summit of the MERCOSUR presidents on July 5, 2002, an economic complementarity agreement was signed with Mexico. The parties thereby assumed a commitment to create a free trade area. That same meeting also saw the conclusion of the negotiations for an agreement on the automotive sector, with the aim of securing real sectoral integration as well as greater reciprocal trade in automotive products.⁴⁹ This agreement arose from pressure exerted by the automotive industry, motivated by the interest of the large transnational firms present in both markets, which sought to rationalize their production further and to exploit economies of scale.

A further step in integration between MERCOSUR Mexico was taken in November 2003, during the thirteenth Ibero-American Summit, when the presidents of Mexico, Argentina, Chile and Brazil discussed the possibility of Mexico's becoming an associate member of MERCOSUR.⁵⁰ The decision was finally taken during the third summit of heads of state and government of the EU, Latin America and the Caribbean in May 2004. The official announcement of Mexico's accession to MERCOSUR as an associate member, a status similar to that of Chile, Peru and Bolivia, was made on July 8, during the MERCOSUR summit, at which Mexican President Vicente Fox took part as a special guest. That summit sought the formal start of talks on a free trade agreement with MERCOSUR, as defined in the negotiating calendar.

According to Mexican diplomatic sources, the process of Mexico's integration with MERCOSUR does not focus solely on the South American bloc but on the whole of Latin America, which should recover strength and representation in international fora. Moreover, they say, Mexico's accession to MERCOSUR does not run counter to the FTAA negotiations, since the latter recognize the importance of "multilateral relations". In this regard it can be inferred that Mexico's accession to MERCOSUR as an associate member is more a political than economic matter, since it allows the country to take an active part in the regional political dialogue and coordinate joint positions. That offers Mexico an opportunity to strengthen its position in Latin America.

Moreover, it was a way of mitigating the incompatibility between the customs union in MERCOSUR and the system of free trade agreements that Mexico has with more than 40 countries, since in many cases those agreements establish external tariffs with non-MERCOSUR countries that are lower than those adopted jointly by MERCOSUR. Mexico would be obliged to adapt its import tariffs to MERCOSUR's CET, which would inevitably lead to conflicts with the agreements that it has already signed. Hence trade relations between Mexico and MERCOSUR will continue to be based on economic complementarity agreements, which will have to be expanded so as to reduce tariffs and establish clear rules for investment, probably without involving services trade.

In the case of South America, Mexico has free trade agreements not only with Chile and Uruguay but also economic complementarity agreements with Argentina and Brazil. Mexico's trade with Brazil amounted to US\$ 3.25 billion in 2003, and the country is negotiating the expansion of the current agreement.⁵¹ It is

⁴⁹ The automotive agreement establishes that, in the case of new goods, the following products will have a 100% tariff preference, or a 0% *ad valorem* tariff: (i) automobiles; (ii) vehicles with a maximum total cargo weight of or below 8845 kg (light commercial vehicles, chassis with engine and cabins and coachwork for such vehicles, trucks and chassis with engine or cabin of the total cargo weight of or below 8845 kg; (iii) vehicles with a maximum total cargo weight above 8845 kg (trucks, tractors and chassis with engine and cabin of total or cargo weight above 8845 kg); (iv) buses (complete buses, chassis with engine and coachwork for buses); (v) and coachwork; (vi) trailers and semitrailers; (vi) agricultural tractors harvesters and agricultural machines; (vii) vehicle parts necessary for the production of all of vehicles listed in items (i) to (vi), as well as those for the parts market. It was also stipulated that the application of the free trade rules for these products would be gradual, between the agreement's entry into force and June 30, 2011.

⁵⁰ The associate members, among other characteristics, are not obliged to maintain a common external tariff with the bloc and can separately negotiate trade agreements with other countries.

