MERCOSUR Report

2009 (Second Semester) - 2010 (First Semester)

IDB

Integration & Trade Sector
Institute for the Integration of Latin America and the Caribbean - IDB-INTAL

Inter-American Development Bank
MERCOSUR Report N° 15 - March 2011

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Integration and Trade Sector

Institute for the Integration of Latin America and the Caribbean - IDB-INTAL
Esmeralda 130, 11th and 16th Floors C1035ABD, Buenos Aires, Argentina
Ph.: (54 11) 4323-2350 Fax: (54 11) 4323-2365
E-mail: *pubintal@iadb.org* *http://www.iadb.org/intal*

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PRESENTATION

The annual publication of the MERCOSUR Report has, since 1996, been accompanying the most significant aspects of economic and trade development in this regional bloc, founded by the 1991 Treaty of Asunción. The work presented here is part of a broader framework of activities carried out by the Inter-American Development Bank (IDB), and is intended to examine and strengthen the regional and multilateral integration processes of Latin America and the Caribbean.

IDB/INTAL's objective in publishing this annual series is to observe and analyze the economic evolution of MERCOSUR over the months covered by the work. The selection of issues and approaches takes into account the wide and varied audience -academia, the public and private sectors, and civil society at large- which has, over the years, shown interest in the publication.

Report No. 15 covers the period between the second semester of 2009 and the first of 2010. The macroeconomic chapter was produced at INTAL by Alejandro Ramos and Kathia Michalczewsky, with the coordination of the Institute Director, Ricardo Carciofi. The initial draft of Chapters II, III, IV, and V was prepared by a team of economists led by Ricardo Markwald comprising Lucia Maduro, Fernando Ribeiro, and Sandra Rios. IDB's Integration and Trade Sector (INT), managed by Antoni Estevadeordal, also collaborated on the project and the work's contents. INTAL's Director, Ricardo Carciofi, and its Senior Integration Economist, Alejandro Ramos, were in charge of coordinating and editing the final Report, assisted by Kathia Michalczewsky and Gala Gómez Minujín.

As with previous editions, about which readers have sent in valuable comments and suggestions, we once again invite you to send us your views to *pubintal@iadb.org* in order to improve the scope and content of the Report.

ABBREVIATIONS & ACRONYMS

BsF	Venezuelan bolivars (*Bolívares fuertes*)
€	Euro
R$	Brazilian *Real*
$	Argentine *Peso*
$	Uruguayan *Peso*
US$	US Dollar
1º H	First half
2º H	Second half
1º Q	First quarter
a.a.	Cumulative annual
ABDI	Brazilian Agency for Industrial Development (*Agencia Brasileira de Desenvolvimento Industrial*)
AFIP	Federal Administration of Public Revenues (*Administración Federal de Ingresos Públicos*)
AL	Automatic Licensing
ALICE-Web	Internet-Based Foreign Trade Information Analysis System (*Sistema de Análise das Informações de Comércio Exterior via Internet*)
ANCAP	National Administration of Fuels, Alcohol, and Portland (*Administración Nacional de Combustibles, Alcohol y Portland*)
ANDE	*Administración Nacional de Electricidad*
Art.	Article
ASEAN	Association of Southeast Asian Nations
BCB	Central Bank of Brazil (*Banco Central do Brasil*)
BCP	Central Bank of Paraguay (*Banco Central de Paraguay*)
BCRA	Central Bank of the Argentine Republic (*Banco Central de la República Argentina*)
BCU	Central Bank of Uruguay (*Banco Central de Uruguay*)
BCV	Central Bank of Venezuela (*Banco Central de Venezuela*)
BICE	*Banco de Inversión y Comercio Exterior*
BNDES	National Economic and Social Development Bank (*Banco Nacional de Desenvolvimento Econômico e Social*)
BPS	Social Security Bank (*Banco de Previsión Social*)
BRIC	Brazil, Russia, India, and China
CADIVI	Commission of Foreign Exchange Administration (*Comisión de Administración de Divisas*)
CAM	*Código Aduanero del MERCOSUR*
CAN	Andean Community of Nations (*Comunidad Andina de Naciones*)
CARICOM	Caribbean Community and Common Market
CARU	*Comisión Administradora del Río Uruguay*
CCM	*Comisión de Comercio del MERCOSUR*
CCPTC	*Certificado de Cumplimiento de la Política Tarifaria Común*
CCROM	*Certificado de Cumplimiento del Régimen de Origen del MERCOSUR*

CET	Common External Tariff
CIF	Cost, Insurance and Freight
CIJ	International Court of Justice
CMC	*Consejo del Mercado Común*
CNB	Biregional Negotiations Committee (*Comité de Negociaciones Birregionales*)
CNCE	National Foreign Trade Commission (*Comisión Nacional de Comercio Exterior*)
CNI	Brazilian National Confederation of Industry (*Confederação Nacional da Indústria*)
CNV	*Comisión Nacional de Valores*
COPOM	Monetary Policy Committee (*Comitê de Política Monetária*)
CPB	CPB Netherlands Bureau for Economic Policy Analysis
CPI	Consumer Prices Index (Uruguay)
CPI	Consumer Prices Index (Argentina)
CRPM	*Comisión de Representantes Permanentes del MERCOSUR*
Dec.	Decision
DeTIEC	Technology Development, Innovation and Conformance Assessment (*Desarrollo Tecnológico, Innovación y Evaluación de la Conformidad*)
DGI	*Dirección General Impositiva*
DINAMA	National Directorate for the Environment (*Dirección Nacional de Medio Ambiente*)
DIR	Directive (*Directriz*)
DLSP	Public Sector Liquid Debt (*Dívida Líquida do Setor Público*)
DUAM	*Documento Único Aduanero del MERCOSUR*
ECA	Economic Complementation Agreement
ECB	European Central Bank
ECI	Joint Investigation Team (*Equipo Conjunto de Investigación*)
ECLAC	Economic Commission for Latin America and the Caribbean
ECPI	Extended Consumer Price Index
EMBRAER	*Empresa Brasileira de Aeronáutica*
ENCE	Spain National Pulp Company (*Empresa Nacional de Celulosas de España*)
EPH	Permanent Household Survey (*Encuesta Permanente de Hogares*)
EU	European Union
EUROSTAT	Statistical Office of European Communities
FAF	*Fondo de Agricultura Familiar del MERCOSUR*
FDI	Foreign Direct Investment
FED	Federal Reserve System
FOB	Free on Board
FOCEM	*Fondo para la Convergencia Estructural del MERCOSUR*
FOGADE	Deposits Guarantee and Bank Protection Fund (*Fondo de Garantía de los Depósitos y Protección Bancaria*)
FONDEN	*Fondo de Desarrollo Nacional*

FSB	Financial Stability Board
FSF	Financial Stability Forum
FTA	Free Trade Agreement
G20	Group of Twenty
G8	Group of Eight
GAHCAM	*Grupo Ad Hoc para la Redacción del Código Aduanero del MERCOSUR*
GAHE-FOCEM	*Grupo Ad Hoc de Expertos del FOCEM*
GATT	General Agreement on Tariffs and Trade
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIP	*Grupo de Integración Productiva*
GMC	*Grupo Mercado Común*
GR	Group
GSP	Trade Generalized System of Preferences
GT	*Grupo de Trabajo*
GTAN	High-Level Technical Group (*Grupo Técnico de Alto Nivel*)
HOPE II	Haitian Hemispheric Opportunity through Partnership Encouragement Act
IBGE	Brazilian Institute of Geography and Statistics (*Instituto Brasileiro de Geografia e Estatística*)
ICTSD	International Centre for Trade and Sustainable Development
IDB	Inter-American Development Bank
IDB-INTAL	Institute for the Integration of Latin America and the Caribbean
IFC	International Finance Corporation
IFI	International Financial Institutions (*Instituciones Financieras Internacionales*)
ILO	International Labor Organization
IMF	International Monetary Fund
INDEC	National Institute of Statistics and Censuses (*Instituto Nacional de Estadística y Censos*)
INDIRA	Customs Register Information Exchange (*Sistema de Intercambio de Información de Registros Aduaneros*)
INE	National Statistics Institute (*Instituto Nacional de Estadística*)
INPC	National Consumer Price Index (*Índice Nacional de Precios al Consumidor*)
INTI	Argentina’s National Industrial Technology Institute (*Instituto Nacional de Tecnología Industrial*)
IPEA	Institute of Applied Economic Research (*Instituto de Pesquisa Econômica Aplicada*)
IPI	Industrial Product Tax (*Imposto sobre Produtos Industrializados*)
IPI	Implicit Price Index
IRACIS	*Impuesto a la Renta de las Actividades Comerciales, Industriales o de Servicios*

IVSS	Venezuelan Institute of Social Security (*Instituto Venezolano de los Seguros Sociales*)
Kg.	Kilogramo
LAIA	Latin American Integration Association
LDCs	Least Developed Countries
LEBAC	Central Bank Accounts (*Letras del Banco Central*)
MDIC	Ministry of Development, Industry, and Foreign Trade (*Ministério de Desenvolvimento, Indústria y Comércio Exterior*)
MECON	Ministry of Economy and Production (*Ministerio de Economía y Finanzas Públicas*)
MERCOSUR	*Mercado Común del Sur*
MFN	Most Favoured Nation
MIGA	Multilateral Investment Guarantee Agency
MINUSTAH	United Nations Stabilization Mission in Haiti
MPR	Monetary Policy Rate
MS	*Mato Grosso do Sul*
n.a.	Not available
NAFTA	North American Free Trade Agreement
NAL	Non-Automatic Licensing
NCM	*Nomenclatura Común del MERCOSUR*
NEGINT	*Unidade de Negociações Internacionais da Confederação Nacional da Indústria*
NGO	Non-Governmental Organization
NOBAC	Central Bank Notes (*Notas del Banco Central*)
NTBs	Non-tariff barriers
OCDE	Organisation for Economic Co-operation and Development
p.	Page
PAC	Common Tariff Policy (*Política Agrícola Común*)
PAC	Common Automotive Policy (*Política Automotriz Común*)
PAC	Growth Acceleration Program (*Programa de Aceleração do Crescimento*)
PAMA	*Programa de Acción MERCOSUR Libre de Fiebre Aftosa*
PAMI-INSSJP	*Programa de Asistencia Médica Integral - Instituto Nacional de Servicios Sociales para Jubilados y Pensionados*
PDVSA	Venezuela Petroleums Inc. (*Petróleos de Venezuela Sociedad Anónima*)
PIPM	*Programa de Integración Productiva del MERCOSUR*
p.p.	Percentage point
PPTA	*Presidencia Pro Tempore Argentina*
PPTB	*Presidencia Pro Tempore Brasil*
PPTU	*Presidencia Pro Tempore Uruguay*
PTC	Common Tariff Policy (*Política Tarifaria Común*)
PTR	Regional Tariff Preference Agreement (*Acuerdo de Preferencia Tarifaria Regional*)

RAD	*Régimen de Administración de Divisas*
RANAIM	*Reunión de Alto Nivel para el Análisis Institucional del MERCOSUR*
SAQME	*Sistema de Administración y Distribución de Cupos otorgadas al MERCOSUR por Terceros Países o Grupos de Países*
SACU	South African Customs Union
SCA	Special Customs Areas
SDR	Special Drawing Rights
SEBRAE	Brazilian Service of Support for Micro and Small Enterprises (*Serviço Brasileiro de Apoio às Micro e Pequenas Empresas*)
SECEX - MDIC	Secretariat of Foreign Trade-Ministry of Development, Industry, and Foreign Trade (*Secretaria de Comércio Exterior - Ministério de Desenvolvimento, Indústria e Comércio Exterior*)
SEDEBAN	*Superintendencia de Bancos y otras Instituciones Financieras*
SELIC	Special System for Settlement and Custody (*Sistema Especial de Liquidação e Custódia*)
SGTs	Working Subgroup (*Subgrupos de Trabajo*)
SICA	Central American Integration System (*Sistema de Integración Centroamericana*)
SIPA	*Sistema Integrado Previsional Argentino*
SM	*Secretaría del MERCOSUR*
SMEs	Small and Medium Enterprises
SML	Local Currency Payment System (*Sistema de Pagos en Moneda Local*)
SP	State Party
TM	Treaty of Montevideo (*Tratado de Montevideo*)
UN	United Nations
UNASUR	Union of South American Nations (*Unión de Naciones Suramericanas*)
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
UTE	National Administration for the Generation and Transmission of Electricity (*Administración Nacional de Usinas y Transmisiones Eléctricas*)
UTF/SM	*Unidad Técnica del FOCEM de la Secretaría del MERCOSUR*
UTNF	*Unidad Técnica Nacional FOCEM*
var.	Variation
VAT	Value-Added Tax
WCO	World Customs Organization
WTA	World Trade Atlas
WTO	World Trade Organization
YOY	Year-on-Year

MERCOSUR'S INSTITUTIONAL FRAMEWORK

COMMON MARKET COUNCIL (CMC)

MINISTERIAL MEETINGS

- Agriculture (**RMA**)
- Culture (**RMC**)
- Economy and Central Bank Presidents (**RMEPBC**)
- Education (**RME**)
- Industry (**RMIND**)
- Interior (**RMI**)
- Justice (**RMJ**)
- Environment (**RMMA**)
- Mines and Energy (**RMME**)
- Health (**RMS**)
- Labor (**RMT**)
- Tourism (**RMTUR**)
- MERCOSUR Ministers and High Authorities in Science, Technology and Innovation (**RMACTIM**)
- Ministers and Authorities in charge of Social Development (**RMADS**)

GROUPS

- High Level Group for MERCOSUR Employment Growth Strategy (**GANEMPLE**)
- High Level Group to Examine the Consistency and Dispersion of the Current Structure of the CET (**GANAEC**)
- High Level Group for the Elaboration of the Strategic Plan to Overcome Asymmetries in MERCOSUR (**GANASIM**)
- High Level Group for the Elaboration of a South-South Cooperation Program (**GANASUR**)
- High Level Group on Institutional Relations between the CMC and the MERCOSUR Parliament (**GANREL**)
- *Ad Hoc* Working Group for the Incorporation of the Republic of Bolivia as a MERCOSUR State Party (**GTBO**)
- Working Group for the Negotiation of the Membership Process of the Bolivarian Republic of Venezuela (**GTVENE**)

COMMISSION OF PERMANENT REPRESENTATIVES OF MERCOSUR (CRPM)

COORDINATION COMMISSION FOR MERCOSUR SOCIAL AFFAIRS MINISTERS (CCMASM)

POLICY CONSULTATION AND CONSENSUS-BUILDING FORUM (FCCP)

- Working Group on Firearms and Munitions
- Working Group on Legal and Consular Affairs
- Working Group on the Prevention Weapons of Mass Destruction Proliferations
- *Ad Hoc* Working Group on the Common Registration of Motor Vehicles and Drivers

MEETING OF HIGH AUTHORITIES IN THE AREA OF HUMAN RIGHTS (RADDHH)

COMMON MARKET GROUP (GMC)

WORKING SUBGROUPS

- Communications (**SGT N° 1**)
- Institutional Aspects (**SGT N° 2**)
- Technical Regulations and Conformance Assessment (**SGT N° 3**)
- Financial Affairs (**SGT N° 4**)
- Transport (**SGT N° 5**)
- Environment (**SGT N° 6**)
- Industry (**SGT N° 7**)
- Agriculture (**SGT N° 8**)
- Energy (**SGT N° 9**)
- Labor Affairs, Employment, and Social Security (**SGT N° 10**)
- Health (**SGT N° 11**)
- Investments (**SGT N° 12**)
- E-Business (**SGT N° 13**)
- Mining (**SGT N° 15**)

SPECIAL MEETINGS

- Family Farming (**REAF**)
- MERCOSUR Film and Audiovisual Authorities (**RECAM**)
- Application Authorities in Drugs, Prevention of Drugs Abuse, and Drug Renovation (**RED**)
- Science and Technology (**RECYT**)
- Social Communication (**RECS**)
- MERCOSUR Cooperatives (**RECM**)
- Official MERCOSUR Ombudsmen (**REDPO**)
- Integration Infrastructure (**REII**)
- Youth (**REJ**)
- Women (**REM**)
- MERCOSUR Public Ministries (**REMPM**)
- Internally Controlled Government Organizations (**REOGCI**)
- MERCOSUR Joint Trade Promotion (**REPCCM**)
- Tourism (**RET**)
- Government Entities for Nationals Resident Overseas (**REEG**)
- MERCSOUR Statistics (**REES**)
- Specialist Meeting on Socionatural Disaster Risk Reduction, Civil Defense, Civil Protection and Humanitarian Aid (**REHU**)
- MERCOSUR Institutional Analysis (**RANAIM**)

AD HOC GROUPS

- MERCOSUR Structural Convergence Fund' Experts (**GAHE-FOCEM**)
- MERCOSUR Customs Code (**GAHCAM**)
- Concessions (**GAHCON**)
- Consultation and Coordination for WTO and SGPC Negotiations (**GAH OMC- SGPC**)
- External Networking (**GAHRE**)
- Sanitary and Phytosanitary (**GAHSF**)
- Sugar Sector (**GAHAZ**)
- Agricultural Biotechnology (**GAHBA**)
- Cigarette Trade in MERCOSUR (**GAHCC**)
- Border Integration (**GAHIF**)
- Biofuels (**GAHB**)
- Toward a Regional Policy on Tires, including Retreaded and Used (**GAHN**)
- MERCOSUR Support Fund for Small and Medium Enterprises (**GAHFPME**)
- Capital Goods, and Information Technology and Telecommunications Goods Sectors (**GAH BK/BIT**)
- MERCOSUR Domain (**GAHDM**)

MERCOSUR TRAINING INSTITUTE (IMEF)

MERCOSUR OBSERVATORY FOR DEMOCRACY (ODM)

MERCOSUR LABOR MARKET OBSERVATORY (OMTM)

CONSULTATIVE FORUM OF MERCOSUR MUNICIPALITIES, FEDERATED STATES, PROVINCES, AND DEPARTMENTS (FCCR)

GROUPS

- MERCOSUR Public Contracting Group (**GCPM**)
- MERCOSUR Production Integration Group (**GIP**)
- Services (**GS**)
- SAM Budgetary Affairs Group (**GAP**)

MERCOSUR SOCIAL LABOR COMMISSION (CSLM)

COMMITTEE

- Automotive Committee (**CA**)
- MERCOSUR Technical Cooperation (**CCT**)

TECHNICAL MEETING FOR THE INCORPORATION OF THE MERCOSUR REGULATORY FRAMEWORK (RTIN)

MERCOSUR TRADE COMMISSION (CCM)

TECHNICAL COMMITTEES

- Tariff, Nomenclature, and Goods Classification (**CT 1**)
- Customs Matters (**CT 2**)
- Trade Rules and Disciplines (**CT 3**)
- Competitiveness-Distorting Public Policies (**CT 4**)
- Defense of Competition (**CT 5**)
- MERCOSUR Foreign Trade Statistics (**CT 6**)
- Consumer Defense (**CT 7**)
- Trade Defense and Safeguards Committee (**CDCS**)

MERCOSUR PARLIAMENT (PM)

SOCIAL AND ECONOMIC CONSULTATIVE FORUM (FCES)

MERCOSUR SECRETARIAT (SM)

- Board
- FOCEM Technical Unit (**UTF**)
- Foreign Trade Technical Statistics Unit to Member Countries (**UTECE**)
- Technical Advisory Sector (**SAT**)
- Regulation, Documentation and Dissemination Sector (**SND**)
- Administration Sector (**SA**)
- Support Sector (**SAP**)

MERCOSUR PERMANENT REVIEW TRIBUNAL (TPR)

MERCOSUR ADMINISTRATIVE AND LABOR TRIBUNAL (TAL)

MERCOSUR CENTER FOR THE PROMOTION OF DEMOCRACY (CMPED)

Source: Official MERCOSUR Portal *http://www.mercosur.int* (own translation).

CONTENTS

EXECUTIVE SUMMARY

MERCOSUR Report No. 15 (July 2009-June 2010) reviews and analyzes key aspects of the bloc's integration process in relation to both the internal and external agendas in the period from July 2009 to June 2010. The opening two chapters respectively analyze the macroeconomic outlook of the economies of the Southern Common Market (MERCOSUR) and their trade flows.

Macroeconomic outlook: A recent forecast notes that world Gross Domestic Product (GDP) will grow by 4.8% in 2010, significantly down -0.6% in 2009. The bulk of this increase comes from the emerging economies, which will grow 7.1%, while the developed countries' GDP will rise 2.7%, not even offsetting the severe contraction (-3.2%) these countries underwent the previous year. The world economy did not plunge into depression in 2009, but nor did the uncertainty over the new expansionary stage go away, especially where its traditional instigators, the developed countries, were concerned. The effect of the international crisis on activity levels in the MERCOSUR countries was concentrated in the last trimester of 2008 and the first of 2009, when the median rate of change of the bloc's quarter-on-quarter GDP—excluding Venezuela—was negative (-0.2% and -1.5% respectively). Since then, there has been a strong recovery in growth across all the countries, except Venezuela. In the same measurement, growth accelerated gradually, reaching 3% in the first trimester of 2010, but cooling slightly in the second trimester (1.7%), as it did in United States and China.

The evolution of trade and foreign direct investment (FDI): The MERCOSUR countries' trade flows were not immune to the effects of the recessive stage of the international financial crisis, which broke out in September 2008, and registered severe falls in 2009, interrupting a cycle of extraordinary highs in previous years. Although the bloc's GDP generally performed better than the rest of the world economy, imports fell faster than exports, generating an increase in the region's total trade balance. This rise was mainly due to two factors: the relatively more favorable performance of sales to Asian countries—especially China—which managed to keep up internal growth even during the crisis; and the sharp decline in the bloc's imports, due both to shrinking volumes and falling prices. The figures for the first semester of 2010 show that MERCOSUR's trade flows grew rapidly again, nudging toward pre-crisis levels. The profile of this expansion also displays the same features seen up to 2008: rapid export growth, based largely on rising prices; even faster import growth, resulting in a rapid drop in the balance of trade; and the falling share of the most developed countries (those of the North American Free Trade Agreement - NAFTA and the European Union - EU) in total exports due to the difference between the rapid recovery of growth in emerging economies and the weak trajectory of activity in Europe and the United States.

MERCOSUR's trade with Venezuela also experienced significant falls in 2009, especially in the bloc's exports. In the early months of 2010, imports grew again, but exports remained fairly stable compared to the same period the previous year, due to the recession still affecting Venezuela.

Where foreign investment was concerned, the international crisis did not prevent MERCOSUR attracting a significant flow of resources in 2009, albeit far below the volumes of 2008, when such investment reached a record high. In the early months of 2010, income from investment was somewhat disappointing, remaining below the levels recorded in the same period in 2009. However, the prospects for the rest of the year and the next few years remain highly favorable, the region being seen as one of the most promising in the world in terms of both its expanding internal market, and opportunities for production and commodity exports.

The internal agenda: The results obtained during the second semester of 2009 and the first semester of 2010 are contrasting: on one hand, there were few developments during Uruguay's Pro Tempore Presidency (PPTU), and, on the other, results were quite significant during Argentina's *Pro Tempore* Presidency (PPTA), taking into consideration the decisions adopted at the end of the period at the San Juan Summit in that country. It could be claimed that the satisfactory settlement of the disagreements over the pulp mill on the River Uruguay and Brazil's improved compensation to Paraguay over the exploitation of the Itaipú Dam were more key to the relative success of the San Juan Summit than was overcoming the impacts of the international crisis. These disputes had been gathering strength and overcoming them will help the bloc to move on from the climate of relative deadlock prevailing at recent MERCOSUR summits.

At the close of the 39th Meeting of the Common Market Council (CMC), the MERCOSUR countries announced the approval of the MERCOSUR Customs Code (CAM), significant breakthroughs in the process of eliminating double levying of the Common External Tariff (CET) and distributing customs revenue, the approval of an ambitious group of projects in the area of the MERCOSUR Structural Convergence Fund (FOCEM), the authorization of a fresh draft of the FOCEM Regulations, and various other important measures for the advancement of the bloc's internal agenda.

Since mid-2008, the strengthening of production integration in the region has been taking up more space on the agenda of MERCOSUR issues. Along these lines, the MERCOSUR Production Integration Program (PIPM) was adopted in June this year, and the MERCOSUR Production Integration Group (GIP) was also created.

In institutional matters, the CMC decided at the end of 2009 to alter the modus operandi of the Commission of Permanent MERCOSUR Representatives (CRPM), albeit apparently only temporarily: the figure of the President was replaced, for the time being, with an alternating system to coordinate the CRPM's activities, and an interim administrative arrangement was implemented to ensure its smooth running. In April 2010, the Common Market Group (GMC) approved the setting-up of a *High-Level Meeting for the Institutional Analysis of MERCOSUR* (RANAIM), comprising the Acting National Coordinators of the GMC or equivalent-ranking officials, whose function it is to advise the GMC and draw up proposals on institutional matters.

Sectoral disputes and the trade environment: The contraction of foreign demand for MERCOSUR products, coupled with the shortage of credit lines for international companies, had a widespread negative impact on the region's export performance. Accordingly, the countries used a wide range of economic policy measures with the aim of cushioning the impact of the sharp fall in exports.

The second semester of 2009 was also a period of sectoral controls and difficulties, especially between the two largest partners, but the atmosphere of recovery from the crisis and good prospects of economic growth enabled the MERCOSUR countries to start 2010 in a climate of improved trade relations.

Among the group of trade administration measures, "voluntary export agreements" already played an important role in the containment of Argentina's imports from Brazil. Difficulties over negotiation and implementation, however, showed the obsolescence of the instrument for certain sectors of the industry. This was true of sectors such as the white line (stoves, refrigerators, and washing machines) and paper sectors, which suspended their respective voluntary agreements. On the other hand, the footwear sector signed a new agreement in June 2009. Other sectors, such as powdered milk, and brakes and clutches, also tried following the path of understanding in order to ensure a swift release from non-automatic licensing (NAL).

The main sectoral issues involving MERCOSUR countries were in the area of trade relations between Brazil and Argentina, specifically the disputes affecting the bloc's smaller partners. The main sectors affected are textiles (including yarns, fabrics, and garments), footwear, electrical white line appliances, paper, tires, and furniture. Brazil also adopted measures that match Argentina and Uruguay in the dairy sector.

The external agenda: In the second half of the decade, MERCOSUR began to face increasing difficulties in closing preferential trade agreements with third countries. The emergence of the international financial crisis made it even more difficult to move forward on trade liberalization initiatives, whether in the multilateral, regional, or bilateral spheres. However, in recent times, there has been a certain shift in MERCOSUR toward a search for new bilateral agreements that represent improvements in conditions of market access for the bloc's countries. The resumption of negotiations with the EU and the signing of an agreement with Egypt in July 2010 are the main signposts of this shift.

After a long period of procedures and steadfast commitment on the part of the representatives of the Ministry of Foreign Affairs, Brazil's Federal Senate adopted the Protocol of Adherence of Venezuela to MERCOSUR, December 15, 2009. After Brazil's approval, it remains for the Protocol to be ratified by Paraguay, Argentina, Uruguay, and Venezuela having already approved it.

In the coming year, moves in MERCOSUR's external agenda will be limited by two main conditioning factors: an international environment marked by protectionist pressures and unilateral trade restriction measures, and a internal environment in which there is a tendency to invest the negotiating mindset in Brazil and Argentina, with greater willingness to negotiate on the part of the Argentine government, bent on salvaging its international relations, and greater withdrawal on the part of Brazil, facing growing deficits in its Balance of Payments and demands for protection from its internal industrial sector.

Contents

CHAPTER I. MACROECONOMIC OVERVIEW

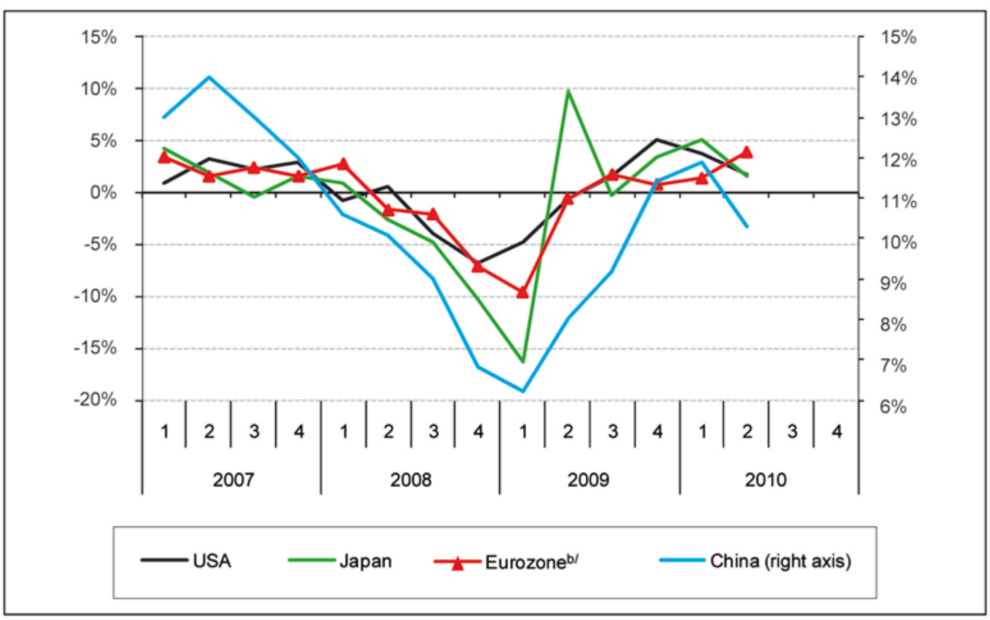
A. *The International Scene*

The Uneven Recovery of the World Economy

According to one recent forecast, the world economy's GDP will expand 4.8% in 2010, after a drastic -0.6% slide in 2009.[1] The greater weight of the increase is due to the emerging economies, which will grow 7.1%, while the GDP of advanced countries will rise 2.7%, not even offsetting the severe contraction (-3.2%) these countries underwent the previous year. Although, in mid-2009, these economies several trimesters of contraction behind them, their recovery has been shaky and uneven (Graph 1). The unprecedented deployment of expansionary monetary and fiscal policies in virtually all countries was, therefore, a partial success story. The global economy did not plunge into depression in 2009, but nor has the uncertainty over the new expansionary phase not been dispelled, especially where its traditional instigators, the advanced countries, are concerned.

Graph 1. Quarterly dynamic of real GDP of the major economies 2006-2010

Rate of change[a/]



Note: [a/] China: year-on-year (YOY) growth rate; others: annualized rates of the seasonally-adjusted series. [b/] At 2000 prices; aggregation in dollars with purchasing power parity for that year.

Source: Compiled with data from the US Bureau of Economic Analysis, the Organisation for Economic Cooperation and Development (OECD), the Economic and Social Research Institute of Japan, and the National Bureau of Statistics of the People's Republic of China.

[1] (IMF, 2010). World GDP is aggregated by purchasing power parity, a procedure that gives greater weight to rates of change in emerging economies. The calculation using market exchange rates gives a fall of 2.0% in 2009 and forecast growth of 3.7% in 2010. See also, UN (2010).

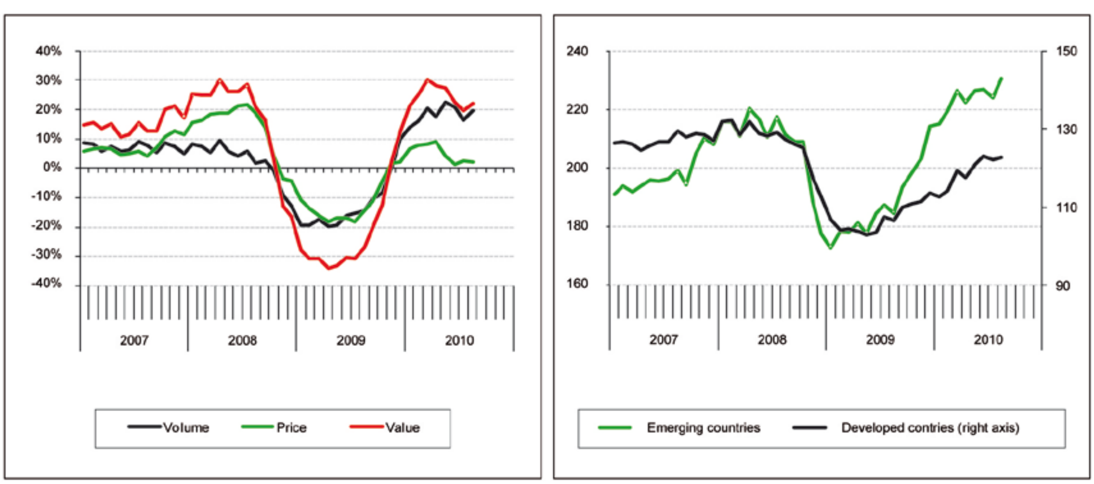
US GDP, which grew at an annualized rate of 5.0% in the last trimester of 2009, subsequently slowed to a bare 1.7% in the second trimester of 2010. Although GDP growth in the Eurozone was stronger in the first semester of the year (an annualized average of 2.6%), this was the result of high-performing countries like Germany, and others with pronounced recessions like Spain, Greece, and Ireland. The activity of the Japanese economy has not only seen major fluctuations, but also underwent cooling halfway through the year.

Among the emerging nations, the People's Republic of China was again prominent. The crisis brought about a slowdown in activity that lasted until the first trimester of 2009, later returning to levels close to those of 2007. However, a cooling of the economy was also seen in mid-2010, accompanied subsequently by measures of the authorities geared to easing the intensification of existing monetary imbalances. In Latin America and the Caribbean, the Great Recession of 2009 meant a 1.9% drop in GDP (2.9% per inhabitant), affecting the vast majority of countries. Levels of growth similar to those of the pre-crisis period (5.2%) are forecast for 2010, but in a mixed scenario, with countries (mostly South American) in very much higher ranks and others with weaker recoveries (ECLAC, 2010).

Although the emergence from recession was relatively swift, there are uneven growth patterns across regions in the post-crisis world economy. The evolution of world trade speaks for itself (Graph 2). Over the past year, between November 2008 and October 2009, the volume and value of world trade fell at record average rates of 15.2% and 25.8% respectively. While the subsequent recovery was intense (the corresponding rates in the first eight months of 2010 were 18.4% and 24.5%), trade was channeled along very different paths in the developed and the emerging economies. In August 2010, the developed countries' average volume of exports and imports was still 3.4% below the pre-crisis levels of December 2007, whereas the volume for emerging countries was 10.7% higher at the same point.

Graph 2. Dynamics and monthly levels of world trade 2007-2010

YOY rates of change[a/]　　　　Volume (2000=100) [b/]



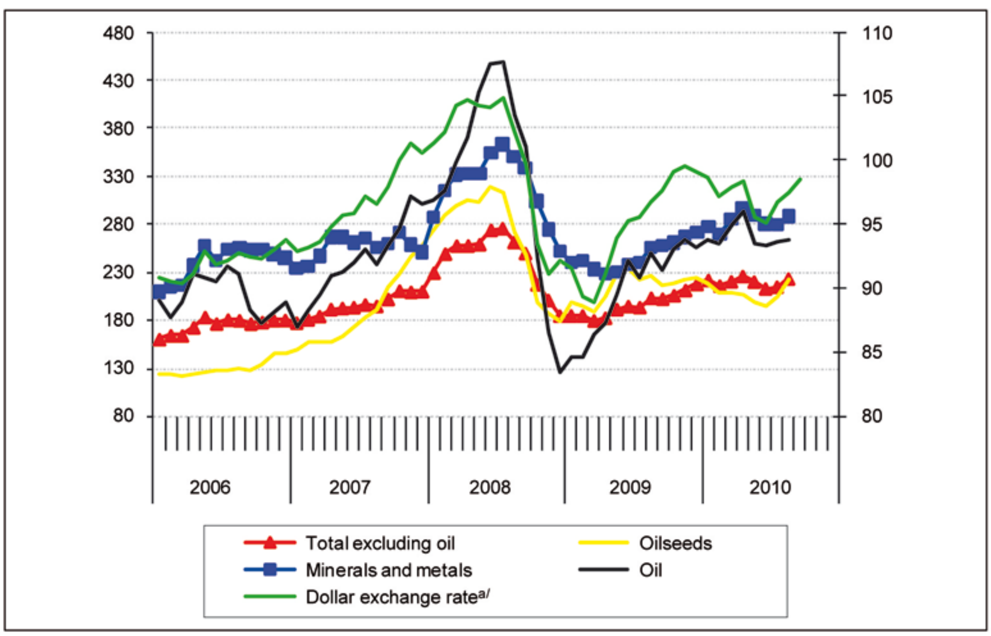
Note: [a/] Seasonally-adjusted series. [b/] Simple average for export and import indexes; seasonally-adjusted series.

Source: Compiled with data from the Netherlands Bureau for Economic Policy Analysis (CPB).

Other significant aspects of the development of the crisis at the financial and real levels are worth noting. First, where the prices of *financial assets* are concerned, once the critical stage of the crisis was past,[2] some of these assets stabilized and even improved. Between April 2009 and the same month in 2010, the moving quarterly average for the housing index in 20 metropolitan areas in United States fluctuated around a mark 30% below the peak of mid-2006. While this defused the main focus of instability that led to the crisis in the mortgage market, it is a far cry from expressing the revitalization of that activity and reversing its financial implications. In contrast, stock asset prices rose substantially. In 2009, the Dow-Jones closed 59.3% up on the low reached in March that year, albeit 26.4% down on the high of October 2007. With less intensity, commodity prices also experienced a recovery from the low reached in the second trimester of 2009 (Graph 3). The average price of a representative basket of such goods exported by Latin America and the Caribbean (excluding oil) grew by 24.1% between March 2009 and August 2010. The price of oilseeds rose 18.2%, and the price of metal ores and oil, 23.5% and 60.3% respectively. The dollar experienced significant fluctuations during the period, depreciating for most of 2009, then appreciating again, reflecting the sovereign debt problems of some European countries and introducing a new factor of financial instability in the world economy.

Graph 3. Monthly prices of some commodities and the dollar exchange rate 2006-2010

2000=100 indexes



Note: [a/] Right axis; nominal effective dollar exchange rate against a broad basket of currencies; depreciation = positive slope.

Source: Compiled with data from ECLAC and the Federal Reserve.

