



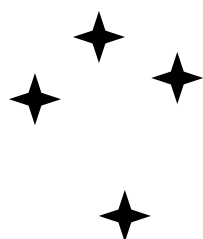
2005 (SECOND SEMESTER) - 2006 (FIRST SEMESTER)



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

Inter-American Development Bank
MERCOSUR Report N° 11, February 2007





REPORT

MERCOSUR

2005 (SECOND SEMESTER) - 2006 (FIRST SEMESTER)

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The Subregional Integration Reports series represents an effort by INTAL to promote knowledge and the spread of information about the integration process currently underway in Latin America and the Caribbean. As part of this trend of economic integration, the Southern Common Market has, since the signing of the Treaty of Asunción in 1991, 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 potential readership interested in MERCOSUR, while spanning the public, private and academic sectors, and the community of the subregion as a whole. We also seek to go beyond the interest MERCOSUR awakens at subregional level by making the Report available to an international audience with this version in English, alongside the official languages of the process, Spanish and Portuguese.

Report #11 covers the second half of 2005 and first half of 2006. The document's initial draft was produced by Ricardo Markwald, a senior economist specializing in international trade, with the technical and statistical assistance of the economists, Fernando Ribeiro, Sandra Ríos, INTAL research assistant Romina Gayá, Leane Naidin, Henry Pourchet and Alejandro Ramos. Paolo Giordano and Cristian Volpe, both economists from the Integration, Trade & Hemispheric Issues Division, contributed valuable comments and suggestions at the document's revision stage. INTAL Director, Ricardo Carciofi, and Senior Economist in Integration, Uziel Nogueira, were responsible for coordinating and editing the final draft of the Report.

Readers are invited to send their comments and/or suggestions on how to improve the scope and focus of future publications to help us continue to live up to the expectations prompted by previous reports.

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EXECUTIVE SUMMARY

In the context of a growing world economy, a steady demand for raw materials and a wealth of liquidity, the Southern Common Market (MERCOSUR: *Mercado Común del Sur*) continues to expand. The **macroeconomic indicators** reveal a more solid bloc than last year, and growth is combined with lower vulnerability in the external sector, fiscal discipline and inflation at a historic low. Economic expansion in 2006 is estimated to be around 4.9%, similar to 2005 but below the group of emerging countries.

Economic policy instruments -and in particular the exchange rate- are obeying various designs, while greater harmony is seen in fiscal policy. The MERCOSUR economies' recovery was grounded in a major drive toward saving. While net exports in Brazil went on expanding at a faster pace, in the other countries investment was a more dynamic factor of aggregate demand.

Likewise, MERCOSUR countries' **trade flow** in 2005 displayed excellent indicators, with growth in both exports and imports, and a rise in the trade balance. Indeed, trade in the bloc rose in 2005 for the third year running after a prolonged period of instability. The bloc's performance has outstripped world trade, with MERCOSUR's share in world trade climbing from 1.36% in 2002 to 1.56% in 2005.

Recent expansion has been more intense in **intrabloc trade** flows, which more than doubled in 2003–2005, reaching the a record US\$ 21 billion last year. Two recent developments in intrabloc trade flows attract attention: the asymmetry seen in the evolution of trade balances, with Brazil recording high and rising surpluses with all partners, and the fall in the partners' market share in imports from Brazil. Analysis shows that this drop is due both to a problem of composition of the product basket of exports from these countries to Brazil (quite heavily concentrated on products for which there is increasingly less demand in Brazil, that is, products whose recent growth has been below average), and to problems of product competitiveness, which translated into a smaller market share for the partners in Brazilian imports in the vast majority of products with the highest impact on their export baskets. The second effect was seen across the board with the exception of Paraguay, which is why everything is explained by the composition effect. MERCOSUR's **extrazone trade** performed quite well in 2003-2005: exports showed average annual growth of 21.9%, imports grew by 21.1% a year and the trade balance reached US\$ 54.7 billion in 2005. The extreme dynamism of trade with other LAIA countries and Asia was paramount.

MERCOSUR exports were boosted by sharp price rises in commodities and industrialized products. Export prices account for almost a third of growth in exported value in Brazil's case, and 26% of the total in Argentina's. The phenomenon in Uruguay was less intense, but still significant. Nevertheless, it should be stressed that exchange rates declined during 2005 throughout the bloc, with the exception of Argentina. Where Brazil and Paraguay are concerned, this index is at the lowest level for the last decade.

The asymmetry of Brazil's performance in intrabloc trade has for some years been causing recurrent trade friction with its partners, especially Argentina. By mid-2006, the Argentina/Brazil Bilateral Trade Monitoring Commission (*Comisión de Monitoreo del Comercio Bilateral Argentina-Brasil*) was following up on 17 products. However, there has been a slight but detectable reduction in bilateral trade friction thanks to factors like the appreciation of the Brazilian real against the Argentinian peso, the clear slowing in the growth of Brazilian exports to the neighboring market and the relative success of certain sectoral agreements concluded in the recent past. Both countries' industries are now mainly concerned about the threat of imports from China, whose products are rapidly gaining ground in both markets.

The net income from **foreign direct investment** (FDI) in MERCOSUR countries performed relatively poorly in 2005, totaling US\$ 20.5 billion, 17% down on the previous year. Their share in the world total dropped to just 2.3% and to 7.5% of the total to developing countries. This fall was fundamentally due to

the reduction of almost US\$ 3 billion in flows to Brazil, while investments in Argentina and Uruguay rose, and in Paraguay remained stable. Note should be taken of the growing importance of the overseas investments of Brazilian companies and the Argentina's preeminence as a destination for these resources.

The issues dominating the bloc's **internal agenda** between mid-2005 and July 2006 included the progress in the removal of "double levying" of the Common External Tariff or CET (*AEC: Arancel Externo Común*), the renegotiation of the Agreement on Automotive Policy (*Acuerdo sobre la Política Automotriz*) between Argentina and Brazil, the establishment of the Competitive Adaptation Mechanism or CAM (*MAC: Mecanismo de Adaptación Competitiva*) -an instrument agreed by both countries with the aim of disciplining the imposition of bilateral trade protection measures-, the treatment of **asymmetries**, the MERCOSUR member countries' incorporation of rules and, lastly, the "paper mills" dispute -a environmental/legal conflict that seriously affected the relationship between Argentina and Uruguay over the installation of two pulp mills in a border region on the east bank of the River Uruguay.

Progress in the removal of the double CET levying is important, for, even in the present day MERCOSUR is characterized by the existence of four separate customs territories instead of the single territory of an authentic customs union. Indeed, only "original" goods -goods meeting the requirements established by MERCOSUR's rules of origin- may circulate freely within the customs union. Other goods must pay import tariffs again on crossing another national border within the union, hence the problem of "double CET levying."

An important event in dealing with asymmetries was the setting-up of the MERCOSUR Structural Convergence Fund or MSCF (*FOCEM: Fondo para la Convergencia Estructural del MERCOSUR*). The MSCF is clearly a redistributive fund, with the countries contributing most resources receiving fewest. Paraguay and Uruguay together contribute 3%, but receive 80% of the Fund's resources annually. The contributions were determined on the basis of individual countries' average shares of Gross Domestic Product (GDP) in MERCOSUR's total GDP, while for resource distribution between countries the size of partners' economies and their relative degree of development were taken into account.

In recent years, the Common Market Council (*CMC: Consejo del Mercado Común*) has adopted various provisions designed to speed up the **incorporation of MERCOSUR rules** in the States Parties' legislation, but progress to date has not been satisfactory. On March 31, 2006, the MERCOSUR Secretariat or MS (*SM: Secretaría del MERCOSUR*) informed that of the 1,712 rules passed between 1991 and that date, almost 67.5% were valid in the four States Parties.

Two issues dominated MERCOSUR's **external agenda** last year: the multilateral negotiations of the Doha Round in the framework of the World Organization of the Trade (WTO), and the full incorporation of Venezuela into MERCOSUR.

Despite its extensive **external negotiating agenda**, MERCOSUR has run into difficulties in making progress in negotiations. Despite the wide variety of negotiating initiative, only three agreements have been concluded in the last three years, namely, with the Andean Community of Nations (*CAN: Comunidad Andina de Naciones*), India and the Southern African Customs Union (SACU). The last two have not yet come into effect. Where the developed countries are concerned, it has not been possible to overcome the stagnation caused by conflicts of interest and comprehensive, non-convergent agenda of issues. Where the developing countries are concerned, negotiations have produced rather unambitious agreements both in terms of product coverage and level of preferences negotiated. In an international context where regional trade agreements proliferate, there is growing debate over the reasons for the poor performance of MERCOSUR's external agenda.

Another outstanding issue highlighted on the 2005-2006 MERCOSUR agenda was the negotiating process for the Protocol for the Bolivarian Republic of Venezuela's Membership of MERCOSUR (*Protocolo de*

Adhesión de la República Bolivariana de Venezuela al MERCOSUR). The Protocol entitles Venezuela to the rights and obligations of the Treaty of Asunción, the Protocol of Ouro Preto and the Protocol of Olivos, while giving the country four years to adopt the regulatory legacy of MERCOSUR, the CET and the MERCOSUR Common Nomenclature or MCN (*NCM: Nomenclatura Común del MERCOSUR*). The process demands a reasonable effort from Venezuela, as there is a considerable gap between its tariffs and those of MERCOSUR. The widest gap is seen in labor-intensive agricultural and manufactured products, in which Venezuela's sensitive products seem to be concentrated.

The deadlines defined for the scope of free trade between MERCOSUR countries and Venezuela (the upper limit is 2014) will involve bringing forward the liberalization timeframes already negotiated under Economic Complementation Agreement (ECA) #59 (*ACE: Acuerdo de Complementación Económica*).

Regardless of the priorities of MERCOSUR and Venezuela's foreign policies, the characteristics of their foreign trade and productive structures exhibit significant differences. This suggests that the kind of trade policy coordination required of member countries in a customs union may be no small matter.

CHAPTER I. MACROECONOMIC OVERVIEW

The international context and the evolution of the internal economy play a key part in shaping the regional integration process. This first chapter therefore aims to gauge the external and internal macroeconomic climate of the Southern Common Market countries (MERCOSUR) to gain a more complete idea of the evolution of trade relations within the bloc.

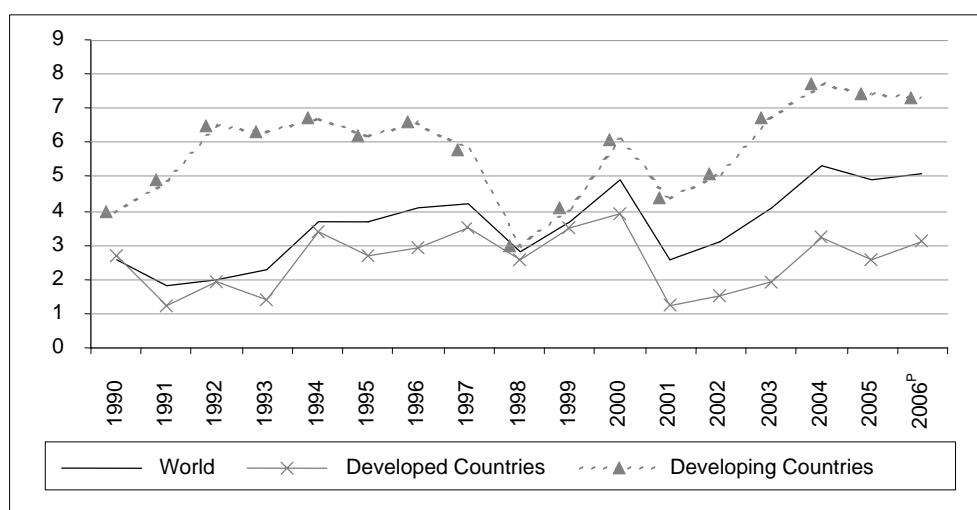
In the context of a growing world economy, a steady demand for raw materials and a wealth of liquidity, the Southern Common Market (MERCOSUR: *Mercado Común del Sur*) continues to expand. The **macroeconomic indicators** reveal a more solid bloc than last year, and growth is combined with lower vulnerability in the external sector, fiscal discipline and inflation at a historic low. Nevertheless, there are still many asymmetries within the block.

MERCOSUR's trade with the rest of the world is undergoing sustained expansion, reaching its historical maximum values, despite a slight decline in exchange rates. Intra-bloc trade continues to recover, although its share in total exports has remained several percentage points below the record of the 1990s.

A. The International Context

According to preliminary estimates, the world economy grew by 5.1% in 2006, similar to 2005 (4.9%) (IMF [2006b] p. 189). The global Gross Domestic Product (GDP) has thus grown at over 4% annually four years running, not only up on the performance during the slowing of 2001 and 2002, but also on that of previous phases of expansion. This phenomenon is explained by the dynamism of the emerging economies, as the developed countries are growing on average more slowly than in the late 1990s.

GRAPH 1
GROWTH OF THE WORLD ECONOMY
Real Percentage Variation in GDP



Note: (P) Projections.

Source: IMF.

There were positive variations in all the major blocs during the first half. US year-on-year GDP grew 3.6% in the first half, though followed by a period of slowing caused by inflationary tensions and the downturn in the real estate market. The European Union (EU) and Japan showed signs of economic intensification, the developing countries performed well, prominent among them China, whose investment peak, starting in 2003, extended throughout the period. GDP in Latin America rose around 5% in 2006, a half point up on 2005 according to the projections available to us (ECLAC [2006 b] p. 17).

World trade in commodities rose 13.1% during 2005, a rate well above the 7.6% cumulative annual average of the last 15 years, but down on 2003–2004's record growth of nearly 19%.

Global expansion kept up the steady demand for raw materials. During the first half of 2006, the average price of commodities, excluding fuels,¹ was up 23% on the same period the previous year, over 70% higher than the lowest value of the late 1990s. The price of a barrel of crude oil,² on the other hand, was 33% higher than 2005 in the first half of the year, as a result of the Middle East conflicts and the shortage of idle refining capacity faced with growing demand, among other important factors. In 2005, the oil price had already climbed 41% and raw materials, excluding fuels, 10%.

Until mid-2006, there were strong signs of global change: signs like lower growth in US GDP from the second quarter, higher global inflation, the toughening of monetary conditions and a degree of financial turbulence were expressions of a deterioration in the favorable context in which the emerging economies had been operating during the expansion phase. Although such changes have not altered the picture for 2006 -as positive as the previous year's- they are highly likely to have repercussions in the future. Also, it is encouraging that many developing countries -including those of Latin America- today display greater solidity than in the past in facing up to a change in the external context.

B. MERCOSUR in the Global Context

According to available estimates, MERCOSUR economies grew 5.4% in 2006,³ a figure similar to 2005. As in 2005, this growth is in line with the increase in global demand, which stimulated exports, while low international interest rates helped the continued improvement in the conditions of foreign debt. MERCOSUR's impact on global economic activity is expected to hold at around the 2005 mark (3.5%).⁴

External Demand & Rates of Exchange

During 2006, strong world demand continued to boost MERCOSUR exports beyond the bloc, keeping the price of the main export products at record highs. This growth of the bloc's economies continued to dynamize external purchases. MERCOSUR exports and imports thus reached record levels (Chapter 2).

The value of MERCOSUR's first half extrazone exports rose 12.6%, while imports of extrabloc products grew 23.1%. The trade balance surplus in transactions with the rest of the world reached US\$ 23.7 billion. In 2005, extrazone trade performed very well with a positive balance of US\$ 54.7 billion, US\$ 11 billion up on 2004. Exports grew 20.7% (US\$ 142 billion) and imports around 18% (US\$ 87.8 billion).

¹ International Monetary Fund (IMF) Commodity Price Index, excluding fuels. The rise in price of metals like copper (83%), aluminum (38%) and iron ore (19%) is particularly noteworthy, as is that of certain agricultural raw materials such as sugar (91%) and wheat (23%). At the other extreme, the price of sunflower oil (34%), pig meat (12%), chicken (7%), beef (5%) and, in the soya complex, doughs (5%) and beans (4%) all fell.

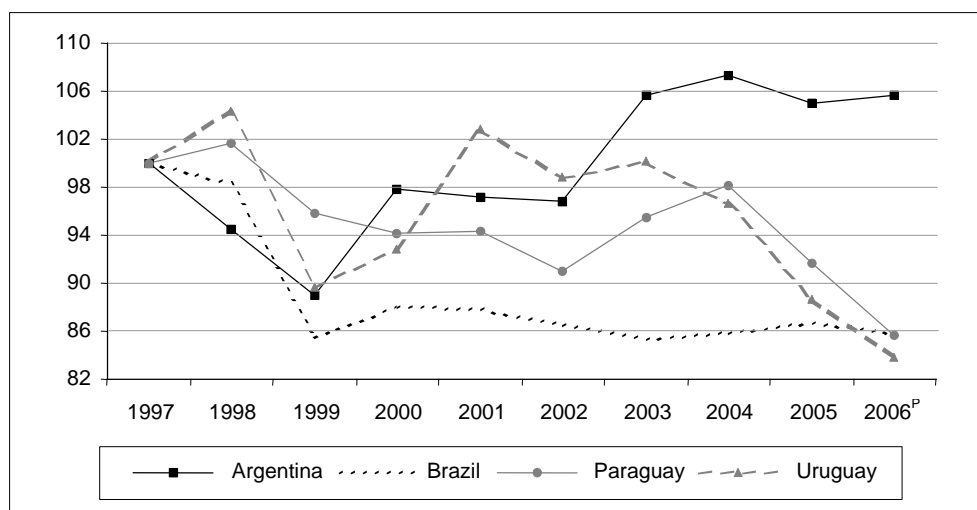
² Simple average Brent price, West Texas Intermediate (WTI) and Dubai Fateh, according to IMF calculations.

³ Simple average of the four MERCOSUR countries.

⁴ Global product measured by the purchasing power parity (PPP) exchange rate, using IMF estimates.

The aggregate value of intrabloc trade (exports plus imports) set a new record in 2006, after making up, in 2005, the ground lost during the crisis. Overall, Argentinian and Uruguayan exports to other MERCOSUR partners stayed below previous maximums and the bloc's share of total exports in the four countries showed slow growth, and was even several percentage points below the 1990s.

GRAPH 2
EXCHANGE RATES
Indexes 1997 = 100



Note: (P) Projections.

Source: Author's, based on INDEC, FUNCEX, BCU and ECLAC data. ECLAC Projections.

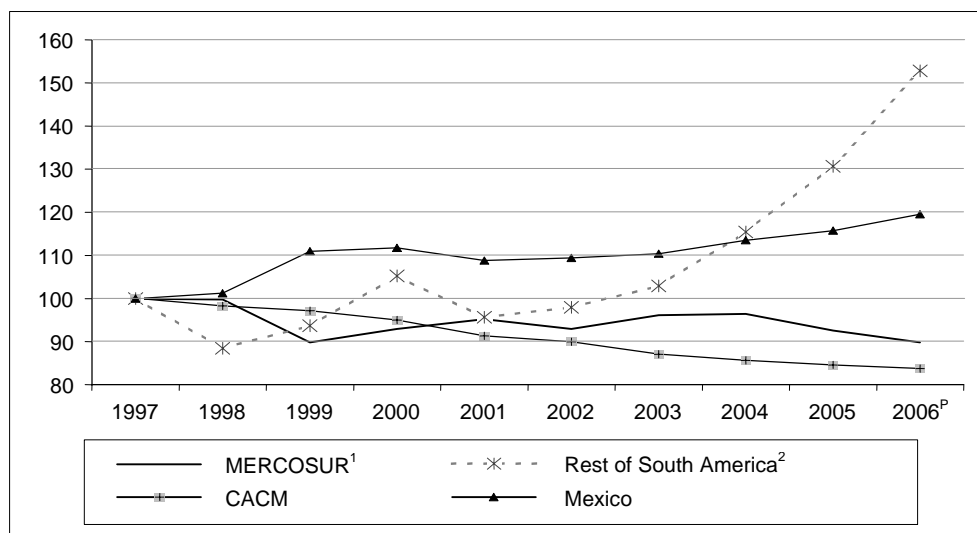
For MERCOSUR countries, the evolution of exchange rates (ER) during the global economy's expansion phase had mixed results. If the average for 2003–2006⁵ is compared with 1998–2002, only Argentina shows gains (around 11%), while the other countries show losses, especially Uruguay, which was extremely hard hit by the rise in energy prices. Continuing with the comparison, the positive evolution of prices of some of Paraguay and Brazil's exports was perceived to have lessened the impact of price increases in imported goods. Brazil's ER have experienced no major fluctuations since 1999. In 2005–2006, Uruguay and Paraguay were especially badly hit by the sharp rise in the price of oil and oil derivatives, and by the fall in the price of certain export commodities. This explains the almost 7% cumulative annual average decline in the two countries during this period, putting the price ratio of MERCOSUR's two smaller economies at its lowest for a decade.

The relatively poor evolution of MERCOSUR's ER contrasts with other Latin American economies. Graph 3 shows that, while the bloc's ER⁶ displayed a slight downward trend over the last decade -not as pronounced as the Central American Common Market or CACM (*MCCA: Mercado Común Centroamericano*)- other countries in the region showed significant improvement in their ER, boosted mainly by the metal price.

⁵ Estimates from official sources and the Economic Commission for Latin America and the Caribbean or ECLAC (*CEPAL: Comisión Económica para América Latina y el Caribe*); 2006 projections prepared by ECLAC.

⁶ Simple average ER for the four countries.

GRAPH 3
EXCHANGE RATES
Indexes 1997 = 100



Notes: (1) MERCOSUR: simple average for the four MERCOSUR countries.

(2) Rest of South America: simple average for Bolivia, Chile, Ecuador, Peru and Venezuela.

(3) CACM: simple average for Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.

(P) Projections.

Sources: Author's, based on INDEC, FUNCEX, BCU and ECLAC. ECLAC Projections.

Current Account Balance & Capital Flow

The evolution of the current account balance of the balance of payments in the last two years revealed the asymmetries in MERCOSUR trade performance. While the balance enabled the two largest economies to accrue surplus results, the smaller countries showed a deficit, due largely to the decline of their ER.

According to preliminary estimates, Brazil's surplus current account balance for 2006 reached 1.2% of GDP, while Argentina's represented 2.9%, down in both cases on the previous year. Paraguay and Uruguay's current accounts were also down on 2005, with respective deficits of 2.1% and 1.6% of GDP.⁷

As in 2005, low international interest rates in the first half of 2006 facilitated access to financing and increased the attraction for foreign investors of emerging economies' financial assets, with a consequent influx of capital into MERCOSUR. Sovereign risk premiums thus hit record lows,⁸ international reserves rose considerably and MERCOSUR countries -with different strategies- again participated in the debt market, although both the public and part of the private sectors took advantage of the favorable context to reduce their external liabilities.

⁷ The current account surplus in 2005 reached 1.7% of GDP in Brazil and 3.2% in Argentina. (The exchange of the public debt, which was in suspension of payments and substantially reduced the burden of interest influenced Argentina's result). In Uruguay, the balance for 2005 was virtually even, while Paraguay recorded a deficit of 2% of GDP after three years of surplus.

⁸ Risk premiums in Brazil and Uruguay hit a record low during the first half of 2006. In Argentina, country risk was just 15% up on the minimum of end of August 1990. The analysis does not extend to Paraguay, as it has no debt in international markets.

Between late 2005 and early 2006, Argentina and Brazil paid off the whole of their debt to the International Monetary Fund (IMF) ahead of schedule, and Brazil did the same with the Paris Club. More recently, Uruguay paid 50% of its financial obligations to the IMF and covered its entire debt with this organization with due dates in 2006 and 2007.

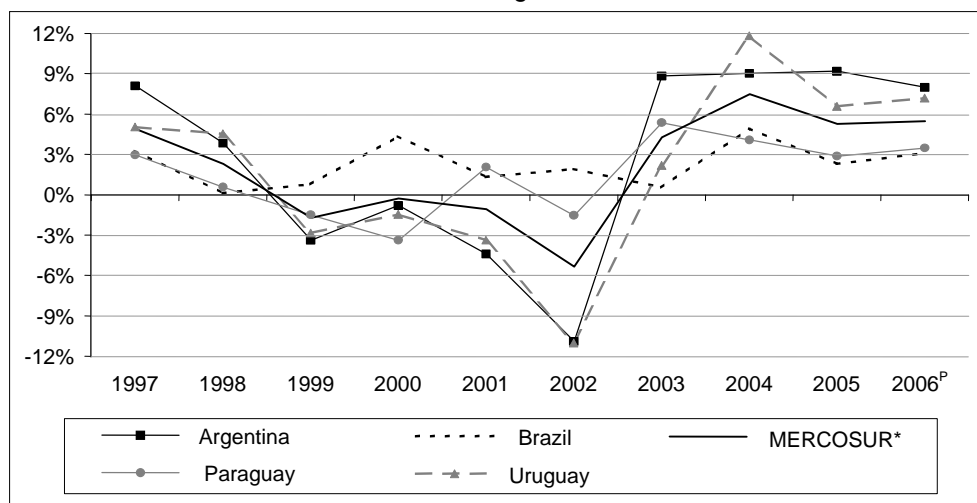
MERCOSUR countries continued to accumulate international reserves to reduce the vulnerability of their economies in the event of an external upset. The sharpest rise occurred in Argentina, where international liquid reserves -negative in 2003- quadrupled between late 2004 and the first half of 2006, in excess of US\$ 26 billion. Reserves in Brazil rose 128% from December 2004 and with a final total of almost US\$ 63 billion, while the rise in reserves in Paraguay and Uruguay in same period was 40% and 25% respectively.

C. MERCOSUR's Macroeconomic Development

MERCOSUR countries' GDP continues to expand, with macroeconomic indicators currently showing a more solid bloc than last year: this growth is combined with surpluses in the external sector, and growth is combined with lower vulnerability in the external sector, fiscal discipline and inflation at a historic low.

Preliminary estimates suggest that, as in previous years, Argentina and Uruguay had the highest growth rates of 2006. Paraguay and Brazil continue to expand at a more moderate pace, slightly faster than 2005. Notwithstanding these differences, GDP in all four countries reached record levels in 2006.⁹

GRAPH 4
GROSS DOMESTIC PRODUCT
Real Percentage Variation



Notes: * Simple average of the four MERCOSUR countries.

(P) Projections.

Sources: Author's, based on MECON, BCB, BCU, BCP AND ECLAC databases.

⁹ Argentina and Uruguay had made up all the ground lost in the crisis of 2005. And *per capita* GDP in the four countries is up on the 1990s.

Macroeconomic Policy

From the point of view of the application of macroeconomic instruments, MERCOSUR countries' policies over 2006 were similar to previous years, with the partners adopting different exchange regimes. While Brazil and Uruguay employ a predominantly fluctuating currency model, Argentina implicitly pursues an exchange target with considerable intervention from the Central Bank. Paraguay is intermediate between the two, letting the Guaraní fluctuate, but without significant appreciation.

Keeping in mind these definitions and preferences in exchange matters, the individual economies' monetary policies were adjusted to avoid inflationary pressure. It is in the fiscal area that the greatest convergence of objectives can be identified, with all the countries aiming to produce primary surpluses as a way of stabilizing public debt coefficients in relation to GDP.

- Argentina -

As pointed out, Argentina displays differences with its fellow MERCOSUR partners in exchange design. Authorities pay attention to the evolution of the nominal exchange rate in order to reduce the peso's trend toward nominal appreciation and ease inflationary pressure. The surplus current account balance of the balance of payments, plus the liquid income from financial capital as from 2005, have meant that a large exchange surplus was available. This strengthened the accumulation of reserves and forced authorities to sterilize the expansion of internal assets. With the monetary base reconstructed post-crisis, the growth rate of real monetization accompanying the demand for money was capped in early 2005.

The authorities incorporated into the monetary measures certain income policies such as regulated prices for several sectors and the announcement of guidelines for the wage round. The conjunction of these monetary measures and the other provisions made it possible to keep inflation during 2006 slightly below 2005 levels (the cumulative rate reached 4.9% in June 2006, as against 6.1% for the first half of 2005).

Although retail prices in Argentina rose faster than in its main trading partners, the nominal devaluation of the peso -mainly against the Brazilian real- translated into improved exchange competitiveness. The peso appreciated in real terms during 2005 and the first half of 2006 against the currencies of all its MERCOSUR partners (14.2% against the real, 9.6% against the Guaraní and 6.7% against the Uruguayan peso). The effective exchange rate in 2005 thus rose 0.2% and a 2.5% rise is a projection for 2006.

Fiscal policy in 2006 generated consolidated primary saving levels of around 4% of GDP. The 4.4% drop in 2005 was due to the worsening of the provincial balance. The national government's result was similar to the previous year's, enabling not only due dates of interest on the public debt to be kept, but also part of the amortization of capital. The public debt's interest burden decreased visibly after the restructuring of the debt in suspension of payments, which went from just over 8% of GDP in 2001 to 1.5% in 2006.

At the start of 2006, Argentina repaid its US\$ 9 billion debt to the IMF. Despite payment being made with reserves, the decision did not generate distrust over foreign exchange and, by late June, the Central Bank had managed to replace 73% of the level of reserves prior to repayment. Argentina also placed public debt securities through issues subject to domestic legal system. Venezuela facilitated these operations between 2005 and the first half of 2006 by buying Argentinian bonds for a nominal value of over US\$ 2.5 billion.

In this context, the level of country risk came close to a record low during the first half, despite the increase seen in June due to greater international financial volatility. Although Argentina has been

successful in improving its debt conditions and reducing the burden of its financial obligations, the public debt/GDP ratio remains high (69.4%).¹⁰

- Brazil -

Protected by the fluctuation of the real, its considerable positive trade balance and greater global liquidity, Brazil allowed its currency to appreciate and the prices of exportable goods to be reduced, a step that helped achieve inflation targets.

Monetary policy remained restrictive until the third quarter of 2005, when the Central Bank began to reduce the benchmark interest rate. In any event, although monetary policy is more biased toward expansion, it has limited potential for encouraging a fall in interest rates.

Fiscal policy performed in line with monetary targets. In 2005, Brazil increased the primary surplus to 4.8% of GDP, one percentage point up on the start of the current government, during whose term fiscal adjustment essentially relied on pressure from increased taxation. Although fiscal control in 2006 remained tight, it enjoyed greater flexibility, in keeping with monetary policy. Thus the primary surplus stood at around 3.9% in the first half, three tenths down on the same period in 2005.

Greater fiscal solvency, coupled with the margins offered by external monetary and financial conditions, enabled authorities to repay the debt to the IMF (over US\$ 15 billion) and the Club of Paris (US\$ 3.6 billion) and to recover Brady bonds of over US\$ 6.6 billion ahead of schedule.

It must be stressed that Brazil is showing signs of improvement regarding the public debt. In 2004–2006 the public debt/GDP ratio fell almost six percentage points to its current level of 50.3%. Regarding the appreciation of the real, the proportion of obligations indexed by the exchange rate dropped from 37% in 2002 to 2.3% at the start of 2006 (BIS [2006] p. 45). Furthermore, the average due dates of financial obligations rose slightly.

Despite improving its profile, Brazil's debt continues to place considerable restrictions on investment through a high interest rate, estimated at around 15%,¹¹ a level in contrast to low international rates. In this area, Brazil, despite great fiscal efforts, still has to borrow to pay interest whose burden relative to GDP is high, nearly 8% of GDP in 2003–2006. Notwithstanding improvements in the structure of due dates, two thirds of securities in reals in the hands of the public mature in under two years.

Nevertheless, Brazil's macroeconomic policies obtained a significant reduction of the inflation index (1.5% accumulated from January to June 2006, as against 6.6% for the first half of 2003). Although price levels are below other MERCOSUR countries, the nominal appreciation of the real was behind the falling real exchange rate. In 2005–2006, the real appreciated 12.4% against the Argentinian peso, 4% against the Guarani and 6.5% against the Uruguayan peso. Although the real exchange rate fell 19% in 2005, and an appreciation of 11% is a projection for 2006, this had no negative effect on import growth. However, it should not be ignored, as it may affect export performance, a key element in Brazil's growth model.

¹⁰ The public debt/GDP ratio reaches 82.5% if obligations with the holders of bonds who did not enter the exchange, or "holdouts," are incorporated in the calculation. Data corresponding to the first half of 2006.

¹¹ Implicit interest rate calculated as a ratio of interest effectively paid in the year and the stock of the end-of-year debt.

- Paraguay -

Paraguay is facing rising oil prices and worsening exchange rates, processes that began in 2005 and intensified over the following year. In 2006, the monetary authorities -who have also set themselves inflation targets- kept the target at 5% (with a tolerance margin of ± 2.5 points). The accumulated retail price rise in the first half was 3.7% as against 5.1% for the same period in 2005. This slowing is largely in response to the nominal value of the Guarani, which helped curb the price rise in exportables.

Although Paraguay places no debts in international markets, this greater liquidity strengthened the Guarani against the dollar. However, given the appreciation of its trading partners' currencies, especially Brazil's, it did not lose foreign exchange competitiveness in 2005, when the effective real exchange rate grew by around 10%. However, the compensatory effects of the loss of foreign exchange competitiveness were not so intense in 2006: it is calculated that there will be a 6% effective real appreciation of the Guarani in the annual balance.

The continuous growth of reserve assets since 2003 is one of the underlying factors accounting for the Guarani's tendency to appreciate against the dollar. The monetary consequences of this translated into higher demand for the local currency, channeled mainly via an increase in circulating capital. To reduce the monetary effects of the accumulation of reserves, sterilization operations were carried out, as demand for circulating capital from the public continued to rise.

Based on fiscal adjustments carried out in recent years, Paraguay obtained a primary surplus during 2005 that allowed it to meet its interest payments, giving rise to an overall surplus of 0.8% of GDP.¹² In terms of GDP, central government's public debt continued to fall, representing 31.4% of GDP by 2005, several percentage points below previous years and lower than for the other MERCOSUR countries.

- Uruguay -

Uruguay, the MERCOSUR country with the lowest inflation over 2005, showed an acceleration in retail prices in the first half of 2006 (3.9% accumulated in June as against 2.1% for the same period the previous year). Monetary policy -relatively expansive during 2005- thus became more difficult to apply.

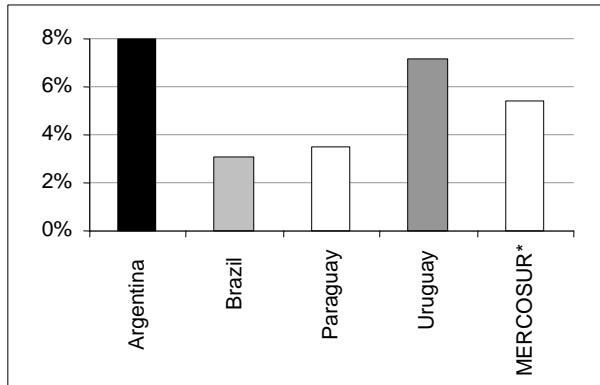
In the first half of 2006, the Uruguayan peso's tendency to appreciate seen in the previous year weakened. The fall in the effective real exchange rate projection for 2006 is thus around the 0.5% mark, as against an appreciation of 10% during 2005, which helped absorb the impact of the rise in the oil price.

The consolidated primary surplus in 2005 represented 3.9% of GDP and gave rise to an overall deficit of 0.8% of GDP. In 2006, the target of consolidated primary surplus (3.7%) was still not enough to cover interest payments, estimated at 4.8% of GDP. By the end of 2005, the liquid public debt represented 62% of GDP. Significantly, the debt is down on the previous year, the due dates are longer and the share of obligations in local currency is higher.¹³

¹² Data for the central administration.

¹³ Among the measures adopted by Uruguay regarding indebtedness is the early repayment of commitments to the IMF of over US\$ 1.5 billion, due in 2006 and 2007. Precancellations of the debt were also made with other international organizations for an amount of almost US\$ 500 million.

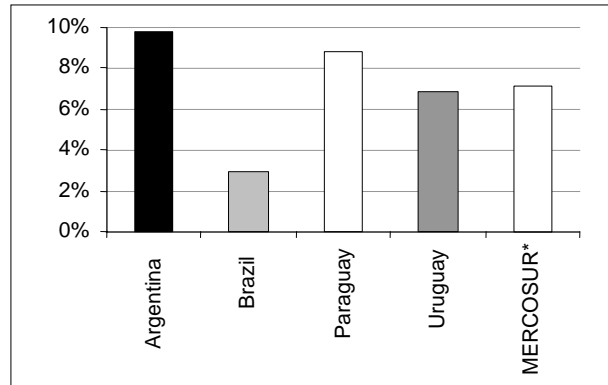
GRAPH 5
REAL GDP GROWTH
% Variation 2006



Note: (*) Simple average for the four MERCOSUR countries.

Source: Survey of market expectations by Central Banks and ECLAC Projections.

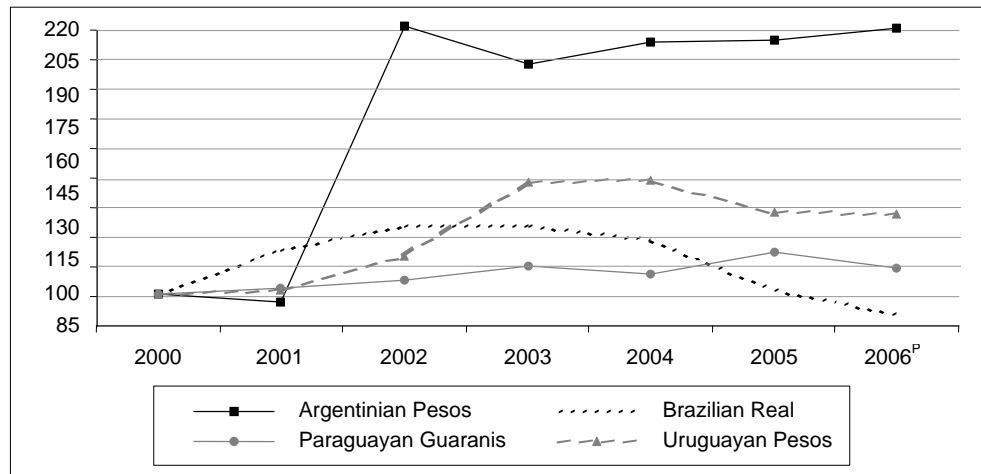
GRAPH 6
RETAIL INFLATION
% Variation 2006



Note: (*) Simple average for the four MERCOSUR countries.

Source: Survey of market expectations by Central Banks and ECLAC Projections.

GRAPH 7
EFFECTIVE REAL EXCHANGE RATE*
Indexes 2000=100, deflated for the CPI



Notes: Rising estimated real exchange rate (ERER) = Devaluation; Falling ERER = Appreciation.

* Yearly average. The effective exchange rate is calculated by adjusting individual trading partners' bilateral real exchange rate by their share of trade in that country's trade total.

(P) Projections.

Source: ECLAC.

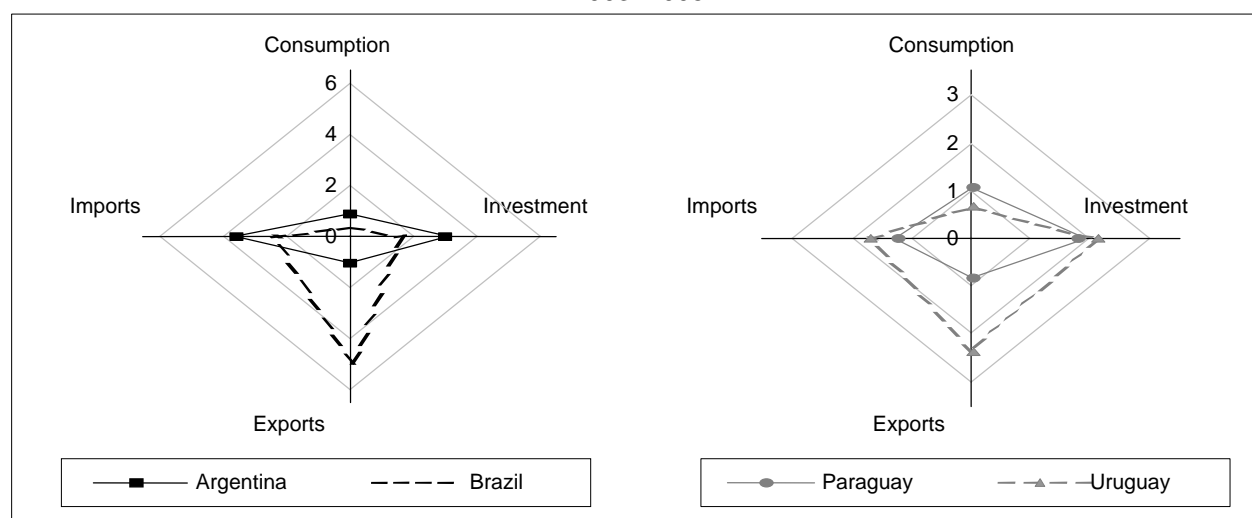
MERCOSUR Economies' Pattern of Recovery: Saving, Investment & Net Exports

During 1998–2002, MERCOSUR countries underwent recession, in some cases severe. The bloc's annual average GDP growth¹⁴ over these years was negative (-1.2%), fuelled by a sharp contraction of investment (-7.7%) and also consumption (-2.1%) (see Annex I, Table A2). Only Brazil escaped this contraction, thanks to its vigorous exports, a variable in which Argentina also saw a degree of expansion over the period. Paraguay and Uruguay suffered sharp contractions in all the components of spending, especially, investments and imports.

Since 2003, the end of the crisis has been felt through a decisive increase in activity in the four MERCOSUR countries, with average GDP growth of around 5.5% in 2003–2005. Argentina and Uruguay were the countries that had suffered most in the earlier recession.

There are certain similarities and differences in this pattern of recovery between countries. They can be seen in the relatively intense growth of the different components of current spending (consumption, investment, imports and exports) in relation to GDP growth, in other words, in the elasticity resulting from these aggregates (Graph 8).

GRAPH 8
SPENDING COMPONENTS' PRODUCT ELASTICITY DURING RECOVERY
2003–2005



Notes: *Product elasticity*: The ratio between the aggregate and GDP's average rates of variation in the same period, 2003–2005; variables measured at constant 2000 prices. All elasticities are positive.

Consumption: Private and government spending in final consumption.

Investment: Gross internal capital formation = gross internal fixed capital formation + variation in stocks.

Exports & Imports: These include goods and services.

Source: Author's, based on the ECLAC database.

First, relative growth in consumption in the four countries making up MERCOSUR remained limited and product elasticities were the same or below 1. Brazil's case is particularly relevant, displaying elasticity in consumer products of just 0.4. This relative rigidity of consumption only means that the recovery of MERCOSUR economies was seen after a significant saving drive in all the countries except possibly Paraguay, where this measurement exhibits unitary elasticity.

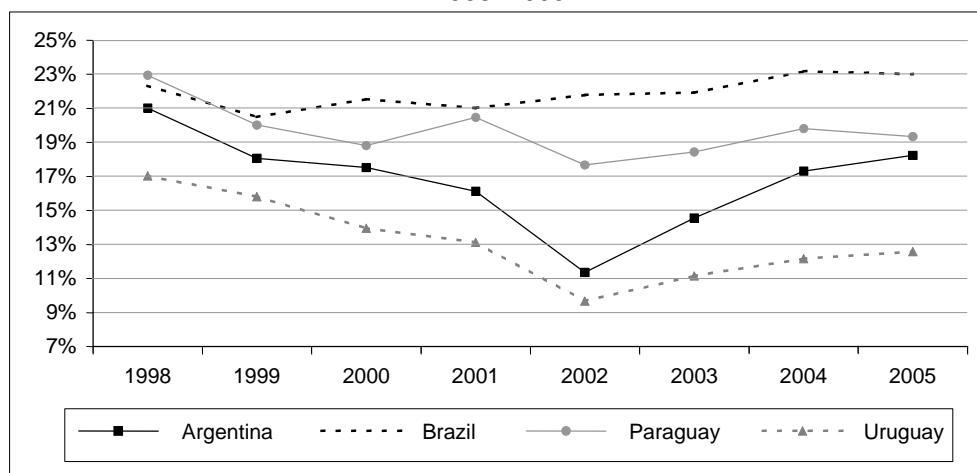
¹⁴ Unweighted aggregate rates.

Second, two different types of bias are seen in relation to the use of saving generated in the period of expansion: on the one hand, net exports boosted growth in Brazil with an export elasticity well above import and investment elasticity. Capital accumulation in Brazil is the variable relatively least favored; the country's exports have acted as the main engine of economic activity. The opposite pattern is seen in the other three countries, although to varying degrees. Argentina's emphasis of growth centers on investment, whose product and import elasticity is clearly higher than its export elasticity. This also occurs to a lesser degree in Paraguay. The data on saving in the Uruguayan economy is more balanced between investment and net exports.

However, the greater importance of investment dynamism in relation to net exports in Argentina, Paraguay and Uruguay should not be overstated, as it incorporates a strong cyclical component. The intensity demonstrated by this variable in these economies is partly explained by the fact that it was the aggregate most affected by the 1998–2002 recession. This becomes clear when these economies' levels of investment/GDP ratio are analyzed (as measured at constant prices). Despite the saving drive, this rate in 2005 had not still reached pre-recession levels.

Contrasts are also seen in this respect between the countries, especially Argentina and Uruguay. The investment/GDP ratio rose more slowly in Uruguay. This also represents an apparently inadequate absolute level, with investment in Uruguay representing just 13% of GDP in 2005. In the case of Brazil, which has the bloc's most stable investment/GDP ratio, the climate of growth starting in 2003 meant only a slight rise in this key coefficient. Besides the favorable evolution of activity starting in 2003, investment in the four MERCOSUR countries is still perceived as a long way off representing a variable capable of triggering more sustained growth, although it must be stressed that, under the current circumstances, it was a drive for internal saving that has strengthened investment.

GRAPH 9
COMPARATIVE EVOLUTION OF THE INVESTMENT/GDP RATIO
1998–2005



Note: *Investment*: gross capital formation = gross fixed capital formation + variation of stocks; variables measured at constant 2000 prices.

Source: Author's, based on the ECLAC database.

Income & Employment

Per capita GDP during 2006 continued to grow in all MERCOSUR countries. In line with preliminary projections, the market exchange rate-associated income per inhabitant reached US\$ 5,800 in Uruguay, US\$ 5,700 in Argentina and US\$ 5,100 in Brazil, expanding by a cumulative annual average of 22%, 19% and 24.8%

since 2004. At the other extreme, Paraguay's *per capita* GDP rose by a cumulative annual average of just 9.4% in the same period, remaining below the US\$ 1,500 mark. This shows the depth of asymmetry within MERCOSUR.

On measuring GDP per inhabitant in terms of the purchasing power parity (PPP) exchange rate,¹⁵ the differences are finer but do not vanish altogether. Indeed, Paraguay's *per capita* GDP represents less than half the other three countries' average and is growing more slowly by a cumulative annual average of 3.7% in 2004–2006, as against 11% in Uruguay, 7.1% in Argentina and 4.3% in Brazil. This behavior is not a recent phenomenon. In fact, although PPP *per capita* GDP in the four countries stands at its highest level for ten years, in Brazil, Argentina and Uruguay it expanded at a cumulative annual average rate of between 2% and 3% over the last ten years, while in Paraguay it rose 1.6% per annum.

Despite these improvements, poverty and homelessness remain high, although they show an encouraging falling trend largely in response to the increase in salary mass. During 2005 and the first half of 2006, real remuneration in the four countries improved, while unemployment in MERCOSUR fell from 11.9% in 2004 to 10.1% in 2005. This gave rise to the net creation of over a million jobs. It should be stressed that employment within the bloc is growing faster than the general index, contributing to the fall in the high index of informal labor.