⁵¹ Among other things the agreement between Brazil and Mexico led to the reciprocal reduction of tariffs on 800 products.

important to note, however, that Mexico's trade with MERCOSUR is still very low compared to its trade with NAFTA. Bilateral trade does not amount to 3% of total trade in the region. In 2003, for example, Mexican exports to MERCOSUR totaled US\$ 759 million, while its imports stood at US\$ 4.2 4 billion; primary products were important in the latter regard. It bears emphasizing that this situation has little to do with the lack of Mexico's integration with MERCOSUR. Essentially, it stems from the fact that Mexico's trade is largely focused on its trade partners to the north, especially the United States, with which it has marked commercial interdependence.

As regards investment, Mexico is the Latin American country with the highest level of investment in the region. Its investment in Latin America surpasses US\$ 20 billion, of which about 79% is in South America, 16% in Central America, and 5% in the Caribbean. Mexico's investment in MERCOSUR stands at about US\$ 8 billion.

Finally, it is worth noting that the announcement of Mexico's accession to MERCOSUR was made at a time when the negotiations for the FTAA were stagnant because of differences in the positions of MERCOSUR and the United States. MERCOSUR wanted the United States to reduce agricultural subsidies so as to facilitate the competitiveness of MERCOSUR products in the US market. The United States wanted clear rules on foreign investment and the opening of the government procurement market (see this chapter's section on the MERCOSUR-FTAA negotiations). In this problematic context Mexico's position, as the only Latin American country that is a member of NAFTA and MERCOSUR, could make the country a natural mediator in the resolution of regional differences, which would enhance its strategic leverage.

H. The MERCOSUR-Russia Negotiations

MERCOSUR and Russia have made efforts to broaden their trade and cooperation links with a view to raising bilateral relations to the level of a long-term strategic association. The first summit between Russia and MERCOSUR is scheduled for November 2004 in Puerto Iguazú. MERCOSUR currently accounts for more than half of the trade between Russia and Latin America.

Evidence of Russia's interest in closer relations with MERCOSUR is that the country's president, Vladimir Putin, recently stated that he favored the creation, in the short term, of a mechanism for political consultation and collaboration between Russia and the MERCOSUR countries. According to Putin, such contacts are an essential complement to the existing channels for interaction with the Latin American countries' multilateral organizations.

The areas of greatest interest for both sides are high-technology sectors such as the aeronautical and space industry, telecommunications, fuels and energy. Brazil, in particular, is interested in the transfer of Russian technology for its satellite launch vehicle, and in exchange would grant Russia the right to use the space base at Alcántara. Russia also wants to sell its Sukhoi aircraft to Brazil, while the latter wants to export its Embraer jets. Argentina's main point of interest is the development of joint products in the space field, the extraction of oil and gas, energy, and hydraulic technology. It is particularly interested in Russian participation in the construction of oil and gas pipelines in Argentina, as well as in the modernization of railways and electrical power stations. It should be noted that the latter were built with Soviet technology and equipment.

Another point conducive to closer relations between Russia and MERCOSUR is that the parties share significant strategic interests, including the establishment of a multipolar world order and a "more just and symmetrical" form of globalization. They support the strengthening of the United Nations and the Security Council as mechanisms for the settlement of international conflicts and as a means of counteracting the political and economic influence of the United States.

CHAPTER VI. MERCOSUR AND PHYSICAL INTEGRATION

A. Challenges Remain

The inclusion of the issue of physical integration on the MERCOSUR agenda arises from the consideration that trade, investment and the free movement of people among the member countries remain hindered, if not blocked, by physical barriers. The level of regional trade depends crucially on the quality of support infrastructure that, if it is low, can account for more than 40% of transport costs in developing countries (MERCOSUR Secretariat [2004]).

In South America the most important initiative to unite efforts geared to upgrading and integrating regional infrastructure began in 2000, with the Initiative for the Integration of Regional Infrastructure in South America (IIRSA). At that time the participating countries adopted an action plan, with proposals to expand and upgrade transport, energy and telecommunications infrastructure within ten years. This plan was called the Initiative for the Integration of Regional Infrastructure in South America (IIRSA). Its main aim was to transform South America into a more competitive region, with benefits for all the countries of the continent.