At the level of *real variables*, the milder climate in the financial markets by mid-2010 was not sufficient to decisively reverse the serious decline in investment and employment in the

[2] September 2008 to March 2009; more details in IDB/INTAL (2009), pp. 1-2.

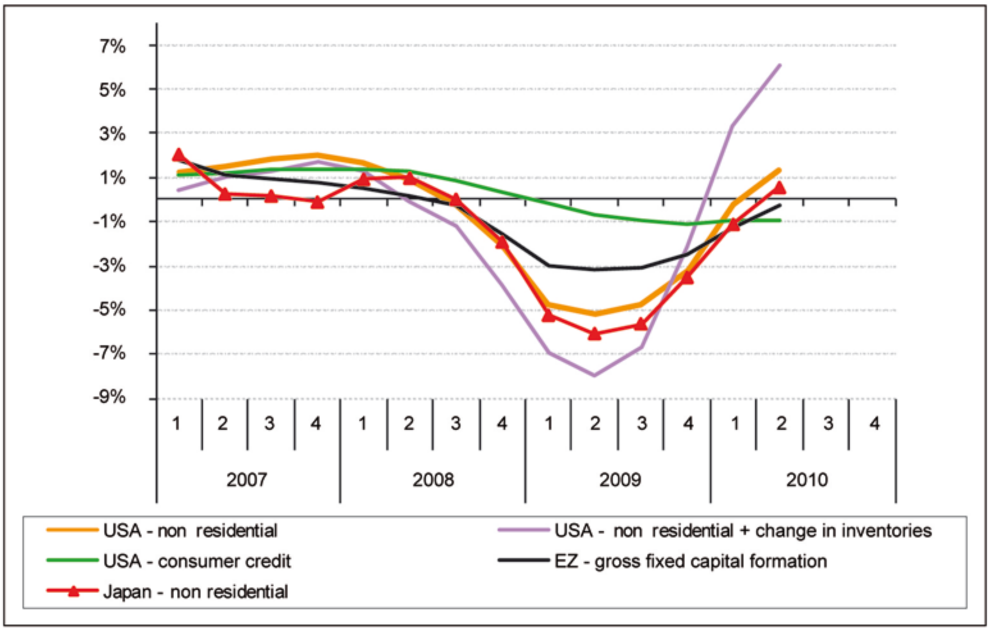
leading advanced economies (Graph 4). At that time, investment indicators in United States, the Eurozone, and Japan showed negative or slightly positive rates of between -0.3% and 1.3%.[3] In United States, the recession brought an exceptional inventory decumulation,[4] the subsequent dynamics of which account for much of the recovery of early 2010. First, the slowdown in the reduction of stock levels[5] and their subsequent incipient growth account for 59% of GDP growth between mid-2009 and mid-2010. This effect made the trend in investment positive by as early as the first trimester of 2010, if one includes in it changes in stocks, whereas, if one just looks at non-residential capital formation, the recovery only appears toward the middle of the year and is low-intensity. The recession had a severe impact on levels of employment in all three economies. The rate of unemployment in United States, the Eurozone, and Japan rose from an average 4.6% 7.5%, and 3.8% in 2007 to 9.5% 10.0%, and 5.3% by the middle of 2010. The average six-monthly rate of net job destruction in United States between 2008 and 2009 was 2.1 million, whereas in the first semester of 2010 just 880,000 jobs were created. The process of debt reduction for many private actors is another recessionary factor also illustrated by the case of United States, where, halfway through 2010, consumer credit was still contracting.

In any event, it is glaringly obvious in this far-from-bright scenario that economic policy measures managed to avoid a repeat performance of critical episodes in world finance such as those of the previous two years (see IDB/INTAL, 2010, p. 1, Note 2). But this did not involve the elimination of complex elements of vulnerability, particularly in the fiscal area. The cyclical deterioration itself,[6] coupled with the cost of the fiscal stimulus packages and bailouts, thus affected public accounts, particularly in the advanced countries (Graph 5). The high levels of (public and private) borrowing aggravated these problems in some countries, giving rise to a new facet of the crisis. In late November 2009, the Dubai Government had to renegotiate the debt arising from aggressive real estate developments embarked upon during the world economy's expansionary phase. Not long after that, and with greater systemic repercussions, Greece's sovereign debt was degraded by rating agencies once the seriousness of its fiscal difficulties became known (Kerr & Hughes, 2009; Tett, 2009; Oakley & Hope, 2009; Wolf, 2010). A phenomenon of contagion soon affected the debt instruments of Spain, Portugal, Ireland, and Italy, and damaged the euro. [7]

[3] Annual moving average of quarterly rates of change for seasonally adjusted series.
[4] Between 2004 and 2007, the average level of private inventories held fairly steady, equivalent to 208 days of the goods consumption flow. As a result of falling aggregate demand, the ratio had risen to 215 days the end of 2008 (3.1% above the average) before undergoing an unprecedented collapse. By mid-2010 inventories covered 196 days of consumption, 9% below the level of the fourth trimester of 2008. The fall in stocks lasted eight consecutive trimesters.
[5] A negative change in low-value stocks across two trimesters indicates a positive contribution to GDP change.
[6] Reinhart & Rogoff (2009, pp. 9-10) show how the subsequent deterioration of public finances is a structural feature of the banking crises: the drop in income and the leaps in spending needed to ease the recession significantly raise the levels of government borrowing. The average for a significant sample of crisis episodes shows 86.3% growth in the real public debt in the three years following the crisis.
[7] From the start of December 2009 to early June 2010, the exchange rate went from €0.662 to €0.836 per dollar, i.e. the euro depreciated 26.3%.

Graph 4. Investment and credit dynamics indicators[a/] 2007-2010

Annual moving average of rates of change compared with the previous quarter

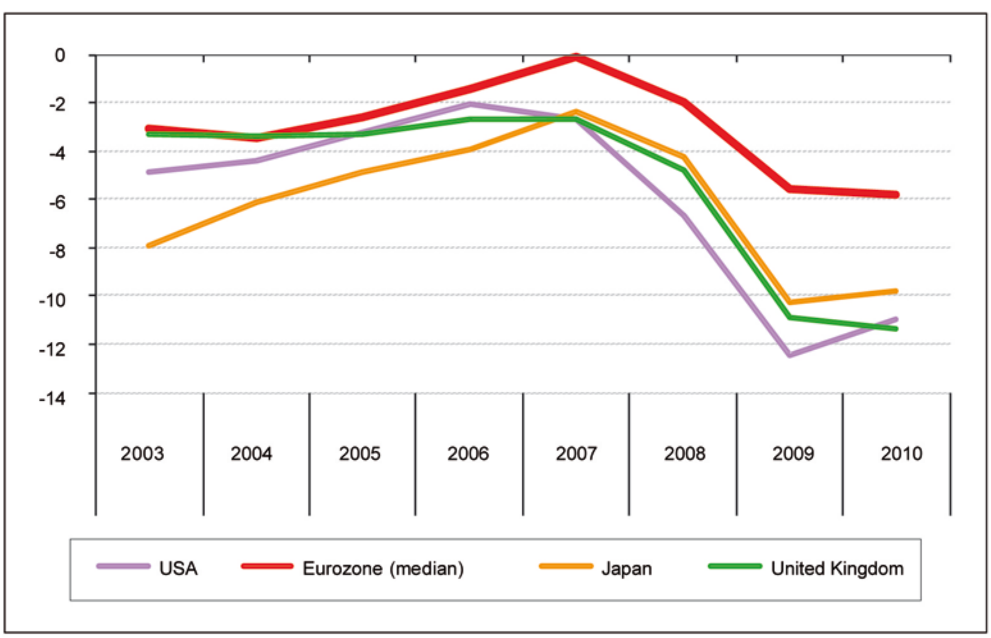


Note: [a/] Seasonally-adjusted series; consumer credit in USA corresponds to nominal balances at the end of the trimester; investment is measured at constant prices.

Source: Compiled with data from US Bureau of Economic Analysis, the Organisation for Economic Cooperation and Development (OECD), the Economic and Social Research Institute of Japan, and the Federal Reserve.

Graph 5. Fiscal result of some developed economies 2003-2010

% of GDP



Source: Compiled with data from the International Monetary Fund (IMF).

There were two types of reaction to the latent threat to the European monetary system. On the one hand, most countries—even those not directly affected by the crisis, like Germany—changed their fiscal stance, making procyclical adjustments intended to ensure the governments' ability to pay, but, in the short term, having a negative effect on the recovery of the world economy. On the other hand, after overcoming coordination difficulties, in May, the EU authorities agreed to set up a mechanism to stop the spread of distrust in the markets (Council of the European Union, 2010) and to dispel expectations of the potential disintegration of the monetary union.[8] The crisis brought to light the difficulties of the coexistence of monetary union and sovereign fiscal policies, as well as the effect of growing disparities in productivity between countries as reflected in the uneven performance of their foreign sectors.

The other factor of tension in the world economy lies in the non-operation of remedial mechanisms for the imbalances displayed by its key players' foreign sectors. Policy and international coordination actions in this area have not been successful. While the deficit in the US current account balance of payments fell during the recession (from 4.8% to 2.4% of GDP between the third trimester of 2008 and the second of 2009), the recovery quickly pushed it back up to 3.4% of GDP by midway through 2010. Similarly, China's trade surplus correspondingly shrank with the implementation of policies to stimulate internal activity, but began to expand from the second trimester of 2010. This scenario was further complicated because, in the environment of fragile growth, and the depletion of the fiscal and monetary space to stimulate the economy, interventions by various countries in the foreign exchange markets have intensified, aimed at gaining competitiveness and opening up the possibility of spiraling competitive devaluations. In a process of this nature, countries with less firm intervention policies (e.g. the well-known case of Brazil) were punished through their monetary appreciation (Beattie, 2010; Wolf, 2010b; Wheatley & Garnham, 2010). These problems have recently been noted by G-20 technical bodies.[9]

Both the European fiscal crisis, which emphasized the existing fiscal difficulties in the advanced countries, and the difficulties of reducing global imbalances have weakened the recovery process of the developed economies. In contrast, the emerging economies, including those of MERCOSUR, have seen high activity rates.

The transmission of the recovery to MERCOSUR

The global economic crisis was transmitted to the MERCOSUR countries mainly through trade channels, with a steep, synchronized drop in foreign demand at the end of 2008 (Graph 6). Demand from the advanced economies remained in full contraction throughout 2009, whereas Chinese demand drove the bloc's early recovery. US non-oil imports from MERCOSUR were down 33.5% in 2009, and EU purchases from Argentina and Brazil also plummeted (-28.7%) in the same period. In the case of total Chinese imports, the fall was significant, but not as intense, reaching 11.3%, whereas the contraction for purchases in MERCOSUR was 15.9%.

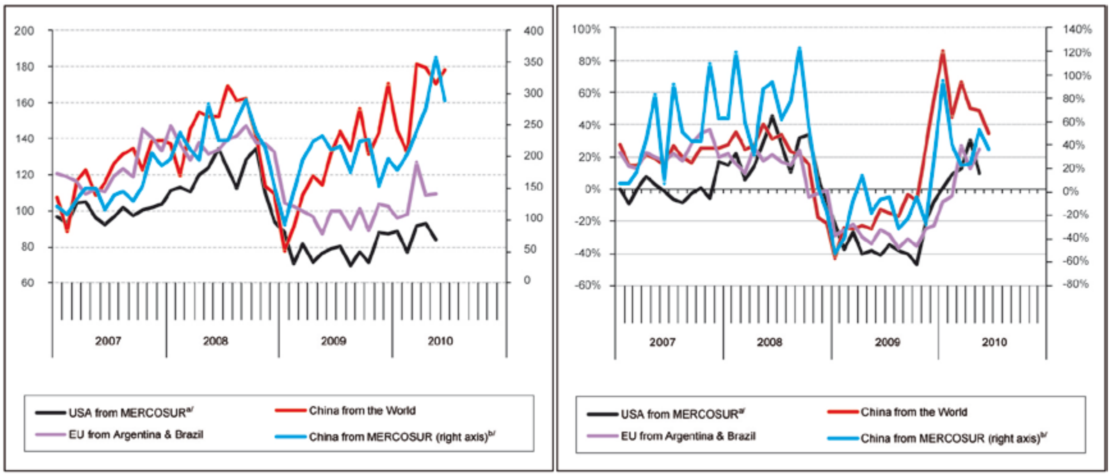
[8] The instrument combines government and IMF guarantees to grant loans totaling €720 billion. The guarantees include €440 billion from countries in the Eurozone, €60 billion from the other EU countries, and €220 billion from the IMF. (Hall, Barber, & Atkins, 2010).

[9] (G-20, 2010). The communiqué of the meeting of Finance Ministers and Governors of the Central Banks in October 2010 calls for multilateral cooperation to curb the process of competitive devaluation and reduce global imbalances. Among other things, it was also agreed to reform the system of IMF quotas and government in order to promote the representation of emerging countries.

Graph 6. Monthly development of imports of selected economies 2007-2010

At current prices; YOY levels and rates of change

Indexes: 2006=100 *YOY rates*



Note: [a/] Not including oil. [b/] Seasonally-adjusted series; March-June estimated with figures from Brazil.

Source: Compiled with data from US International Trade Commission (USITC), EUROSTAT, IMF, and BCB.

Again, in trade terms, what needs to be highlighted is the uneven pattern of the recovery. Although imports from all origins recorded positive annual rates of change in mid-2010, the level of advanced countries' purchases fell far short of the pre-crisis highs of September or October 2008. In the case of *United States*, imports from MERCOSUR in May were 37.6% down on these highs; and the *European Union* (EU) was 22.1% down. In contrast, *China's* total imports underwent a recovery not only sooner, but more intense than in June 2010, 26.1% up on pre-crisis levels. China's purchases from MERCOSUR reached a medium level between April and June identical to the pre-crisis high in September 2008.

The rapid takeoff of Chinese imports was prompted by an aggressive countercyclical plan in November 2008 (amounting to 12% of GDP in 2009 and with a two-year horizon) designed to offset the collapse of foreign demand. The impetus given to imports against a background of contracting activity in the rest of the world marked a significant deterioration in China's trade balance, but also a strong incentive for exports from countries producing raw materials, including MERCOSUR (see IDB/INTAL, 2010). In 2010, this moderation of China's growth was expressed in the return of large trade balances. This did not, however, affect the markets for raw materials sold by the MERCOSUR countries.

B. The Evolution of the Balance of Payments

MERCOSUR Report No. 14 distinguished two initial stages of development in the international economic crisis. The first stage, dominated by inflationary trends underpinned by strong tensions in commodity markets, covers the third trimester of 2007 and the same period of 2008. In the second stage, covering the fourth trimester of 2008 and the first of 2009, the world economy was dominated by instability and deflationary pressures. The rest of

2009 can be viewed as a third stage, characterized by the lifting of the instability and the appearance of signs of recovery, which were more significant for emerging economies than developed countries. During the first semester of 2010, however, signs of weakness in the recovery process in advanced countries began to appear, and there were even isolated foci of financial instability associated with the fiscal decline of some European countries and with the behavior of some foreign exchange markets.

However, during these last two stages, due to the traction of emerging countries' demand and most MERCOSUR countries' insertion in financial circuits, their balances of payments in general performed well, unlike previous critical episodes (Graph 7).

Argentina

Throughout this difficult period for the world economy, Argentina maintained a positive balance in the balance of goods. This was the backbone of the surplus result in the current account in Argentina's balance of payments, which, in 2009, was US$11.3 billion (3.7% of GDP).[10] The contraction in exports in late 2008 and early 2009 was more than offset by a drop in imports, which produced an outstanding positive balance in trade in goods in the second trimester of the last year. The subsequent recovery of imports was accompanied by rising exports, which, if rather modest, propped up the surplus in this balance. The trend was, however, toward major acceleration in imports, which were up 42.0% (YOY) in the first semester of 2010, whereas external sales were up just 18.0%. The balance of goods stood at US$8.6 billion, a YOY drop of 19.4%. At the same time, net payments of the balance of income grew 19.4% YOY in line with the economic recovery of the first semester of 2010. The main counterpart of the surplus in Argentina's current account since the second trimester of 2008 has been the deficit in its financial balance (including errors and omissions), suggesting a persistent formation of foreign assets by private agents, which topped US$9.95 billion (3.2% of GDP) in 2009. While this reduced the accumulation of international reserves, which grew just US$1.58 billion (0.5% of GDP) in 2009, their average level remained historically high (US$46.5 billion, or 15% of GDP), especially considering the global disturbance that characterized the period. In the first semester of 2010, the deficit in the financial balance was just US$975 million, 85% down on the same period the previous year.[11] This enabled a YOY increase of 7% of the level of international reserves, reaching US$49.24 billion by the end of June.

[10] In the third trimester of 2009, Argentina saw the allocation of IMF Special Drawing Rights (SDR) for approximately US$2.5 billion as a current transfer. Without this bill, the annual surplus would have been US$8.95 billion.
[11] The net foreign assets of the non-financial private sector through the single free exchange market were US$11.2 and US$6.7 billion in the first semester of 2009 and 2010 respectively (-40.2%).

Graph 7. MERCOSUR: Quarterly development of the balance of payments 2008-2010

Millions of US$

Source: Compiled with data from INDEC, BCB, BCP, BCU, and BCV.

Brazil

Although, at the climax of the international crisis, Brazil experienced a significant net outflow of financial capital, its subsequent stabilization reestablished the country as a major recipient of these flows. The average income in the last three trimesters of 2009 was US$22.4 billion, or 5.6% of GDP. Although the uncertainty created by the European crisis was reflected in falling income over the first semester of 2010, the quarterly rate stood at around US$20.2 billion. The sustained dynamic of net debt capture is closely related to the appreciation of the real and the behavior of the current account, which, for the whole of 2009, was US$24.3

billion (1.5% of GDP) in deficit. While this annual result was an improvement on the indicator for 2008 (1.8%), the current account saw a steady deterioration. Indeed, the deficit in the first semester of 2010 (US$23.8 billion) was almost equal to that for the previous year's total. In that period, all the headings of the current account had a negative YOY contribution, due either to the falling surplus or the rising deficit: the balance of goods with US$6 billion (36%), the balance of services with US$5.7 billion (35%), and the balance of income with US$4.8 billion (29%). The uneven dynamic of the exports and imports of goods is striking: these grow 27.5% and 45.1% YOY respectively, leading to a sharp reduction in the balance of goods surplus, which fell 43.4% YOY Also, the deficit in the balance of services increased sharply, driven by rises under the "travel" headings (which reached US$7 billion (58% YOY)) and the "equipment rental" heading, US$6.2 billion (41% YOY). The deficit in the balance of income also climbed (32.5% YOY) to US$19.4 billion.

At the end of June 2010, international reserves totaled US$253.114 billion, with an annual increase of US$51.646 billion (25.6%). Within the picture of deficit and deterioration in the current account balance, this result was explained by the surplus recorded in the financial balance.

Paraguay

In 2009, the current account showed a small surplus, equivalent to 0.3% of GDP (US$39.8 million), an improvement on the 1.8% deficit of GDP (US$298.2 million) in 2008.[12] The decline in exports (-25.6%) was coupled with a sharp fall in imports (-22.7%), signifying a slight reduction in the balance of goods deficit, which rose from US$1.0461 billion to US$1.0315 billion. Also, the net income of the balance of services totaled US$910.7 million (growth of 63.1% YOY), explained by the rising income generated by tourism and binational entities. The balance of transfers also contributed to the improvement in the current account balance. The net income of the financial balance (including errors and omissions) totaled US$875.4 million. The net positive change of international reserves was US$915.2 million. The first semester of 2010 saw a marked recovery in exports and imports (42.6% and 46.9% YOY respectively). This had a negative impact net on the balance of goods over the same period the year before, marked by the international crisis. The level of international reserves rose over 2009, reaching US$3.908 billion by the end of June 2010.

Uruguay

In 2009, the significant deficit in the current account balance of payments recorded by Uruguay the previous year was turned around, obtaining instead a US$215 million surplus, equivalent to 0.7% of GDP. This turnaround is explained mainly by the large drop in imports (24.4%) as a result of the climate of crisis prevailing during the first part of the year. Exports, in turn, fell 10.0%. It should be noted that the international crisis also brought changes in the trends of financial flows received by Uruguay. While, in 2009, the surplus in the financial balance remained very high (US$1.4 billion, or 4.4% of GDP), it was 63.0% down on the previous year. The trend has deepened in the first part of 2010, with a net outflow of US$975 million. This net capital outflow is explained by zero change in financial capital income in parallel with the formation of external assets. The net capital outflow was offset by a US$500 million surplus in the current account. The behavior of the balance of goods enabled this result thanks to export and import growth of 28.3% and 20.9% respectively. At the close of the first semester of 2010, the level of international

[12] Estimates published in October 2010. Earlier figures indicated deficits of US$149.1 million (2009) and US$424.4 million (2008).

reserves (US$7.509 billion) was US$477 million down on the previous end of year, although it was US$71 million up in year-on-year terms.

Venezuela

In the fourth trimester of 2008 and the first of 2009, Venezuela recorded an exceptional negative balance in the current account balance of payments, which, coupled with a net capital outflow, meant a significant reduction in its levels of international reserves. The current account deficit reflected the impact of falling oil prices in its exports,[13] sufficient to reverse the balance of goods surplus; unlike the other countries considered, imports did not experience a fall in that period. After the average price of oil reached a low in the first trimester of 2009, Venezuela returned to surplus in the balance of goods, closing 2009 with a positive balance in the current account balance of payments of US$8.6 billion, or 2.6% of GDP (11.5% in 2008). However, the sign of the overall balance remained negative as a result of net capital outflows, concentrated in the first trimester of the year (US$10,300, or 3.2% of GDP). In the first semester of 2010, export growth of 33.2% and an 18.1% fall in imports raised the positive balances of the balance of goods and the current account to US$15.1 and US$9.1 billion respectively, but there was a significant deficit in the financial balance (US$16.3 billion). At the end of 2009, international reserves stood at US$35.83 billion, falling 16.9% in relation to 2008, the main cause being the transfer of US$12.299 billion to the National Development Fund (FONDEN). The average level of stock represented 9.8% of GDP. In June, reserves totaled US$29.351 billion, after the transfer of US$6 billion to the FONDEN.

C. The Macroeconomic Evolution of MERCOSUR

Characteristics of the recovery and growth factors[14]

The effect of the international crisis on the MERCOSUR countries' levels of activity was concentrated in the last trimester of 2008 and the first of 2009, when the median rate of change in quarter-to-quarter GDP for the bloc's countries (excluding Venezuela) was negative (-0.2% and -1.5% respectively) (Graph 8). Since then there has been a strong recovery in growth across all the countries, excepting Venezuela. In the same measurement, growth gradually accelerated, reaching 3.0% in the first trimester of 2010, and, as in the United States and China, cooling somewhat in the second (1.7%). The average rate of growth in the first semester is similar to that of the third trimester of 2007, the last one before the international financial crisis began to affect the MERCOSUR economies' rates of activity.

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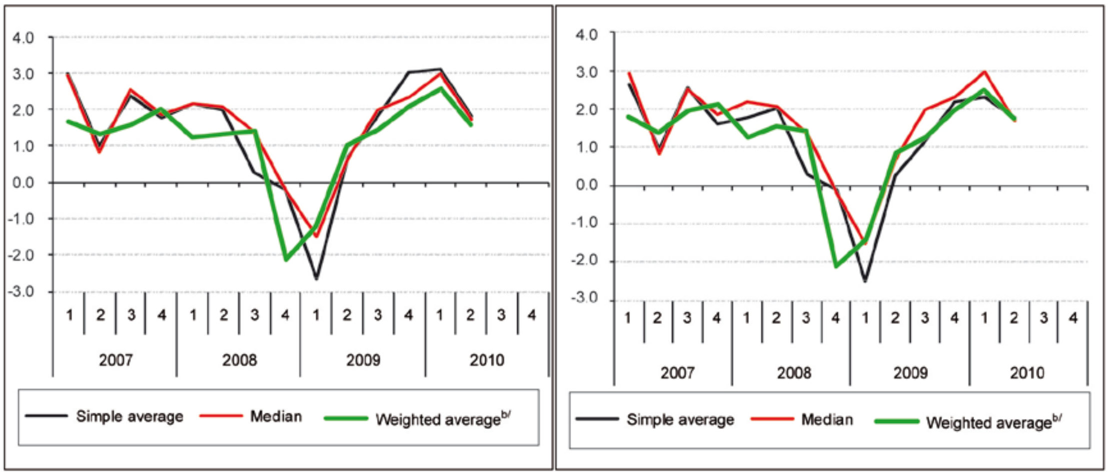
[13] The oil price dropped 46.7% YOY in these two trimesters; the corresponding drop in 2009 was 35.1%.

[14] The projections and estimates contained in this section are based on the median for the surveys of private expectations conducted by the Central Banks in Argentina and Brazil (October 2010), and Uruguay (September 2010). In Paraguay's case, it is based on the Bank's own projection (August 2010).

Graph 8. MERCOSUR: Quarterly development of GDP[a/] 2007-2010

Rates of change compared to the previous quarter

Excluding Venezuela *Including Venezuela*



Note: [a/] At constant prices (2000=100); seasonally-adjusted series. [b/] Through the average level of GDP (2007-2008).

Source: Compiled with data from national statistics offices and ECLAC.

An examination of the sources of growth (Graph 9)[15] shows that, in the recovery period of the world economy (II.2009–IV.2009), the predominant momentum of the expansion in the four original partners of MERCOSUR was due to internal demand, although exports also made a positive contribution. The contribution of investment also was relevant. In the first semester of 2010, however, the countries' behavior became mixed. In Argentina and Brazil, internal demand remained the main factor of traction in growth. In fact, net exports made a negative contribution to both in the period. However, in Paraguay and Uruguay, the expansion was led by exports. In Venezuela, during the first semester of 2010, there was a slight expansion of GDP resulting from the buoyancy of internal demand.

GDP in **Argentina** grew 0.9% in 2009 (6.8% the previous year) and a 7.8% increase is forecast for 2010. Growth accelerated progressively over 2009 at a quarter-to-quarter rate of 3.2% in the first trimester of 2010, slowing slightly (3.0%) in the second. In the first three trimesters of 2009, government consumption kept up activity levels, with a year-on-year expansion of 7.1%, while private consumption, exports, and gross capital formation were down 0.4%, 9.1%, and 10.7% respectively. In the first semester of 2010, GDP grew 9.4%. Government consumption kept up a high rate of growth (10.9%), but was overtaken by gross fixed capital formation (16.2%) and exports (11.7%). Private consumption also rose significantly (7.7%). After a 19.0% contraction in imports in 2009 in the first semester of 2010, there was year-on-year growth of 32.9%.

[15] Graph 9 shows the factors that explain the change in GDP over two periods: II.2009-IV.2009, when there was an incipient recovery of the global economy, and I.2010-II.2010, when signs of weakening of the process appear. The scope of change in GDP in each of these periods appears in the first panel of each graph. In the second panel, this variation is broken down into the proportion corresponding to the demand covered by internal production (C+S+I−M) and into that explained by foreign demand (X) the sum of the two changes is equal to the sum of GDP. The third panel illustrates the changes in two unique components of changes in GDP: investment (I) and net exports (X−M).

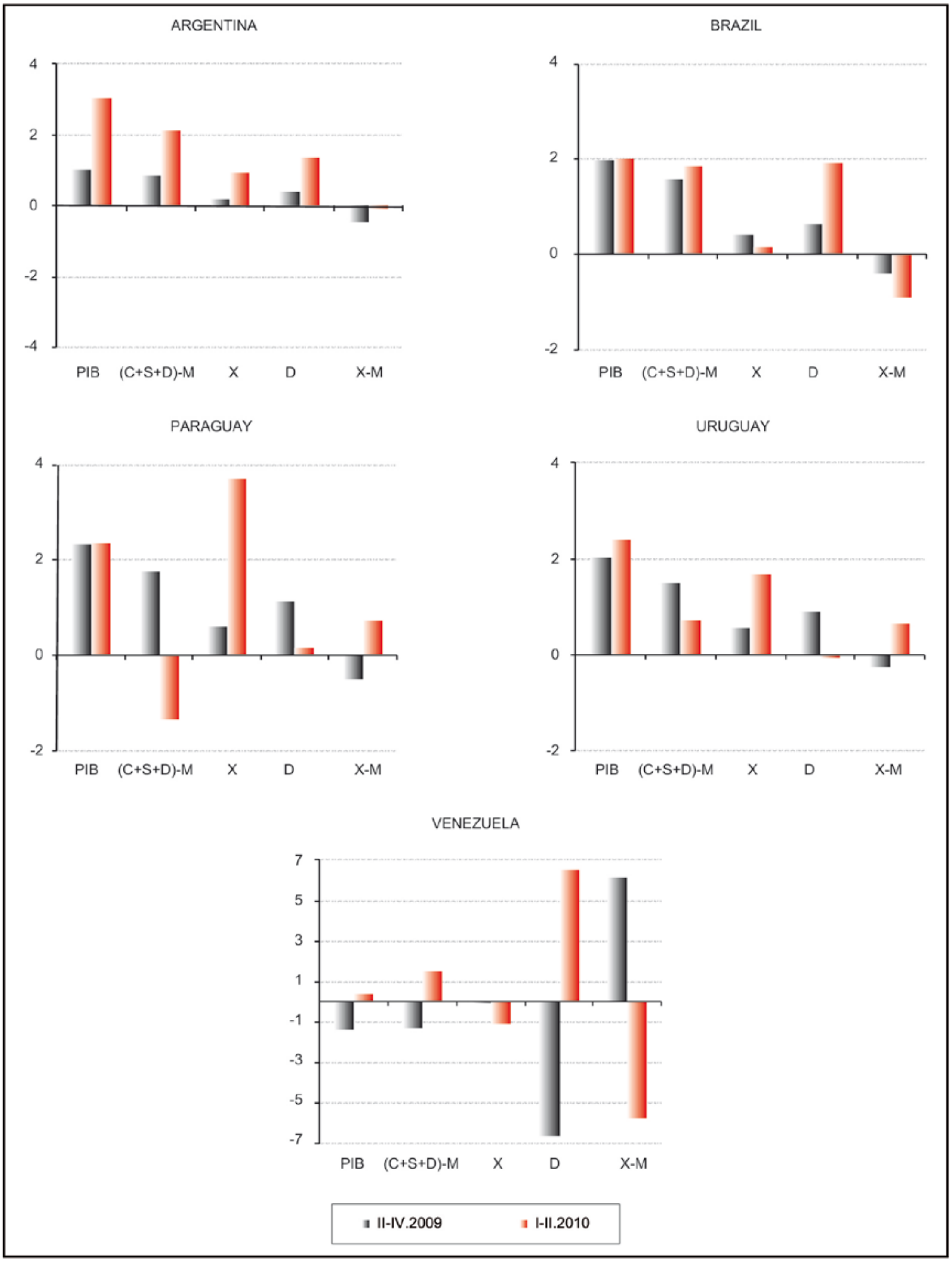
Brazil's GDP contracted 0.2% in 2009 and expectations suggest a 7.6% increase in 2010. In the quarter-to-quarter measurement, the recovery began to be seen in the second trimester of 2009, reaching a rate of 2.8% in the first trimester of 2010, and then slowing in the following trimester (1.2%). The contribution of public consumption was extremely pronounced in the first trimester of 2009, when it was up 4.4% on the previous trimester. However, in the year as a whole, the aggregate grew 3.7%, while private consumption stood at 4.1%, reflecting the credit and tax stimulus packages implemented by the government. The recession experienced in 2009 was the result of a sharp retraction in the gross capital formation (-18.4%) and exports (-10.3%). These variables recovered impressively in the first semester of 2010, with YOY growth of 37.8% and 10.5% respectively. GDP grew 8.9% in the same period. The acceleration in activity was expressed in a 39.2% rise in imports in the first part of 2010, after the 11.4% drop the previous year.

In 2009, the international crisis and the effects of drought on the agricultural sector affected **Paraguay**'s GDP, which contracted 3.8%, interrupting six years of sustained expansion. The forecast for 2010 is 9.0%. The first semester of 2009 was recessive, with a very steep retraction in the first trimester of the year, 6.8% down on the immediately preceding period in the seasonally-adjusted series. Once stabilized, activity gathered pace in the second semester of the year, a trend that lasted until the first trimester of 2010, with an increase of 3.8%. The contraction of 2009 came about due to a sharp fall in exports (-13.9%), gross capital formation (-11.9%), and even private consumption (-3.4%), while, as in other countries, public consumption played a stabilizing role, growing 13.7%. In the first semester of 2010, GDP rose at a record year-on-year rate of 11.7% thanks to the good results in the agricultural, livestock, industrial, construction, and service sectors. Unlike the previous year, agriculture benefited from excellent climatic conditions. Exports and capital formation grew by 32.1% and 18.2% respectively, while private consumption began to recover from the fall of 2009, with growth of 7.6%. The 29.3% rise in imports reflected the buoyancy of the economy.

Despite the picture of international crisis, **Uruguay**'s GDP grew 2.9% in 2009, without entering recession. A 7.0% rise is forecast for 2010. GDP only contracted in the first trimester of 2009, when, in the seasonally-adjusted quarter-to-quarter measurement, gross fixed capital formation, private consumption, and public consumption were down 6.0%, 3.0%, and 2.6% respectively. Exports, however, were up 2.0%. The slump was overcome in the second trimester of the year. In the first semester of 2010, the YOY increase in GDP was 9.6%, with significant increases in gross capital formation (19.9%), exports (10.5%), and private consumption (9.4%). Imports accompanied this trend in the semester, growing 14.1%, after an 8.6% contraction in 2009.

Graph 9. MERCOSUR: Decomposition of the dynamics of GDP[a/] 2009-2010

Average rates of change compared to the previous quarter for the periods indicated



Note: [a/] Seasonally-adjusted GDP series are the official ones from Argentina and Brazil. For Paraguay, Uruguay, and Venezuela seasonal adjustments use the X-12 ARIMA methodology. C: Consumption. S: Public spending. D: Gross domestic capital formation (gross domestic fixed capital formation + changes in stocks). X: Exports. M: Imports.

Source: Compiled with data from Ministry of Economy and Public Finance (MECON), IBGE, BCP, BCU, and BCV.

The performance of **Venezuela**'s economy was not synchronized with its MERCOSUR partners, experiencing more prolonged effects of the international crisis. In 2009, GDP contracted 3.3% and continued to perform negatively even in the first semester of 2010, falling again by 3.5% YOY. In the second trimester of the year, however, the rate of decline slowed, the YOY rate being -1.9%. The recession of 2009 involved all expenditure aggregates except government consumption, which expanded 2.3%. Gross capital formation and exports saw sharp falls of 20.0% and 12.9% respectively, with private consumption also contracting by 3.2%.[16] The main factors that slowed the fall in the second trimester of 2010 were government consumption and gross capital formation, which expanded 3.1% and 0.1% respectively. Venezuelan imports contracted 19.6% in 2009, and 21.6% YOY in the first semester of 2010.

D. Economic Policies

Fiscal policy

Argentina. In 2009, the overall result of the Non-Financial National Public Sector (cash basis)[17] showed a deficit of 0.6% in GDP, with a primary surplus equivalent to 1.5%. In 2008, both figures were positive, at 1.4% and 3.1% respectively (Table 1). The decline was due to the slowdown in the rate of activity, the implementation of cyclical measures, and an increase in interest payments.[18] In 2009, total income[19] slowed, growing 18.4% compared to 35.8% the previous year. Primary expenditure[20] also slowed (27.4% in 2009 as against 37.1% in 2008), but with far less intensity than income.

In current income, the addition of tax revenues and social security contributions rose 11.8% in 2009, headed mainly by the latter. The contribution of the IMF's special drawing rights (SDR), entered in transfers, accounted for 23% of the increase in revenue. In contrast, and in line with the downward phase of the cycle, levies of foreign trade and gains taxes were down on the previous year. The growth in primary expenditure was largely explained by wage increases to public servants, social security benefits, and current transfers to the private sector.[21] The growth of the latter, however, was lower than 2008 (15.7% as against 60.1%). The weakened labor market was shored up by reductions in payroll tax and a moratorium on social security debts, and by aid to companies to pay wages and keep up employment against the background of declining production. Capital expenditure grew by 52.7%, explained mainly by the doubling of capital transfers to the provinces.

[16] The previous recession occurred in the 2002-2003 biennium, when GDP fell by an annual average of 8.3%, with contractions of 34.7% 7.2%, and 5.7% in gross capital formation, exports, and consumption respectively. Imports fell 23.1%.
[17] Including National Administration, PAMI, Trust Funds, Federal Administration of Public Revenues (AFIP), and public sector companies.
[18] Interest reached 2.1% of GDP, as against 1.7% in 2008. The increase was due to higher coupon payments linked to evolution of GDP and debt swaps with multilateral organizations that boosted the local currency variable-rate and foreign currency fixed-rate balances.
[19] Current earnings, capital resources, and figurative contributions.
[20] Current spending, capital spending, figurative spending, less interest.
[21] Family allowances, subsidies on energy, passenger transport, and the consumption of farm-produced foods.

Table 1. MERCOSUR: Main fiscal indicators 2007-2010

As % of GDP

Country	Period	Primary result[/]	Interest[a/]	Global result[a/]	Public debt[b/]
	2007	3.2	2.0	1.1	56.1
	2008	3.1	1.7	1.4	48.8
Argentina	2009	1.5	2.1	-0.6	48.8
	2009 1st S	0.7	0.8	-0.2	49.4
	2010 1st S	0.9	0.9	0.0	48.6
	2007	3.4	6.1	-2.6	45.1
	2008	3.6	5.5	-1.9	38.4
Brazil	2009	2.1	5.4	-3.3	42.8
	2009 1st S	2.4	5.3	-2.9	41.2
	2010 1st S	2.4	5.4	-3.0	41.4
	2007	1.8	0.8	1.0	21.7
	2008	3.1	0.6	2.5	19.0
Paraguay	2009	0.7	0.6	0.1	19.0
	2009 1st S	1.5	0.3	1.2	19.7
	2010 1st S	1.9	0.2	1.7	18.0
	2007	3.5	3.5	0.0	68.1
	2008	1.3	2.9	-1.5	53.0
Uruguay	2009	1.1	2.8	-1.7	69.5
	2009 1st S	1.7	3.0	-1.3	60.6
	2010 1st S	2.9	3.0	-0.1	56.8
	2007	-1.2	1.6	-2.8	19.5
	2008	-1.2	1.5	-2.6	14.2
Venezuela	2009	-6.7	1.5	-8.2	18.4
	2009 1st S	n.a.	n.a.	n.a.	n.a.
	2010 1st S	n.a.	n.a.	n.a.	21.3

Note: [a/] Argentina: Non-Financial National Public Sector. Brazil: Consolidated Public Sector. Paraguay: Central Government. Uruguay: Consolidated Public Sector. Venezuela: Restricted Public Sector. [b/] Argentina: Non-Financial National Public Sector Debt. Brazil: Net Public Sector Debt. Paraguay: Non-Financial Public Sector Debt. Uruguay: Gross Global Public Sector Debt. Venezuela: Aggregate Balance of the Domestic and Foreign Public Debt.