The sharpest drop in unemployment was seen in Argentina, where it fell four points¹⁶ between 2004 and the first half of 2006 (2.7 percentage points, if beneficiaries of social schemes rendering services in return are considered employed). Nevertheless, Argentina's unemployment is still the highest in the bloc, with an average of 13.5% in the first half of this year (10.9% including beneficiaries of schemes), as against a 10.1% average in Brazil, 11.7% in Uruguay and 5.8% in Paraguay.¹⁷

Although income is up and poverty down, progress in income distribution is substantially slower in MERCOSUR countries. Uruguay exhibits the least unequal conditions (the income of the richest 20% of the population is 10.4 times higher than that of the poorest 20%), followed by Argentina where the ratio rises to 13.6. Brazil and Paraguay show the widest inequities (their richest sectors are 22.4 and 17.9 times richer respectively than the 20% with the lowest income).¹⁸

D. Conclusions

Keeping all this in mind, accompanied by a favorable external scenario, MERCOSUR countries kept up their phase of economic expansion. Growth was combined with lower vulnerability in the external sector, fiscal discipline and inflation at historic lows.

Various asymmetries still persist within the bloc. Economic policy instruments -especially exchange policy- obey differences in design, and greater convergence is being seen in fiscal policy.

The MERCOSUR economies' recovery was based on a major saving drive. Whereas net exports expanded faster in Brazil, investment was a more dynamic factor in aggregate demand elsewhere.

MERCOSUR trade with the rest of the world is expanding at a sustained rate and reaching record values, despite signs of a slight decline in exchange rates.

Intrabloc trade continues its recovery, although its share in total exports has remained several percentage points below the 1990 record.

¹⁵ PPP exchange rate = Cost of a basic basket in a given country vs. Cost of a basic basket in the United States. It measures the purchasing power of different countries' currencies in terms of the same kinds of goods.

¹⁶ This measurement of unemployment views any beneficiaries of social schemes as unemployed.

¹⁷ Data for Paraguay is for 2005.

¹⁸ Data for Brazil and Paraguay is for 2004.

CHAPTER II. THE EVOLUTION OF TRADE & FOREIGN DIRECT INVESTMENT

This chapter sets out to analyze the recent evolution of MERCOSUR countries' foreign trade flows and Foreign Direct Investment (FDI), with especial emphasis on the statistical data for 2005 and the first half of 2006. The bloc's total trade is dealt with first. This data shows a difference in the evolution of intraregional and extraregional flows. The evolution of MERCOSUR's market share in total global imports is also analyzed.

The second section looks in greater detail at the evolution of foreign trade in each of the four MERCOSUR countries and establishes a distinction between intrabloc and extrabloc flows. It also presents an analysis of individual countries' market shares in the other partners' total exports.

Having substantiated that Brazil has been performing better than the other countries in intrabloc flows -with growing trade surpluses and gains in market share, while Argentina, Paraguay and Uruguay have lost market share in Brazilian imports- the third section sets about analyzing the anatomy of the intrabloc trade imbalance in favor of Brazil in greater detail by examining two analytical instruments: a) the dynamism of Brazilian imports in 1999–2000 and 2004–2005 at product level in order to identify the category of dynamism where the other three partners' exports to Brazil are concentrated, and b) the other partners' market share in Brazilian imports in order to establish whether these countries are increasing or decreasing their share in Brazilian imports of the main products in their export product baskets.

The fourth and last section maps the recent behavior of FDI in the four MERCOSUR countries, highlighting foreign investments in Argentina by Brazilian companies.

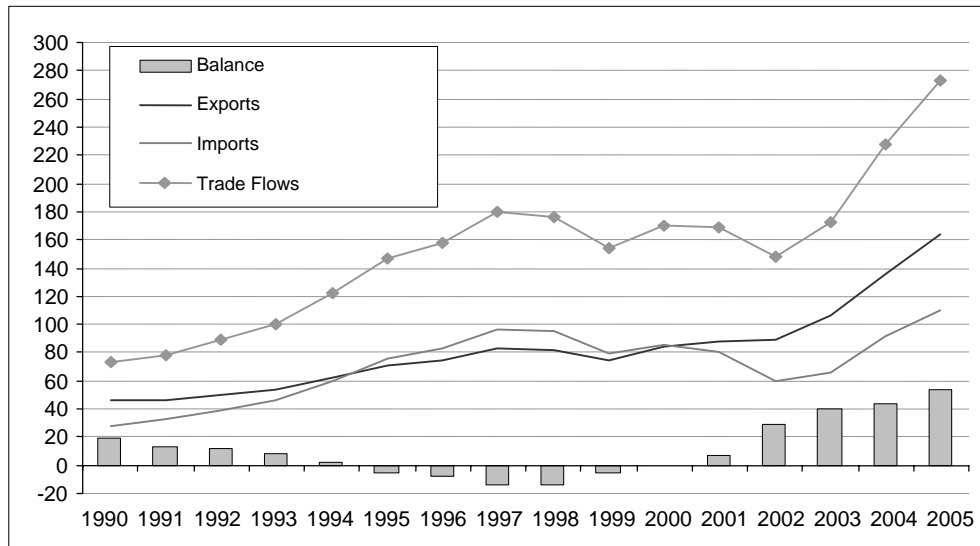
A. Total MERCOSUR Trade

2005 was another excellent year for MERCOSUR countries' trade flows, with significant growth in both exports and imports, and a rising trade balance. Growth occurred in fairly positive external and internal contexts. Indeed, the four countries saw a fairly reasonable growth in GDP, while trade expanded at a rate of 13.3% in current dollars, with a significant rise in both amounts traded and commodity prices.

MERCOSUR exports topped US\$ 163.5 billion over the year, 20.8% up on the previous year. Imports were up 19.1% at US\$ 109.4 billion. The result was a trade balance of US\$ 54.1 billion, US\$ 10 billion up on 2004. The bloc's trade flow reached record levels of US\$ 272.9 billion.

As Graph 10 shows, 2005 was the third year running of significant trade growth in MERCOSUR after a long period of instability (1997–2002). The change in the bloc's trade dynamics in recent years is reflected in truly impressive figures. In 2003–2005, exports grew at an average annual rate of 22.6%, boosted by the sharp rise in the price of commodities and industrialized products, imports grew at a similar rate, and the trade surplus saw an accumulated rise of 86%. This performance contrasts with 1997–2002, when exports showed cumulative annual growth of just 1.3%, imports decreased by a cumulative annual average of 9.3% and the trade flow fell sharply from US\$ 180.3 billion to US\$ 148.5 billion.

GRAPH 10
MERCOSUR FOREIGN TRADE
1990–2005 – Billions of US\$



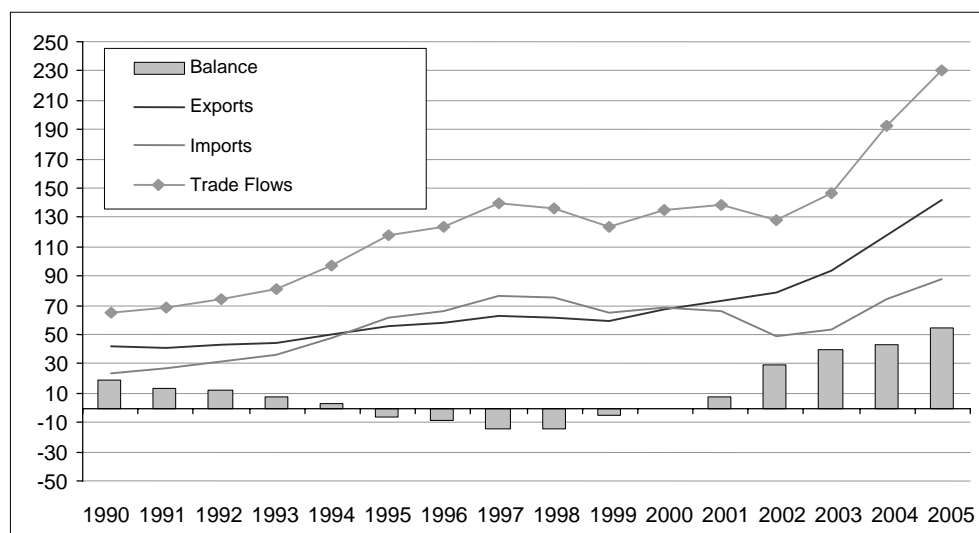
Sources: Abeceb.com and INDEC (Argentina); SECEX (Brazil); Paraguay and Uruguay Central Banks.

Intrabloc trade was particularly hard hit during the crisis, when transactions between member countries were cut by half, from US\$ 20.4 billion in 1997 to US\$ 10.2 billion in 2002. In compensation, in 2003–2005 the resumption of the intrabloc trade flow was faster than the one seen in the total flow. In fact, the intrabloc flow in that period more than doubled: it grew by a cumulative annual average of around 27.4%. In 2005, inter-MERCOSUR trade stood above the peak of 1997, at US\$ 21.1 billion. The recent performance seems to replicate the trend seen in 1991–1997, when intrabloc trade grew continuously, quintupling as a result of regional liberalization promoted by the Treaty of Asunción.

The evolution of MERCOSUR's extrabloc trade was also quite favorable in 2003–2005, although the growth rate was a little slower than for the intrabloc flow. In the same period, exports recorded average annual growth of 21.9%, while imports grew by a cumulative annual average of 21.1%. The trade balance underwent significant growth, reaching a total of US\$ 54.7 billion in 2005, when the trade flow reached US\$ 230 billion (Graph 11).

Table 1 shows the latest data in detail. As can be seen, intrabloc trade flows perform better in 2005, up 21.8%, although in the first half of 2006 there was a slowing, with a result of 17.4%. The extrabloc trade flow, on the other hand, was up 20.7% on 2005 in exports, and 18% in imports. This brought about a significant rise in the trade balance, which reached a total of US\$ 54.1 billion for the year. Overall, there was a turnabout in the trend in the first half of 2006, as exports slowed, growing at 12.6%, while imports gained momentum, climbing 23.1%. The result was a slight 3.2% drop in the trade balance, yielding an accumulated result of US\$ 23.7 billion in the half.

GRAPH 11
MERCOSUR EXTRABLOC TRADE
1990–2005 – Billions of US\$



Sources: Abeceb.com and INDEC (Argentina); SECEX (Brazil); Paraguay and Uruguay Central Banks.

TABLE 1
MERCOSUR'S INTRABLOC & EXTRABLOC TRADE FLOWS
Millions of US\$

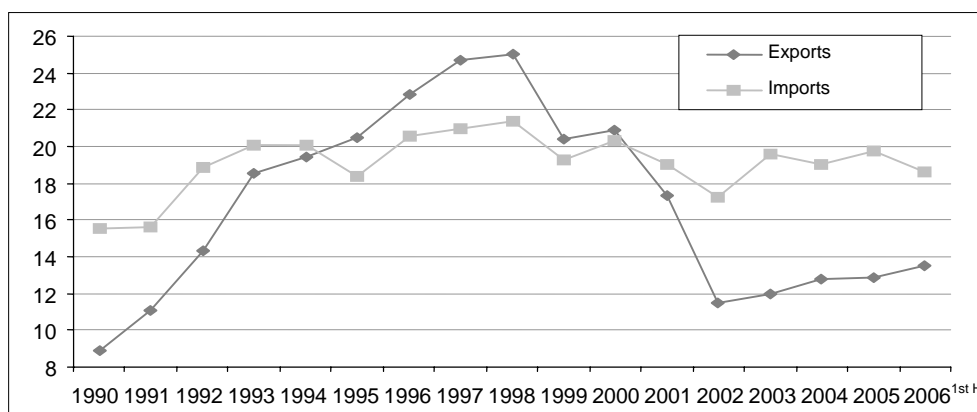
	2004	2005	% Var.	1 st Half 2005	1 st Half 2006	% Var.
Intrabloc						
Exports*	17,293	21,066	21.8	9,804	11,506	17.4
Extrabloc						
Exports	118,053	142,441	20.7	65,419	73,686	12.6
Imports	74,394	87,767	18.0	40,609	50,000	23.1
Total						
Exports	135,346	163,507	20.8	75,223	85,192	13.3
Imports	91,841	109,370	19.1	50,690	61,448	21.2
Balance	43,505	54,137	24.4	24,533	23,744	(3.2)

Note: * By definition equivalent to intrabloc imports, despite minor accounting differences.

Sources: Abeceb.com and INDEC (Argentina); SECEX (Brazil); Paraguay and Uruguay Central Banks.

The differing dynamics of intra- and extrabloc trade flows have produced significant changes in the share of intrabloc trade in MERCOSUR's total trade, not just in the recent period, but from the start of the 1990s on. Graph 12 shows that the changes were particularly significant for exports. Representing just 9% of the four countries' exports in 1990, sales to MERCOSUR partners reached 25% in 1998, a reflection of the initial success of subregional liberalization. In the crisis years, the trend was reversed and the share of intrabloc exports in the export total fell to 11.5% in 2002, a percentage similar to 1991. Starting in 2003, there was a gradual recovery, the indicator standing at 13.5% in the first half of 2006, still a good way off the 1997–1998 peak. Interestingly, in the case of imports, the intrabloc trade flow's share in the total flow has altered little over the last 15 years, at between 18% and 20%. In the first half of 2006 it was 18.6%.

GRAPH 12
MERCOSUR INTRABLOC TRADE/ TOTAL TRADE RATIO
 1990–1st Half 2006 – In %



Sources: Abeceb.com and INDEC (Argentina); SECEX (Brazil); Paraguay and Uruguay Central Banks.

Recent Developments in Intrabloc Trade

Recent data tell of significantly different behavior in intrabloc trade between the four member countries flows. Table 2 shows that Brazil's performance between 2004 and 2005 was much better than its partners, with intrabloc sales rising 31.6%, while Argentina's exports grew by 13.3%, Uruguay's by 5.4% and Paraguay's just 2.2%. Brazil's share in intrabloc exports thus rose to 55.7%, as against 36.3% for Argentina, 4.3% for Paraguay and 3.7% for Uruguay.

Where imports were concerned, the highest growth rate between 2004 and 2005 was recorded in Argentinian purchases (38.9%). This was also high in Uruguay (17.8%), but less significant in Brazil (10.3%) and Paraguay (5%). There is no doubt that the main explanation for these differences must be sought in the countries' 2005 GDP growth rates, which were relatively high in Argentina and Uruguay and lower in Brazil and Paraguay. Still, it is worth underlining the fact that Argentina accounts for more than half the intrabloc import flows (52.5% in 2005), while Brazil has a share of just 32.6%, despite Brazil's economy being approximately four times larger than Argentina's, measured in current dollars.

The differential in the growth rate of intrabloc exports and imports has produced an ever greater imbalance in the composition of the region's trade balance: Brazil has high surpluses (US\$ 4.7 billion in 2005), while the other countries show deficits, particularly Argentina (US\$ 3.7 billion). This gap has been the cause of friction within MERCOSUR, especially in the Brazil/Argentina bilateral relationship. Argentina often calls for restrictions to be applied on its neighbor's exports (see Annex II on products that are the subject of trade disputes between Argentina and Brazil).

TABLE 2
MERCOSUR INTRABLOC TRADE FLOWS BY COUNTRY
Millions of US\$

	2004	2005	% Var.	1 st Half 2005	1 st Half 2006	% Var.
Exports	17,293	21,066	21.8	9,804	11,506	17.4
Argentina	6,751	7,647	13.3	3,563	4,386	23.1
Brazil	8,912	11,726	31.6	5,359	6,252	16.7
Paraguay	866	912	5.4	514	424	(17.6)
Uruguay	764	781	2.2	368	444	20.6
Imports	17,447	21,603	23.8	10,081	11,447	13.6
Argentina	8,169	11,345	38.9	5,220	5,887	12.8
Brazil	6,393	7,052	10.3	3,398	3,859	13.6
Paraguay	1,502	1,576	5.0	710	829	16.8
Uruguay	1,384	1,631	17.8	753	872	15.8
Trade Balance	(154)	(537)	247.9	(277)	58	(121.1)
Argentina	(1,417)	(3,698)	160.9	(1,657)	(1,501)	(9.4)
Brazil	2,519	4,675	85.6	1,961	2,393	22.0
Paraguay	(636)	(664)	4.4	(196)	(405)	107.1
Uruguay	(620)	(850)	37.0	(385)	(428)	11.3

Sources: Abeceb.com and INDEC (Argentina); SECEX (Brazil); Paraguay and Uruguay Central Banks.

Compared to 2005, the figures for the first half of 2006 show certain important differences with the pattern of previous years. Table 2 shows acceleration in the intrabloc exports of Argentina (23.1% up) and Uruguay (20.6% up) and a slowing of Brazilian sales (16.7% up). The change with respect to the earlier situation is explained, among other factors, by the strong real appreciation in Brazil's exchange rate, which led to a gradual loss of dynamism in the volume it exported. For its part, Paraguay intrabloc sales were down 17.6%. This was especially poor in sales to Brazil (-26%) and Uruguay (-21%).

The MERCOSUR countries' performance in imports was more homogeneous during the first half, with growth rates between 12.8% (Argentina) and 16.8% (Paraguay). Argentina's share in intrabloc purchases remained above 50%. However, in the trade balance, the present situation showed no change: Brazil still has a high surplus (US\$ 2.4 billion), while the other countries accumulate significant deficits.

Extrabloc Trade

An analysis of the MERCOSUR countries' trade flows with the major countries and regions of the world (Table 3) shows great dynamism in trade with the countries of the Latin American Integration Association or LAIA (*ALADI: Asociación Latinoamericana de Integración*), with the exception of MERCOSUR/Mexico trade, as Mexico belongs to the North American Free Trade Agreement (NAFTA). Transactions with the most traditional markets, namely, the EU and NAFTA, which together represent almost 50% of total exports and imports, grew less briskly. These movements reflect the steep GDP growth rate of the Latin American economies compared to the global average and the expansion of trade flows for energy products in Latin America, whereas the demand for imports from the United States and Europe has developed more slowly than the rest of the world.

Exports to the LAIA rose 44.4% in 2004–2005, accounting for US\$ 12.6 billion or 18.8% of the total, the main destinations being Chile and Venezuela. Sales to the United States were up 14.5% and to the EU, just 9.1%. Sales to Asia (24.4%) and "other countries" (30.2%) also performed relatively better.

In terms of imports, purchases from the various economic blocs in 2005 generally showed higher growth than exports to these destinations. The most significant was the rise in imports from the LAIA (33.16%), followed by products from Asia (up 27.2%), while products from NAFTA grew 15.8% and those from the EU, 17.4%. The major exception is "other countries," a category in which MERCOSUR imports grew just 7.7% over the year. This is basically due to the contraction in oil imports from the Middle East and Africa.

TABLE 3
MERCOSUR TRADE FLOWS BY SELECTED REGION
Millions of US\$

	2004	2005	% Var.	1 st Half 2005	1 st Half 2006	% Var.
Destination of Exports	118,053	142,441	20.7	65,419	73,686	12.6
NAFTA	31,289	35,820	14.5	16,721	17,812	6.5
EU	30,837	33,629	9.1	16,530	17,743	7.3
LAIA*	8,723	12,592	44.4	5,492	7,160	30.4
Asia	20,454	25,441	24.4	11,301	12,893	14.1
Other countries	26,750	34,959	30.7	15,375	18,078	17.6
Origin of Imports	74,394	87,767	18.0	40,609	50,000	23.1
NAFTA	17,793	20,605	15.8	9,649	10,840	12.3
EU	20,537	24,109	17.4	11,582	12,379	6.9
LAIA*	3,290	4,396	33.6	1,783	2,961	66.1
Asia	17,259	21,952	27.2	9,935	14,355	44.5
Other countries	15,516	16,705	7.7	7,660	9,466	23.6
Trade Balance	43,659	54,673	25.2	24,810	23,686	(4.5)
NAFTA	13,496	15,215	12.7	7,072	6,972	(1.4)
EU	10,300	9,520	(7.6)	4,948	5,364	8.4
LAIA*	5,434	8,196	50.8	3,710	4,199	13.2
Asia	3,196	3,488	9.1	1,365	(1,462)	(207.1)
Other countries	11,234	18,254	62.5	7,715	8,612	11.6

Note: * Except MERCOSUR and Mexico.

Sources: Abeceb.com and INDEC (Argentina); SECEX (Brazil); Paraguay and Uruguay Central Banks.

In the trade balance, MERCOSUR recorded a high surplus with the major economic blocs in 2005, as it did in 2002. Only the surplus with the EU was slightly down on 2004, standing nevertheless at US\$ 9 billion. The balance with NAFTA countries was US\$ 15.2 billion, with LAIA countries US\$ 11.2 billion, and with Asia US\$ 3.49 billion. There was a US\$ 18.3 billion positive balance with the rest of the world.

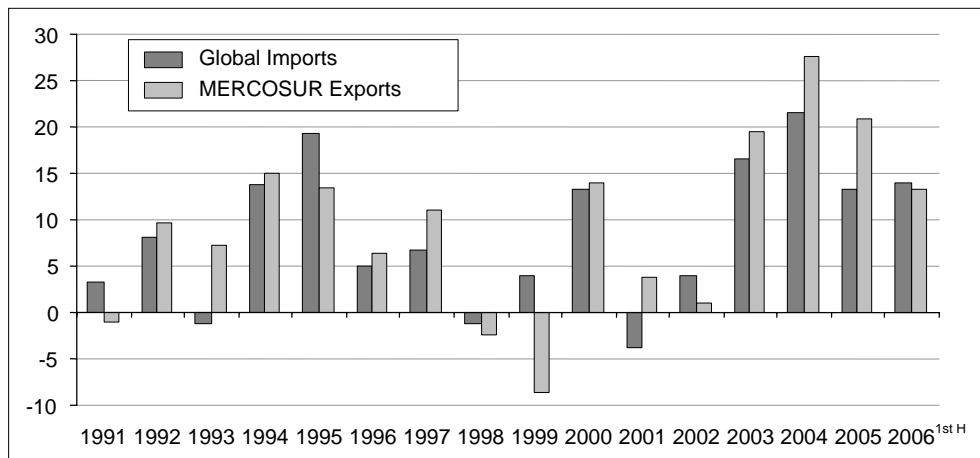
The general picture in the first half of 2006 was similar, with one salient difference: imports outstripped exports, producing a slight fall in the trade balance. The largest rise in exports was again seen in operations with LAIA countries (30.4%), with lower rates recorded in sales to NAFTA (6.5%) and the EU (7.3%). LAIA countries also played a prominent role in imports, a healthy 66% up on the same period for 2005. The trade balance fell by slightly over US\$ 1 billion. This should be exclusively attributed to trade with Asia. Consequently, MERCOSUR's trade result went from a US\$ 1.37 billion surplus in the first half of 2005 to a

US\$ 1.46 billion deficit in 2006. Practically the whole of this turnabout is connected to Brazil, whose surplus with China fell sharply and whose deficit with the other major Asian countries, in particular South Korea and Taiwan rose significantly. Indeed, much of the recent rise in Brazilian imports is due to the influx of intermediate and consumer goods from Asia, especially electrical and electronic appliances.

Exports, World Trade & Prices

MERCOSUR's exports in 2003–2005 performed extremely well, not just in absolute terms, but compared to the evolution of world trade. Graph 13 shows that the bloc's exports grew faster over this period than global imports (a cumulative annual average of 22.6% as against 17.1%), making it possible for MERCOSUR to raise its market share by 0.2 percentage points, from 1.36% in 2002 to 1.56% in 2005.

GRAPH 13
MERCOSUR EXPORT & GLOBAL IMPORT GROWTH
1991–1st Half 2006 – In %



Sources: IMF, Abeceb.com and INDEC (Argentina), SECEX (Brazil), Paraguay and Uruguay Central Banks.

This buoyant performance contrasts with the 1990s or even the start of the current decade, when the bloc's sales were incapable of sustaining regular growth higher than world trade. Nevertheless, the data on the first half of 2006 seem to indicate a new turnabout. Against the same period for 2005, MERCOSUR exports again grew less than world imports (13.3% as against 14%). Thus, after just three years of growth, the bloc is again showing a loss of market share in global imports. Indeed, even with recent gains, MERCOSUR's current share differs little from the start of the 1990s (around 1.4%).

Another point to stress is that the international situation in recent years has been characterized by sharp price rises, not just in commodities but in industrialized products, and MERCOSUR countries have benefited enormously from this process, especially Brazil and Argentina. In Brazil, export prices accumulated an rise of 30% in 2003–2005, almost a third of the growth in exported value in the period. Prices in Argentina rose 21.6% in the same period, representing 26% of the total. In Uruguay, this phenomenon was less pronounced, but significant nevertheless: a price rise of 8.6% was recorded for the triennium, accounting for 10.5% of the rise in exported value. In the first half of 2006, prices became even more significant, accounting for two thirds of Argentina's export growth and over 80% of Brazil's. It should be stressed, however, that exchange rates declined across the board in MERCOSUR in 2005, with the exception of Argentina. In the case of Uruguay and Paraguay, this index was the lowest in ten years.

B. MERCOSUR Trade

The upbeat performance of total MERCOSUR exports in 2005 -20.8% up on the previous year- was mainly due to the 22.6% rise in Brazilian sales, which broke the US\$ 100 billion a year barrier, reaching US\$ 118.3 billion. Thanks to this, the Brazilian share in MERCOSUR's total external sales peaked at 72.4%. Argentina and Uruguay also performed reasonably well in 2005, with respective growth rates of 16.9% and 16.2%. Paraguay, on the other hand, was not in line with its partners' performance, with exports rising just 3.8%, a mere 1% of the bloc's total external sales in 2005 (Table 4).

TABLE 4
TOTAL MERCOSUR TRADE FLOW
Millions of US\$

	2004	2005	% Var.	1 st Half 2005	1 st Half 2006	% Var.
Exports	135,346	163,507	20.8	75,223	85,192	13.3
Argentina	34,314	40,106	16.9	19,061	21,541	13.0
Brazil	96,475	118,308	22.6	53,677	60,900	13.5
Paraguay	1,626	1,688	3.8	872	927	6.3
Uruguay	2,931	3,405	16.2	1,613	1,824	13.1
Imports	91,841	109,370	19.1	50,690	61,448	21.2
Argentina	23,288	28,689	23.2	13,546	15,606	15.2
Brazil	62,782	73,551	17.2	34,027	41,368	21.6
Paraguay	2,658	3,251	22.3	1,300	2,370	82.4
Uruguay	3,114	3,879	24.6	1,817	2,104	15.8
Trade Balance	43,505	54,137	24.4	24,533	23,744	(3.2)
Argentina	11,027	11,418	3.5	5,515	5,935	7.6
Brazil	33,693	44,757	32.8	19,650	19,532	(0.6)
Paraguay	(1,032)	(1,564)	51.5	(428)	(1,443)	237.2
Uruguay	(183)	(474)	159.4	(204)	(280)	37.1

Sources: Abeceb.com and INDEC (Argentina), SECEX (Brazil), Paraguay and Uruguay Central Banks.

The pattern displayed by the MERCOSUR countries in imports was more homogeneous in 2005, with Argentina, Uruguay and Paraguay recording similar growth rates (between 22% and 24%), while Brazil's rate was lower, but equally significant (17.2%). The countries' share in the bloc's total imports reveals the predominance of Brazil (67.2%), although less pronounced than for exports. Argentina has 26.2%, Uruguay 3.5% and Paraguay 3%.

The result of the trade balance naturally once again highlights the importance of Brazil, whose surplus was 32.8% up on 2004 at US\$ 44.8 billion, accounting for more than 80% of MERCOSUR's total trade balance. Argentina also accumulated a fairly positive balance (US\$ 11.4 billion), whereas Paraguay and Uruguay again recorded deficits (US\$ 1.56 billion and US\$ 474 million respectively).

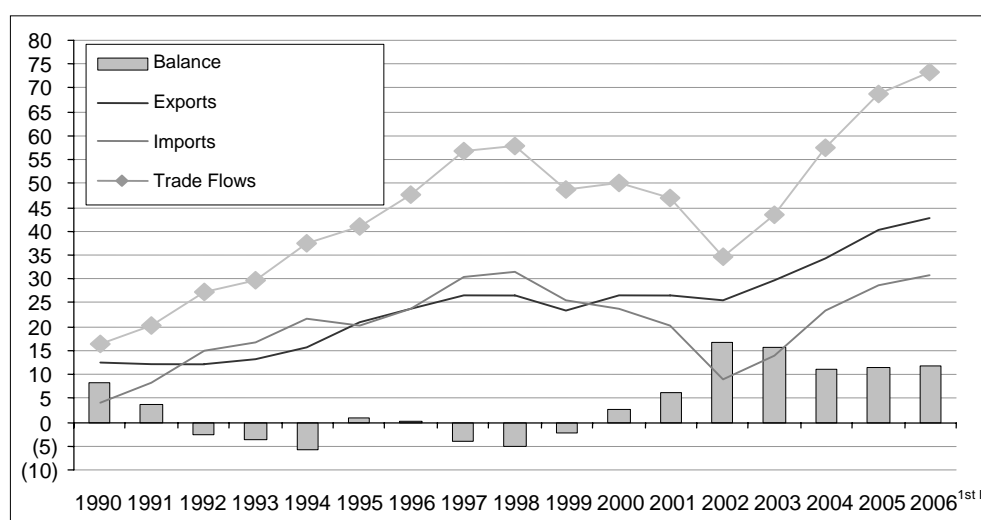
In the first half of 2006, there was a slowing in export growth, with the exception of Paraguay, where growth was 6.3% in relation to the same period in 2005. Brazil continues to account for over 70% of MERCOSUR sales. In terms of imports, the main reason for growth compared to 2005 was due fundamentally to the acceleration of Brazilian purchases, which rose 21.6% in the half. A real improvement in the trade balance was only recorded in Argentina, whose surplus reached a total of US\$

5.9 billion in the half. In Brazil, a 0.6% reverse was recorded, while in Paraguay and Uruguay, the deficit grew substantially, which accounts for the fall in the bloc's total surplus.

Argentina

Graph 14 leaves no room for doubt about the continued rapid recovery of Argentina's foreign trade flows in comparison with the sharp shrinkage of the volume of trade in the latter years of Argentina's currency convertibility regime. After virtual stagnation in 1997–2002, Argentinian exports reached US\$ 42.6 billion in the twelve months prior to June 2006, 66% up on the whole of 2002. Imports in the same period grew a staggering 242% to a total of US\$ 30.75 billion.

GRAPH 14
ARGENTINA: TRADE FLOWS
1990–1st Half 2006 – Billions of US\$



Note: The value for the first half of 2006 corresponds to that accumulated in the 12 months to June 2006.

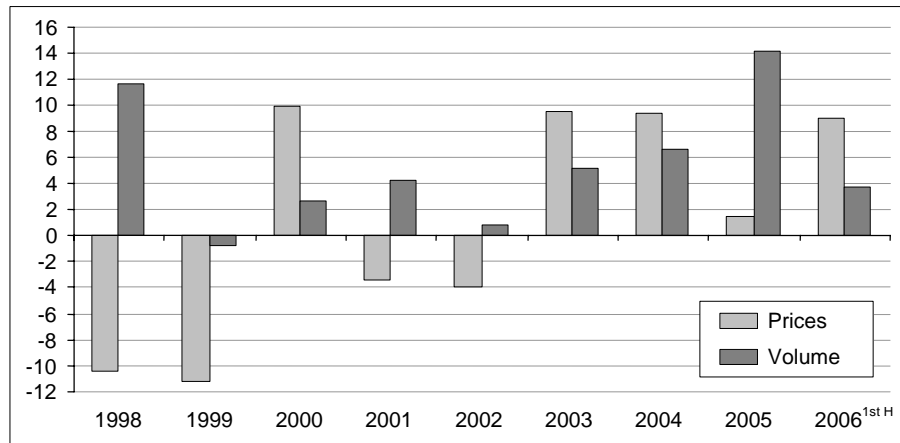
Sources: Abeceb.com and INDEC.

Consequently, in the accumulated total over the 12 months to June 2006, the country's trade flow reached US\$ 68.8 billion, 111.7% up on the previous 12 months, while the trade surplus rose to US\$ 11.8 billion. Although below the balance of 2002 (US\$ 16.7 billion) and 2003 (US\$ 15.7 billion), this is equivalent to 27.7% of exports, a fairly significant rate, especially considering that the country's economy is now back to normal. In fact, 2002 and 2003 were utterly atypical, with extremely low imports, less than a third in 2002 of Argentina's total imports for 1998.

One fact that deserves underlining in evaluating Argentina's export performance in 2005 is the prevalence of growth in terms of exported volume rather than price rises.¹⁹ In fact, almost 90% of the increase in exported value should be attributed to volume growth, which went from 14.2%, with prices rising just 1.5%. This picture contrasts with 2003 and 2004, when prices grew faster than volume (Graph 15). However, prices in the first half of 2006 once again played a leading role, 9.1% up on the same period for 2005, while exported volume rose 3.7%.

¹⁹ This distinction enables the evolution of the current values to be analyzed in terms of price and volume variation.

GRAPH 15
ARGENTINA: PRICE RISE & EXPORTED VOLUME
 1998–1st Half 2006 – In %



Sources: Abeceb.com and INDEC.

In fact, Argentina can, in light of this, be said to have had difficulty achieving more significant growth rates in its exported volume. In 1998–2005, average yearly growth in exported volumes was running at a cumulative annual average of just 4.6%. Even if we only consider the recovery period of 2003–2005, when there was a sharp rise in the amounts traded globally, exported volume underwent cumulative annual average growth of 8.6%, slightly above the price rise (a cumulative annual average of 6.8%).

The growth in Argentinian exports in 2005 owed far more to a 17.8% rise in extrabloc sales than to sales to its three MERCOSUR partners (13.3%). Brazil maintained absolute domination, increasing its purchases of Argentinian products by 13.9%, remaining the main destination for Argentinian sales, with 15.8% of the total (Table 5). In terms of extrabloc exports, sales grew significantly in 2005 to NAFTA (22.5%) and other countries (25.2%), although there was also a rise in sales to Asian and LAIA countries.

In terms of imports in 2005, MERCOSUR maintained its status as Argentina's main partner due largely to the 37% share in purchases of Brazilian products, which again grew faster than total imports. Among extrabloc countries, the highest growth was recorded in purchases of products from LAIA countries (65.7%), although there were also significant growth in imports from NAFTA and the EU. On the other hand, imports from Asia fell by 8.9%, as they did to other countries, with a fall of 9.3%.

In terms of the trade balance, Argentina had a large deficit with Brazil, US\$ 4.3 billion (100% up on 2004), while registering a surplus with the remaining partners, including Paraguay and Uruguay. It achieved its largest surplus (US\$ 5.5 billion) in trade with the other LAIA countries.

Analyzing the data for the first half of 2006, the main new development is the faster growth of Argentina's sales to MERCOSUR (23.1%) in relation to extrabloc exports (10.7%). A prominent feature of Argentinian sales was the acceleration of sales to Brazil and the sharp rise in exports to Paraguay. In extrabloc trade, exports to the EU showed the highest growth (15.7%), and there was a sharp slowing in sales to NAFTA and Asia.

Conversely, extrabloc imports grew faster in the first half, especially those from other LAIA countries (up 20.6%) and Asia (32.6%), while intrabloc imports underwent faster growth in purchases from Uruguay. However, the picture in terms of the trade balance changed little compared to 2005: Argentina still has a large deficit with Brazil (US\$ 1.78 billion in the half), as well as a surplus with the rest of the world.

TABLE 5
ARGENTINA: TRADE FLOWS BY COUNTRY & SELECTED ECONOMIC BLOC
Millions of US\$

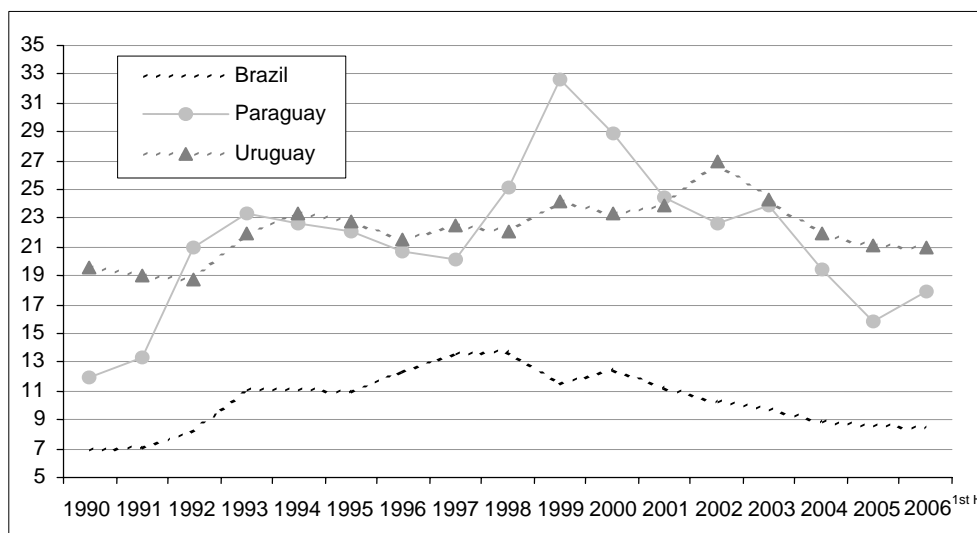
	2004	2005	% Var.	% Share 2005	1 st Half 2005	1 st Half 2006	% Var.
Exports	34,314	40,106	16.9	100.0	19,061	21,541	13.0
MERCOSUR	6,751	7,647	13.3	19.1	3,563	4,386	23.1
Brazil	5,552	6,326	13.9	15.8	2,973	3,530	18.7
Paraguay	515	504	(2.0)	1.3	228	439	92.6
Uruguay	685	817	19.3	2.0	362	417	15.2
Extrabloc	27,563	32,460	17.8	80.9	15,498	17,155	10.7
NAFTA	4,916	6,023	22.5	15.0	2,695	2,947	9.4
EU	6,006	6,360	5.9	15.9	3,344	3,869	15.7
LAIA*	5,606	6,708	19.6	16.7	2,973	3,450	16.0
Asia	5,540	6,488	17.1	16.2	3,188	3,452	8.3
Other Countries	5,495	6,881	25.2	17.2	3,298	3,437	4.2
Imports	23,288	28,689	23.2	100.0	13,546	15,606	15.2
MERCOSUR	8,169	11,345	38.9	39.5	5,220	5,887	12.8
Brazil	7,562	10,625	40.5	37.0	4,549	5,308	16.7
Paraguay	380	451	18.8	1.6	294	359	22.2
Uruguay	227	268	18.3	0.9	119	153	28.7
Extrabloc	15,119	17,344	14.7	60.5	8,326	9,719	16.7
NAFTA	4,317	5,357	24.1	18.7	2,457	2,538	3.3
EU	4,090	5,350	30.8	18.6	2,417	2,637	9.1
LAIA*	713	1,182	65.7	2.9	470	567	20.6
Asia	4,012	3,654	(8.9)	9.1	1,920	2,545	32.6
Other Countries	1,986	1,801	(9.3)	11.1	1,062	1,432	34.8
Trade Balance	11,027	11,418	3.5	100.0	5,515	5,935	7.6
MERCOSUR	(1,417)	(3,698)	160.9	(32.4)	(1,657)	(1,501)	(9.4)
Brazil	(2,011)	(4,300)	113.9	(37.7)	(1,576)	(1,778)	12.8
Paraguay	135	53	(60.7)	0.5	(66)	80	(221.1)
Uruguay	458	549	19.8	4.8	243	263	8.5
Extrabloc	12,444	15,115	21.5	132.4	7,172	7,436	3.7
NAFTA	599	666	11.3	5.8	238	409	71.8
EU	1,916	1,010	(47.3)	8.8	927	1,232	32.9
LAIA*	4,893	5,526	12.9	48.4	2,503	2,883	15.2
Asia	1,528	2,835	85.6	24.8	1,268	907	(28.5)
Other Countries	3,509	5,079	44.7	44.5	2,236	2,005	(10.3)

Note: * Except MERCOSUR and Mexico.

Sources: Abeceb.com and INDEC.

The evolution of Argentina's share in MERCOSUR member's imports deserves a paragraph to itself. Graph 16 shows that its share in the other partners' imports has fallen continuously in recent years. In Uruguay, its market share peaked at 27% in 2002, then dropped to 21% in the first half of 2006. In 1999, Argentina represented almost two thirds of Paraguay's total imports, a percentage that fell to just 15.8% in the first half of 2006. In Brazil, Argentinian products accounted for almost 14% of total imports, but have lost ground since, representing just 8.6% in the first half of 2006. The difficulties faced by Argentinian products in penetrating the Brazilian market, and the growing share of Brazilian products in the Argentinian market, is a basic factor in the amount of trade friction between the two countries.

GRAPH 16
ARGENTINA: SHARE OF MERCOSUR PARTNERS' IMPORTS
 1990–1st Half 2006 – In %



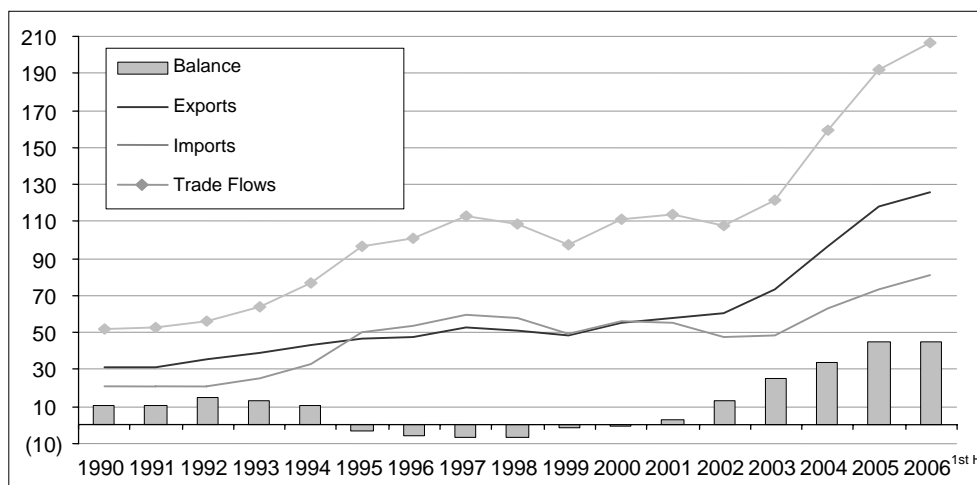
Sources: Abeceb.com and INDEC.

Brazil

Brazilian foreign trade has risen steeply in recent years after a period of relative stagnation in 1997–2002 characterized by the existence of foreign exchange crises, low GDP growth and the sharp devaluation of the real. The trade flow in the period remained relatively stable at around US\$ 110 billion, exports saw a cumulative annual increase of just 2.6% and imports fell by a cumulative annual drop of 4.6% (Graph 17).

However, with renewed economic growth since mid-2002, the normalization of foreign exchange conditions and the expansion of world trade, Brazilian trade entered a phase of rapid growth, so rapid that, in the 12 months to June 2006, its trade flow was over 90% up on 2002 (US\$ 206 billion). Exports grew by a staggering 108% in the same period, climbing to US\$ 125.5 billion, while imports rose 71% (US\$ 80.9 billion). There was also an extraordinary leap in the trade balance, reaching a surplus of US\$ 44.6 billion in the 12 months to June last, as against the almost US\$ 6 billion per year deficits of 1997 and 1998.

GRAPH 17
BRAZIL: TRADE FLOWS
 1990–1st Half 2006 – Billions of US\$

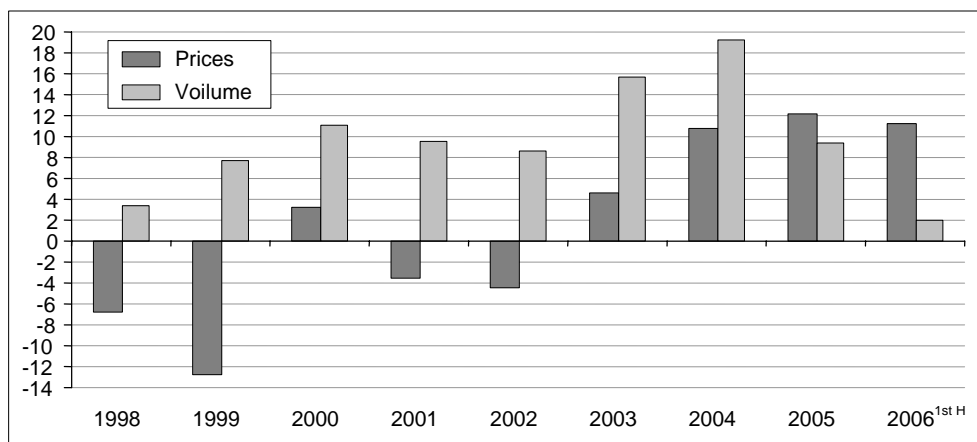


Note: The value for the first half of 2006 corresponds to that accumulated in the 12 months to June 2006.

Source: SECEX/MDIC.

Brazil undoubtedly benefited from an extremely favorable international scenario, mainly in the evolution in the prices of primary export products. Indeed, the accumulated price rise from 2003 to the first half of 2006 was 40%. It is important to note that, in previous years, prices had almost always negatively affected exports, with the exception of the slight rise in 2000 (Graph 18).

GRAPH 18
BRAZIL: RISE IN PRICES & EXPORTED VOLUME
 1998–1st Half 2006 – In %



Source: FUNCEX.

However, it is wrong to attribute the main merit for the country's recent good export performance to prices. Graph 18 shows that exported volume grew at faster than prices in almost every year, especially in 2003 and 2004, when its respective growth rates were 15.7% and 19.2%. Overall, the trend has been reversed and the 12.2% rise in prices predominated over the 9.3% growth in exported volume. This trend intensified even further during the first half of 2006, when prices rose 11.3% compared to the same period the previous year and exported volume grew just 2%. At present, the rise in international prices is effectively the main factor accounting for Brazilian export growth.

In 2005, Brazil's sales to its MERCOSUR partners performed better than its total exports, rising 31.6%. It is necessary here to draw attention to the 34.5% increase in sales to Argentina. Yet MERCOSUR still represented less than 10% of the country's total sales (Table 6). On the other hand, exports to extrabloc countries rose 21.7% over the year, despite relatively weak growth in sales to NAFTA and the EU, due to increased sales to LAIA countries (up 40.9%), and Asia, where Brazilian exports were up 27.4%.

As can be seen in Table 6, the value of extrabloc imports between 2004 and 2005 grew more intensely than total imports (17.9%). The highest rate was seen in imports of products from the EU. Imports of products from its MERCOSUR partners grew much slower (10.3%) yet, even so, with major differences between the various countries. Purchases from Argentina grew faster (12%), whereas imports of products from Paraguay and Uruguay were down (7.1% and 5.6% respectively).

Unlike the other MERCOSUR countries, Brazil displays significant trade surpluses with all its main trading partners, even within MERCOSUR. The surplus with MERCOSUR reached US\$ 4.7 billion, 85.6% up on 2004. The most remarkable result was with Argentina, with Brazil obtaining a positive balance of US\$ 3.7 billion.²⁰ The trade balance with extrabloc countries was also high, reaching a total of US\$ 40.1 billion. Interestingly enough, the distribution of Brazilian trade flows within and without MERCOSUR is fairly well balanced. Both exports and imports and the trade balance with its MERCOSUR partners account for approximately 10% of Brazil's total flow.

There were no major changes in the general picture of Brazilian trade in the first half of 2006. Exports to both MERCOSUR and extrabloc countries grew at a rate below 2005 (16.7% and 13.1%, respectively), while imports accelerated, with respective rises of 13.6% and 22.5%. Given that the acceleration of imports and the slowing of exports were more pronounced with the extrabloc countries, the trade balance with these countries fell 3.1% (US\$ 17.1 billion). This drop was connected with trade with NAFTA and Asia, with Brazil's trade balance ending in deficit. However, its trade balance with MERCOSUR rose again to a total of US\$ 2.4 billion over the half.

TABLE 6
BRAZIL: TRADE FLOWS BY COUNTRY & SELECTED ECONOMIC BLOC
Millions of US\$

	2004	2005	% Var.	% Share 2005	1 st Half 2005	1 st Half 2006	% Var.
Exports	96,475	118,308	22.6	100.0	53,677	60,900	13.5
MERCOSUR	8,912	11,726	31.6	9.9	5,359	6,252	16.7
Argentina	7,373	9,915	34.5	8.4	4,549	5,308	16.7
Paraguay	872	961	10.2	0.8	395	508	28.7
Uruguay	667	850	27.4	0.7	415	435	4.8

²⁰ This figure differs from the one in Table 5 due to differences in the accounting of the trade flows detected between Argentinian and Brazilian sources.