IIRSA is a multinational initiative because, for the first time, it involves the twelve sovereign countries of South America; it is multisectoral, because it deals not only with transport but also with the energy and telecommunications sectors; and it is multidisciplinary, because among other things it covers economic, political, social, cultural and environmental matters. Technical coordination of the initiative is in the hands of the three development banks that operate in the region: the Inter-American Development Bank (IDB), the Andean Finance Corporation (CAF) and the Financial Fund for the Development of the River Plate Basin (FONPLATA).

MERCOSUR regards IIRSA as an opportunity to hasten its own integration. In this connection, the 2004-2006 Work Program includes the following targets:

- prioritizing projects that are of interest to the MERCOSUR member countries in the IIRSA;
- instituting a special fund for infrastructure projects so as to increase coverage in this area, with a view to improving the integration of the MERCOSUR countries and regions by means of physical infrastructure projects with the rest of the continent;
- designing a program of investment in physical infrastructure and physical linkages among the operations of the actors involved in the services provided on the basis of that investment;
- analyzing the possibility of defining a matrix of future energy demand among the member countries and the availability of supply; devising physical infrastructure programs that foster the distribution of resources, with the corresponding feasibility analysis, the terms of financing and adjudication of public works, and the disciplines regulating the necessary trade and transport services.

B. Trends in the Main Issues

Energy

The South American governments' budget constraints have posed a substantial obstacle to progress on physical integration in MERCOSUR. According to Brazil's Mines and Energy Ministry, the large-scale energy interconnection projects between Brazil and some of its neighbors are paralyzed, especially those

with Argentina and Bolivia. Pending projects include: the building of a gas-chemical pole on the border with Bolivia, a gas pipeline to connect Porto Alegre with Uruguayana on the border with Argentina, and the binational hydroelectric station on the Rio Uruguay (the Garabi station), which will have the capacity to generate 1,200 to 1,8000 megawatts.

Apart from financial constraints, political problems have also hampered the projects. In the case of Bolivia, the talks to realize the gas-chemical pole were interrupted following the worsening of the political crisis that culminated with the fall of President Lozada in October 2003. Another sensitive point in the negotiations between the two countries is related to Brazil's purchase of Bolivian gas. The purchase and sale contract should be reviewed in 2004 and Brazil seeks a price cut; the recent discovery of large reserves of gas in Brazil has tended to intensify the dispute. Representatives of the Brazilian oil company aver that they have good relations with the Bolivian government and that, during the crisis, Petrobrás increased its daily imports of natural gas from 14 million cubic meters to 19 million, a demonstration of Brazil's goodwill.

In Argentina, projects are paralyzed because of the difficulties of recovering investments in the country. Also at a standstill are the talks between Argentina and Brazil on the building of a gas pipeline connecting Argentina and Bolivia. Although this does not cross Brazilian territory, Brazil's government could hold stock in the project, probably through Petrobrás.

In 2004, Brazil exported electricity to Argentina and Uruguay. The electricity to Uruguay was transmitted across Argentine territory – the first energy triangulation in the region. There is still no full electricity connection in the Southern Cone because of the countries' differing electrical systems. Brazil's current runs at 60 cycles, while in its neighbors the system operates at 50 cycles. Frequency converters would have to be built to make the interconnections feasible, an endeavor that calls for significant investment.

Electricity connections between countries or regions: (i) improve operational conditions in terms of the security and reliability of supply (a reduction in power outages), as well as the quality of the service (constant voltage and frequency); (ii) facilitate planning; (iii) reduce the environmental effects (replacing thermal energy with renewable energy); and (iv) enhance the economic efficiency of the system by reducing the level of emergency reserves needed, facilitating optimal use of power stations and the exchange of surpluses, increasing the expanded system's burden factor, and enabling economical operation and transmission.