Source: Compiled with data from the Secretariat for Economic Policy and the Secretariat for Finance (Argentina), IPEA and BCB (Brazil), the Treasury Ministry and BCP (Paraguay), the Ministry of Economy and Finance and BCU (Uruguay), and the Ministry of the Popular Power for Planning and Finance (Venezuela).

During the first semester of 2010, the fiscal picture improved, with a meager overall surplus (0.02% of GDP) and a primary surplus of 0.9% in GDP, two tenths up on the same period in 2009. The recovery in the rate of activity, employment, wages, and the taxable base favorably influenced the collection of VAT, and foreign trade and gains taxes, and of social security revenues. Year-on-year growth of total revenue in the first semester was 32.9%, a similar figure to primary expenditure (31.8%). Tax revenues (32.2% YOY) and social security contributions (28.0%) were more significant factors in rising revenues, contributing 48.8% and 21.5% of the total respectively. On the other hand, taken overall, the increase in public sector remuneration, social security benefits, and private sector transfers accounted for nearly 60% of the increase in public spending in the first semester of 2010. The increase in transfers is mainly a reflection of the broader coverage of the Integrated Program of Medical Care-National Social Service Institute for Retirees and Pensioners (PAMI-INSSJP), the implementation of the Universal Child Allocation for Social Protection, and energy and transport subsidies. With regard to the high growth seen in 2009, capital expenditure decelerated in the first semester of 2010, 14.2% up on the same period a year earlier.

At the close of the first semester of 2010, the balance of the gross national public debt (National Office of Public Credit, 2010) was US$156.691 billion, or 48.6% of GDP, slightly below the 48.8% of late 2009.[22] It is worth noting that 49.8% of this liability lay with agencies from the same public sector and 35.4% with the private sector. In early 2010, the Fund was established in reducing by transferring a fraction of the International Reserves. This instrument helped meet debt maturities with international agencies and other public debt holders. Between April and August there was a debt swap on a sample of bonds (leftovers of the 2005 restructuring) for US$18.3 billion, 67% of which were redeemed.

Brazil. Anticipating the impact of the international financial crisis, in May 2009, the Brazilian authorities changed the Consolidated Public Sector's primary surplus target[23] from 3.8% to 2.5% of GDP. The year closed with a surplus of 2.1% of GDP, 1.4 percentage points (p.p.) below the 2008 result, while the overall deficit stood at 3.3% of GDP, down on 2008 (1.9%). Interest represented 5.4% of GDP.

In 2009, total Central Government income[24] rose just 3.2%, sharply down on 2008 (15.8%). Indeed, during the first nine months of the year, income displayed negative annual rates, experiencing a strong recovery only in the last trimester (18.2%).

Tax revenues and contributions contracted 2.9% in the year, as a result of the deterioration in the economy and reductions in tax rates, adopted by the government to stimulate aggregate demand, in durables and capital goods, including a waiver for investments in oil refining and petrochemicals. In 2009, Central Government primary expenditure grew 14.9%, almost five times the growth in total income. Notable here was the increase in transfers due to unemployment insurance (31.9%), and care benefits (18.1%), while staff expenditure grew 15.9%. The government also implemented measures to encourage the construction and purchase of one million housing units.

The first semester of 2010 closed with an improvement in the fiscal accounts for the Consolidated Public Sector: a primary result equivalent to 2.4% of GDP and an overall deficit of 3.0%. Total Central Government income grew 16.9% YOY thanks to the increase in tax collection and contributions (accounting for 61% to the increase) and social security (22%). In this semester, primary central government expenditure grew even faster than in 2009, 18.2% up on the same period a year earlier. The increase in social security benefits, subsidies, and staff costs together accounted for 53.4% of the increase.

The deteriorating fiscal situation in 2009, associated with the effects of the international crisis, and the appreciation of the real,[25] brought about a significant increase in the proportion

[22] The balance stood at US$147.119 billion; by the end of 2008, it was US$145.976 billion (48.5% of GDP).
[23] Including federal government, state and municipal governments, public sector companies, the National Institute of Social Security, and the Central Bank of Brazil.
[24] Net Treasury income, Central Bank, and social welfare.
[25] According to the Central Bank of Brazil, the 25.5% appreciation of the real over 2009 was one of the most relevant variables in determining the public debt, affecting its share of GDP by 2.5 p.p.

of net public debt in the Consolidated Public Sector. At the end of this year, the balance was R$1.345 trillion, representing 42.8% of GDP, while, at the end of 2008, it stood at 38.4%. This was the first time the downward trend established since 2002 had been reversed. At the end of the first semester of 2010, the balance reached R$1.385 trillion, GDP 1.4 p.p. down on December 2009.

Paraguay. In 2009, the Central Government's primary surplus[26] stood at 0.7% of GDP, down on the 3.1% result in 2008, whereas the overall surplus was 0.1% of GDP. However, in spite of the challenge presented by the unfavorable climate, Paraguay achieved fiscal balance this year.

The deterioration derives from a significant deceleration of total income, coupled with the expansion of spending in an effort to contain the effects of the crisis on activity levels. Total revenue grew 8.8% in 2009, whereas a year earlier the figure was 17.6%. The greatest impact was on customs revenue collection, which fell 7.7%, and VAT collection, which rose just 0.5%. This was partially offset, however, by a significant increase in Income Tax (IRACIS) collection, which expanded 43.2%. Collections in this heading represented 3.1% of GDP, 1 p.p. up on the previous year. The significant increase reflects a delayed effect, as this tax is levied on the previous financial year, when there was a sharp rise in utilities. In non-tax revenues, the levying of royalties deriving from the activity of Binational Entities was also up 14.4%, with an agreement between Paraguay and Argentina playing a major part.[27] The government also implemented an expansionary fiscal policy, notable in which was a 63.8% increase in capital expenditure. This meant that the heading represented 4.6% of GDP (2.7% in 2008). Total expenditure rose 26.6% and almost 5 p.p. in the share of GDP (19.6%). Current expenditure grew 18.3% and, including 15.5% staff costs.

The primary and overall results of the first semester of 2010 showed a surplus: 1.9% and 1.7% of GDP respectively. While total revenue grew 15.5%, costs were 12.0% up on the same period a year earlier. This dynamic is explained by a significant year-on-year improvement in customs (42.3%) and VAT (39.1%) revenue, while the pace of growth in current expenditure (12.0%) and capital expenditure (12.1%) was down on 2009.

At the end of 2009, the balance of the total public sector debt was US$2.882 billion, or 19.0% of GDP. 77.6% of this amount was foreign debt. At the end of the first semester, the balance was virtually the same: US$2,886 million.

Uruguay. In 2009, the overall Consolidated Public Sector deficit[28] stood at 1.7% of GDP, down slightly on 2008, when it reached 1.5%. There was a primary surplus, slightly down on the previous year (1.1% and 1.3% of GDP respectively). In spite of total Non-financial Public Sector income growing 15.4% in 2009—almost twice the 8.8% rate achieved in 2008—the corresponding total primary outlay kept up the rate of growth of 17.3%, slightly down on the previous year. The structure of spending, however, was different, as investments, which were up 31.5% in 2008, rose 13.2% in 2009, while earnings grew by 21.4% in the last year, a rate

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[26] Budgetary implementation on collected income/cost obliged basis. *Banco Central de Paraguay* (2009), Table 33. Interest is from the *Ministerio de Hacienda de Paraguay* (2009a).
[27] *Ministerio de Hacienda de Paraguay* (2009b, p. 12). Total foreign income from Itaipú and Yaciretá reached US$671.8 million, 7.2% up on 2008.
[28] Including consolidated central government, departmental governments, public sector companies, and the Central Bank of Uruguay (BCU), and excluding other State organizations. The Non-Financial Public Sector excludes the BCU. (*Ministerio de Economía y Finanzas*, 2007, p. 22).

higher than the 15.5% of 2008. Primary outlays represented 27.0% of GDP in 2009. The acceleration of income was mainly the result of increased collection by the Social Security Bank (BPS) (23.4%) and public companies, thanks to the performance of the National Administration for the Generation and Transmission of Electricity (UTE), (74.3%). The income/GDP ratio reached 27.7%.

In the first semester of 2010, the Consolidated Public Sector obtained practically a balanced result, with a slight deficit of 0.1% of GDP, while the primary surplus stood at 2.9% of GDP. The total income of the Non-Financial Public Sector in the semester grew 24.8% year-on-year thanks especially to public companies' results[29] and tax collection, including taxation on foreign trade, which grew again after their 2009 fall. BPS income also expanded (15.7% YOY). Primary expenditure, for its part, grew less than income (19.0% YOY), prominent in which was the 49.8% rise in investment from the accumulation of oil inventories by the National Administration of Fuels, Alcohol, and Portland (ANCAP).

At the end of the first semester of 2010, public debt amounted to US$21.885 billion (56.8% of GDP), significantly down on the end of 2009, when the balance was US$21.89 billion, but represented 69.5% of GDP.

Venezuela. As mentioned above, the international financial crisis adversely affected the oil price, with the resulting impact on Venezuela's public accounts. The Restricted Public Sector's overall deficit[30] reached 8.2% of GDP (2.6% in 2008), mainly due to the negative results of Central Government and Petroleum of Venezuela (PDVSA), whose operating surplus was down from 13.8% to 4.4% of GDP between 2008 and 2009. The Restricted Public Sector's primary deficit was 6.7% of GDP (1.2% in 2008).

Total income contracted 17.6% in 2009 after expanding 30.6% in 2008. Rising tax revenues (income tax, social insurance contributions, etc.) were not enough to offset the steep drop in the surplus of PDVSA and other non-financial public companies.

On the other hand, total expenditure saw a major slowdown in 2009, growing just 0.9%, as against 30.4% in 2008. The reduction in current and capital transfers was a major factor in the slowdown. Public sector remuneration grew at a rate of 22.7% (46.4% in 2008).

The policies implemented to lessen the impact of the international crisis include the increase in investment by the FONDEN and the Joint Chinese-Venezuelan Fund. To ease the fall in income, the VAT rate was raised from 9% to 12% in April 2009, while the price administration and control policy begun in 2003 was maintained, although fewer prices were adjusted in 2009. Where wages were concerned, there were two increases in the minimum wage for workers in the public and private sectors.

The public debt grew to 18.4% of GDP (14.2% in 2008).

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[29] The current primary result of public sector companies represents 42% of the increase in income of the period analyzed, after showing a negative result in the first semester of 2009.
[30] Including budgetary central government, PDVSA, a sample of non-financial public sector companies, the Venezuelan Institute of Social Insurance (IVSS), and Deposit Guarantee and Banking Protection Fund (FOGADE).

Monetary and exchange policy

Argentina. From the second semester of 2009 to the first of 2010, the negative effects of the episode of monetary instability caused by the international crisis tended to dissipate. Interest rates showed a downward trend and limited fluctuations, while private sector credit and the demand for local currency accelerated toward the end of the period. In parallel, the rate of inflation tended to be high. In 2008, nominal private sector credit, [31] grew 31.6%, although, in the second semester of the year, it felt the impact of the cooling in activity and global uncertainty, slowing up to October 2009, when it grew just 5.7% (-0.8% in real terms using the Consumer Prices Index (CPI) as a deflator). From this point on, and in keeping with the recovery in the pace of activity, credit expanded, achieving a year-on-year rise of 14.6% in May 2010. Moreover, the growth of M2 in pesos (an indicator of demand for local currency) showed a downward profile up to the last trimester of 2009, when it experienced a sharp acceleration. While average growth in 2009 was 11.6%, year-on-year change in the second trimester of 2010 stood at 20.2%.[32] The expansion of this aggregate kept within the parameters laid down in the Monetary Program of the Central Bank of the Argentine Republic (BCRA). Moreover, interest rates showed a gradual decline, moving away from the levels seen in the critical episode of November-December 2008, when the Buenos Aires Deposit Large Amount Rate (BADLAR) peso rate was 15.9%. In the second semester of 2009, the BADLAR average slid from 11.0% to 8.8% in June 2010. From the third trimester of 2009, the monetary authority brought rates down via their regulatory instruments, while supplying the information requirements for private sector loans.

To December 2009, the CPI showed a 12-monthly change of 7.7%, a similar rate to 2008. However, its behavior throughout the year was different, slowing in the first semester (minimum of 5.3% in June), offset by a sharp price hike in the second semester of the year. This trend continued in the first part of 2010: in June, the CPI accumulated an increase of 5.9% (11.0% YOY). The Implicit Price Index (IPI) for GDP grew 10.0% in 2009, significantly down on 2008 (19.2%), whereas, in the first semester of 2010, it gathered pace again, growing 13.8% YOY

The BCRA kept up its policy of active intervention in the foreign exchange market aimed at reducing the volatility of the exchange rate, slowing the nominal depreciation of the peso in light of events in the first part of 2009. In June 2010, the exchange rate was AR$3.9265 per dollar, with a year-on-year change of 4.2%, whereas, in the first 9 months of 2009, the accumulated depreciation had been 12.3%. In real effective terms,[33] the peso depreciated 15.8% year-on-year in December 2009, while, in the first semester of 2010, it accumulated an appreciation of 4.8%.

Brazil. During the international crisis, the BCB applied expansionary monetary policies consistent with its inflation target regime, including the implementation by the Monetary Policy Committee (COPOM) of five consecutive reductions of the Special System for Settlement and Custody (SELIC) rate, beginning in September 2008. It was decided to stabilize this rate in July 2009 at the minimum 8.75%, which continued up to April 2010.

[31] Estimates from IMF International Financial Statistics.

[32] It should be noted that the international financial crisis and the legislative elections in June 2009 prompted a recomposition of the private sector's fixed term portfolio, raising the proportion of these assets in US dollars from 19.1% in late December 2007 to 27.2% in August 2009, subsequently tailing off to 24.7% of the total by June 2010. This preference for the dollar as a reserve currency did not, however, translate into distrust of the financial system.

[33] The estimates of the real effective exchange rate are from ECLAC. They correspond to the average bilateral real exchange rates aggregated to the export and import structure, and cover all the countries traded with.

Given the strong positive turn of activity levels and an acceleration in prices, this policy shift was prompted by the scenario of an overheating economy. In 2009, the trend in inflation had been downward, closing the year with a year-on-year change in the Extended Consumer Price Index (ECPI) of 4.3% and achieving the target of 4.5% per annum (p.a.). In April 2010, however, the 12-month rate of inflation reached 5.3%, with the monetary policy hardening as a result: between that month and June, the SELIC rose 200 basic points to 10.75%. As early as February, the authorities had raised mandatory deposits to pre-crisis levels. In June and July, the price hike was almost zero, with an accumulated increase of 3.1% for this last month, the annual target being 4.5%.

The policy measures implemented in 2009 generated a major credit expansion, particularly in the second semester of the year. The public financial institutions played a key role in the anticyclical policy, providing resources for the infrastructure and construction sectors, and the production of capital goods. The National Treasury granted the National Economic and Social Development Bank (BNDES) R$100 billion to boost the credit supply, stipulating job conservation or creation as a condition for its allocation to companies. The participation by public banks in credit operations continued to rise in 2010, BNDES financing being one of the main stimuli for infrastructure projects. Also, private sector credit grew 12.9% in 2009, driven mainly by mortgage lending and loans for vehicle purchase. The acceleration continued into 2010, driven by the financing of housing units. To June, private sector credit accumulated an increase of 8.1%.

The real followed a path of appreciation in January 2009, taking it to a level of R$1.7518 in December, a 27.0% drop in the nominal exchange rate. In the first semester of 2010, there was a slight accumulated nominal depreciation 3.3%. In real effective terms, the appreciation in 2009 was 25.8%, with a further 3.5% in the first semester of 2010. In November 2009, the authorities took steps such as the levying of a 2% tax on capital inflows for the purchase of fixed-income securities or Stock Exchange shares, with the aim of halting the appreciation of the currency.

Paraguay. After enduring heavy external inflationary pressures for most of 2008, at the end of that year and in early 2009, the Central Bank of Paraguay (BCP) faced a scenario of rising interest rates and a slowdown in demand for the guaraní (linked to the currency's depreciation) and credit. These circumstances meant that inflation was below the benchmark range established by the Monetary Program,[34] closing December with growth of 1.9% (2.6% annual average). This new situation set up a risk of contraction in the economy, which the BCP sought to offset by cutting short-term policy and other funds interest rates, lowering local and foreign currency reserves, and even authorizing a short-term liquidity window. These measures brought interest rates down. The time deposit rate, for example, which reached 6.6% in November-December 2008, was down to 3.7% in the second semester of 2009 and continued to decline in the first semester of 2010 (2.0%).

The effect of the uncertainty generated by the foreign financial scenario, M2, which includes the main means of payment in guaranís,[35] slowed to just 4.7% year-on-year in April 2009 (39.2% on average in 2008). The BCP's policy and the recovery of the economy reversed this trend, the aggregate growing 17.5% in the second semester of 2009 and 31.1% in the first in 2010. In the first nine months of 2009, whereas the demand for financial assets denominated in guaranís tailed off, dollar deposits grew steeply (47.3% YOY), weakening the

[34] Growth of CPI from 5% ±2.5 p.p. Although the BCP has no outline for inflation targets, it is moving gradually toward such policy design, while still attending to the development of monetary aggregates.
[35] Coins and banknotes in circulation, sight deposits, savings deposits, time deposits, and savings certificates.

dedollarization process. In May 2009, private sector deposits in that currency reached 49.6% of total but this fell to 45.1% in June 2010.[36] Over the course of 2009, the impact of uncertainty on total private sector bank credit was moderate, although still within an overall trend toward deceleration. In the second semester of the year, this variable grew 26.6%, whereas it had grown 51.8% in 2008. In 2010, there were major increases in lending, reaching 36.5% YOY in June.

Accumulated inflation in June 2010 stood at 2.3%,[37] denoting an acceleration of price rises; growth for the semester was 4.0% YOY

The nominal depreciation of the guaraní in late 2008 and early 2009 was reversed as of the second trimester of 2009 thanks to increased income from binational entities, the disbursement of foreign loans, and the inflow of remittances. In June 2010, the exchange rate was G4,767 per dollar, an appreciation of 7.2% on the May 2009 high. In real effective terms, the guaraní saw an average depreciation of 10.2% in 2009, and an appreciation of 2.4% in the first semester of 2010. The BCP carried out various interventions to reduce exchange rate volatility.

Uruguay. The scenario of uncertainty in late 2008 and early 2009 was transmitted through a depreciation of the peso, even against a background of strong inflationary pressures. In this context, the COPOM had to deepen its restrictive monetary policy in January 2009 and raised the Monetary Policy Rate (MPR) from 7.75% to 10%. The same month saw an annual CPI rate of 9.2%, when the target range set in January was between 3% and 7% over an 18-month horizon. Mandatory reserves were reduced to guard against potential restrictions on liquidity. The rate of inflation declined over the course of the year—not without fluctuations—closing at 5.9% (7.1% annual average). This allowed the reduction of the MPR on three occasions, which was finally fixed at 6.25% in December.

The external crisis meant a hike in peso interest rates. In November 2008, the rate for medium and large companies up to 366 days thus reached 19.31%. The stabilization brought about a gradual decline in the rate: 12.56% in June 2010, close to the average for 2008.

Between September 2008 and August 2009, the growth of M2[38] underwent a persistent slowdown, the counterpart of which was the rapid growth in residents' dollar deposits against the backdrop of a weak Uruguayan peso.[39] The situation reversed in the last trimester of 2009 and the first part of 2010. In June that year, M2 grew at a rate of 27.4% YOY, the peso appreciated, and dollar deposits stood at pre-crisis levels, around 80% of the total.

The balance of total private sector credit,[40] which had seen a significant 26.0% rise in 2008, displayed a downward trend in 2009, in a sense reversing the previous excessive expansion. In 2010, however, placements began to grow again, albeit at a lesser rate. The balance in June 2010 stood at UR$170.2 billion, 6.9% up on December 2009 and 35% higher than the 2007 average.

[36] The BCP defined M3 as the sum of M2 and private sector dollar deposits. Note that despite the relative increase experienced by these deposits, the proportion is much lower than the 66.7% they represented in 2003.
[37] The 2010 benchmark target is 4.5%, ±2 p.p.
[38] Circulation, sight deposits, savings deposits, and time deposits in national currency.
[39] Between August 2008 and July 2009, the nominal depreciation of the peso was 21.2%; in same period, the proportion of dollar deposits (residents and non-residents) was 79.9% and 84.8% respectively.
[40] Residents and non-residents in both national and foreign currency.

In December 2009, the COPOM set the inflation target range at between 4% and 6%. The accumulated increase in the CPI to June and September 2010 was 3.1% and 5.8% respectively, with expectations exceeding the target undertaken, and the MPR was raised 25 basis points in that last month.

In June 2010, the nominal exchange rate was $20.3 per dollar, representing an annual appreciation of 12.8%. In real effective terms the appreciation during that period was 16.9%. That month, the government announced a major intervention in the foreign exchange market to curb the peso.

Venezuela. Venezuela's rate of internal inflation began to follow a path of deceleration against the backdrop of the recession that began to dominate the world economy late in 2008.[41] But this new scenario also negatively affected key variables in the external sector and, eventually, the stability of the financial system. The monetary authority, therefore, took various steps to safeguard liquidity and stimulate credit. Among other provisions, the rate of marginal reserves was reduced, as were interest rates for injection and absorption instruments, and the ceilings and floors for borrowing and lending transactions in the banking system.[42] Against such a complex background, the authorities had to intervene in ten banking entities at the end of 2009, winding up two and merging four (*Banco Central de Venezuela*, 2009, p. 75).

During 2009, the deficit in the overall foreign balance (determined by the falling oil price, the delay in the tightening of import controls, and the outflow of financial capital) led to a contractionary monetary dynamic. PDVSA and the Venezuelan government had a lesser impact on the expansion of the monetary base, whose nominal balance grew by an annual average of 18.9%, as against the 39.8% of 2008. In real terms, it went from an average expansion of 7.8% to a contraction of -6.5% over the two years. This phenomenon took place against the backdrop of an inflation rate that reached an average of 27.1% in 2009. The real contraction of the base was transmitted to other monetary aggregates and to credit. To November 2009, the real private sector credit balance was estimated to have fallen 8.4% YOY.[43]

The insecurity of the external sector reduced the amount of foreign currency available, with the Central Bank of Venezuela (BCV) liquidating US$31.256 billion in 2009, 37.8% down on the previous year (*Banco Central de Venezuela*, 2009b, p. 21). During that period, the Foreign Currency Administration Regime continued to operate and the exchange rate remained at Bs.F.2.1446 per US dollar buying and Bs.F.2.1500 selling. However, in early 2010, a dual foreign exchange regime was established, setting a different dollar price according to use. For the import of certain goods (such as food and medicines), the exchange rate was set at Bs.F.2.6 per dollar, while other imports, and PDVSA exports, are performed at Bs.F.4.3 per dollar. Also, the BCV carried out various foreign exchange bond placements to cover the demand for foreign assets. In real effective terms, the bolívar appreciated 16.2% YOY in 2009. The shift in foreign exchange policy meant a real effective depreciation of 62.9% in June 2010. In the first semester, the rate of inflation began to accelerate again, reaching 31.3% YOY in June.

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[41] In September 2008, the YOY rate peaked at 34.5% and troughed at 24.3% in January 2010.

[42] However, in 2009, the open market operations (through DPN Bonds, Treasury Bills, and Certificates of Deposit) meant net absorption equivalent to 16.5% of the monetary base (17.9% in 2008), even when this proportion in the second semester stood at just 9.3%.

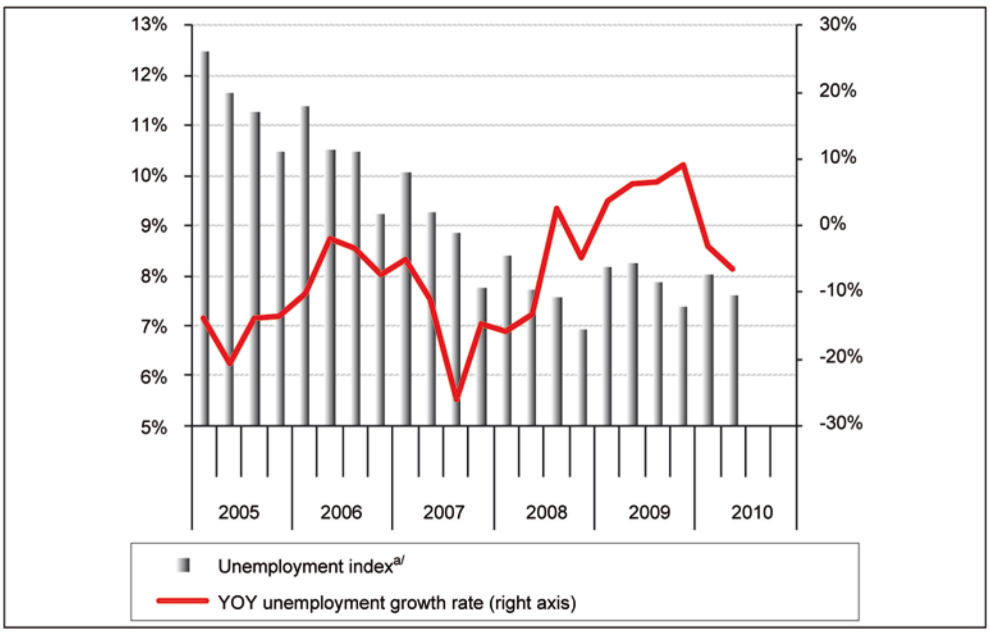
[43] Credit granted by the Universal, Trade, and Development Banks; latest data available.

E. Income and Employment

In 2009, the average rate unemployment in the MERCOSUR countries (including Venezuela and excluding Paraguay)[44] was up 0.3 p.p. on the previous year, from 7.6% to 7.9% (Graph 10). In the year-on-year comparison, the rate deteriorates over the last three trimesters, even though rates of activity began to pick up as of the second trimester (Graph 8). In the first semester of 2010, the indicator stood at 7.8%, down on the 8.2% of the same period a year earlier.

Graph 10. MERCOSUR: Quarterly unemployment indicators 2005-2010

%



Note: [a/] Simple average for rates of unemployment, including Venezuela and excluding Paraguay.

Source: INDEC, MECON, IBGE, INE (Uruguay), and INE (Venezuela).

The absolute number of unemployed rose year-on-year over 2009, after falling steadily since 2004. In 2009, the average number of unemployed ran to 3.9 million (6.2% up on the previous year), falling to 3.7 million by the end of the second semester of 2010. This is similar to the same period in 2008, just before the recessive phase of the crisis in the world economy.

During 2009, real earnings grew in all MERCOSUR countries, except Venezuela. This growth was led by Uruguay and Argentina. In the first semester of 2010, the indicator continued to improve, but with far less intensity than the previous year, due mainly to the resurgence of inflationary pressures in all countries.

[44] Paraguay does not provide quarterly employment indicators. The Permanent Household Survey (EPH), carried out between October and December 2009, estimated an unemployment rate of 6.4% (some 202,400 people); in 2008, the rate was 5.7%.

Contents

ANNEX I

Table AI.1. MERCOSUR: Gross Domestic Product (GDP)

Real YOY percentage change

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela	MERCOSUR[a/]
1998	3.9	0.0	0.6	4.5	0.3	1.9
1999	-3.4	0.3	-1.5	-1.9	-6.0	-2.5
2000	-0.8	4.3	-3.3	-1.9	3.7	0.4
2001	-4.4	1.3	2.1	-3.8	3.4	-0.3
2002	-10.9	2.7	0.0	-7.7	-8.9	-5.0
2003	8.8	1.1	3.8	0.8	-7.8	1.4
2004	9.0	5.7	4.1	5.0	18.3	8.4
2005	9.2	3.2	2.9	7.5	10.3	6.6
2006	8.5	4.0	4.3	4.3	9.9	6.2
2007	8.7	6.1	6.8	7.5	8.2	7.4
2008	6.8	5.1	5.8	8.5	4.8	6.2
2009	0.9	-0.2	-3.8	2.9	-3.3	-0.7
2010[b/]	7.8	7.6	9.0	7.0	n.a.	7.8

Note: [a/] Simple average for all five countries. [b/] Central Banks projections.

Source: BCRA, CBB, BCP, BCU, ECLAC.

Table AI.2. MERCOSUR: Breakdown of GDP dynamics[a/] 2009-2010

Average rate of change of GDP seasonally-adjusted against the previous quarter for the specified periods as %

Country / Aggregate demand component	Quarters	
	II-IV.09	I-II.10
Argentina		
GDP	1.1	3.1
(C+S+I)-M	0.9	2.1
X	0.2	1.0
I	0.4	1.4
X-M	-0.4	-0.1
Brazil		
GDP	2.0	2.0
(C+S+I)-M	1.6	1.8
X	0.4	0.2
I	0.6	1.9
X-M	-0.4	-0.9
Paraguay		
GDP	2.3	2.3
(C+S+I)-M	1.7	-1.4
X	0.6	3.7
I	1.1	0.2
X-M	-0.5	0.7

Table AI.2. (CONTINUED)

Country / Aggregate demand component	Quarters	
	II-IV.09	I-II.10
Uruguay		
GDP	2.0	2.4
(C+S+I)-M	1.5	0.7
X	0.6	1.7
I	0.9	-0.1
X-M	-0.3	0.7
Venezuela		
GDP	-1.4	0.4
(C+S+I)-M	-1.3	1.5
X	-0.0	-1.1
I	-6.7	6.5
X-M	6.1	-5.8

Note: [a/] The seasonally-adjusted GDP series are official series from Argentina and Brazil. For Paraguay, Uruguay, and Venezuela seasonal adjustments are made with the X-12 ARIMA methodology. C: Consumption. S: Public spending. I: Gross domestic capital formation (gross domestic fixed capital formation + changes in stocks). X: Exports. M: Imports.

Source: Compiled with data from the Ministry of Economics and Public Finance (MECON), IBGE, BCP, BCU, and BCV.

Table AI.3. MERCOSUR: Consumer price index

YOY percentage change

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela	MERCOSUR[a/]
1998	0.7	1.7	14.6	8.6	29.9	11.1
1999	-1.8	8.9	5.4	4.2	20.0	7.3
2000	-0.7	6.0	8.6	5.1	13.4	6.5
2001	-1.5	7.7	8.4	3.6	12.3	6.1
2002	40.9	12.5	14.6	25.9	31.2	25.1
2003	3.7	9.3	9.3	10.2	27.1	11.9
2004	6.1	7.6	2.8	7.6	19.2	8.7
2005	12.3	5.7	9.9	4.9	14.4	9.4
2006	9.8	3.1	12.5	6.4	17.0	9.8
2007	8.5	4.5	6.0	8.5	22.5	10.0
2008	7.2	5.9	7.5	9.2	30.9	12.1
2009	7.7	4.2	1.9	5.9	25.1	8.9

Note: [a/] Simple average for all five countries.

Source: INDEC, CBB, BCP, INE, and BCV.

Table AI.4. MERCOSUR: Real effective exchange rate

2000=100 Indexes, end of each period

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela	MERCOSUR[a/]
1998	110.2	76.9	101.4	107.0	109.0	100.9
1999	100.4	105.4	100.9	98.7	100.9	101.3
2000	99.2	103.9	97.5	100.0	97.5	99.6
2001	97.2	115.8	113.7	104.9	94.0	105.1
2002	230.9	156.9	115.0	134.3	127.4	152.9
2003	218.4	126.2	107.2	157.7	130.8	148.1
2004	222.8	115.4	113.4	145.5	136.1	146.6
2005	214.9	93.7	114.5	130.3	137.9	138.3
2006	213.7	89.1	96.0	132.2	123.4	130.9
2007	216.4	78.0	91.4	123.1	109.2	123.6
2008	191.7	97.7	87.1	124.6	80.8	116.4
2009	222.0	72.5	91.8	106.2	67.7	112.0
2010[b/]	211.3	70.0	90.7	102.3	110.3	116.9

Note: [a/] Simple average for all five countries. [b/] First semester.

Source: ECLAC.

Table AI.5. MERCOSUR: Net international reserves

Billions of US$, to end of period

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela
2005	28.077	53.799	1.293	3.078	30.368
2006	32.037	85.839	1.703	3.091	37.440
2007	46.176	180.334	2.462	4.121	34.286
2008	46.386	193.783	2.864	6.360	43.127
2009	47.967	238.520	3.861	7.987	35.830
2010[a/]	49.240	253.114	3.908	7.509	29.351

Note: [a/] To June.

Source: BCRA, BCB, BCP, BCU, and BCV.

Table AI.6. MERCOSUR: Rate of unemployment

As % of the economically active population, annual average

Year	Argentina		Brazil[b/]	Paraguay[c/]	Uruguay[d/]	Venezuela[e/]	MERCOSUR[f/]
	a1/	a2/					
2003	17.3	22.7	12.4	8.1	16.5	18.0	14.4
2004	13.6	16.7	11.5	7.3	12.9	15.3	12.1
2005	11.6	13.7	9.9	5.7	12.2	12.3	10.3
2006	10.2	12.3	10.0	6.5	11.4	10.0	9.6
2007	8.5	9.4	9.3	5.5	9.6	8.5	8.3
2008	7.9	8.2	7.9	5.7	7.6	7.2	7.3
2009	8.7	8.9	8.1	6.4	7.3	7.6	7.6
2010[g/]	8.1	8.1	7.3	0.0	7.1	8.7	7.8

Note: [a1/] Urban areas. The beneficiaries of social plans performing labor considerations are considered employed. [a2/] Urban areas. Persons whose main occupation comes from a social plan are considered unemployed. [b/] Six metropolitan areas. [c/] Total population (urban and rural). [d/] Before 2008 the data refer to "urban country total," defined as localities of 5,000 inhabitants or more; they subsequently refer to "country total." [e/] National total. [f/] Simple average for all five countries. In Argentina's case the rate in note [a1/] is taken. [g/] First semester.

Source: INDEC, IBGE, DGEEC, INE (Uruguay), and INE (Venezuela).

Table AI.7. MERCOSUR: Numbers of unemployed

Thousands of people

Year	Trimester	Argentina	Brazil[a/]	Paraguay	Uruguay[b/]	Venezuela[c/]	MERCOSUR[d/]
2004	I	1,508	2,737	n.a.	265	2,073	6,583
	II	1,577	2,524	n.a.	251	1,940	6,291
	III	1,408	2,379	n.a.	232	1,819	5,838
	IV	1,281	2,080	n.a.	234	1,553	5,149
2005	I	1,369	2,352	n.a.	244	1,705	5,671
	II	1,281	2,029	n.a.	254	1,423	4,986
	III	1,194	2,118	n.a.	248	1,461	5,021
	IV	1,087	1,823	n.a.	267	1,271	4,447
2006	I	1,234	2,281	n.a.	250	1,337	5,102
	II	1,148	2,306	n.a.	221	1,210	4,885
	III	1,136	2,257	n.a.	225	1,239	4,857
	IV	961	1,864	n.a.	193	1,097	4,116
2007	I	1,093	2,281	n.a.	214	1,256	4,844
	II	947	2,187	n.a.	188	1,029	4,351
	III	305	2,058	n.a.	189	1,045	3,597
	IV	826	1,681	n.a.	169	839	3,515

Table AI.7. (CONTINUED.)

Year	Trimester	Argentina	Brazil[a/]	Paraguay	Uruguay[b/]	Venezuela[c/]	MERCOSUR[d/]
2008	I	940	1,952	n.a.	175	1,008	4,075
	II	894	1,807	n.a.	160	916	3,778
	III	869	1,777	n.a.	161	887	3,695
	IV	828	1,567	n.a.	145	802	3,342
2009	I	946	2,082	n.a.	159	1,034	4,221
	II	993	1,867	n.a.	156	997	4,013
	III	1,034	1,799	n.a.	156	943	3,932
	IV	960	1,592	n.a.	134	960	3,646
2010	I	943	1,788	n.a.	164	1,198	4,092
	II	896	1,647	n.a.	141	1,066	3,751

Note: [a/] Six metropolitan areas. [b/] In 2006, the National Survey of Households was expanded to include rural areas. The figures from this year are therefore not comparable with previous years (Urban Total). [c/] National total. [d/] Simple average for all four countries.

Source: MECON, IBGE, INE (Uruguay) and INE (Venezuela).

Table AI.8. MERCOSUR: Real earnings

YOY percentage change, nominal wage index, deflated by CPI

Period/Country	Argentina	Brazil	Paraguay	Uruguay	Venezuela	MERCOSUR[a/]
2007	10.8	3.2	0.7	4.8	1.5	4.2
2008	12.7	3.4	-0.6	3.5	-4.0	3.0
2009	12.5	3.2	3.9	7.3	-4.7	4.4
2010[b/]	8.6	1.7	n.a.	3.8	-3.6	2.6

Note: [a/] Simple average for all five countries. [b/] First semester.

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

CHAPTER II. THE EVOLUTION OF TRADE AND FOREIGN DIRECT INVESTMENT

MERCOSUR countries' trade flows were not immune to the effects of the recession ushered in by the international financial crisis that erupted in September 2008, seeing very significant falls in 2009 and interrupting an extraordinary cycle of rises in previous years. Although the bloc's GDP has generally performed better than the rest of the world economy, the drop in imports was higher than that in exports, increasing the region's total trade balance. This rise was primarily down to two factors: the more favorable performance of sales to Asian countries, mainly China, which were able to sustain their internal growth even during the crisis; and the sharp decline in MERCOSUR's imports, due both to shrinking quantities and falling prices. Here, the drop in the price of oil and its derivatives was significant.[45] Also, after a sharp decline at the end of 2008 and early 2009, MERCOSUR export commodity prices recovered in the ensuing months, helping to hold up the dollar value of exports.