TABLE 6 (Continued)

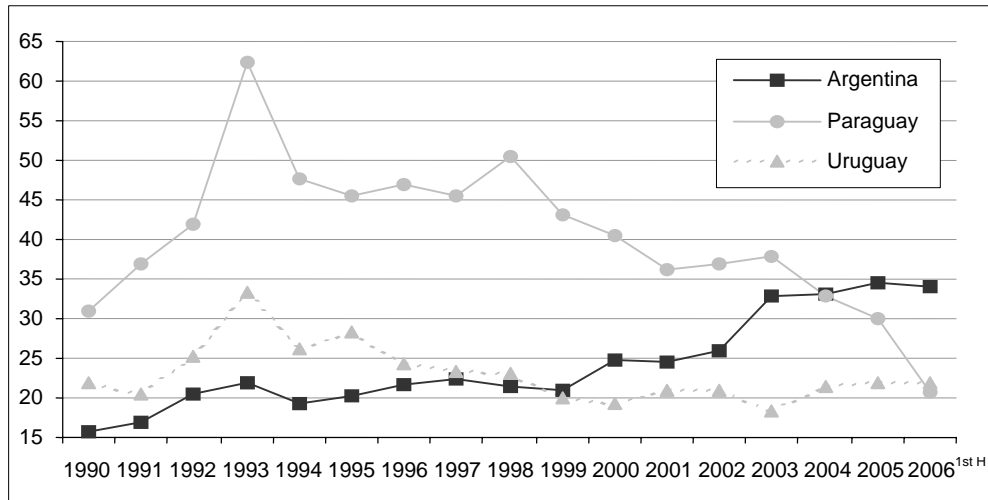
	2004	2005	% Var.	% Share 2005	1 st Half 2005	1 st Half 2006	% Var.
Extrabloc	87,563	106,582	21.7	90.1	48,318	54,648	13.1
NAFTA	25,488	28,749	12.8	24.3	13,533	14,460	6.9
EU	24,160	26,493	9.7	22.4	12,760	13,510	5.9
LAIA*	6,840	9,639	40.9	8.1	4,344	5,607	29.1
Asia	14,564	18,552	27.4	15.7	7,916	9,243	16.8
Other countries	16,511	23,149	40.2	19.6	9,766	11,828	21.1
Imports	62,782	73,551	17.2	100.0	34,027	41,368	21.6
MERCOSUR	6,393	7,052	10.3	9.6	3,398	3,859	13.6
Argentina	5,572	6,239	12.0	8.5	2,984	3,482	16.7
Paraguay	298	319	7.1	0.4	173	119	(31.2)
Uruguay	523	494	(5.6)	0.7	241	258	7.2
Extrabloc	56,389	66,499	17.9	90.4	30,629	37,509	22.5
NAFTA	13,081	15,444	18.1	21.0	6,977	8,594	23.2
EU	15,923	18,146	14.0	24.7	8,868	9,422	6.2
LAIA*	2,924	3,672	25.6	5.0	1,644	2,520	53.3
Asia	12,278	16,870	37.4	22.9	7,480	10,572	41.3
Other countries	12,182	12,367	1.5	16.8	5,660	6,401	13.1
Trade Balance	33,693	44,757	32.8	100.0	19,650	19,532	(0.6)
MERCOSUR	2,519	4,675	85.6	10.4	1,961	2,393	22.0
Argentina	1,801	3,677	104.2	8.2	1,565	1,827	16.7
Paraguay	574	642	11.9	1.4	222	389	75.6
Uruguay	144	356	146.9	0.8	174	177	1.5
Extrabloc	31,174	40,082	28.6	89.6	17,689	17,139	(3.1)
NAFTA	12,407	13,305	7.2	29.7	6,556	5,866	(10.5)
EU	8,237	8,347	1.3	18.7	3,891	4,088	5.1
LAIA*	3,916	5,967	52.4	13.3	2,700	3,087	14.3
Asia	2,286	1,682	(26.4)	3.8	436	(1,33)	(404.9)
Other countries	4,329	10,782	149.1	24.1	4,106	5,428	32.2

Note: * Except MERCOSUR and Mexico.

Source: SECEX/MDIC.

Where Brazil's market share in its MERCOSUR partners' imports was concerned, Graph 19 shows very different evolutions for individual countries. Argentina displays a significant increase in recent years, leading to Brazil's market share, which in 1999 stood at 21%, falling to around 35% today. Paraguay's share, on the other hand, has been falling dramatically (from 60% in 1993, 50% in 1998 and just 22% today). In Uruguay, this indicator has remained stable at around 20% since the late 1990s.

GRAPH 19
BRAZIL: MARKET SHARE IN ITS MERCOSUR PARTNERS' IMPORTS
 1990–1st Half 2006 – In %

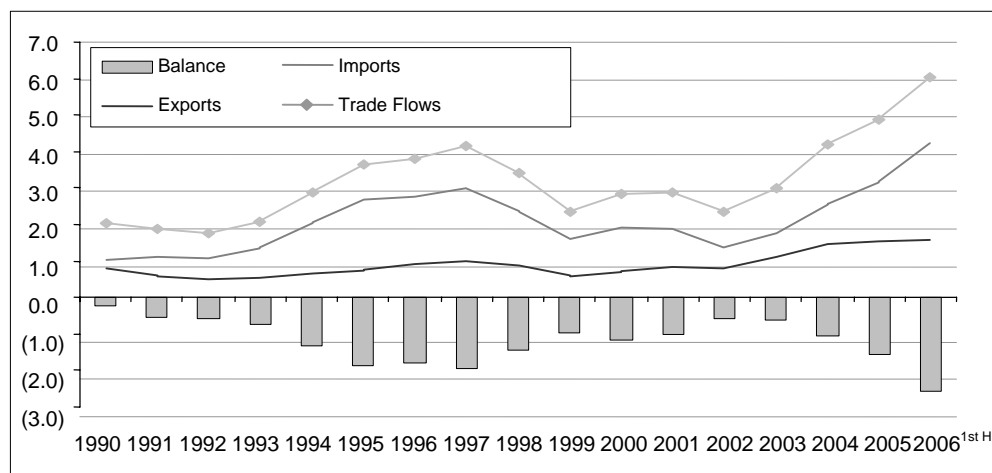


Source: SECEX/MDIC.

Paraguay

Paraguay's foreign trade flow has also expanded steadily in recent years, reaching US\$ 6 billion in the 12 months to June 2006, 146% up on the total for 2002 (Graph 20). The major contributing factor to such growth came from imports, which grew 186% in the period, standing now at US\$ 4.3 billion. Exports rose 83.3% with sales amounting to US\$ 1.7 billion. This performance contrasts with 1997–2002, a period in which the trade flow accumulated a fall of 42%. This was down 16.7% in exports and 51.3% in imports.

GRAPH 20
PARAGUAY: TRADE FLOW
 1990–1st Half 2006 – Billions of US\$



Note: The value for the first half of 2006 corresponds to that accumulated in the 12 months to June 2006.

Source: Central Bank of Paraguay.

Graph 20 illustrates the persistence of negative results of the trade balance since 1990. The trade imbalance grew almost continuously to 1997. It then showed a downward trend to 2002 mainly due to the fall in the rate of imports, but has grown again in recent years. Indeed, in the 12 months to June 2006, the trade deficit reached the record figure of US\$ 2.6 billion.

2005 was not a very good year for Paraguayan exports, which were up just 3.8% on the previous year. Table 7 shows that this poor performance was generalized: external sales to MERCOSUR increased just 5.4%, while those to extrabloc countries rose just 2% due to the 17.1% drop in sales to "other countries" (mainly Eastern European). It must be stressed that MERCOSUR continues to play a preeminent role in Paraguayan exports, representing 54% over the total in 2005.

TABLE 7
PARAGUAY: TRADE FLOW BY COUNTRY & SELECTED ECONOMIC BLOC
Millions of US\$

	2004	2005	% Var.	% Share 2005	1 st Half 2005	1 st Half 2006	% Var.
Exports	1,626	1,688	3.8	100.0	872	927	6.3
MERCOSUR	866	912	5.4	54.0	514	424	(17.6)
Brazil	312	326	4.2	19.3	162	119	(26.2)
Argentina	102	107	5.4	6.4	47	64	35.8
Uruguay	451	479	6.2	28.4	306	241	(21.1)
Extrabloc	760	776	2.0	46.0	358	503	40.6
NAFTA	63	102	61.5	6.0	21	50	139.1
EU	102	189	85.2	11.2	50	67	33.8
LAIA*	90	60	85.6	3.6	53	86	61.4
Asia	116	103	85.2	6.1	63	40	(35.7)
Other countries	389	323	(17.1)	19.1	170	259	51.9
Imports	2,658	3,251	22.3	100.0	1,300	2,370	82.4
MERCOSUR	1,502	1,576	5.0	48.5	710	829	16.8
Brazil	821	884	7.7	27.2	395	442	12.0
Argentina	619	639	3.2	19.7	294	359	22.2
Uruguay	61	53	(13.5)	1.6	21	28	33.1
Extrabloc	1,156	1,675	44.9	51.5	590	1,541	161.2
NAFTA	129	202	56.3	6.2	53	204	288.9
EU	192	205	7.1	6.3	80	114	41.3
LAIA*	39	60	54.4	1.8	28	54	94.9
Asia	636	957	50.6	29.4	337	985	192.1
Other countries	161	251	56.1	7.7	92	184	99.9
Trade Balance	(1,032)	(1,564)	51.5	100.0	(428)	(1,443)	237.2
MERCOSUR	(636)	(664)	4.4	42.5	(196)	(405)	107.1
Brazil	(509)	(558)	9.8	35.7	(233)	(323)	38.5
Argentina	(517)	(532)	2.8	34.0	(247)	(296)	19.6
Uruguay	390	426	9.3	(27.3)	285	213	(25.1)
Extrabloc	(396)	(900)	127.2	57.5	(232)	(1,038)	346.9

TABLE 7 (Continued)

	2004	2005	% Var.	% Share 2005	1 st Half 2005	1 st Half 2006	% Var.
NAFTA	(66)	(100)	51.4	6.4	(32)	(154)	388.8
EU	(90)	(17)	(81.3)	1.1	(30)	(46)	53.9
LAIA*	51	0	(99.3)	(0)	25	32	24.9
Asia	(519)	(855)	64.6	54.7	(274)	(944)	244
Other countries	229	72	(68.6)	(4.6)	78	75	(4.3)

Note: * Except MERCOSUR and Mexico.

Source: Central Bank of Paraguay.

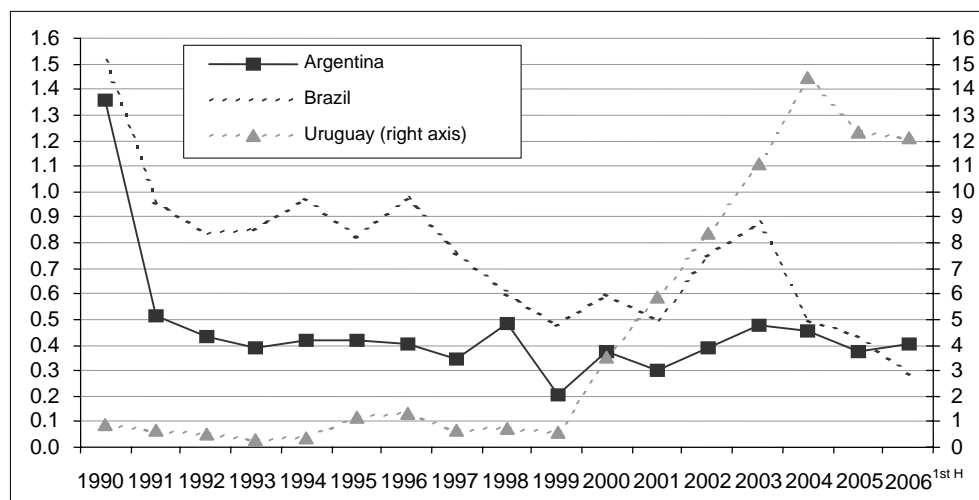
However, import growth in 2005 was significant (22.3%), driven mainly by 44% growth in purchases from extrabloc countries, prominent among which were the rise in imports of products from Asia and other countries. The intrabloc imports rose just 5%, with performance a little better in the case of Brazil (up 7.7%). MERCOSUR's share in Paraguayan imports in 2005 fell to 42%.

As a result, the country's trade deficit with extrabloc countries in 2005 was more pronounced (US\$ 900 million), more than double 2004, due mainly to a large trade imbalance with Asian countries. In terms of MERCOSUR, Paraguay's deficit was US\$ 664 million, slightly up on 2004. Its deficit with Argentina and Brazil was around the US\$ 500 million mark, and it had a US\$ 426 million surplus with Uruguay.

Paraguayan exports again showed a low index of growth (6.3%) in the first half of 2006 compared to the same period for 2005. We must also remember the 17.6% drop in Paraguayan sales to its MERCOSUR partners. This fall in intrabloc exports was the result of an abrupt reduction in sales to both Brazil and Uruguay, with a significant increase in sales to Argentina. Extrabloc exports, however, performed well, climbing 40.6%, in which the 60% plus rise in sales to LAIA countries loomed large. In terms of imports, the most significant growth during the period also occurred in extrabloc transactions (161.2%), the least significant of which (16.8%) was unsurprisingly the import of products from Paraguay's MERCOSUR partners. However, Paraguay's trade balance declined against all its main partners, reaching a deficit of US\$ 405 million with MERCOSUR and US\$ 1 billion with extrabloc countries.

The poor recent performance of Paraguayan exports to MERCOSUR has prompted the country to lose share in its three MERCOSUR partners' imports markets, as seen in Graph 21. The most interesting case is Uruguay, where Paraguay's market share in the 1990s was low, rose sharply to 14.5% in 2000–2004, fell during the last two years and currently stands around the 12% mark. Paraguay's share in Argentina has remained relatively stable in recent years, fluctuating between 0.3% and 0.5%, whereas in Brazil it reached 0.9% in 2003, but fell to just 0.3% in the first half of 2006. It is important to note that, Paraguay represented over 1% of Brazil's total imports at the start of the 1990s. Curiously, Paraguay's market share in Brazil began to fall subsequent to the signing of the Treaty of Asunción in 1991 creating MERCOSUR.

GRAPH 21
PARAGUAY: SHARE IN ITS MERCOSUR PARTNERS' IMPORTS
 1990–1st Half 2006 – In %

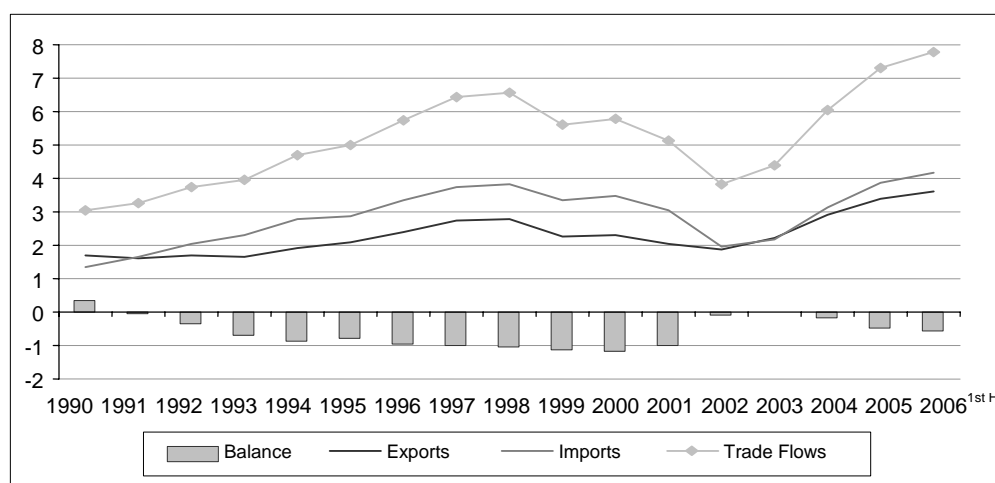


Source: Central Bank of Paraguay

Uruguay

Like its partners, Uruguay has seen steady growth in its foreign trade flow in recent years, reversing the downward trend of 1999–2002. In the 12 months to June 2006, the country's trade flow reached US\$ 7.3 billion, 103% up on 2002 (Graph 22). Exports in the same period grew 94.3%, currently standing at US\$ 3.6 billion, while imports saw a 112% rise, currently totaling US\$ 4.2 billion. In the accumulated total for the 12 months to June 2006, the deficit was US\$ 550 million, with an upward trend in recent years.

GRAPH 22
URUGUAY: TRADE FLOW BETWEEN
 1990–1st Half 2006 – Billions of US\$



Note: The value for the first half of 2006 corresponds to that accumulated in the 12 months to June 2006.

Source: Central Bank of Uruguay.

Uruguayan export growth in 2005 (16.2%) was due mainly to the good performance of sales to extrabloc countries (up 21.1%), prominent among which were exports to Asian and LAIA countries (Table 8). Only exports to Argentina grew (19.8%) in trade with MERCOSUR countries, while sales to Brazil and Paraguay fell. In 2005, MERCOSUR represented a relatively low share of Uruguayan exports (22.9%).

Import growth in 2005 (24.6%) was also due more to extrabloc purchases (up 30%) than to purchases from MERCOSUR countries (17.8%). Even so, the three partners accounted for 42% of Uruguay's total imports. This imbalance in the composition of trade with intra- and extrabloc countries is reflected in the trade balance. In 2005, Uruguay recorded a US\$ 850 million deficit with its partners (US\$ 519 million with Argentina and US\$ 366 million with Brazil). However, it accumulated a surplus of US\$ 375 million with the rest of the world, prominent in which were the positive balances with NAFTA and the EU.

The first half of 2006 saw a relatively sounder export performance with MERCOSUR countries, with a rise of 20.6% driven mainly by 28.7% growth in sales to Argentina. Extrabloc exports grew by just 10.8%, with sales to NAFTA and the EU falling sharply. A comparison with the first half of 2005 shows that the import growth rate (15.8%) between the various countries of origin was relatively balanced. The overall picture of the trade balance changed only slightly: Uruguay had a US\$ 428 million deficit with MERCOSUR countries and a US\$ 148 million surplus in extrabloc trade. Significantly, the country's deficit with MERCOSUR has risen since 2004, whereas its surplus with extrabloc countries has fallen.

TABLE 8
URUGUAY: TRADE FLOW BY COUNTRY & SELECTED ECONOMIC BLOC
Millions of US\$

	2004	2005	% Var.	% Share 2005	1 st Half 2005	1 st Half 2006	% Var.
Exports	2,931	3,405	16.2	100.0	1,613	1,824	13.1
MERCOSUR	764	781	2.2	22.9	368	444	20.6
Brazil	483	458	(5.1)	13.5	225	261	16.1
Argentina	223	267	19.8	7.8	119	153	28.7
Paraguay	58	56	(4.6)	1.6	24	29	22.8
Extrabloc	2,167	2,624	21.1	77.1	1,245	1,380	10.8
NAFTA	822	988	20.3	29.0	472	291	(38.4)
EU	568	587	3.3	17.3	376	296	(21.2)
LAIA*	135	182	34.4	5.3	77	160	107.2
Asia	234	275	17.5	8.1	134	158	18.1
Other Countries	407	591	45.2	17.4	185	475	156.1
Imports	3,114	3,879	24.6	100.0	1,817	2,104	15.8
MERCOSUR	1,384	1,631	17.8	42.0	753	872	15.8
Brazil	676	825	21.9	21.3	381	444	16.6
Argentina	691	786	13.6	20.3	362	417	15.2
Paraguay	16	20	24.9	0.5	10	12	12.5
Extrabloc	1,730	2,248	30.0	58.0	1,064	1,232	15.7
NAFTA	265	360	35.7	9.3	162	192	18.4
EU	332	407	22.8	10.5	217	206	(5.0)
LAIA*	317	326	2.8	8.4	37	391	963.3
Asia	332	471	41.7	12.1	199	253	27.5
Other countries	483	684	41.6	17.6	450	189	(58.0)

TABLE 8 (Continued)

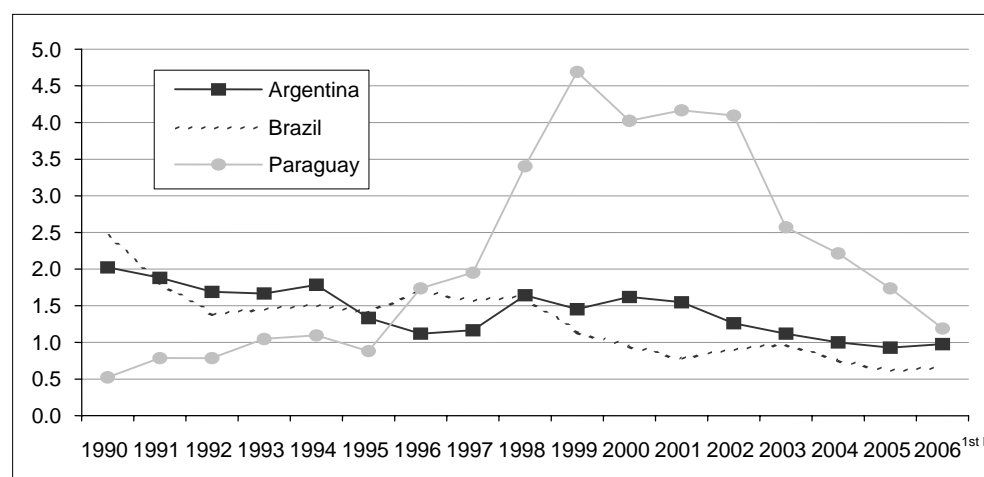
	2004	2005	% Var.	% Share 2005	1 st Half 2005	1 st Half 2006	% Var.
Trade Balance	(183)	(474)	159.4	100.0	(204)	(280)	37.1
MERCOSUR	(620)	(850)	37.0	179.1	(385)	(428)	11.3
Brazil	(194)	(366)	89.2	77.2	(156)	(182)	17.3
Argentina	(469)	(519)	10.7	109.4	(243)	(263)	8.5
Paraguay	42	36	(15.8)	(7.5)	14	18	30.6
Extrabloc	437	375	(14.2)	(79.1)	181	148	(17.9)
NAFTA	556	628	12.9	(132.3)	309.8	98.5	(68.2)
EU	237	180	(23.9)	(38.0)	159.5	90.5	(43.3)
LAIA*	(182)	(144)	(20.8)	30.3	40	(232)	(676.3)
Asia	(98)	(196)	99.6	41.2	(64)	(95)	47.2
Other Countries	(76)	(93)	22.7	19.7	(264)	286	(208.2)

Note: * Except MERCOSUR and Mexico.

Source: Central Bank of Uruguay.

As regards Uruguay's share in its MERCOSUR partners' imports, Graph 23 shows a fairly similar picture to Argentina and Paraguay. Its share in Brazilian imports has been in continuous decline since 1996, when it stood at 1.7%, while in the first half of 2006 it fell to just 0.6%. The course of Uruguayan imports is similar to Argentina's: in 2000, their share was 1.6%; today it is less than 1%. As regards Paraguay, Uruguay recorded a 4.7% share in 1999, but has deteriorated ever since. Its level today is a mere 1.2%.

GRAPH 23
URUGUAY: SHARE IN ITS MERCOSUR PARTNERS' IMPORTS
1990–1st Half 2006 – In %



Source: Central Bank of Uruguay.

C. The Intrabloc Trade Imbalance in Favor of Brazil

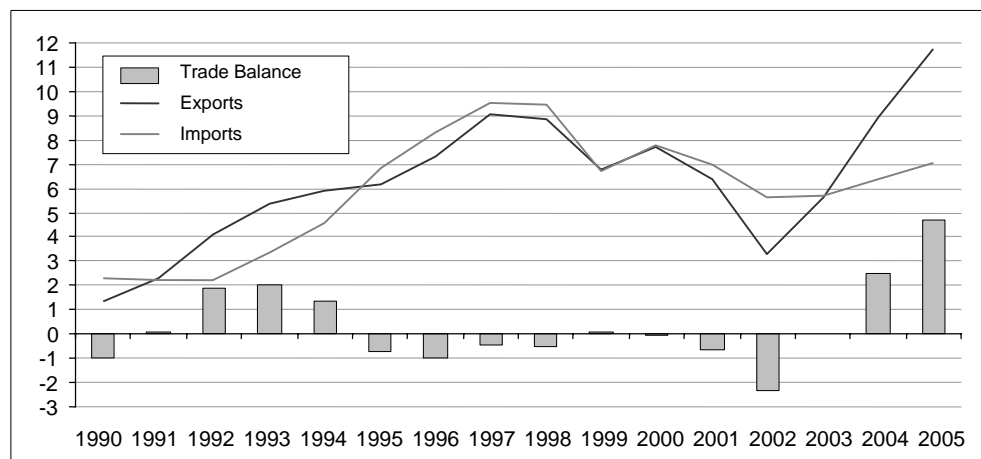
There are two aspects of the figures in the previous section that are striking and deserve closer analysis. The first has to do with the asymmetry seen in recent years in the evolution of Brazil's trade balances with

its MERCOSUR partners. It has high surpluses with all its partners, and these surpluses are also growing fast (Annex II). The second aspect has to do with the reduction in MERCOSUR countries' share in the Brazilian import market, a phenomenon that has been observed continuously since 1997 and 1998.

Graph 24 shows that the large trade balances in Brazil's favor are a recent phenomenon. In the first decade of MERCOSUR's existence (1991–2001), Brazil's trade balances with its partners showed a degree of alternation, with periods of surplus in favor of Brazil (e.g. 1992–1994) and periods of deficit (1995–1998). 2002 was totally atypical, because the economic crisis in Argentina unleashed by the devaluation of the peso not only brought about a sharp drop in Argentinian imports, but also in exports to the other partners.

Nevertheless, the balance in favor of Brazil in 2004 was positive to the tune of US\$ 2.5 billion, a figure that rose again in 2005. And, if the data from the first half of 2006 are anything to go by, the balance will be up again in 2006. Graph 24 shows that these surpluses, with an increasingly upward trend, are the result of the real gap between the rise in Brazilian exports to its partners and the fall in its partners' imports, a phenomenon that clearly emerges from 2003 on. In 2003–2005, Brazilian sales to its partners accumulated a rise of 254%, ten times the rate of imports (25.6%).

GRAPH 24
BRAZIL'S TRADE FLOW WITH ITS MERCOSUR PARTNERS
1990–2005 – Billions of US\$

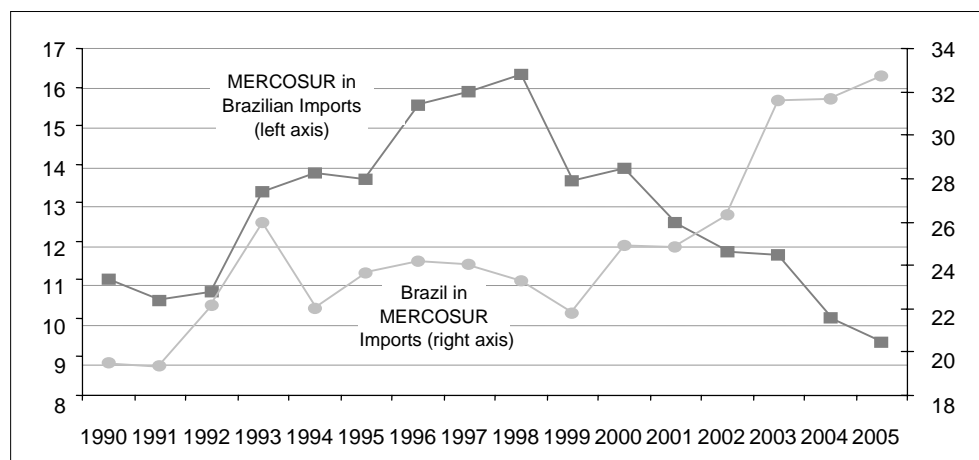


Source: FUNCEX based on SECEX/MDIC data.

This gap is undoubtedly due largely to differences in economic growth. This is reflected in similarly differentiated total import expansion rates. In fact, in 2003–2005, Argentinian imports grew by a cumulative annual average of 47%, Uruguay's by a cumulative annual average of 25.5% and Paraguay's by a cumulative annual average of 29%, while Brazil's had annual average variation of just 16%. However, the differences in growth rates do not explain the significant variations in the partners' share in Brazilian imports, nor the evolution of Brazil's market share in its partners' imports, as seen in Graph 25.

In the early years of MERCOSUR, Brazil's share in its partners' imports grew moderately from 20% in 1991 to around 24% in 1998. In the same period, the partners' share in Brazilian imports grew by more than 5 percentage points, reaching 16% in 1998. Since then however, MERCOSUR partners' share plunged uninterruptedly, reaching a percentage (9.6%) in 2005 below 1990 levels. The Brazilian market share, on the other hand, experienced continued growth, reaching almost 33% in 2005.

GRAPH 25
BRAZILIAN AND MERCOSUR PARTNERS' SHARE IN RESPECTIVE IMPORTS
 In %



Source: FUNCEX based on SECEX/MDIC.

This increase in the Brazilian share can be seen as normal, and even desirable, in a customs union. But the loss of its partners' share in Brazil's imports suggests there is cause for concern, as the prospective result of trade opening at the regional level is precisely an increase in member countries' share in their partners' trade flows. Also, given that Brazil is the largest economy in the bloc, it would be natural for the countries to have placed great hopes in MERCOSUR as an effective instrument to jack up their exports thanks to free access (under preferential conditions) to a large market. Such an expectation was not to be, and continues to be frustrated daily.

There are two possible explanations for this loss of market share. The first is to do with the composition of the basket of products exported to Brazil by the partners (the so-called "composition effect"). A possible explanation for this fall in market share would be greater concentration of partners' sales in products that have grown at rates below total Brazilian imports. If this were the case, the problem would be a structural one, indicating that there is no positive correspondence between the structures of Argentinian, Paraguayan and Uruguayan export supply, and Brazilian import demand. The second possible argument is to do with lower levels of competitiveness in the products exported by the partners compared with third countries supplying the same products to Brazil. This may be due to the lower prices applied by the competition and the limitations in the partners' export supply in terms of production volume. Both phenomena may at any rate be concurrent.

The validity of such explanations is an empirical issue. The relevance of the former must be analyzed -as a first approach at least- in terms of the dynamism of Brazilian imports. Basically this involves: (i) classifying Brazilian imports disaggregated to six digits (MCN-6) in a restricted number of categories depending on the growth rate observed between two periods, and (ii) comparing the performance observed for total imports with imports from the partner countries.

The periods selected were 1999–2000 and 2004–2005, intervals during which Brazil's partners' loss of share was more pronounced and continuous. In these periods, average annual growth of Brazilian imports was 5.5%. We thus obtain a classification of MCN-6 products in the following dynamism categories:

- *Upward*: products whose cumulative annual imports grew more than 8% over the period;

- *Intermediate*: products with a cumulative annual growth of 3% to 8% growth (near average rates), and
- *Downward*: products with a cumulative annual growth below 3%.

Table 9 presents the distribution of total Brazilian imports and imports from individual MERCOSUR partners classed by the above dynamism categories, as well as the annual average growth rate for imports across the two biennia in question. The first section of Table 9 shows that almost half Brazil's total imports in 1999–2000 consist of products whose average growth would be below 3% in the next five years. In contrast, the share of upward products in the export basket rose substantially from 32.3% in 1999–2000 to 56.2% in 2004–2005, with cumulative annual growth of no less than 17.7%. Intermediate products represented almost 17% of the export basket's total across both periods.

TABLE 9
TOTAL BRAZILIAN & MERCOSUR IMPORTS
CLASSED ACCORDING TO BRAZILIAN IMPORT DYNAMISM

Products	1999–2000 Average		2004–2005 Average		Cumulative Annual Growth %
	Millions of US\$	% Share	Millions of US\$	% Share	
Total Brazilian Imports					
Upward	16,941	32.3	38,326	56.2	17.7
Intermediate	8,816	16.8	11,500	16.9	5.5
Downward	26,740	50.9	18,341	26.9	(7.3)
Total	52,497	100.0	68,167	100.0	5.4
Imports from Argentina					
Upward	1,482	23.4	2,071	35.1	6.9
Intermediate	617	9.7	737	12.5	3.6
Downward	4,229	66.8	3,098	52.5	(6.0)
Total	6,328	100.0	5,906	100.0	(1.4)
Imports from Paraguay					
Upward	24	7.9	111	35.9	35.6
Intermediate	5	1.7	11	3.5	15.7
Downward	276	90.4	187	60.6	(7.5)
Total	305	100.0	308	100.0	0.2
Imports from Uruguay					
Upward	87	14.0	174	34.3	14.8
Intermediate	158	25.2	177	34.8	2.3
Downward	379	60.8	157	30.9	(16.1)
Total	624	100.0	508	100.0	(4.0)

Source: Author's, based on SECEX/MDIC data.

An analysis of imports from Argentina (second section of Table 9) shows that downward products represented no less than 66.8% of the country's total sales to Brazil in 1999–2000. The share for upward products stood at just 23.4%. Also, downward products in 2004–2005 still represented 52.5% of Argentinian sales to its neighbor, as against just 35.1% for upward products. In other words, Argentina's export supply shows little correlation to Brazil's demand for imported products.

Table 9 reveals another negative. While downward product sales to Brazil recorded a cumulative annual fall of 6%, a rate near that of these products in total Brazilian imports, upward product sales grew by a cumulative annual average of just 6.9%, under half the rate of Brazil's total for upward products. This gap is almost entirely explained under a single heading, namely, oil. This product constituted almost half of Argentina's exports to Brazil in upward products in 1999–2000 (US\$ 704 million from a total of US\$ 1.48 billion). Brazilian imports across the biennia underwent cumulative annual growth of 21%, while imports from Argentina fell by a cumulative annual average of 31.6% (just US\$ 105 million in the 2004–2005 average).

A contrafactual exercise shows that, if Argentinian exports of crude oil to Brazil had grown at the same rate as total Brazilian imports, it would have represented an increase in sales of US\$ 1.7 billion in the 2004–2005 average. In that case, Argentina's total exports to Brazil would have reached US\$ 7.6 billion, a cumulative annual rise of 3.7% against 1999–2000, in contrast to the fall of 1.4% that actually occurred.

An analysis of the case of Paraguay (third section of Table 9) reveals an even more impressive profile: more than 90% of exports to Brazil in 1999–2000 corresponded to downward products, while upward products represented just 7.9%. In 2004–2005, these products still represented 60% of Paraguayan exports to Brazil, even with the enormous growth gap in the product categories: the sales of upward products grew by a cumulative annual average of 35.6% for the period, whereas downward products fell 7.5%. The concentration in downward products essentially concerned with two headings, soya and cotton, representing 58% of Paraguay's total exports to Brazil in 1999–2000, sales of which showed negative cumulative annual growth of 11% to 2004–2005. Among upward products, Paraguay's basket is basically concentrated in vegetable oils and beef. This analysis leads to the conclusion that the drop in Paraguay's market share of Brazilian imports is almost totally due to the "composition effect."

In terms of Uruguayan exports to Brazil (fourth section of Table 9), downward products represented 60.8% of the total in 1999–2000, as against just 14% for upward products. Until 2004–2005, the former fell by a cumulative annual average of 16.1% in values exported to Brazil, while the latter recorded a cumulative annual rise of 14.8%. Downward products in Uruguay's export basket to Brazil in 1999–2000 included dairy produce, automobiles (whose sales fell US\$ 36 million on average for 1999–2000 to zero in 2004–2005) and meat products. Upward products included resins, and iron and steel tubing.

This analysis shows that the composition of MERCOSUR partners' exports to Brazil was poor in recent years. As a result, the most important products in these countries' export baskets recorded relatively weak growth overall. The "composition effect," in other words, largely accounts for the losses in market share.

Let us move on to verify the second argument or explanation, which attributed the fall in partners' share in the Brazilian market to the bloc's partners' effective loss of competitiveness against third countries. To do this, it is necessary to analyze the evolution of products in individual MERCOSUR partners' market share in total Brazilian imports. The objective is to tag those products in which there was a reduction of the share in the period in question, while identifying the main supplier responsible for the contraction in that MERCOSUR partner's share.²¹

In Argentina's case, Table 10 highlights the products (or sectors) that dominated the export basket to Brazil in 1999–2000, representing 92.5% of total sales. In 2004–2005, these products were the most representative, despite their share decreasing to 83.3%. It is also significant that just 3 of the 21 products included in Table 10 form part of the upwardly dynamic group: oil, spare parts for automobiles and tractors, and various chemical products. Most of these (12) are downward products in Brazilian imports.

²¹ To make the interpretation of the results easier, only the MCN-6 disaggregation will be analyzed, albeit in more aggregated sectoral terms.

TABLE 10
ARGENTINA'S SHARE IN BRAZILIAN IMPORTS FOR THE MAIN EXPORT BASKET

Sectors or Products	1999–2000		2004–2005		Variation in Share (in p.p.)	Dynamism	Country with largest market share gain
	Millions of US\$	% Share	Millions of US\$	% Share			
Motor vehicles	1,085	58.3	635	53.5	(4.8)	Down	United States
Wheat	837	95.3	652	93.8	(1.5)	Down	Paraguay
Refined Oil & Petrochemicals	764	10.6	1,666	18.5	7.9	Intermediate	*
Crude Oil	704	26.3	105	1.5	(24.8)	Up	Algeria
Agricultural Produce	334	39.0	208	31.0	(7.9)	Down	Indonesia
Dairy Produce	259	63.0	58	52.5	(10.5)	Down	Uruguay
Spare Parts for Automobiles & Tractors	257	15.8	358	14.9	(0.9)	Up	Japan
Heavy Machinery & Tractors	200	3.3	177	2.8	(0.6)	Down	China
Automobile Engines	163	19.9	116	11.0	(8.9)	Intermediate	Germany
Textiles	147	14.7	79	9.2	(5.5)	Down	China
Chemical Elements	126	4.5	156	4.2	(0.3)	Intermediate	China
Various Chemicals	105	4.2	312	6.8	2.6	Up	*
Medicines	81	5.7	61	3.2	(2.5)	Intermediate	India
Pulp	68	35.0	45	25.0	(10.0)	Down	Chile
Fish	65	47.8	55	39.2	(8.6)	Down	Chile
Malt	59	41.2	60	31.0	(10.2)	Intermediate	Uruguay
Prepared Horticultural Products	44	78.0	42	77.9	(0.2)	Down	Belgium
Candies & Baking Products	34	37.3	21	44.2	6.9	Down	*
Books, Magazines, Periodicals & Printed Matter	28	14.7	6	8.8	(5.9)	Down	Spain
Perfume Products	18	14.1	39	29.0	14.9	Down	*
Alcoholic Beverages	7	5.4	65	33.1	27.7	Intermediate	*
Other Products	940	-	989	-	-	-	-
<i>Total</i>	<i>6,328</i>	<i>12.1</i>	<i>5,906</i>	<i>8.7</i>	<i>(3.4)</i>	<i>-</i>	<i>-</i>

Note: * Argentina increased its share.

Source: Author's, based on SECEX/MDIC data.

Argentina clearly lost share in Brazilian imports in virtually all these products across the two biennia in question, although its share in many of these products remains high in absolute terms. The most significant cases in terms of volume are motor vehicles (the country that gained most ground in Brazilian imports was the United States), wheat (displaced mainly by Paraguay), crude oil (Algeria), agricultural produce (Indonesia) and dairy produce (Uruguay). Prominent among products that successfully increased their share were those related to the oil-refining and petrochemical industries (basically gasolines and polymers), various chemical products (including insecticides, antkillers, etc., as well as manures and fertilizers), candy and baking products, perfume products and alcoholic beverages.

In the case of Paraguay, Table 11 presents a series of products responsible for 96.3% of exports to Brazil in 1999–2000 and 90% in 2004–2005. The vast majority are low dynamism products, in keeping with the information in Table 9. The evolution of Paraguay's share in Brazilian imports was seen to be positive in

virtually across the board. The only product to lose share was wood (displaced mainly by Argentina). In the four main products (agricultural produce, cotton, oils and beef), Paraguay's share in Brazilian imports is fairly significant and the country managed to gain market share across the two biennia in question. These figures confirm the idea that the drop in Paraguay's share in total Brazilian imports is basically a reflection of the "composition effect."

TABLE 11
PARAGUAY'S SHARE IN BRAZILIAN IMPORTS FOR THE MAIN EXPORT BASKET

Sectors or Products	1999–2000		2004–2005		Variation in Share (in p.p.)	Dynamism	Main Winner
	Millions of US\$	% Share	Millions of US\$	% Share			
Agricultural Produce	141	16.5	116	17.4	0.9	Down	*
Cotton	70	20.5	28	27.7	7.2	Down	*
Vegetable Oil	35	15.8	42	18.5	2.7	Down	*
Beef	19	22.2	33	43.5	21.3	Down	*
Wood	7	3.8	5	2.6	(1.2)	Up	Argentina
Leathers & Hair-Off Hides	6	3.5	5	3.5	-	Down	Italy
Treated Fibers & Natural Yarns	4	5.1	7	9.8	4.7	Up	*
Chemical Elements	3	0.1	3	0.1	-	Intermediate	China
Wheat	3	0.3	30	4.3	4	Down	*
Various Chemicals	2	0.1	5	0.1	-	Up	Argentina
Other Products	15	-	33	-	-	-	-
<i>Total</i>	<i>305</i>	<i>0.6</i>	<i>308</i>	<i>0.5</i>	<i>(0.1)</i>	<i>-</i>	<i>-</i>

Note: * Paraguay increased its share.

Source: Author's, based on SECEX/MDIC data.

For Uruguay, Table 12 shows a table similar to the one for Argentina. Regarding the main products in the basket to Brazil, responsible for almost 90% of the total in 1999–2000 and for 86% in 2004–2005, Uruguay lost share in over half, 13 from a total of 21 products. Prominent among these losses were meat (displaced by Paraguay), motor vehicles and clothing (displaced by China). Uruguay did, however, increase its share in certain important products, such as rice, dairy produce and malt.

To sum up, this analysis demonstrates that Argentina and Uruguay's losses of market share in Brazilian imports have largely to do with problems of competitiveness in their production against extrabloc suppliers, and with the composition of their export baskets, highly concentrated in products imported by Brazil more cheaply in recent years. In Paraguay's case, the loss of share in Brazil was due exclusively to the "composition effect," as it increased its share in almost all the main products exported to Brazil.

TABLE 12
URUGUAY'S SHARE IN BRAZILIAN IMPORTS FOR THE MAIN EXPORT BASKET

Sectors or Products	1999–2000		2004–2005		Variation of Share (in p.p.)	Dynamism	Main Winner
	Millions of US\$	% Share	Millions of US\$	% Share			
Rice	87	46.9	80	48.9	2.0	Intermediate	*
Dairy Produce	80	19.4	27	24.5	5.1	Down	*
Meat	52	31.3	27	18.1	(13.2)	Down	Paraguay
Resins, Elastomers, Artificial & Synthetic Fibers	40	2.6	56	2.6	-	Intermediate	India
Motor vehicles	36	1.9	-	-	(1.9)	Down	United States
Malt	35	24.1	71	36.9	12.9	Intermediate	*
Rubber Manufacture	30	4.6	34	3.1	(1.6)	Up	United States
Various Chemical Products	29	1.2	22	0.5	(0.7)	Up	Argentina
Textiles	26	2.6	14	1.6	(1.0)	Down	China
Agricultural Produce	21	2.5	17	2.5	0.1	Down	*
Clothing	20	13.5	3	1.3	(12.3)	Up	China
Medicines	18	1.3	7	0.4	(0.9)	Intermediate	India
Chemical Elements	17	0.6	10	0.3	(0.3)	Intermediate	China
Fish	13	9.8	6	4.4	(5.4)	Down	Chile
Leathers & Hair-Off Hides	13	8.5	5	4.0	(4.5)	Down	Italy
Iron & Steel Tubing	8	8.5	10	6.6	(1.9)	Intermediate	United Kingdom
Paper & Cardboard for Graphic Use	7	3.2	11	7.3	4.2	Down	*
Polymers	6	1.3	6	0.7	(0.5)	Up	Argentina
Dyes, Pigments, Colorants	6	1.3	6	1.2	(0.1)	Down	United States
Heavy Machinery & Tractors	5	0.1	4	0.1	-	Down	China
Gasolines	3	0.2	16	1.3	1.1	Down	*
Other Products	71	-	75	-	-	-	-
<i>Total</i>	<i>624</i>	<i>1.2</i>	<i>508</i>	<i>0.7</i>	<i>0.5</i>	<i>-</i>	<i>-</i>

Note: * Uruguay increased its share.

Source: Author's, based on SECEX/MDIC data.

D. Foreign Direct Investment in MERCOSUR

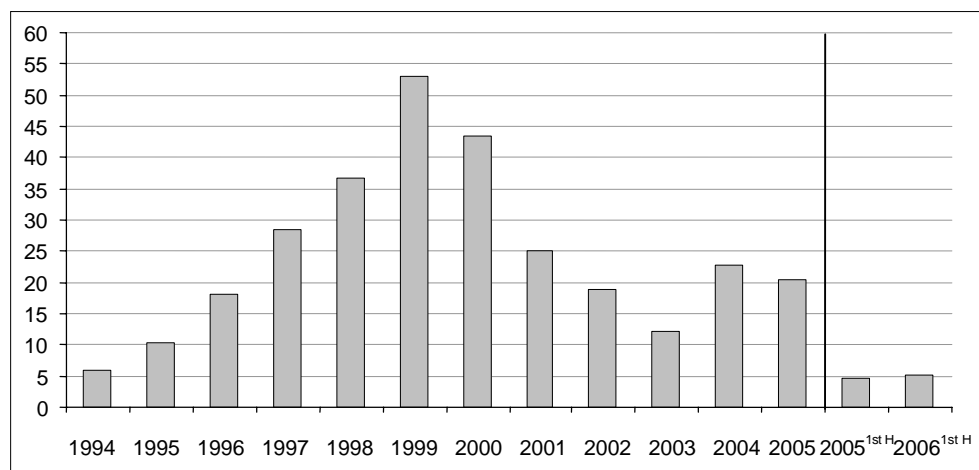
The General Picture

The net income of US\$ 20.5 billion from FDI in MERCOSUR countries in 2005 was 17% down on the previous year. The growth recorded in 2004 of almost 90% against the previous year created the expectation that the foreign investment flow into the bloc was entering a stage of recovery after four years of decline running. But the 2005 figures of below 40% of the 1999 record value of almost US\$ 53 billion (Graph 26) punctured this expectation.

The 2005 fall was due basically to the drop of almost US\$ 3 billion in investment flows to Brazil, given that investments in Argentina and Uruguay rose almost US\$ 400 million, while those in Paraguay

remained stable. Brazil continued to be the bloc's main destination for FDI, with 73.5% of the total in 2005, while Argentina accounted for 22.7%, Uruguay 3.5% and Paraguay 0.3%. The figures for the first quarter of 2006 show a net FDI income of US\$ 5.2 billion, 94% up on the same period in 2005.

GRAPH 26
FOREIGN DIRECT INVESTMENT IN MERCOSUR
 1994–1st Quarter 2006 – Billions of US\$



Sources: INDEC (Argentina) and Central Banks of Brazil, Paraguay and Uruguay.

Compared to global FDI flows, MERCOSUR's performance in 2005 was negative, its share in the world total falling to just 2.3%, and to 7.5% in the total to developing countries. These figures are below 2004 (3.3% and 9.4% respectively) and remain well below 1996 and 2000 levels (4.4% and 17.7% respectively)

- Evolution by Country -

The pattern of evolution of FDI flows to Brazil has been irregular in recent years, for the sharp fall of 2003 (down to just over US\$ 10 billion) was followed by significant growth in 2004 and another fall in 2005, when they hit US\$ 15 billion. The figures for the first six months of 2006 are US\$ 7.4 billion, just over US\$ 1 billion down on the same period in 2005.