An integrated energy system would have mitigated Argentina's supply crisis in 2004. In the first third of the year, because of the shortage of gas and the expectations that the situation would worsen with the arrival of winter, gas suppliers declined to renew contracts that guaranteed supply (the contracts oblige the concessionaires to ensure a supply to the client in return for a higher tariff).

Argentina's small and medium firms were the most affected by the shortage because, unlike large companies, they lacked the means to find alternative solutions. The provision of gas to Chile was also affected. Chile depends on Argentina for 25% of its energy. At the end of March the Argentine government issued a decree making gas and electricity exports conditional on total coverage of domestic demand. Immediately afterwards, it cut its gas supplies to Chile by 15%.

For energy integration in MERCOSUR to become a reality, there is a clear need for national models in the sector to feature a reasonable degree of harmonization. The problems that arose in the wake of the sector's partial privatization in Argentina and Brazil led to widespread (albeit not wholly consolidated) reviews of the previous models.

Transport

The deficiencies of transport integration in the Southern Cone have often been a barrier to intra-regional trade. The problem of integration is not always physical. That is, it is not solely the result of the absence of roads, railways or waterways. In the most recent episode involving Argentina and Brazil, the problem lay in the absence of a regulatory framework allowing for a proper division of responsibilities.

At the start of July the Argentine government issued a resolution whereby all truck traffic used for bilateral trade between Brazil and Chile was confined to a single corridor across Argentine territory. Apart from Ecuador, Chile is the only South American country that does not border Brazil. Argentina argued that unlimited foreign cargo traffic increased the costs of maintaining the country's road infrastructure.

The resolution stipulated that the movement of Brazilian and Chilean trucks across Argentine territory would be confined to a route that added 2,000 kilometers to the distance between Santiago and Uruguayana, a city in Rio Grande do Sul, the location of the dry dock through which 70% to 80% of trucks between Brazil and Chile pass. In addition to the increased distance, transport through the only corridor would create a bottleneck in trade between the two non-contiguous countries, according to a representative of Brazil's international carriers (*Valor Económico*, July 13, 2004).

An agreement between Argentina, Brazil and Uruguay at the end of 1988 made provision for the latter to receive compensation for the movement of Brazilian cargo en route to Argentina. Since 1990 the Argentine government has sought unsuccessfully to secure similar treatment. This friction with Brazil is not an isolated episode. In December of last year the Argentine government blocked the movement of Uruguayan trucks traveling to Paraguay. In an effort to find a definitive solution to the problem, the Argentine and Uruguayan governments agreed to set up a bilateral committee to discuss commercial traffic between the two countries. Argentina agreed to a similar procedure in the recent episode with Brazil.

As regards the expansion and upgrading of the region's transport network, it is worth noting the Argentine government's recent decision to reopen the trans-Andean railway. This stretch, connecting Mendoza province in center-west Argentina with Chile, was decommissioned in the late-1970s because of the border disputes in the Beagle Channel. If the deadlines set by the Argentine authorities are met, the restoration should be finished in mid-2005. The trans-Andean railway is part of MERCOSUR's "bi-oceanic axis" transport corridor.

Another development was the IDB's announcement of a donation of US\$ 1 million to Bolivia's National Highway Service for a strategic environmental assessment of the area around the La Paz-Guayaramerín-Cibija Northern Corridor. The study financed by this operation covers preliminary activities to assess and prevent problems in future projects. The Northern Corridor is a long-term project by the Bolivian government to upgrade and complete the Victor Paz Estenssoro road that will link La Paz with two cities on the border with Brazil: Guayaramerín and Cobija.

Finally, one of the first missions of former Argentine President Eduardo Duhalde as head of the commission of permanent MERCOSUR representatives is to raise foreign private sector interest in financing large-scale infrastructure projects in MERCOSUR. Duhalde, who too up his new post in December, has visited the United States, Spain and Japan, accompanied by IDB President Enrique Iglesias.