A more detailed analysis of the figures for 2009 shows that, strictly speaking, the lows only signified the shrinking of the extraordinary gains made in 2008, with quantities falling to levels close to 2007. Indeed, analyzing the situation solely from the point of view of trade balances, the crisis was beneficial to MERCOSUR, considering that results were up on the previous year, reversing the trend of deterioration of the three previous years.

The figures for the first semester of 2010 show that MERCOSUR trade flows returned to rapid growth, almost reaching pre-crisis levels. The profile of this expansion also displays the same features seen up to 2008: rapid export growth based largely on rising prices; even faster growth than in imports, resulting in a rapidly deteriorating trade balance; and falling shares for the most developed countries (NAFTA and the EU) in export destinations as a result of the divergence between the rapid recovery of growth in emerging economies and the weak trajectory of activity in Europe and the United States.

In short, 2009 seems only to have been a brief lapse in the progress of the MERCOSUR countries' trade flows, which displayed such positive features as diversification of destinations, gains in the terms of trade, an increased market share in world trade, and the consolidation of competitive capacity in various products, especially agricultural commodities. However, there are causes for concern, such as loss of competitiveness in various industrial sectors and the gradual worsening of trade balances, a trend that will be accentuated over the coming months and years as the growth of the bloc's economies remains above the world average.

MERCOSUR's trade with Venezuela also saw significant falls in 2009, especially in exports. In the early months of 2010, imports returned to growth, but exports remained virtually stable compared to the same period a year earlier, due to the recession still affecting Venezuela.

In foreign investment, the international crisis did not prevent MERCOSUR attracting a significant flow of resources in 2009, albeit down on the volumes of 2008, when these reached historic highs. In the early months of 2010, the income from investments was somewhat disappointing, below the levels recorded for the same period in 2009. However, the prospects for the rest of the year and for the next few years remains extremely positive, since the region is viewed as one of the most promising in the world, both in terms of expansion of the internal market, and its potential for the production and export of commodities.

[45] Average international oil prices in 2009 were around 50% lower than the previous year.

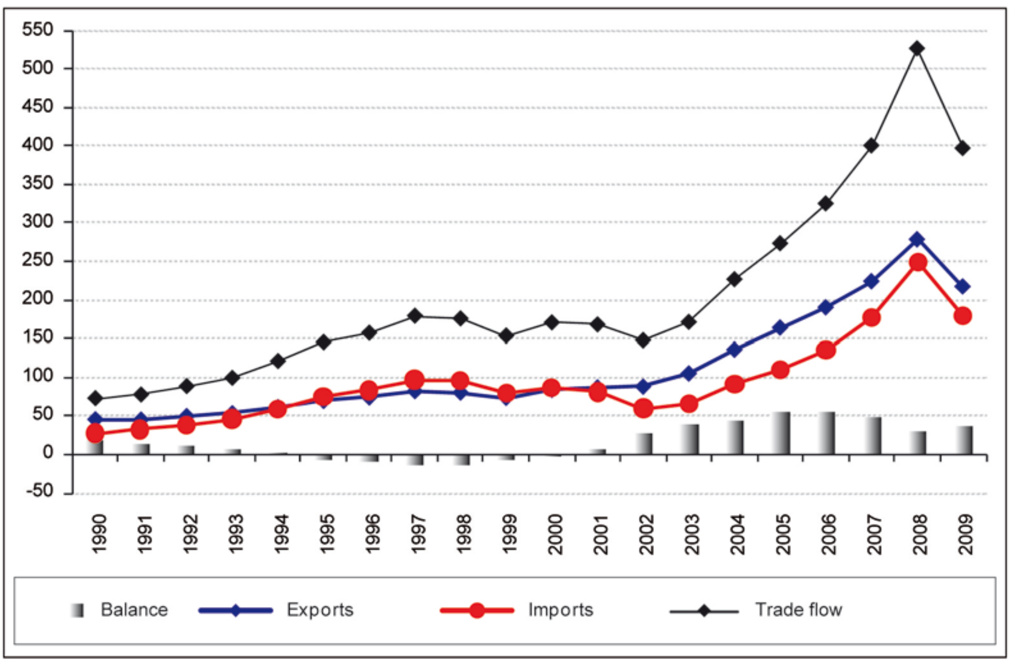
A. Total MERCOSUR trade[46]

The MERCOSUR countries' total exports reached US$217.2 billion in 2009, 22.0% down on the previous year.[47] The performance of imports was even worse, recording a 27.5% fall. The bloc thus increased its overall trade balance to US$37.4 billion, as against the US$30.2 billion recorded in 2008. The bloc's trade flow fell 24.6% in 2009, to US$397 billion.

Graph 11 shows that the 2009 result represented an interruption in the process of rapid expansion between 2003 and 2008, when average annual export growth stood at 21.2%, the fastest in recent decades. Imports grew even faster in the same period, especially in 2006-2008, with cumulative annual (c.a.) growth of 31.5% year-on-year.

Graph 11. Total MERCOSUR foreign trade, 1990-2009

Billions of US$



Source: INDEC (Argentina), SECEX-MDIC (Brazil), Central Banks of Paraguay and Uruguay.

[46] As the process of Venezuela's membership of MERCOSUR is not yet complete, all references to the bloc's trade flows in this section only take into account the four original partners. Section C discusses MERCOSUR-Venezuela trade.

[47] This section is based on primary trade figures produced by the national statistics bodies and may differ from the ones obtained from the balance of payments in Chapter I. The differences arise from two circumstances: (a) date of the series' update and (b) different definitions. On the last point, the following cases should be made clear: (i) *Argentina*: imports are taken into account in the balance of payments on a free-on-board (FOB) basis (in this section, these are cost, insurance, and freight (CIF)); (ii) *Paraguay*: in the balance of payments, both flows are measured in FOB and include both registered and unregistered trade, as well as binational entities and reexports (in this section, only registered FOB trade is taken into account); (iii) *Uruguay*: in the balance of payments, flows include customs exclave trade (excluded in this section's figures). Also, balance of payments imports are FOB and imports in this section are CIF.

In the first semester of 2010, the bloc's trade flows displayed strong growth, in part related to the low base for comparison of the first semester of 2009, but also reflecting the intense recovery in the region's economic growth. Total MERCOSUR exports rose 25.1% to US$127.1 billion, and imports grew even faster (43.8%), reaching US$114.1 billion. The trade surplus dropped accordingly to US$13 billion (Table 2).

The partial data suggest that the bloc's trade flows closed 2010 at levels similar to those achieved in 2008, i.e. countries in the region needed just a year to recoup the losses generated by the international crisis. The worrying aspect of this movement is that the trend of a rapidly falling trade surplus, which had been temporarily reversed in 2009, also resurfaced. Indeed, the partial data available indicate that the total balance for the year could be the lowest since 2002.

Trade flows by country

Brazil was responsible for 70% of MERCOSUR's total exports in 2009, with a slight loss of share compared to the previous year, since the fall in its exports (22.7%) was slightly higher than the bloc's total (Table 2). Argentina's share rose to 25.6%, while Paraguay and Uruguay held steady at 1.5% and 2.5% respectively. Uruguay was the MERCOSUR country that suffered the lowest fall in exports over the year (just -9.4%). In comparison with previous years, there was a gradual reduction in Brazil's importance in the bloc's exports since 2005 and a gradual increase in the other countries' share, especially Argentina's, which gained 2 p.p. between 2005 and 2009.

Table 2. Total trade flows for the MERCOSUR countries at selected periods

Billions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
Exports	**88.901**	**163.987**	**278.368**	**217.215**	**-22.0**	**101.597**	**127.059**	**25.1**
Argentina	25.651	40.387	70.021	55.668	-20.5	27.378	32.251	17.8
Brazil	60.439	118.529	197.942	152.995	-22.7	69.952	89.187	27.5
Paraguay	0.951	1.655	4.463	3.167	-29.0	1.707	2.384	39.6
Uruguay	1.861	3.416	5.942	5.386	-9.4	2.560	3.236	26.4
Imports	**59.705**	**109.239**	**248.195**	**179.831**	**-27.5**	**79.346**	**114.085**	**43.8**
Argentina[1]	8.988	28.687	57.423	38.780	-32.5	17.367	24.802	42.8
Brazil	47.243	73.600	173.197	127.647	-26.3	56.027	81.309	45.1
Paraguay	1.510	3.073	8.506	6.497	-23.6	2.811	4.172	48.4
Uruguay[1]	1.964	3.879	9.069	6.907	-23.8	3.141	3.802	21.0
Trade balance	**29.195**	**54.748**	**30.173**	**37.384**	**23.9**	**22.251**	**12.973**	**-41.7**
Argentina	16.662	11.700	12.598	16.888	34.1	10.011	7.449	-25.6
Brazil	13.196	44.929	24.746	25.347	2.4	13.925	7.878	-43.4
Paraguay	-0.560	-1.418	-4.043	-3.330	-17.6	-1.104	-1.788	62.0
Uruguay	-0.103	-0.463	-3.127	-1.521	-51.4	-0.581	-0.566	-2.6

Note: [1/] CIF values.

Source: INDEC (Argentina), SECEX-MDIC (Brazil), Central Banks of Paraguay and Uruguay.

On the import side, Argentina saw the most significant contraction in 2009 (32.5%), its share in the bloc's total external purchases falling to 21.6% (-1.5 p.p. against 2008). Brazil's share rose to 71.0%, while Paraguay and Uruguay recorded rates of 3.6% and 3.8% respectively, slightly up on the previous year. Since 2005, Brazil's share in the bloc's imports saw an increase of 3.6 p.p., as did Paraguay's (0.8 p.p.) and Uruguay's (0.3 p.p.), as against Argentina's 4.7 p.p. loss.

The more marked difference in the pace of export and import growth meant that Argentina contributed most to the growth of the bloc's trade balance in 2009, US$4.3 billion up on the previous year. Despite still recording a trade deficit, Uruguay's contribution was also significant, its deficit falling US$1.6 billion. This situation was similar to Paraguay's, whose deficit recorded a drop of US$713 million. Brazil, while still responsible for the bloc's largest surplus, made a positive contribution of just US$602 million.

In the first semester of 2010, however, all the countries' contributions to MERCOSUR's aggregate trade balance were down on the same period in 2009, with the exception of Uruguay's, whose deficits remained almost stable. It was the only country whose exports showed higher growth than imports in the period (26.4% as against 21.0%). Brazil's surplus was down US$6 billion (-43.4%), Argentina's contracted by US$2.6 billion (-25.6%), and Paraguay's loss balance grew by nearly US$700 million. In all three cases, the expansion of imports outstripped the growth of exports, particularly in Argentina's case.

However, in terms of distribution by country, the changes seen in the first semester of 2010 were negligible compared to 2009, with a slight increase in Brazil's and Paraguay's share of both exports and imports, in contrast with a slight loss of share for Argentina in total exports and for Uruguay in imports.

The recent evolution of intrazone trade

Individual MERCOSUR countries' total exports to the other three partners in 2009 were down 21.3% on 2008, a less significant percentage than that seen in extrazone trade flows, which fell 22.1% in exports and 28.1% in imports (Table 3). In the first semester of 2010, intrazone flows began to grow briskly again, 42.7% up on the same period a year earlier, easily outperforming the expansion of exports to countries outside the bloc, up 22.3%. Extrazone imports grew even faster, 45.7% up.

As a result of this, intrazone exports continued to increase their share in the bloc's total sales, after reaching a low (11.5%) in 2002 amid the serious economic crises affecting the region's countries. In 2009, this share reached 15.1%, slightly up on 2008, and rose further in the first semester of 2010, to 15.6%. Even so, it should be remembered that this share is still a long way off the levels reached at the end of the 1990s, of between 20.0% and 25.0%.

Table 3. MERCOSUR intrazone and extrazone trade flows at selected periods

Billions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
Intrazone*								
Exports	10.189	21.111	41.596	32.756	-21.3	13.914	19.857	42.7
Imports	10.300	21.095	42.758	32.027	-25.1	14.149	19.086	34.9
Extrazone								
Exports	78.712	142.876	236.772	184.459	-22.1	87.683	107.201	22.3
Imports	49.406	88.144	205.436	147.804	-28.1	65.197	94.999	45.7
Total								
Exports	88.901	163.987	278.368	217.215	-22.0	101.597	127.059	25.1
Imports	59.705	109.239	248.195	179.831	-27.5	79.346	114.085	43.8
Balance	29.195	54.748	30.173	37.384	23.9	22.251	12.973	-41.7

Note: * Intrazone exports and imports are not the same due to differences in each country's accounting methods.

Source: INDEC (Argentina), SECEX-MDIC (Brazil), Central Banks of Paraguay and Uruguay.

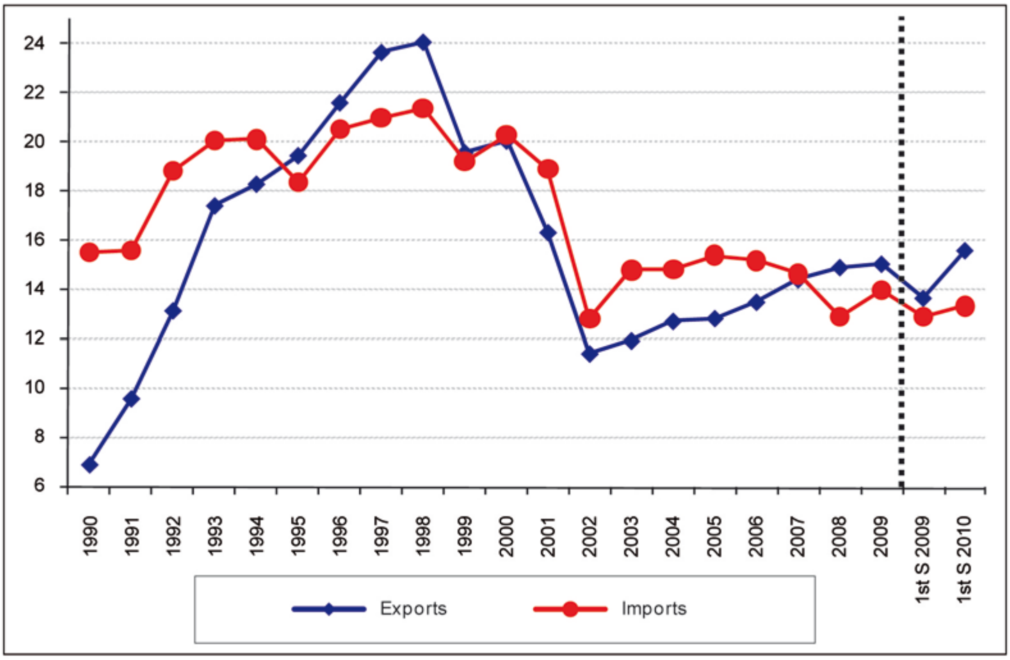
Intrazone imports (each country's total imports from the other three partners), by contrast, have not performed outstandingly in recent years, despite falling less sharply than extrazone imports in 2009 (Graph 12). The MERCOSUR partners' share of purchases was 17.8% in 2009, a higher percentage than the previous year, but still very close to the 17.3% low of 2002. In the first semester of 2010, this share dropped still further, to 16.7%. These recent trends enable us to predict that intrazone imports will not play such an important role in MERCOSUR trade as they did at the end of 1990, when they accounted for around 20.0%.

Table 4 shows the composition of intrazone trade flows by country. In 2009, Argentina exported US$13.9 billion to its neighbors, 14.0% down on the previous year. This fall was far lower than the 35.1% fall in the country's imports. Argentina thus reversed the balance of trade with its partners, which became positive by US$706 million, as against a US$4.2 billion deficit in 2008. In the first semester of 2010, however, the country recorded a further deficit (US$301 million) due to faster growth of imports (43.0%) over exports (30.0%). The last few years have seen a sharp deterioration in Argentina's trade balance with the other members of MERCOSUR, a trend that may resurface after the interlude of 2009. It is important to note that Argentina has, for several years, been the MERCOSUR country that imports most goods from its partners.

Brazil exported US$15.8 billion to its MERCOSUR partners in 2009, 27.2% down on the previous year. Its imports totaled US$13.1 billion, just 12.2% down. There was thus a significant reduction in the balance of trade, from US$6.8 billion in 2008 to US$2.7 billion in 2009. However, in the first semester of 2010, the intrazone trade surplus grew to US$2 billion due to a 56.5% growth in sales to neighbors, as against a 33.4% increase in imports. The trend in recent years has been toward the expansion of Brazil's trade balance with its MERCOSUR partners. This, by all indications, will resurface in the next few years, after the reversal seen in 2009. Indeed, Brazil remains the country that exports most to its MERCOSUR partners.

Graph 12. Share of intrazone trade in MERCOSUR total trade 1990-1st semester of 2010

As %



Source: INDEC (Argentina), SECEX-MDIC (Brazil), Central Banks of Paraguay and Uruguay.

Table 4. Intrazone trade flows in MERCOSUR by country at selected periods

Billions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
Exports	**10.189**	**21.111**	**41.596**	**32.756**	**-21.3**	**13.914**	**19.857**	**42.7**
Argentina	5.718	7.689	16.123	13.865	-14.0	6.130	7.969	30.0
Brazil	3.311	11.746	21.737	15.829	-27.2	6.196	9.697	56.5
Paraguay	0.553	0.893	2.135	1.533	-28.2	0.877	1.228	39.9
Uruguay	0.607	0.783	1.601	1.529	-4.5	0.711	0.964	35.6
Imports	**10.300**	**21.095**	**42.758**	**32.027**	**-25.1**	**14.149**	**19.086**	**34.9**
Argentina	2.895	10.909	20.287	13.159	-35.1	5.783	8.270	43.0
Brazil	5.615	7.054	14.934	13.107	-12.2	5.759	7.681	33.4
Paraguay	845	1.502	3.619	2.632	-27.3	1.099	1.745	58.9
Uruguay	944	1.631	3.919	3.130	-20.1	1.508	1.391	-7.8
Trade balance*	**-0.111**	**0.016**	**-1.162**	**0.729**	**-**	**-0.235**	**0.771**	**-**
Argentina	2.823	-3.220	-4.164	0.706	-117.0	347	-301	-186.7
Brazil	-2.304	4.692	6.804	2.722	-60.0	437	2.016	361.1
Paraguay	-0.293	-0.610	-1.483	-1.099	-25.9	-0.221	-0.518	134.0
Uruguay	-0.337	-0.847	-2.319	-1.600	-31.0	-0.798	-0.427	-46.5

Note: * The balance is not zero due to accounting differences across the four countries.

Source: INDEC (Argentina), SECEX-MDIC (Brazil), Central Banks of Paraguay and Uruguay.

Paraguay exported US$1.5 billion to its other MERCOSUR partners in 2009, down 28.2% on the previous year, and imported US$2.6 billion, down 27.3%. This brought the intraregional trade deficit down to US$1.1 billion. In the first semester of 2010, however, Paraguayan imports from the bloc began to grow faster than exports, making the intrazone trade deficit more than twice that seen in the same period a year earlier.

Last, Uruguay exported US$1.5 billion to its partners in 2009 (-4.5%) and imported US$3.1 billion (-20.1%), reducing its deficit to US$1.6 billion (-31.0%). Uruguayan exports to its partners returned to growth in 2010, up 35.6% in the first semester on the same period in 2009, but imports continued to shrink (-7.8%), further contributing to a reduction in the deficit with its MERCOSUR partners, which stood at just US$427 million.

Box A. The buoyancy of intraregional trade in recent years

Since 2003 and the full recovery of activity levels in the MERCOSUR countries, intraregional trade has been more dynamic than extrazone trade. The phenomenon is visible in an indicator of exports estimated at constant prices for Argentina and Brazil, countries that provide the relevant information for it.

Between 2002 and 2008, intrazone export growth was 143.0%, while extrazone exports grew 43.5% (Graph 1). These years mark the respective minimum and maximum of the expansionary phase that followed the period of serious macroeconomic instability that the MERCOSUR countries became embroiled in and whose most dramatic event was the crisis and abandonment of convertibility in Argentina between 2001 and 2002.

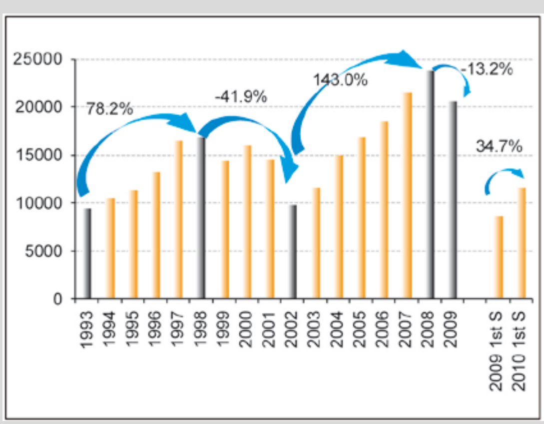
In 2002, intrazone trade represented just 10.6% of Argentine and Brazilian exports, rising to 16.8% in 2008. Despite the intensity of the growth in these flows, the ratio is still a long way from the 24-25% seen in 1997-98. This result is not surprising if one remembers the differential evolution of exports according to destination.

First, the high value of intraregional trade in 1997-98 is due to the fact that, in 1993-98, these flows grew by 78.2% in the heat of the liberalization generated by the creation of MERCOSUR, whereas extraregional trade in those years (hit by the Asian and Russian crises, and by the weakness of commodity markets) behaved far more buoyantly, with growth of 21.2% (Graph 1.B). This combination raised the proportion of intraregional trade to a level that now appears exceptional.

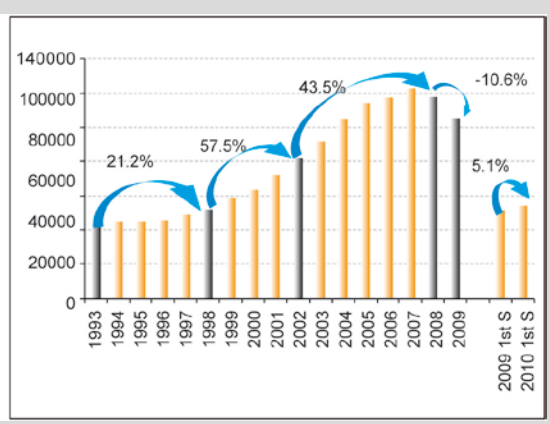
Graph A. Argentina and Brazil: Evolution of exports at constant prices by target area 1993-2010

Millions of US$ at constant prices

Intraregional exports



Extraregional exports



In addition, in the next cyclical phase, between 1998 and 2002, intraregional trade collapsed (-41.9%), whereas the behavior of sales to the rest of the world was highly favorable (57.5%). The relative loss suffered in those years has not been made up, in spite of the inequality in the growth of both flows in 2002-2008. The information of real interest, however, is that the cumulative annual (c.a.) growth in intrazone exports in recent years has been higher than in the early days of MERCOSUR: shipments to the region grew at a rate of 16% c.a. and extraregional shipments at 12.3% c.a. in these periods. Another expression of this recent dynamism is that, in 2008, the level of intrazone exports was 41.3% up on the 1998 high.

In 2009, as a result of the international crisis, trade contracted sharply. However, unlike previous crises, the contraction of extrazone exports was similar to sales within the bloc (-10.6% and -13.5% respectively). It should also be remembered that the beginning of the recovery, in the first half of 2010, involved a far greater increase in intraregional exports than those to the rest of the world, the former growing 34.7%, and the latter, 5.1%. The effect of the basis for comparison aside, this is a reflection of the better performance of the MERCOSUR economies relative to other countries—especially the developed countries—over the period. It is interesting to note that, should there be another phase of growth like 2003-2008, when intra- and extraregional trade grew 16.0% and 6.2% c.a. respectively, it will still take 6 years for intrazone trade to attain a 25% ratio.

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* Argentina and Brazil's statistics institutes provide price indexes for exports disaggregated by generic product classes. To obtain exports at constant prices, different price indexes for exports to MERCOSUR and extrazone were built up. In Argentina, the index is disaggregated in primary commodities, manufactures of agricultural origin, manufactures of industrial origin, and energy and fuel, whereas in Brazil the components are commodities, and semi-manufactured and manufactured goods. These indexes were aggregated to the nominal weighting structure of each of these products for each target market. In the case of Argentina, the original indexes have a 1993=100 base, and in Brazil's case, 2006=100, with the year 2000 being established as a common benchmark period.

Extrazone trade

The behavior of MERCOSUR exports to Asian countries[48] in 2009 differed from sales to other destinations, just 1.9% down on the previous year, while exports to other regions were down more than 20.0%. The worst performance was seen in exports to the NAFTA countries, down 38.7% (Table 5). Although sales to Asia performed rather better in the four MERCOSUR countries' exports, the most favorable differentials were recorded in the sales of Brazil and Uruguay. In the first case, sales to Asia rose 5.3% in the year, in contrast with significant falls for the other regions. Uruguay, for its part, recorded an 8.4% increase in sales to Asia in 2009.

Asian countries thus came to occupy first place as a destination for MERCOSUR exports for the first time in history, accounting for 27.9% of the total, ahead of the EU, which had occupied first place in previous years, but whose share fell to 24.6% in 2009. NAFTA accounted for just 13.8% of the total, the Latin American Integration Association (LAIA)[49] 11.4%, and other countries 22.3%.

NAFTA's falling share in MERCOSUR's exports is a remarkable phenomenon that has been ongoing since the start of the decade. In 2002, for example, United States, Canada, and Mexico were responsible for 28.8% of the bloc's total sales, even exceeding the share of the EU. This gradually fell up to 2007, when it stood at 20.1%, and then plummeted in 2008 to 17.6% and 2009 to 13.8%, a period when the US economy was in recession. NAFTA's loss of

[48] Including the Middle East.
[49] For the purposes of this Report, LAIA is consistently taken as excluding MERCOSUR and Mexico.

share—and, to a lesser extent, the EU's as well—has been offset by gains in Asia and "other countries," a phenomenon related to two basic factors: faster growth in these economies and the rising prices of MERCOSUR commodities for export.

Table 5. Extrazone trade flows of MERCOSUR countries by economic bloc at selected periods

Billions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
Exports	**78.712**	**142.876**	**236.772**	**184.459**	**-22.1**	**87.683**	**107.201**	**22.3**
NAFTA	22.713	35.858	41.680	25.530	-38.7	11.900	14.397	21.0
EU	21.251	34.587	61.152	45.368	-25.8	21.445	25.084	17.0
LAIA*	8.727	16.758	27.892	21.017	-24.6	9.556	11.883	24.4
Asia	13.598	26.974	52.413	51.422	-1.9	25.417	32.605	28.3
Other countries	12.423	28.699	53.635	41.121	-23.3	19.365	23.232	20.0
Imports	**49.406**	**88.144**	**205.436**	**147.804**	**-28.1**	**65.197**	**94.999**	**45.7**
NAFTA	12.482	16.551	42.371	32.191	-24.0	15.187	19.610	29.1
EU	16.017	23.686	46.427	36.724	-20.9	16.263	22.496	38.3
LAIA*	2.424	5.114	12.284	8.320	-32.3	3.753	5.695	51.8
Asia	9.565	23.142	63.101	47.915	-24.1	20.711	32.401	56.4
Other countries	8.918	19.651	41.253	22.654	-45.1	9.283	14.797	59.4
Trade balance	**29.306**	**54.732**	**31.336**	**36.656**	**17.0**	**22.486**	**12.202**	**-45.7**
NAFTA	10.231	19.307	-0.691	-6.661	0.863.2	-3.287	-5.213	58.6
EU	5.234	10.901	14.725	8.645	-0.041.3	5.182	2.588	-50.0
LAIA*	6.304	11.644	15.608	12.697	-0.018.7	5.803	6.188	6.6
Asia	4.033	3.832	-10.687	3.508	-	4.706	0.204	-95.7
Other countries	3.505	9.049	12.381	18.467	49.2	10.082	8.435	-16.3

Note: * Except MERCOSUR and Mexico.

Source: INDEC (Argentina), SECEX-MDIC (Brazil), Central Banks of Paraguay and Uruguay.

In terms of MERCOSUR imports, the falls in 2009 were similar in purchases from both Asia (-24.1%), and NAFTA (-24.0%) and the EU (-20.9%). Asia's share in the bloc's imports rose to 32.4%, while maintaining the position it has held since 2006 as the main origin for the region's imports. Asia grew its share by 1.7 p.p. in comparison with the previous year, as it did in purchases from EU (2.2 p.p.) and NAFTA (1.2 p.p.). In contrast, purchases from LAIA and "other countries" lost share due to more pronounced falls over the year (-32.3% and -45.1% respectively).

MERCOSUR's extrazone trade surplus totaled US$36.7 billion in the year, 17.0% up on 2008. This improvement was due mainly to trade with Asia, the bloc managing to transform its deficit with the region from US$10.7 billion in 2008 to a US$3.5 billion surplus in 2009. The change, equivalent to approximately US$14 billion, was almost entirely down to Brazil, which went from a US$9.7 billion deficit with Asia in 2008 to a US$3.3 billion surplus. Trade with the group of "other countries" also contributed to the MERCOSUR surplus, with the balance showing a positive swing of about US$6 billion. MERCOSUR's balance with the other economic blocs, however, deteriorated over 2009: -US$6 billion with NAFTA, -US$6.1 billion with the EU, and -US$3 billion with LAIA. It should be noted that the region accumulated positive balances with all regions except NAFTA.

In the first semester of 2010, exports to all destinations, particularly Asia (28.3%) and LAIA (24.4%), returned to growth. Asia achieved a 30.4% share in sales, as against 23.4% by the EU, 13.4% by NAFTA, 11.1% by LAIA, and 21.7% by other countries. There was also recovery in imports from all regions, but there was higher growth in purchases from Asia (56.4%), LAIA (51.8%), and "other countries" (59.4%). In light of this, the MERCOSUR extrazone trade balance was down 45.7% on the same period in 2009, to US$12.2 billion. The deficit with NAFTA rose 58.6%, the surplus with the EU fell by half, and the surplus with Asia, US$4.7 billion in the first semester of 2009, dropped to just US$204 million in 2010.

Box B. Chinese products' penetration in MERCOSUR imports

China's rising share in world trade over the first decade of this century has been nothing short of extraordinary. Naturally, this has had a significant impact on the geographic composition of MERCOSUR imports: the Asian country has gone from being a minor supplier at the start of the decade to a position of prominence in recent years.

China's share of Argentina's total imports rose from 4.6% in 2000 to 12.4% in 2009, lying third, just behind Brazil and United States. In Brazil's case, the penetration of Chinese imports grew even faster, from 2.2% in 2002 to 12.5% in 2009. The country already ranks second among its major suppliers, only behind United States, and its share exceeds the MERCOSUR partners', at 10.3% in the last year.

In Paraguay's case, the growth of China as a source of imports has also been dramatic in recent years, its share rising from 10.7% in 2000 to 30.1% in 2009. China is already the largest supplier of the Paraguayan market, overtaking Brazil, whose share in 2009 was 23.3%. China will soon equal the joint share of MERCOSUR members, close to 40%. In Uruguay, China's relative weight in imports in 2009 was the lowest of the MERCOSUR countries (11.9%), still well up on the figure for 2000 (3.2%).

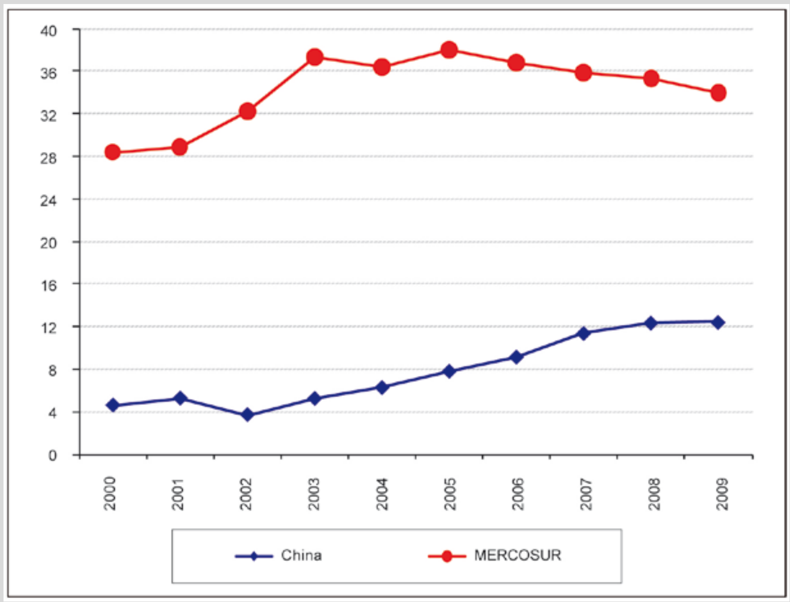
It should be asked whether the rise in China's share has been at the expense of the MERCOSUR partners due to displacement and substitution of intrazone flows.

In **Argentina's** case, the analysis falls into two distinct periods. Graph B shows that, between 2000 and 2005, China's expansion did no apparent harm to the other MERCOSUR partners, as their share in imports also grew, reaching a historic high of 38.0%. In that period, sales in China were particularly strong in three categories of products: capital goods, spare parts, and accessories for capital and consumer goods, accounting for over 70.0% of China's sales to Argentina in 2005. MERCOSUR also raised its share in these three categories, and automobile imports. The Chinese gain came at the expense of suppliers in the European Union (EU) and the North American Free Trade Agreement (NAFTA) in all product categories except fuels.

Between 2005 and 2009, however, MERCOSUR's share in Argentine imports fell 4.1 p.p. due exclusively to the loss of Brazilian market share (down 4.4 p.p.). The main evidence for substitution of MERCOSUR products by products from China is that this country's gain in share in the same period (up 4.6 p.p.) was similar to the bloc's loss, while the shares of the other countries and economic blocs, including NAFTA and the EU, remained relatively constant.

Graph B. Argentina: China's and MERCOSUR' share in the country's total imports 2000-2009

As %



Source: INDEC.

The displacement of MERCOSUR' output was concentrated in three product categories:

- *Capital goods*: MERCOSUR exports to Argentina saw an accumulated fall of 15.6% in 2005, as against the 126% growth in Chinese sales over the same period. The MERCOSUR market share in these products rose from 36.8% in 2005 to 24.9% in 2009, while China's rose from 9.7% to 17.6%.

- *Intermediate goods*: accumulated MERCOSUR exports grew just 7.6% between 2005 and 2009, as against 127.7% growth for Chinese exports. The MERCOSUR market share fell from 41.3% in 2005 to 36.6% in 2009, while China's rose from 5.8% to 10.9%.

- *Consumer goods* (excluding passenger automobiles): MERCOSUR exports rose 31.8% in 2005-2009, as against 108.5% growth in Chinese exports. The MERCOSUR market share fell from 33.2% in 2005 to 27.3% in 2009, while China's rose from 18.0% to 23.4%.

Significantly, loss of market share in these three product categories in the other countries and economic blocs was minor and, in the case of capital goods, NAFTA and the EU's share rose. Where automobiles were concerned, MERCOSUR also saw a loss of market share in Argentina between 2005 and 2009 at the expense of purchases from NAFTA, although the bloc still represented over 70% of imports.

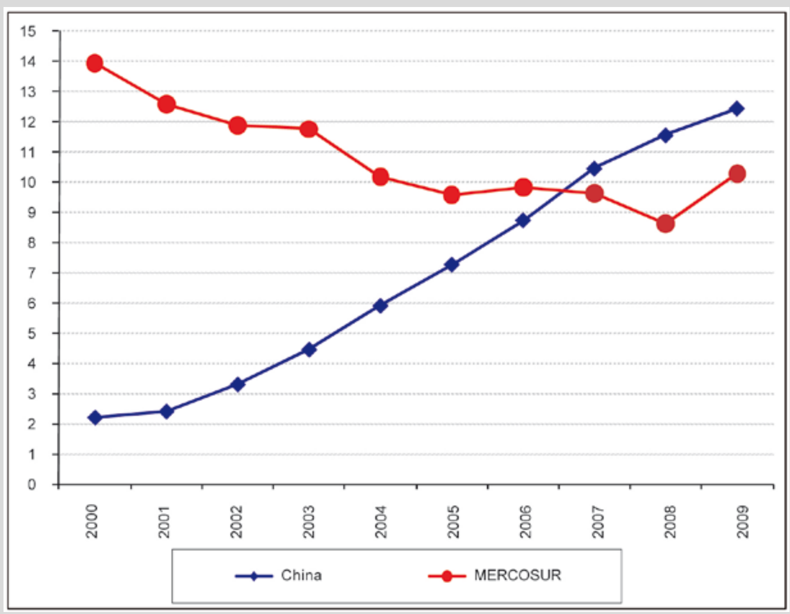
With regard to imports from **Brazil**, Graph C shows that the rise in China's share accompanied the fall in the MERCOSUR partners' share, just 3.7 p.p. in 2000 and 2009, or just one third of the gain seen by China in the same period.

Yet there is no evidence that Argentina, Paraguay, and Uruguay's sales are being displaced by Chinese products, as the products Brazil imports from MERCOSUR are different than those from China. About 75% of MERCOSUR sales in Brazil belong to five sectors: motor vehicles, agricultural products, food and beverages, petroleum and derivatives, and chemicals. In contrast, the sectors that contributed most to China's rising market share in Brazilian imports between 2000 and 2009 were desktop computers and IT equipment (37 p.p.), textile products (36.6 p.p.), electronic and communications equipment (34.9 p.p.), electrical machines, appliances, and equipment (21.5 p.p.), machinery and equipment (11.9 p.p.), and chemicals (5.0 p.p.).

Only in chemical sales did the MERCOSUR partners see significant volumes of exports to Brazil in 2000 (US$ 853 million). The loss of market share in Brazilian imports was not, at any rate, significant in the period (from 8.1% to 6.0% in 2009).