Furthermore, we must remember that the reduction in net flows in both 2005 and the first half of 2006 was basically the result of higher volumes of remittances of capital abroad due to the acquisition by Brazilian companies of foreign subsidiaries in Brazil. Graph 27 illustrates how the net inflow of FDI into Brazil currently is well below the late 1990s, when FDI stood at about US\$ 30 billion per annum.²²

It is also relevant to underline the growing importance of Brazilian companies' foreign investments. In 2004, these flows reached US\$ 9.8 billion (over half the net investments entering Brazil in the same year). In 2005, the flow was smaller (US\$ 2.5 billion) but has gained fresh momentum in the first half of 2006 (US\$ 4.5 billion).

²² It should still be remembered that, in this period, there was a spate of privatizations in Brazil, a process that brought resources not only for the acquisition of Brazilian state enterprises, but for the new investment necessary to modernize and expand the services provided by these enterprises. In 1998–2000, telecommunications services, and electrical energy and gas supplies alone accounted for the equivalent of 30% of the country's total earnings in the period. If we add in the financial sector, where there was high foreign investment for the acquisition of state and some private banks, this amount is equivalent to 48% of the total.

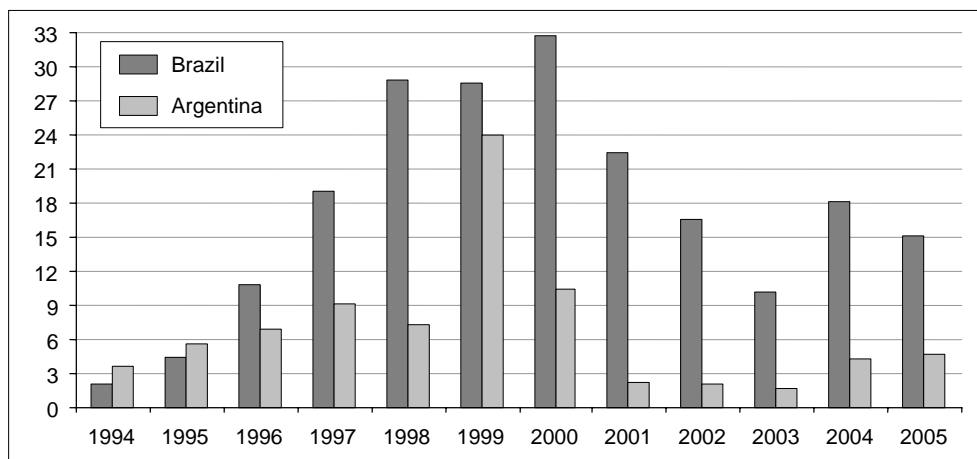
Argentina holds a prominent position in this process. Brazilian companies' desire to participate in direct operations in the neighboring market is recent, as is its desire to invest abroad. In 2004, Brazil invested US\$ 653 million in Argentina (15% of Argentina's total FDI), the fourth largest investor in Argentina. Its performance in 2005 was even more positive, investing 7% of Argentina's total FDI (US\$ 440 million), taking into account only resources for greenfield investment or the expansion of existing plants.²³

The outlook for Brazilian investment in Argentina in the near future seems quite positive due to a combination of four factors: first, the growing interest shown by Brazilian companies in expanding their overseas operations base; second, the rapid growth of Argentina's domestic market; third, the fact that production costs in dollars are relatively lower in Argentina than Brazil, and fourth, companies' desires to exploit the advantages of the integration of productive chains in an integrated regional market, despite the absence of public policies to stimulate the formation and development of such chains.

Regarding Argentina, Graph 27 shows a significant recovery of FDI inflows over 2004 and 2005, which reached US\$ 4.7 billion in 2005, almost triple 2003. As in Brazil, FDI flows in Argentina are still currently well below the second half of the 1990s, when they rose on average to almost US\$ 10 billion per annum. True it is that these levels were atypical, due also to privatizations and a prolonged process of foreign groups acquiring Argentinian private companies. But there is no doubt that the shrinkage seen in recent years -especially in 2001–2003- was related to Argentina's grave economic crisis. By analogy, the recovery begun in 2004 can be attributed to renewed economic growth.

The MERCOSUR partner that the best recent performance in FDI growth rates is Uruguay. In 2005, the FDI inflow reached a record US\$ 711 million, over 100% up on the previous year and well above the levels of the late 1990s, when it stood around the US\$ 240 million per annum mark. Also, in just the first quarter of 2006, FDI inflow climbed to US\$ 456 million, more than the whole of 2004. It should be pointed out that this growth is largely related to two major investment projects, namely, the construction of pulp mills.

GRAPH 27
FOREIGN INVESTMENT IN BRAZIL AND ARGENTINA
1994–2005 – Billions of US\$



Sources: INDEC and Central Bank of Brazil.

²³ The value is certainly much higher if the acquisitions of Argentinian companies by Brazilian groups are taken into account. Two operations alone –the purchase of the Loma Negra cement plant by the manufacturer, Camargo Corrêa, and of the Swift Armour company by the meat packaging company, Friboi, came to over US\$ 1 billion. Data from the *Investment Database (Base de Inversiones)* of the Study Center for Production (*Centro de Estudios de la Producción*), a body linked to Argentina's Economy Ministry.

Regarding Paraguay, FDI flow remains fairly low in both absolute terms and in terms of the size of the country's economy. The net inflow of US\$ 64 million in 2005 represented below 1% of Paraguay's GDP. The recent figures are also below the records of the late 1990s: in the period 1996–2000 FDI recorded an annual average of US\$ 185 million.

E. Conclusions

The data presented in this chapter have shown the excellent performance of MERCOSUR countries' foreign trade flow in recent years, especially since 2003. The performance has been especially good in exports and trade growth is more notable with MERCOSUR member countries than with those outside the bloc. In terms of intrabloc flow, the relatively more favorable performance of Brazil, which accumulated growing surpluses with all the other partners, is also striking. The fall in the partner countries' share of Brazil's import market is also pronounced.

The third section showed that this fall is related to a problem of composition of the basket of products these countries export to Brazil -fairly highly concentrated in products with a downward demand in the Brazilian market, that is, products whose growth in recent years has been quite a lot below average- and to problems of competitiveness at the level of products, factors reflected in the partners' losses of market share in Brazilian imports for the vast majority of leading products in their respective export baskets. Only in Paraguay's case was this second effect not observed, a phenomenon fully accounted for by the "composition effect."

Lastly, the FDI data show a slowing of inflows in 2005 and 2006, which remain well below the peak values of the late 1990s. However, there is one relatively new interesting fact, namely, the increase in Brazilian companies investing in Argentina.

CHAPTER III. THE INTERNAL AGENDA

This chapter describes the main issues of MERCOSUR's internal agenda between July 2005 and July 2006, the year of the 30th Meeting of the Common Market Council (*XXX Reunión del Consejo del Mercado Común*) in Córdoba, Argentina. The Meeting dealt with the issues of CET consolidation, the renegotiation of the Automotive Agreement, the creation of the CAM, the treatment of asymmetries, the incorporation of rules and the "paper mills" dispute. It should be stressed that three of the matters examined are bilateral issues.

A. The Common External Tariff

Since the introduction of the CET in 1995, its effective implementation has been extremely pragmatic and flexible. Strictly speaking, the CET is not applied to the whole product range but observes certain exceptions: (i) *specific sectoral regimes*: motor vehicles, sugar, capital goods (KG), and information technology and telecommunications goods (ITTG); (ii) various national exceptions; (iii) special import regimes differentiated in each country, including drawback and other temporary admission regimes; and (iv) non-harmonized bilateral preferences granted by States Parties in third party negotiations.

Aware of the need to finetune MERCOSUR's Common Tariff Policy (*Política Arancelaria Común*), the CMC stipulated three essential tasks in the framework of the 2004–2006 Work Program:²⁴

- i. Drafting a proposal to remove double levying of the CET that should broach a solution to the problem of customs revenue distribution between the member countries;
- ii. Identifying priority sectors for establishing special common import regimes, including ITTG and KG.
- iii. Analyzing further the dispersion and consistency of the CET, an issue that led to the creation in 2001 of the High Level Group to Examine the Consistency & Dispersion of the CET's Current Structure (*GANAE: Grupo de Alto Nivel para Examinar la Consistencia y Dispersión de la Actual Estructura del AEC*).

The Double Levying of the CET

As pointed out in MERCOSUR Report #10, the inclusion of the issue of "double levying of the CET" on the MERCOSUR agenda was prompted by a demand from the EU. In the course of negotiations to establish an Association Agreement between the two blocs, the EU highlighted the need for MERCOSUR to comply with the principle of reciprocity and, as in EU territory, to guarantee the single tariff payment for goods circulating in the customs union.

In actual fact, MERCOSUR's current situation is characterized by the coexistence of four different customs territories instead of a single one, as ought to be the case in a true customs union. Indeed, to date only the original goods -those meeting the requirements laid down by the MERCOSUR origin regime- can circulate freely within the customs union. Other goods have to pay the CET again on crossing another national border within the union.

The problem started to be dealt with more formally after CMC Decision #27/00 requesting that the bloc's Trade Commission study different ways of tackling the issue. In 2003, a proposal was drafted to gradually

²⁴ These issues are dealt with in MERCOSUR Report #10 (INTAL [2005]).

remove double levying of the CET. In the first stage, goods from extrabloc countries whose effective CET was zero would be granted the status of original goods, as would goods granted a 100% third country preference margin. These are goods that in neither case generate any customs revenue in terms of imports. For other products, a second stage would establish a timeframe for gradual inclusion. This division responded to the concerns of Paraguay, whose fiscal revenue depends on import duty to a much greater extent than the other MERCOSUR countries: approximately 20% of the total, as against 2% in Brazil, 3% in Argentina and 5% in Uruguay.

This proposal sparked CMC Decision #54/04 of December 2004 establishing the principle that extrabloc countries' imported goods be treated as original goods from MERCOSUR, both for circulation within the member countries' territory and their incorporation in the productive processes, providing they conform to the rules of the common tariff policy. Subsequently, at the Montevideo Summit held in December 2005, the CMC passed Decision #37/05, by which it concluded the process envisaged for the first stage.

CMC Decision #37/05 defined the provisional regulation for the circulation of a group of goods that were to be treated as original goods as of January 2006. The goods to be included in the regulation fell into two categories: (i) those whose CET was zero in all States Parties (listed in Annex I of the Decision); and (ii) those for which the four MERCOSUR members had granted a 100% tariff preference to the advantage of third countries (Annex II).²⁵ Excluded were tariff items on one of the national CET exception lists, to which some trade protection measure such as antidumping, compensatory duties or safeguard measures was applied in one of the States Parties, as well as those involving regional supply or compulsory production within MERCOSUR countries.

The regulations also envisage the periodic updating of the list of items benefited, as new tariff lines satisfy one condition or another (zero tariff or 100% preference). CMC Decision #37/05 also defined the customs procedures for products benefited, matters relating to compliance with the origin regime and the real-time online exchange of product information between the four countries' customs. For customs identification of the products benefited, the countries' customs information systems would issue a computerized Certificate of Compliance with the Common Tariff Policy (*Certificado de Cumplimiento de la Política Arancelaria Común*) and the Certificate of Compliance with the MERCOSUR Origin Regime (*CCROM: Certificado de Cumplimiento del Régimen de Origen MERCOSUR*), which must be available for consultation by the other member countries' customs.

For 2006, studies were planned to define how to implement the second stage envisaged in CMC Decision #54/04 regarding the removal of double levying of the CET on the products not envisaged in CMC Decision #37/05. The current commitment is to the free circulation being fully applicable to all goods by no later than 2008. However, compliance with this target involves additional difficulties, considering that CMC Decision #54/04 established three conditions for the implementation of the second stage: (i) the entry into effect of the MERCOSUR Customs Code; (ii) the online interconnection of the four countries' customs administration computer systems, and (iii) the adoption of a customs revenue distribution mechanism that takes into account each country's specific needs and the impact on their tax collection. It is worth pointing out that Brazil's Minister of Foreign Relations recently stated that the 2008 deadline could be brought forward as part of a set of benefits offered to the smaller MERCOSUR partners.

The customs revenue distribution mechanism has been the subject of studies by the MS, with backing from the General Secretary of the LAIA. The rule for customs revenue distribution must have a specific target. Three alternatives can be identified to achieve this: (i) maintaining fiscal neutrality, involving minimizing impacts on member countries' public finances; (ii) creating a distribution mechanism to generate a net transfer of resources from the largest and/or richest countries to the smaller and/or poorest;

²⁵ Much of the trade with Chile and Bolivia already meets this condition.

and (iii) using customs revenue to form a fund to finance policies seeking to promote the integration process. Be that as it may, the study deems necessary the inclusion in the main selection criteria of the requirement that the system be simple to operate and easy to implement.

Nevertheless, the three alternatives entail investment to finetune common institutions. The study includes an estimate of the volume of resources that would be committed in the customs revenue distribution mechanism. Various different hypotheses conclude that only a fraction of member countries' total customs revenue (somewhere between 3% and 5%) comes from products effectively circulating in MERCOSUR. This surprisingly low estimate suggests that the genuinely important hurdles to the formation of a single customs territory are less significant than first imagined.

In the case of the online interconnection of the customs administration systems, the Trade Commission has been working to create a single web page for each State Party to access the other partners' foreign trade operations, enabling those complying with the common tariff policy to be identified.

Lastly, although the MERCOSUR Customs Code was passed at the Ouro Preto meeting in 1994, it was not incorporated in the countries' various legislations. In 2006, CMC Decision #25/06 provided for the creation of an ad hoc group to draft a new version of the MERCOSUR Customs Code. The project will be submitted to the CMC for consideration at its first meeting in 2007.

Special Import Regimes

CMC Decision #69/00 established the deadline 31/12/2005 for countries to remove their special national regimes. This was extended to 31/12/2007 by CMC Decision #33/05. It had also been laid down that the products to be subjected to special common regimes would be defined at the end of the term. The 2004–2006 Work Program had planned for studies identifying the priority sectors to be included in such regimes to be concluded by the first half of 2004, a deadline that was successively extended. Lastly, CMC Decision #02/06, passed at the last Summit in July 2006, defined the list of priority sectors and ordered the Trade Commission to design tasks aimed at establishing the special common regimes for those sectors, a job that will be complete by the first half of 2007. The priority sectors are: goods forming part of projects such as investment, science and technology, transborder land trade, education, the aeronautical industry, the shipbuilding industry and health. In addition, CMC Decision #03/06 laid down that countries could maintain special unilateral import regimes in specific cases such as diplomatic missions, postal remittances without commercial value, marketing samples, art objects, goods to tackle emergencies and catastrophes, etc. However, these regimes may not be modified unilaterally to extend the range of goods or beneficiaries, except through the express authorization of the other States Parties in the MERCOSUR Trade Commission or MTC (*CCM: Comisión de Comercio del MERCOSUR*). The Annex to the Decision includes a connection with the national regimes contemplated. The numbers are surprising: Brazil 22 regimes, Argentina and Uruguay 17 each, and Paraguay 13.

However, regarding ITTG and KG-related special regimes, movements have so far been limited to successive postponements of the dates envisaged for the common regimes' entry into effect. In the case of ITTG, CMC Decision #33/2003 defined the deadline for the passing of the common regime as 31/12/2005 and for Paraguay and Uruguay kept the deadline for applying the 2% CET as 2010. CMC Decision #39/05 extended these terms to 31/12/2006 for passing the common regime and to 31/12/2011 for the exceptions of Paraguay and Uruguay. At the last Summit in Córdoba, Argentina, in July 2006, CMC Decision #13/05 extended these dates further to 30/06/2007 and 30/06/2012 respectively.

Regarding capital goods, CMC Decision #34/03 had set 31/12/2005 as the deadline for the validity of the exceptional measures adopted by Argentina, Paraguay and Uruguay, while setting a more flexible deadline -the end of 2010- for goods imported by Paraguay and Uruguay. Similarly, it established the validity of the common regime for capital goods from extrabloc countries as the end of 2011. In addition, it ruled that a common list of goods subject to zero tariff would be effective as of January 2006 and kept lists of exceptions for each country with products to which a 2% tariff would be applied until December 2007. CMC Decision #40/05 of December 2005 extended the first deadline to 31/12/2006 and the deadline for transition from individual countries' lists of exceptions to the common list to 31/12/2010, while keeping the deadline for the full validity of the KG common regime as 2011.

Consistency & Dispersion of the CET

The issue of the CET's dispersion and consistency led to the creation of the GANAEC High Level Group in 2001. However, the issue has so far shown no significant progress. Negotiations in the Doha Round contributed to the postponement of discussion on the matter, given that some of the alternatives contemplated in the multilateral negotiation include the choice for the Swiss Formula of parameters that may bring about an effective reduction in the CET's tariff lines (Chapter 4). The negotiation of trade agreements with third countries also contributes to postponing any discussion involving a potential reduction in the CET, as there is feeling that this would weaken MERCOSUR's negotiating position.

B. Renegotiating the Automotive Agreement

The Automotive Agreement was signed by Brazil and Argentina -after long and hard negotiations- on June 28, 2006, for the period of July 1, 2006, to June 30, 2008. The still provisional Agreement will be implemented as the 35th Additional Protocol to the LAIA's ECA 14.²⁶

As it was not possible to conclude the negotiations by the end of 2005, when the deadline of the 31st Additional Protocol to ECA 14 expired, the two governments signed the 32nd Additional Protocol extending the validity of the previous one by sixty days. In March 2006, the deadlines had to be extended again, and both countries' governments signed the 33rd Additional Protocol to ECA 14, by which they agreed to keep to the conditions of the bilateral automotive agreement in force in 2005 until July 31, 2006.

Although the 31st Protocol envisaged the adoption of free trade as of January 1, 2006, the negotiations in the second half of 2005 already indicated that such a commitment would not be kept. One of the main Brazilian demands -the fixing of a date for the start of free trade- was not included in the new agreement. According to information from the representatives of the automotive sector, there was consensus between both parties in the private sector about the need to set a date for the complete opening of borders to trade. The Argentinian government, however, was reluctant to accept the measure.

The 35th Protocol keeps the annual export deviation coefficient known as "flex" to define the bilateral trade limit of imports exempt from duties, in other words with a 100% preference margin. To June 30, 2006, the valid trade flow coefficient between the two countries was US\$ 2.6 imports for every US\$ 1 exports. As of July 1, the coefficient became US\$ 1.95. The penalty for imports exceeding the limit will be the application of 75% of the CET tariff for auto parts and 70% for automobiles.

²⁶ Table 13 indicates the main features and differences of the agreement with the previous one (35th and 31st Protocols -*Acuerdo de Alcance Parcial* -#14).

The methodology used to calculate the coefficient was another bone of contention between the two countries. Although the Argentinian government defended the coefficient being calculated by company, the agreement stipulated that should continue to be done by country. Two 12-month periods will be considered for the calculation: from July 1, 2006, to June 30, 2007, and from July 1, 2007, to June 30, 2008. Providing the export deviation does not exceed a coefficient of 2.1 in the first 12 months, the calculation will be based on July 2006-June 2008.

The products included in the new agreement are automobiles and light utility vehicles, buses, trucks, tractors, engine chassis and auto parts. CET levels remained the same as for the previous Protocol and are now adopted by both countries, bringing the Argentina's convergence timeframe to a close.

Another issue at the heart of negotiations was the treatment given to auto part imports. During the negotiating process, both countries' auto part manufacturing sectors released a document proposing the removal of the 40% extrabloc import duty cut in force in Brazil at the time. The terminals, for their part, pressed for across-the-board cuts in import duty, with the argument that they needed to improve their competitiveness with other markets.

To avoid dispute, Brazilian extrabloc auto part imports will continue to benefit from the 40% import duty cut while Argentina maintains its current protection. The Agreement removed the demand for a minimum content of 5% of Argentinian auto parts and a maximum content of 65% of imported auto parts, even for MERCOSUR partners. Both countries' private sectors will have to reach consensus over the list of auto parts not produced in MERCOSUR, which will be subject to the CET's 2% tariff. In order to reduce current asymmetries, both countries undertook to develop a common policy for this sector.

The difficulties involved in incorporating the automotive sector in MERCOSUR's free trade area increased with the crisis that this Argentinian sector faced as of 1999. Although there are discrepancies among different sources over production volumes from one country to another, all sources mention a sharp contraction of Argentina's motor vehicle market, peaking in 2002. In 2006, the market recovered its 1999 levels again.

TABLE 13
AUTOMOTIVE AGREEMENT BETWEEN BRAZIL & ARGENTINA:
31ST & 35TH PROTOCOLS COMPARED

Issue	31st Protocol	35th Protocol
Extrabloc Trade in Vehicles	A 35% CET was set for automobiles, buses, trucks, chassis, tow trucks and semitrailers, coaches and cabs, and 14% for tractors, harvesters, agricultural machinery and self-propelled machinery. The CET's original levels were maintained for auto parts (Article 3). A progressive convergence timeframe from 2000 to 2006 was also defined for Argentina's adoption of these levels (Article 9).	CET levels from the previous Protocol, now adopted by both countries, remained the same. This brings to an end Argentina's timeframe of convergence (Article 3.th).
Extrabloc Auto parts Trade	Progressive timeframes were defined for the Import Duty (II) for auto parts imported from third countries and targeting automotive production in Argentina and Brazil. For Argentina's imports, the addition of 0.5 percentage points was authorized at II (Articles 5 & 6).	Before December 31, 2006, the countries will make every effort for consensus by working together with the private sectors to define a common auto parts policy and remove existing asymmetries (Article 7). Both agreements envisage a 2% II for auto parts not produced in MERCOSUR to be applied to products, a list of which will be drawn up by the two countries' private sectors (Article 6 of the current Protocol and Article 8 of the previous one).

TABLE 13 (Continued)

Issue		31st Protocol	35th Protocol
Intrabloc Trade Administration - Area of Application		As well as those listed in the current agreement, the following products are subject to monitoring for some time: tow trucks and semitrailers, coaches, agricultural tractors, harvesters and self-propelled agricultural machinery, and self-propelled machinery (Article 12).	Products subject to monitoring: automobiles and light utility vehicles, buses, trucks, tractors, engine chassis and auto parts (Article 11).
Export Coefficient	Deviation	US\$ 1 exports=US\$ 2.6 imports in 2005 (rising coefficient between 2001 and 2005) (Article 13).	US\$ 1 exports=US\$ 1.95 imports from July 1, 2006, to June 30, 2008 (Article 12a).
Trade Period for Calculation of Export Deviation		Annual periods from January to December 2001 to 2005 (Article 13a).	Two 12-month periods, from July 1, 2006, to June 30, 2007, and from July 1, 2007, to June 30 2008. Providing the export deviation coefficient does not exceed 2.1 in the first 12 months, the deviation coefficient will be calculated on the two-year period from July 2006 to June 2008 (Article 12b).
Free Trade		Projection for January 2006 (Article 13a)	No date envisaged.
Argentinian Regional Content Index		5% minimum content of Argentinian auto parts and 65% maximum content of imported auto parts, even for MERCOSUR partners (in 2005) (Article 23).	No demand for local Argentinian content.
Temporary Admission & Drawback		Removal of such operations for MERCOSUR countries in vehicle and auto part exports (Article 24).	Automotive sector exports will be subject to general MERCOSUR rules for these operations (Article 25).
Technical Regulations		Demand for compliance with MERCOSUR Technical Regulations on the environment and active and passive security, regardless of products origins (Article 31).	Before December 31, 2006, the countries have to agree the provisions for Technical Regulations, which will be incorporated in the Agreement (Article 29).

Source: CNI, MERCOSUR Report #393.

Despite the Argentinian market's remarkable recent recovery, the 2005 data show the clear asymmetries characterizing the two countries' automotive sectors. These asymmetries are the result of the difference in production scales and the strategies of the terminals. The differences in strategy stem from the fact that Brazil has concentrated on producing popular models, while Argentinian production concentrated on models targeting the middle segment. The economic crises in both countries and the improved success of popular models have expanded the market for vehicles produced in Brazil.

TABLE 14
INTERNAL MARKET EVOLUTION
In Units of Vehicles

Year	Brazil	Argentina
2000	1,489,000	307,000
2001	1,601,000	177,000
2002	1,487,000	82,000
2003	1,429,000	156,000
2004	1,579,000	312,000
2005	1,715,000	403,000

Source: Bedran [2006].

TABLE 15
AUTOMOTIVE SECTOR PERFORMANCE IN BRAZIL & ARGENTINA IN 2005
 In Units of Vehicles

Brazil	Argentina
• Production: 2,450,000	• Production: 320,000
• Internal Market: 1,715,000	• Internal Market: 403,000
• Exports: 800,000	• Exports: 181,000
• Exports to Argentina: 236,000	• Exports to Brazil: 62,000
• Argentinian Market Share: 59%	• Brazilian Market Share: 3.5%
• Employees - Terminals: 197,000	• Employees - Terminals: 14,000

Source: Bedran [2006]. The role of the MDIC in promoting international agreements in the automotive sector.

This panorama tends to change with the recent trends seen in the two economies. The recovery of economic activity and *per capita* GDP in Argentina, and the divergent trends in the evolution of the real exchange rates in both economies has encouraged the growth of the Argentinian automotive market and the reduction in the share of imported products in that market. Similarly, the evolution of peso/real exchange parity has stimulated the relocation of the production of the terminals across plants in Brazil and in Argentina. Certain lines for export to third markets have been reallocated to Argentinian plants, raising Argentina's exports to extrabloc destinations.

In general terms, the new Agreement seems to answer the main claims made by Argentina. First, the new US\$ 1.95 flex is lower than the previous one (US\$ 2.6), thus reducing duty-free trade in the diametrically opposite direction to free trade. Second, not setting a deadline for the full implementation of free trade is another important point for Argentina. Although less important, two of Brazil's demands were met: the calculation of the coefficient by country was retained, rather than by company as Argentina was demanding, and the 40% cut in Brazilian auto part import duty was upheld, in line with the wishes of the terminals installed there.

The Automotive Agreement indefinitely postpones the incorporation of the automotive sector in MERCOSUR rules, while also restricting trade administration even further. Little progress was made in a common policy for the auto-partist sector, which will continue with its dialog. The new Agreement should reinforce the consolidating trends in both countries' automotive markets: the reduction in the share of imported products in the Argentinian market and the increase of these products in the Brazilian market (Abeceb.com [2006]).

The negotiation of extrabloc trade agreements continues to consolidate itself as an effective strategy for MERCOSUR's automotive sector. The experience of ECA 55, which tackles the sector's preferences in MERCOSUR/Mexico trade, has been very positive for both Brazil and Argentina. The sector's business organizations, the National Association of Motor Vehicle Manufacturers (*ANFAVEA: Associação Nacional dos Fabricantes de Veículos Automotores*) and the Association of Automotive Factories of Argentina (*ADEFA: Asociación de Fábricas de Automotores de Argentina*) have shown a keen interest in signing an agreement with South Africa while the negotiation process is in full swing. Coordinating the two countries in negotiations with the EU has been trickier, given the Argentinian government's reluctance to accept the quotas proposed by Brazil in the offer to the EU.

C. Safeguards: Necessary Flexibility or a Step Backward?

Background

International experience has demonstrated the importance of conflicts arising from the gap in levels of productivity of countries involved in regional integration processes (Marceau [1994]). Ever since 1999, within MERCOSUR and particularly in trade relations between Argentina and Brazil, there has been a history of bilateral trade administration initiatives. In various guises and degrees of formalization, these initiatives have been nothing but agreements over voluntary export restrictions on bilateral trade (Gadelha [2005]).

The debate over the application of safeguards within MERCOSUR has been long-drawn-out. The Treaty of Asunción (1991) envisaged that "*Each State Party may [...] apply safeguard clauses to imports of products benefiting from the trade liberalization programme established under the Treaty,*" but it expressly set December 31, 1994, as the deadline for application (TA, Annex IV, Article 1). CMC Decision #05/94, establishing the conditions of the Regime for Final Adaptation to Customs Union (*Régimen de Adecuación Final a la Unión Aduanera*), subsequently ruled that products subject to the safeguards regime envisaged in the Treaty of Asunción would have an automatic linear four-year tax relief deadline as of January 1, 1995. In synthesis, by January 1, 1999 all restrictions on intrabloc trade arising from the imposition of safeguard measures had to be removed.

By mid-January 1999, less than two weeks after the deadline set by CMC Decision #05/94, Brazil devalued its currency and encouraged a significant shift in conditions of intrabloc competitiveness. This had very negative repercussions in Argentina, generating the fear of an invasion of Brazilian products. Argentina was hostage to convertibility and had already begun the long cycle of stagnation that would culminate in the crisis of December 2001. In July 1999, the Argentinian government established a system of safeguards (Resolution 911/99), invoking LAIA Resolution CR 70 applicable to regional agreements. Brazil reacted in no uncertain terms, arguing that it was not appropriate to apply the rule to intrabloc trade and, in August 1999, Argentina formally announced its decision not to apply the controversial resolution (Ablin & Lucángeli [2002]). The same year, however, Argentina introduced a three-year transition safeguard on imports of cotton and mixed yarns from Brazil, Pakistan and China, invoking the provisions of Article 6 of the Agreement on Textiles & Clothing (*ATV: Acuerdo sobre Textiles y Vestido*) of the World Organization of the Trade (WTO). This started a dispute within the WTO, encouraged by Brazil, which had an unfavorable outcome for Argentina, culminating in an agreement between the parties and the subsequent removal of the measure (ME Resolution #337/00).

These episodes marked the beginning of a protracted history of bilateral trade disputes between the two main MERCOSUR partners, accompanied by insistent and recurrent demands from Argentina for some escape mechanism or "safety valve" that, under given circumstances, would provide legal protection for applying provisional intrabloc trade restrictions. The reasons invoked by Argentina were both macro- and microeconomic. The absence of any kind of mechanism for macroeconomic coordination in MERCOSUR, coupled with the lack of harmonization of trade and industrial policy instruments distorting intrabloc competition, were the justifications repeatedly invoked by Argentina in defense of some kind of safeguard being adopted. Brazil has always shown little inclination to discuss the matter, although there were occasions when negotiations for the formal creation of a safeguard mechanism made considerable headway, mainly in the latter half of 2001.

The issue was back on the MERCOSUR agenda after the election of President Néstor Kirchner in 2003. In October that year the Bilateral Trade Monitoring Commission was set up in response to pressure from the Argentinian private sector. The Commission's objective was to open up channels negotiation between the two countries' businessmen with the participation of the respective governments to negotiate quantitative restrictions on bilateral trade in productive sectors deemed asymmetrical. Several private agreements were

subsequently negotiated and quotas established for exports from different sectors: textiles, TV sets, household linen, footwear and wines (STN [2006] p. 29) (Annex II).

However, in September 2004, Argentina insisted on the advisability of establishing formal mechanisms and the then Minister of the Economy, Roberto Lavagna, sent a proposal to the Brazilian authorities based on three types of instruments: (i) a provisional safeguard mechanism for situations of sharp macroeconomic asymmetry; (ii) a sectoral safeguard mechanism called the Competitive Adaptation Clause (*Cláusula de Adaptación Competitiva*); and (iii) a Code of Good Business Practice whose objectives were to regulate investment incentives, promote responsible business behavior and, one way or another, to encourage a geographically balanced investment by transnationals (INTAL [2005] pp. 43–46).

The negotiations taking place since have been almost exclusively bilateral in nature, concentrating on the microeconomic or sectoral instrument.²⁷ It took almost 15 months of negotiations, with a whole series of proposals and counterproposals, before Brazil and Argentina agreed, on February 1, 2006, to sign the Additional Protocol to ECA 14, Competitive Adaptation, Productive Integration & Balanced and Dynamic Trade Expansion (*Adaptación competitiva, integración productiva y expansión equilibrada y dinámica del comercio*).

The Main Features of the Competitive Adaptation Mechanism

The Protocol's provisions clearly reflect agreed mechanism's "committed solution", which translates into a good many ambiguities and loopholes, as seen below.

The Protocol consists of a set of rules and disciplines that must be followed in the event of a substantial rise in imports in one or other of the countries that "*causes or threatens to cause damage*" to a branch of national production of a product similar or in direct competition with the other State Party. Such a scenario would justify the imposition of intrabloc trade protection measures.

The foundations are laid out in the preamble to the Protocol and include the importance of consolidating the process of productive integration, expanding trade flows and furthering the integration of value chains in both countries. It is grounded in the notion that existing differences in productivity between the two countries in certain fields of activity would be remedied by means of a bilateral trade "administration" mechanism, described in Article 1 of the Protocol as a means of establishing measures that contribute to the "competitive adaptation" of the activities in question in the context of a regional integration project.

The CAM contains concepts and rules of procedure for governments defining the criteria and conditions for the application of bilateral trade restriction measures. The mechanism would be implemented in two stages (Graph 1).²⁸

The *first stage* proper constitutes a "consultation" procedure involving negotiation between the two countries' private sectors. This would take place within the Bilateral Monitoring Commission with the backing of the respective governments. In this stage, the adoption of one of the following measures would be sought (Article 5): productive integration agreements; full preference import tariff quotas, and "*other actions and measures*" to remove or reduce the negative effects of the rise in imports above the national production of the relatively least productive country requesting application of the mechanism. The "other actions and measures," however, are not defined. When the deadline established for a possible agreement

²⁷ Paraguay also tabled a safeguard proposal in the course of the negotiations.

²⁸ The diagrams in Graphs 1 and 2 were taken from the Brazilian National Confederation of Industry (CNI: *Confederação Nacional da Indústria*) MERCOSUR Report #386 [February 2006].

has expired (a total of four months, according to Article 5), we would have as a "mutually satisfactory solution" nothing but a "voluntary" export restriction agreement, accompanied or not by investment plans for productive integration with a minimum term of one year and an option for extension (Article 6).

In terms of the effective duration of the "consensus" measures, an omission regarding the term for the extension of the restriction measure should be pointed out. This omission would allow the measure to be maintained indefinitely and, above all, for a term longer than the CAM itself. In fact, in accordance with Article 18 (a), the measure that would be established if the bilateral consultation stage does not lead to an agreement would have a maximum duration of three years, extendible for just one more year. It should also be pointed out that no review mechanism whatsoever is envisaged for the restrictions, even were trade deviation to be observed.

It must also be pointed out that the practice of "voluntary export restriction agreements" is incentive for commitment from all the WTO member countries that agreed their removal when the WTO Agreement on Safeguards was signed.²⁹ The introduction of this stage may therefore be considered not only a step backward for the process of economic integration, but also a violation of the multilateral rules, which are again being applied among MERCOSUR partners when they no longer hold for third countries. This is actually a "preference the other way around."

The *second stage* of the mechanism would be initiated in the event of agreement not being reached at the first stage. Here, protected by the inquiry and follow-up of the Monitoring Commission, a State Party's national authorities could open an inquiry based on the models adopted in trade defense inquiries and the WTO Agreement on Safeguards. The inquiry has to be concluded in no more than 120 days, extendible for another 30 days (Article 14) in order to determine the existence of "significant damage" (or the threat of it) to the importing country's national production caused by a substantial rise in imports. This rise is to be evaluated in absolute terms or in relation to national production.

Consequently, one of the basic concepts for this evaluation is the definition of "national production" suffering damage by imports from the other State Party, a definition by which the industry must generate at least 35% of national production of the similar or directly competing product. At this point, an issue arises that provides food for debate: this parameter will enable a protection measure to be applied even when most (65%) of the importing country's producers are suffering no "significant damage" as a result of the rise in imports. Also, it tends to underestimate the total sales of national production, an important element in measuring apparent consumption. There is a consequent tendency to overestimate the share of imports in the importing country's internal market.

All inquiries aim to reach a conclusion over the relevancy or otherwise of establishing protection measures against imports, as envisaged in Article 16: an annual full preference export tariff quota and, a tariff for exports over the level of the annual tariff quota equal to the CET plus a 10% preference. Based on the CAM, the measure established will be in force for three years, extendible by one year.

Due to Brazil's insistence, the commitment to monitor imports of similar or directly competing products from third States was included to avoid any potential trade deviations. Nevertheless, the solutions tabled in the event of this happening are ambiguous and not very satisfactory. Indeed, the importing country has to adopt "measures designed to correct this situation" and, should the deviation persist, *"the Commission is to be notified about this situation for its analysis"* (Article 17, Paragraphs 1 and 2).

²⁹ Article 11 (b) of the WTO Agreement on Safeguards states that "Furthermore, a Member shall not seek, take or maintain any voluntary export restraints, orderly marketing arrangements or any other similar measures on the export or the import side. These include actions taken by a single Member as well as actions under agreements, arrangements and understandings entered into by two or more Members."

The possibility of applying a provisional *emergency measure* with the same features as the CAM, was strongly opposed by Brazil but was eventually contemplated (Article 19) (Graph 2).

The Protocol defines no limits for the tariff quota, restricting itself to stipulating that it will be calculated "*in the context of the level of imports of the period of thirty-six (36) months prior to the opening of the inquiry.*" This presupposes great flexibility if the importing country is to determine the volume of imports subject to quotas, unlike that envisaged in the WTO Agreement on Safeguards, which clearly establishes as a general rule that, in the absence of consensus, the quota will correspond to average imports over the last 36 months.

It should also be noted that the CAM's application does not remove the possibility of applying antidumping measures on such products. In other words, the protection measures' redundancy is admitted.

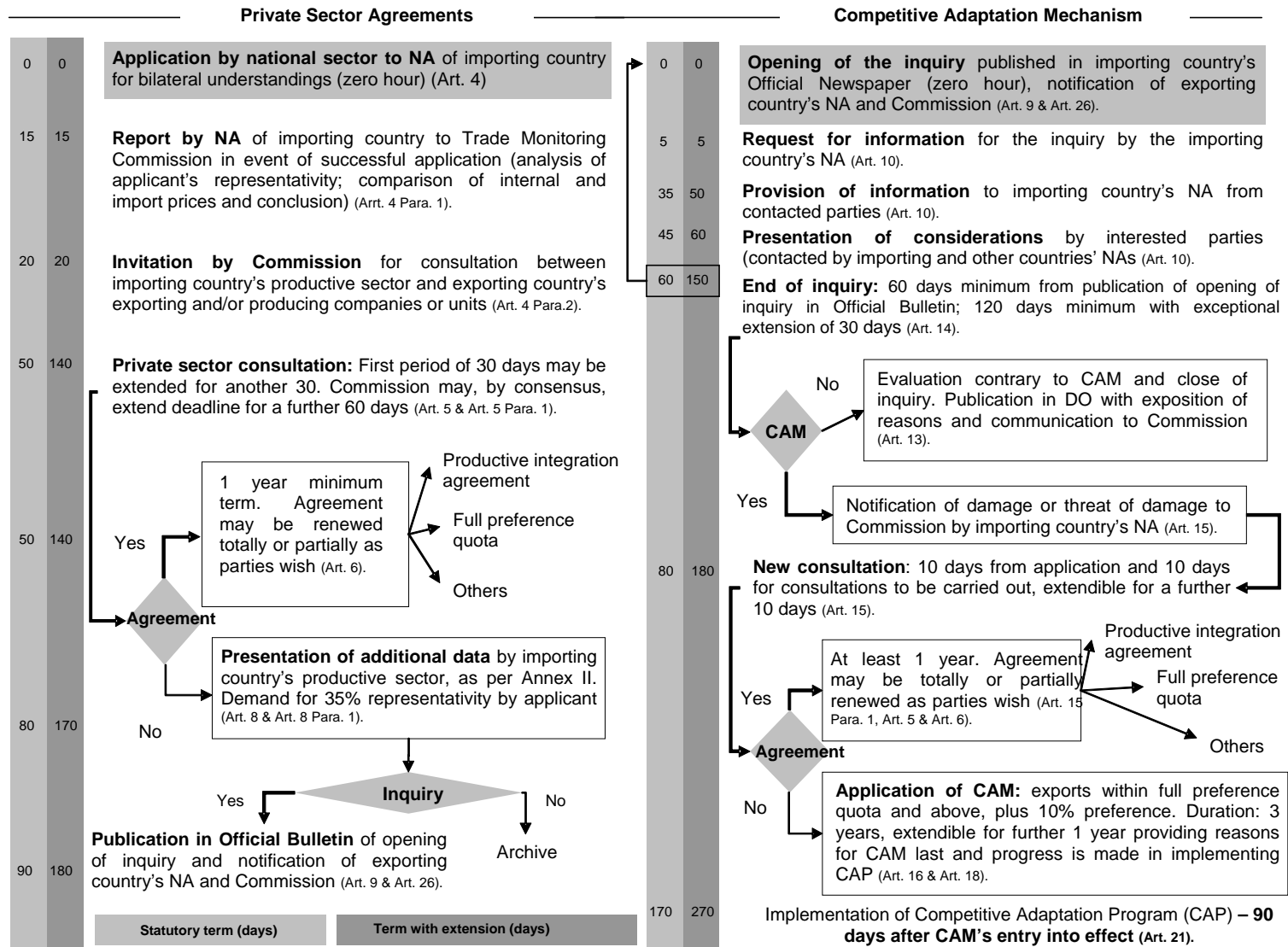
Also envisaged are notification and transparency mechanisms of the decisions taken (Articles 25 and 26). However, these procedures present significant loopholes: they do not include notification to exporters at the start of the inquiry -fundamental if one keeps in mind their impact on defense capacities, given the short time the parties have to present their allegations. Also, exporters are not presented with the technical opinion on which the decision to open the inquiry is founded, and must therefore submit the relevant application to proceed to consultation of the records of the process. As for the share of the parties involved in the process, it is particularly noteworthy that the investigating authority is not obliged to collect information from exporters, which would be fundamental in reaching any balanced decision. Another loophole is the absence of any reference to the drafting of technical opinion containing the final decision. This limits the parties' capacity to speak out, debate the case and try to reach a "mutually satisfactory agreement" in the consultations envisaged for the end of the procedure (prior to application of the CAM).

Articles 21 to 24 of the Protocol state that, in a term of 90 days subsequent to the CAM's entry into effect, a "Competitive Adaptation Program" of the importing country's branch of national production is to be implemented. Oddly enough, this obligation need not apparently be applied if the procedure is concluded at the first stage, that is, with agreement between the private sectors. Thus, the "negotiated" restriction measure whose term may, as pointed out above, be rather protracted is not accompanied by an effective industrial restructuring project aimed at raising productivity. Also, the features of this program are geared to State assistance schemes implemented by the importing country, without clearly specifying how it is sought to promote productive integration in the context of Brazil/Argentina trade integration. This would seem to be fundamental if the CAM is not to become a mere protection mechanism capable only of avoiding the costs of the adjustment arising from regional integration.

The Protocol grants the Exporting State the chance to request that the Commission form a three-member Group of Experts to act as an appeal body in the analysis of such issues as the existence of representativity, increased imports, determining the existence of significant damage or the threat of significant damage, causality, etc. (Annex II). The Group of Experts' conclusions are unappealable and compliance with them is binding for the importer (Graph 29).

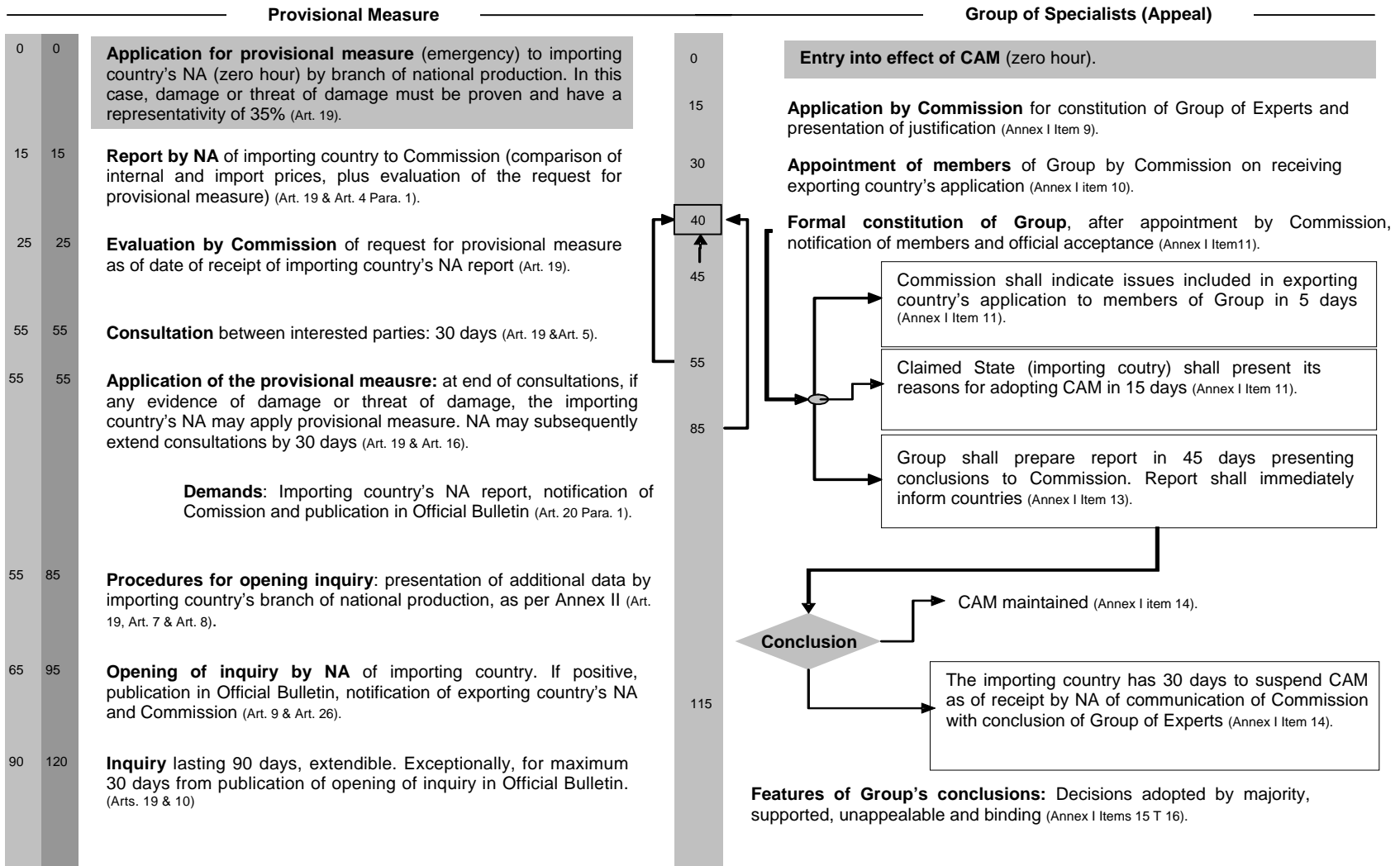
Lastly, a word about Article 29, which states that the Protocol "*shall be without effect in the case of the entry into effect of a similar instrument in the scope of MERCOSUR.*" As expected, the bilateral nature of this mechanism was heavily criticized by Uruguay and Paraguay.

GRAPH 28



Source: CNI [2006a] February, #386.

GRAPH 29



Source: CNI [2006a] February, #386.

The Competitive Adaptation Mechanism's Impact on the Brazilian Business Sector

The reaction of Brazil's business sector to the institution of the mechanism was generally very hostile. Criticism centered on (i) the mechanism's non-provisional nature, whereby it only ceases to exist when replaced by an alternative mechanism; (ii) the possibility of adopting temporary measures without the mediation of exporter consultation; (iii) the mechanism's immediate non-revocation once the existence of trade deviation is proven; (iv) the low sectoral representativity required to open inquiries; (v) the possibility of concomitantly adopting other trade defense instruments like antidumping, and (vi) the fact that the review mechanism (appeal) is presented when the restriction has already been implemented and trade limited. A handful of analysts, however, highlighted the gain in predictability and transparency from the creation of the CAM. They even considered it a legal guarantee for foreign investors.

The agreement was protocolized in the LAIA in April 2006, but to date neither of the two countries has incorporated the CAM in its domestic legal system by decree in the Official Bulletin, as required. Some analysts hold that the inclusion of the mechanism in ECA 14 makes the Protocol legally vulnerable, as the allegation is valid that trade transactions between Brazil and Argentina operate in the context of ECA 18, protected by MERCOSUR. Still, both governments clearly prefer to continue resolving trade conflicts through voluntary export restriction arrangements, a solution encouraged explicitly by the Protocol itself.