Telecommunications

The first Technical Executive Group meeting of the IIRSA Initiative was held in Brasilia in September 2003. Its theme was information and communications technology, and it acknowledged the huge potential of the integration of these sectors in South America. The region's basic challenge is to enable all citizens to access the information society, thereby smoothing the way for social inclusion.

Expert participants at the meeting included the Information Society representative of the European Commission, who related the successful experience of integration in the region. The EU is a pioneer in e-strategy. It aims to meet the target, set by the EU heads of state and government in 2000, to make Europe "the world's most competitive and dynamic knowledge economy by 2010, especially as regards the development of the online economy and in giving citizens the access and capacity needed to work and live in the information society". This approach was imitated by other countries, including some in Latin America, where Mexico (e-Mexico) and Brazil (the Information Society Program) are prominent.

In line with the European experience, a successful electronic strategy must meet the following requirements: (i) lead to joint action involving governments, public authorities and the private sector; (ii) enjoy high-level political support; (iii) give rise to the benchmarking of national progress in each member country; and (iv) promote the dissemination of best practices. An intermediate goal of the e-strategy's first stage in Europe was to secure a cheaper, faster and safer Internet working on two fronts: increased competition within a predictable regulatory framework, so as to offer legal security to investors; and the development of people's knowledge by means of digital education. A sign of the initiative's success is the doubling of household Internet access after three years. Moreover, most companies and schools in the EU are connected to the Internet.

One illustrative aspect of the EU experience of information technology integration is the role of the regulatory framework. In tackling the challenge of integration, the EU was clear as to the need for a new framework consistent with the harmonization of telecommunications services and infrastructure.

STATISTICAL ANNEX

TABLE A.1
ECONOMIC GROWTH RATES

	2002	2003	2004*	2005*
World	3.0	3.9	4.6	4.4
Advanced economies	1.7	2.1	3.5	3.1
<i>United States</i>	2.2	3.1	4.6	3.9
<i>Eurozone</i>	0.9	0.4	1.7	2.3
Germany	0.2	-0.1	1.6	1.9
France	1.2	0.2	1.8	2.4
Italy	0.4	0.3	1.2	2.0
Spain	2.0	2.4	2.8	3.3
<i>Japan</i>	-0.3	2.7	3.4	1.9
<i>United Kingdom</i>	1.7	2.3	3.5	2.5
<i>Canada</i>	3.3	1.7	2.6	3.1
<i>Other advanced economies</i>	2.8	1.9	3.2	3.5
Newly industrialized Asian countries	5.1	3.0	5.3	5.0
Other emerging markets and developing countries	4.6	6.1	6.0	5.9
<i>Africa</i>	3.5	4.1	4.2	5.4
Sub-Saharan	3.5	3.5	4.2	5.7
<i>Central and Eastern Europe</i>	4.4	4.5	4.5	4.4
<i>CIS</i>	5.1	7.6	6.0	5.2
Russia	4.7	7.3	6.0	5.3
Except Russia	6.2	8.1	5.9	5.0
<i>Emerging Asia</i>	6.4	7.8	7.4	7.0
China	8.0	9.1	8.5	8.0
India	4.7	7.4	6.8	6.0
ASEAN-4	4.3	5	5.4	5.4
<i>Middle East</i>	4.2	5.4	4.1	5.0
<i>Western Hemisphere</i>	-0.1	1.7	3.9	3.7
Brazil	1.9	-0.2	3.5	3.5
Mexico	0.7	1.3	3.3	3.3

Notes: * Projections.

Source: IMF [2004a].