Graph C. Brazil: China's and MERCOSUR's share in the country's total imports 2000-2009

As %



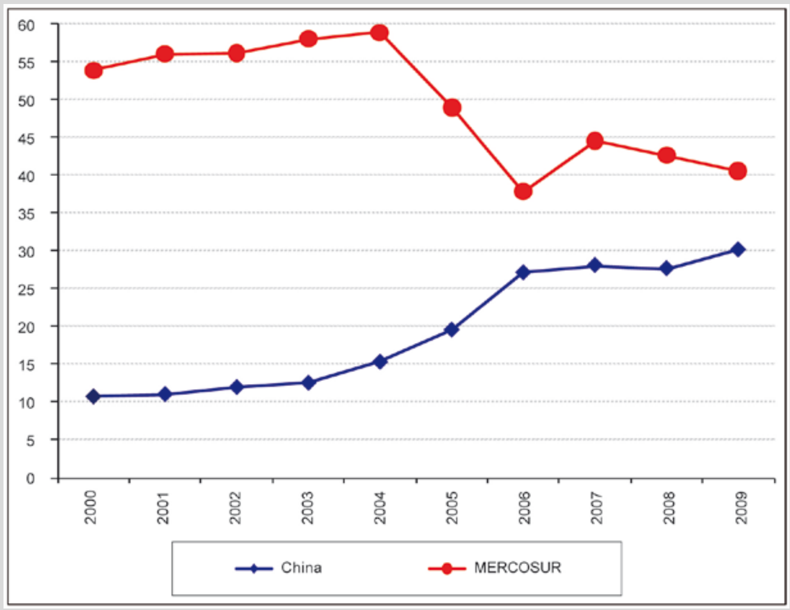
Source: SECEX-MDIC.

Those worst hit by China's ascendancy were the NAFTA countries, whose share in the Brazil total exports was reduced by 7.4 p.p., between 200 and 2009, followed by the EU's fall by 3.1 p.p.. These blocs dominated Brazilian imports in most sectors where China had higher growth, mainly machinery and equipment, electrical equipment, electronic equipment, and chemicals.

In **Paraguay's** case (Graph D), almost all China's gain in market share in imports came in 2004-2006 (14.5 p.p.), the precise same period of MERCOSUR's most significant loss of share (21 p.p.). The increase in the Chinese share was due primarily to extraordinary growth in equipment, machinery, and engine sales, which rose seven-fold in just three years. In 2006, these products accounted for over 60% of Chinese exports to Paraguay.

Graph D. Paraguay: China's and MERCOSUR's share in the country's total imports 2000-2009

As %



Source: Central Bank of Paraguay.

Where MERCOSUR was concerned, most of the loss of market share in Paraguayan imports in 2004-2006 was associated with three product groups:

- *Fuels and lubricants*: This was the largest group in the MERCOSUR export basket in Paraguay, with most sales coming from Argentina. In the period under consideration, these sales were down in absolute terms, while Paraguay's total imports continued to grow at high rates.

- *Equipment, machinery, and engines*: This was the third most important item in MERCOSUR sales, mainly from Brazil. Paraguay's total imports in the sector were 10 times purchases from MERCOSUR in the period.

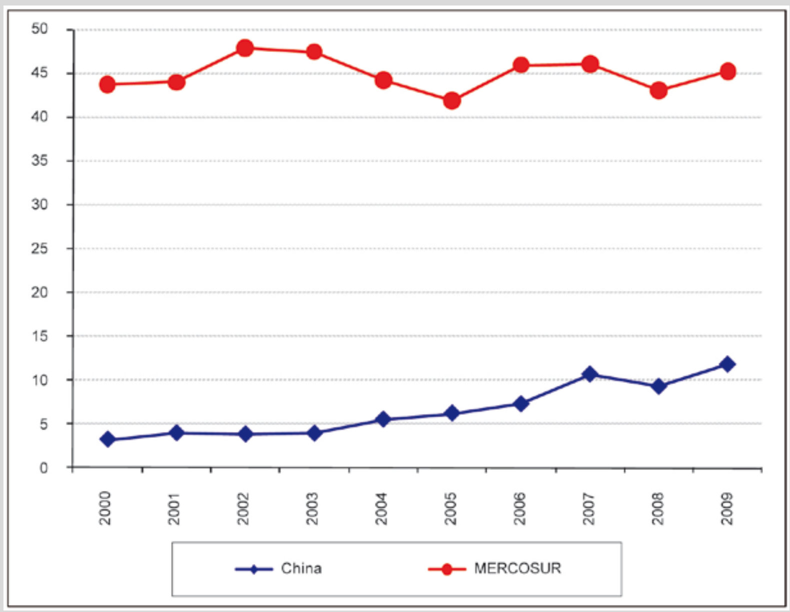
- *Transport equipment and accessories*: This was the fifth most important item in MERCOSUR's export basket to Paraguay, originating mainly in Brazil. Paraguay's total imports of these products in the period were three times higher than purchases from MERCOSUR.

There is, then, strong evidence that China did displace Brazil in equipment, machinery, and engine sales to Paraguay in this period. In fuels and lubricants, MERCOSUR's loss of share was to due to problems in the oil supply from Argentina. In the case of transport equipment and accessories, MERCOSUR's lower share was mainly at the expense of Japanese exports, which accounted for over half Paraguayan imports in 2006.

Last, in **Uruguay's** case, MERCOSUR's share remained reasonably stable over 2000-2009, at around 45% (Graph E). Almost all of China's increased market share was at the expense of imports from the EU, whose share dropped 7.7 p.p. between 2000 and 2009, and, to a lesser extent, the NAFTA countries, whose share was down 1.6 p.p.

Graph E. Uruguay: China's and MERCOSUR's share in the country's total imports 2000-2009

As %



Source: Central Bank of Uruguay.

Exports, world trade, and market share

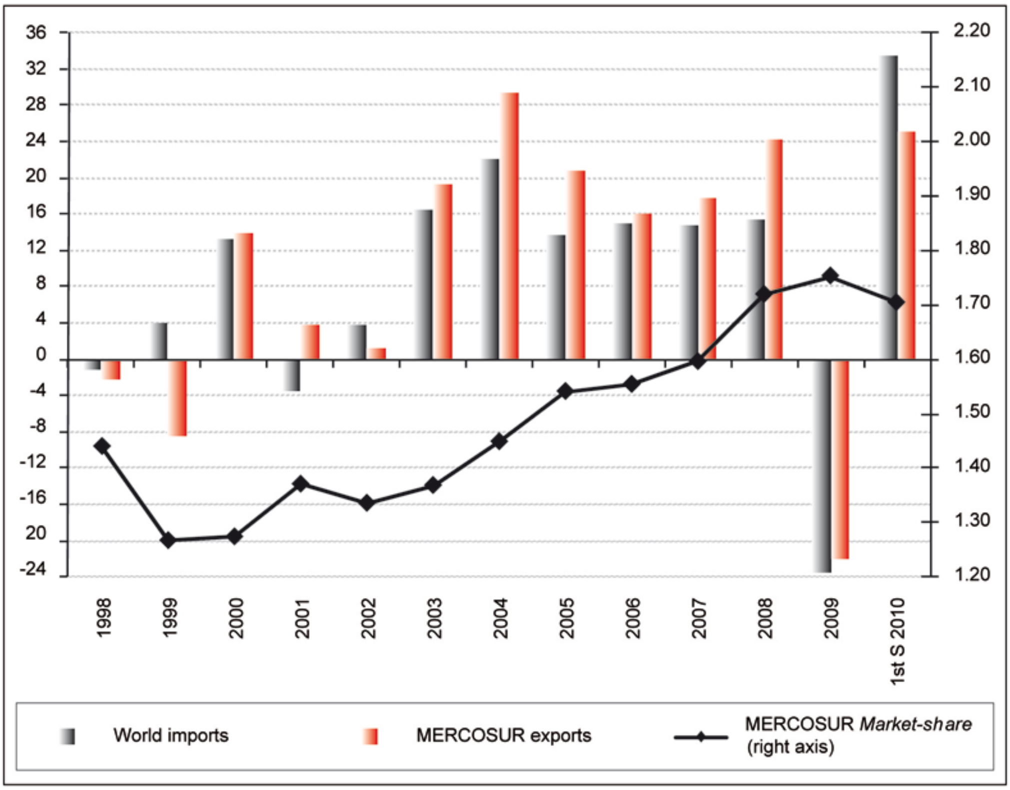
The international crisis did not stop MERCOSUR continuing to grow its market share in world trade in 2009, which reached 1.75%, the highest percentage since the 1980s. The drop in the bloc's exports (-22.0%) was lower than the drop in world imports over the year (-23.5%). Indeed, MERCOSUR'S market share rose continuously over 2003-2008 (Graph 13), with consistently higher performance in exports than world imports every year between 2003 and 2008.

In the first semester of 2010, however, the bloc's exports did not keep pace with the recovery in world imports, up 33.5% on the same period in 2009. In light of this, the bloc's market share fell to 1.70%, similar to 2008 levels. In any event, with the prospect of the bloc's exports keeping up the pace of growth in the second semester of the year, along with an expected slowdown in global imports in the same period,[50] the bloc's share may recover and close 2010 at somewhere near 2009 levels.

[50] According to a WTO news item, September 20, 2010.

Graph 13. Growth in MERCOSUR exports, world imports, and evolution of MERCOSUR's market share 1998-1st S 2010

As %



Source: IMF, INDEC (Argentina), SECEX-MDIC (Brazil), Central Banks of Paraguay and Uruguay.

B. Country trade

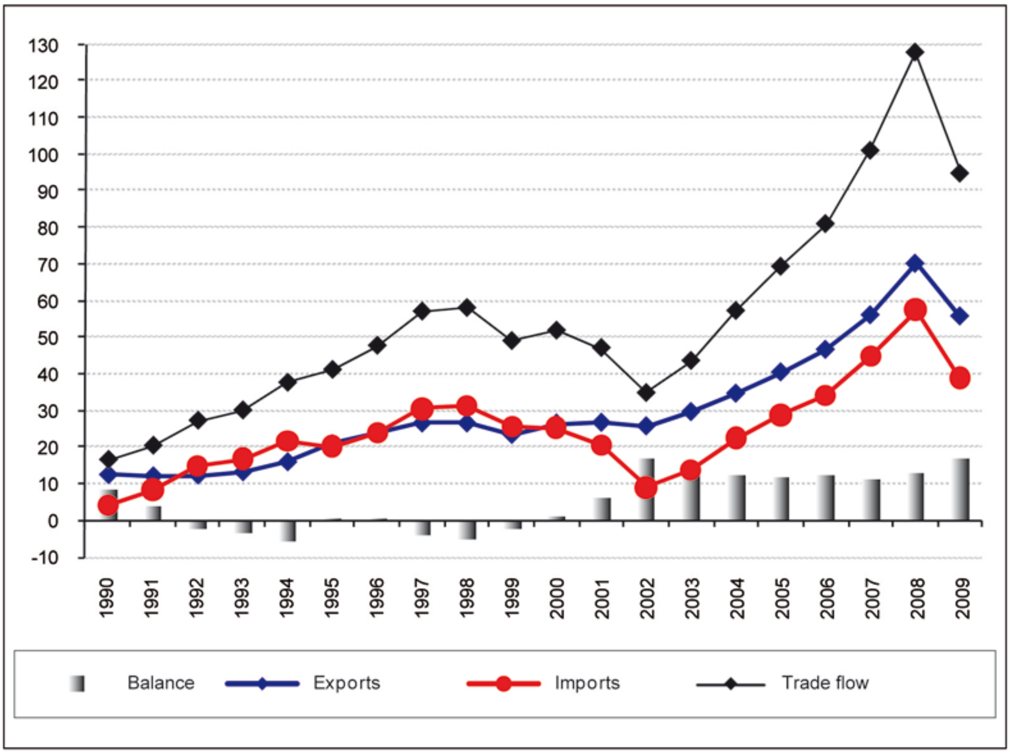
Argentina

Argentina's foreign trade flows in 2009 performed negatively for the first time since 2002, with exports recording a 20.5% low and falling to US$55.7 billion, while imports underwent an even more significant 32.5% drop, totaling US$38.8 billion. The trade surplus rose to US$16.9 billion, the largest in the country's history, and the flow of trade was US$94.4 billion (Graph 14). The effects of the international crisis interrupted a six-year phase of rapid growth in trade flows, from the end of the crisis that followed the elimination of the convertibility regime. Between 2003 and 2008, exports rose 18.2% c.a., while imports grew 36.2% c.a.

In the first semester of 2010, exports already showed a recovery, 17.8% up on the same period in 2009. However, imports grew much faster in that period (42.8%), leading to a 25.6% drop in the trade balance to US$7.4 billion. Considering the prospects for the second semester, the total balance for the year is very likely to be significantly down on 2009.

Graph 14. Argentina: Trade flows in 1990-2009

Billions of US$



Source: INDEC.

The poor performance of the country's exports in 2009 was determined, above all, by primary commodities, which dropped 42.6% over the year, far sharper than the rates of contraction in industrial manufacturing (-23.3%), agricultural manufacturing (-18.8%), and fuels (-9.8%). Although representing just 23.0% of the country's total exports, primary commodities accounted for almost half the total drop in external sales in 2009.

There was a notable drop in the sales of three products of signal importance to the country's exports: soybeans (-62.9%), wheat (-60.0%), and maize (-55.8%). Together, these three products accounted for a US$6.3 billion fall in the country's exports. Also of note were the falling sales of soy oil (-32.2%), gasolines (-47.1%), sunflower oil (-52.2%), and fuel oil. The only products to do relatively well in external sales and perform positively in 2009 were crude oil (42.5%), and meals and pellets from soy oil extraction (15.3%).

In the first semester of 2010, the recovery in exports was headed precisely by primary commodities, which grew 54.0%, influenced by the excellent performance of soybean (144.2%) and maize (88.4%) sales. There was also a sound contribution from industrial items (33.0%), especially automobiles for personal use (64.9%), while agricultural manufacturing and fuels contracted (-5.0% and -3.0% respectively).

In the composition of imports, there was a significant reduction in 2009 in all categories of use, notably fuels (-40.0%) and intermediate goods (-38.0%). There was also a general recovery in the first semester of 2010 across the various different categories

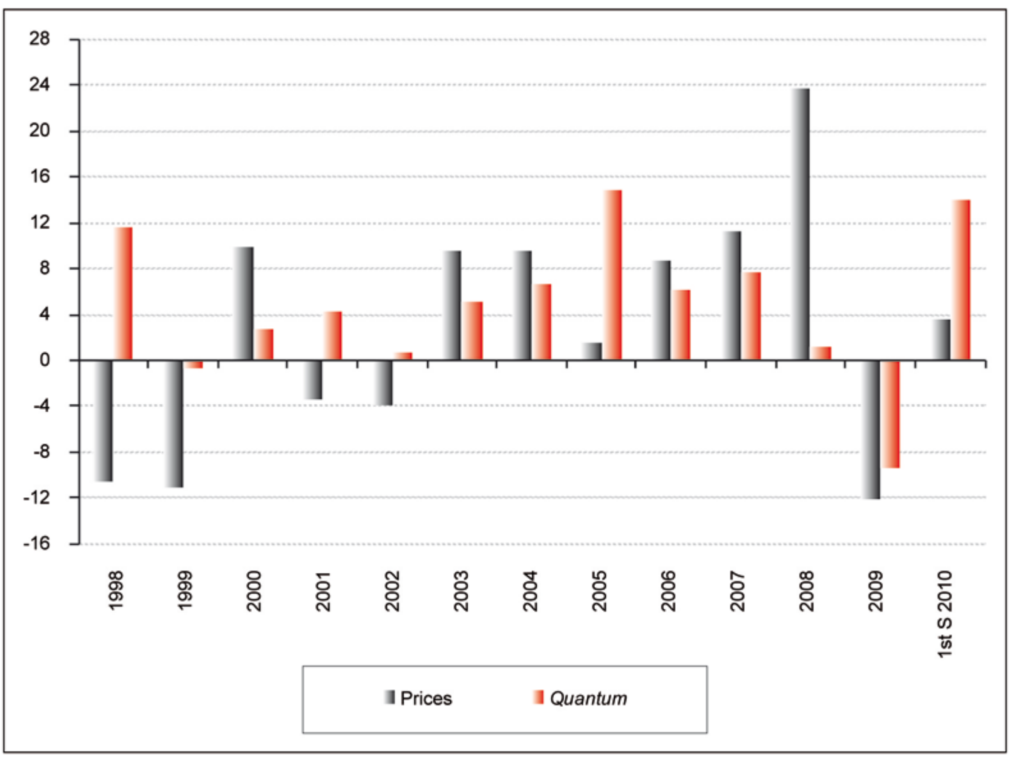
Graph 15 illustrates that the reduction in the quantities exported in 2009 was due to both the reduction in export prices (-12.2%) and the falling quantum (-9.3%). Between 2006 and 2008, prices were the main factor behind export growth, and the reduction seen in 2009 only absorbed part of the extraordinary gains obtained over 2008. As a result, the average for 2009 remained above that for 2007. In the case of the quantum, the loss was more significant, with the index falling to levels below 2006.

As import prices also saw a significant drop in 2009, the gains in the terms of trade obtained in previous years were sustained, with the rate for 2009 just 0.4% down on the previous year. Since 2002, the country has seen an accumulated gain in the terms of trade of around 33.0%.

In the first semester of 2010, the recovery in the country's exports was driven by quantum growth (14.0%), coupled with a modest 3.6% gain in prices. Again, there was a slight drop in the terms of trade of 0.4% but the rate remained very close to the historic high of 2008.

Graph 15. Argentina: Growth in prices and export quantum 1998-1st semester 2010

As %



Source: INDEC.

The reduction in Argentina's exports to its MERCOSUR partners in 2009 (-14.0%) was lower than total exports, signifying a rise in the three other members' share in the country's total sales to 24.9%, or US$13.9 billion. The percentage was the highest since 2001, consolidating the recovery of MERCOSUR's importance in Argentine sales, with Brazil as the main destination (20.4% of total sales). In the first semester of 2010, MERCOSUR again saw above average performance (+30.0%) thanks particularly to rising sales to Brazil (41.0%) and Paraguay (44.9%), while exports to Uruguay dropped 34.6% (Table 6).

On the import side, falling purchases from the partners (-35.1%) exceeded the total fall, leading to the bloc's importance in the country's total imports falling to 33.9%, well below the 38.0% high of 2005. This reduction was particularly strong in purchases from Paraguay (-60.8%), although this accounts for just 15.2% of the total fall. In the first semester of 2010, purchases from the bloc grew at a rate very close to the average (43.0%), driven primarily by 52.1% growth in imports from Brazil and despite falling Paraguayan imports.

Argentina's trade balance with its MERCOSUR partners, which, since 2004, had recorded growing deficits, returned to surplus in 2009 (US$706 million) thanks mainly to the reduction of its deficit with Brazil (from US$4.7 billion in 2008 to US$690 million in 2009) and the positive results obtained with regard to Paraguay and Uruguay. In the first semester of 2010, however, the country returned to deficit with its partners (US$301 million), due to the almost 300% rise in its deficit with Brazil compared to the same period in 2009.

Table 6. Argentina: Trade flow with MERCOSUR countries at selected periods

Billions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
				Exports				
MERCOSUR/total(%)	**22.3**	**19.0**	**23.0**	**24.9**	**-**	**22.4**	**24.7**	**-**
MERCOSUR	**5.718**	**7.689**	**16.123**	**13.865**	**-14,0**	**6.130**	**7.969**	**30.0**
Brazil	4.846	6.335	13.272	11.374	-14,3	4.878	6.876	41.0
Paraguay	0.343	0.509	1.088	0.843	-22,5	0.345	0.500	44.9
Uruguay	0.529	0.845	1.763	1.649	-6,5	0.906	0.593	-34.6
				Imports				
MERCOSUR/total(%)	**32.2**	**38.0**	**35.3**	**33.9**	**-**	**33.3**	**33.3**	**-**
MERCOSUR	**2.895**	**10.909**	**20.287**	**13.159**	**-35,1**	**5.783**	**8.270**	**43.0**
Brazil	2.517	10.187	17.977	12.064	-32,9	5.108	7.771	52.1
Paraguay	0.255	0.453	1.783	0.699	-60,8	0.497	0.291	-41.4
Uruguay	0.122	0.269	0.527	0.396	-24,8	0.178	0.208	17.0
				Trade balance				
MERCOSUR	**2.823**	**-3.220**	**-4.164**	**0.706**	**-**	**0.347**	**-0.301**	**-**
Brazil	2.329	-3.852	-4.704	-0.690	-85,3	-0.230	-0.895	288.9
Paraguay	0.087	0.056	-0.695	0.144	-120,7	-0.151	0.210	-238.3
Uruguay	0.407	0.576	1.236	1.252	1,4	0.729	0.384	-47.2

Source: INDEC.

Despite the drop in the value exported, Argentina managed to grow its market share in its partners' imports in 2009, although this remains well below the record levels achieved in the late 1990s. Its market share reached 8.9% in Brazil, 13.0% in Paraguay, and 24.8% in Uruguay. However, these percentages fell again in the first semester of 2010.

Argentina's exports to markets outside MERCOSUR (extrazone) totaled US$41.8 billion in 2009, 22.4% down on the previous year. There was a significant reduction in sales to the NAFTA countries (-32.3%), who saw their share in the country's total exports fall to just 11.9%, slightly over half the rate recorded at the start of the decade (Table 7). Asia remained the main destination of Argentine sales, with a share of 26.1%, as against the EU's 24.7%. In the first semester of 2010, extrazone exports grew 14.3%, with sales to Asia (25.2%) and LAIA (14.4%) both performing well, and anemic growth in sales to NAFTA and the EU (1.0% in both cases).

Table 7. Argentina: Extrazone trade flows by country and economic bloc at selected periods

Billions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
Exports								
Extrazone/total (%)	**77.7**	**81.0**	**77.0**	**75.1**	**-**	**77.6**	**75.3**	**-**
Extrazone	**19.932**	**32.698**	**53.898**	**41.803**	**-22.4**	**21.248**	**24.282**	**14.3**
NAFTA	3.744	5.954	7.372	4.994	-32.3	2.453	2.478	1.0
EU	5.114	6.846	13.234	10.315	-22.1	4.960	5.010	1.0
LAIA*	4.247	6.715	9.447	8.265	-12.5	4.040	4.620	14.4
Asia	4.435	7.825	13.816	10.904	-21.1	6.089	7.620	25.2
Other countries	2.393	5.359	10.029	7.325	-27.0	3.705	4.554	22.9
Imports								
Extrazone/total (%)	**67.8**	**62.0**	**64.7**	**66.1**	**-**	**66.7**	**66.7**	**-**
Extrazone	**6.093**	**17.778**	**37.136**	**25.621**	**-31.0**	**11.584**	**16.532**	**42.7**
NAFTA	0.430	1.300	8.936	6.595	-26.2	3.015	3.739	24.0
EU	2.028	4.832	9.013	6.402	-29.0	2.885	4.501	56.0
LAIA*	0.255	1.011	1.542	1.211	-21.5	0.568	0.752	32.3
Asia	1.072	4.926	11.393	7.972	-30.0	3.640	5.097	40.0
Other countries	2.309	5.709	6.252	3.441	-45.0	1.475	2.443	65.6
Trade balance								
Extrazone	**13.839**	**14.920**	**16.762**	**16.182**	**-3.5**	**9.664**	**7.750**	**-19.8**
NAFTA	3.315	4.654	-1.564	-1.601	2.4	-0.562	-1.261	124.4
EU	3.086	2.014	4.221	3.913	-7.3	2.075	0.509	-75.5
LAIA*	3.992	5.704	7.905	7.054	-10.8	3.472	3.868	11.4
Asia	3.363	2.898	2.423	2.932	21.0	2.449	2.523	3.0
Other countries	0.084	-0.350	3.777	3.884	2.8	2.230	2.111	-5.3

Note: * Except MERCOSUR and Mexico.

Source: INDEC.

Extrazone imports dropped 31.0% in 2009, with significant contractions in purchases from all the major regions. Asia remained the main region of origin for Argentine imports, accounting for 31.1% of the total, followed by NAFTA (25.7%) and the EU (25.0%). In the first semester of 2010, extrazone imports grew 42.7%, with a notable 56.0% rise in purchases from the EU. In light of this, the region's share in total imports rose to 27.2%, still below the percentage for Asia (30.8%).

Regarding the trade balance, Table 7 shows that Argentina only recorded a trade deficit in 2009 with NAFTA (-US$1.6 billion), in contrast to significant surpluses with other regions, in particular LAIA (US$7 billion). Compared to previous years, there was a notable evolution of the balance with the NAFTA countries, which was positive until 2007 and became negative in 2008 and 2009. This trend did not alter significantly in the first semester of 2010, with a notable reduction in the surplus with the EU, at just US$509 million, and an increase in the deficit with NAFTA (US$1.3 billion).

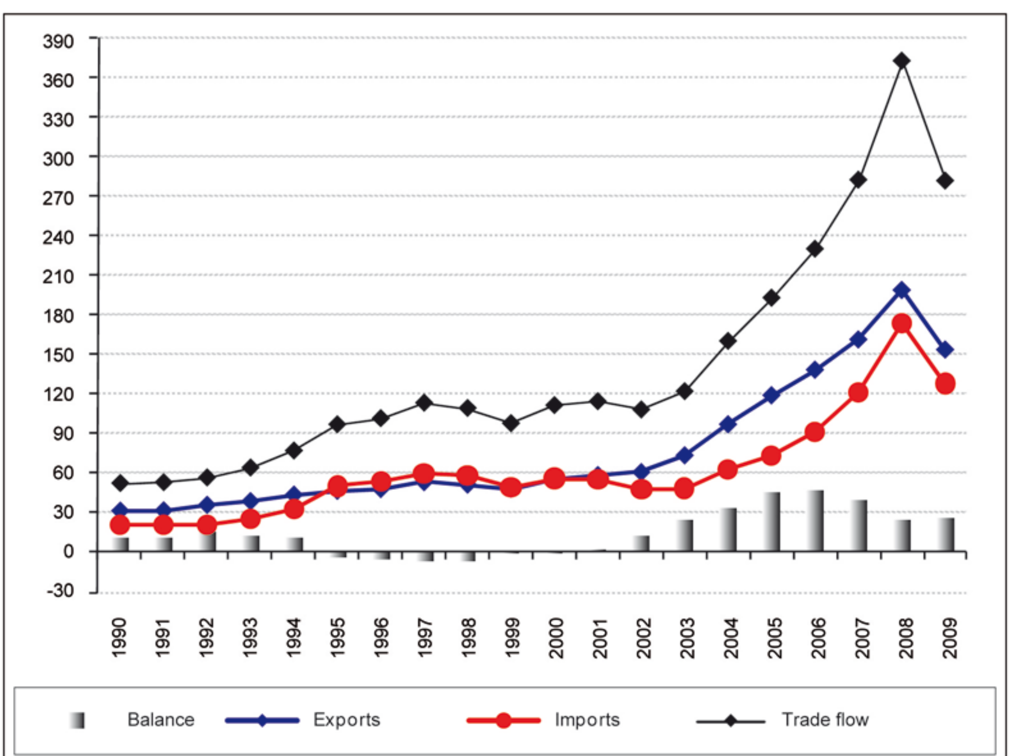
Brazil

Brazil's foreign trade flows were significantly down in 2009 in response to the deterioration in the international economic climate. However, the result for the balance of trade was positive, with a surplus of US$25.3 billion, 2.4% up on the previous year, due to the 26.3% fall in imports outweighing the 22.7% contraction in exports. As Graph 16 shows, it was the first time exports had fallen since 1998, while imports last contracted in 2002. The flow of trade saw a 24.4% contraction over the year, to US$280.6 billion.

Flows rallied strongly in the first semester of 2010, especially imports, which totaled US$81.3 billion, 45.1% up on the same period in 2009. Exports totaled US$89.2 billion, with growth of 27.5%. This difference between the growth rate of external purchases and sales brought the trade surplus down 43.4%. Strictly speaking, the data for 2010 resumed the trends seen before the outbreak of the international crisis, after a brief lapse in 2009: imports rising much faster than exports and a falling trade balance, which would end the year with a surplus of around US$15 billion, the worst result for the last eight years.

Graph 16. Brazil: Trade flows in 1990-2009

Billions of US$



Source: SECEX-MDIC.

The drop in exports in 2009 affected all kinds of exported products, especially manufactured (-27.3%) and semi-manufactured (-24.3%) goods. Commodities fell less steeply (-15.2%), due to growth in sales of relevant products in the export basket, such as soybeans and residues from soy oil extraction, and to the shallow drop in products such as coffee beans, chicken, and iron ore. Among semi-manufactured goods, there was a significant fall in important products like pulp, semi-manufactured iron and steel goods, iron alloys, hides and skins, and soy oil, while the performance of manufactured goods was negative across almost all items, notably in the automotive industry, aircraft, and machinery and equipment.

In the first semester of 2010, the recovery of Brazilian exports was headed by commodities (31.6%) and semi-manufactured goods (40.0%). There was particularly strong growth in the latter group in unprocessed cane sugar sales (which already occupies an important position among the country's major export products), pulp, and semi-manufactured iron and steel goods. In the case of commodities, the highest growth was due mainly to crude oil sales (194.3%), with further salient increases in iron ore, beef, chicken, and coffee bean exports. Manufactured goods saw a slower recovery (19.3% in the semester), driven by sales in the automotive industry, and some chemical and petrochemical products, as well as machinery and equipment.

In terms of the composition of imports, the 2009 fall covered all categories of use, but was most intense in fuels (-46.0%), due mainly to falling oil prices, and in intermediate goods (-28.3%), in this case as a response to the sharp contraction in internal industrial activity. The decline in purchases of capital goods was more moderate (-12.6%) and, in consumer goods, held relatively steady at 2008 levels as a result of the Brazilian population's income and consumption levels holding up even during the crisis.

In the first semester of 2010, the recovery in imports covered all categories of use, albeit most intensely in fuels (86.1%), intermediate goods (45.3%), and consumer goods (42.9); and, more slowly in capital goods (20.2%).

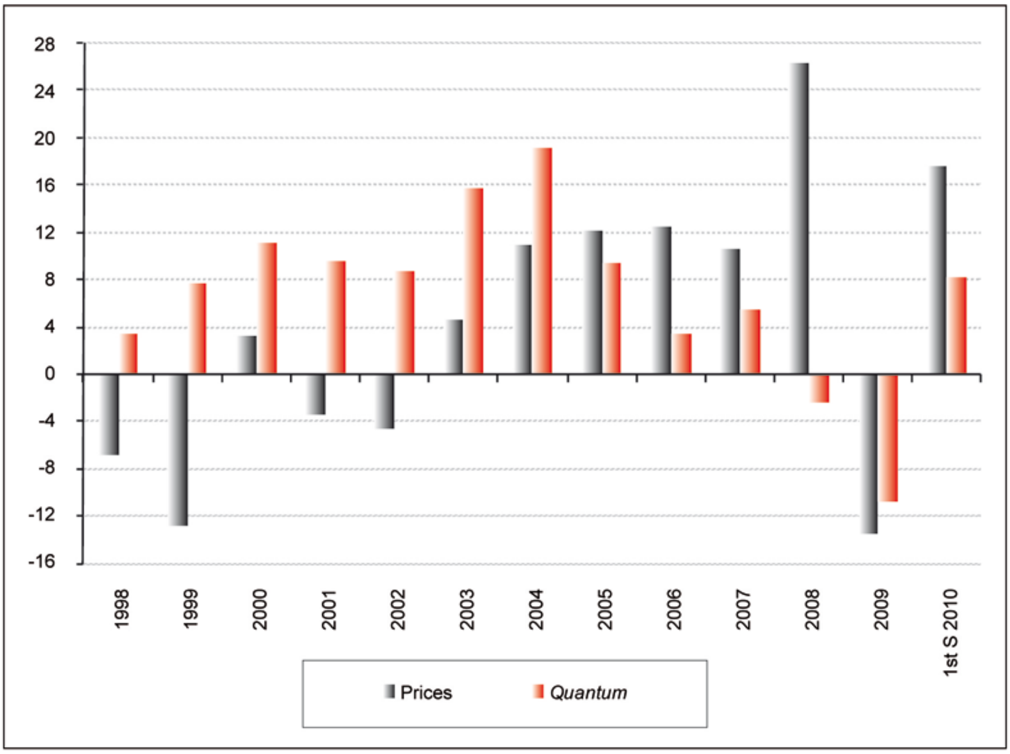
Shrinking Brazilian exports in 2009 were due to the 10.7% drop in the quantities exported and to the 13.4% drop in export prices (Graph 17). The contraction in prices, however, represented the loss of just part of the extraordinary gains obtained in 2008, caused by the explosion of agricultural and mineral commodity prices. As a result, the 2009 price index was still 9.4% up on the average rate for 2007. There was a pronounced decline in the quantum, with the rate returning to levels similar to those seen in 2004-2005. Indeed, Graph 17 illustrates how Brazilian export growth has, since 2005, been determined primarily by the increase in prices.

In the first semester of 2010, the same trend resurfaced, with prices accounting for about two-thirds of the growth of the exported value, up 17.6%, while the quantum saw a rise of 8.3%, still a long way off the pre-crisis levels.

Where the terms of trade were concerned, Brazil had seen reasonably modest gains before the crisis (an accumulated increase of 11.6% between 2003 and 2008) and suffered a loss in 2009 (-2.3%). In the first semester of 2010, however, the recovery of trade flows was characterized by significant increases in export prices and relative stability in import prices, enabling the country obtain a 15.2% increase in the terms of trade as of the first semester of 2009. The index of terms of trade index accordingly reached the highest level in the last 20 years.

Graph 17. Brazil: Growth in the prices and the quantum of export, 1998 to the 1st semester of 2010

As %



Source: FUNCEX based on SECEX-MDIC data.

Brazilian exports to its MERCOSUR partners totaled US$15.8 billion in 2009, with 27.2% down on 2008 (Table 8). This amount was equivalent to 10.3% of the country's total sales, with 8.4% going to Argentina, 1.1% to Paraguay, and 0.9% to Uruguay. It was the first time since 2002 that MERCOSUR members' share had recorded a fall, although the percentage is still well below the levels of the late 1990s, which were around 17.0%.

In imports, on the other hand, the less pronounced drop in purchases from MERCOSUR with respect to Brazil's total (-12.2% as against -26.3%) pushed MERCOSUR's share up to 10.3%, the highest percentage for six years, though still well below the 16.3% record of 1998. Argentina contributed 8.8%, Uruguay 1.0%, and Paraguay, 0.5%.

As a result of the wide differential between the rates of change for exports and imports, Brazil's trade balance with its MERCOSUR partners dropped 60.0% in 2009 to US$2.7 billion, the worst result since 2004. In absolute terms, the most serious contraction in the surplus was Argentina (-US$2.8 billion), followed by Paraguay (-US$731 million), and Uruguay (-US$506 million). Nevertheless, the balances remained positive in all cases.

Table 8. Brazil: Trade flow with MERCOSUR countries at selected periods

Billions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
				Exports				
MERCOSUR/total (%)	**5.5**	**9.9**	**11.0**	**10.3**	**-**	**8.9**	**10.9**	**-**
MERCOSUR	**3.311**	**11.746**	**21.737**	**15.829**	**-27.2**	**6.196**	**9.697**	**56.5**
Argentina	2.347	9.930	17.606	12.785	-27.4	4.941	7.812	58.1
Paraguay	0.560	0.963	2.488	1.684	-32.3	0.697	1.197	71.7
Uruguay	0.413	0.853	1.644	1.360	-17.3	0.558	0.688	23.3
				Imports				
MERCOSUR/total (%)	**11.9**	**9.6**	**8.6**	**10.3**	**-**	**10.3**	**9.4**	**-**
MERCOSUR	**5.615**	**7.054**	**14.934**	**13.107**	**-12.2**	**5.759**	**7.681**	**33.4**
Argentina	4.744	6.241	13.258	11.281	-14.9	4.985	6.712	34.6
Paraguay	0.383	0.319	0.658	0.585	-11.0	0.212	0.278	31.0
Uruguay	0.485	0.494	1.018	1.240	21.8	0.561	0.691	23.1
				Trade balance				
MERCOSUR	**-2.304**	**4.692**	**6.804**	**2.722**	**-60.0**	**0.437**	**2.016**	**361.1**
Argentina	-2.397	3.689	4.348	1.504	-0.065.4	-0.044	1.100	-
Paraguay	0.177	0.644	1.830	1.098	-0.040.0	0.485	0.918	89.5
Uruguay	-0.072	0.359	0.626	0.120	-0.080.9	-0.0033	-0.0026	-23.2

Source: SECEX-MDIC.

In the first semester of 2010, the picture was very different, with Brazilian exports to MERCOSUR growing 56.5% to US$9.7 billion, and imports up 33.4% to US$7.7 billion. In light of this, the country's surplus with its partners rose almost fivefold to US$2 billion against the surplus in the first semester of 2009. The bloc's share in the country's total sales rose to 10.9%, while its share in imports dropped to 9.4%.

Despite falling exports, Brazil increased its share in the MERCOSUR partners' imports in 2009, keeping in mind that the three countries' total purchases fell even more significantly (30.5%). Brazil's market share reached 30.5%, 1.4 p.p. up on the previous year. However, it is still below the historic 33.0% high of 2005. Brazil accounted for 33.0% of total Argentina's imports in 2009, 25.9% of Paraguay's, and 20.4% of Uruguay's.

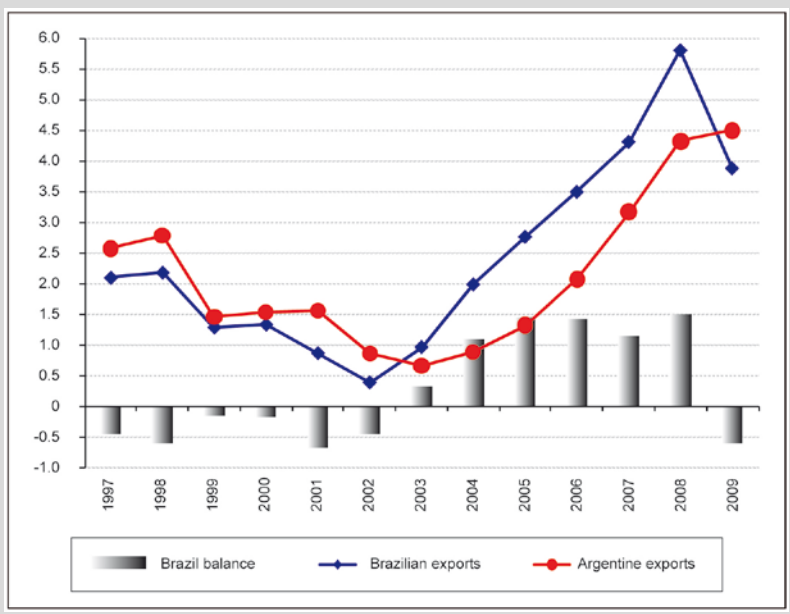
Box C. Argentine and Brazilian trade in the automotive sector

Since the creation of MERCOSUR, the automotive industry has occupied a key position in trade flows between Brazil and Argentina. At the end of the 1990s, the flow of bilateral trade in the sector stood at close to US$5 billion, or about one third of total trade between the two countries. Between 1999 and 2002, these flows fell drastically due to the succession of crises affecting the region's economies. However, the subsequent economic recovery boosted automotive trade again, which stood at US$10.2 billion in 2009, or around 33% of total bilateral trade. Up to 2002, the sector's trade balance was in Argentina's favor, but, between 2003 and 2008, Brazil accumulated a significant surplus, which reached a record US$1.5 billion in 2008 (Graph F).