D. Asymmetries: Making Up for Lost Time

The issue of "asymmetries" has until recently been a matter little addressed by the MERCOSUR agenda. Only in 2003, eleven years after the formation of MERCOSUR, did the member countries begin to tackle the issue head on. It is no coincidence that the existence of significant asymmetries between the States Parties has been recognized during Paraguay's pro tempore presidency (first half of 2003) and that the CMC's first initiatives in this matter were passed during Uruguay's pro tempore presidency at the Montevideo Summit in December 2003. The smaller partners have certainly been the ones most harmed by MERCOSUR's neglect of the issue. It was, consequently, left to them to press for the matter to be given priority on the bloc's agenda. In light of the growing expressions of frustration in Uruguay and Paraguay over the results of integration, the incorporation of asymmetries on the MERCOSUR agenda is tardy to say the least.

The Importance of Asymmetries in the Integration Processes

In general, although a regional integration agreement increases the overall welfare of its members, its costs and benefits are likely (perhaps inevitably so) to be distributed unequally across the different countries and regions. Graver still, the inequalities encouraged by integration may persist for a long time and even grow. Consequently, unless redistributive public policies are implemented, regional integration agreements are unlikely to be politically or economically sustainable in themselves (Bouzas [2003] p.2).

It is essential that MERCOSUR gains a clear grasp of this concept. The justification for adopting public policies geared to dealing with asymmetries does not arise out of any ethical or altruistic motive, as is usually decried in political discourse, but out of the simple need to guarantee the continuance of a societal arrangement agreed voluntarily. Indeed, experience shows that, in the long term, sustaining integration models is unviable when there is no clear perception among those involved that benefits will be higher than costs. The motivation for adopting corrective measures is therefore mainly pragmatic.

It is relevant to trace a distinction between structural and policy asymmetries. Structural asymmetries originate in such factors as size of economy, geographical location, size of population quota, factor

endowment, degree of market flexibility, and level of economic development (a concept embracing wealth, quality and diversity of infrastructure, qualification of the workforce, quality of institutions, and so on. Some of these attributes are permanent or unalterable (geographical size and location), while others change very slowly (institutional quality, workforce qualifications), but all condition or limit member countries' capacity to benefit from market integration.

Policy asymmetries, on the other hand, are generated by the adoption of public policies or by regulatory interventions based on preferences, choices or national institutional features, and involve the use of a varied set of instruments, such as tax incentives, investment or export promotion programs, special import regimes and the granting of financing at preferential rates, as well as various kinds of subsidies. The problem caused by policy asymmetries is that they can generate negative regional externalities with a consequent loss of efficiency and the emergence of problems potentially capable of undermining the political cohesion of the integration project (Giordano *et al.* [2004]).

In general terms, the appearance of structural asymmetries may demand the adoption of negotiated discrimination policies -"preferential and differentiated treatment"- aiming at granting the less developed countries more time to adapt to the integration process. Similarly, it may be necessary to rely on the direct support of the other partners, which presupposes transfers of financial resources. Policy asymmetries, for their part, make it necessary to "level out the playing field," or harmonize the use of public policy instruments, as well as adopting collective rules.

All in all, the treatment of asymmetries is not straightforward. The adoption of joint rules and the harmonization of public policies presuppose a restriction of the countries' autonomy in the use of the instruments designed and developed on the basis of perfectly genuine national preferences. Structural asymmetries may also require the mobilization of institutional capacities and financial resources not always available. Both difficulties are present in the MERCOSUR region.

Asymmetries in MERCOSUR & Obstacles to their Removal

The differences in size in MERCOSUR countries are obvious. Brazil occupies two thirds of the total surface of the bloc and accounts for more than three quarters of the bloc's population and GDP. Taken together, Uruguay and Paraguay represent just over 4% of MERCOSUR's territory and population, and less than 3% of its aggregate GDP. Argentina represents 29% of MERCOSUR territory, 17% of the total population and just under 20% of GDP. Such differences in market size are comparable only to those within NAFTA, but easily exceed those of other integration models such as the EU, the Association of Southeast Asian Nations (ASEAN), the CAN, the Caribbean Community & Common Market (CARICOM) or the CACM.

Market size bestows unquestionable initial advantages in the use of economies of scale and agglomeration on the largest economies in MERCOSUR, and in the ability to attract investment. Moreover, other attributes associated with the level of partners' economic development such as diversification of productive structure, quality of infrastructure and degree of technological and institutional development, tend to consolidate such initial advantages. However, when various welfare indicators are taken into account, such as *per capita* GDP, *per capita* consumption or the Human Development Index (HDI), it becomes clear that there is no correlation whatsoever among the MERCOSUR member countries between economic size and wealth. Brazil is in fact the second poorest country in the region, behind Argentina and Uruguay. These discrepancies become even more pronounced when regions (instead of countries) are compared. As Giordano *et al.* have rightly observed

[2004], the lack of correlation between size and wealth is an immense obstacle when designing policies aimed at coping with the structural asymmetries in MERCOSUR.³⁰

The "leveling out of the playing field" and the adoption of collective rules to minimize the effects of policy asymmetries are objectives that present even greater challenges. There are considerable differences between MERCOSUR member countries in terms of the implementation of direct measures geared to spurring companies to be competitive and attract investment. A good many studies have attempted to catalog the institutions, programs and actions developed in individual countries pursuing these objectives (see Baruj *et al.* [2005]). As was to be expected, all the studies confirm that the instruments mobilized by the largest countries, mainly Brazil, have greater scope and effectiveness. They include those with more capacity to distort intrabloc competition, discourage the emergence or consolidation of productive chains in the region and generate negative transborder externalities. Even so, the initiatives designed to harmonize regimes, set rules and remove distorting instruments inevitably come up against resistance from both national governments and subnational authorities. This explains the scant progress seen on this issue in the framework of MERCOSUR.

Regrettably, very few empirical studies have been carried out, not to "identify" or "catalog" asymmetries, but to gauge their effects. Nevertheless, there is preliminary empirical evidence that points to (i) an increase in the concentration of economic activity in certain countries or regions; (ii) the widening of regional inequalities; (iii) the existence of agglomeration effects in the major markets; (iv) the meager rise in productive specialization in the smaller countries in the bloc, and (v) the scant export diversification (markets, products, companies) in these countries.

The Treatment of Asymmetries in MERCOSUR from 1991 to 2003

The issue of asymmetries was present in the relationship between the current MERCOSUR partners, both in the old days of the Latin American Free Trade Association or LAFTA (*ALALC: Asociación Latinoamericana de Libre Comercio*) and in the present of the LAIA. In both stages, categories such as "less developed country" or "inadequate market country" were created to provide differentiated treatment (Rock [2004]). These concepts were also present in Chapter 12 of the Cartagena Agreement (*Acuerdo de Cartagena*), which defined a special regime in support of Bolivia and Ecuador in the framework of the Andean Pact (*Pacto Andino*). As Giordano *et al.* remark [2004, p. 1] "*Latin American experiences of integration were conceived with complex legal and institutional architectures reflecting great political sensitivity for the equity of distribution of the benefits of integration.*" This was not, however, the approach adopted by the Treaty of Asunción, which established an integration model based on reciprocity of rights and obligations.

There are four reasons for the scant attention paid to asymmetries in MERCOSUR:

- First, the idea of privileging reciprocity in negotiations was dominated the final phase of the Uruguay Round, which opted to adopt a homogeneous regulatory framework and attempted to avoid excessive fragmentation and inefficacy in rules (Giordano *et al.* [2004]). The formation of MERCOSUR thus took place in a rather inauspicious context for considering asymmetries. This situation would only change with the Doha Round, when concepts like "special and differentiated treatment" and "asymmetrical reciprocity" resurfaced.
- Second, when the Treaty of Asunción was signed, it was argued that the benefit from expanding the market was far greater for the smaller countries than for Brazil or Argentina, as it offered them the

³⁰ It is necessary to mention that, in a context where countries have high poverty indexes and distributional inequality, it becomes more difficult to apply compensatory mechanisms.

chance to promote the exploitation of economies of scale and attract foreign investment flows from intra- and extra-bloc countries.

- Third, an issue of timing took precedence. Simultaneous with the discussion of the Treaty of Asunción, Brazil and Argentina bilaterally negotiated ECA 14, signed in December 1990, a few months before MERCOSUR was formed. ECA 14 envisaged the total removal of tariffs between partners over a four-year period and effectively diluted and even removed the preferences obtained by Paraguay and Uruguay in Brazilian and Argentinian markets in the framework of the LAIA. These risks certainly influenced and hastened the smaller countries' decision to join MERCOSUR, even when no clauses granting "special treatment" had been envisaged.
- Last, it is impossible to ignore the fact that the Treaty of Asunción established the rule of decision by consensus, which decisively contributed to the acceptance of the principle of reciprocity of rights and obligations. This was the deal offered to the smaller countries.

Consequently, between 1991 and 2003, MERCOSUR only admitted temporary exceptions in the interests of Paraguay and Uruguay. These consisted basically of longer lists and convergence periods. This was in fact the gist of the concessions envisaged in Annex I of the Treaty of Asunción, the Trade Liberalization Program (*Programa de Liberalización Comercial*), and CMC Decision #05/94 or the Regime for Final Adaptation to Customs Union, and CMC Decision #07/94 or the Capital Goods Convergence on the CET (*Convergencia de los Bienes de Capital al AEC*). CMC Decision #08/94 or Duty-Free Zones, Export Processing Zones & Special Customs Areas (*Zonas Francas, Zonas de Procesamiento de Exportaciones y Áreas Aduaneras Especiales*) was aimed at the less developed regions of Tierra del Fuego and Manaus rather than countries as a whole. Nevertheless, the extensions granted were generally inadequate to rationalize the sectors affected. Furthermore, neither individual countries nor the bloc as a whole encouraged clear training policies for the sectors most affected by the new market's rules.

Declarations of intent regarding policy asymmetries were frequent, but real progress was thin on the ground or non-existent. In 1994, a technical committee was set up to examine public policies capable of distorting competition, but was inactive for three years. Only in 1998 were the instruments of industrial and trade policy catalogued, along with investment incentives effective in each country. Even so, there was no progress in correcting the asymmetries.

To the pre-2003 paralysis in solving asymmetries we must add two other factors that do particular damage to the smaller economies: (i) in MERCOSUR, the expansion of the market is inconclusive as there are still barriers to intrabloc trade and the free circulation of goods does not apply. This contributes to great uncertainty among investors about unrestricted access to the expanded market, and (ii) the CET's definition and level essentially contemplated the needs of the largest countries, especially Brazil by encouraging trade deviation to the disadvantage of the smaller economies.

Dissatisfaction with this situation led, in the first half of 2003, to the Paraguayan delegation tabling a proposal for the treatment of asymmetries. At the Montevideo Summit in December that year, a variety of measures explicitly tackling the issue of asymmetries in the integration process for the first time were passed in the interests of Paraguay and Uruguay. The main measures were (i) the granting of differentiated treatment for Paraguay in third market negotiations in recognition of its condition as a less developed country without a coastline (CMC Decision #28/03); (ii) the establishment of differentiated regional content in the interests of Paraguay in the MERCOSUR Origin Regime (CMC Decision #29/03), and (iii) authorization for Paraguay and Uruguay to table lists supplementing the CET, and reduced tariffs for extrabloc capital goods imports, information technology and telecommunications, and certain raw materials and agricultural inputs (CMC Decisions #31/03 and #32/03).

However, the most significant measure adopted on the issue was CMC Decision #27/03 on Structural Funds (*Fondos Estructurales*), encouraging preliminary studies for the creation of such an instrument in MERCOSUR. This involved "a U-turn in the way of tackling asymmetries" in the bloc.

The MERCOSUR Structural Convergence Fund

After CMC Decision #27/03, the process to create a fund to correct or lessen asymmetries accelerated. In 2004, a High Level Group with the following goals: (a) to identify initiatives and programs to encourage competitiveness among the States Parties -mainly the smaller economies- and structural convergence in MERCOSUR; and (b) to provide formulas to finance these initiatives, and strengthen the institutional framework of MERCOSUR (CMC Decision #19/04).

The GAN's work resulted in CMC Decisions Nos. 45/04 and 18/05, respectively establishing and integrating the MERCOSUR Structural Convergence Fund. It was decided that the FOCEM would have an annual budget of US\$ 100 million, progressively completed over the three-year term, with 50% for the first year for pilot projects, 75% for the second year and 100% for the third year.

Modeled on the EU's Structural and Cohesion Funds, the FOCEM has is clearly redistributive in nature, as the countries contributing most resources are those receiving the least. Indeed, Paraguay and Uruguay together contribute 3%, but receive 80% of the Fund's annual resources, as shown in Table 16. The contributions were based on the historical average of each country's share in MERCOSUR's total GDP, while the distribution of resources across the countries took into account the partners' size of economy and degree of development.

TABLE 16
USES & SOURCES OF THE FOCEM*
Millions of US\$ – %

	Sources	Uses	Net Transfers	Structure (%)
Argentina	27	10	- 17	22
Brazil	70	10	- 60	78
Paraguay	1	48	47	61
Uruguay	2	32	30	39
	100	100	0	

Note: * The Table envisages the amount of resources envisaged after the third year (US\$ 100 millions).

Source: MS/SAT/CE. Study #002/05.

The resources envisaged for the FOCEM (US\$ 100 million annually) represent just 0.01% of MERCOSUR's GDP, well below the EU's Structural Fund, which is 0.4% of the EU's GDP. Even so, these resources do have a certain significance for the smaller economies in MERCOSUR, as they are equivalent to 0.7% of Paraguay's GDP. It should be noted that the main beneficiaries in the EU received between 1.3% (Spain) and 3% (Portugal) of GDP in 2000–2003.

It should also be stressed that the FOCEM allows contributions from third countries or international institutions and organizations. It was also stipulated that beneficiary States Parties must contribute out of their own resources at least 15% of the total value of each project financed by the Fund.

The FOCEM's resources target four types of programs with the following objectives: (i) to promote structural convergence (countries and less developed regions); (ii) to develop competitiveness; (iii) to promote social cohesion, and (iv) to strengthen the institutional framework. The projects for this last component will be presented by the MS.

The FOCEM's Regulations were passed in July 2005–July 2006 (CMC Decision #24/05) and an initial list of pilot projects was drawn up (CMC Decision #17/06).

The FOCEM's Regulations define aspects relating to the presentation, implementation and monitoring of the projects to be financed, as well as institutional aspects relating to the management and use of the resources. In accordance with the regulations, the procedure of the mechanism for presenting and approving projects is as follows:

- i. The initiative for presenting projects belongs to the States Parties and the MS. Each State Party presents its projects via a national body, the FOCEM National Technical Unit of FNTU (*UTNF: Unidad Técnica Nacional del FOCEM*). The MS, for its part, can only present projects included in Program IV, the institutional component. The receiving body for projects is the Commission of Permanent MERCOSUR Representatives of CPMR (*CRPM: Comisión de Representantes Permanentes del MERCOSUR*).
- ii. Technical evaluation of the projects (compliance with requirements of demandability, cost consistency, proper use of resources, and technical and financial viability) is the job of the FOCEM Technical Unit of the MERCOSUR Secretariat or FTU/MS (*UTF/SM: Unidad Técnica del FOCEM/Secretaría del MERCOSUR*) together with the Ad Hoc Group of Experts or AHGE (*GAHE: Grupo Ad Hoc de Expertos*) set up by CMC Decision #18/04.
- iii. The decision process involves the following stages: (i) a report from the FTU/MS to the CPMR on the technical evaluation of projects, including those considered technically unviable; (ii) a report from the CPMR to the GMC on technically viable projects, but with no classification; (iii) a report from the GMC to the CMC, including the evaluations of the CPMR and FTU/MS; and (iv) CMC approval of projects to be financed, with the relevant definition of resources. Last, it will be up to the director of the MS to sign the legal instruments for the implementation of projects with each State Party.

Certain aspects of the implementation, financing, follow-up and inspection of projects merit our attention. The FOCEM's resources are deposited biannually in the respective States Parties' accounts by order of the MS. The resources are therefore distributed across four accounts. Each CMC-approved project is financed with resources from these accounts, with the proportions fixed on formation of the FOCEM. In other words, any outlay for financing the chosen projects is made up of 70% of resources from the Brazil Account, 27% from the Argentina Account, 3% from the Uruguay Account and 1% from the Paraguay Account.

Each State Party's FNTU is responsible for project implementation and management, while monitoring and inspection are left to the FTU/MS with the assistance of the AHGE. Projects will be subject to internal audits and to annual external audits. Furthermore, the drafting and passing of the FOCEM's annual budget follows the same institutional sequence as the decision process described above, beginning in the FTU/MS and concluding in the CMC, the body responsible for passing annual items.

A list of eleven pilot projects was passed during the 30th Meeting of the CMC, held in the city of Córdoba in July 2006. This included seven projects in the interests of Paraguay,³¹ three aimed at strengthening its

³¹ Three projects for developing road infrastructure, one project for developing biosecurity laboratories and food controls, one project to increase productivity for cotton and corn, and an comprehensive support program for microenterprises.

institutional framework and one processed by the States Parties' Agriculture ministers to support the Foot-and-Mouth-Free MERCOSUR Action Program.

Similarly, it should be stressed that the States Parties are on the verge of completing the process of internalization of the FOCEM and, apparently, the four countries have the items stipulated in their respective budgets.

The time between the decision to study the possibility of setting up a structural fund in MERCOSUR until the FOCEM actually became effective was three years (end of 2003–end of 2006), a term period that may be considered relatively short given the bloc's experience in other matters. It is true that the smaller countries' repeated criticisms about the unfair distribution of the costs and benefits of integration, as well as their desire to seek alternative ways ahead -including the signing of free trade agreements with the United States- influenced the speed at which decisions were made about the issue. The idea that the FOCEM should consist of the States Parties' budgetary resources instead of some deduction on imports being introduced was also positive, mainly in terms of transparency.

Furthermore, although the project presentation mechanism defined in the regulations allows for the presentation of joint initiatives, it is not particularly suited to encouraging *common public activities*. It would have been highly desirable to include the MS as a proponent of projects aimed at promoting structural convergence (Program I), developing competitiveness (Program II) and promoting social cohesion (Program III). But the States Parties insist on restricting the institutional authority's ability to take initiatives. The FOCEM is thus likely to take its place as a mechanism of revenue redistribution by means of budget transfers, and will therefore contribute very little to promoting common public activities.

E. The Rules Incorporation Process

MERCOSUR has produced no express *autonomous* legislation by which the Treaty of Asunción acts as a "constitution" in the Member States' individual internal legislations. Nevertheless, the rules adopted by the common institutions are *binding*. For decisions, resolutions and directives passed by the community organs to possess *effectiveness*, Member States are obliged in certain cases explained below to incorporate or transpose these rules to their respective domestic legal systems. Overall, "*the conditions in which the transposition operates limit the scope of Member States' obligations and generate serious problems of systemic coherence at the level of the effectiveness of rules*" (Ventura [2005] p. 2). It is thus necessary to gain a grasp of the difficulties imposed by the system for incorporating rules into national legal legislations and also to briefly analyze the evolution of the rules produced, in order to clarify and speed up the process.

*The Rules Incorporation System*³²

The basic provisions regulating the system of rules incorporation in MERCOSUR, in cases where "internalization" is necessary, are defined in the Protocol of Ouro Preto (POP). First, the POP imposes on the States Parties the commitment to adopt any measures necessary to ensure compliance with the rules issued by the common organs (Article 38) in its respective territories. In other words, the Member States are assigned the function of controlling the application of the law in their respective jurisdictions. Second, the POP defines the procedures to be followed in order to guarantee the simultaneous effectiveness in the Member States of the rules passed by the common organs. The gist of the mechanism stipulated in POP Article 40 is as follows: (i) the States Parties will adopt any measures necessary for their incorporation into the domestic legal system and will inform the Administrative Secretariat of MERCOSUR (MS) of

³² This section is based largely on Ventura & Perotti [2004] and Ventura [2005].

these; (ii) when all the States Parties have given notice of incorporation in their respective internal legislations, the MS will inform each State Party, and (iii) the rules will come into effect simultaneously in the four States Parties 30 days after such communication. Last, the POP draws a distinction between rules that must comply with the procedures described and rules that need not to obey the mechanism and would be *immediately effective*. Article 42 states that "*The decisions adopted by the Mercosur organs provided for in Article 2 of this Protocol shall be binding and, when necessary, must be incorporated in the domestic legal systems in accordance with the procedures provided for in each country's legislation.*"

Apparently, the interpretation accepted by the organs of MERCOSUR and the respective governments is that the *condition of necessity* established in Article 42 is exclusive authorized by MERCOSUR: it is effectively the job of community legislation to decide when the rule issued by the common organs should be internalized according to the procedures envisaged in individual countries' legislations in order for it to become *operational* and comply with its binding nature. This is the reason why the rules issued by the MERCOSUR organs include a general article, making the need or lack of it for their incorporation in the domestic legal systems explicit (Decisions CMC #23/00 and #22/04).

The system of rules incorporation envisaged in the POP has been questioned in various ways. First, the system grants the States Parties a certain power of veto, as the effectiveness of the rules adopted by the common organs in cases where they have no immediate effect is conditional on compliance with two actions (transposition to the domestic legal system and informing the MS) that may be delayed by States' governments. Second, the simultaneous effectiveness of the rules in the four States Parties as defined in Article 40 of the POP is a legal fiction, for in practice the rules produce effects in each country immediately after their transposition, when they can already be invoked in court as a domestic rule. There are other questions marks over the legislative process in MERCOSUR, including problems like the possible defective transposition of rules, the absence of guarantees about uniform application of rules, lack of definition in terms of the hierarchy of the rules issued by the common organs after their transposition to the domestic legal systems, the non-publication of the effective date of the MERCOSUR rule in States Parties' official bulletins.

The derived law, as well as certain arbitration awards issued in the framework of the MERCOSUR dispute settlement system, has taken it upon itself to clarify and help speed up the complex system of rules incorporation prescribed by the POP. Below is a brief outline of the major provisions.

- In 1993, GMC Resolution #08/93 ruled that CMC decisions and GMC resolutions should include an article identifying the authorities responsible for adopting measures needed to ensure implementation of the rule, the kind of measure or rule required and the date it would come into force.
- In 1996, the CMC Minutes of 01/96 from the 10th Meeting of the CMC recorded that the "*only rules whose incorporation in domestic legal systems will not be necessary are those that are interna corporis, that is, when they aim exclusively to organize the work and workings of the organs of the integration process.*"
- Concerned about the delay in incorporating MERCOSUR rules in its members' internal law, the GMC in 1998 adopted two resolutions urging the States Parties to speed up the process, and established a series of rules to unify the deadlines for internalization of community rules (Resolutions Nos. 22/98 and 23/98).
- In 2000, the CMC passed Decision #23/00, regulating the legislative process instituted mainly by POP Articles 40 and 42. This decision stipulated that the clauses included in the MERCOSUR rules setting deadlines or dates for their incorporation were binding. It also stipulated that the non-binding nature of the incorporation of rules dealing with matters relating to MERCOSUR's internal operation was explicitly stated in the text of the rules themselves.

- In 2001, the GMC provided that the minutes and documents of MERCOSUR should include legal foundations in the IN VIEW OF clause, reasons and objectives in the CONSIDERING clause; and in the provisions, the need for incorporation or lack of it and, in the event of incorporation, the term foreseen.
- Concerned again by the slow incorporation of MERCOSUR rules in domestic legal systems, the CMC passed Decision #20/02 in 2002, instituting a system of prior consultation of the States Parties. This is essentially a consultation mechanism for those with authority, at the internal level, in the subject of the future community rule, with the intention of drafting a regulatory text compatible with domestic legal systems, and thus facilitate incorporation. The decision was a decisive step toward raising MERCOSUR's credibility and legal security. The effectiveness of the provision caused numerous draft rules, whose submission to the decision-making organs was not preceded by the consultation mechanism envisaged in the rule, to return to their original organs.
- In 2004, the scant and asymmetrical incorporation of MERCOSUR rules was again the subject of a long-drawn-out negotiation between the Member States, leading to CMC Decision #22/04. The Decision's objective is the adoption by each State Party of a procedure for the effectiveness and application of community rules that do not require legislative approval, that is, MERCOSUR rules that can be incorporated by means of regulatory acts from the Executive Power, thus sidestepping the use of an intermediate instrument of incorporation. In line with this Decision, the rules will indicate the date of entry into effect and, as of then, any contrary national rules, be they of similar or less importance, will be without effect. Strictly, once implemented, the Decision will create a parallel incorporation mechanism to that established in Article 40 of the POP, which will remain effective for rules that need approval by domestic legislative organs.
- Also in 2004, the incorporation of the amendments to the MERCOSUR Common Nomenclature and its corresponding CET led to CMC Decision #31/04, which instituted an exceptional mechanism for the incorporation and effectiveness of community provisions on this subject. Save in exceptional circumstances, approval of this kind of rule will not be subject to the consultation mechanism established by CMC Decision #20/02 and the States Parties, once the term foreseen for internalization has been met, will not be able to refuse to start processing imports from the other bloc members protected by valid Certificates of Origin based on divergences of nomenclature. The Decision is undoubtedly another step in the direction of implementing the principle of immediate effect.
- Finally, in 2005, the drafting of reports on all draft rules requiring legislative approval was assigned to the future MERCOSUR Parliament by its authorities (CMC Decision #23/05, Article 4, Paragraph 12). The Parliament will have a term of 90 days to issue its recommendations. Where the relevant MERCOSUR decision-making organ passes the rule in accordance with the Parliament's recommendations, the States Parties will have 45 days to refer the rule to their respective parliaments. These will in turn set up a preferential procedure to consider MERCOSUR rules, whose term may not exceed 180 days as of the rule's entry into the respective national Parliament.

The above regulatory evolution reveals that the problem brought on by slow and unequal incorporation of MERCOSUR rules in domestic legal systems is a matter that has been on the agenda of the bloc's decision-making organs since its formation.

The Effectiveness of MERCOSUR Rules in the States Parties

Between 1991 and August 2006, MERCOSUR's decision-making organs passed 1,778 rules. Almost two thirds of these rules are resolutions issued by the GMC; slightly over a quarter are decisions adopted by the CMC and less than a tenth are directives of the CMC, an authority set up in 1994 (Table 17).

TABLE 17
NUMBER OF RULES PASSED
1991–August 2006

Rule	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	Accumulated	
																	No.	(%)
Decisions	16	11	13	29	9	18	26	23	27	70	16	32	41	55	40	25	451	25.4
Resolutions	12	67	93	131	42	156	82	78	89	95	66	58	54	41	66	40	1170	65.8
Directives	0	0	0	1	23	19	20	16	17	14	12	10	8	6	9	2	157	8.8
<i>Total</i>	<i>28</i>	<i>78</i>	<i>106</i>	<i>161</i>	<i>74</i>	<i>193</i>	<i>128</i>	<i>117</i>	<i>133</i>	<i>179</i>	<i>94</i>	<i>100</i>	<i>103</i>	<i>102</i>	<i>115</i>	<i>67</i>	<i>1778</i>	<i>100</i>

Source: MS.

The high number of resolutions reflects the efficient concentration of the decision-making process of the GMC, the destination for the negotiating work of most of the 260 dependent organs (technical committees, working groups, specialist forums, ad hoc committees, etc.) which lack decision-making powers of their own (Ventura [2005]).

A recent study based on rules passed up to mid-2003 classified the matters covered in the MERCOSUR rules into 64 different issues (Rivas [2004]). Almost two thirds of rules came under just six issues: tariffs (14.5%), the institutional framework (12.8%), agricultural products (11.8%), foodstuffs (11.4%), health (10.2%) and customs (4.5%).

The study by Rivas [2004] also took into account the number and type of rules (law, decree, resolution, memorandum, act, notice, circular, regulatory instruction, provision, official statement, etc.) used by the States Parties in internalization of rules issued by MERCOSUR organs as well as the domestic organ responsible for their adoption.³³ The variety of rules used by the Member Countries is astounding: 75 by Brazil, 52 by Argentina, 22 by Uruguay and 13 by Paraguay. It is clearly essential for Member States to swiftly define a uniform procedure avoiding the use of such a wide variety of intermediate instruments of incorporation, in line with the provisions of CMC Decision #22/04.

It is the MS's job to report quarterly on the degree of effectiveness of MERCOSUR rules in the States Parties. The most recent information available takes into account the rules passed in 1991–March 2006 covers a total of 1,712.³⁴

According to this information, 67.5% of the rules passed are in force in the four Member States (Table 18). It should be noted, however, that the degree of effectiveness in the States Parties considered individually is a good deal higher, fluctuating between 76.6% (Paraguay) and 80.3% (Brazil).

³³ Thus, for example, resolutions issued by different organs are counted as different kinds of rules.

³⁴ Strictly, the information refers to 1,711 rules passed in 1991–2005 and another Directive passed in March 2006.

TABLE 18
EFFECTIVENESS OF RULES BY STATE PARTY AND TYPE OF RULE
1991–March 2006

Rule	Rules Passed	Effectiveness by State Party (%)				Effective in all 4 States Parties	
	No.	Argentina	Brazil	Paraguay	Uruguay	No.	%
Decisions	426	73.9 ⁽¹⁾	70 ⁽¹⁾	68.1 ⁽¹⁾	73.9 ⁽¹⁾	295	69.2
Resolutions	1130	80	84	79	77	750	66.4
Directives	156	78.2	82.1	82.7	85.3	111	71.2
<i>Total</i>	<i>1712</i>	<i>78.3 ⁽¹⁾</i>	<i>80.3 ⁽¹⁾</i>	<i>76.6 ⁽¹⁾</i>	<i>77 ⁽¹⁾</i>	<i>1156</i>	<i>67.5</i>

Note: (1) These data do not include information relating to 22 Decisions.

Source: Based on MS data.

However, the criterion of effectiveness utilized in the information provided by the MS is questionable, as it includes interna corporis rules, that is, those for organizing the work and workings of the integration organs. These rules do not strictly have effect. The same is true of repealed rules, also included in the MS count.

For a more precise and revealing quantitative evaluation, it is advisable to distinguish between rules that "require" and rules that "do not require" incorporation (Table 19). Classification according to this distinction shows that 34.6% of rules passed do not require incorporation. As regards the remaining 65.4% that do require it, only slightly over half can be said to have been effectively incorporated.

TABLE 19
INCORPORATION & EFFECTIVENESS OF RULES BY TYPE OF RULE
1991–March 2006

Rule	Rules Passed (1)	No Incorporation required (2)	Incorporation Required			Effective (6)
			Total (3=1–2)	Incorporated (4=3–5)	Not Incorporated (5)	
Decisions	426	209	217	86	131	295
Resolutions	1,130	346	784	404	380	750
Directives	156	38	118	73	45	111
4 States Parties	1,712 (100.0%)	593 (34.6%)	1,119 (65.4%)	563 (32.9%)	556 (32.5)	1,156 (67.5%)

Sources: MS for columns (1), (5) and (6); Rivas [2004] and the authors, based on MS data, for column (2).

Almost half (49.1%) of CMC decisions do not require incorporation, a rather higher percentage than for GMC resolutions (30.6%) and CCM directives (24.4%). The reason for this difference lies in the high number of interna corporis rules adopted by the Council in its capacity as both the supreme authority of MERCOSUR and the organ responsible for the bloc's political leadership. But there is another more questionable reason. More recently, the provisions of some of the Council's decisions include approval of the signing of a rule contained in the annex. The decision does not therefore require incorporation and is thus counted. However, this is not the case with the annex which contains the rule proper and which therefore requires it to be incorporated in internal law. Such practice clearly distorts statistics.

Where the degree of rules incorporated (rules incorporated / rules requiring incorporation) is concerned, the percentages are 39.6% for decisions, 51.5% for resolutions and 61.9% for directives. The high deficit

of incorporation for decisions is due both to administrative and bureaucratic factors and to deeper-lying causes to do with difficulties in harmonizing the legislations (Ventura [2005]).

When evaluated individually, the incorporation of rules in the States Parties reveals no serious asymmetries (Table 20). Indeed, the indicators for Brazil and Argentina are more favorable, but the differences between the four Member States are not significant. It is striking, however, that there is such low coincidence in terms of which rules the four States Parties decide to incorporate. In other words, the degree of incorporation is reasonably even across Member States, but the rules incorporated are different.

TABLE 20
INCORPORATION OF RULES BY TYPE OF RULE & STATE PARTY
1991–March 2006

Rule	Incorporation Required No.	Incorporation by State Party (%) *				Incorporated in all 4 States Parties	
		Argentina	Brazil	Paraguay	Uruguay	No.	%
Decisions	217	51.6	44.2	40.6	51.6	86	39.6
Resolutions	784	71.2	76.9	69.8	66.8	404	51.5
Directive	118	71.2	76.3	77.1	80.5	73	61.9
<i>Total</i>	<i>1,119</i>	<i>67.4</i>	<i>70.5</i>	<i>64.9</i>	<i>65.3</i>	<i>563</i>	<i>50.3</i>

Notes: * Not all rules have to be incorporated by all States Parties. The incorporation calculation by State Party is therefore underestimated.

Source: Authors' based on MS data.

The above analysis is undoubtedly incomplete. It should be supplemented with qualitative analysis based on some appropriate typology of rules. Such an analysis would give a more accurate picture of the real importance of the rule incorporation deficit by enabling evaluation of the degree of relevancy of rules pending incorporation.

Finally, the percentage of rules incorporation in the four States Parties seems to have undergone no significant alterations in the last two years. This is corroborated by comparing the incorporation data (rules incorporated / rules requiring incorporation) in the works of Rivas [2004] and Ventura [2005]. The former are presented here: 49.3%, 48.8% and 50.3%, respectively.

F. The "Paper Mills" Dispute³⁵

The installation of two pulp mills on the left bank of the River Uruguay has been the source of conflict between Argentina and Uruguay. Notwithstanding the bilateral dimension of the dispute, it may have repercussions throughout the bloc and even on the integration process itself.

The Economic & Financial Background of the Dispute

In the latter half of the 1980s, Uruguay performed a series of studies with the intention of developing a forest area in the country's western region to help diversify the economy, particularly, its export sector, which is excessively dependent upon agriculture. The studies were financed by such multilateral and

³⁵ This section includes information available up to September 1, 2006.

bilateral organs as the World Bank, the IDB, the Japanese International Cooperation Agency and Eximbank from the United States. Some time later -again with foreign technical and financial backing- Uruguay passed laws to encourage forestry activity, created a certification system for sustainable forest management and invested in improving its road network to ensure the transport of forest production. By late 2002, Uruguay had over 457,000 hectares of forests planted with eucalyptus, two thirds of which had been afforested under the previously instituted promotion mechanisms. In the same year, exports of forest produce, especially tree trunks and chippings, represented 2.6% of total income from domestic exports.

As of mid-2002, two major European producers of pulp, the *Empresa Nacional de Celulosa España* (ENCE) from Spain and *Oy Metsä-Botnia Ab* (Botnia) from Finland, began to process projects to install two pulp mills on the River Uruguay in the west of the country. In October 2003, after complying with Uruguay's environmental legislation, the ENCE Group obtained Prior Environmental Authorization or PEA (AAP: *Autorización Ambiental Previa*) to install and operate a plant for the production of 500,000 tonnes of pulp per annum. The enterprise -named *Celulosa de M'Bopicuá* or CMB, and currently at the construction phase- is to operate 12 km outside the town of Fray Bentos on the west bank of the River Uruguay, facing the Argentinian town of Gualaguaychú (Entre Ríos Province), and will use M'Bopicuá's Logistical Terminal, already up and running.

In February 2005, the Metsä Botnia Group obtained environmental permission for the installation of a pulp mill twice the size of the Spanish Group's (1 million tonnes per annum). The company, called Project Orion, will also have a port terminal 4km from Fray Bentos, whose construction was authorized in July 2005. There will be just 6km between the sites chosen for the projects.

The economic benefits of both projects will be quite significant, especially considering the size of the Uruguayan economy. The total investment envisaged is US\$ 1.5 billion, with US\$ 500 million for the CMB Project and US\$ 1 billion for the Orion Project. Measured in terms of GDP at 2004 prices, the economic impact of the projects at the construction stage will be around 2% of GDP and 2.5% of GDP at the fully operational stage. It must also be borne in mind that the plants' shelf life is estimated at 40 years.³⁶ The impact on employment will also be significant: 1.3% of the domestic labor force (2004 data) at the construction stage and just below 1% of the labor force during the operational stage. Lastly, the impact on net exports -once the drop in exports of forest products has been deducted- and on tax collection will also be very significant (IFC [2005]).

Both projects demanded the financial support of the International Financial Corporation (IFC) of the World Bank Group. The loans requested for the CMB Project total US\$ 250 million and for the Orion Project US\$ 170 million. Moreover, Botnia has also requested the support of the Multilateral Investment Guarantee Agency (MIGA), also part of the World Bank Group, for the award of US\$ 300 million as security against potential political risks. The MIGA provides private investments in developing countries with guarantees against political risks, losses from restrictions on foreign currency transfer, breaches of contract, expropriation, warfare, etc. (IFC [2006]). Both institutions should respect operational rules by which they are obliged to take into account the environmental and social impact of the projects they support, publicize their actions and base their procedures on the principle of transparency. The applications for loan and guarantees from ENCE and Botnia have not yet been submitted for consideration by the respective Boards of the IFC and MIGA, as technical studies are not yet complete.

Those heading the Orion and CMB projects also made loan applications to private financial institutions such as the Dutch group, ING, and the Banco de Bilbao y Vizcaya (BBVA).³⁷ It should be stressed that

³⁶ Uruguay's GDP would have reached US\$ 13.186 billion in 2004, according to estimates by the World Bank quoted by the IFC (IFC [2006]).

³⁷ The loan application presented to the ING group was for US\$ 480 million.

both institutions have kept to the Ecuador Principles, a set of rules and guidelines that specify the framework for socially and environmentally "responsible" behaviors for project financing to be granted.

The environmental aspects of the dispute are being resolved within public and private financial institutions under strong pressure from Argentina and with the intense participation of non-government organizations (NGOs), mainly environmental groups.

The Environmental Dimensions of the Dispute

The concern for environmental issues expressed in different areas involves a variety of questions being asked of the CMB and Orion projects based on the information in the environmental impact studies by ENCE and Botnia for the PEA from Uruguay's competent environmental authorities. The questions focus on three aspects: (i) the choice of the plants' location; (ii) the choice of production technique, and (iii) the measures and technologies envisaged in the projects for treating liquid waste, limiting gas emissions and managing solid residues. However, these questions are colored by a more general argument: the omission and consequent neglect in both the environmental studies and the processing and passing of the projects of the potential negative transborder impact of both ventures, affecting not only a shared water resource -the River Uruguay- but areas located in Argentinian territory on the west bank of the Uruguay as well.

The projects' close locations are being questioned, analysis of alternative locations having been neglected. The environmental impact studies by ENCE and Botnia did envisage alternative site selection processes (IFC [2005] p. 2), but apparently both the final choice and the analysis itself were governed first and foremost, or exclusively, by private criteria of cost/benefit, without considering the possible environmental and social impact. Similarly, the concept of the projects' "area of influence" utilized in the studies has brought a host of questions as this apparently contributed to the transborder impact of the ventures not being taken into consideration. Such impact -which from the point of view of the Argentinian authorities and environmental groups are taken as read- would affect both water resources and tourist investments on the right bank of the River Uruguay. It should be stressed here that the town of Gualeguaychú in Entre Ríos Province has successfully developed tourist ventures, which in the high season, attract a tourist contingent several times that of the resident population. The Argentinian spa town of Ñandubaysal, one of Gualeguaychú's tourist attractions, is located on the right bank of the River Uruguay opposite the site chosen by Botnia for the installation of its pulp mill. The negative visual impact, as well as the fear of toxic gas emissions and nauseating odors from the future plant explain the broad social support for the demonstrations by neighboring Argentinian communities.

The question marks over the choice of production technique as well as future treatment of liquid, gaseous and solid waste raise complex issues that often divide specialist opinions on the subjects, a common occurrence in environmental disputes. Generally speaking, the plants claim to strictly comply with the rules of the Reference Document on Best Available Techniques in the Pulp & Paper Industry (BREF) that specify the concept of "Best Available Techniques" (BAT) for authorizing ventures in the paper and pulp industry within the framework of the EU's International Plant Protection Convention (IPPC). The Uruguayan side implicitly questions the good faith of Argentinian criticisms, as Argentina has paper and pulp mills that use environmentally inferior techniques. The Argentinian side alleges that the projects pay lip service to the BAT but their effective compliance is not clearly proven. On the other hand, in the case of new ventures, environmental organizations like Greenpeace defend the use of the pulp bleaching process known as "totally chlorine-free" (TCF) or the alternative process "elemental chlorine-free-light" (ECF-light) instead of the ECF process, the one proposed by both projects and accepted by European rules.³⁸

³⁸ These rules are, however, undergoing review and updating.

The locus of the environmental dispute is mainly the IFC. In November 2005, the ombudsman from the IFC and the MIGA circulated a preliminary report in response to a claim signed by over 39,000 people in Argentina and Uruguay, and supported by an Argentinian NGO, the Center for Human Rights & the Environment (*CEDHA: Centro de Derechos Humanos y Ambiente*). The evaluation's conclusions justified the claimants' concerns in general terms, as they were criticizing the hasty disclosure of information by the IFC, which presented the projects' approval as a *fait accompli*. The ombudsman recommended uniformity in the evaluation criteria to the IFC and the MIGA, full public access to information and absolute observance of the procedural rules effective in the World Bank Group.

The dispute gave rise to new clashes when, in December 2005, the preliminary version of the cumulative impact study commissioned by the IFC from two private consultants was made public, followed in mid-April 2006 by the disclosure of the conclusions of a team of Canadian experts called on by the IFC to evaluate both the preliminary study and the subsequent criticism. The team emphatically stated that concerns over "*catastrophic environmental damage are unsupported and unreasonable, and ignore the experience in many other modern kraft bleached pulp mills.*" It added that the TCF process is not the only acceptable one, but admitted that some of its environmental advantages might be achieved by adopting the "EFC-light" version. Nevertheless, it did recognize that various comments suggesting "*improvements to certain aspects of the mill design, definitions of operating procedures and environmental discharge monitoring are valid and merit implementation.*"

The team's conclusions were criticized again by environmental groups (Greenpeace [2006]) and, in May 2006, the IFC made public a plan of action essentially involving the preparation of the final version of the cumulative impact study by independent consultants based on information collection and cumulative analysis, as suggested by the critics and the Canadian team. In line with IFC estimates, the process would at least take another four months.

The Legal Dimensions of the Dispute

- The Statute of the River Uruguay & the Legal Foundations of the Dispute -

Though based on environmental issues and potential socioeconomic damage, the legal basis of Argentina's mainly concerns failure to comply with the obligations and commitments laid down in 1975 in the Statute of the River Uruguay.

In February 1975, in compliance with the provisions of the Limit Agreement signed by both countries in 1961, Uruguay and Argentina signed the Statute of the River Uruguay, designed to determine "*the common mechanisms necessary for sound and rational exploitation*" of the River. This instrument set up the Administrating Commission of the River Uruguay (*CARU: Comisión Administradora del Río Uruguay*), made up of an equal number of delegates from both countries.

According to the Statute, if a Party plans to carry out "*work of sufficient magnitude to affect shipping, the regime of the river or quality of its waters,*" it must make notify the CARU with the relevant technical information so that the commission can determine whether the project will cause the other Party "tangible damage." In the event of a dispute arising over the issue, the Statute establishes certain rules of procedure, setting deadlines and entitling the affected part to request cumulative information, to survey the work in order to verify whether it is in line with the project presented and also to suggest modifications. If misunderstanding persists, the Statute recommends the establishment of direct negotiations between the Parties. Failing this, after a term of 180 days, either Party may bring the case before the agreed dispute settlement forum, namely, the International Court of Justice in The Hague.

Argentina claims that Uruguay acted unilaterally and violated the 1975 Statute of the River Uruguay on three successive occasions by authorizing the construction and operation of two pulp mills and the installation of port structures for exclusive use by one of the plants without prior notification. By granting such authorization, Uruguay violated several of the Statute's provisions and failed to comply with both substantive and procedural obligations. The substantive obligations were covered by Article 41 of the above instrument establishing the Parties' obligation to protect and preserve the aquatic environment, and prevent its contamination, under international conventions and the rules and recommendations of international organizations. On the other hand, the procedural obligations were related to the notification and consultation mechanisms envisaged within the CARU. It should be noted that, according to the Argentinian interpretation, Uruguay could not have authorized the start of the work without previous complying with the procedures laid down in the Statute.

Uruguay claims to have complied with the substantive obligations laid down in Article 41, given that the authorization for installation of the pulp mills respected the most exacting international requirements, rules and standards. In terms of the procedural obligations, Uruguay understands that the provisions of the 1975 Statute invoked by Argentina do not grant one Party the power of veto to restrict the other's industrial development projects. In the Uruguayan interpretation, the extent of these provisions is more limited and they only constitute a commitment in good faith for a broad exchange of information at the stage prior to implementation of the work, with the potential to affect the quality of the water or the environment in border areas. This commitment has not been kept. According to the Uruguayan claims, after the projects' effective entry into operation (August 2007 for the Orion Project, June 2008 for the CMB Project), the responsibility for environmental monitoring and verification of strict compliance with the obligations laid down in the Statute will fall to the CARU.

- The Evolution of the Dispute -

The conflict surrounding the installation of the paper mills began in late 2002, when the Argentinian government became aware through informal channels of the possible building of a pulp mill on the west bank of the River Uruguay in the Fray Bentos region, and requested the Uruguayan government to provide the relevant information within the CARU. Apparently, according to the Argentinian Government, the information given was alleged to be incomplete, late or not processed through the channels provided for in the Statute. The conflict was aggravated when Uruguay, once the procedures envisaged in the internal environmental legislation had been complied with, granted ENCE and Botnia authorization to set up their ventures (in October 2003 and February 2005 respectively).³⁹

Between late 2003 and April 2005, there were alternating periods of intensification and apparent detente of misunderstandings. The data are rather contradictory, but at that time there was some exchange of information, makeshift agreements were struck between the governments to get certain aspects back on track, and there was joint work within the CARU to draw up a monitoring plan and even send a binational delegation to Finland. Nevertheless, the tension mounted after April 2005 as a result of pressure from the

³⁹ The procedures and rules in force in Uruguay for the approval of environmental impact projects envisage the following stages: (i) project notification of the competent environmental authority; (ii) project classification into three different categories depending on the intensity of its environmental impact; (iii) presentation by project proponent of a more detailed Environmental Impact Statement (EIS) for projects with potentially significant negative impacts; (iv) technical evaluation by the competent environmental authority; (v) publication in the Official Newspaper of a Environmental Report Summary with a deadline for the written protest of the interested parties; (vi) notification of public hearing, only for projects with serious cultural, social or environmental repercussions; (vii) final decision of the competent authority on the award of Prior Environmental Authorization (PEA). Once granted, the proponent must apply for and obtain approval in stages for an Environmental Management Plan or EMP (*PGA: Plan de Gestión Ambiental*) including both the construction and operation stages. As mentioned above, both projects obtained the PEA. Also, in late April 2006, the Uruguayan government gave notification that the ENCE Project had the approval of an EMP for the earthmoving, while the Botnia Project had four approved EMPs and had a fifth at the evaluation stage (MVOTMA [2006]).

Entre Ríos Provincial Government and especially after the formation of the Citizens' Environmental Assembly of Gualeguaychú (*Asamblea Ciudadana Ambiental de Gualeguaychú*) NGO at the end of the month. This organization brought together environmentalists, businessmen, and rural and urban productive sectors and, with significant social support in Entre Ríos Province, began to spearhead the protests against the "paper mills."

In May 2005, both governments agreed to form a bilateral commission, the High Level Technical Group (*GTAN: Grupo Técnico de Alto Nivel*), which began its activities in August that year, a month after Uruguay authorized the construction of port facilities on the bank of the River Uruguay for the transport of production from the Orion Project (Botnia).