TABLE A.2
MERCOSUR: EXPORTS, IMPORTS AND TRADE BALANCE BY ORIGIN AND DESTINATION

Exports Main destinations	1994	1995	1996	1997	1998	1999	2000	2001	2002	Change 02/01	2003 accumulated *
European Union	16,701	17,994	18,093.00	19,336.00	20,075.00	19,168.00	19,872.00	19,940.00	20,782.00	4.20	23,586.00
NAFTA	12,839	11,981	13,078.00	13,495.00	14,261.00	15,893.00	19,746.00	20,764.00	22,764.00	9.60	24,498.00
South America (except MERCOSUR and Mexico)	4,394	5,560	5,488.00	6,280.00	6,043.00	5,149.00	6,791.00	7,631.00	8,529.00	11.80	5,457.00
Japan	3,041	3,576	3,586.00	3,654.00	2,887.00	2,755.00	2,913.00	2,351.00	2,488.00	5.80	2,328.00
China						1,266.00	1,986.00	3,149.00	3,638.00	15.50	4,641.00
Rest of the world	23,978	29,074	32,539.00	37,182.00	35,992.00	30,475.00	33,148.00	33,598.00	30,061.00	-10.50	23,999.00
Total	60,952	68,184	72,784.00	79,946.00	79,257.00	74,707.00	84,455.00	87,432.00	88,262.00	0.90	84,508.00

Imports Main origins	1994	1995	1996	1997.00	1998	1999	2000	2001	2002	Change 02/01	2003 accumulated *
European Union	15,903	20,702	22,081.00	25,257.00	26,609.00	22,978.00	20,689.00	20,158.00	15,582.00	-22.70	15,269.00
NAFTA	13,361	18,009	20,555.00	24,488.00	23,921.00	19,953.00	21,070.00	19,546.00	14,076.00	-28.00	13,392.00
South America (except MERCOSUR and Mexico)	2,029	2,902	3,087.00	3,217.00	3,242.00	2,866.00	3,775.00	2,866.00	2,229.00	-22.30	2,220.00
Japan	3,671	4,316	3,759.00	4,994.00	4,947.00	3,816.00	4,100.00	3,967.00	2,738.00	-31.00	2,917.00
China						2,068.00	2,528.00	2,534.00	1,976.00	-22.00	2,793.00
Rest of the world	23,257	27,954	31,679.00	36,528.00	34,280.00	27,917.00	34,068.00	31,565.00	22,855.00	-27.60	26,488.00
Total	58,222	73,883	81,162.00	94,483.00	92,999.00	79,598.00	86,230.00	80,637.00	59,456.00	-26.30	63,079.00

Trade balance	1994	1995	1996	1997	1998	1999	2000	2001	2002	Difference 02/01	2003 accumulated *
European Union	797	-2,7086	-3,988.90	-5,920.80	-6,534.50	-3,810.00	-816.60	-218.40	5,199.52	5,417.92	8,316.85
NAFTA	-523	-6,029	-7,476.40	-10,993.20	-9,660.70	-4,059.30	-1,324.00	1,217.80	8,687.45	7,469.65	11,105.50
South America (except MERCOSUR and Mexico)	2,365	2,658	2,401.26	3,062.74	2,801.60	2,283.60	3,015.90	4,764.30	6,300.97	1,536.67	3,237.10
Japan	-630	-740	-172.95	-1,339.82	-2,059.50	-1,061.40	-1,187.60	-1,615.70	-249.46	1,366.24	-589.28
China	0	0	0.00	0.00	0.00	-802.25	-542.45	614.25	1,661.45	1,047.20	1,847.99
Rest of the world	721	1,120	859.70	654.08	1,711.40	2,558.46	-919.54	2,032.75	7,206.01	5,173.26	-2,489.56
Total	2,731	-5,699	-8,378.00	-14,537.00	-13,742.00	-4,891	-1,774	6,795	28,806.00	22,010.94	21,428.60

Note: Argentina, Brazil, Paraguay and Uruguay (Jan-Dec); Argentina (Jan-Oct.).

Source: MERCOSUR Secretariat [2004].

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