2009 saw a significant drop in Brazil's exports to Argentina (-33.0%), but Brazilian purchases continued to grow (4.1%), swinging the trade balance in Argentina's favor to the tune of US$600 million. In the first semester of 2010, the sector underwent a remarkable recovery, with the flow of bilateral trade recording 73.7% growth. Growth was faster in Brazilian exports, leading to a further surplus for Brazil in the sectoral trade balance (US$113 million).

Graph F. Trade in motor vehicles between Argentina and Brazil 1997-2009

Billions of US$



Source: SECEX-MDIC.

Most bilateral trade in the automotive sector is composed of finished automobiles, vans, and utility vehicles, accounting for between 60% and 70% of the sector's total, with trucks, omnibuses, bodies, parts, and components making up the remaining 30% to 40%. Table A shows there is a degree of asymmetry between the two countries. Argentina's sales are more concentrated in the first group of products, which have accounted for more than 70% of the total sector in recent years (in 2009, the share reached 81.8%). Auto parts account for about 20%, and trucks and buses for less than 5%. In Brazil's case, automobiles make up approximately 60% of exports to its neighbor, auto parts 30%, and trucks and omnibuses around 10%.

Although there is evidence that Argentina's auto parts sector has competitive deficiencies compared to Brazil's, the analysis of data from 1997 seems to indicate that the composition of trade by product is also due to factors of a macroeconomic order. Between 2002 and 2006, auto parts came to represent over 30% of automotive exports from Argentina to Brazil, possibly linked to high idle capacity in industries in the two countries. This means that each country's automobile manufacturers covered the demand for end goods without the need for major imports. Also, the bilateral exchange rate was not yet so favorable to Argentina, keeping in mind that this is a decisive factor in automobile imports, but not so important in the case of auto parts.

Table A. Argentina-Brazil trade in the automotive industry by product group in selected years

Millions of US$

Products	1997	2002	2005	2008	2009
Brazilian Exports	**2,102**	**389**	**2,772**	**5,825**	**3,894**
Automobiles, vans and utility vehicles	988	186	1,755	3,487	2,344
Trucks and omnibuses	375	15	422	791	270
Bodywork, parts, and accessories	740	188	595	1,547	1,280
Argentine Exports	**2,575**	**854**	**1,319**	**4,333**	**4,510**
Automobiles, vans and utility vehicles	1,981	589	769	3,265	3,688
Trucks and omnibuses	211	51	74	186	122
Bodywork, parts, and accessories	384	213	476	882	700
Brazilian Balance	**-473**	**-465**	**1,453**	**1,492**	**-616**
Automobiles, vans and utility vehicles	-993	-404	987	222	-1,343
Trucks and omnibuses	164	-36	347	605	148
Bodywork, parts, and accessories	356	-25	119	665	579

Source: SECEX-MDIC.

Over the following years, the sharp appreciation of the Brazilian real and growth in the country's internal demand led to a more rapid expansion of finished vehicle imports, mainly medium-sized models of greater unit value. This had a direct impact on purchases from Argentina, whose industry is more highly specialized in these vehicles. Although auto part imports also recorded good sound growth, purchases of finished products far outstripped them.

Table 9 lays out the distribution of Brazil's extrazone trade flows according to the main economic blocs. In 2009, exports totaled 137.2 billion, a drop of 22.2%. For the first time, Asia was the main destination of Brazilian sales, representing 28.7% (7.5 p.p. up on the share in 2008), the only region to which Brazilian exports showed a positive change in the year (5.3%). The EU's share fell to 24.8%, NAFTA's to 14.7% (half the levels of five years ago), and LAIA's to 8.3%.

Table 9. Brazil: Extrazone trade flows by economic bloc at selected periods

Billions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
				Exports				
Extrazone/total (%)	**94.5**	**90.1**	**89.0**	**89.7**	**-**	**91.1**	**89.1**	**-**
Extrazone	**57.128**	**106.783**	**176.205**	**137.166**	**-22.2**	**63.756**	**79.490**	**24.7**
NAFTA	18.687	28.831	33.796	20.128	-40.4	9.254	11.723	26.7
EU	15.609	27.039	46.395	34.037	-26.6	15.990	19.281	20.6
LAIA*	4.226	9.678	17.076	11.392	-33.3	5.014	6.668	33.0
Asia	8.798	18.566	37.442	39.426	5.3	18.847	24.386	29.4
Other countries	9.807	22.669	41.496	32.184	-22.4	14.650	17.433	19.0
				Imports				
Extrazone/total (%)	**88.1**	**90.4**	**91.4**	**89.7**	**-**	**89.7**	**90.6**	**-**
Extrazone	**41.628**	**66.547**	**158.263**	**114.540**	**-27.6**	**50.268**	**73.629**	**46.5**
NAFTA	11.760	14.716	32.144	24.567	-23.6	11.729	15.175	29.4
EU	13.495	18.236	36.192	29.216	-19.3	12.898	17.334	34.4
LAIA*	2.033	3.719	9.432	5.994	-36.5	2.680	4.213	57.2
Asia	7.996	16.870	47.125	36.142	-23.3	15.484	24.867	60.6
Other countries	6.344	13.006	33.370	18.622	-44.2	7.479	12.039	61.0
				Trade balance				
Extrazone	**15.500**	**40.237**	**17.942**	**22.625**	**26.1**	**13.488**	**5.862**	**-56.5**
NAFTA	6.927	14.115	1.651	-4.440	-	-2.475	-3.452	39.5
EU	2.114	8.804	10.204	4.821	-52.8	3.093	1.947	-37.1
LAIA*	2.194	5.959	7.644	5.398	-29.4	2.334	2.454	5.1
Asia	0.802	1.696	-9.683	3.284	-	3.364	-0.481	-
Other countries	3.463	9.663	8.126	13.562	66.9	7.172	5.394	-24.8

Note: * Except MERCOSUR and Mexico.

Source: SECEX-MDIC.

On the import side, there was a significant fall in purchases from all blocs in 2009, particularly from the LAIA countries (-36.5%). Asia kept up its position as a leading supplier of Brazil, with a share of 31.6%, followed by the EU (25.5%), and NAFTA (21.4%). Brazil's extrazone trade surplus totaled US$22.6 billion in 2009, US$4.7 billion up on 2008, thanks mainly to the improvement in the balance with Asia, which went from a US$9.7 billion deficit in 2008 to a US$3.3 billion surplus in 2009. The same occurred with the group of "other countries:" the surplus with them rose from US$8.1 billion to US$13.6 billion. The balance with NAFTA moved in the opposite direction, from a US$1.7 billion surplus to a US$4.4 billion deficit. The balances with the EU and LAIA were in surplus in 2009, but also saw significant falls for 2008.

In the first semester of 2010, Brazilian extrazone exports recovered, 24.7% up on the same period in 2009, but imports grew even faster (46.5%), driven mainly by purchases from Asia (60.6%) and LAIA (57.2%). The country's extrazone trade balance fell 56.5% to US$5.9

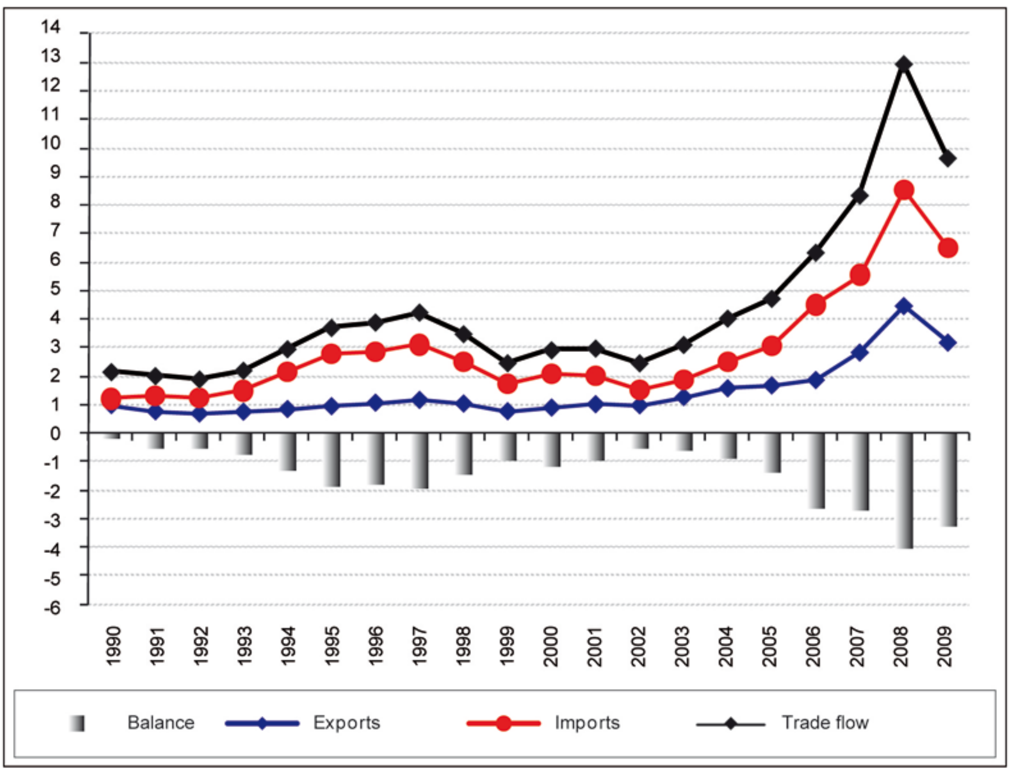
billion, notable in which was with the US$3.5 billion deficit with the NAFTA and the new change of sign in the balance with Asia, which again became negative (-US$481 million).

Paraguay

Paraguay's foreign trade flows in 2009 were not immune to the negative effects of the international crisis. Its exports fell 29.0% to US$3.2 billion and its imports shrank 23.6% to US$6.5 billion. Graph 18 shows that this was the first drop in the country's trade flows since 2002. The balance of trade was in deficit by US$3.3 billion, the second worst result in the country's recent history, just below the 2008 record (-US$4 billion).

Graph 18. Paraguay: Trade flows in 1990-2009

Billions of US$



Source: Central Bank of Paraguay.

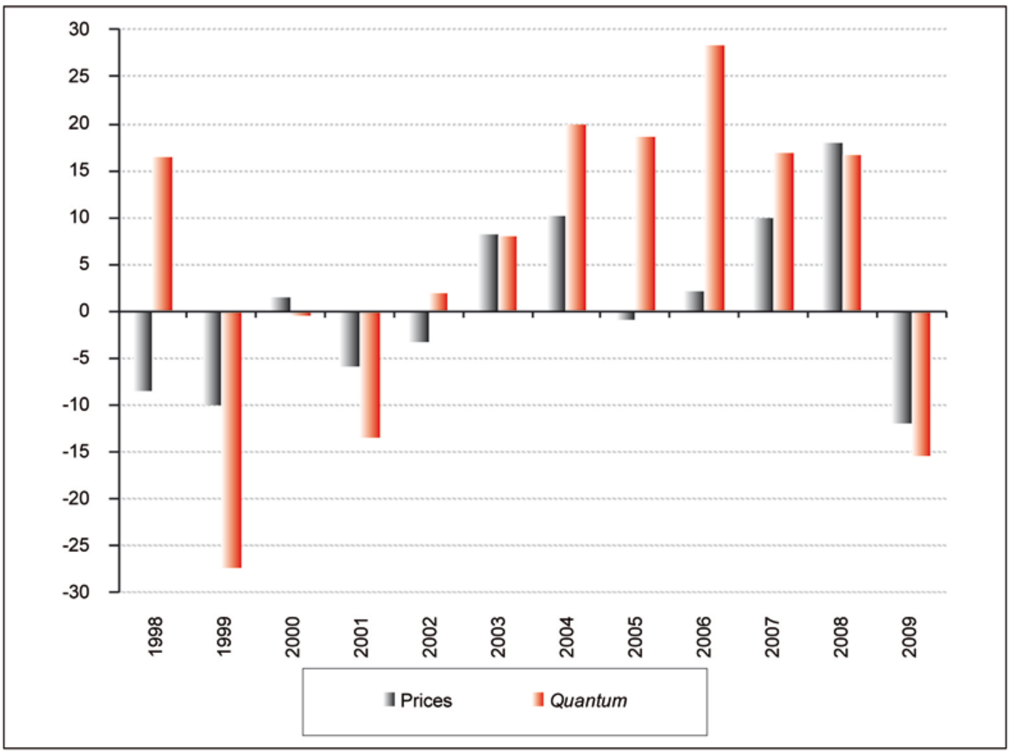
The drop in exports was determined primarily by falling shipments of soybeans and derivatives (-45.8%), which account for around half the country's total external sales. In imports, the fall was general across the products' various categories of use, especially intermediate goods (-30.6%) and fuels (-30.1%).

Both exports and imports saw a strong recovery in the first semester of 2010, with exports growing 39.6% and imports, 48.4%, generating a US$1.8 billion deficit, far higher than the same period in 2009 (62.0%). The recovery in sales was due mainly to an approximately 80.0% expansion in sales of soy and derivatives, and to rising beef exports: 60.0% up.

The drop in exports in 2009 was due both to the contraction in the quantities exported (-15.4%) and to falling prices (-12.0%). However, it is important to note that growth in previous years was governed by a rise in the quantum, which grew at a rate of 17.9% c.a. between 2003 and 2008, while prices rose 7.7% c.a. In that period, the terms of trade contributed little, expanding just 1.8% c.a. The fall in 2009 also was modest: just 2.2%.

Graph 19. Paraguay: Growth in prices and export quantum 1998-2009

As %



Source: CEPAL.

The MERCOSUR countries were the destination for almost half Paraguay's exports in 2009 (48.4%), a figure similar to previous years. Table 10 shows that the amount of US$1.5 billion represented a drop of 28.2%. This was no steeper on account of the country's increased exports to Brazil (4.4%). In light of this, the Brazilian share in Paraguayan sales rose to 20.7%, the highest percentage since 2003. The same was not true of Uruguay, a destination that experienced a 31.5% drop, nor of Argentina, where the drop was 52.8%.

Imports from MERCOSUR totaled US$2.6 billion, down 27.3%, signaling a reverse in the partners' share in total Paraguayan external purchases to 40.5%, a far lower percentage than in the late 1990s, when it stood at around 55.0%. The biggest drop was seen in purchases from Brazil (-34.3%), which saw its share in Paraguayan imports cut to 23.3%.

Table 10. Paraguay: Trade flow with MERCOSUR countries at selected periods

Billions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
				Exports				
MERCOSUR/total (%)	**54.5**	**53.9**	**47.8**	**48.4**	**-**	**51.4**	**51.5**	**-**
MERCOSUR	**0.518**	**0.893**	**2.135**	**1.533**	**-28.2**	**0.877**	**1.228**	**39.9**
Argentina	0.035	0.103	0.727	0.343	-52.8	0.247	0.273	10.7
Brazil	0.353	0.316	0.628	0.656	4.4	0.270	0.298	10.4
Uruguay	0.165	0.474	0.780	0.534	-31.5	0.361	0.657	81.9
				Imports				
MERCOSUR/total (%)	**56.0**	**48.9**	**42.5**	**40.5**	**-**	**39.1**	**41.8**	**-**
MERCOSUR	**0.845**	**1.502**	**3.619**	**2.632**	**-27.3**	**1.099**	**1.745**	**58.9**
Argentina	0.309	0.612	1.216	1.037	-0.014.7	0.426	0.651	52.7
Brazil	0.478	0.841	2.302	1.513	-0.034.3	0.633	1.028	62.3
Uruguay	0.058	0.050	0.100	0.082	-0.0185	0.039	0.066	70.6
				Trade balance				
MERCOSUR	**-0.327**	**-0.610**	**-1.483**	**-1.099**	**-0.0259**	**-0.221**	**-0.518**	**134.0**
Argentina	-0.275	-0.509	-0.489	-0.694	0.0419	-0.180	-0.378	110.3
Brazil	-0.125	-0.525	-1.674	-0.857	-0.0488	-0.364	-0.730	100.8
Uruguay	0.107	0.424	0.680	0.452	-0.033.5	0.322	0.590	83.3

Source: Central Bank of Paraguay.

The country's trade balance with its partners showed a deficit, at US$1.1 billion, 25.9% down on the previous year. This reduction was due entirely to a drop of over US$800 million in the deficit with Brazil, since the deficit with Argentina grew and the surplus with Uruguay contracted.

In the first semester of 2010, exports to MERCOSUR saw a significant recovery, growing 39.9% and reaching levels higher than those recorded prior to the international crisis. The increase was particularly strong in sales to Uruguay, which overtook Brazil and Argentina as the main market within MERCOSUR, accounting for 27.5% of the country's total exports. Imports, however, grew at an even higher rate of 58.9%, leading the Paraguayan trade deficit with its partners to grow more than 100% compared to the same period in 2009.

Paraguay's market share in the MERCOSUR partners' imports remained stable between 2008 and 2009, at close on 0.9%, with a slight increase in its share of the Brazilian market (0.5%) and losses in the Argentine and Uruguayan markets, where it closed with a share of 0.9% and 8.0% respectively. In the first semester of 2010, there was a marked increase (18.3%) in the Uruguayan market share.

Where extrazone trade flows were concerned, Table 11 shows that the 29.8% drop in exports in 2009 was general. The LAIA countries, excluding MERCOSUR, were the main destinations that year as in previous years, representing 20.5% of total exports. The "other countries" group also had a significant share (14.0%) while NAFTA, the EU, and Asia together accounted for just 17.0%.

Table 11. Paraguay: Extrazone trade flows by economic bloc at selected periods

Millions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
				Exports				
Extrazone/total (%)	**45.5**	**46.1**	**52.2**	**51.6**	**-**	**48.6**	**48.5**	**-**
Extrazone	**433**	**762**	**2,328**	**1,634**	**-29.8**	**830**	**1,157**	**39.4**
NAFTA	42	57	88	59	-32.9	25	10	-61.5
EU	83	105	373	190	-49.0	87	295	237.6
LAIA*	99	126	869	649	-25.3	323	398	23.3
Asia	48	144	418	292	-30.0	143	143	0.0
Other countries	160	331	581	444	-23.6	252	312	23.7
				Imports				
Extrazone/total (%)	**44.0**	**51.1**	**57.5**	**59.5**	**-**	**60.9**	**58.2**	**-**
Extrazone	**665**	**1,571**	**4,887**	**3,865**	**-20.9**	**1,712**	**2,427**	**41.7**
NAFTA	92	204	448	340	-24.2	165	219	32.4
EU	142	203	453	358	-21.0	168	224	33.0
LAIA*	29	58	527	459	-12.8	249	194	-21.9
Asia	305	862	3,187	2,591	-18.7	1,093	1,709	56.4
Other countries	95	244	272	117	-57.1	38	81	115.5
				Trade balance				
Extrazone	**-232**	**-808**	**-2,559**	**-2,231**	**-12.8**	**-882**	**-1,270**	**43.9**
NAFTA	-50	-147	-360	-281	-22.0	-140	-209	49.4
EU	-59	-98	-80	-168	109.0	-81	71	-
LAIA*	69	68	342	190	-44.5	74	204	175.7
Asia	-257	-718	-2,770	-2,299	-17.0	-950	-1,567	64.9
Other countries	65	87	308	327	6.0	215	231	7.7

Note: * Except MERCOSUR and Mexico.

Source: Central Bank of Paraguay.

The fall in extrazone imports was lower than that seen in exports (-20.9%), and was also general across the various regions, albeit less so in the case of LAIA (-12.8%). Moreover, Asian countries held their place as the main source of Paraguay's purchases, with a 40.0% share in the country's total external sales, while NAFTA, the EU, and LAIA together accounted for just 17.8%. As a result, virtually all Paraguay's extrazone trade deficit, US$2.2 billion in 2009, was due to trade with Asia, although there are minor deficits with NAFTA and the EU, and small surpluses with LAIA and "other countries".

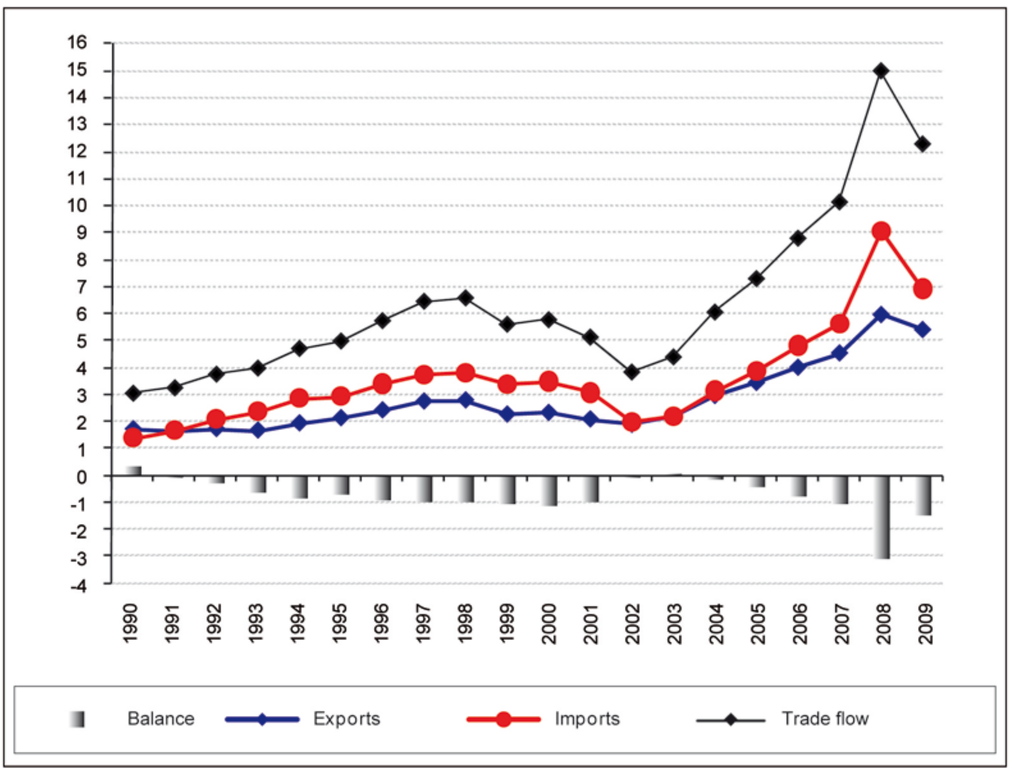
In the first semester of 2010, extrazone exports saw growth of 39.4%, determined primarily by a 237.6% increase in sales to the EU, while the volume of exports to NAFTA remained remarkably low (just US$10 million). Imports grew at a slightly higher rate (41.7%), especially because of purchases from Asia (56.4%). Imports from LAIA, in contrast, continued to fall. The extrazone trade deficit was up 43.9% to US$1.3 billion, again concentrated in trade with Asia, whose deficits in the period totaled US$1.6 billion.

Uruguay[51]

Uruguay's foreign trade flows in 2009 were also affected by the international crisis, but the effect on exports was far less severe than in the other MERCOSUR countries. They saw a drop of just 9.4%, contracting to US$5.4 billion. Imports, however, fell 23.8% to US$6.9 billion (Graph 20). The country was thus able to cut its trade deficit to US$1.5 million, less than half that recorded the previous year.

Graph 20. Uruguay: Trade flows in 1990-2009

Billions of US$



Source: Central Bank of Uruguay.

The drop in exports was determined primarily by falling sales of beef (-20.0%), mineral products (-60.7%), hides and skins (-34.1%), and wood and wood-based products (-20.1%), partially offset by the 24.3% growth in cereal exports. In imports, the most important reduction occurred in fuels (-45.9%).

Both exports and imports saw a significant recovery in the first semester of 2010, with increases of 26.4% and 21.0% respectively, enabling the country to maintain a relatively stable trade balance compared to the first semester of 2009, when it was -US$570 million. The recovery in sales was due to the same products that had led to the 2009 contraction,

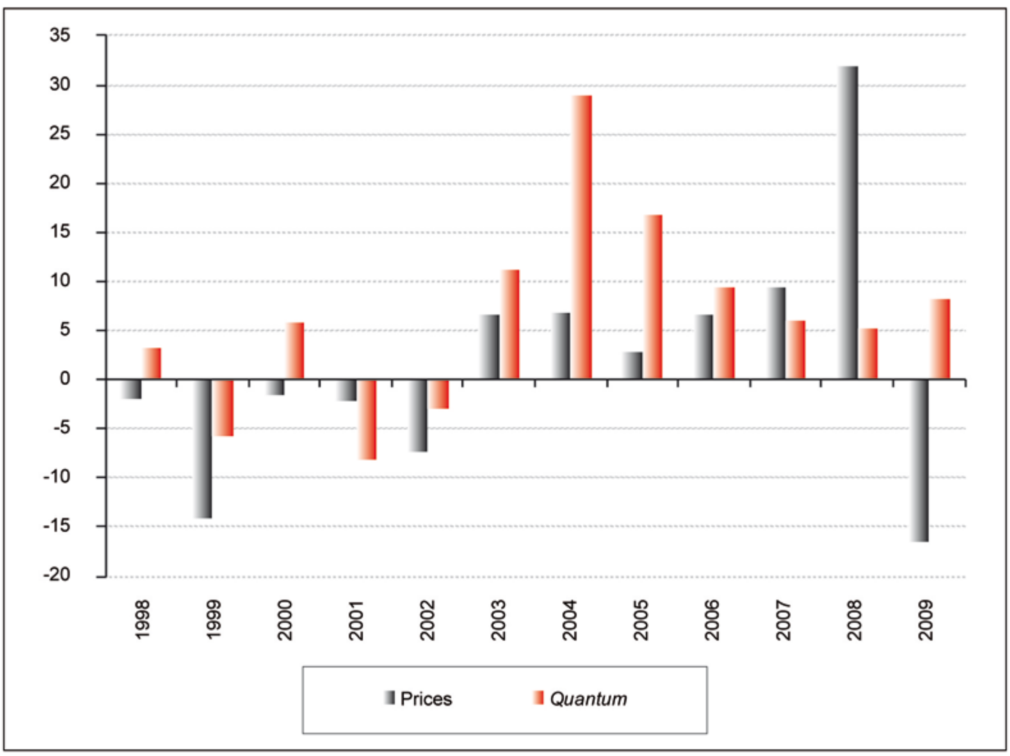
[51] All measurements of Uruguayan import data are CIF-based.

whereas the expansion of imports was more intense in consumer goods (37.2%) and capital goods (30.8%).

The 2009 drop in exports was due solely to falling prices (-16.6%), with the quantities exported expanding 8.2%. Graph 21 illustrates the quantum's steady trajectory of growth in recent years, despite slowing in 2007 and 2008. Between 2003 and 2009, the average annual growth rate was 12.0%, far higher than the 6.0% increase in export prices. Unlike its MERCOSUR partners, Uruguay did not record significant gains in its terms of trade during the "boom" in world trade. Indeed, the index for terms of trade in 2008 was 9.0% below the rate recorded in 2003. In 2009, there was a rise of 3.0%.

Graph 21. Uruguay: Growth in prices and export quantum 1998-2009

As %



Source: ECLAC.

The MERCOSUR countries were the destination for 28.4% of Uruguayan exports in 2009, slightly up on previous years but well down on late 1990s levels, when they reached over 50%. Table 12 shows that the US$1.5 billion exported to MERCOSUR over the year represents a fall of just 4.5%, primarily because of the 11.2% growth in sales to Brazil, with exports to Argentina and Paraguay performing rather negatively. Brazil's share in Uruguayan sales rose to 20.4% as a result, the highest rate since 2003.

Imports from MERCOSUR totaled US$3.1 billion in 2009, a drop of 20.1%, meaning that the partners' share in total Uruguayan external purchases rose to 45.3%, a percentage that has stayed reasonably stable since the late 1990s. The steepest fall was in purchases from Argentina (-27.6%), which nevertheless kept its place as Uruguay's leading supplier in MERCOSUR.

Table 12. Uruguay: Trade flow with the MERCOSUR countries at selected periods

Millions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
Exports								
MERCOSUR/total (%)	**32.6**	**22.9**	**26.9**	**28.4**	**-**	**27.8**	**29.8**	**-**
MERCOSUR	**607**	**783**	**1,601**	**1,529**	**-4.5**	**711**	**964**	**35.6**
Argentina	113	267	507	346	-31.8	170	254	48.9
Brazil	432	460	988	1,099	11.2	498	633	27.1
Paraguay	62	56	107	85	-28	42	77	83.6
Imports								
MERCOSUR /total (%)	**48.1**	**42.0**	**43.2**	**45.3**	**-**	**48.0**	**36.6**	**-**
MERCOSUR	**944**	**1,631**	**3,919**	**3,130**	**-21**	**1,508**	**1,391**	**-7.8**
Argentina	541	786	2,250	1,628	-27.6	803	646	-19.6
Brazil	390	825	1,618	1,460	-9.8	683	719	5.3
Paraguay	14	20	51	41	-19.1	22	26	16.2
Trade balance								
MERCOSUR	**-337**	**-847**	**-2,319**	**-1,600**	**-31.0**	**-798**	**-427**	**-46.5**
Argentina	-427	-519	-1,743	-1,283	-26.4	-633	-392	-38.0
Brazil	42	-364	-630	-361	-42.8	-185	-86	-53.5
Paraguay	48	36	55	43	-22.4	20	51	159.4

Source: Central Bank of Uruguay.

The country' trade balance with its partners was US$1.6 billion in deficit in 2009, down 31.0% on the previous year. This contraction was due entirely to the US$460 million and US$269 million falls in the deficit with Argentina and Brazil respectively, while trade with Paraguay kept up a small surplus.

In the first semester of 2010, exports to MERCOSUR saw a significant recovery, growing 35.6%, notably the 83.6% rise in sales to Paraguay. Brazil remained the main destination for Uruguayan sales in MERCOSUR, accounting for almost 20.0% of the country's total exports. Imports, however, saw a 7.8% drop, influenced by a 19.6% fall in purchases from Argentina, allowing Uruguay's deficit with its partners to fall to just US$467 million in the period, largely due to trade with Argentina.

Uruguay's market share in its MERCOSUR partners' imports rose to 0.9% in 2009, significantly up on previous years. In Argentina and Brazil, the market share stood at the same level (0.9%), while in Paraguay the figure was 1.3%. In the first semester of 2010, there was a rise in market share in Argentina (1.0%) and Paraguay (1.85%), and a drop in Brazil (0.80%).

Box D. A profile of Paraguayan and Uruguayan exports to the Brazilian market

A small country's trade integration with a larger one provides, at least in theory, a major opportunity not only for the expansion of the volume of exports from these countries, but also for the diversification of its export baskets, considering the greater scale and diversity of larger country's consumer market. The reality in MERCOSUR, however, is not so favorable. While Brazil represents a significant portion of Paraguay's and Uruguay's exports, the result is certainly below their potential and the expectations during the bloc's creation, especially where diversification of sales is concerned.

From the early years of MERCOSUR, Paraguay's exports to Brazil were heavily concentrated in commodities, whose share in external sales totals for 1998-2009 ranged from 69.3% in 1998 to 91.8% in 2003. Also, even in more favorable years, just 10 products were responsible for less than 75% of Paraguayan sales to Brazil.

Throughout the period, 5 products stood out with significant shares across all years: wheat, maize, soybeans, beef, and cakes and residues from soy oil extraction. These products, along with rice, which gained importance in Paraguay's export basket in the second semester of the current decade, and cotton, which played a significant part up to the start of the decade, represented at least 60% of Paraguay's exports to Brazil every year (Table B).

Table B. Paraguayan exports to Brazil Share of main products in selected years

As %

Products	1998	2002	2005	2008	2009
Wheat grain	4.1	2.8	14.4	23.1	28.8
Maize grain	3.3	6.6	13.4	18.8	22.3
Rice grain	-	-	2.2	4.3	6.6
Soy grain	18.6	45.6	21.5	6.0	6.5
Beef	7.3	6.0	9.7	2.8	3.5
Cakes and soy-oil extraction residues	6.7	15.2	10.0	5.7	2.5
Unprocessed cotton	20.7	7.2	2.7	1.8	0.3
Subtotal	**60.8**	**83.4**	**74.0**	**62.6**	**70.5**
Total exports (US$ millions)	**351.2**	**383.1**	**318.9**	**657.5**	**585.4**

Source: SECEX-MDIC.

Brazil regularly imports relatively high volumes of just two products in this group: wheat and rice. Brazil is a major cotton and maize producer, but may need to supplement internal supply with imports in response to problems with its harvests. Where beef, soybeans, and cakes and residues from soy oil extraction are concerned, Brazil is actually a major exporter. Brazilian imports may, therefore, reflect occasional exports as a means of complementing internal production in order to meet export contracts.

Given the current profile of Paraguayan exports to Brazil, the prospects for expansion are limited. Furthermore, it is clear that access to the Brazilian market has brought no major benefits in terms of diversification, particularly in relation to industrial products. Although some products (e.g. plastics articles, hides and skins, footwear parts, and sunflower and soybean oil) have seen significant export volumes in certain years, the country was unable to sustain and strengthen its sales in the following years.

This finding only reinforces the importance of initiatives in the scope of MERCOSUR that aim to reduce asymmetries and stimulate investment in the smaller countries, among which are projects geared to developing their infrastructure, such as those promoted with FOCEM funding, and the attraction of foreign investment, mainly from Brazil.

Uruguayan exports to Brazil, in addition to recording far higher quantities, are more diversified in terms of products and mainly comprise manufactured goods. These traditionally accounted for over 60% of Uruguayan sales in the 1990s, reaching a high of 74% in 2005, whereas commodities represent between 30% and 40% of the total and semi-manufactured goods have insignificant share.

In terms of diversification, however, the picture has not been very favorable. Around 20 products have generally accounted for approximately 75% of the total value exported to Brazil, a situation that has changed little over the last decade.

Table C. Uruguayan exports to Brazil Share of main products in selected years

As %

Products	1998	2002	2005	2008	2009
Commodities	42.3	27.5	24.4	29.4	38.7
Wheat grain	0.3	0.4	0.8	3.2	16.9
Rice grain	20.9	17.4	13.1	9.3	10.1
Beef	7.1	4.6	3.7	4.4	3.1
Sheep and goat meat	1.0	0.8	2.2	2.2	1.7
Unconcentrated, unprocessed milk	4.3	0.8	0.0	0.0	0.2
Other commodities	8.5	3.5	4.6	10.3	6.8
Manufacture goods	56.6	69.3	74.2	69.8	60.3
Whole or split malt, unroasted	4.1	8.2	14.0	13.5	13.1
Plastic items for transport or packaging	1.6	8.2	11.1	10.0	8.5
Concentrated milk and cream	4.3	11.0	5.3	1.5	3.7
Unvulcanized rubber mixture, in plates, sheets, etc.	2.5	5.2	6.7	5.7	3.4
Soaps, cleaning products and preparations	0.0	0.6	3.8	3.6	2.7
Cast iron tubing, iron or steel and accessories	0.9	1.5	2.4	2.8	2.5
Cheeses and rennets	1.7	1.4	0.7	0.9	1.8
Motor vehicle and tractor parts and pieces	0.1	0.4	1.2	1.5	1.5
Gasolines	0.1	1.1	0.6	1.7	1.4
Medicines for human and veterinary medicine	2.2	2.1	1.7	1.5	1.0
Wheat flour	0.8	0.3	0.8	1.9	1.0
Insecticides, pesticides, herbicides, etc.	0.5	0.3	0.2	2.3	0.9
Plastic plates, sheets, strips, films, etc.	0.1	1.0	1.0	1.4	0.9
Passenger coaches	2.0	4.8	-	-	0.8
Food preparations	4.8	0.8	0.9	0.6	0.5
Other manufactured goods	30.9	22.2	24.0	20.8	16.5
Total exports (US$ millions)	**1,042.4**	**484.8**	**493.7**	**1,018.2**	**1,240.3**

Source: SECEX-MDIC.

Table C shows that there are four commodities that dominate exports: wheat, rice, beef, and sheep and goat meat. Until the start of this decade, milk too played a significant part, but sales are currently insignificant. Only wheat and rice imports are significant. In wheat, Uruguay only achieved more significant export volumes to its neighbor in 2009, while rice sales have fluctuated over the last few years, without showing a firm trend toward growth.In the case of the manufactured products, two items were of significant weight in recent years: malt and plastic articles for transport or packaging. In 2009, these accounted for 21.6% of Uruguay's total exports to Brazil and for 36.0% of the sales of manufactured goods. They are products in which total Brazilian imports have seen good growth.

There is also a clear specialization in products relating to just two sectors of activity: foodstuffs (apart from malt, there is milk and cream, cheese and rennets, wheat flour and food preparations), and chemicals and pharmaceuticals (soaps and cleaning products, gasolines, medicines, and insecticides).

The case of the automotive industry is an important one. In 2002, passenger automobiles, as well as vehicle parts and pieces, represented over 5% of Uruguayan exports to Brazil. In the ensuing years, automobile exports stopped and sales of auto parts were negligible. But, in 2009, Uruguay again began to sell cars, which, with auto parts, represented 2.3% of the country's total sales. The installation of a Chinese vehicle plant in the country has brought favorable prospects for export growth in these products over the years to come.

To summarize, the profile of Uruguayan exports to Brazil has more favorable prospects over the next few years due to the potential for growth in certain industrialized products. It is certainly a far more favorable situation than Paraguay's, a reflection of the country's greater industrial development. Even so, Uruguay has been unable to integrate new products in its exports more intensively and the degree of diversification accordingly remains essentially the same as that seen in the late 1990s.