The GTAN represents the second instance (direct negotiations) for dispute settlement envisaged in the 1975 Statute. Between August 2005 and February 2006, the GTAN held 12 sessions without the governments reaching an understanding. The Argentinian delegation's final report to the GTAN insists that Uruguay violated the 1975 Statute, questions the criteria used in selecting the sites for installation of the plants, reiterates its concern about possible environmental and socioeconomic damage (depreciation in rural and urban real estate, damage to tourism, loss of productivity due to the impact of acid rain), claims the ventures did not comply with the legal rules effective in their countries of origin for projects with potential transborder environmental effects, and records Uruguay's refusal to consider the Argentinian proposal to suspend work until a decision is reached over the projects' cumulative environmental impact.

In January and February 2006, at the peak of Uruguay's tourist season, residents of Gualeguaychú, accompanied by numerous civil society organizations, staged a succession of roadblocks for land traffic on international roads and bridges between the two countries. In March 2006, after negotiations at presidential level, the ventures announced the temporary suspension of work for a 90-day period. At the same time, the roadblocks were suspended. In April, however, the conflict was again aggravated and, on May 3, Uruguay appealed to the Protocol of Olivos, the dispute settlement mechanism agreed within MERCOSUR, claiming losses of almost US\$ 500 million as a result of the blockade on binational bridges. The Uruguayan claim, however, was not for economic damages but for the Argentinian State's omission to take appropriate measures to prevent the roadblocks, a violation of the Treaty of Asunción, which guarantees the free circulation of goods among its members. The following day, after a previous announcement, Argentina took its claim against Uruguay to the International Court of Justice (ICJ).

In short, the dispute is currently being aired in two forums: the MERCOSUR's Ad Hoc Arbitration Tribunal (*Tribunal Arbitral Ad Hoc*), where Argentina stands accused of violating the Constitutive Treaty of MERCOSUR (*Tratado Constitutivo del MERCOSUR*), and in the ICJ, where Uruguay is accused of violating the Statute of the River Uruguay.

- The ICJ Ruling & the Evolution of the Dispute in the MERCOSUR Arbitration Tribunal -

On July 13, 2006, the ICJ announced its first judgment, which did not allow the Argentinian request to establish precautionary measures designed to force the Uruguayan State to demand that ENCE and Botnia suspend work on the plants. The ICJ decision, adopted by 14 votes to 1, was founded on the non-existence of convincing proof showing a threat of imminent or irreparable damage to the environment or economic and social interests of the population residing in the vicinity of the River Uruguay.

This decision certainly went in Uruguay's favor. It should nevertheless be stressed that the rejection of the adoption of precautionary measures does not imply prejudgement in the heart of the matter, interpretation of which will probably take at least two years. Moreover, the Court made certain observations that go some way toward answering Argentina's interests. First, it stated that the decision does not affect

Argentina's right to table fresh applications for precautionary measures in the future, providing they are grounded in new facts. Second, the ICJ dissipated Argentinian fears that construction of the plants could be considered a foregone conclusion, emphasizing that it was not necessary to rule out a decision over the dismantling and relocation of the plants in advance, as the ICJ has ruled in previous trials. Third, the Court stated that it was issuing no judgment whatsoever relating to the correct interpretation of the CARU's information exchange mechanism which, so the Argentinian interpretation goes, presupposes the obligation "not to build" until agreement is reached between the Parties. Last, the ICJ understood that the issue of the projects' socioeconomic impact is covered by the provisions of the 1975 Statute, a fact contested by Uruguay.

In late July, Argentina, which always tried to keep the conflict out of the regional sphere, presented its defense to the MERCOSUR Arbitration Tribunal in Montevideo, formed after intense behind-the-scenes disputes over the choice of the third arbitrator.⁴⁰ In its presentation, the Argentinian government argued that it is forced by the Constitution to respect freedom of speech, a right that takes precedence over the free circulation of goods. Similarly, according to the Argentinian government, the free circulation of goods presupposes a government commitment restricted to regulatory acts and does not therefore include the acts of private individuals. Even so, the deterrence measures taken by the authorities would eventually have come into force. The Tribunal has until September 7 to make a statement, but in the absence of diplomatic understanding, the process is certain to go on to the next and last instance, the MERCOSUR Permanent Review Tribunal (*Tribunal Permanente de Revisión del MERCOSUR*) in Asunción.

The "Paper Mills" & MERCOSUR

The installation in Uruguay's border region of two pulp mills with foreign investments of some US\$ 1.5 billion could be taken, a priori, boding well for the future of MERCOSUR. In fact, one of Uruguay and Paraguay's main motivations in joining the subregional integration project has undoubtedly been the expectation of increasing the attraction of their economies to prompt the inflow of foreign capital able to encourage the diversification of the country's productive structures and exports. However, the accomplishments of the smaller economies in MERCOSUR have not so far been very encouraging.

The decision of the European groups, ENCE and Botnia, to base their ventures in Uruguayan territory owes little to MERCOSUR. The expanded market was not a factor in attracting the projects, as all the pulp produced in both plants will be exported to markets outside MERCOSUR. Credit should go first and foremost to government planning, which contemplated various actions such as preparing studies, adopting promotion models, instating rules and certification processes, and investing in road infrastructure. However, had these projects not awoken a bilateral dispute, they may have contributed to alleviating the frustration at MERCOSUR's scant effectiveness in attracting foreign investment to the smaller economies. Moreover, harmonious project management by the neighbors could have led not just to foreign investors, but to various mutually beneficial alternatives like the installation of pulp mills in Argentinian territory, as more than one observer has suggested. Economic promotion in border areas -generally not very dynamic regions with almost invariably unsatisfactory social indicators- should clearly be one of MERCOSUR's objectives. However, instead of promoting and exploiting potential positive "spillover" from the ventures, what has prevailed is mutual distrust and an utter inability to embark upon dialogue to develop joint management of the risks and threats of the projects' potential transborder impacts.

⁴⁰ The Ad Hoc Tribunal has three arbitrators: one from Argentina, one from Uruguay and one from Spain. Apparently, Argentina's dissatisfaction with the appointment of this third arbitrator stems from the fact that one of the investment groups is Spanish. It should be added that the arbitrator in question was involved in an earlier dispute between the two countries over bicycles, which went against Argentina.

Disputes between countries are an everyday occurrence and their settlement, by either diplomatic or legal channels, should be approached as a matter of course. However, the war of attrition being caused by this conflict is excessive and exposes the current frailties and shortcomings long present within MERCOSUR.

The shortcomings are of at least three kinds. First, there is the difficulty MERCOSUR member countries encounter in agreeing a common investment attraction policy. This difficulty is prevalent even at national level, where the "fiscal war" between subnational units is a fact of life, causing conflict and contributing to an increase in fiscal sacrifices or exemptions. There is thus no shortage of incentive for countries to strive to establish a harmonious regulatory framework in MERCOSUR. Nevertheless, the 1994 Protocol of Colonia, providing on intrabloc investments, has not been incorporated by any of the States Parties, and the Protocol of Buenos Aires (1994) on extrabloc investments, which came into force as recently as late 2005, "allows each State to adopt its own incentive mechanisms in accordance with respective internal legislations" (Ventura [2006]). It seems more than likely that competition over attracting investments will form part of the dispute. But it must be stressed that Entre Ríos Province, an important player in the conflict, in 1990 adopted rules to attract investment that embrace the paper and pulp segment. Moreover, Uruguay's reluctance to provide information within the CARU can only be understood as being born of distrust, the most likely source for which is fear of questions from its neighbor that may delay or jeopardize significant foreign investments. The end result could not have been worse: investment in industry and tourism on both banks of the River Uruguay which had the support and incentive of the respective governments are today under threat from the tortuous meanderings of the dispute.

The second prominent shortcoming has to do with the weakening of MERCOSUR's status as the natural political forum for dispute settlement (Ventura [2006]). Uruguay tried to take the dispute into the sphere of MERCOSUR, but the Argentinian rebuttal was swift and decisive, constantly insisting on the bilateral nature of the conflict. Brazil, for its part, has tried its hand at silent mediation, to no avail.

Lastly, the "paper mills" conflict reveals the fragility of the rules and institutions governing MERCOSUR. Initiatives geared to "institutional strengthening" are not only slow or even late, but their credibility is put in doubt every time they have to be implemented, in light of the underlying distrust prevalent among the member countries themselves: (i) in 2001, the bloc established a Framework Agreement on the Environment, which has been in effect since mid-2004; (ii) Member States have also signed or joined various international agreements on environmental matters, which are therefore also valid in MERCOSUR, and (iii) MERCOSUR has a dispute settlement system and recently installed its Permanent Inspection Tribunal. In light of this, the Argentinian decision to take the case to the ICJ, albeit the legitimate forum envisaged in the 1975 Statute, reveals the bloc's institutional limitations.

In this and other disputes, the four countries' diplomatic representatives show massive mutual mistrust over the use of the agreed instruments. This explains the inclusion of the "forum option clause" in the MERCOSUR dispute settlement system, making it possible for the claimant to present the dispute to extrabloc forums (the WTO, etc.).⁴¹ Indeed, as various critics have pointed out, Member Countries show low tolerance levels at any "cession of sovereignties" within MERCOSUR, a fact that contrasts with their willingness to comply with resolutions, restrictions or decisions issued by multilateral organizations like the WTO.

Still, there is no shortage of incentives to settle the dispute through diplomatic and political channels. The two-year term established to examine the matter in depth in the ICJ generates excessive uncertainty in investors and the possibility of contradictory developments in the other forums where the conflict is being thrashed out, such as the MERCOSUR Arbitration Tribunal and IFC, cannot be excluded. Bilateral negotiations are therefore fairly likely to be renewed.

⁴¹ The "forum option clause" was included by the Protocol of Olivos (Article 1, Paragraph 2). Note, however, that such a clause is forbidden in other integration models like the EU's and the Andean Pact's.

G. Closing Remarks

Bilateral issues have dominated MERCOSUR's internal agenda in the last year. This "category" includes the renegotiation of the Automotive Agreement between Brazil and Argentina, the institution of the CAM (an instrument agreed by these countries aiming at disciplining the enforcement of bilateral trade protection measures), and lastly, the controversial case of the "paper mills," a legal-cum-environmental conflict that has seriously marred relations between Argentina and Uruguay over the installation of two pulp mills in the Argentinian/Uruguayan border region on the east bank of the River Uruguay.

Strictly speaking, the predominance of bilateral issues is just a symptom of the difficulty the partners are encountering in redefining the outline of an integration model that can only be sustained voluntarily if a clear perception of common benefits prevails among its members. From the late 1990s, this perception has grown more and more fragile, translating into the fact that bilateral issues periodically arise which in most cases cover up partners' inability to make progress in consolidating and intensifying quadrilateral integration.

When examined in light of the routine administrative acts of its institutional framework (CMC decisions, GMC resolutions and CCM directives) or the more political official statements announced at the end of each summit, the evolution of integration almost always leads to hybrid balances. Some more minor matters are eventually passed, others make significant progress, and there is always a lengthy list of difficult-to-digest issues that remains indefinitely as part of the backlog of the discussion agenda (Markwald [2005] p. 26). The balance in the evolution of the internal agenda over the last year is no exception. Certain problems like the Automotive Agreement or the CAM have apparently been settled, although the quality of the solutions adopted arouses no special enthusiasm. Progress in other areas is reticent, as in rules incorporation, or inadequate, as in rules and disciplines. In conclusion, there are issues such as the double levying of the CET or the handling of asymmetries that have been channeled in such a way as to bring about positive expectations. Only the future will tell.

CHAPTER IV. THE EXTERNAL NEGOTIATING AGENDA

Two issues dominated MERCOSUR's external agenda over the last year: the multilateral negotiations of the Doha Round within the WTO and the incorporation of Venezuela as a full member of the bloc. Despite its vast external negotiating agenda, MERCOSUR has not been able to make significant progress on any of its ongoing negotiating fronts. This is in stark contrast to the negotiating process for the Protocol for the Bolivarian Republic of Venezuela's Membership of MERCOSUR.

MERCOSUR has encountered difficulty in moving forward in negotiations whose content is relevant for both developed and developing countries. Despite the multiplicity of negotiating initiatives, just three agreements have been concluded in the last three years, namely, with the Andean Community, India and the Southern African Customs Union (SACU) -though the last two have not yet come into effect.

Making the most of the presence of the Cuban president, Fidel Castro, at the last MERCOSUR Summit in July 2006, MERCOSUR and Cuba an ECA. The agreement consolidated the multilateralization of preferences already negotiated in MERCOSUR's bilateral agreements with Cuba within the LAIA.

Impasses with developed countries caused by conflicts of interest and extremely wideranging, divergent agenda of issues were not resolved. Negotiations with developing countries produced unambitious agreements in terms of both products covered and preferences negotiated. In an international context of proliferating regional trade agreements, there is growing debate over the reasons for this poor performance

MERCOSUR countries' claims center on improving market access conditions for agricultural and agribusiness products precisely in sectors where the bulk of developed countries' protectionist efforts are concentrated. But the United States and the EU have an interest in liberalizing industrialized product markets and introducing into regional agreements rules on matters of investment, intellectual property, services and access to public sector purchasing, areas where Brazil and not the other partners has proved reluctant to make commitments.

Negotiations with CAN countries were complex and generated commitments deemed rather irrelevant by MERCOSUR exporters, particularly compared to the awards offered by certain Andean countries like Peru and Colombia to US exporters in the free trade agreements they signed with the United States.

MERCOSUR's negotiations with other developing countries like India and South Africa also produced agreements of little economic consequence, the result of a lack of willingness to progress toward the realization of further-reaching integration programs. In these selective tariff preference agreements, countries tend to include products with lower tariff protection, which limits improvements in new access to markets.

It is in the multilateral sphere that Brazil has had found it easiest to obtain positive results. In the WTO, Brazil has made significant achievements in the Dispute Settlement Mechanism in cotton and sugar, while in the Doha negotiations it has demonstrated a capacity for leadership (G-20) and defense of its interests, despite not yet producing effective results, as negotiations have been suspended. The WTO's Doha Round has been the main focus of Brazil's foreign trade policy in the last year and this priority seems to have affected MERCOSUR's external agenda. Recently, despite the many ongoing regional negotiating initiatives, very little progress has been made in this agenda.

Over the last few years, several new negotiating initiative were launched with various countries or blocs, including Morocco, Egypt, Canada, the Gulf Cooperation Council (GCC), Israel and Pakistan, which took part in the last MERCOSUR Summit. The intention to negotiate a trilateral free trade area (MERCOSUR/India/SACU) was also announced as part of the IBSA (India, Brazil, South Africa) initiative. There was also rapprochement with Panama, the Dominican Republic and the Central American

countries and CARICOM. An impact and viability study for possible negotiations with South Korea was opened and more recently Turkey expressed its interest to MERCOSUR about opening trade negotiations.

The objectives and methodology adopted in these negotiations vary according to the initiative, but the criteria determining the choices are not clear: in some cases, a fixed preference agreement model is adopted (with or without product reciprocity) and, in others, free trade areas. The agreements negotiated with India and the SACU are fixed preference ones, while negotiations with Israel and the GCC aim at creating free trade areas. Even so, each of these fronts follows different negotiating formats.

Analysis of MERCOSUR's external negotiating agenda does not help identify the criteria and elements guiding the bloc's choices. With regional negotiations with developed countries at a virtual standstill, MERCOSUR seems to have centered its attention on South/South agreements without including economic selectivity criteria. Many of the initiatives have been started without any continuity in the negotiating process, as with Egypt, Morocco and Canada.

This chapter examines the recent tensions between MERCOSUR partners over the bloc's external agenda strategy-making, the evolution of the four Member Countries' trade flows and their repercussions for priority-setting for the trade agreement negotiation. Special attention is paid to current trends in subregional economic integration models in South America. The chapter also presents a brief retrospective analysis of the evolution on the main trade negotiating fronts making up MERCOSUR's external agenda, with especial emphasis on the Doha Round. Last, there is a section devoted to Venezuela's membership of MERCOSUR, the opportunities for trade growth and the difficulties the new member's entry will add to the already complex task of coordinating the bloc's external agenda.

A. Partner Tensions over Coordination of the External Agenda

Faced with a lack of substantial progress, tensions between MERCOSUR partners over the priorities of the external agenda grew. Although divergences over foreign trade policy are nothing new in MERCOSUR, for the first time there were movements that went beyond simple expressions of interest in bilateral agreements escaping the 4+1 format. At the start of the year, Uruguay began negotiations with the United States to expand trade with this country. If they prosper, they may be included in the investment agreement in force between these two countries since 2004.

The crisis suffered by Uruguay in 1999 brought about a sharp fall in its exports and imports in subsequent years. In 2005, exports rose 20% above the 1998 peak. But this performance entails significant structural transformation: MERCOSUR's loss of volume and relative importance as a destination for Uruguayan exports, and the expansion of exports to the United States. In 1998, MERCOSUR was absorbing 55.3% of total foreign sales; in 2005, its share was 22.9%.

The Uruguayan government's report to the WTO, released in April this year in the framework of the Trade Policy Review Mechanism (WT/PRT/G/163) makes clear the direction the country wants to follow in terms of its international positioning. It defends multilateralism, open regionalism in MERCOSUR and bilateral agreements as additional efforts to expand Uruguayan products' access to markets.⁴²

⁴² The report presents the following policy guidelines: (i) preservation of property rights, protecting the rights of debtors and creditors through compliance with contracts, development of the capital market, strengthening the framework for the restructuring of companies by reviewing bankruptcy law, improvement of the management of public corporations, and review of investment promotion regimes. (ii) expanding market access as a high-priority objective for international negotiations at all levels, bilateral, regional and multilateral.

The report mentions as priorities the expansion of MERCOSUR and the exploration of individual opportunities through the establishment of bilateral agreements. It highlights the free trade agreement with Mexico signed in November 2003 and the ongoing dialog with the United States on the strengthening of economic and trade links between the two countries.

Perhaps as a sign that it recognizes MERCOSUR's scant contribution to the growth of the Uruguayan economy, Brazil's Minister for Foreign Relations, Ambassador Celso Amorim, paid an official visit to Uruguay in June 2006, accompanied by a large delegation of representatives from various Brazilian public organizations and a business mission. The visit aimed to promote bilateral cooperation mechanisms. Action was agreed in areas as diverse as border cooperation, electrical energy, metrology, medications, sanitary and phytosanitary measures, and others.

In a Joint Official Statement circulated at the end of the visit, the two countries' foreign ministers restated *"the need for MERCOSUR to become an effective instrument for MERCOSUR countries' competitive positioning in international trade."* The official statement also underlines *"the need to tackle problems arising from MERCOSUR countries' asymmetries that negatively affect the smaller economies, among them Uruguay, via measures that help reduce the imbalances in both the process of consolidating MERCOSUR and in negotiations with third parties designed to improve its extraregional positioning."*

Although the possible understandings between Uruguay and the United States have been attracting more attention, there have also in recent months been rumors about the existence of similar initiatives by Paraguay. The two countries were expected, in July this year, to present a formal application to the other two partners for authorization to negotiate preferential agreements with the United States.

At the start of September 2006, the Uruguayan president, Tabaré Vázquez, via the president of Brazil, which currently holds the pro tempore MERCOSUR presidency, sent the other MERCOSUR presidents a letter urging them to *"regain the momentum of external negotiation by flexibilizing it via the incorporation of bilateralities, either in the framework of combined negotiations or by allowing individual negotiations."*

The discrepancies between MERCOSUR partners in the bloc's external agenda have been raising doubts over the suitability of the customs union model to its members' individual interests. The debate really hotted up around two years ago, when the four partners' difficulties of coordinating the formulation of liberalization proposals in the framework of the FTAA and negotiations with the EU became apparent.

In this period, certain Brazilian trade analysts and businessmen began supporting the idea of transforming MERCOSUR into a free trade area, thus leaving the partners free to negotiate trade agreements with other countries. In this view, MERCOSUR had been losing importance as a destination for Brazilian exports and Brazil therefore needed to seek integration in other more promising markets. This also seems to be the predominant stance in Uruguay among defenders of a trade agreement with the United States.

B. The Evolution of Trade Flows & External Agenda Priorities

Does the geographical evolution of trade flows herald a trend toward fragmentation or convergence in the processes of MERCOSUR members' international positioning? The answer to this question should indicate the national positioning strategy-making and the congruence between MERCOSUR's trade policy options and the economic and trade trends of its individual partners.

When analyzing the evolution of MERCOSUR countries' exports over the last ten years by country or bloc destination, it is possible to identify the following stylized trends:

- MERCOSUR loses share as a destination for its individual partners' exports. The gravest case is Uruguay, which saw its exports fall significantly in nominal terms in the period.
- The fall in South America's share is fundamentally due to MERCOSUR's poor performance, while the CAN countries' share in the destination of MERCOSUR sales remains virtually constant.
- The United States records a slight increase in its share as a destination for the total exports of Brazil and Argentina, but displays significant growth in Uruguay's case.
- Mexico consolidates its position as a still minor player, but with growing importance for Argentina, Brazil and Uruguay.
- Despite continuing to be a trade interlocutor of great importance, the EU lost relative importance for all partners, except Uruguay.
- China emerges as an important trade destination for MERCOSUR exports, especially for Argentina and Brazil, but also for Paraguay.

In other words, where export destinations are concerned, MERCOSUR countries generally share convergent trends toward a reduction in the importance of MERCOSUR and South America, and an increase in the influence of the United States, China and Mexico. The four countries also have another feature in common: in the period, the share of "other markets" as a destination for their exports grew at different rates, indicating geographical diversification.

These developments enable us to conclude that, from the point of view of exporting interests, it is not difficult to fix a list of joint priorities for the four MERCOSUR partners in the markets to be targeted by trade negotiating initiatives. Nevertheless, some of these trends exhibit widely varying intensities in the various countries: MERCOSUR's loss of importance and the growth of the United States as a destination are particularly significant for Uruguay. This seems to justify the ongoing trade policy debate there.

An overview of the evolution of MERCOSUR exports shows the United States and the EU remain important markets, albeit with opposite dynamics. Mexico is budding as an attractive market taking up more and more space in the MERCOSUR countries' trade strategies. From the trade point of view, these three markets should occupy a pre-eminent place in the bloc's external agenda.

Although China has been gaining in importance as a destination for MERCOSUR exports, it also represents a major threat to intraregional trade, as Chinese competitors have been displacing MERCOSUR suppliers in the bloc's imports. The Chinese threat has quite different impacts across the four countries: Brazil is the most affected by the competition, both in its domestic market and in exports to the region and elsewhere. Consequently, China will probably not be included on the MERCOSUR negotiating agenda, although Uruguay has expressed its interest in negotiating a trade agreement with China.

Lastly, the trend toward the geographical diversification of MERCOSUR countries' exports corroborates the strategy of incorporating developing markets in the bloc's external agenda. Debate should focus on the need to define priorities -given that negotiating resources are scarce- and evaluate the effective results obtained in some of these negotiations in terms of the scope and coverage of products and awards exchanged.

C. The Scope of the Agenda of Issues & the Matter of Regulatory Space

The choice of the priorities for MERCOSUR's external agenda demands an analysis of individual countries' willingness to tackle the issues that make up the different negotiating agendas. It is well known that partners with intentions to negotiate free trade agreements with the United States must be prepared to

assume commitments that go far beyond the liberalization of commerce of goods. The menu of issues included in the free trade agreements negotiated by the US, aside from trade in agricultural and industrial products, includes issues such as the liberalization of trade in services, protection of investments and intellectual property, and access to public sector purchasing markets.

The MERCOSUR partners' willingness to negotiate over these issues is very uneven. In the main it has been Brazil and Argentina that have recently intensified resistance to negotiating any commitments limiting their degree of freedom to implement industrial policy measures. The need to preserve policy space means these countries are opposed to negotiating commitments in these areas and in public sector purchasing or intellectual property. Even in the debate in Uruguay over a possible agreement with the United States, there are expressions of concern over the demands the country can try to impose.

These trends in internal policies have guided the definition of priorities in MERCOSUR's external negotiating agenda. Under the influence of Brazil, priorities have shifted toward negotiating with countries that exert no pressure to impose extremely comprehensive negotiating agendas in order to limit the scope of understandings to the area of trade in goods.

This orientation also makes negotiations with the EU more acceptable to MERCOSUR than agreements with the United States. Despite having an interest in negotiating commitments in several such areas, the European demands are more specific and do not demand such deep commitments as NAFTA-type agreements.

Diverging views over the priorities of external negotiations will persist in the near future. The debate about MERCOSUR's integration model and the viability of finding mechanisms to flexibilize the commitments of joint negotiations, reaffirmed in 2000, will remain on the bloc's internal agenda.

D. Trade Policy in South America: Integration or Fragmentation?

The negotiation or readiness to negotiate agreements with the United States have been central to debates over MERCOSUR and CAN integration models such as customs union or free trade area. The bilateral agreements negotiated by Colombia and Peru with the United States were the reason advanced by Venezuela for leaving the CAN. Moreover, Chile requested to be reincorporated in the CAN, this time as an associate member.

Apart from questioning the customs union projects in the region, the bilateral agreements signed with the United States may damage intraregional trade and stand in the way of the objective to intensify flows between MERCOSUR and the CAN. In the negotiated agreements, Colombia and Peru generally grant the United States more significant preferences than MERCOSUR countries in the MERCOSUR/CAN agreement. Also, the agreements signed with the United States are far more thematically comprehensive than those signed by the CAN countries with MERCOSUR, thus ensuring greatly enhanced conditions of access and standards of protection for US service providers and investors than are being applied to MERCOSUR investors.

These agreements, which may prove suitable for South American signatory countries, potentially reinforce the centrifugal trends that have characterized these countries' foreign trade. This possibility starts becoming feasible if South American countries cannot react at the level of intraregional trade liberalization and infrastructure integration initiatives to counter the challenges posed by US bilateral agreements in the region.

In summary, the current situation points to the growing fragmentation of trade policy in South America, fragmentation present in the two existing blocs in the region and which may lead to the remaking of South American integration.⁴³

The South American Community of Nations: A New Path toward South American Integration?

The South American Community of Nations or SACN (*CSN: Comunidad Sudamericana de Naciones*) was created in Cuzco, Peru, on December 8, 2004, during the Summit of the region's Heads of State. It is made up of MERCOSUR Member Countries and the Andean Community, as well as Chile and the Republics of Guyana and Suriname. The initiative, initially with the decisive backing of the Brazilian government (INTAL [2005]), is attracting growing interest from other governments in the region.

Moved by the need to endow the project with more content and depth, the presidents decided to set up the Strategic Commission for Reflection on the South American Integration Process (*Comisión Estratégica de Reflexión sobre el Proceso de Integración Sudamericana*) in December 2005, constituted by the presidents' personal representatives. The Commission has the authority to present a Reflection Document to be presented to the presidents by the end of 2006.

The version for discussion of the Document debated at the 2nd Meeting of the Reflection Commission in July 2006, places the constitution of the SACN in a context of deep economic, social and political asymmetries attributed to the direction of globalization in recent decades. The Commission states that "regional integration is the appropriate response to the international challenges, as it enables a more solid, competitive presence for our region in the world" and draws attention to the fact that South America is the only region in the world not organized on political lines, unlike ASEAN, the EU and the African Union.

The document acknowledges the contradictions in the region's integration movements, the different trade regimes adopted and the asymmetries between the members of the economic blocs. It also recognizes that the trade agreements negotiated with the United States by the region's countries make intraregional trade relations even more complex. Meanwhile, the Commission feels that this complexity does not prevent South American countries forming an association to secure broader political and economic coordination.

Regional integration is viewed as reinforcing the reaffirmation of the National State and as a catalyst for national development projects. The document identifies opportunities for cooperation in infrastructure, energy, industrial and agricultural complementation, the environment, the war on poverty and social exclusion, sources of development funding, border integration projects, security, education, culture, and science and technology.

The Reflection Commission's job is to reinforce the institutional architecture envisaged by the SACN. Given its original conception, the project should hinge on the convergence of existing integration models in the region. But in the Commission's view, given the difficulties experienced by the two pillars -the CAN and MERCOSUR- have been experiencing, a more significant measure needs to be taken to strengthen the Community as an institution. The proposals for institutional architecture include:

- The creation of a Permanent Secretariat;
- The creation of thematic commissions with individually appointed deputies;
- The establishment of channels for the participation of civil society like MERCOSUR's Economic & Social Consultative Forum (*Foro Consultivo Económico-Social del MERCOSUR*);

⁴³ For a detailed analysis of the fragmentation process of South American trade policy, see CNI [2006b], Year 15, Nos. 8 & 9.

- The convergence and coordination of subregional Parliaments with a view to setting up a South American Parliament, and
- The establishment of a reconciliation mechanism and political dialogue.

Considering the scope of the proposed measures, the document suggests the need to negotiate a foundational constitutive agreement for the SACN, one that looks ahead to the creation of a true South American Union.

Regarding external relations, the Commission foresees that the experience of regional summits like the South America/Arab Countries Summit should be continued. It looks ahead to the potential convergence of the region's countries over major international issues within the United Nations Organization (UNO), the Organization of American States (OAS), the WTO, and so on. But it makes clear convergence of actions in these spheres should be reached without losing the identity of national foreign policies.

The project recognizes the limitations of the current scenario, but envisages quite an ambitious institutional architecture and an extremely comprehensive agenda of issues. If regional integration is seen as a means of realizing national development projects, a fundamental criterion in the choice of topics for its agenda should be integration's contribution to each of them through the identification of instruments for its effective implementation.

In certain areas, the benefits of integration and its instruments are easily identifiable: physical integration, and energy and border integration are examples. In other areas, like the coordination of social policy, the regional instruments or mechanisms that can effectively contribute to reducing social exclusion have not been identified, except by the positive effects on the region's development.

The creation of a free trade area in the region through the convergence of the various subregional trade agreements in force across the continent could be one of the SACN's main contributions on the road to achieving greater economic integration in the region. The coexistence of various trade regimes, which involves the existence of a complex and divergent fabric of tariff concessions and trade rules, does not represent the most suitable option for the development of trade and intraregional investments. The convergence of liberalization models and trade rules, especially rules of origin, could significantly boost regional integration.

This does not necessarily imply the submergence of subregional blocs like MERCOSUR or the CAN in one broader bloc, but it does involve the creation of a free trade area in South America that could facilitate the development of business in the region. Although the LAIA has been performing studies with this in mind, the issue is little explored in the document being debated by the SACN Reflection Commission.

E. The Evolution of MERCOSUR's Regional & Bilateral Negotiations

The Free Trade Area of the Americas: An Ever More Remote Possibility

After Brazil and the United States' attempts to reach an understanding over the reestablishment of negotiations for a Free Trade Area of the Americas (FTAA) in early 2005, expectations were pinned on the 4th Summit of the Americas held in November that year in Mar del Plata, Argentina. Under the banner "*Create work to confront poverty and strengthen democratic governability*," for the first time since the 1994 Miami Summit, the meeting closed without the drafting of a joint declaration (AB INTRA [2005] #9). In an atmosphere marked by street demonstrations, disagreement arose over the inclusion in the final declaration of a paragraph on the FTAA. Although progress was made in other issues on the meeting's agenda, it was the debates on the FTAA that caught the media's and the public's eye.

The debate over the advisability of including a paragraph in support of renewal of the FTAA negotiations revealed the existence of three different stances in the hemisphere:

- i. On the one hand, the Latin American countries and Canada, who pressed for a date to be set for the renewal of negotiations (April 2006). The United States, which for the last year had shown little enthusiasm for the idea of resurrecting the project, came in on this stance, and it was eventually supported by 29 countries;
- ii. Taking the opposite stance, the President of Venezuela, Hugo Chávez, rejected the initiative and refused to accept inclusion of any mention of the FTAA in the Final Declaration;
- iii. MERCOSUR took an intermediate stance, refusing to reject a declaration supporting the negotiations, but claiming conditions were not right for resuming negotiations. Hence, it avoided setting a date. Brazilian negotiators, in particular, reiterated the need to await the results of the WTO talks.

Despite having the support of most of the American continent, there is very little chance of the project's resumption next year. The deadlock in the Doha negotiations, the soon-to-be-defunct Trade Promotion Authority, a power bestowed by the United States Congress on the Executive for it to fast-track trade agreements, the outspoken opposition of Venezuela -now a MERCOSUR member- and the lack of enthusiasm for the project from the two leaders of the negotiating process, Brazil and the United States, suggest there is little room for restarting negotiations.

The MERCOSUR/EU Negotiations On Hold

With the FTAA negotiating process at a standstill, talks between MERCOSUR and the EU became the most economically relevant initiative on the external agenda. Although it represents significant challenges in terms of competition in the industrial and service sectors, a trade agreement with Europe encounters little opposition in the most active governments and segments of civil society in MERCOSUR countries.

The negotiations, which effectively began in 2001 when the two blocs exchanged the first proposals for liberalization, went through a period of stagnation and were renewed in 2003. Subsequently, the two blocs made an effort to conclude the agreement before October 2004, when the mandate of the European Commission ended. The stages of the negotiation process and the analysis of the proposals tabled in 2004 are described in detail in MERCOSUR Report #10.

Between May and September 2004, there were intense efforts to overcome the differences. Yet MERCOSUR had difficulty extending its proposal in the automotive and textile sectors, and Europe in the agricultural sector, both considered inadequate by each party. Other difficulties regarding the conditionalities demanded by the parties and the lack of progress in trade rules, such as rules of origin, drawbacks and so on, meant the agreement would definitely not be concluded by the end of October.

Again with the old European Commission members, the meeting between the two blocs in Lisbon in October 2004 ended with a commitment to resume talks and hold a Ministerial Meeting in the first quarter of 2005. The Davos World Economic Forum in late January 2005 brought a meeting between Brazilian negotiators of the MERCOSUR/EU agreement and the new European Trade Commissioner, Peter Mandelson. Another ministerial meeting between the blocs was set for September 2, 2005, in Brussels.

The momentum given to the WTO Doha negotiations during 2005 and the first half of 2006 took the wind out of concluding understandings between MERCOSUR and the EU. The progress of bilateral liberalization in the sphere of agriculture depended fundamentally on multilateral commitments.

The last EU/MERCOSUR Ministerial Meeting was held in Vienna, Austria, on May 13, 2006, on the occasion of the Fourth Summit between the EU and Latin American and Caribbean countries. In March, MERCOSUR had sent a non-paper, entitled *Elements for a Possible Agreement*, in which the bloc revised its demands for tariff quotas on agricultural products, improved its offer of services and reaffirmed the need for flexibility in the deadlines for liberalization and coverage of liberalization offers.

At the Vienna Meeting, Europe presented its comments on the MERCOSUR document, claiming that the quotas requested were far beyond Europe's scope, reiterating its demands for protection of the geographical indications and requesting total MERCOSUR's liberalization of a limited range of agricultural products. Similarly, the European negotiators demanded broader commitment in various service sectors, the raising to 90% of the coverage of the tariff lines and the removal of backloading⁴⁴ in MERCOSUR's offer for industrial products. The EU presented a list of 353 products of great interest to the European industrial sector, expressed its expectation to receive an acceptable proposal for the automotive sector, as well as a proposal of a preference on products on the list of exceptions.

The EU reiterated that it expected MERCOSUR to ensure the free circulation of goods and services between bloc members and affirmed its will to include elements of special and differentiated treatment, for which asymmetrical tariff exemption timeframes would be incorporated that would take into account each sector's degree of competitiveness.

Despite the difficulties involved in making progress from these positions, the Brazilian government, occupying the pro tempore presidency of MERCOSUR, intends to conclude the negotiations shortly. Both parties are studying possible points of convergence for the renewal of talks.

Apart from the enduring divergences between the two blocs, the likelihood of achieving effective progress is also affected by uncertainty over the outlook for the Doha Round, which have a decisive impact on agricultural negotiations between the two blocs. Last, the effective renewal of negotiations will have to tackle a new challenge: the incorporation of Venezuela, which now plays a full part in the process of negotiations as a member of MERCOSUR.

Agreements with the Andean Countries: Matters Pending & Review Expectations

The MERCOSUR/Peru Agreement was signed in August 2003 and the Agreement between MERCOSUR and CAN countries (Colombia, Ecuador and Venezuela) in December the same year. Both agreements were singled out as the main achievements of the December 2003 MERCOSUR Summit, despite being signed before the respective negotiation processes were concluded.

ECA 58, the culmination of MERCOSUR's negotiations with Peru, was only signed on November 30, 2005 and incorporated in the five countries' legal systems over the next two months. The main delay to the agreements being concluded was to do with the difficulty of reaching consensus over Argentina, Brazil and Peru's treatment of foreign trade zones and special customs areas in the context of the Trade Liberation Program (Annex IIA).

According to the wording of the original text, Article 48 of ECA 58 already envisaged the need for countries to keep tackle the issue. But a temporary solution was reached with the adoption of the Second Additional Protocol between Brazil and Peru, also signed on November 30. This Protocol defined a fixed preference regime for products originating in the two countries' foreign trade zones and special customs areas, subject to the LAIA's Origin Regime and to specific special rules, until such time as negotiations on

⁴⁴ As well as presenting non-linear timeframes, the MERCOSUR's offer concentrates the liberalization of industrial products in the slowest categories of tax relief.

the issue are concluded. Brazil has not yet incorporated the Protocol in its domestic legal system, while Peru did so in February 2006. The Protocol will only come into effect when both countries incorporate it in their internal law in line with their respective legislations.

The First Additional Protocol of the Agreement was also signed on the same date and refers to the Dispute Settlement Regime. Paraguay alone has incorporated this Protocol in its domestic legal system through Decree 7,111 of February 2006.

The free trade agreement between MERCOSUR and Colombia, Ecuador and Venezuela (ECA 59), protocolized in the LAIA on 10/18/2004, came into effect in MERCOSUR countries in the first two months of 2006. Whereas, the First Additional Protocol on Dispute Settlement has not yet been incorporated in all the countries' domestic legal systems.

In the view of Argentina and Brazil's business sectors, ECA 58 and 59 are complex and biased in favor of Andean interests regarding market access. The negotiation of bilateral agreements with the United States by Peru and Colombia provoked criticism of the two ECAs with the verification that the concessions granted to US products are broader in scope than those granted to Argentinian and Brazilian producers.

In terms of relations with Venezuela, its MERCOSUR Membership Protocol reduces the imbalance in conditions of market access. The deadline for tariff exemption in Venezuela has been moved to January 2014, four years before the deadline stated in ECA 59 for almost all exports. Talks on the new timeframes represent a fresh opportunity for more favorable treatment for the two largest MERCOSUR partners.⁴⁵

Regarding ECA 58, the MERCOSUR authorities are likely, at the next meeting of the Agreement's Management Committee, to request a comparison of the concessions being offered by Peru with those it granted the United States.

India & the Southern African Customs Union: Modest Agreements

- MERCOSUR/India -

In January 2004, on the occasion of President Luiz Inácio Lula da Silva's visit to New Delhi, the text of the Preferential Trade Agreement between MERCOSUR and India was signed. This agreement is inserted in the Framework Agreement signed by the parties in Asunción on 06/16/2003 for the creation of a free trade area, Article 3 of which already contemplated the signing of a Fixed Preference Agreement.

In December 2004, during the MERCOSUR Summit Meeting in Belo Horizonte, negotiations of the agreement's annexes were concluded. These were signed in May 2005. MERCOSUR's legal protection is provided for this kind of negotiation by Article 27 of the 1980 Treaty of Montevideo. Accordingly, LAIA countries are authorized to sign partial scope agreements with other developing countries and integration areas outside Latin America. More than a year after the agreement was signed, it had still not been incorporated in Argentina and Brazil's domestic legal systems.

Just three preference levels (10%, 20% and 100%) were defined in the agreement with India. The list of concessions from MERCOSUR was made up of 452 tariff items. 100% preference margins were granted to 13 items, but the tariff applied to these products is already 0% in MERCOSUR. Other concessions were granted for products with an average CET of between 5% and 7.5%. India's offer contains concessions on 450 tariff items. The lowest preferences (10% and 20%) were applied to products with higher tariffs, while the 100% preference was granted to products with an average tariff of 3.1%.

⁴⁵ This issue will be dealt with in greater detail in the next section of this Chapter.

TABLE 21
FEATURES OF THE MERCOSUR/INDIA OFFERS

Preference margin	MERCOSUR Offers		India Offers	
	No. of Entries	Average CET	No. of Entries	Average Tariff
10	394	5.27	93	90.94
20	45	7.50	336	37.04
100	13	0	21	3.13
<i>Agreement Total</i>	<i>452</i>	<i>-</i>	<i>450</i>	<i>-</i>

Source: NEGINT/CNI based on information from the MERCOSUR/India Agreement, SECEX/MDIC and TRAINS/WITS.

Once verified that the scope of mutually granted concessions must be extended, a proposal for modalities to broaden the agreement was passed at the intrabloc meeting in late June. This includes a) the existing 10% and 30% preferences in the agreement being raised to 30% and 50% respectively, and b) the minimum preference margin of 20% to 50% of the tariff range would be granted via an exchange of lists of requests and an indication of priority interests, once the lists of offers have been defined.

The Indian government representatives' declarations during preparations for the meeting of the IBSA Cooperation Forum in Brasilia in late September 2006, lead one to believe that there is strong interest in strengthening the bonds of cooperation in such strategic sectors as energy, infrastructure, information technology and agriculture. There is not the same enthusiasm in extending the trade agreement.

- MERCOSUR/SACU -

The start of negotiations between MERCOSUR and the SACU was based on the talks headed by the Negotiating Commission of the MERCOSUR/South Africa Framework Agreement, signed on December 15, 2000, to set up a free trade area. In October 2003, the negotiations shifted to incorporate all members of the SACU (South Africa, Namibia, Botswana, Lesotho and Swaziland).

In December 2004, after three rounds of talks, a Fixed Tariff Preference Agreement was signed at the MERCOSUR Summit in Belo Horizonte. However, there are still issues over the reciprocity of the concessions pending resolution. The agreement therefore is still under negotiation and has not yet come into effect. As with the Agreement with India, MERCOSUR's legal protection for this kind of negotiation is provided by Article 27 of the 1980 Treaty of Montevideo.

Preferences were negotiated for trade in about 1,900 items, 958 of them granted by MERCOSUR under the MCN and 951 granted by the SACU under its nomenclature. The preference margins are 10%, 25%, 50% and 100%. In MERCOSUR's offer, almost the entire value of trade was granted with a 100% preference margin, although the CET average for these products is low, at 1.7%. The SACU's offer is similar: a considerable volume receives a 100% preference margin, but has low ad valorem tariffs.

TABLE 22
FEATURES OF THE OFFERS OF THE MERCOSUR/SACU AGREEMENT

MERCOSUR Offers			SACU Offers		
Preference Margin	No. of Entries	Average CET Tariff	Preference Margin	No. of Entries	Average SACU Tariff
Items with Ad Valorem Tariffs					
10	94	13.51	10	256	18.05
25	78	8.03	25	94	7.99
50	34	7.41	50	157	7.96
100	752	1.73	100	419	0.25
Articles with Specific Tariffs					
			25	9	
			50	4	
			100	12	
<i>Total</i>	<i>958</i>	<i>-</i>	<i>Total</i>	<i>951</i>	<i>-</i>

Source: NEGINT/CNI based information from the MERCOSUR/SACU Agreement, SECEX/MDIC and TRAINS/WITS.

In February 2006, during Argentina's presidency of MERCOSUR, the bloc agreed to send the SACU a proposal to continue the negotiation. The meeting was held in Pretoria on August 28–29 and included the debate of a extension package for the agreement, including products in automobiles, auto parts, textiles, fruits, juices, conserves and fish. Also under study are new preferences to be granted by the SACU exclusively to Paraguay and Uruguay in leathers, soya, dairy produce and meat.

- A Trilateral Free Trade Agreement -

The first meeting between MERCOSUR officials, the SACU and India was held on August 2–3, 2005, to study the possibility of signing a trilateral agreement which, on the initiative of MERCOSUR (Brazil), would include access to goods and services, and investment markets. The agreement, in principle over free trade, will cover 80% of trade.

At the start of 2006, MERCOSUR proposed the creation of a Working Group to explore modalities for the liberalization process. Over the IBSA Cooperation Forum in Brasilia in September, the Group will sit down to study the free trade negotiation. It must be recognized that the initiative will have difficulty in making progress in the short term. For more effective results, existing agreements must be intensified.

The Gulf Cooperation Council & Israel: Influences of the International Context

The Economic Cooperation Framework Agreement between MERCOSUR countries and the GCC, signed in May 2005, is the first step in constructing a mechanism promoting bilateral relations. Aiming to establish an atmosphere that favors the expansion of trade and investment, the agreement seeks (i) to intensify the exchange of information on foreign trade, (ii) to remove tariff and non-tariff barriers, (iii) to provide incentives for business relations, (iv) to promote training and technology transfer and (v) to boost capital flows by encouraging joint ventures and facilitating corporate investment in such areas as trade, agriculture and industry.

Although the agreement may bring about considerable opportunities for growth in MERCOSUR exports, the bloc's motivation to hold negotiations with the GCC is related to Brazil's policy of fostering

South/South dialog. It was no coincidence that the Framework Agreement was signed on the occasion of the South America/Arab Countries Summit, held in Brasilia on March 10–11, 2005.

The MERCOSUR presidents' Joint Official Statement of December 2005 ratifies the commitment to start free trade negotiations on access to goods and services, and investment markets. In a preparatory meeting in Riyadh in November that year, the countries had agreed to conclude negotiations in 2006.

The parties have set about drafting the initial lists of requests for goods and the initial offers of services and investments with the positive list format. A joint meeting was held on September 2–3, 2006, to evaluate MERCOSUR's methodological proposal for a free trade agreement. The proposal proposes the following elements: an eight-year timeframe for automatic exemption with an initial 10% preference margin in the first year, expanded by 10 percentage points until the sixth year, and by 20 percentage points in the last two years (10%, 20%, 30%, 40%, 50%, 60%, 80% and 100%).

Based on Israel's response to MERCOSUR's initiative of strengthening relations with GCC countries, the bloc also began trade negotiations with Israel. Both parties exchanged lists of requests and offers in the first half of 2006. The offers covered 90% of trade and were organized into baskets of immediate exemption, then in four, eight and ten years. The timeframe for the talks sought to shadow the MERCOSUR/GCC negotiations. Nevertheless, it is observed that, although the two initiatives aim to remove tariffs for a substantial part of trade, the methodologies proposed for tariff exemption are different.

Faced with the war in Lebanon, the MERCOSUR presidents signed a declaration at the Córdoba Summit expressing their concern over the situation in the Middle East. New understandings will have to wait until the conflict has been resolved.

Egypt & Morocco: Paralyzed Processes

The Framework Agreement MERCOSUR/Egypt, passed by Decision 16/04 of July 2004, was signed the same year. That agreement defined a two-stage negotiation: the signing of a fixed preference agreement and the subsequent negotiation of the free trade area.

In the Official Bulletin of October 29, 2004, the Brazilian government published Circular #68 of the Secretariat of Foreign Trade, informing that rounds of talks designed to establish a fixed tariff preference trade agreement will be held. The governments set about drawing up lists of interests that must incorporate the concept of reciprocity. By September 2006, the first round of talks had not yet been catered for.

In November 2004, during King Mohammed VI's visit to Brazil, the MERCOSUR/Morocco Framework Agreement was also signed, specifying the negotiation of a fixed preference agreement as a prerequisite for the negotiation of the free trade area.

As with Egypt, in its Official Bulletin of January 20, 2005, the Brazilian government published Circular #4 of the Secretariat of Foreign Trade, informing that rounds of talks will be held between MERCOSUR and Morocco, and setting in motion the consultations process regarding products of interest to the private sector, according to the concept of reciprocity. There have been no results from these negotiations since the launch of the initiative.

MERCOSUR/Canada: Hanging on the FTAA

The Canadian Prime Minister, Paul Martin, went to Brasília on a working visit on November 23, 2004, at the invitation of President Luiz Inácio Lula da Silva. The Joint Official Statement of the meeting states that the governments "agreed to promote the broadening of trade relations between MERCOSUR and Canada via negotiation of access to their respective markets in the areas of goods, services and investment, in the context of establishing a future Free Trade Area of the Americas."

The Canadian authorities were consistently reticent about signing a bilateral agreement in the framework of the FTAA negotiations. After meetings between both parties in the first half of 2005, representatives of the Canadian Executive announced they would try to obtain a mandate to start bilateral negotiations. On not obtaining such a mandate, both parties' representatives stated that talks would be renewed in 2006. There has to date been no such renewal.

MERCOSUR/Cuba: An Agreement Announced at the Córdoba Summit

All MERCOSUR countries maintained bilateral agreements with Cuba under Article 25 of the 1980 Treaty of Montevideo. This Article enables LAIA countries to sign agreements with other Latin American countries outside the Association. In November 1998, Cuba was accepted into the LAIA and became a full member as of August 26, 1999, after meeting the relevant legal requirements.

In July 2006, with Fidel Castro's appearance at the MERCOSUR Summit in Córdoba, Argentina, an ECA between MERCOSUR and Cuba was signed in the framework of the LAIA, establishing a trade liberalization program through the multilateralization of preferences effective in earlier bilateral agreements. The main features of the agreement are:

- *MERCOSUR Preferences*: multilateralization of preferences granted to Cuba by the MERCOSUR countries for a list of around 1,240 products.
- *Cuba Preferences*: multilateralization of preferences for 2,780 products granted to MERCOSUR countries by Cuba.
- *Timeframes*: 10 tariff liberalization timeframes, a 4-year timeframe for the full liberalization of customs duties with a 100% preference margin (PM), 2 3-year timeframes with a final PM of 90% and 80%, 4 2-year timeframes with a final PM of 75% to 60%, a one-year timeframe with a final PM of 50%, and 2 timeframes with a final PM of 35% and 33% in January 2007.
- *Origin Regime*: change of tariff classification or, if not feasible, the CIF value of materials not from the signatory countries may not exceed 50% of the end product's FOB value (60% in Paraguay's case).
- *Effectiveness*: coming into bilateral effect between countries notifying the LAIA of incorporation of the agreement in their domestic legal systems. The parties will be able to determine the temporary application of the agreement in accordance with their respective legislations.

MERCOSUR/Mexico: Progress in Bilateral Understandings

In July 2002, a Framework Agreement (ECA 54) was signed for the creation of a Free Trade Area between MERCOSUR and Mexico. According to the agreement's effectiveness clause, it should come into force on January 5, 2006.

Despite several expressions of interest from the Mexican authorities and certain MERCOSUR partners in promoting closer relations between Mexico and MERCOSUR (there has been a good deal of talk of Mexico's incorporation in the bloc), all the negotiating initiatives in recent years occurred in the sphere of bilateral instruments (Brazil/Mexico, Argentina/Mexico and Uruguay/Mexico).

Mexico and Uruguay already reached a free trade agreement covering a substantial part of trade between the two countries. ECA 60 was signed in November 2003 and put into effect by both parties in June 2004. The agreement is a sizeable exception for the MERCOSUR customs union, but Uruguay obtained the other partners' permission to sign the agreement.

In the first half of 2006, Mexico and Argentina signed an agreement extending ECA 6, already effective. The number of items included in the new agreement represents 18% of total trade between the two countries (AB INTRA [May 2006] #17). The preferences negotiated are divided into three categories for the total exemption of tariffs: immediate liberalization, after five years and after ten years.

In July 2002, ECA 53 was signed by Brazil and Mexico, establishing fixed preferences for some 800 items in the LAIA Tariff Nomenclature/Harmonized System (NALADI-SA: *Nomenclatura Arancelaria de la Asociación Latinoamericana de Integración-Sistema Armonizado*). The result of four years of negotiations between the two countries, the process of incorporating the agreement in internal rules was more protracted in Mexico than in Brazil. ECA 53 was incorporated in Brazilian legislation in September 2002, but in Mexico only in May 2003.

ECA 55, signed by MERCOSUR and Mexico in 2002, establishes the trade in automotive products and new goods included in NALADI-SA figures, with the respective descriptions: automobiles; vehicles weighing up to 8,845kg fully loaded (light commercial, engine chassis, cabs and coaches for these vehicles, engine and cab trucks and chassis weighing up to 8,845kg fully loaded); agricultural tractors, combine harvesters, self-propelled agricultural machinery and self-propelled road machinery; and auto parts for the production of vehicles in this paragraph, including those for the replacement market.

In August 2006, meetings to review these agreements were held in Brasilia. Mexico expressed interest in reviewing the Automotive Agreement (ECA 55) concerning negotiations on buses and trucks, whose preferences are to come into effect only in 2011. Brazil tabled the following proposal to extend the bilateral agreement, ECA 53:

- inclusion of the tariff range with a 30% linear preference;
- the higher preferences already benefiting ECA 53 products would be respected, and
- the products on LAIA's list of exceptions to Regional Tariff Preference (RTP) #4 (*PAR: Preferencia Arancelaria Regional*) would receive a 20% linear preference.

In recent years, the growth of Mexico as a destination for MERCOSUR exports has been attracting the bloc's interest in extending existing instruments. It is curious that this growing interest and the positive expressions of the Mexican government's representatives have not been enough to prompt negotiations to make possible the effective application of ECA 54, a Mexico/MERCOSUR free trade area.

Pakistan: The Most Recent Member on the List of Countries Negotiating with MERCOSUR

The Framework Trade Agreement between MERCOSUR and Pakistan was signed at the July 2006 MERCOSUR Summit in Córdoba, Argentina. It laid the foundations for the start of negotiations on preferential agreements progressively leading to a free trade agreement. The agreement establishes the

creation of a Negotiating Committee to exchange information on tariffs and market access conditions, and to establish criteria for the negotiation of a Free Trade Area. The agreement will come into effect 30 days after the countries' last notification of compliance with the internal legal formalities.

F. The Doha Round & its Potential Impact on MERCOSUR's Common External Tariff

The multilateral negotiations within the WTO constituted the main priority of Brazilian trade policy in the last two years.⁴⁶ This is reflected in MERCOSUR's agenda in two ways: first, it subordinates the regional negotiations which developed countries take part in to the evolution of multilateral negotiations and, second, it increases pressure on MERCOSUR countries to act in a more coordinated way in WTO forums.

Brazil's role as leader of the G-20 and representative of the Group in informal negotiations in the WTO - small groups that meet to resolve divergences- makes it more difficult for the country to move toward understandings with the EU, for example, in the framework of MERCOSUR/EU negotiations. With the concept of 'single packet' (the non-accumulation or dividing up of quotas) the EU clearly made the concessions in agriculture on the regional front depend on the effort for agricultural liberalization on the multilateral front. The conclusion of a regional agreement that may have an impact on Europe's capacity to offer multilateral access to agricultural products may affect the interests of other members of the G-20.

More important is the impact of the coordinated performance of MERCOSUR partners on the Round. MERCOSUR does not act as bloc in the WTO. In the special GMC meeting in December 2004, an ad hoc consultation and coordination group was set up for WTO negotiations over market access. If acting as a bloc is important in other areas, in issues that have a bearing on import tariffs, coordination is essential, as they must have repercussions for MERCOSUR's CET.⁴⁷

Although the group has held meetings, the performance in Geneva does not reflect this coordination yet, in particular in the talks on Non-Agricultural Market Access (NAMA). In agriculture, coordination is produced positively, as all MERCOSUR countries are now members of the G-20,⁴⁸ which states its position on behalf of all its members. But where NAMA is concerned, there is no group of interests in which the four countries participate. Only Argentina and Brazil have been acting in a coordinated manner. In 2005, the two countries tabled a joint proposal to India, known as the ABI formula and, more recently, they have been working in the area of NAMA-11, a group of countries tabling joint proposals in negotiations over industrial products. Paraguay and Uruguay are not members of the group. In services, there is no kind of coordination whatever, as the talks are about proposals by individual countries.

Although the Round has been interrupted, given the impossibility of reaching consensus over liberalization modalities in terms of agriculture and industrial products, it is important to look at what stage the negotiations stagnated and how far some of the issues being debated affect MERCOSUR.

⁴⁶ After the WTO Ministerial Meeting in Cancun and the creation of the G-20, Brazil was invited to take part in the small informal groups made up of the main WTO actors, aiming to table solutions to the major impasses in talks. The performance of the G-6, consisting of the United States, the EU, Japan, Australia, India and Brazil has lately been of note.

⁴⁷ It is important to mention that there are still some incongruities between the tariffs consolidated by the MERCOSUR countries in the WTO and the levels applied by the CET. One of the aims of the consultation group would be the drafting of a proposal to enable such incongruities to be removed as part of the implementation of the Round's commitments.

⁴⁸ Uruguay, which was not a founder member, joined the Group in March 2005.

Agriculture

The only concrete advance achieved in this matter was the setting of dates for the removal of export subsidies (2013) and the removal of export subsidies for cotton in 2006. In the other issues on the agricultural agenda deadlock persists. In summary, the Hong Kong Ministerial Declaration of December 2005, records the following situation:

- *Export Subsidies*: Progressive removal of export subsidies by the end of 2013, substantially complete by the end of the first half of the period of application up to 2010.
- *Internal Aid*: There will be three bands for reductions, with greater linear cuts in the higher bands. All the developing countries will be included in the lower band.
- *Market Access*: This is one of the most important issues of the Round for MERCOSUR. No decision regarding the treatment of sensitive products, special products and special safeguards has yet been reached –definitions that may directly affect MERCOSUR countries' offensive claims, focusing on a handful of products. An intense debate is underway over the average tariff reduction for agricultural products, an issue that remained a top priority until the suspension of the negotiations.
- *Cotton*: The developed countries will remove export subsidies for this product in 2006 and grant "tariff- and quota-free" treatment to exports from the Least Developed Countries (LDC). This issue directly affects four Central African countries unable to compete with US subsidies.

When the Round's negotiations were suspended in July 2006, the main conflicts centered on the scale of the reduction in the amount of internal aid for production and the tariff reduction for agricultural produce. The United States, which had tabled an offer to reduce internal subsidies (deemed inadequate by the G-20 and the EU), demanded more substantial cuts in the tariffs of European countries and G-20 members.

Industrial Products (NAMA)

The mandate defined in the Doha Ministerial Declaration in November 2001 establishes the Round's negotiations on industrial products, which will aim *"to reduce or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers, in particular on products of export interest to developing countries. Product coverage shall be comprehensive and without a priori exclusions. The negotiations shall take fully into account the special needs and interests of developing and least-developed country participants, including through less than full reciprocity in reduction commitments, in accordance with the relevant provisions of Article XXVIII bis of GATT 1994 and the provisions cited in paragraph 50 below."*

The Work Program passed in July 2004 stipulates that negotiations on industrial products include the following main elements: (i) the adoption of a non-linear formula to be applied on tariffs consolidated by the member countries in the WTO; (ii) the increased consolidation of tariff lines not yet consolidated; (iii) the use of flexibilities for the treatment of sensitive products from developing countries in the liberalization of industrial products (iv) the negotiation of sectoral agreements for tariff removal or harmonization, in particular regarding products whose export is of interest to developing countries.

The combination of these elements should determine the degree of opening resulting from the negotiations on industrial products. When talks were suspended in July 2006, the understandings in connection with these items converged to produce the following situation:

Formula: the adoption of a simple Swiss formula with two coefficients, one for developing countries, the other for developed countries.

$$\text{The Swiss Formula: } t_{\text{Swiss}} = \frac{\alpha \times a_{\text{Consolidated}}}{\alpha + a_{\text{Consolidated}}} \quad \alpha = 1, \dots, 8, \dots, 30, \dots$$

The formula introduces a non-linear correction into the tariff structure by encouraging larger reductions in the highest tariffs and smaller reductions in the lowest. The result is a more homogeneous tariff structure with less dispersion across tariffs. Once the formula was agreed, the debate centered on the definition of the coefficients to be applied. It is important to stress that the higher the coefficient, the lower the reduction obtained when applying the formula. Hence, two coefficients are adopted: a lower one for developed countries and a higher one for developing countries. The focus of debate has now shifted to the gap between the two coefficients.

Also important to stress is the fact that the formula will be applied on tariffs consolidated by the countries in the WTO. With very rare exceptions, the tariffs consolidated by MERCOSUR members in the WTO are quite a lot higher than the ones effectively applied by the individual partners (the CET with its national exceptions).⁴⁹ This means that part of the cut will not result in an effective tariff reduction, given the gap between applied and consolidated tariffs. For example, Brazil consolidated most of its tariff items at 35%, but effectively applies this level only in automobiles and footwear. In the original CET, the highest level envisaged is 20%, although Brazil and Argentina apply 35% due to the automotive regime.

Table 23 shows a simulation of the impact of application of the Swiss formula with several different coefficients in the parameters of the CET based on the tariff structure consolidated by Brazil in the WTO.

TABLE 23
MARKET ACCESS NEGOTIATIONS – NAMA
Summary of the Swiss Formula's Application to Brazil's Consolidated Tariff – Various Coefficients

Statistics	CET	Swiss Formula							
		Coefficients							
		8	10	15	20	23	25	30	35
Average	10.77	6.20	7.35	9.79	11.74	12.73	13.34	14.68	15.81
Trend	14.00	6.51	7.78	10.50	12.73	13.88	14.58	16.15	17.50
Medium	14.00	6.51	7.78	10.50	12.73	13.88	14.58	16.15	17.50
DP	6.77	0.66	0.84	1.27	1.67	1.90	2.04	2.38	2.68
Maximum	35.00	6.51	7.78	10.50	12.73	13.88	14.58	16.15	17.50
Minimum	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Average Tariff Reduction (%)		77.71	73.74	65.43	58.85	55.51	53.5	49.05	45.3
"Perforated" Items		6,059	6,005	5,456	4,933	4,933	3,413	2,450	2,297

Source: NEGINT/CNI based on MDIC information.

In general, the developed countries and many developing countries defend coefficients close to 15 for developing countries, while for the developed countries the coefficient is around 10. Brazil and Argentina hinted informally that they might accept a coefficient of 30 as the bottom threshold. In the days prior to the last meeting of the G-6 in Geneva, the Brazilian negotiators showed signs that they would be willing to accept a coefficient of 23 if there is an effective improvement in agricultural liberalization offers.

⁴⁹ Paraguay has lower consolidated tariffs than the other members.

A coefficient of 15 defended by many WTO countries would take the Brazilian tariff ceiling to 10.5% and the average tariff to 9.8%. In this case, there would be 5,456 "perforated" tariff items with an average reduction of 65.4%, indicating that a more far-reaching review of the CET is needed.

A coefficient of 23 mentioned by Brazilian negotiators at the latest talks seeking consensus in Geneva corresponds to a new tariff ceiling of 13.88% and an average tariff of 12.73%. The number of "perforated" products is 4,933, a figure identical to the one obtained by applying the coefficient 20. This is because, as the structure of the CET is organized in tariff levels varying from 2 in 2 percentage points, the setting of the maximum tariff at 13.88% would correspond in the CET to 12%, and the same would happen were a coefficient of 20 to be applied, taking the tariff ceiling to 12.73%, also corresponding to 12% in the CET.

This simulation, which should be replicated for the tariff structure consolidated by individual MERCOSUR partners in the WTO, gives an idea of the adjustments to the CET that will come out of the industrial product talks, if the Doha Round reaches a conclusion. Generally, the lower the coefficient defined, the greater the subsequent degree of opening and the more homogeneous the CET's structure.

- Flexibilities -

Flexibilities are escape mechanisms to resolve complexities in developing countries' sensitive products. They involve adopting different coefficients in calculating the tariff reduction formula, the possibility of a small percentage of products subject to reductions below those of the formula for example, and longer deadlines for compliance with commitments.

Flexibilities should incorporate two concepts: asymmetrical reciprocity (the developed countries have to make relatively more effort for opening) and special and differentiated treatment for developing countries (in positioning their sensitive products). Although the document does not define how asymmetrical reciprocity is to be incorporated, several countries have been advocating the adoption of two coefficients for the formula: a lower coefficient for developed countries and a higher one for developing countries, which will demand relatively greater liberalization efforts from the developed countries, as stated above.

If special and differentiated treatment are granted, developing countries will enjoy longer deadlines for compliance with tariff reduction commitments and will be able to apply lower reductions than those calculated by the formula for a small percentage of their tariff lines. Although the percentage remains to be defined, the latest document from the president of the NAMA negotiating group pointed to 10% of tariff lines that could be subject to lower reductions than established by the formula (at least, half the cut), providing these lines do not exceed 10% of the total value of the country's industrial imports. Alternatively, it could exceptionally maintain tariff lines without applying a cut on 5% of tariff lines, providing the quantity of products receiving such treatment does not exceed 5% of total industrial imports.

The decision over the products individual MERCOSUR members may include on their sensitive product lists will also require intrabloc coordination because, in order to respect the CET, the exempted products will receive equal treatment in all countries. It will certainly be a delicate negotiation. As is already become apparent on other negotiating fronts, sensitive products in the industrial sector vary enormously from one MERCOSUR partner to the next. As the total number of tariff lines may not exceed a certain percentage of the value of imports per country, the decision over which products are included on the list will have to overcome complex conflicts of interest between the partners.

- Sectoral Agreements -

The sectoral agreements for removing or harmonizing tariffs are considered one of the central modalities of the Round's process of tariff liberalization of industrial products. This modality has been the subject of heated debate, as some countries are absolutely set on obtaining the complete removal of tariffs for certain sectors of interest to them, while others are reluctant to accept binding participation in these initiatives. So as not to complicate the issue any further, it was resolved that countries' participation in such agreements will be voluntary, but it will be necessary to form a significant critical mass in terms of the number of participants for any sectoral agreement to be concluded.

Brazil and Argentina have been refusing to take part in the informal working groups established to assess the likelihood of negotiating agreements in certain sectors. To maintain the coherence with the CET, the eventual share of any MERCOSUR country in sectoral agreements should be coordinated with the other partners, otherwise, one of the partners will be agreeing to the reduction or removal of tariffs in a certain sector without these commitments being reflected in the CET.

- Other Issues -

As well as these tariff negotiation modalities, there are other topics on the table at the Round that will have repercussions for MERCOSUR's commitments. Among them should be mentioned the negotiation on the removal of tariffs on environmental goods. The very definition of environmental goods has provoked a prolonged debate, as the issue was included in the Doha Ministerial Declaration without a heading for the product category being made explicit. Some countries have already presented extensive product lists they feel qualify as environmental goods. Many of those products are dual-purpose, which means they are not used exclusively for environmental purposes. Argentina tabled a proposal for the definition of environmental goods to be clarified. The motion proposes that each country may remove import tariffs on goods used for the development of domestic environmental projects.

Another salient topic was the commitment adopted during the WTO Ministerial Meeting in Hong Kong, via which developed and developing countries able to join the program will grant free access or "*tariff- and quota-free*" treatment for all products originating from LDCs until 2008. In response to concerns regarding the competitiveness of specific products from these countries, there is a possibility that the granting country will exempt up to 3% of tariff lines. This commitment is not part of the Doha Round's 'single undertaking.' In other words, it will be adopted regardless of the outcome of global negotiations.

The Brazilian government announced that it intends to grant free access to the 32 LDCs belonging to the WTO and has already begun consultations with the private sector to define criteria, exceptions and rules of origin. The concession of such benefits should also be made in a coordinated way with MERCOSUR partners. If the other MERCOSUR members are not willing to participate in the initiative, Brazil will request a waiver from its MERCOSUR partners in order to apply the concessions unilaterally.

The Doha Round is the first multilateral negotiation since the implementation of customs union in MERCOSUR. However, even after the bloc was created, member countries continued to act individually in the WTO. Recently, they have attempted to establish some form of coordination, still at the very early stages. Significantly, the presentation of negotiating documents and the definition of negotiating positions continues to be conducted by national governments, with a reduced amount of coordination from the partners. More recently, a greater rapprochement of interests between Argentina and Brazil has facilitated greater coordination between the two countries in industrial product negotiations. The G-20 has also contributed toward a common framework for each country's role in the agriculture negotiations.

It is not still clear what the Round's outcome will be. During the G-20 Meeting in September 2006, in which the main actors in the negotiations took part, WTO Director General, Pascal Lamy, announced that negotiations will be renewed by March 2007 at the latest. Should the Round's negotiations effectively be restarted, it will be necessary to define specific tariff liberalization commitments that may be affected by several of the negotiation modalities. Intrabloc coordination will have to be intensified. That may also be an opportunity to correct currently existing discrepancies between the tariffs consolidated by each MERCOSUR country during the Uruguay Round.

G. Venezuela's Membership of MERCOSUR

The Protocol for the Bolivarian Republic of Venezuela's Membership of MERCOSUR was signed in Caracas on July 4. Negotiations for the Membership Protocol were brief. Venezuela formally applied for membership to MERCOSUR during the 15th Ibero-American Summit, held in Salamanca, Spain, on October 14–15, 2005. The Framework Agreement for Venezuela's membership of MERCOSUR was signed on December 8, 2005.

CMC Decision #28/05 of late 2005 ruled that, after unanimous approval of the application, the negotiation between the parties over the terms and conditions of membership should necessarily include:

- i. Adherence to the Treaty of Asunción, the Protocol of Ouro Preto and the Dispute Settlement Protocol of Olivos;
- ii. The adoption of the MERCOSUR Common External Tariff by defining a timeframe of convergence for its application;
- iii. Venezuela's adherence to ECA 18 and its Additional Protocols;
- iv. Adoption of MERCOSUR's regulatory legacy, including rules in the process of incorporation;
- v. Adoption of the international instruments signed in the framework of the Treaty of Asunción;
- vi. Definition of the modality of incorporation in the agreements signed by MERCOSUR with third countries or groups of countries, as well as participation in any ongoing external negotiations.

To perform these tasks an Ad Hoc Group was set up that, as of its first meeting set for May 2006 would have a period of 180 days, extendible for the same period, to present the results of the negotiations to the CMC. Analysts' expectations were that, even were the Group's tasks to be performed in exemplary fashion (flying in the face of MERCOSUR's experience regarding targets and deadlines), the process would not be concluded before mid-2007. The negotiators, however, found formulas to reduce the procedure and the Protocol was signed during the Presidential Summit in Buenos Aires in July 2006.

To join MERCOSUR, Venezuela would clearly need to pull out of the CAN, as this is also a customs union and the same country cannot be a member of two customs unions at the same time. Venezuela adopted this decision on April 22, 2006, arguing that the agreements signed by two CAN partners the, Peru and Colombia, were incompatible with MERCOSUR rules.

Through the Membership Protocol, Venezuela takes on the rights and obligations of the Treaty of Asunción, the Protocol of Ouro Preto and the Dispute Settlement Protocol of Olivos. The country will gradually adopt MERCOSUR's regulatory legacy, at the latest in four years as of the Protocol's entry into effect. Nevertheless, the Protocol stipulates that, as of its entry into effect, Venezuela will acquire the status of State Party and will share in all the rights and obligations of MERCOSUR.

Venezuela's adoption of the CET and the MCN will also be completed in a maximum term of four years as of the entry into effect of the Membership Protocol. The definition of the timeframe of CET application and its possible exceptions will be down to a Working Group created by Article 11 of the Protocol.

The definition of the deadlines for establishing free trade between MERCOSUR countries and Venezuela incorporates economic asymmetry criteria:

- *January 1, 2010*: Argentina and Brazil to Venezuela.
- *January 1, 2013*: Paraguay and Uruguay to Venezuela.
- *January 1, 2012*: Venezuela to MERCOSUR countries.

A more prolonged deadline is provided for exemption, extendible to 2014 for sensitive products. Also, Venezuela offers immediate exemption for the top products of Paraguay and Uruguay's exportable supply.

The definition of the timeframes for compliance with these deadlines is also down to the Working Group. The Protocol clearly states that the liberalization program will be applied on the total of tariffs and measures having equivalent effects with the exception of the provisions of the rules in force in MERCOSUR. During the period of transition, the Origin Regime envisaged in ECA 59 will be applied to trade with Venezuela. The rules and disciplines provided for by this ECA will cease to govern trade between the parties by January 1, 2014, at the latest.

The Protocol rules that, from its signature until its entry into effect, Venezuela will belong to the MERCOSUR Delegation negotiating with third countries. Regarding already negotiated external agreements, the Working Group will define the conditions and initiatives to be negotiated with third countries for the incorporation of Venezuela in these agreements.

The entry into effect of the Protocol requires it to be ratified by the Congresses of the five countries involved. The National Assembly of Venezuela did so in record time: the ratification of the Protocol was published on July 19, 2006, that is, just 15 days after it was signed. Although no difficulties are foreseen in the other countries' Parliaments, the instrument's entry into effect is likely to take some months longer.

Venezuela will enjoy the status of State Party as soon as the Protocol comes into effect, although, in the timeframes foreseen, the country will not be fully integrated in MERCOSUR's trade rules until 2014, when the rules of ECA 59 for trade with the current members of MERCOSUR expire.

In terms of MERCOSUR countries' trade interests, Venezuela's membership raises four important issues:

- i. The new member's economic and trade importance;
- ii. The impact on the conditions of market access to Venezuela;
- iii. The conditions of Venezuela's adherence to the MERCOSUR CET, and
- iv. Venezuela's influence on MERCOSUR's external agenda.

Venezuela: Economic Indicators

In 2004, Venezuela's GDP stood at US\$ 110.1 billion (current dollars) and its *per capita* GDP, US\$ 4,250 -higher than all current members of MERCOSUR. The country's membership of MERCOSUR represents a 14% rise in the bloc's total GDP and 11% in *per capita* GDP, based on the same year.

Foreign trade is 47.8% of Venezuela's GDP, mainly due to the high value of its exports, around US\$ 40 billion in 2004. Venezuela's external sales rose significantly in recent years due to the performance of its main export, petroleum. Its imports are more modest, US\$ 14.7 billion this year, well below Argentina's.

TABLE 24
ECONOMIC INDICATORS – MERCOSUR & VENEZUELA – 2004

Countries	GDP (Billions of US\$)	Per Capita GDP (US\$)	Population (Millions)	Exports (Millions of US\$ FOB)	Imports (Millions of US\$ CIF)	Trade/GDP (%)
Argentina	153.0	4,060	37.7	34,314	23,288	37.7
Brazil	603.8	3,325	181.6	96,475	62,782	26.4
Paraguay	7.0	1,219	5.7	1,626	2,658	61.6
Uruguay	13.3	3,903	3.4	2,931	3,114	45.6
Venezuela	110.1	4,235	26.1	37,987	14,688	47.8

Source: IMF, INDEC, SECEX, BCU, BCP AND PC-TAS.

The integration in MERCOSUR of a new member of the size of Venezuela has a moderate impact on the bloc's economic and trade profile. Although it has a higher *per capita* GDP than the MERCOSUR average, the value of its annual imports is not very significant. The most salient aspect in cost-benefit analyses of Venezuela's entry to MERCOSUR is the energy potential the country adds to the bloc.⁵⁰

A Profile of Venezuelan Trade Relations with MERCOSUR & the Rest of the World

Individual MERCOSUR members' trade with Venezuela is relatively insignificant. The bloc absorbed only 3.3% of Venezuelan world exports in the average for 2003–2004. This share was down on 1995–1996. Nor is Venezuela an important market in MERCOSUR countries' external sales (see Table 25).

Analysis of the origin of imports from these countries shows Venezuela is not a major supplier of MERCOSUR countries. Yet Brazil is a relatively important supplier of products to Venezuela, responsible for 7.7% of the country's imports, while Argentina's share is 1.9%, Paraguay's 0.6% and Uruguay's 0.2%.

TABLE 25
EXPORTS OF MERCOSUR COUNTRIES & VENEZUELA BY DESTINATION
In %

Destination Market	Argentina		Brazil		Paraguay		Uruguay		Venezuela	
	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004
United States	8.4	10.7	19.2	21.1	4.1	3.4	6.0	16.6	56.0	22.1
South America	45.2	34.9	20.8	19.3	66.5	60.9	55.4	32.5	16.6	4.8
Argentina	-	-	9.8	11.5	9.0	5.8	7.3		0.2	0.0
Brazil	27.0	15.8	-	-	47.5	25.7	18.6		5.8	0.6

⁵⁰ However, as Peña states [2006], cooperation on energy could develop without full membership of MERCOSUR.

TABLE 25 (Continued)

Destination Market	Argentina		Brazil		Paraguay		Uruguay		Venezuela	
	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004
Paraguay	2.7	1.4	2.8	0.9	-	-	2.0		0.0	0.0
Uruguay	3.1	1.9	1.7	0.6	3.9	24.2	-		0.1	0.0
Venezuela	1.6	0.9	1.0	1.2	1.8	0.5	0.7		-	-
Other Countries	10.8	15.0	5.6	5.1	4.3	4.6	3.8		10.5	4.1
Mexico	0.9	2.8	1.2	3.8	0.5	0.3	0.9	4.0	0.8	1.2
EU (25 Countries)	20.6	19.2	28.1	24.1	20.5	6.4	19.0	21.3	8.6	6.0
China	2.0	8.0	2.5	5.6	0.0	2.1	5.3	4.1	0.0	0.6
Other Countries	22.9	24.3	28.1	26.1	8.3	27.0	13.4	21.5	17.9	65.2
<i>Total</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>

Source: PC-TAS and FUNCEX.

Strangely, the United States' share in the destination of Venezuelan exports and in the origin of its imports is far higher than in the export and import baskets of MERCOSUR countries. Another striking feature the makeup of Venezuelan exports is their high degree of geographical diversification (see Table 26).

TABLE 26
IMPORTS OF MERCOSUR COUNTRIES & VENEZUELA BY ORIGIN
 In %

Origin Market	Argentina		Brazil		Paraguay		Uruguay		Venezuela	
	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004	1995/ 1996	2003/ 2004
United States	20.4	15.3	23.0	19.0	11.6	3.4	10.8	7.1	43.6	31.8
South America	27.9	38.8	19.0	15.5	48.2	52.7	48.2	47.6	18.0	25.0
Argentina	-	-	11.6	9.3	17.5	21.3	20.8	23.6	2.9	1.9
Brazil	21.6	33.0	-	-	26.5	27.6	23.2	21.2	3.9	7.7
Paraguay	0.7	1.8	1.0	0.7	-	-	0.6	0.5	0.7	0.6
Uruguay	1.3	1.0	1.8	0.9	1.5	2.0	-	-	0.2	0.2
Venezuela	0.4	0.1	1.8	0.5	0.2	0.3	1.4	0.0	-	-
Other Countries	3.9	2.8	2.8	4.1	2.5	1.6	2.2	2.3	10.4	14.6
Mexico	2.1	2.7	1.7	1.1	0.6	0.5	1.4	0.9	3.5	4.7
EU (25 Countries)	29.6	18.7	27.4	25.2	9.9	6.1	19.0	11.4	17.6	18.8
China	2.9	5.7	1.5	5.5	0.0	15.5	1.2	4.6	0.0	2.5
Other Countries	17.1	18.9	27.5	33.6	29.7	21.8	19.3	28.4	17.2	17.1
<i>Total</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>

Source: PC-TAS and FUNCEX.

Paraguay and Uruguay's trade with Venezuela is concentrated in a tiny handful products. Sales of cotton, soy and sunflower oils account for 94% of the total exported by Paraguay to Venezuela, while

Venezuela's sales to Paraguay almost 85% are concentrated in three products: unprocessed tobacco, artificial filament cables and synthetic or artificial fiber padding.

The main products exported by Uruguay to Venezuela are milk, cheese, inorganic tanning agents and beef. The top ten products exported by Uruguay to Venezuela account for 93.4% of total Uruguayan sales to the country, while herbicides represent 62% of Venezuelan sales to Uruguay. Other products imported by Uruguay from Venezuela are knives and razors, synthetic fiber padding, medications, ethylene glycol, insecticides, cast iron towers and derricks, and petroleum oils.

Argentina's trade to Venezuela is slightly more diversified. Ten products form 61% of total Argentinian exports to Venezuela, the highest values being in sales of powdered milk, soy oil and medications. Argentinian sales also include higher added value products such as automobile engine chassis. Venezuela's exports to Argentina are dominated by chemical and petrochemical products.

Trade relations between Brazil and Venezuela are the most diversified. The top ten products exported by Brazil to Venezuela are just 32% of the total, while Venezuela's top ten is 77% of the total value exported to Brazil. Brazilian sales are mainly in the automotive and capital goods sectors, but chicken and medications are also in the top ten. Brazilian imports are largely based on petroleum, urea, sardines, anhydrous ammonia and soft coals.

Though not very significant and highly concentrated, Venezuela's trade pattern with MERCOSUR countries is quite different from the five countries' trade relations with the rest of the world. The escalation of trade relations may bring about greater trade diversification for all involved.

TABLE 27
MAIN MERCOSUR PRODUCTS EXPORTED TO VENEZUELA
In Order of Value – 2003–2004 – Free-On-Board (FOB) Value – Millions of US\$

No.	S.A.	Description	Total Value (a)	% Share in (a)	To Venezuela		
					Value (b)	% Share	
						in (b)	in (a)
Argentina							
1	0402–21	Powdered, granulated or other solid forms of milk and cream with fat content below or equal to 1.5%.	271.2	0.8	50.5	17.9	0.2
2	1507–10	Untreated soy oil including degummed	2,115.9	6.6	33.3	11.8	0.1
3	3004–90	Other medications containing blended products for therapeutic or prophylactic ends, dosed or conditioned for retail	141.4	0.4	14.7	5.2	0.0
4	0202–30	Beef, deboned, frozen	286.9	0.9	13.8	4.9	0.0
5	7304–29	Other unsoldered iron piping for tubing, supply (gas or oil) or production	236.4	0.7	13.6	4.8	0.0
6	2709–00	Crude petroleum or bituminous mineral oils	2,277.2	7.1	12.0	4.3	0.0
7	1512–11	Untreated sunflower or safflower oil and fractions	495.2	1.6	11.9	4.2	0.0
8	0201–30	Beef, deboned, fresh or refrigerated	346.5	1.1	9.1	3.2	0.0
9	8706–00	Engine chassis for motor vehicles from items 8701 to 8705	9.0	0.0	7.4	2.6	0.0
10	0713–33	Common pulses, dry, wholegrain including peeled or split	81.2	0.3	5.7	2.0	0.0
Subtotal			6,260.8	19.6	172.0	61.0	0.5
Total			31,921.1	100.0	281.8	100.0	0.9
Brazil							
1	8703–23	Automobiles for personal transport, including multipurpose vehicles (station wagons) and racing cars with rotary piston engine and spark ignition, cylinder capacity > 1,500cm ³ and <= 3,000cm ³	2,356.2	2.8	60.8	5.9	0.1
2	8525–20	Transmitting equipment with in-built receiver for radiophony, radiotelegraphy, radio or television broadcasting	1,037.4	1.2	47	4.6	0.1
3	8708–99	Other parts and accessories for motor vehicles from items 8701 to 8705	668.6	0.8	40	3.9	0.0
4	8701–90	Other tractors	393.1	0.5	34.7	3.4	0.0
5	0207–12	Domestic species of poultry, uncut, frozen	709.5	0.8	32.3	3.1	0.0
6	7308–10	Bridges and iron or steel cast bridge parts	25.9	0.0	25.1	2.4	0.0
7	2106–90	Other food preparations	135.6	0.2	24.5	2.4	0.0
8	8433–59	Other harvesting machinery and equipment	178.4	0.2	24	2.3	0.0
9	8708–29	Other coach parts and accessories (including cabs) for motor vehicles from items 8701–8705	173.7	0.2	22.6	2.2	0.0
10	3004–90	Other medications containing blended products for therapeutic or prophylactic ends, dosed or conditioned for retail	163.1	0.2	19.9	1.9	0.0
Subtotal			5,841.5	7.0	331.0	32.2	0.4
Total			84,030.2	100.0	1,029.3	100.0	1.2

TABLE 27 (Continued)

No.	S.A.	Description	Total Value (a)	% Share in (a)	To Venezuela		
					Value (b)	% Share	
						in (b)	in (a)
Paraguay							
1	5201-00	Unteased and uncarded cotton	91.5	6.4	3.3	44.2	0.2
2	1507-10	Untreated soy oil including degummed	94.5	6.6	2.3	30.2	0.2
3	1507-90	Soy oil and fractions, including refined, but chemically unaltered	2.1	0.1	0.8	10.6	0.1
4	1512-11	Untreated sunflower or safflower oil and fractions	6.8	0.5	0.7	8.9	0.0
5	2402-20	Cigarettes containing tobacco	14.3	1.0	0.1	1.7	0.0
6	1515-40	Tung oil and fractions including refined, but chemically unaltered	3.8	0.3	0.1	1.4	0.0
7	3004-90	Other medications containing blended products for therapeutic or prophylactic ends, dosed or conditioned for retail	7.4	0.5	0.1	1.1	0.0
8	6109-90	T-shirts and undershirts, knitted and other materials	1.2	0.1	0.1	0.8	0.0
9	1108-19	Other starches and feculæ	0.1	0.0	0.0	0.4	0.0
10	4412-19	Other plywood sheeting <= 6mm thick	1.4	0.1	0.0	0.3	0.0
Subtotal			223.1	15.6	-	7.5	99.7
Total			1,428.9	100.0	-	7.6	100.0
Uruguay							
1	0402-21	Powdered, granulated or other solid forms of milk and cream with fat content below or equal to 1.5%.	42.6	1.7	11.2	63.4	0,4
2	0406-90	Other cheeses	46.6	1.8	3.3	18.3	0,1
3	3202-90	Inorganic tanning products, tanning preparations, enzymatic preparations for pretanning	4.7	0.2	0.4	2.2	0.0
4	0202-30	Beef, deboned, frozen	349.4	13.7	0.3	1.7	0.0
5	3923-30	Canisters (demijohns), bottles, jars and similar plastic items	40.6	1.6	0.3	1.6	0.0
6	2833-23	Chromium sulfate	7.4	0.3	0.3	1.4	0.0
7	3920-42	Sheets, plates, leaves, strips, coatings of vinyl chloride polymers, flexible, unsupported and unreinforced	7.6	0.3	0.2	1.4	0.0
8	8421-21	Water filtering or purifying apparatus	0.6	0.0	0.2	1.4	0.0
9	3808-40	Disinfectants	1.9	0.1	0.2	1.1	0.0
10	4104-31	Other bovine and equine leathers and hides, full grain and split full grain	197.2	7.7	0.2	0.9	0.0
Subtotal			698.6	27.4	16.6	93.4	0.6
Total			2,550.7	100.0	17.7	100.0	0.7

Source: FUNCEX based on PC-TAS data.

TABLE 28
MAIN MERCOSUR PRODUCTS IMPORTED FROM VENEZUELA
In Order of Value – 2003–2004

					To Venezuela		
No.	S.A.	Description	Total Value (a)	% Share in (a)	Value (b)	% Share	
						in (b)	in (a)
Argentina							
1	2710–00	Petroleum or bituminous mineral oils, excluding crude oils and preparations	244.1	1.3	4.4	20.9	0.0
2	2712–90	Microcrystalline petroleum wax, "slack wax," ozokerite, other mineral waxes and similar products	9.8	0.1	4.4	20.8	0.0
3	2713–11	Uncalcined petroleum coke	1.8	0	1.8	8.7	0.0
4	2905–31	Ethylene glycol (ethynodiol)	65.8	0.4	1.5	6.9	0.0
5	7616–99	Other aluminum products	10.7	0.1	1.3	6.3	0.0
6	2849–20	Silicon carbide, chemically defined or otherwise	2.1	0	1.3	6.1	0.0
7	2503–00	Sulfur of any kind, except sublimated, precipitated or colloidal sulfur	8.7	0	1.3	6.0	0.0
8	8207–19	Common metal multipurpose equipment for perforation or drilling tools, including parts	9.1	0	0.7	3.4	0.0
9	8212–10	Common metal knives and razors	21.7	0.1	0.7	3.1	0.0
10	2811–22	Silicon dioxide	5.4	0	0.5	2.2	0.0
Subtotal			379.2	2	17.9	84.4	0.1
Total			18,551.3	100	21.2	100	0.1
Brazil							
1	2710–00	Petroleum or bituminous mineral oils, excluding crude oils and preparations	2,064.9	3.6	97.7	36.7	0.2
2	3102–10	Urea, including aqueous solutions	332.6	0.6	19.4	7.3	0.0
3	0303–71	Sardines, sardinettes and sprats, frozen, excluding livers, roe and milt, or fillets and other meats from item 0304	23.6	0.0	16.7	6.3	0.0
4	2701–19	Other soft coals, including powdered, but unagglomerated	678.6	1.2	15.1	5.7	0.0
5	2814–10	Anhydrous ammonia	64.4	0.1	13.2	5.0	0.0
6	2713–11	Uncalcined petroleum coke	75.7	0.1	11.3	4.2	0.0
7	2701–12	Unagglomerated bituminous coal	170.7	0.3	9.5	3.6	0.0
8	7614–10	Uninsulated steel-cored aluminum, cables, plaited bands and similar items for electrical use	11.5	0.0	8.8	3.3	0.0
9	7005–10	Float glass, with absorbent layer, reflecting or in sheets or plates	19.9	0.0	8.6	3.2	0.0
10	7602–00	Scrap and waste aluminum	17.8	0.0	4.6	1.7	0.0
Subtotal			3,459.8	6.0	204.9	77.0	0.4
Total			58,064.8	100	266.2	100	0.5

TABLE 28 (Continued)

No.	S.A.	Description	Total Value (a)	% Share in (a)	To Venezuela		
					Value (b)	% Share	
						in (b)	in (a)
Paraguay							
1	2401-20	Unprocessed tobacco, total or partially denerved	23.2	1.5	1.3	30.1	0.1
2	5502-00	Artificial filament cables	8.8	0.6	1.2	27.7	0.1
3	5601-22	Textile padding, other synthetic or artificial fiber padding	1.6	0.1	1.1	26.6	0.1
4	4011-10	New rubber tires of the type used in passenger transport motor vehicles	12.6	0.8	0.2	5.7	0.0
5	4010-21	Endless trapezoidal cross-section vulcanized rubber drive belt, circumference > 60cm and = < 180cm	0.6	0.0	0.1	1.9	0.0
6	8544-19	Other insulated threads for reeling for electrical use	0.1	0.0	0.1	1.9	0.0
7	7614-90	Uninsulated steel-cored aluminum, cables, plaited bands and similar items for electrical use	0.2	0.0	0.1	1.8	0.0
8	4101-29	Other bovine raw hides, fresh or salted (wet)	0.1	0.0	0.1	1.8	0.0
9	7005-21	Other colored metal float glass, opacified, plated, or rough, in sheets or plates	0.3	0.0	0.1	1.3	0.0
10	8201-30	Common metal hoes, picks, weeding hoes, rakes and scrapers	0.2	0.0	0.0	0.8	0.0
Subtotal			47.6	3.1	4.2	99.5	0.3
Total			1,536.4	100.0	4.3	100.0	0.3
Uruguay							
1	3808-30	Herbicides, germination inhibitors and plant growth regulators	26.2	1.0	0.8	62.3	0.0
2	8212-10	Common metal knives and razors	1.6	0.1	0.2	12.5	0.0
3	5601-22	Textile padding, other synthetic or artificial fiber padding	0.4	0.0	0.1	8.2	0.0
4	3004-90	Other medications containing blended products for therapeutic or prophylactic ends, dosed or conditioned for retail	35.7	1.4	0.1	7.2	0.0
5	2905-31	Ethylene glycol (ethynodiol)	0.3	0.0	0.1	4.8	0.0
6	3808-10	Insecticides	10.1	0.4	0.0	3.6	0.0
7	7308-20	Cast Iron or steel towers and derricks	2.1	0.1	0.0	1.1	0.0
8	2710-00	Petroleum or bituminous mineral oils, excluding crude oils and preparations	81.9	3.1	0.0	0.3	0.0
9	0101-11	Thoroughbred stud horses	0.3	0.0	0.0	0.0	0.0
10	0101-19	Other live horses	0.1	0.0	0.0	0.0	0.0
Subtotal			158.6	6.0	1.3	100.0	0.0
Total			2,630.1	100.0	1.3	100.0	0.0

Source: FUNCEX based on PC-TAS data.

Opportunities for Trade Growth

To identify the opportunities for trade growth after Venezuela's entry into MERCOSUR, a product selection exercise was performed, for which the Trade Complementarity Index (TCI) was used as the prime criterion. The indicator seeks to determine the existence of complementarity in trade flows between countries. It is calculated on the basis of comparative advantage indexes for the exporting country and comparative disadvantage indexes for the importing country.⁵¹

Usually, there is deemed to be complementarity in the trade of a certain product when the TCI is higher than one, indicating that there is specialization in trade of the product. For the selection of products made here, products with comparative advantage indexes in the exporting country and/or comparative disadvantage in the importing country of less than one were also removed.⁵²

As the purpose of the exercise is to identify products whose trade may rise significantly with Venezuela's incorporation in MERCOSUR, products whose purchases in the importing country were below US\$ 1 million were also removed, as were those for which the market share of the exporting country was higher than 20% in the reference period, the average for 2003–2004. These cross-section criteria aimed to remove products for which the importing market is not very significant in terms of value, and those in which the exporter already has a high share and which do not represent unexplored opportunities.

Lastly, products whose nominal import tariffs are below 10% of the importing market were removed.⁵³ This criterion was designed to remove products already having reduced tariffs, for which the rise in preferences resulting from Venezuela's integration in free trade with MERCOSUR will not involve a significant difference in terms of increased market access.

The results of this exercise are recorded in Table 29. Argentina is the country with the highest number of export opportunities to Venezuela, followed closely by Brazil. Strangely, in individual MERCOSUR countries' bilateral trade with Venezuela, the number of opportunities for MERCOSUR partners is substantially higher than for the new partner (Table 30).

The selected products for the MERCOSUR country group are highly varied. Products include those from the agricultural and agribusiness sectors, textiles, footwear, paper and cardboard, chemicals, steel, capital goods, auto parts and automobiles. The 46 products selected as opportunities for Venezuela are mainly in the steel, aluminum and chemical sectors. It should be pointed out that among the products identified as opportunities for MERCOSUR countries in Venezuela are sugar and automobiles, the two sectors that continue to be exempted in MERCOSUR.⁵⁴

⁵¹ TCI – Trade Complementarity Index

$$C_{ij}^s = \frac{X_i^s / X_i * M_j^s / M_j}{M_W^s}$$

Where s is the sector; i is the exporting country and j the importer; W is the world; X represents exports and M imports. For reasons of incompatibility of classifications, we have used OECD and Chinese imports as a proxy for world imports.

⁵² The use of this additional criterion was aimed at removing products that could have $TCI > 1$, but did not display comparative advantages in the exporting country or comparative disadvantages in the importing country.

⁵³ It is important to note that all the products already have some trade preference negotiated in the old LAIA agreements and, therefore, the tariffs effectively applied in trade between the MERCOSUR countries and Venezuela are lower than the nominal tariffs.

⁵⁴ The sugar and alcohol sectors are also exempted in Venezuela's offer to the MERCOSUR in line with ECA 59.

TABLE 29
MERCOSUR/VENEZUELA TRADE COMPLEMENTARITY
Products selected by TCI, Import Value & Tariff Level

MERCOSUR Countries	No. of Products in Selection	TCI (MERCOSUR) Venezuela										
		Exports from MERCOSUR Countries			Imports from Venezuela							
					Total			Originating in MERCOSUR Countries				
		Total (Millions of US\$)	Selection (Millions of US\$)	% Share	Worth (Millions of US\$)	Selection (Millions of US\$)	% Share	Total (Millions of US\$)	Selection (Millions of US\$)	% Share	Market Share	
											% Total	% Selection
Argentina	109	31,921	8,820	27.6	11,521	1,628	14.1	217	46	21.0	1.9	2.8
Brazil	103	84,030	9,367	11.1	11,521	1,223	10.6	891	54	6.0	7.7	4.4
Paraguay	35	1,429	353	24.7	11,521	756	6.6	71	3	3.9	0.6	0.4
Uruguay	58	2,551	753	29.5	11,521	675	5.9	22	3	13.0	0.2	0.4
<i>Total *</i>	224	119,931	19,293	16.1	11,521	2,640	22.9	1,200	105	8.8	10.4	4.0

Note: * Product considered only once.

Sources: FUNCEX based on PC-TAS for 2003–2004 average.