In terms of extrazone trade flows, Table 13 shows that the drop in exports in 2009 (11.2%) was determined by falling sales to NAFTA, the EU, and LAIA. Exports to Asia showed growth of 8.4% to a share of 14.9% in total external sales. The "other countries" group, however, remains the main destination outside MERCOSUR, with 28.2%.

The drop in extrazone imports in 2009 (-26.7%) was higher than the one seen in exports to that destination, and their share in Uruguay's total purchases was down to 54.7%. The poor result for the year was caused mainly by the drop in purchases from the "other countries" group (-65.1%). Asia remained as the main source of extrazone imports, with 17.5% of the country's total, still behind Argentina and Brazil, the country's main suppliers. Uruguay's extrazone trade balance became positive (US$79 million in 2009), an absolute change of US$888 million compared to 2008, thanks to the US$1 billion surplus obtained with the "other countries" group, the balances with NAFTA, LAIA, and Asia remaining in deficit.

In the first semester of 2010, extrazone exports grew 22.9%, with significant increases in sales to all regions. Imports grew at a much steeper rate (47.7%), especially thanks to purchases from LAIA (109.3), prominent among which was the 121.0% growth of imports from Venezuela. The extrazone trade balance showed a deficit of US$139 million.

Table13. Uruguay: Extrazone trade flows by economic bloc at selected periods

Millions of US$

	2002	2005	2008	2009	% Var. 2009/2008	1st S 2009	1st S 2010	% Var.
Exports								
Extrazone/total (%)	**67.4**	**77.1**	**73.1**	**71.6**	**-**	**72.2**	**70.2**	**-**
Extrazone	**1,254**	**2,633**	**4,341**	**3,856**	**-11.2**	**1,849**	**2,272**	**22.9**
NAFTA	239	1,017	424	349	-17.6	168	187	11.4
EU	445	597	1,150	827	-28.1	407	499	22.5
LAIA*	156	239	500	362	-27.6	179	197	10.2
Asia	317	440	738	800	8.4	338	457	35.0
Other countries	98	340	1,529	1,518	-0.7	758	933	23.1
Imports								
Extrazone/total (%)	**51.9**	**58.0**	**56.8**	**54.7**	**-**	**52.0**	**63.4**	**-**
Extrazone	**1,020**	**2,248**	**5,150**	**3,777**	**-26.7**	**1,633**	**2,411**	**47.7**
NAFTA	200	332	842	688	-18.3	278	477	71.7
EU	352	416	769	748	-2.8	312	437	39.9
LAIA*	106	326	783	656	-16.2	256	535	109.3
Asia	191	484	1,396	1,210	-13.3	495	728	47.0
Other countries	171	691	1,359	475	-65.1	292	234	-19.8
Trade balance								
Extrazone	**234**	**384**	**-809**	**79**	**n.a.**	**216**	**-139**	**n.a.**
NAFTA	39	685	-419	-339	-19.0	-110	-290	163.2
EU	93	181	381	79	-79.3	95	62	-35.0
LAIA*	49	-87	-283	-294	3.8	-77	-338	338.6
Asia	125	-44	-658	-410	-37.6	-157	-271	73.1
Other countries	-73	-351	170	1,044	513.8	466	699	50.0

Note: * Except MERCOSUR and Mexico. n.a.: Does not apply.

Source: Central Bank of Uruguay.

C. MERCOSUR-Venezuela trade[52]

Venezuela's total trade flows also underwent a significant contraction in 2009 compared to the previous year. In particular, exports were down 39.5% to US$57.6 billion in 2009, while imports suffered a 22.3% drop, to US$38.4 billion. As a result, the country's trade surplus fell to US$19.2 billion, down in absolute terms US$26.5 billion on the historical record reached the previous year (US$45.7 billion). The 2009 result was the worst for the last six years.

Although the poor export performance was driven by the 39.2% drop in oil exports, there was also a drop in sales of other products (-43.5%). Even so, oil reached a share of 94.1% in Venezuela's total external sales in 2009, the highest for many years (in 1998, for example, it was just 68.8%). This was due not only to rising sales of the product, whose prices are at a

[52] Statistics from MERCOSUR countries' national sources.

historical high, but also to the absolute drop in exports of other products, which totaled just US$3.4 billion. Just three years ago, these reached US$7.6 billion.

In the first four months of 2010, there was a recovery in exports, up 33.2% on the same period in 2009, but imports fell again (-18.1%) because of the recessive situation still affecting the Venezuelan economy. This allowed the trade surplus to rise significantly to US$15.1 billion, well above the US$3.2 billion for the same period in 2009.

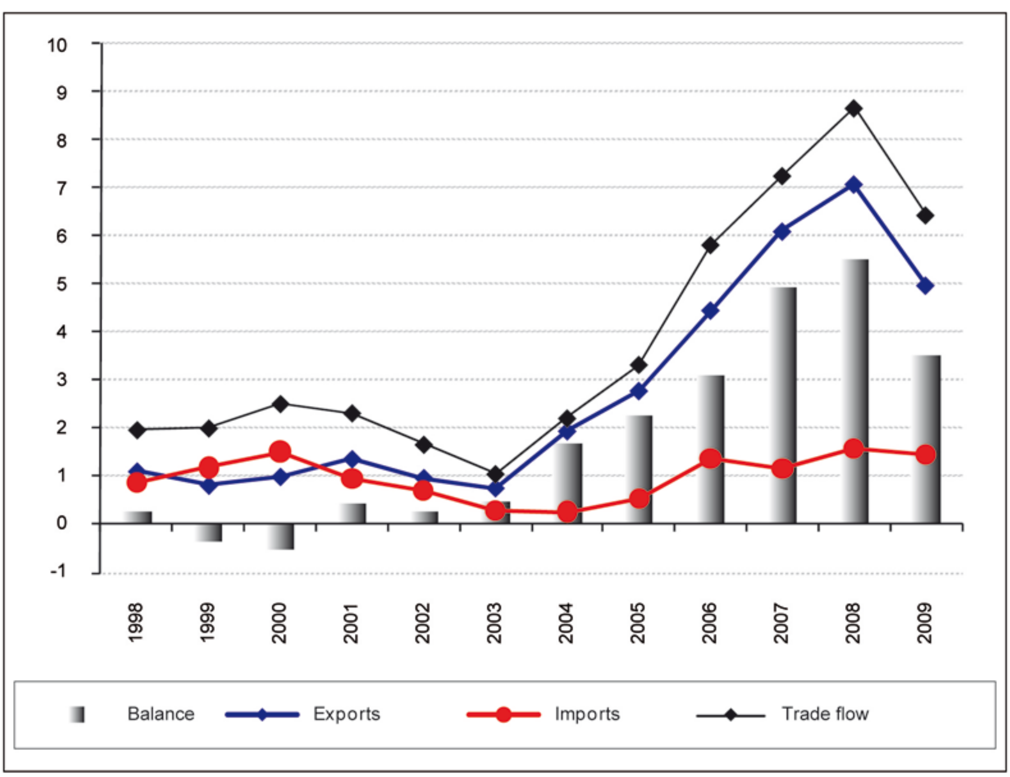
The MERCOSUR countries' trade with Venezuela followed different trends than those recorded in Venezuela's total trade. In 2009, MERCOSUR exports totaled US$5 billion, 29.7% down on the previous year, a higher percentage than the one seen in Venezuela's total imports. Venezuela's sales to MERCOSUR dropped just 7.7%, well below the percentage for total exports. The MERCOSUR trade surplus with this country fell to US$3.5 billion accordingly (Graph 22).

In the first four months of 2010, MERCOSUR exports to its South American partner grew just 2.8%, while imports saw a rise of 81.4%, reducing the trade surplus even further, to just US$933 million.

All the MERCOSUR countries' exports to Venezuela declined significantly in 2009 (Table 14), particularly Paraguay (-51.7%). Brazil was responsible for 72.7% of MERCOSUR exports to Venezuela in 2009, followed by Argentina (21.0), Uruguay (3.8%), and Paraguay (2.5%).

Graph 22. MERCOSUR: Trade flows with Venezuela in 1998-2009

Billions of US$



Source: INDEC (Argentina), SECEX-MDIC (Brazil), Central Banks of Paraguay and Uruguay.

Table 14. MERCOSUR: Trade flows with Venezuela at selected periods

Billions of US$

	2002	2005	2008	2009	% Var. 2009/2008	Jan-Apr 2009	Jan-Apr 2010	% growth 2010/2009
				Exports to Venezuela				
MERCOSUR	**0.968**	**2,778**	**7,062**	**4,964**	**-29.7**	**1,497**	**1,539**	**2.8**
Argentina	0.148	0.513	1,420	1,042	-26.6	0.267	0.362	35.3
Brazil	0.799	2,224	5,150	3,610	-29.9	1,132	1,112	-1.7
Paraguay	0.010	0.007	0.257	0.124	-51.7	0.038	0.020	-46.6
Uruguay	0.011	0.034	0.235	0.188	-20.3	0.060	0.044	-25.9
				Imports from Venezuela				
MERCOSUR	**0.689**	**0.538**	**1,576**	**1,455**	**-7.7**	**0.334**	**0.605**	**81.4**
Argentina	0.007	0.032	0.025	0.015	-38.5	0.003	0.007	158.3
Brazil	0.633	0.256	0.539	0.582	8.0	0.103	0.296	188.0
Paraguay	0.005	0.005	0.365	0.334	-8.4	0.145	0.081	-44.3
Uruguay	0.044	0.245	0.647	0.524	-19.1	0.083	0.221	166.9
				Trade balance				
MERCOSUR	**0.279**	**2,240**	**5,486**	**3,508**	**-36.1**	**1,163**	**0.933**	**6.6**
Argentina	141	481	1,394	1,026	-26.4	0.264	0.354	**34.0**
Brazil	166	1,968	4,612	3,029	-34.3	1,029	0.817	-20.6
Paraguay	0.005	0.002	-0.108	-0.210	94.6	-0.107	-0.061	-43.5
Uruguay	-0.033	-0.211	-0.412	-0.336	-18.4	-0.023	-0.177	666.3

Source: INDEC (Argentina), SECEX-MDIC (Brazil), Central Banks of Paraguay and Uruguay.

On the import side, however, the countries' performance was extremely varied. Brazil recorded an increase of 8.0% in imports from Venezuela, totaling US$582 million, with the country's share in Venezuela's total sales to MERCOSUR rising to 40.0% accordingly. Argentine imports also suffered a drop (38.5%), standing at just US$15 million in 2009. Paraguayan imports fell 8.4% and Uruguay's, 19.1%. It is important to note that, in 2008, Uruguay was the MERCOSUR country that imported most from Venezuela, with a share of 41.1% in the bloc's total, a position it lost to Brazil in 2009, its share falling to 36.0%.

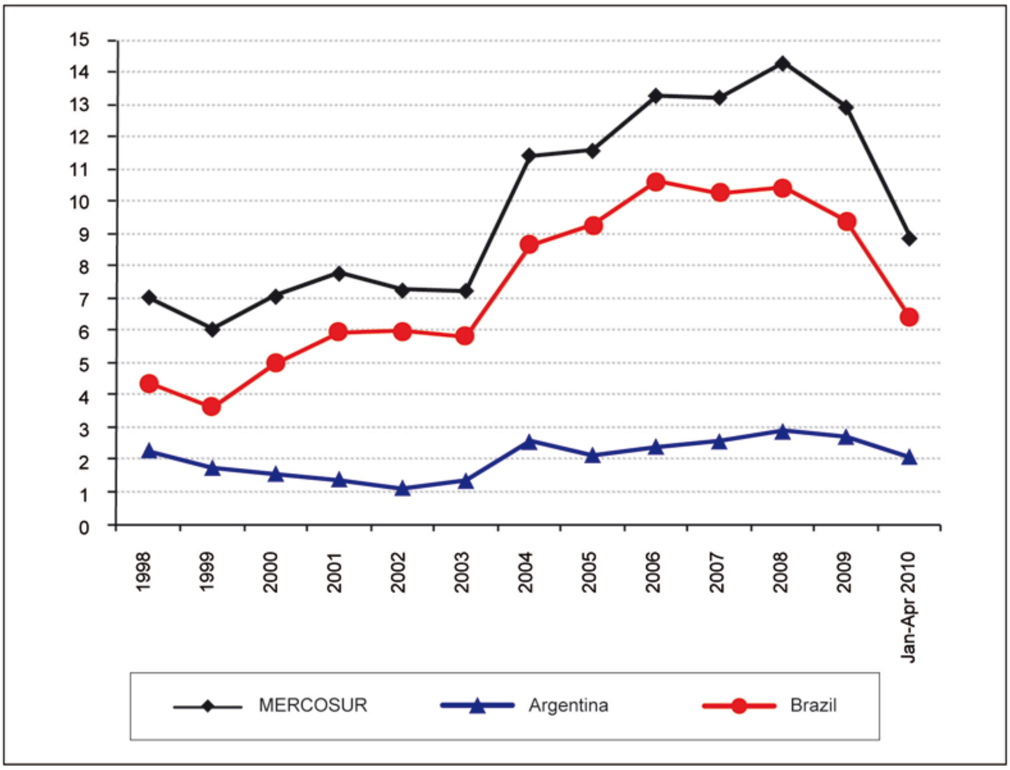
The bulk of MERCOSUR's trade surplus with Venezuela in 2009 was due to trade with Brazil, but the result of US$3 billion recorded in 2009 was down US$1.6 billion in absolute terms on the previous year. The surplus in Argentina also dropped in 2009, to US$1 billion. Paraguay and Uruguay remain in deficit with Venezuela.

In the first four months of 2010, the growth of MERCOSUR exports to Venezuela was exclusively down to Argentina, whose sales grew 35.3%. Exports from Brazil saw a slight fall (-1.7%), and Paraguay and Uruguay's shrank heavily. On the import side, however, there was strong growth in Argentine, Brazilian, and Uruguayan purchasing. The balance of trade with Argentina and Brazil remained in surplus, and in deficit with Paraguay and Uruguay.

MERCOSUR's weaker export performance in comparison with Venezuela's total imports meant the bloc lost market share in this partner's market. After reaching a 14.3% high in 2008, it dropped to 12.9% in 2009 and just 8.9% in the first four months of 2010. Graph 23 shows that this fall was due mainly to Brazilian imports' loss of share, about 4 p.p. between 2008 and 2010. But Argentina also contributed, with its market share reaching almost 2.9% in 2008 and falling to just 2.1% in 2010. Paraguay and Uruguay's shares remained very low, at below 0.5%.

Graph 23. MERCOSUR's market share of Venezuelan imports 1998-2009

Millions of US$



Source: INDEC (Argentina); SECEX-MDIC (Brazil), Central Banks of Paraguay and Uruguay.

D. Foreign direct investment in MERCOSUR

The international financial crisis also had a strong impact on international flows of foreign direct investment (FDI), which totaled US$1.1 billion in 2009, 37.1% down on the previous year. Investments toward the MERCOSUR countries saw an even more significant fall of 44.7%, totaling US$31.4 billion. The countries' share as recipients of foreign investment fell to just 2.8%, below the 3.2% reached in 2008.

In fact, the poor performance in 2009 meant the interruption of the second great cycle of foreign investment in MERCOSUR (Graph 24). The first great cycle occurred between 1994 and 1999, when commercial and financial opening of the bloc's countries, coupled with the privatizations in Argentina and Brazil, took foreign investment to a record US$52.9 billion. In the following years, the combination of the economic crisis in the bloc's countries, uncertainties in its economic direction after the election of new leaders, and low international growth, brought flows down to just US$12.2 billion. The second cycle began in 2004 and meant that investments reached a new historical record of US$56.7 billion in 2008, falling the following year.

The preliminary numbers for the first trimester of 2010 show foreign investment of US$7.8 billion, 7.1% up on the same period in 2009.

Graph 24. Foreign direct investment in MERCOSUR 1994-2009

Billions of US$

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

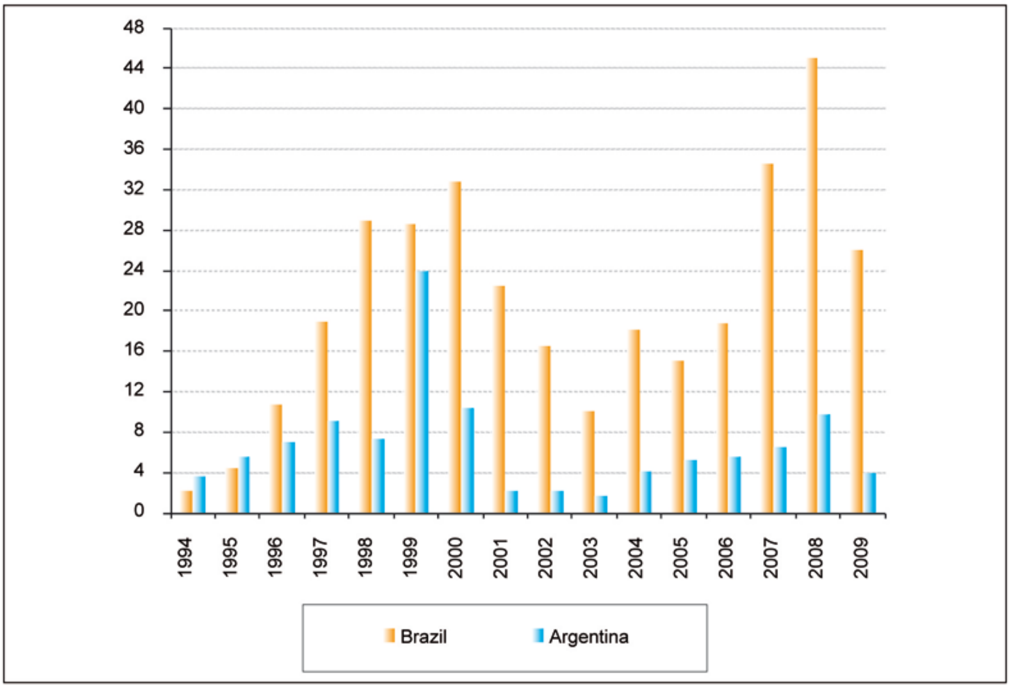
Brazil consolidated its position as the largest recipient of investments in MERCOSUR, being largely responsible for the increase in flows between 2004 and 2008, and also suffering the sharpest absolute fall in 2009, US$19.1 billion down on the previous year (Graph 25). Even so, in this last year, the country accounted for 82.8% of the total received by the bloc. In the first trimester of 2010, investments in the country totaled US$5.6 billion, 4.7% up on the same period the year before.

Argentina also saw a significant fall of 58.8% in direct investment in 2009, which totaled just US$4 billion. This amount was the lowest since 2003 and was also below the levels reached in the second semester of the 1990s. The country has not recovered the levels of attraction for foreign investment that it reached at that time (Graph 25). Despite the US$9.7 billion recorded in 2008 being the highest this decade, it remained below the annual average of US$10.6 billion for 1995-2000.

Uruguay, for its part, continues to perform outstandingly in attracting foreign investment. Despite being 30.8% down the previous year, the amount entering in 2009 was fairly high in terms of the country's levels in recent history. Between 2005 and 2009, average annual investment was US$1,330 million, well above the quantities recorded up to 2004 (Graph 26). In the first trimester of 2010, the volume of investment totaled US$370 million, 21.5% up on the same period in 2009, marking an annual amount equal or higher than the average in recent years.

Graph 25. Foreign Investment in Brazil and Argentina 1994-2009

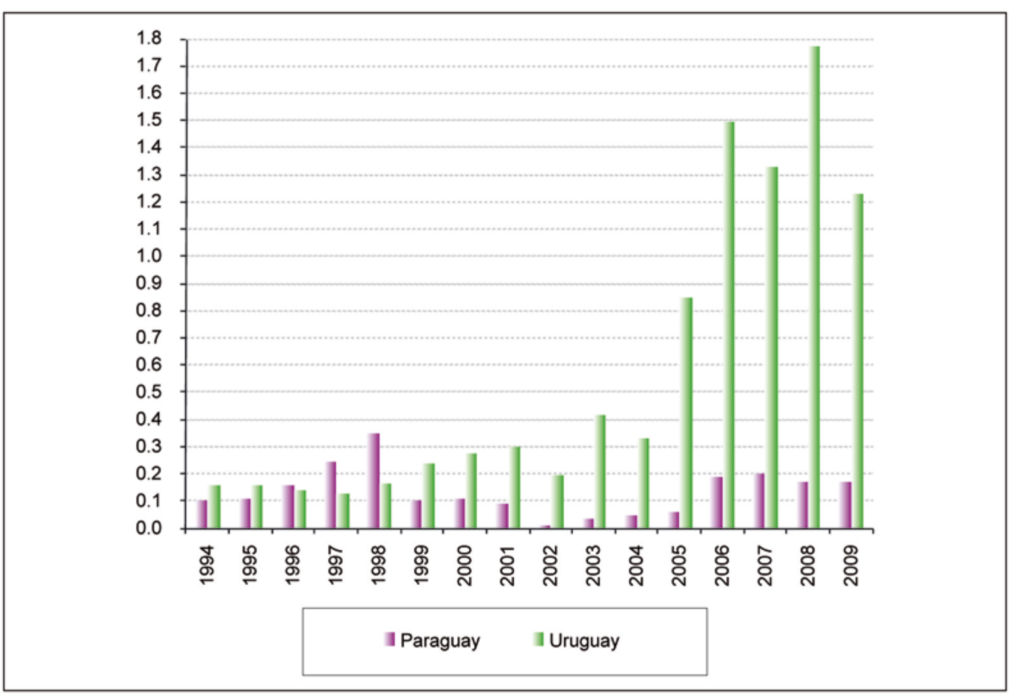
Billions of US$



Source: INDEC (Argentina) and Central Bank of Brazil.

Graph 26. Foreign investment in Paraguay and Uruguay 1994-2009

Millions of US$



Source: Central Banks of Paraguay and Uruguay.

In the case of Paraguay, investments remained very low, at US$168 million in 2009, the same as the previous year, but well below the historic high of US$348 million in 1998 (Graph 26).

Brazilian Investments in MERCOSUR

Unlike previous years, Brazil's share as an investor in the MERCOSUR countries in 2009 was down. Direct investment flows to Argentina totaled US$191 million, just 4.8% of the total received by the country. Investment in Uruguay was US$77 million (6.3%) and in Paraguay, US$11 million (6.5%).

In the first trimester of 2010, there was a recovery in Brazilian investments, totaling US$78 million in Argentina (53.0% up on the same period in 2009), US$12.2 million in Paraguay (30.3%), and US$20 million in Uruguay (300.0%).

CHAPTER III. THE INTERNAL AGENDA

This chapter describes the evolution of MERCOSUR's internal agenda during the *Pro Tempore* Presidencies of Uruguay (PPTU), in the second semester of 2009, and Argentina (PPTA), in the first semester of 2010. The results achieved during this period could not be more contrasting, with little happening during the PPTU and highly significant results when evaluated in light of the decisions approved at the close of the PPTA in San Juan.

What are the factors that explain the contrast between the San Juan Summit, described—with a degree of overstatement—as one of the most productive in the history of MERCOSUR, and the mediocre results achieved by other *Pro Tempore* presidencies in recent years?

The MERCOSUR economies' capacity to deal fairly well with the effects of the grave international financial crisis, the impacts of which, especially in the external sphere, were particularly severe in the last trimester of 2008 and the first semester of 2009, is only part of the explanation. The recovery of intrazone and extrazone trade flows from the second semester of 2009 no doubt contributed to the development of a discussion agenda less contaminated by apprehensions provoked by the international crisis and the escalation of trade restrictions imposed on intrazone trade by some of the MERCOSUR member countries, highly significant up to the end of 2009. It is also true that once the initial impacts of the international crisis had been overcome, the countries were able to resume discussion of various problems that had, for some time, been blocking the evolution of MERCOSUR's internal agenda.

Far more important, however, than overcoming the impacts of the international crisis for the relative success of San Juan was the satisfactory settlement of certain political disputes between the bloc's partners, the relevance of which goes a long way to explaining the climate of relative deadlock that had prevailed in recent MERCOSUR summits.

Chronologically speaking, the overcoming of these disputes began in July 2009, when the presidents of Paraguay and Brazil signed the foundations of a political agreement designed to deal—albeit partially—with Paraguayan claims for better distribution of benefits from the joint exploitation of the Itaipú hydroelectric dam. The issue had featured prominently in the electoral dispute that led Fernando Lugo to the Paraguayan Presidency in August 2008, and the country's coolness toward relevant issues on the internal agenda, such as elimination of double CET levying and the institution of a customs revenue distribution mechanism, can be credited partly to the lack of a satisfactory agreement with Brazil over the dispute.

This time, MERCOSUR acted as a facilitator for the agreement between Brazil and Paraguay reached in mid-2009, with one of its main instruments—the FOCEM—serving as a vehicle for US$300 million in Brazilian voluntary contributions to finance the 550kV Itaipú-Villa Hayes transmission line. This contribution, which was one of the conditions of the agreement, did not completely remove Paraguay's reluctance to promote progress toward meeting the "second stage of CMC Decision No. 54/04—Elimination of Double CET levying and Customs Revenue Distribution," but it did create a more favorable atmosphere in the search for a solution capable of overcoming the deadlock over the main issue pending on the bloc's internal agenda.

Also, the election of José Mujica as Uruguayan president in November 2009 and the publication of the final decision of the International Court of Justice (ICJ) in April 2010 in the dispute over the establishment of pulp mills on the left side of the River Uruguay helped to overcome a conflict that had made political dialogue between the other two MERCOSUR partners, Argentina and Uruguay, extremely difficult, while also obstructing progress in various issues on the bloc's internal agenda.

From May 2010, however, the two countries adopted attitudes that showed their readiness for the restoration of more fluent dialogue. Indeed: (i) Uruguay agreed to the appointment of Néstor Kirchner as Secretary General of the Union of South American Nations (UNASUR); (ii) Argentina gave its consent to the FOCEM's approval of the Uruguayan electrical interconnection project with Brazil; and (iii) both countries initiated an exchange of proposals to establish an outline for joint monitoring of the River Uruguay, a process that resulted in the agreement signed by Presidents José Mujica and Cristina Fernández de Kirchner in late July 2010, on the eve of the San Juan Summit.

This overcoming of the above political obstacles and the more favorable regional economic context, therefore, contributed to the relaxation of hitherto uncompromising negotiating positions. Even so, the San Juan Summit demanded a considerable last-ditch presidential negotiating effort to approve certain important decisions in the area of the CMC.

At the end of the 39th CMC Meeting, the countries somewhat overeagerly announced the adoption of the MERCOSUR Customs Code, significant breakthroughs in the process of eliminating double levying of the Common External Tariff (CET) and customs revenue distribution, and the adoption of a series of ambitious projects in the scope of FOCEM, as well as various other relevant measures for the advancement of the bloc's internal agenda.

Analysis of these measures in this chapter confirms the importance of the last meeting of the CMC, but also brings out various uncertainties and postponements that run through some of the most relevant decisions taken at the recent San Juan Summit. In light of this finding, a new stage capable of conferring a fresh dynamic on the integration process cannot be said to have been ushered in.

A. Trade Aspects

Elimination of double CET levying and customs revenue distribution

Background. The elimination of double CET levying is an essential condition for the consolidation of MERCOSUR as a Customs Union. Indeed, products imported from extrazone should be able to move freely within MERCOSUR once the CET has been paid at the Customs Union's point of entry. But that is not the case, since many products from countries outside the bloc undergo a double CET levying when they are exported from one MERCOSUR member to another.

The first truly meaningful breakthrough in eliminating double CET levying occurred in 2004, with the approval of CMC Decision No. 54/04, setting out the guidelines for the process of transition to a fully-functioning Customs Union. This decision established the principle that goods imported from extrazone complying with MERCOSUR's common tariff policy should receive treatment as goods originating in MERCOSUR, both in terms of their movement within the territories of the States Parties, and their eventual incorporation in production processes.

Furthermore, Article 2 of CMC Decision No. 54/04 stated that goods to which the 0% CET was applied, as well as extrazone goods with 100% simultaneous, quadripartite preference under trade agreements signed by the bloc, would receive treatment as goods originating in the MERCOSUR as of January 1, 2006.

Subsequently, in December 2005, CMC Decision No. 37/05 regulated CMC Decision No. 54/04 and defined the customs procedures and rules for the issuing of the Certificate of Compliance with the Common Tariff Policy (CCPAC) and the Certificate of Compliance of the MERCOSUR Origin Regime (CCROM), as well as other complementary standards relating to the origin regime and information exchange between customs.

More importantly, the annexes to CMC Decision No. 37/2005 included three product lists: (i) Annex I detailed the goods with 0% CET in all the States Parties; (ii) Annex II listed the goods to which the MERCOSUR member countries simultaneously granted 100% tariff preference and which also came under the same origin requirement, with the consequent exclusion of those goods for which temporary origin quotas or requirements were applied; and (iii) Annex III listed the goods from Annexes I and II that were the subject to trade defense measures in force in one or other of the States Parties. Based on these lists, CMC Decision No. 37/05 stated that products included in Annexes I and II should be granted treatment as goods originating in MERCOSUR, with the exception of those listed in Annex III.

In short, Article 2 of CMC Decision No. 54/04 and the positive lists included in the annexes to CMC Decision No. 37/05 marked the "first stage" of the process of transition to a fully-functioning Customs Union. Strictly speaking, this "first stage" was essentially symbolic, granting treatment as goods originating in MERCOSUR to products imported from extrazone whose impact on customs revenue distribution was zero, given that these goods paid no import duty. Even so, the completion of this first stage was important, since it began the process of consolidation of the Customs Union and set a path and a deadline for its realization.

The extension of the rule of free movement of goods not covered in the first stage depended on three requirements defined in Article 4 of CMC Decision No. 54/04: (i) the adoption of the MERCOSUR Customs Code; (ii) online interconnection of customs administration computer systems of the bloc’s member countries; and (iii) the definition of a customs revenue distribution mechanism. In short, Article 4 defined the objectives to be met during the "second stage of compliance with CMC Decision No. 54/04," which should not extend "beyond 2008".

Of the three requirements set by Article 4 of CMC Decision No. 54/04, the one that made most rapid progress was the relating to the online interconnection of the States Parties’ customs. Indeed, in the first semester of 2008, the points of CMC Decision No. 01/08, intended to spell out the technical specifications for computing infrastructure for the Customs Register Information Exchange (INDIRA), stated that the INDIRA "is in operation and available in the four States Parties". The development of the CAM and the definition of the customs revenue distribution mechanism, however, faced almost insurmountable obstacles, causing frustration for the *Pro Tempore* Presidencies of Brazil, Paraguay, and Uruguay, which ended their mandates without meeting the objectives set for the "second stage".

Recent developments. Between 2008 and mid-2010, the member countries’ negotiators discussed various alternative proposals for the elimination of double CET levying and the institution of a customs revenue distribution mechanism without achieving consensus. Brazil and Uruguay can generally be said to tend to favor proposals that could lead to the rapid elimination of double CET levying, while Paraguay and Argentina showed a clear preference for the adoption of more gradual, or possibly little more than symbolic, solutions.

Paraguay’s resistance was motivated first and foremost by the fact that its customs revenue represents an important fiscal resource, and it therefore refuses to admit the possibility of losing this income. Paraguay’s objective has always been to obtain come benefit and therefore incessantly advocated the introduction of a "redistributive" factor in the formula that will determine the customs revenue distribution to be collected when double CET levying is eliminated. It is worth noting here that the elimination of double CET levying must have some impact on corporate decisions relating to the import of inputs, parts and pieces, thus affecting the movement of goods within the bloc. Given its status as a landlocked country, the changes resulting from the unification of the customs territory are likely to be particularly harmful to Paraguay, thus justifying some sort of compensation, the scale of which will always be open to negotiation.

A second reason for Paraguay’s resistance is to do with the agency responsible for collecting and managing the common customs resources. Paraguay has insisted on the need for this body to be supranational, since it believes that this is the best alternative to ensure transparency and, above all, greater flexibility in the receipt of resources. The dependence of an intergovernmental body or MERCOSUR body would not be considered a satisfactory solution in the Paraguayan authorities understanding. Paraguay has grounds for such apprehensions, since in some countries, e.g. Brazil, the levying of import duty is allocated by law to the Treasury, and the realization of any transfers to the other partners would involve the creation of complex institutional and legal mechanisms.

A third, more contingent and political reason should be attributed to the lack of definition, up to July 2009, of the dispute between Paraguay and Brazil over the value of compensation and the sale price to be received by Paraguay for the energy generated by the binational Itaipú hydroelectric dam. Paraguay’s willingness to negotiate over this and other issues was naturally low, until Presidents Luiz Inácio Lula da Silva and Fernando Lugo reached an agreement in Asuncion at the end of July 2009.

Argentina’s resistance regarding the rapid elimination of double CET levying was due to slightly different reasons. Since the crisis in 2001, the regeneration of the country’s industrial base has become the major objective of national economic policy. In light of this objective, the adoption of a common tariff policy (PAC) is seen as a threat, a factor capable of weakening the value-adding requirements required for a good to be considered as original and move freely within the bloc. With the elimination of double CET levying, extrazone products acquire the status of original products after paying import duty on crossing the border of one of the members of the Customs Union, being able to move and be reexported freely to any other country in the bloc. Argentina’s fear is that its regional partners—especially the smaller economies—importing extrazone products will make small changes and reexport them to Argentina, harming the local production of similar products. This would, without doubt, constitute behavior that is not only possible, but perfectly legitimate, and represents one of the attractions for smaller economies of the formation of the Customs Union. Argentina accordingly prefers to promote slow and gradual progress in the process of eliminating double CET levying.

CMC Decision No. 10/10, Elimination of Double CET Levying and Customs Revenue Distribution, adopted during the recent San Juan Summit, should, therefore, be considered as a compromise solution designed to keep step with the partners’ divergent interests and, at the same time, avoid the frustration of concluding yet another summit without promoting some progress in implementing the "second stage of compliance with CMC Decision No. 54/04".

The rule adopted in San Juan, the contents of which are summarized in Table 15 below, defines still very generic guidelines, takes a gradual approach, and subdivides the process of eliminating double CET levying into three stages.

The first stage, to be implemented up to January 1, 2012, covers products imported from extrazone that move within MERCOSUR untransformed. If the consumption or ultimate use of the untransformed product takes place in another country in the bloc that is not the one where the import duty was paid, the relevant customs collection is to be transferred to the country of final destination. The transfer procedure is not specified, but the guidelines approved state that it is to be "transparent, flexible, and simplified" and in operation in all States Parties "no later than January 1, 2012".

Table 15. Guidelines for implementing the elimination of double CET levying and customs revenue distribution

Annex to CMC Decision No. 10/10

1st Stage	
Scope *	Includes goods imported from third countries by a State Party that comply with the PAC and move **within** MERCOSUR **untransformed**. Exceptions to the CET (national or sectoral lists of exceptions and special import regimes) will continue to be governed by current rules and will not receive CCPAC.
Customs Revenue	In general, customs collection will be carried out by each State Party. If the untransformed product is imported from third countries under compliance with the PAC in one of the States Parties, but its consumption or ultimate use occurs in another State Party, **customs collection will be transferred to the country of final destination**. The transfer procedure must be transparent, flexible, and simplified.
Deadline	The first stage should be in operation at the latest by January 1, 2012. The transfer procedure must be operating in all States Parties by the same date.
2nd Stage	
Precondition	As a precondition to the start of the second stage, the GMC is to define the treatment the following will be subject to: (i) goods simultaneously incorporating inputs that comply with the PAC and inputs imported under special import regimes and/or subject to promotional regimes, and (ii) goods produced under promotional regimes that incorporate inputs complying with the PAC.
Scope*	Goods imported from third countries that comply with the PAC whose CET is 2% or 4% moving within MERCOSUR after their incorporation in the production process. Any CCPACs and CCROMs issued by a State Party will be recognized by all other States Parties.
Customs revenue	In general, customs collection will be performed by each State Party. A customs revenue distribution mechanism will be set up to take account which State Party any goods imported from third countries are consumed in. For the transfer of resources, a procedure will be set up to take account of automaticity, flexibility, transparency, and monitoring and control.
Deadline	This stage will be implemented as of January 1, 2014.

Table 15 (CONTINUED)

3rd Stage	
Scope	This stage includes goods imported from third countries not included in the preceding stages that are incorporated in a production process and have complied with the PAC. Any CCPACs and CCROMs issued by a State Party will be recognized by all other States Parties.
Customs revenue	Customs revenue will be distributed under the mechanism implemented in the second stage, with possible changes arising from the experience of its implementation.
Deadline	The CMC will define the date for the entry into force of this stage before December 31, 2016, and it is to be in operation by January 1, 2019 at the latest.
Provisions for all three stages	
	Online interconnection of customs administration computer systems and the database to enable information exchange on PAC compliance. Entry into force of CAM. Establishment of a **compensation package for Paraguay**, considering its special specific status as a landlocked country, its heavy dependence on customs collections, and potential loss of revenue from double CET levying. Periodic monitoring of economic and trade impacts, and possible adjustments to the customs revenue distribution mechanism.

Note: * To simplify matters, the above table omits certain guidelines featuring in the Annex to CMC Decision No. 10/10 that relate to cases of tariff preferences arising from trade agreements signed by MERCOSUR with third countries.

The progress resulting from this first stage is, again, only symbolic. According to a technical note from the Brazilian National Confederation of Industry (CNI), intrabloc trade in untransformed products imported from third countries in 2006 was insignificant in absolute terms, at just US$4 million. Strictly speaking, it is hard to imagine situations that justify intrabloc reexport of untransformed products from extrazone, once these imports have been subject to the levying of the internal taxes in force in the country of entry, which should make this operation unprofitable and, therefore, unusual.[53] Compliance with this stage should, nevertheless, promote some progress, since the MERCOSUR member countries will be forced to implement a transfer procedure for any customs revenues arising from these situations, even if they are exceptional.

Truly meaningful progress should only occur in the second stage, to be implemented from January 1, 2014, which will see the incorporation of "goods imported from third countries with a CET of between 2% and 4%, and which comply with the common tariff policy and move within MERCOSUR after their incorporation into a production process". This stage has a prerequisite, however: the GMC is to define what treatment goods that simultaneously incorporate inputs complying with the common tariff policy and inputs imported under special import regimes and/or subject to promotional regimes will be subject to.