TABLE 30
MERCOSUR/VENEZUELA TRADE COMPLEMENTARITY
Products selected by TCI, Import Value & Tariff Level

MERCOSUR Countries	No. of Products in Selection	TCI Venezuela (MERCOSUR)										
		Exports from Venezuela			Imports from MERCOSUR countries							
					Total			Originating in Venezuela				
		Total (Millions of US\$)	Selection (Millions of US\$)	% Share	Worth (Millions of US\$)	Selection (Millions of US\$)	% Share	Total (Millions of US\$)	Selection (Millions of US\$)	% Share	Market Share	
											% Total	% Selection
Argentina	25	31,475	264	0.8	18,565	254	1.4	21	4.1	19.2	0.1	1.6
Brazil	18	31,475	273	0.9	58,068	321	0.6	266	5.6	2.1	0.5	1.7
Paraguay	12	31,475	235	0.7	2,363	25	1.1	7	0.2	3.1	0.3	0.8
Uruguay	11	31,475	259	0.8	2,631	30	1.1	1.3	0.2	13.6	0.0	0.6
<i>Total *</i>	46	31,475	546	1.7	81,628	630	0.8	296	10.0	3.4	0.4	1.6

Note: * Product considered only once.

Sources: FUNCEX based on PC-TAS for 2003–2004 average.

Venezuela's main competitors in MERCOSUR markets for the selected products are Brazil and Argentina, and the United States, Germany, China and Russia. As regards the Venezuelan market, the largest suppliers in the selected products are the United States, Brazil and Colombia. Venezuela therefore is up against the competitors of the two largest MERCOSUR partners in its exports to the bloc. This means that it will be competing, largely, with suppliers that are also the beneficiaries of free trade preferences. On the other hand, MERCOSUR partners face Brazilian competition to sell Venezuela the products they are competitive in, indicating that the preferences will not make any great difference.

Impacts on Market Access Conditions

The evaluation of the benefits resulting from trade expansion after Venezuela's full incorporation in MERCOSUR requires identification of the tariff treatment conferred on countries in accordance with trade agreements currently in force. Trade relations between MERCOSUR and Venezuela are governed by the December 2003 Agreement between MERCOSUR and the CAN (ECA 59). The agreement is characterized by high operational complexity and its central element is a Trade Liberalization Program that will, after various bilaterally negotiated periods of transition, lead to the removal of tariffs and other customs duties.

The Program takes into account the asymmetries between the signatory countries through 67 different timeframes for tariff exemption. The liberalization program between Brazil and Venezuela, for example, includes the following timeframes:

- Immediate exemption applicable to both countries.
- Four general timeframes, 4 years (Brazil grants preferences to Venezuela) as against 6 years (Venezuela to Brazil) and 8 years (Brazil to Venezuela) as against 12 (Venezuela to Brazil).
- Two timeframes for products of the Historical Heritage (preferences effective in previous bilateral agreements), maximum 6-year terms (granted by Brazil) as against 10 years (granted by Venezuela). The deadlines for exemption depend on the item preference margin: the greater this margin, the shorter the deadline for exemption of the residual tariff.
- Three timeframes for sensitive products with or without Historical Heritage, 15 years as against 15 years, but with different timing.

It is worth mentioning that a significant portion of MERCOSUR exports to Venezuela will not benefit from free trade under the provisions of ECA 59. Limitations on liberalization are associated with three types of restrictions: (i) those excluding a group of products from the trade liberalization program (exceptions for products from the sugar and alcohol sectors) and those limiting preference margins until the Origin Regime is renegotiated; (ii) the quantitative limits and partial liberalization of products associated with the Andean price stabilization mechanism,⁵⁵ and (iii) quantitative limits contained in Appendix 3.9 of ECA 59. The scope of these restrictions can be gauged by its impact on Venezuela's offer to Argentina. With these restrictions, Venezuela will offer free access to only 50% of Argentinian exports (Rozemberg & Saslavsky [2006]).

Another element that complicates the agreement's operability is the negotiation of "observations." As the negotiations are held within NALADI/SA, the LAIA traditionally allows different preference margins for certain detailed product specifications to be defined. This involves indicating different timeframes (initial deadlines and preference margins) for products with different specifications, but a single tariff code.

Table 31 presents an overview of the final terms for total liberalization envisaged in ECA 59 for the products identified as trade opportunities on the basis of the exercises performed. Although the timeframes for adaptation to the terms established in the Protocol have not yet been defined, it is possible to evaluate the benefits achieved in terms of the final deadline for total liberalization. Considering the deadlines set for free trade in Venezuela's MERCOSUR Membership Protocol, there is a four-year advantage in the liberalization of sensitive products, which is moved from 2018 to 2014. For other products, the benefits in terms of deadlines are not as significant.

⁵⁵ Known as the Andean Price Band System, this mechanism establishes the application of a variable tariff, on top of the fixed tariff, and fluctuating with variation in international prices. ECA 59 preferences are only applied on the tariff's fixed component.

TABLE 31
PROJECTION OF TARIFF RELIEF FOR SELECTED PRODUCTS – ECA 59
Number of products with 100% preference margin

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela			
	Venezuela				Argentina	Brazil	Paraguay	Uruguay
2006	2	4	3	15	4	4	0	0
2007	0	14	0	0	0	0	0	0
2008	6	25	0	0	0	0	0	0
2009	4	3	0	0	2	2	0	0
2010	20	0	0	0	0	1	0	0
2011	6	52	0	0	2	2	0	0
2012	0	0	0	0	2	1	0	0
2013	61	0	0	0	1	3	11	0
2015	4	0	13	30	10	3	0	9
2016	0	1	0	0	0	0	0	0
2017	0	1	0	0	0	0	0	0
2018	13	4	19	15	6	2	1	2
<i>Total</i>	<i>116</i>	<i>104</i>	<i>35</i>	<i>60</i>	<i>27</i>	<i>18</i>	<i>12</i>	<i>11</i>

Source: FUNCEX based on SII/LAIA data.

The bringing forward of the timeframe's produces generates relatively more significant benefits for Paraguay and Uruguay. More than half of the products identified as opportunities for Paraguay in Venezuela were classed as sensitive in the ECA 59 timeframes and their full liberalization was envisaged only for 2018.⁵⁶ Similarly, 13 other products of interest to Paraguay have a deadline of 2015 in previous timeframes. In Uruguay's case, exemption of half the products identified as opportunities is envisaged by 2015 and another 25% by 2018. As the deadline offered by Venezuela to MERCOSUR countries is 2012, there will be at least a three-year overlap in the liberalization of non-sensitive products.

For Argentina, the greatest benefits will consist of bringing forward the deadlines for sensitive products. There are 13 relevant products in terms of the opportunities classed in this category by ECA 59. Most of the products of interest to Argentina have a 2013 deadline in the timeframe. These would gain one year at least. For Brazil the benefits seem less significant, as among the sensitive products there are few opportunities for the country in Venezuela.

Venezuela will benefit from the bringing forward of complete liberalization for most products of interest to it in trade with individual MERCOSUR partners. The most relevant advantages will be in trade with Argentina, as this country and Brazil have undertaken to bring liberalization forward to 2010.

Although bringing forward the timeframes will bring benefits, it is important to remember that most of the selected products already have significant preference margins. Bringing forward the deadlines will produce relatively modest benefits in market access conditions. This means that, although there are opportunities for trade expansion, Venezuela's membership of MERCOSUR does not represent significant change in market access conditions for all those involved, given the current preferences, the liberalization deadlines already negotiated in ECA 59 and the new deadlines defined in the Membership Protocol. More

⁵⁶ The total number of products considered as opportunities for each country presented in the synoptic chart is slightly different from the one in Table 29. This is due to the need to convert the classification of products to the NALADI/SA, a nomenclature in which the ECA 59 concessions were negotiated.

substantial benefits may be obtained from removal of the exceptions to full liberalization and of the price band system currently applied by Venezuela in its trade with MERCOSUR countries.

Venezuela's Adherence to the CET

In accordance with the Membership Protocol, Venezuela will have a four-year term to adopt the MERCOSUR CET and the Working Group created will be responsible for defining the convergence timeframe and any possible exceptions.

If the basic parameters of the tariff structures of MERCOSUR and Venezuela are compared, there are no significant differences in aggregate terms between the two tariffs:

TABLE 32
TARIFF STRUCTURES COMPARED – MERCOSUR & VENEZUELA

Country / Parameter	MERCOSUR	Venezuela
Average Tariff	10.7	12
Modal Tariff	14.0	5
Maximum Tariff	35.0	35

Source: *Avaliação da estrutura arancelaria brasileira*, CNI. October 2005.

With the exception of the modal tariff, a parameter highly susceptible to small differences in the number of products subject to a given tariff, the average and maximum tariffs are very close.

Nor are the differences significant when the average tariffs charged by MERCOSUR and Venezuela are analyzed by product use category:

- The average protection in MERCOSUR for capital goods is 2 percentage points higher than that applied by Venezuela. Moreover, the averages calculated for this product category do not take into consideration MERCOSUR's Capital Goods Exemption Regime nor the so-called *ex-tariff* regimes (tariff duties reduced by the import of capital goods not produced in the region).
- Average tariffs for durable consumer items are 17% in both blocs.
- For non-durable consumer goods, the average protection in Venezuela is 4 percentage points higher than MERCOSUR.
- For fuels and lubricants, Venezuela has higher protection than MERCOSUR, at 5 percentage points.
- For raw materials and intermediate products, the average tariffs are fairly close.

TABLE 33
AVERAGE TARIFFS COMPARED BY CATEGORY OF USE – MERCOSUR & VENEZUELA

Countries	Capital Goods	Consumer Goods		Fuels & Lubricants	Raw Materials & Industrial Products
		Durables	Non-Durables		
MERCOSUR	12	17	14	2	9
Venezuela	10	17	18	7	10

Source: *Avaliação da estrutura arancelaria brasileira*, CNI. October 2005.

Comparison of tariff averages by chapter of the Harmonized System (HS) reveals a more complex picture. Of the 96 chapters of the HS:

- Just 44 chapters exhibit differences of below 2 percentage points between the average tariffs in Venezuela and MERCOSUR. Only in three chapters do the averages coincide.
- For 24 chapters, the differences between the average tariffs are between 2 and 4 percentage points.
- For 14 chapters, the differences are between 4 and 6 percentage points.
- For 9 chapters, the differences are between 6 and 8 percentage points.
- For 5 chapters, the differences are over 8 percentage points, with a 10.6 percentage point maximum.

Venezuela's adherence to the CET will produce a reduction in average tariffs for 58 chapters and an increase for 34 chapters. In general terms, the widest gaps occur in agricultural products, woods, fuels, basketwork manufacture and stone, for which MERCOSUR has lower tariffs than Venezuela. On the other hand, MERCOSUR's tariffs are substantially higher than Venezuela's in products in the automotive sector, shipbuilding, optical instruments, clocks and musical instruments, capital goods and others.

Therefore, although the general features of MERCOSUR and Venezuela's tariff structures may be reasonably convergent, there are significant differences when they are analyzed on a more disaggregated level. This will demand reasonable effort from Venezuela to adapt to the CET, particularly in labor-intensive agricultural and manufactured products, where its sensitive products are concentrated.

The convergence process will have to raise the preference margins that industrial products exported by MERCOSUR will have to have to enter the Venezuelan market, as the new partner will have to raise tariffs on various products in the industrial sector. This process will especially benefit Brazilian exports concentrated in these products. There will have to be a reduction of protection in Venezuela for agricultural and agribusiness products.

TABLE 34
MERCOSUR & VENEZUELA: TARIFF STRUCTURES COMPARED ACCORDING TO CHAPTERS

Band	MS < Venezuela		MS = Venezuela		MS > Venezuela	
	Chapter		Chapter		Chapter	
< 2	17	Sugars & Candies	57	Carpeting, Rugs & Other Textile Coverings	22	Beverages, Alcoholic Liquids & Vinegars
	18	Cacao & Cocoa Preparations	61	Clothing & Accessories	32	Tanning & Dyeing Extracts, Dyes
	21	Various Foodstuff Preparations	62	Clothing & Accessories, Knitwear	33	Essential Oils & Resinoids, etc.
	24	Tobacco & Manufactured Substitutes			36	Gunpowders, Explosives, Matches etc.
	25	Salt, Sulfur, Earth & Stone; Plaster, Lime			38	Various Chemical Products
	28	Inorganic Chemical Products			40	Rubber & Rubber Products
	29	Organic Chemical Products			41	Hides (not including Furs) & Leathers
	30	Pharmaceutical Products			42	Leather Products, Travel Items, Bags
	45	Cork & Cork Products			56	Paddings, Felts & Non-Knitted Fabrics, etc.
	48	Paper & Cardboard, Paper or Cardboard Cellulose Pulp Products			59	Coated & Impregnated Fabrics
	50	Silk			64	Footwear, Leggings & Similar Articles & their Parts

TABLE 34 (Continued)

Band	MS < Venezuela		MS = Venezuela		MS > Venezuela	
	Chapter		Chapter		Chapter	
< 2	52	Cotton			65	Hats, Other Headgear & their Parts
	54	Synthetic or Artificial Filaments			66	Umbrellas, Parasols, Canes
	55	Discontinuous Synthetic or Artificial Fibers			74	Copper & Copper Products
	58	Special Fabrics, Lace, Upholstery			78	Lead & Lead Products
	63	Other Manufactured Textile Items			80	Tin & Tin Products
	70	Glass & Glass Products			83	Various Common Metal Products
	73	Iron & Steel Smelting Products			85	Electrical Machinery, Apparatus, Material & Parts, etc.
	76	Aluminum & Aluminum Products			96	Various Manufactured Products
	81	Other Common Metals & Metal Products				
	94	Medical & Surgical Furniture & Furnishings				
	95	Toys, Games, Recreational & Sporting Items				
2-4	5	Animal-Based Products not Expressed Elsewhere			35	Albuminoid Materials, Glues & Enzymes
	9	Coffee, Tea, Yerba Maté & Spices			37	Photographic & Cinematographic Products
	13	Rubbers, Resins & Other Juices & Plant Extracts			72	Iron & Steel Smelting
	19	Cereal, Flour, Starch, Fecula & Milk-Based Preparations			79	Zinc & Zinc Products
	26	Ores, Slag & Ash			82	Tools & Utensils, Cutlery Items
	31	Manures & Fertilizers			84	Nuclear Reactors, Boilers & Machines, Mechanical Apparatus & Instruments
	34	Soaps, Artificial Waxes, etc.			93	Weapons & Ammunition, Weapon Parts & Accessories
	39	Plastics & Plastic Products				
	47	Wood Pulp or Pulp of Other Cellulosic Fibrous Material, Paper or Cardboard				
	49	Books, Newspapers & Graphic Printed Matter				
	51	Wool, Yarns & Spun Textiles				
	53	Other Plant Textile Fibers				
	60	Knitted Fabrics				
	67	Treated Feathers & Down & F Feather & Down Products				
	69	Ceramic Products				
	71	Pearls, Precious Stones, etc. & Related Products, Coins				
	88	Aircraft & Other Aerospace Apparatus				
4-6	1	Livestock			43	Furs & Fur Products, Artificial Furs
	4	Milk & Dairy Produce, Eggs, Poultry, Honey, etc.			75	Nickel & Nickel Products
	6	Horticultural & Floricultural Products			86	Vehicles & Roadway Materials
	7	Garden Produce, Plants, Root Vegetables, etc.			90	Optical, Photographic, etc. Instruments & Apparatus
	8	Fruits, Citrus Rinds & Melons				

TABLE 34 (Continued)

Band	MS < Venezuela		MS = Venezuela		MS > Venezuela	
	Chapter		Chapter		Chapter	
4–6	12	Seeds & oleaginous fruit, grain, etc.				
	14	Braidable Matter & Other Plant-Based Products				
	16	Meat, Fish, etc. Preparations				
	20	Vegetable, Fruit & Other Plant-Based Preparations				
	44	Wood, Charcoal & Wood Products				
6–8	10	Cereals		87	Motor Vehicles, Tractors, Cycles	
	15	Animal & Plant Fats, Oils & Waxes		89	Ships & Floating Structures	
	23	Food Industry Residues & Scraps, Animal Feed				
	27	Mineral Fuels, Mineral Oils & Refined Products, Bituminous Materials				
	46	Wickerwork or Basketry Products				
	68	Stone, Plaster, Cement, Asbestos, Mica or Similar Material Products				
	97	Art Objects or Collectors Items, Antiques				
≥ 8	2	Meats & Edible Scraps		91	Clockmaking Apparatus & Parts	
	3	Fish & Crustaceans, Mollusks, etc.		92	Musical Instruments, Parts & Accessories.	
	11	Milling Industry Products, Malt				

Source: CNI. *Adhesión da Venezuela al MERCOSUR*, CNI. December 2005.

Venezuela's Influence on MERCOSUR's External Agenda

One of the main concerns expressed by the business sector over Venezuela's entry into MERCOSUR is to do with its influence on the bloc's external agenda. According to the National Confederation of Industry (CNI: *Confederação Nacional da Indústria*), which acts as a forum for Brazil's industrial sector, "*The Brazilian private sector's immediate concerns are over the third question: Venezuela's influence on the MERCOSUR external agenda. On signing the Membership Protocol, Venezuela will become part of the MERCOSUR delegation negotiating with other countries and blocs. Thus, without observing a transition period, Venezuela may have a say in such decisions as the construction of the bloc's negotiating agendas with the United States and the EU. And the private sector's economic interests with these partners are major, as the profile itself of Brazil's foreign trade shows*" (CNI, Informa MERCOSUL #392).

Regardless of the rhetoric and priorities of the governments' foreign policy, the convergence of Venezuela's trade interests with MERCOSUR countries can, among others, be gauged by the indicators for main export destinations and tariff protection structure. The first indicator reveals priorities regarding countries that are candidates for taking priority positions on the external agenda. The second is aimed at convergence difficulties in the negotiating positions on the various fronts.

Table 25 reveals that the United States plays an important role in Venezuelan exports, with a share higher than for MERCOSUR countries. The EU, on the other hand, is not a very important destination for Venezuela, compared to its importance for Paraguay's exports. Mexico and China were not important for Venezuelan exports in the period observed. Furthermore, the "other countries" category absorbs 65% of Venezuela's external sales, while representing less than 30% of exports of all MERCOSUR countries.

There is therefore coincidence in the importance of the United States as a trading partner, although this fact is not reflected in Venezuela or MERCOSUR's current trade policy agendas. Convergence regarding other countries or blocs is minor, which may indicate difficulties ahead when it comes to defining the priorities of MERCOSUR's foreign trade agenda, including its new partner.

The import tariff generally reflects the countries' competitiveness conditions and the sensitive areas of the productive structure. The highest tariffs are thus attributed to the most sensitive products, while lower tariffs give less protection to the most competitive products. Venezuela's tariff structure reveals that the country is more sensitive in products from the agricultural and agribusiness sectors, and intermediate products -precisely the sectors making up the bulk of MERCOSUR's comparative advantages and over which the bloc adopts more offensive strategies in its external negotiations.

Venezuela's participation in negotiations with the EU will be an important test of MERCOSUR's ability to coordinate, including the new member. MERCOSUR's main objective in its negotiations with the EU is the liberalization of agricultural and agribusiness products. Among the considerations being demanded by the Europeans is the full liberalization of certain highly protected agricultural products in Venezuela.

Hence, the priorities of MERCOSUR and Venezuela's foreign policies aside, their foreign trade and productive structures display significant differences. This suggests that the coordination of trade policies demanded of member countries in a customs union may be no trivial matter.

H. Conclusions

MERCOSUR's external negotiating agenda in the late 1990s and early part of the current decade acted as a force for cohesion within the bloc. While the partners were confronting the challenges of macroeconomic crisis and difficulty in making progress in the internal agenda, external negotiations represented an element of union, where consensus building was relatively easy.

The tensions arising between MERCOSUR partners in recent years have also been reflected in the priorities of the external negotiating agenda. They first appeared in the tabling of offers lists at the FTAA and EU negotiations, and recently in the debate over the bloc's international positioning strategies.

MERCOSUR's external agenda has been characterized by a high degree of activism regarding the number of negotiating initiatives considered, in contrast to the modest results in terms of the number and relevance of the agreements signed. Since 2003, only three agreements have been concluded, of which only those relating to trade with Andean countries have come into effect.

The FTAA negotiations have been at a standstill since 2004 and, despite efforts to make the understandings with the EU happen, it has not been possible to conclude the agreement. The negotiating space with the United States and the EU then shifted to the multilateral environment of the Doha Round. Due to difficulties in furthering regional negotiations with developed countries, the bloc has embarked upon establishing negotiations with developing countries, which in some cases have generated rather underwhelming agreements in terms of new access to markets or, in others, have had no continuity.

Faced with a lack of substantive progress, divergences between MERCOSUR partners are growing about the bloc's foreign trade policy. These divergences are stimulated by the smaller partners' verification that MERCOSUR has not been helping their exports to expand or their economies to grow.

In early September 2006, the Uruguayan president, Tabaré Vázquez, in his letter to the other MERCOSUR presidents, via the president of Brazil, defended the need to "seek alternatives and flexibilities to

compensate for the asymmetries harming Uruguay." As well as demanding advances in the implementation of free circulation of goods between MERCOSUR countries and review of the levels of the CET, the Uruguayan president urged a "restarting of external negotiations via their flexibilization through the incorporation of bilateralities, either in the framework of joint negotiations or by permitting individual negotiations."

Venezuela's membership of MERCOSUR will certainly make coordinating the bloc's trade policies more of challenge. Venezuela's productive structure and foreign trade are significantly different to the current members', and this will certainly have an impact on its trade policy preferences.

The divergences over the implementation of the external agenda will bring a total rethink of the integration model best suited to the needs of individual MERCOSUR partners. Considering the range of issues mentioned by Vásquez, the ensuing debate may also affect the priorities of the internal agenda.

TABLE A1
GROSS DOMESTIC PRODUCT
 Real Variation -%

Year	Argentina	Brazil	Paraguay	Uruguay
2004	9.0	4.9	4.1	11.8
2005	9.2	2.3	2.9	6.6
2006 ^P	8.0	3.1	3.5	7.2

Notes: (P) Projections.

The data for Paraguay may not coincide with earlier reports due to changes in national accounts.

Source: MECON, BCRA, BCB, BCU, BCP and ECLAC.

TABLE A2
AVERAGE ANNUAL GROWTH RATES OF GDP & SPENDING COMPONENTS
& PRODUCT ELASTICITY BY COUNTRY
 In % & Rate

Country/Bloc	1998–2002	2003–2005	PRODUCT Elasticity
MERCOSUR*			
GROSS Domestic Product at Market Prices	-1.2	5.5	
Total Consumption	-2.1	4.3	-
Gross Internal Capital Formation	-7.7	14.1	-
Exports of Goods & Services	1.7	10.3	-
Imports of Goods & Services	-7.9	14.6	-
Argentina			
GROSS Domestic Product at Market Prices	-3.1	9.0	
Total Consumption	-3.2	7.9	0.88
Gross Internal Capital Formation	-13.0	28.1	3.11
Exports of Goods & Services	3.6	9.3	1.03
Imports of Goods & Services	-13.4	32.7	3.62
Brazil			
GROSS Domestic Product at Market Prices	1.7	2.6	
Total Consumption	0.3	1.0	0.39
Gross Internal Capital Formation	1.2	4.5	1.76
Exports of Goods & Services	8.5	12.9	4.98
Imports of Goods & Services	-3.0	7.4	2.86

⁵⁷ The projections were prepared by ECLAC or correspond to average market expectations researched by the Central Banks.

TABLE A2 (Continued)

Country/Bloc	1998–2002	2003–2005	PRODUCT Elasticity
Paraguay			
GROSS Domestic Product at Market Prices	-0.4	3.6	
Total Consumption	-2.5	3.8	1.06
Gross Internal Capital Formation	-8.1	6.9	1.91
Exports of Goods & Services	-1.1	3.0	0.81
Imports of Goods & Services	-8.4	4.8	1.32
Uruguay			
GROSS Domestic Product at Market Prices	-2.8	6.9	
Total Consumption	-2.8	4.6	0.67
Gross Internal Capital Formation	-10.9	16.7	2.44
Exports of Goods & Services	-4	16.2	2.36
Imports of Goods & Services	-6.6	13.7	2

Note: * Simple Average.

Source: Author's, based on ECLAC data.

TABLE A3
FIXED INTERNAL GROSS INVESTMENT
 As % of GDP – At Constant Prices – %

Year	Argentina	Brazil	Paraguay	Uruguay
2003	14.6	21.9	18.4	11.2
2004	17.3	23.2	19.8	12.2
2005	18.2	23.0	19.4	12.6

Source: MECON, BCB, BCU and ECLAC.

TABLE A4
BALANCE OF PAYMENTS CURRENT ACCOUNT
 Balance as % of GDP

Year	Argentina	Brazil	Paraguay	Uruguay
2004	2.3	1.8	0.8	0.3
2005	3.2	1.7	-2.0	0.0
2006 ^P	2.9	1.2	-2.1	-1.6

Notes: Argentina's current account surplus during 2005 is not comparable with 2004, as it incorporates the results of the exchange of the public debt in suspension of payments. If this effect is eliminated, the corrected estimate shows a slight decline in 2004–2005.

(P) Projections.

Source: MECON-DNCI, BCB-DEPEC, BCU, BCP; the 2006 projection is from ECLAC.

TABLE A5
RETAIL INFLATION

Year-on-Year Variation in Consumer Price Index in December Each Year – %

Year	Argentina	Brazil	Paraguay	Uruguay
2004	6.1	7.6	2.8	7.6
2005	12.3	5.7	9.8	4.9
2006 ^P	9.8	3.0	8.8	6.9

Note: (P) Projections.

Source: INDEC, IBGE, INE, BCP and BLS.

TABLE A6
EFFECTIVE REAL EXCHANGE RATE
Indexes 200 = 100

Year	Argentina	Brazil	Paraguay	Uruguay
2004	214.9	124.6	108.3	151.8
2005	215.4	101.5	118.7	137.0
2006 ^P	220.7	90.5	111.2	136.3

Notes: Decreases/increases are expressed as falls/rises in the index.

(P) Projections.

Source: ECLAC.

TABLE A7
PER CAPITA GDP
In US\$ at Market Exchange Rate

Year	Argentina	Brazil	Paraguay	Uruguay
2004	4,060	3,325	1,219	3,903
2005	4,799	4,320	1,288	5,274
2006 ^P	5,745	5,177	1,460	5,810

Note: (P) Projections.

Source: IMF.

TABLE A8
UNEMPLOYMENT RATE
As % of the Economically Active Population

Year	Argentina (1)		Brazil (4)	Paraguay (5)	Uruguay (5)
	(2)	(3)			
2004	13.6	18.1	11.5	10.0	13.1
2005	11.6	14.8	9.8	7.6	12.2
2006–1st Half	10.9	13.5	10.1	N/D	11.7

Notes: (1) Urban areas.

(2) The beneficiaries of employment schemes rendering services in return are considered to be employed.

(3) Beneficiaries of social schemes are considered to be unemployed.

(4) Six metropolitan areas.

(5) Urban total.

Sources: INDEC, IBGE, INE and ECLAC.

ANNEX II.

PRODUCTS INVOLVED IN TRADE DISPUTES

Since its creation, MERCOSUR has had difficulties relating to trade in certain "sensitive" products in the bilateral exchange between Brazil and Argentina. Tensions grew considerably from 1999 as a result of the devaluation of the real, an event that generated a fear among Argentinians of cheap Brazilian products "invading" their market. Tensions did not lessen after the devaluation of the Argentinian peso in January 2002, when the government adopted a firmer stance in defense of national production. The idea was that Argentina had undergone deep deindustrialization during the 1990s and its productive fabric needed to be reconstructed.

In this scenario, Brazil posed a threat for two basic reasons: it was a major exporter of manufactured products, not just to Argentina but to the rest of the world, and was beginning to show signs of high export dynamism as a result of structural adjustments introduced in the latter half of the 1990s. These were reflected in growing trade surpluses.

The temptation to minimize sectoral tensions led to the creation of the Argentina/Brazil Bilateral Trade Monitoring Commission (*Comisión de Monitoreo del Comercio Bilateral Argentina-Brasil*) in October 2003, whose objective was to monitor the evolution of bilateral trade in sensitive products and formulate recommendations geared to finetune it and make it more evenly balanced. In practice, this Commission has acted as a forum for discussion of trade restrictions between the two countries -more often than not, at Argentina's request- and has tried to promote a rapprochement between the two countries producers associations in order for private sectoral trade administration agreements to be forged.

By mid-2006, the Commission had 17 products under observation. Five of these products -paper, TV sets, denim fabric, car batteries (included in the automotive regime) and dairy produce- were governed by some kind of existing agreement at the time. In the remaining 12 products, one kind of recent agreement or another had been reached by the two private sectors, but these agreements were by that time without effect: footwear, refrigerators, gas stoves, washing machines, air conditioning unit parts, acrylic yarns, CNG cylinders, carpeting and rugs, cotton fabrics, corduroys, wines and wood paneling. Some products investigated by the Commission but recently excluded include porcines, cotton yarns, toweling, combine harvesters and rice.

Two products not currently under investigation by the Commission may be added to the list of disputes: wooden closets, a dumping inquiry into which has just been instigated at Argentina's request, and the wheat and wheat flour.

It should be pointed out that trade friction between the two countries has been easing recently due to the real's appreciation against the peso, the clear slowing of Brazilian exports to its neighbor and the relative success of certain earlier sectoral agreements. Indeed, the current concern of both countries' industrial sectors has shifted mainly to China, whose products have been rapidly gaining ground in both markets.

The analysis below highlights the most important of the aforementioned products, to present an overview of the current scenario of bilateral disputes. Tables A9 and A10 give data on the evolution of bilateral trade flow in the individual products analyzed, namely, the country's market share in its neighbor's total imports, the total value of its neighbor's imports and the share of exports to its neighbor in the country's total exports for 2004, 2005 and the first half of 2006.

A. Argentinian Restrictions on Brazilian Exports

Footwear

In 2004 the Argentinian Footwear Industry Chamber (*CIC: Cámara de la Industria del Calzado*) began negotiations with the Brazilian Footwear Industry Association (*ABICALÇADOS: Associação Brasileira das Indústrias de Calçados*). It was decided that Brazilian sales would be restricted that year to between 12 and 13 million pairs –significantly less than the 15.3 million pairs exported in 2003. An import quota of 12.9 million was established for 2005 and of almost 6.5 million for the first half of 2006. The quotas agreed were exceeded in both 2004 and 2005.

The agreement expired on June 30, 2006, and Brazil requested the definitive removal of the quotas. This was not accepted by Argentina. Brazil argues that the restriction caused trade diversion, especially in favor of China and other Asian countries. Indeed, Brazil's share in Argentina's imports did fall from 77.9% in 2004 to 68.8% in 2005 and 56.1% in the first half of 2006 (Table A9).

At present, negotiations seem to be aimed at establishing new quotas for the near future and Argentina has resorted to new forms of pressure, such as the introduction of a Footwear Import Certificate (*Certificado de Importación de Calzados*) in August 2006. This measure surprised Brazilian producers, who expected it to affect only products from other countries.

Refrigerators, Gas Stoves & Washing Machines

The macroeconomic crisis that befell Argentina in 2001–2002 deepened existing productive asymmetries with Brazil. Shrinkage of the Argentinian market meant that the major transnationals preferred to concentrate production of these goods in Brazil, turning the country into the regional supplier. This meant closing their factories in Argentina. In addition, the drop in purchasing power made Argentinians start buying Brazilian products, which were cheaper than their competitors' from more developed countries. This produced a significant increase in Brazil's market share.

In this context, faced with the Argentinian threat to establish non-tariff restrictions, the two private sectors negotiated agreements in 2004 involving voluntary restrictions on Brazilian exports, with a quota regime until early 2006. Naturally, the Argentinian authorities have expressed their intention to renew it, and there is already consent from the Brazilian private sector, which prefers such agreements to unilateral non-tariff restrictions. In the meantime, there is uneasiness among Brazilian producers about the trade diversion. Table A9 shows that is in fact what happened with washing machines (Brazil's market share falling from 70.2% in 2004 to 67.5% in the first half of 2006) and gas stoves (from 93.6% in 2004 to 88% in 2006).

In the case of refrigerators, where no trade diversion was recorded, the representatives of the two countries' private sectors established a provisional quota agreement, valid from July to September 2006, and decided that Brazil could hold a 50% share of the Argentinian market, while local production would keep 47% and third countries 3%. If the share of third countries should exceed 3%, Brazil could raise its exports by the same number of units. For 2006, the set quota was 316,250 units. No new agreement has so far been reached over gas stoves and washing machines, so there are currently no restrictions in place.

TV Sets

Argentina began an inquiry into safeguards in July 2004, establishing a provisional duty involving a 21% surcharge on Brazilian products from the Manaus Free Trade Zone. This provisional duty remained in

force until early 2005, when the inquiry was closed, and a quantitative restriction of 100,000 units was set in 2005. It was decided that the quota for 2006 and 2007 would go respectively to 9% and 10% of total TV set imports in the previous year. The quota for 2006 is 160,800 units.

The data in Table A9 show that, despite the quotas, Brazil's market share in Argentinian TV set imports has been increasing (50% in the first half of 2006). Argentina, on the other hand, is the destination for 76% of Brazilian television exports.

Textiles

The two countries have trade monitoring agreements in the following product categories: denim, cotton fabrics, carpeting and rugs, acrylic yarns, corduroy-type fabrics and toweling, the latter recently incorporated in 2005. Negotiations began in the second half of 2003, but deadlock was only broken when the Argentinian government decided to impose non-automatic import licensing, which led the two private sectors to close the agreements.

The first agreement was for denim, a product where virtually all Argentina's imports come from Brazil. The agreement is effective as of 2004 and is characterized by a fixed quota regime, by virtue of which a maximum of 15.8 million linear meters has been set for 2005 and 18 million for 2006, divided into quarterly quotas. The quota has not so far been respected, being exceeded by 32.7% in 2005 and 34.7% in the first half of 2006. Another important provision in the agreement stipulates that third country imports may not represent more than 1.5% of Argentina's total imports.

In the case of acrylic yarns, there was a verbal agreement for export floor prices from 2004 (US\$ 3.76 per kg) that ran until December 2005 and was observed by Brazil. Although there was no agreement in force over the first months of 2006, Brazil's export prices remained above the floor price, despite some claims from Brazilian producers to the effect that third countries were selling at very low prices. The Brazilians have been insisting the Argentinian government reinforce the price controls applied for third countries. At first, the Brazilian market share in Argentina's imports fell from 79.1% in 2004 to 65.8% in 2005, but climbed back to 73.7% in the first half of 2006.

Where corduroy is concerned, an agreement ran until the start of 2006, establishing both a quantitative restriction and a floor price for Brazilian exports. A memorandum of understanding signed in December 2004 anticipates the division of the Argentinian market between local enterprises, Brazilian enterprises and third country suppliers. Third countries nevertheless continue to gain ground in the Argentinian market, due to the lack of application of price controls. The Brazilian market share was 58.22% in 2004 and fell to just 26.4% in the first half of 2006.

There was also an agreement for cotton fabrics, setting import quotas for 2004 and 2005. Argentinian business suggested a quota for 2006 that envisages no growth on 2005. The proposal was not accepted by Brazil. By September 2006, no agreement had been reached. The Brazilian Association of the Textile & Apparel Industry (AITTG: *Associação Brasileira da Indústria Têxtil e de Confecção*) argues that third country imports have grown faster and that any new agreement would require stricter control of these imports if it was to avoid trade deviation. Table A9, however, shows that the Brazilian market share has remained relatively stable, at between 87% and 88%.

As regards carpeting and rugs, Argentina applies an import tariff on Brazilian products, arguing non-compliance with rules of origin. Since then, both countries' business sectors have been holding negotiations that include setting both an export floor price and the adoption of quotas. No agreement has been reached, though Argentina's total imports are fairly insignificant, at just US\$ 200,000 in the first half of 2006.

Paper

There is a voluntary restraint agreement on Brazilian exports signed by both countries' private sectors, effective from September 1999 until 2007. Quotas are set quarterly on the basis of the evolution of Argentina's apparent national consumption. The total quota set in 2005 was 31,214 tonnes. The quota for the first quarter of 2006 was 8,776 tonnes. In the past, it is Brazil that has supplied virtually all Argentina's imports of this product.

Wooden Closets

On June 12, 2006 the Argentinian government began a dumping inquiry into closets produced in Brazil. If the inquiry's findings are positive, the product is also very likely to be subject to restrictions between the two countries' companies. Table A9 shows Argentinian imports remaining relatively stable in recent years at around US\$ 8 million, with Brazil providing more than 97% of the total.

Air Conditioning Unit Parts & CNG Cylinders

These products are under negotiation. No agreement is in sight, however.

B. Brazilian Restrictions on Argentinian Exports

Wines

There is a clear competitive asymmetry in favor of Argentina, the scale of whose production is very much higher than Brazil's. This is aided, among other things, by the climate and the country's reasonably low *per capita* consumption. By mid-2005 both countries' producers reached an agreement that set a floor price for Argentinian exports of US\$ 8 per box of 12 750cc bottles. The agreement expired in January 2006 and there have been no applications to renew it. Argentina's market share in Brazilian imports was 24.2% in 2005, falling to 19.6% in the first six months of 2006 (Table A10).

Powdered Milk

Brazil originally began an inquiry into dumping. There is a current standby price agreement negotiated by the private sector, in force to 2007. The Argentinian market share in Brazilian imports had fallen from 69% in 2004 to 63.1% in 2005, but climbed back up to 72.1% in June 2006.

Wood Paneling

There was a quantitative restriction agreement on Argentinian exports, effective to December 2005. The agreement set a limit of 180,000m³ for 2005 for MDF wainscoting, 36,000m³ for chipboards and 48,000m³ for low-pressure chipboards. Argentinian sales were well within the limit in all cases and the agreement has not been renewed. Argentina supplies Brazil with over 90% of its imports.

Wheat & Wheat Flour

The restriction on Argentinian exports of wheat and wheat flour was imposed by the Argentinian government itself via the levying of a 20% export tax. The basic idea was to tax the product in order to restrict external sales and thus limit any price rises resulting from devaluation of the peso. This tax caused damage to Brazilian flourmills, as they began acquiring Argentina's raw material at higher costs, putting them at a disadvantage to Argentinian mills.

Nevertheless, the Brazilian government imposed no restrictions or compensatory measures, but restricted itself to establishing clearer, more rigid rules to differentiate wheat flour (which, long with the wheat itself, pays 20% export tax) from premixed wheat (which pays just 5% tax). Currently, the claims are coming from the Argentinian side in reaction to the actions Brazil's Federal Revenue and Customs Administration (*Secretaria de Receita Federal*), which has since August been demanding laboratory tests be carried out before goods are given clearance, alleging that Argentinian exporters are selling wheat flour as premixed wheat. This measure is delaying the clearance of goods in customs and damaging Argentinian exporters.

Table A10 shows that Brazilian imports are much more significant in wheat and premixed wheat, and much lower for wheat flour. Also, Argentina's market share in the first two products is over 90%. In terms of flour, its share fell from 25.7% in 2004 to just 2.1% in the first half of 2006

C. Conclusions

Analysis of the products caught up in trade disputes between Argentina and Brazil demonstrated that there are still a good number of products that are subject to trade restrictions due to the existence of agreements concluded between the countries' private sectors. However, there is currently a trend to reduce this friction due to various factors, such as the appreciation of the real against the peso and both countries' growing concern over competition from China.

TABLE A9
ARGENTINA: THE TRADE SITUATION & EVOLUTION IN THE MAIN PRODUCTS INVOLVED IN DISPUTES WITH BRAZIL

Product	Situation		Brazilian Market Share in Argentinian Imports (%)			Total Argentinian Imports (US\$ millions)			Argentinian Share in Brazilian Exports (%)		
	To Start of 2006	Current	2004	2005	2006 ^{1stH}	2004	2005	2006 ^{1stH}	2004	2005	2006 ^{1stH}
Footwear	Quotas	Under negotiation	77.9	68.8	56.1	136.8	173.2	103.8	5.9	6.4	6.4
Refrigerators	Quotas	Brazilian share limited to 50% of Argentinian market	84.4	86.8	87.9	64.3	86.2	43.9	22.7	30.2	33.5
Gas Stoves	Quotas	Under negotiation	93.6	92.9	88.0	11.2	14.2	9.3	10.8	12.0	16.0
Washing Machines	Quotas	Under negotiation	70.2	71.9	67.5	34.6	37.2	19.4	58.2	57.8	65.1
TV Sets	Quotas	Quotas to 2007	21.3	23.8	50.0	46.7	10.6	31.5	46.7	68.8	76.0
Denim Fabrics	Quotas	Quotas	99.1	99.6	99.1	30.4	36.1	23.9	23.7	29.3	38.6
Acrylic Yarns	Floor prices	Free	79.1	65.8	73.7	28.4	35.8	14.7	94.4	94.8	98.7
Corduroys	Floor Prices & Quotas	Free	58.2	46.7	26.4	12.9	18.5	11.2	73.4	73.5	60.2
Cotton Fabrics	Quotas	Under negotiation	87.3	87.2	88.8	12.2	18.1	9.9	30.3	51.2	56.9
Carpeting & Rugs	Argentina applies import tariffs	Argentina applies import tariffs; under negotiation by private sectors	14.5	5.6	0.6	0.4	0.2	0.2	60.0	15.4	17.9
Paper	Quotas since 1999	Quotas	97.0	98.4	97.1	15.9	29.0	15.2	4.1	6.7	7.0
Wood Closets	Free	Dumping inquiry pending	98.8	98.1	97.5	8.1	8.0	4.2	2.6	2.5	3.0

Sources: SECEX/MDIC, CNI, INTAL and Abeceb.com.

TABLE A10
BRAZIL: THE TRADE SITUATION & EVOLUTION IN THE MAIN PRODUCTS INVOLVED IN DISPUTES WITH ARGENTINA

Product	Situation		Brazilian Market Share in Argentinian Imports (%)			Total Brazilian Imports (US\$ millions)			Brazilian Share in Argentinian Exports (%)		
	To Start of 2006	Current	2004	2005	2006 ^{1stH}	2004	2005	2006 ^{1stH}	2004	2005	2006 ^{1stH}
Wines	Floor prices	Free	22.2	24.2	19.6	89.7	101.6	52.4	8.8	8.1	6.3
Powdered Milk	Floor prices	Floor prices	69.0	63.1	72.1	49.6	74.6	39.9	8.6	11.7	12.9
Wood Paneling	Quotas	Free	94.7	94.9	92.3	46.7	44.7	30.0	39.7	35.1	41.4
Wheat	20% export tax	20% export tax	95.8	90.9	90.5	741.1	659.8	442.8	51.6	46.5	62.4
Wheat Flour	20% export tax	20% export tax	25.7	13.5	2.1	8.0	6.0	3.0	39.6	54.8	26.7
Premixed Wheat	5% export tax	Receita Federal demands laboratory tests	98,8	99.0	98.5	40.2	44.9	28.2	53.9	58.0	60.9

Sources: SECEX/MDIC, CNI, INTAL and Abeceb.com

ANNEX III. OTHER IMPORTANT RULES PASSED IN JULY 2005–JULY 2006

Below are some important institutional rules passed between July 2005 and July 2006.

A. MERCOSUR Institutional Reform

In the second half of 2004 during Brazil's pro tempore presidency, an attempt was made to table an institutional review of MERCOSUR. "Ouro Preto II" as it was known, did not prosper (INTAL [2005] pp. 71–74).

In December 2005, the CMC passed Decision #21/05 on the Institutional Reform of MERCOSUR. Among its considering clauses, the Decision invokes Article 47 of the Protocol of Ouro Preto ("*When they consider it opportune, the States Parties shall convene a diplomatic conference for the purpose of reviewing the institutional structure of Mercosur established by the present Protocol and the specific functions of each of its organs.*"). This Decision provides for the formation of a High Level Ad Hoc Group (*Grupo Ad Hoc de Alto Nivel*) to draft a comprehensive proposal for institutional reform in MERCOSUR to be tabled before the GMC no later than December 2006. The Group is authorized to request the support of the MS, although, strictly speaking, the MS had tabled its suggestions at the previous attempt at institutional reform.

In line with the MS's proposal, the considering clauses of the rule seem to suggest that the review should not be restricted solely to the institutional dimension of MERCOSUR and may include other matters such as cohesion policy (FOCEM) and expansion policy (Associated States and states in the process of joining).

B. The MERCOSUR Parliament

In 2003, the MERCOSUR presidents agreed to establish a MERCOSUR Parliament and commissioned the Joint Parliamentary Commission (*CPC: Comisión Parlamentaria Conjunta*) to draft a Constitutive Protocol. The CPC tabled its first proposal for a Draft Protocol at the Iguazú Summit, while the CMC passed Decision #49/04, providing that it had to be implemented before December 31, 2006.

In December 2005, the MERCOSUR Parliament Constitutive Protocol (*Protocolo Constitutivo del Parlamento del MERCOSUR*) was passed at the 29th Meeting of the CMC, held in Montevideo, Uruguay (CMC Decision #23/05).

The main features of the new organ are listed below:

- It is a new "principal" organ of MERCOSUR in addition to the ones instituted by the Protocol of Ouro Preto (the CMC, GMC, CCM, CPC, FCES and MS) and the Protocol of Olivos Permanent Review Tribunal (*Protocolo de Olivos, Tribunal Permanente de Revisión*).
- The Parliament will be a unicameral organ representing "the peoples" and will replace the CPC.
- The members of the Parliament will be elected by direct secret ballot by the citizens of the States Parties. They will have a four-year mandate and the organ will be composed according to the criterion of civil representation.
- The Parliament's main powers include: (i) ensuring the observance of democratic rule and human rights in the States Parties, as well as the observance of MERCOSUR rules; (ii) requesting reports from MERCOSUR organs and inviting its representatives to informative or joint meetings; (iii) organizing

public meetings on the integration process, with bodies from civil society and the productive sectors; (iv) intervening in the legislative process through the consultation mechanism, the tabling of draft rules before the CMC and the preparation of preliminary draft measures (harmonization) targeting the national Parliaments; (v) maintaining interinstitutional relations with the national Parliaments, with parliaments of Third States and other legislative institutions; (vi) seeking advice from the Permanent Review Tribunal.

- The Parliament will have a differentiated voting system -simple, absolute, special or qualified majority- depending on each individual case.
- The Parliament will be in ordinary session at least once per month.
- Each representative will be entitled to one vote.
- The Parliament will be based in the city of Montevideo, Uruguay.

Article 1 of the Protocol stipulates that the Parliament shall be constituted in stages and the Temporary Provisions define two "transition" stages with the following durations: from December 31, 2006, (the latest date anticipated for the implementation of the Parliament) to December 31, 2010, and from January 1, 2011, to December 31, 2014. In the first stage, the Parliament will be made up of 18 (eighteen) parliamentarians from each State Party. In the second stage, a "civil representation" criterion shall be prevalent which "will be established by Decision of the Common Market Council, at the Parliament's proposal adopted by qualified majority. This Decision shall be passed no later than December 31, 2007" (Temporary Provisions, 2nd, On Integration).

C. The Permanent Review Tribunal

CMC Decision #30/05 passed the Permanent Review Tribunal Rules of Procedure (*Reglas de Procedimiento del Tribunal Permanente de Revisión*). Its main provisions are as follows:

- The Permanent Review Tribunal or PRT (*TPR: Tribunal Permanente de Revisión*) is defined as an organ constituted as a *jurisdictional* authority to rule on matters of advisory opinions, reviews of awards by the Ad Hoc MERCOSUR Tribunal, non-appealable rulings in the event of disputes and cases where the States Parties activate the procedures established for exceptional emergency measures.
- The PRT, in all cases where it exercises its specific powers, is considered an organ *independent* from others making up MERCOSUR's institutional organization.
- The PRT is a permanent organ and its members will be available to act when necessary.
- The actions of the PRT, adopted at its plenary formation, will be termed "awards," "resolutions," "decisions" or "advisory opinions" as appropriate.
- The PRT presidency will have a duration of 1 (one) year and will be held in rotation by the States Parties (in alphabetical order) and by the Fifth Arbitrator, beginning with the latter.
- The decisions envisaged by the Protocol of Olivos and its rulebook will be adopted by simple majority of the five members of the Tribunal.

The rule comes into force upon being passed by the CMC on December 8 2005.

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