Last, the third stage, whose entry into force must be defined by the CMC by December 31 2016 and whose effective functioning is to be no later than January 1, 2019, will include

[53] For example, reexporting from one MERCOSUR country to another undesirable or unsaleable stocks of untransformed products previously imported from extrazone.

goods imported from third countries not included in the previous stages that are incorporated in a production process and comply with the common tariff policy.

It is important to remember that the criteria for the effective distribution of customs revenue will only be defined at the second stage. Even after that definition, the GMC will be responsible for the daily monitoring of the economic and trade impacts arising from the elimination of double CET levying, as well as the possibility of introducing adjustments to the distribution mechanism in order to mitigate any negative effects. Last, it must be stressed that CMC Decision No. 10/10 provided explicitly for "the establishment of a compensation package to Paraguay, considering its special specific status as a landlocked country, its high dependence on customs collections, and potential loss of revenue arising from the elimination of double CET levying".

In summary, the breakthroughs promoted by CMC Decision No. 10/10 were less significant than expected, and the deadline for the effective consolidation of the Customs Union was yet again postponed, although a new schedule has been agreed and some criteria have been defined to set the limits for the stages to come.

The MERCOSUR Customs Code (CAM)

Background. As mentioned above, CMC Decision No. 54/04, Elimination of Double CET Levying and Customs Revenue Distribution, setting out the requirements for the implementation of free movement of goods imported from third countries in the States Parties' territories was approved in Belo Horizonte at the end of 2004. At Paraguay's insistence, these requirements included the approval and entry into force of the CAM, and the *Ad Hoc* Group for Drafting the MERCOSUR Customs Code (GAHCAM) was set up accordingly, holding its first meeting in October 2005.

Since the first meeting, GAHCAM negotiators clashed over two alternatives: (i) the drafting of a detailed body of rules whose provisions would be directly applied and would include procedures; or (ii) the harmonization of a series of common core rules and criteria, whose validity would be conditional on the implementation of regulatory standards. The choice, recorded in the minutes, fell on the second alternative.

The deadline set by the CMC ("no later than 2008") for the adoption and entry into force of the requirements for the consolidation of the Customs Union was not kept. Specifically regarding the development of the Code, over 20 regular meetings were needed for the GAHCAM to conclude its draft.

The follow-up on the progress and obstacles encountered in drafting the CAM was hampered by the confidential nature of the GAHCAM minutes and of the position papers submitted by the national delegations, which raised criticism from private sector representatives and experts in matters of customs. Even so, it is common knowledge that certain issues, such as the scope of the code, the definition of customs territory, special customs areas, duty-free zones, territorial waters, specific import duties, export duties, and rules of intrazone movement, were particularly difficult to agree on and demanded a major negotiating effort.

Recent de velopments. In August 2010, CMC Decision No. 27/10 approved the CAM, giving the States Parties a six-month period to carry out consultations and negotiations for its implementation in their legal systems. The commitment of the States Parties was also established to proceed with the harmonization of any aspects not covered by the text of the Code, comprising 181 articles.

The approval of the CAM was welcomed by all the participants in the San Juan Summit as a breakthrough for MERCOSUR and a necessary step toward facilitating negotiations with the EU. The reaction of the private sector representatives, as well as tax and customs experts, was, however, more cautious. It raised several questions over the interpretation of many of the provisions included in the Code, which have be clarified in the 6-month period established to carry out consultations.

Below are some of the issues that caused controversy during the drafting of the Code.

Scope of application. Article 1 defines MERCOSUR's customs legislation as being constituted by the Code and its regulatory and complementary standards. Regulatory standards are, in turn, defined as "the provisions published or about to be published by organs of MERCOSUR *necessary* for the application of this Code" [our italics], while complementary standards encompass provisions of organs of MERCOSUR in customs matters, which do not constitute regulatory rules.

Previous definitions are relevant, since the Code explicitly states that "each State Party's customs laws shall be applicable supplementarily within their respective jurisdictions in aspects not specifically regulated by the Code, or by its regulatory and complementary standards". Note that, in this sense, the text adopted in San Juan records over 50 mentions of the need to publish regulatory standards, distributed across over 40 of the 181 articles making up the Code. In many cases, the need for future regulation relates to apparently trivial issues, such as the definition of deadlines or the inclusion of new realities or even exceptions, but there are also situations where the negotiators' difficulty can be detected in reaching a consensus, and this may have contributed to several issues being left open.

Specifically in terms of the scope of application, it was agreed that "MERCOSUR's customs legislation will be applied across the board in the States Parties' territories and enclaves granted in their favor".

Customs Territory. In the process of drafting the Code, the definition of the customs territory was the subject of controversy, involving more traditional definitions based on geographic or economic criteria, and more modern formulations, such as that adopted in the Kyoto Convention of the World Customs Organization (WCO), according to which "Customs territory means the territory in which the Customs law of a Contracting Party applies". The latter prevailed ("MERCOSUR's customs territory is that in which MERCOSUR's common customs law applies"), a reflection of the current international trend and, what is more, the one that serves as a basis for discussions in the Doha Round.

The choice of this definition made it impossible to make any reference to the Falkland, South Georgia, or South Sandwich Islands, as being an integral part of Argentine territory, as Argentina wished to. However, the Code included an article explicitly stating that any commercial documentation from those islands and their surrounding maritime areas, if not issued by the Argentine authorities, will only be received as proof of the description and origin of goods "without this involving any recognition of the authorities issuing such documentation".

The inclusion of territorial waters as customs territory was debated at length by negotiators during the drafting of the Code. Until recently it was believed that the CAM would establish a special regime for the treatment of the entry, presence, and exit of goods in territorial waters, keeping in mind the legislation in force in each MERCOSUR State Party. However, the version approved in San Juan made no reference to territorial waters. Yet it must be emphasized that the classification of the special customs regimes related to the Code includes the proviso that the competent organs of MERCOSUR may introduce other regimes in addition to those envisaged in the Code (Art. 101).

Specific import duties. Unlike ad valorem tariffs, specific import duties are not percentages applied on the value of imports, but fixed values per product unit. Argentina, which expressly applies specific import duties on certain products (e.g. sugar, textiles), defended the possibility of its *unilateral* levying by the States Parties. However, as the CET was entirely defined in terms of ad valorem tariffs, the preference of the other members of the bloc was for them to be levied by a common standard, set by the competent body of MERCOSUR.

Specific import duties were finally included in the Code. Indeed, when it came to defining the different taxation modalities, the CAM admitted the possibility of ad valorem rates ("when expressed as a percentage of the dutiable value of the merchandise"), specific rates ("when expressed in quantities set per unit of measurement of the merchandise"), or a combination of ad valorem and specific rates (Art. 158).

To define the basic elements for setting import duties, the Code provides that the ad valorem rate be determined by applying tariffs foreseen in the CET, structured around the MERCOSUR Common Nomenclature (NCM), on the dutiable value of the merchandise. In the case of the specific import duty, however, there is no reference to common regulations or the need for regulatory standards; all that is established is that it be determined by the implementation of a fixed value per unit of measurement (Art. 163). It can, therefore, be concluded that the other aspects relating to its application may be determined by the respective national customs laws.

Special customs areas and duty-free zones. The MERCOSUR members' national laws distinguish duty-free zones from special customs areas. The output of duty-free zones is exclusively for export, and goods are treated from the customs point of view as if they were not in the national territory, the import duty being levied in full when it enters the territory. The production of special customs areas, on the other hand, is intended mainly for the internal market, since they are production hubs that enjoy tax incentives and benefits in order to promote regional development. Consequently, when goods from these areas enter the national territory, the levying of import duty is only partial.

In the scope of MERCOSUR, the treatment given to duty-free zones, export-processing zones, and special customs areas was established by CMC Decision No. 08/94. It identified the following: (i) "excepting a decision to the contrary," the States Parties would apply the CET to goods from the respective duty-free zones, export-processing zones, and special customs areas; (ii) duty-free zones already in operation could operate in MERCOSUR, as could those that were established under rules laid down by law or pending parliamentary processing (standstill clause); and (iii) existing special customs areas in Manaus and Tierra del Fuego could operate "under the current regime" up to 2013.

The application of the CET to intrazone trade from duty-free zones and special customs areas located in the partners' territories saw various exceptions under the "gap" granted by CMC Decision No. 08/94. Argentina and Brazil signed a bilateral agreement exempting from the CET goods produced in the Manaus and Tierra del Fuego special customs areas that fulfill certain rules of origin. Uruguay and Brazil also agreed exemptions to the CET, based on positive lists of goods produced in the duty-free zones of Nueva Palmira and Colonia in Uruguay, and in the duty-free zone of Manaus in Brazil. Argentina and Uruguay, for their part, also agreed quota-based exemptions to the CET and/or ceiling values for goods from the duty-free zone of Colonia and special customs area of Tierra del Fuego.

Moreover, the deadline for the operation of the special customs areas was breached, first by Brazil, which approved the Constitutional Amendment extending the duration of the Manaus Free Trade Zone to 2023, then by Argentina, which, by decree, extended the validity of the Tierra de Fuego Special Customs Area also to 2023.

Discussions during the drafting of the Code revolved around two points: (i) the number of special customs areas permitted, given that CMC Decision No. 08/94 set a standstill limit on the number of free trade zones, but said nothing about the number of special customs areas; and (ii) the temporary validity of the benefits granted to special customs areas, unilaterally extended by Brazil and Argentina to 2023 in open disobedience of what had been agreed in MERCOSUR.

Other issues up for discussion were to do with the inclusion of provisions relating to special customs areas of new States Parties—of interest to Venezuela—and with the status to be granted to special customs areas in MERCOSUR's extraregional negotiations.

In the final text, many of these issues remained open. Indeed, the Code restricted itself to defining a special customs area as "the customs territory in which applies special temporary treatment, with a more favorable tax regime than the one existing in the rest of the customs territory" (Art. 131), with no mention whatsoever of its numbers or the duration of the special treatment.

Regarding duty-free zones, the Code established that for tax or import duty purposes, goods entering them would be viewed "as if they were not within the customs territory," and that their entry and exit would be governed "by the laws regulating importation and exportation respectively" (Art. 126). Moreover, the Code established that the exit of goods from the rest of the customs territory to a duty-free zone should be considered as exportation, and the entry of goods from duty-free zones across the rest of the customs territory should be considered as importation (Arts. 129 and 130).

Export duties. Export duties were the last issue to be defined, before the Code's approval, and reaching a consensus in this area required the direct participation of the Argentine and Uruguayan presidents during the San Juan Summit.

Argentina has applied export duties (deductions) to a wide range of products since 2002, including soy and soy derivatives, and other key goods export in the country's basket. The revenue from the levying of export duties represents a significant portion of the country's tax collection. However, the legality of such taxation in intrazone trade has been questioned by local exporters, and the Argentine government is facing legal action.

The levying of deductions has created intrazone trade distortions. In Argentina, the internal prices of products subject to the levying of export duties are, as expected, lower than the international prices, contributing to the increasing competitiveness of local producers, who manage acquire part of their inputs at low cost. Accordingly, the levying of export duties has drawn criticism in Brazil and, especially, in Uruguay, since the deductions hinder the competitiveness of these countries' exporters in the Argentine market and/or harms domestic producers, who compete in unequal conditions in their respective local markets with imports from Argentina.

The existence of interests explains the different matters debated in the scope of GAHCAM: (i) the inclusion or non-inclusion of export duties in the Code; (ii) the possibility or impossibility of their application in intrazone trade; (iii) the joint (competent body of MERCOSUR) or unilateral (national authority) determination of the levy.

The final draft responded to Argentina's demand: "The present Customs Code is not about the export duty and the legislation of the States Parties shall, for that reason, be applicable in their territories". It does, however, stress that the provisions of national legislation are liable to be contested by the other States Parties, a line of argument used by the negotiators from the countries that gave in to Argentina's demands to justify the concession to their domestic populations.

Customs clearers. The Code established certain minimum requirements for the authorization of customs clearers, but delegated the decision over the compulsory or non-compulsory nature of their work in the scope of their territories to the States Parties.

Movement of goods among the States Parties. The CAM set the rules for the movement of goods during the transition process until the formation of the Customs Union. In line with Article 178 included in the Interim Provisions of the CAM: (i) the entry and exit of goods from one State Party to another shall be regarded as importation or exportation between different customs territories; (ii) both original goods and goods imported from third countries may circulate among the States Parties in the terms laid down by the regulatory and complementary standards.

The San Juan Summit further established the need for joint implementation of a common customs document to facilitate the movement of goods among member countries. The instrument was the subject of a further measure adopted by the CMC (CMC Decision No. 17/10), which provided for the creation of MERCOSUR Common Customs Document (DUAM). The document was defined as a common data model to integrate the declarations of customs destinations and operations in MERCOSUR, capable of serving as an instrument to generate information for control and risk analysis management, and facilitate the exchange of information between Customs and the free movement of goods among the States Parties. The MERCOSUR Trade Commission (CCM) was responsible for the tasks required for the DUAM's effective implementation.

Other provisions. The inclusion in the Code of the figure of "Authorized Economic Operator," involving the institution of simplified customs procedures and other facilities, was one of the best-received provisions of the CAM. The precedence granted to each country's Customs Administration over the other public administration bodies in the primary customs areas had brought a degree of criticism from customs experts, since the provision is apparently contrary to some member countries' legal systems, which establish the precedence of judicial authority.

Last, the CAM ordered the creation of a committee composed of Customs Administrations employees and representatives designated by the States Parties with the aim of ensuring the uniform application of the measures set out in the Code and the regulatory standards.

MERCOSUR Dutiable Value Control Procedures Manual

Background. In 1994, CMC Decision No. 17/94 adopted an Application Rule on Customs Valuation of Goods in order to harmonize the procedures followed by the States Parties in customs valuation. This first rule, with just 17 articles, was repealed by CMC Decision No. 13/07, which ratified, in the scope of MERCOSUR, the adoption of the Agreement Concerning the Application of Article VII ("Customs Valuation Agreement") of the General Agreement on Tariffs and Trade (GATT) in 1994, and adopted a new Application Rule on Customs Valuation of Goods that was far more complete than the previous one.

In fact, the rule adopted in 2007 contained 30 articles subdivided into 7 chapters (General Provisions, Determination of Dutiable Value, the Valuation Administration, Declared Value Control, Dutiable Value Declaration, Special Cases, and Interim Provisions) and explained various aspects on which the 1994 rule had failed to act.

Recent developments. In San Juan, the CMC approved the MERCOSUR Dutiable Value Control Procedures Manual (CMC Decision No. 16/10) with the aim of establishing common operational guidelines for the States Parties' customs administrations relating to dutiable value control, ensuring uniformity in the implementation of the procedures and controls, and guaranteeing fair treatment to all foreign trade operators.

The Manual deals with the various different customs control procedures that can be used in the administration of the agreement regarding the application of Article VII of the GATT of 1994. The Manual is not, therefore, intended to replace, but only to complement the WTO Agreement.

It contains three chapters and two annexes. Chapter I describes the principles of the Agreement and sets out the valuation methods provided therein for establishing the dutiable value of imported goods.

Chapter II sets out the operating procedures that can be used by Customs Administrations in value control management. This consists of six points:

i. *Stages of Dutiable Value Control*, setting out the various types of control that Customs Administrations can use (before, during, or after clearance).

ii. *Verification of the Value Declaration*.

iii. *Verification of the Dutiable Value*, listing the various tasks of verification of the value declaration to be performed depending on the valuation method applied.

iv. *Inspection Procedures*, describing the various stages of the control process.

v. *Valuation Information Exchange*, reflecting on the possibility of customs administrations requesting information from abroad to verify the accuracy or inaccuracy of the values declared to Customs by importers.

vi. *Procedures in the Event of Undervaluation*, laying out the various different measures that can be taken by customs administrations when, from verification of the declaration, it is clear that the declared value is below what it should be.

Chapter III deals with the development of a Risk Management Program. It also lays down guidelines for the development and use of a valuation database to act as a risk assessment instrument and lists the subjects that represent a fiscal risk.

Annex I contains the WCO Valuation Technical Committee's Guide to the exchange of information on valuation. Last, Annex II contains guidelines for the development and use of a national valuation database to act as a WCO Valuation Technical Committee risk assessment instrument.

CET exceptions

Background. National lists of exceptions to the CET have been in force since 1994 (CMC Decision No. 07/94). The number of items eligible for inclusion in these lists, as well as their terms of validity, has been subject to a succession of changes and extensions since then, until the publication of CMC Decision No. 59/07. In line with this last decision (i) Argentina's and Brazil's lists could contain up to a maximum of 100 NCM items, but should observe a schedule to gradually reduce the number of items, closing on 31/12/2010, when the maximum number of exceptions would already have fallen to 50 NCM items; (ii) Uruguay's and Paraguay's lists could contain a maximum of 100 items with a term of validity until 31/12/2015; (iii) Uruguay and Paraguay could maintain additional lists of exception until 2010, with up to 125 and 150 tariff items respectively; and, last (iv), Paraguay has been authorized to maintain the 399 exceptions in Art. 4 Of CMC Decision No. 07/94 until 2010.

Recent developments. The end of 2009 saw the adoption of CMC Decision No. 28/09 with the aim of extending the provisions of CMC Decision No. 59/07, which expired in 2010.

In fact, Brazil and Argentina were allowed to maintain national lists of exceptions to the CET until 31/12/2011, for up to 100 items tariff. Indeed, in contrast to the provisions of CMC Decision No. 59/07, this time no schedule was included for the gradual reduction of the number of tariff items exempted before the deadline for the exceptions lists expired.

In the case of Uruguay and Paraguay, CMC Decision No. 59/07, which had already extended those countries' lists of exception, up to a maximum of 100 tariff items, remains in effect until 31/12/2015. Where the additional lists of exceptions are concerned, their validity was extended to 31/12/2011, after maintaining 125 additional items for Uruguay and 150 additional items for Paraguay. Last, the term of validity for the 399 exemptions granted to Paraguay was extended until the 31/12/2011, in compliance with the provisions of Art. 4 of CMC Decision No. 07/94.

CET levels above those consolidated in the WTO and the suspension of concessions

The MERCOSUR States Parties signed the Final Act of the Uruguay Round and approved the agreements for the WTO's constitution, subsequently ratified and incorporated into their respective internal legal systems. As a result, they must (i) comply with the obligations undertaken in the WTO regarding the consolidation of tariff levels; (ii) respect the WTO's rules restricting the conduct of customs unions; and (iii) obey the rules and procedures laid down in the WTO's Dispute Settlement System.

Consequently, at the end of 2009, the CMC adopted two decisions designed to make the commitments taken by the MERCOSUR member countries in the WTO compatible with the standards prevailing in MERCOSUR.

This true of CMC Decision No. 17/09, "CET levels above those consolidated in the WTO," which recognizes the validity of the tariff consolidations recorded in the national lists as reflected in the Final Act of the Uruguay Round. Accordingly, in cases of a CET level above the one consolidated by one of the States Parties being approved in MERCOSUR, the CMC allows the tariff consolidated in the WTO to prevail for the State Party. Moreover, when this occurs, the products to which the State Party does not apply the CET will not feature on its exceptions list.

On the other hand, CMC Decision No. 18/09, "Suspension of concessions envisages the opposite situation," in other words, when a State Party raises tariffs applying to third countries, consistent with its WTO obligations, in excess of CET provisions. This situation may be due to: (i) the suspension of concessions to third countries authorized by the WTO Dispute Settlement Body in the context of a dispute involving the State Party; and (ii) the withdrawal of substantively equivalent concessions originally negotiated by the State party with a WTO member seeking to change or retract those concessions. In both cases, the State Party is authorized to raise import duties above those established in the CET for an initial maximum of two years. However, the tariffs must return to the levels set in the CET upon termination of the reasons that led to its raising. If this does not occur within two years, the GMC will be entitled to reassess the situation before the deadline.

CET amendments for yarns, fabrics, and dairy products

Background. In November 2007, due to a Brazilian initiative intended to contain the advance of Chinese imports in the footwear, textiles, and clothing sectors, the CMC promoted a significant rise in tariff levels for products in these sectors (CMC Decision No. 37/07). The aliquots on certain products included on lists were set at 26% for fabrics, and 35% for clothing and footwear. The CMC authorized Paraguay and Uruguay to keep to existing national tariff levels for products included on the lists of textiles and clothing. This treatment was subsequently extended to 8 of 29 tariff items on the footwear list (CMC Decision No. 27/08). It was also decided that the new aliquots should apply until the last regular session of the CMC in 2010, when they would be reassessed in light of the evolution of trade flows.

Recent developments. At the end of 2009, the dairy products sector was the subject of a similar measure. The CMC, as an interim measure until 31/12/2011, set a 28% aliquot on 11 items of a list of dairy products (CMC Decision No. 25/09). Paraguay, however, was authorized to maintain its national tariffs for such products.

In the same period, the CMC released two new measures to extend the product lists in the fabrics and garments sectors, whose aliquots in 2007 were high. In the case of the yarns and fabrics sector, the percentage of items included on the list was quite extensive and, in almost all cases, the new aliquot was set at 18% (CMC Decision No. 26/09). In the case of the clothing sector, just three items were incorporated on the list, all with a 35% aliquot (CMC Decision No. 27/09).

Special Import Regimes

Background. In 2000, with the aim of preserving the CET and avoiding gaps that could affect its integrity, the CMC established the obligation for the States Parties to proceed with full elimination of unilaterally-adopted special customs import regimes up to January 2006 (CMC Decision No. 69/00). This term was successively extended to December 31, 2010 (CMC Decisions Nos. 33/05, 14/07 and 57/08).

On the other hand, the CMC authorized the validity of special import regimes unilaterally-adopted by the States Parties that would have a limited economic impact or non-commercial purpose, provided that they were previously approved by the CCM. CMC Decision No. 03/06 listed these national regimes in its annex.

As of 2007, on the initiative of the States Parties, the Trade Commission began examining several proposals aimed at establishing common import regimes. The proposals submitted by member countries included both sectoral regimes (e.g. shipbuilding, aircraft, medicine, education) and more horizontal regimes (e.g. goods from investment projects, transboundary land trade, and goods for scientific and technological research).

In 2008, the CMC adopted the common regime for goods for scientific and technological research (CMC Decision No. 40/08), and extended the deadline for the development of the other special common sectoral and horizontal regimes, under the supervision of the Trade Commission. However, CMC Decision No. 57/08 established that the Trade Commission’s work was completed in time for consideration by the GMC in its last meeting in the second semester of 2010.

Recent developments. At the end of 2009, the Trade Commission approved DIR No. 31/09, which included the regime for the consumption of various goods intended for the rehabilitation, treatment, and training of people with special needs, on the list of special customs import agreements unilaterally-adopted by Argentina. In line with this directive, "the regime has limited economic impact and is in response to a non-commercial end".

The CMC, for its part, approved CMC Decision No. 20/09 extending the regimes of drawback and of temporary admission to intrazone trade to December 31, 2016. Paraguay and Uruguay, which do not use these regimes for the import of extrazone agricultural inputs, were authorized to apply a 2% aliquot for a list of tariff items to be determined by each State Party before December 31, 2010. In the specific case of Paraguay, a raw materials import regime was also created, with a 2% aliquot, the conditions of which are to be established by the Trade Commission before its last meeting of 2010. The term for these unilateral regimes in favor of the smaller economies is again December 31, 2016.

Where the negotiation of common regimes is concerned, the member countries submitted information, in the second semester of 2009, on national laws governing education, health, shipbuilding, goods from investment projects, and local transboundary trade to the CCM. Subsequently, in the first semester of 2010, the Brazilian delegation proposed the creation of a common regime exclusively for medicines and their active principles not manufactured in MERCOSUR to the Trade Commission. In line with this proposal, the tariffs on medicines not produced in MERCOSUR would be temporarily reduced to 0%. Under the Brazilian proposal, in the event of a medicine or active principle beginning regional production, it would be withdrawn from the list of products benefiting from the 0% tariff and would revert to the original tariff. Brazil proposed, in a first stage, to work on identifying medicines not produced in the region classified in Chapter 30 of the NCM. The Brazilian proposal is still being evaluated.

Last, there was progress in negotiating the common regime for the aviation industry. The proposal already has the backing of Brazil and Argentina, but is still being evaluated by Paraguay and Uruguay.

Trade liberalization in services

Background. As reported in previous editions of the *MERCOSUR Report* (see IDB/INTAL, 2008 and 2010), CMC Decision No. 13/97 approving the Montevideo Protocol on Trade in Services in MERCOSUR entered into force, December 7, 2005. Under the Protocol, the States Parties would hold successive negotiating rounds to complete the Program of Trade Liberalization in Services in a maximum of 10 years as of the instrument's entry into force.

Accordingly, in December 2008, CMC Decision No. 49/08 approved an Action Plan for the Deepening of the Program of Trade Liberalization in Services in the Scope of MERCOSUR, and set guidelines and deadlines for its implementation. The tasks and stages defined in the Plan were as follows:

- *First semester of 2009*: a diagnosis of the current situation ("snapshot"), defining sectors where liberalization presents no great difficulty (least sensitive sectors), sectors presenting intermediate difficulty for liberalization, and highly sensitive sectors; identification of sectors to be harmonized and/or complementation of regulatory frameworks.

- *2010*: consolidation of the regulatory status quo in sectors still without commitments and elimination of restrictions on market access and national treatment in the least sensitive sectors; beginning of the regulatory frameworks' harmonization/follow-up process in any sectors deemed necessary; identification of mechanisms to promote growing participation in the regional services market by the least developed operators.

- *2012*: elimination of restrictions on market access and national treatment in sectors with intermediate difficulty for liberalization; continuation of the regulatory frameworks' harmonization/follow-up process in any sectors deemed necessary; identification of domestic regulatory measures that may act as bureaucratic barriers to intrazone trade and seeking their elimination; deepening of the MERCOSUR disciplines on domestic regulations.

- *2014*: elimination of restrictions on market access and national treatment in highly sensitive sectors; conclusion of the regulatory frameworks' harmonization/follow-up process; conclusion of the process of deepening of MERCOSUR disciplines on domestic regulations; elimination of any domestic regulatory measures identified as bureaucratic barriers to intrazone trade.

Recent developments. December 2009 saw the completion of the Seventh Negotiating Round for Specific Commitments in Services, whose schedules were approved by CMC Decision No. 21/09.

The seven negotiating rounds already concluded have incorporated the vast majority of the services sectors and subsectors on the lists of commitments, and have made good progress in consolidating the regulatory status quo and clarifying the legal status of sectors as yet unconsolidated, i.e. sectors excluded from the lists of commitments. However, there are few cases of effective elimination of restrictions, with only standstill commitments prevailing in most sectors. The restrictions that hold up progress in the liberalization process are of a legal nature and are, in some cases, even embedded in constitutional devices. Their removal is, therefore, quite complex, and necessarily requires strong political momentum in the domestic sphere.

It is hardly surprising, then, that the Action Plan for Deepening the Liberalization Program for Trade in Services, approved at the end of 2008, has seen delays. The Minutes of the 42nd Regular Meeting of the Services Group held at the start of May 2010 reports that the national delegations took note of the lists circulated with the diagnosis of the current situation ("snapshot") and agreed to send the final versions in the first semester of 2010. This first stage, then, displays a one-year delay regarding the deadline laid down in the schedule agreed in the Action Plan.

In the same meeting, Argentina proposed the launch of a fresh round of negotiations—the eighth—whose main objective would be to consolidate the regulatory status in non-consolidated sectors. Under the proposal, the negotiation would take into account the information contained in the "snapshots" provided by member countries, portraying the current regulatory situation. The proposal was warmly welcomed, but was not approved during the PPTA.

B. Asymmetries and Production

MERCOSUR Structural Convergence Fund (FOCEM)

Background. At the end of 2004, the MERCOSUR member countries decided to set up the FOCEM, to finance programs that could help reduce asymmetries, strengthen the integration process, develop competitiveness, and promote social cohesion for the benefit, above all, "of the smaller economies and the least developed regions" (CMC Decision No. 45/04). The creation of the FOCEM thus addressed a demand insistently formulated by Paraguay since at least the start of 2003.

The basic guidelines for integration and the functioning of the FOCEM were established just six months later (CMC Decision No. 18/05), a surprisingly brief term for MERCOSUR standards. These directives defined an asymmetric regime for the States Parties' contributions to the Fund and for distribution of resources among the countries driving the projects. Annual contributions to the FOCEM were set on a rating based explicitly on the historical average of MERCOSUR's GDP (70% for Brazil, 27% for Argentina, 2% for Uruguay, and 1% for Paraguay), while the distribution of resources implicitly obeyed the intensity of the member countries' needs and asymmetries, thus benefiting the smaller economies (48% for Paraguay, 32% for Uruguay, and 10% for Argentina and Brazil).

The States Parties' total annual contribution was set at US$100 million, except for the first two budgetary years of the FOCEM, a period over which the contribution was reduced to 50% of that value in the first year and 75% in the second. The States Parties pledged to contribute to the Fund for a 10-year period, but the possibility was also mooted of the FOCEM receiving contributions from third countries, as well as institutions and international agencies.

CMC Decision No. 18/05, furthermore, established four programs for framing projects: Program I (Structural Convergence), Program II (Competitiveness Development), Program III (Social Cohesion), and Program IV (Institutional Structure and Integration Process Strengthening). The guidelines stressed that priority should be given to Program I and expressly limited resources that could be devoted to Program IV. A six-month period was also set to institute the FOCEM Regulations, but the directives established in advance that the instigators should contribute with their own resources, equivalent to at least 15% of the total value of the project submitted.

The general bases for submitting and approving projects were also predefined in the directives: the CRPM was elected as the gateway for the submission and assessment of project eligibility for Programs I, II, and III, with the assistance of a technical body in the scope of the MERCOSUR Secretariat (SM) responsible for operational aspects. The approval process both for FOCEM projects and budget should also envisage the sequential participation of the CPRM, the GMC, and, ultimately, the CMC.

The Regulations were introduced at the end of 2005 (CMC Decision No. 24/05), but with a term of validity of just two years, when they should be revised in light of the experience gained during the first stage of implementation. The Regulations established an organizational structure and management for the FOCEM involving various authorities: the CRPM, the SM Director, the FOCEM Technical Unit (UTF/SM) within the scope of the SM, and also the FOCEM National Technical Units (UTNFs), located in member countries.

The political urgency to launch the FOCEM's activities meant that the Regulations established interim procedures for assessing and implementing pilot projects "with a strong impact on the citizens of MERCOSUR". The FOCEM's first budget was approved at the end of 2006, already including the cumulative value of the items scheduled for 2006 (US$50 million) and 2007 (US$70 million). In parallel, the CPRM was commissioned to expedite the incorporation into the States Parties' legal systems of the CMC decisions that instituted and regulated the Fund. In September 2007, when the UTF/SM began operating, still precariously and with just four technicians, 15 pilot projects had already been approved by the CMC.

Recent developments. Three aspects stand out in the FOCEM's recent evolution: first, the economic relevance of the recent series of projects approved at the San Juan Summit, as well as the overcoming of the political obstacles that had been contributing to the delay in the approval process for certain initiatives; second, the sanction of a new version of the FOCEM Regulations, which introduced important changes in the Fund's management structure and formally incorporated several measures, which had been the subject of previous decisions of the CMC; and last, the review of the slow pace of implementation of projects approved since 2007 under Programs I, II, and III, none of which still has yet been completed.

New project series. In 2007, the first year of the FOCEM's effective functioning, the pace of project approval was extremely intense, as evinced by the high number of proposals (18) gaining a favorable decision in the CMC and also by the significance of the resources involved (over US$145 million). In 2008-2009, however, the number of projects approved (7) was significantly down, as was their overall value, which fell dramatically (US$52.4 million). In contrast, the recent San Juan Summit is outstanding not just for the rising number of projects approved (9), but, above all, for their scale, which involves resources in the order of US$794 million, around US$650 million of which are to do with resources funded by the FOCEM.

The projects approved in San Juan share certain particularly commendable features. First, five of the nine projects fall under the structural convergence program, three of those initiatives (the 550kV Itaipú-Villa Hayes transmission line, the 500mW Uruguay-Brazil Electrical Interconnection, and the 132kV ET Iberá-ET Paso de los Libres Norte Interconnection Link) being electrical interconnection projects, an area considered key to the integration of MERCOSUR economies.

Table 16. Annual evolution FOCEM-approved projects by driving country

Millions of US$

Instigator	Projects approved by approval date*											
	2007		2008		2009		2010*		Accumulated 2007/2010 *			
	Value	No.	Value	No.	Value	No.	Value	No.	Value	FOCEM		No.
										Value	%	
Paraguay	110.1	8	23.9	5	6.5	1	654.8	2	795.3	582.6	78.7	16
Uruguay	18.7	6	-	-	-	-	97.8	1	116.5	96.8	13.1	7
Brazil	0	-	-	-	22.0	1	13.7	3	35.7	27.3	3.7	4
Argentina	0	-	-	-	-	-	27.7	3	27.7	18.9	2.6	3
Pluristate	16.3	1	-	-	-	-	-	-	16.3	13.9	1.9	1
MERCOSUR Secretariat	0.2	3	-	-	-	-	-	-	0.2	0.2	0.0	3
TOTAL	*145.3*	*18*	*23.9*	*5*	*28.5*	*2*	*794.0*	*9*	*991.7*	*739.7*	*100.0*	*34*

Note: * Up to August 2010.

Source: SM webpage (September 2010).

Second, two of the three projects envisaged in the competitiveness development program (Automotive Deepening and Complementation in the Scope of MERCOSUR, and Supplier Rating in the Oil and Gas Production Chain") have features typical of regional projects, being intended for the training of suppliers or companies located in the region, not just in the territory of the initiative's instigator (Brazil).

Third, it is noteworthy that Brazil has confirmed its political commitment to Paraguay with a US$300 million voluntary contribution to make the 550kV Transmission Line project viable. In addition, Brazil's decision to use FOCEM resources to propose projects that make provision as beneficiaries for companies or suppliers of the other countries and/or involve positive spillovers in border areas[54] suggests a greater willingness on the part of MERCOSUR'S main partner to foot "leadership costs," to benefit its own interests as well.

It should also be remembered that the recent series of CMC-approved projects shows an effective concentration of resources in initiatives that fall under Program I (Structural Convergence), according to the provisions in the directives agreed by the States Parties in 2005 (Table 17).

Table 17. Projects approved under FOCEM program by driving country

Millions of US$

Instigator	Projects approved under FOCEM program*									
	Structural convergence		Competitiveness		Social cohesion		Institutional strengthening		*Total*	
	Value	No.	Value	No.	Value	No.	Value	No.	*Value*	*No.*
Paraguay	747.5	9	17.6	4	30.2	3	-	-	*795.3*	*16*
Uruguay	110.1	3	1.5	1	4.9	3	-	-	*116.5*	*7*
Brazil	6.1	1	7.6	2	22.0	1	-	-	*35.7*	*4*
Argentina	19.1	1	0.7	1	7.9	1	-	-	*27.7*	*3*
Pluristate	-	-	16.3	1	-	-	-	-	*16.3*	*1*
MERCOSUR Secretariat	-	-	-	-	-	-	0.2	3	*0.2*	*3*
TOTAL	***882.8***	***14***	***43.7***	***9***	***65.1***	***8***	***0.2***	***3***	***991.7***	***34***
As %	*89.0*		*4.4*		*6.6*		*0.0*		*100.0*	
FOCEM % share	*74.4*		*82.1*		*72.6*		*100.0*		*74.6*	

Note: * Up to August 2010.

Source: SM webpage (September 2010).

Some political events that contributed to expediting or unblocking the two main projects of the nine adopted at the San Juan Summit need to be highlighted.

In the case of the "500mW Uruguay-Brazil Electrical Interconnection" project the restoration of more fluent political dialogue between Argentina and Uruguay was essential. This had been severely weakened since 2006 as a result of the dispute sparked by the installation of the "pulp mills".[55] In 2010, however, the dissemination of the final decision of the ICJ and the renewal of governmental authorities in Uruguay facilitated political dialogue between the two countries, which signed an agreement for joint monitoring of the River Uruguay. A positive domino effect prevailed in this case.

In the case of the "500kV Transmission Line" project, the relevant political event was the understanding reached between the Brazilian and Paraguayan presidents to meet Paraguay’s claim and promote changes in the Itaipú Treaty, partially renegotiating its terms. In the second semester of 2008, Brazil, holding the MERCOSUR *Pro Tempore* Presidency at the time, submitted a proposal adopted by the CMC (CMC Decision No. 30/08) that opened up the possibility of the FOCEM receiving voluntary contributions from the States Parties. The Brazilian initiative showed the country’s willingness to contribute to the financing of the Itaipú-Villa Hayes transmission line and paved the way for an agreement with Paraguay in July 2009. Among other concessions, the agreement involved an increase from US$120 million/year to US$360 million/year of the value paid for energy not used by Paraguay and

[54] This is true of the Expansion of the Ponta Porã Sanitation System project (in the Brazilian state of Mato Grosso do Sul). Ponta Porã and the Paraguayan town of Pedro Juan Caballero form an urban conglomerate.
[55] See Section D further on.

consumed in Brazil ("Energy Transfer Remuneration")[56] and Brazil's voluntary contribution of resources in the order of US$300 million for the financing of the 550kV transmission line.

The project recently approved in San Juan provides resources amounting to US$555 million, US$400 million of which are funded by the FOCEM and US$155 million of which will come from counterpart funds provided by Itaipú Binacional (US$66.85 million) and Ande (US$88.15 million). It also highlights the fact that the FOCEM's resources will come from (i) the quota to be claimed from Paraguay (48%) on regular contributions (US$70 million/year) to be made by Brazil over 2010-2012, totaling just over US$100 million; and (ii) the voluntary contributions to be made by Brazil, in the same period, making up the remaining US$300 million.

With the approval of nine projects in San Juan, the number of initiatives still at the analysis phase was reduced to just two: "Digital Inclusion in High School Education," presented by Paraguay, and "Engineering Works of the Health Sanitation System of the City of São Borja, RS," in the Brazilian state of Rio Grande do Sul, submitted by Brazil.

New FOCEM Regulations. As mentioned above, after the effective launch of the FOCEM in the second semester of 2007, the CMC approved various measures that affected the Fund's scope and operational mechanics, but which had not yet been formally incorporated in the Regulations. The changes promoted by the CMC between 2007 and 2009 include the following: (i) the adoption of standards for the allocation of resources not used in previous years; (ii) authorization for the maintenance of resources in paid accounts; (iii) the approval of the Application Guide for the Visibility of the FOCEM; (iv) the adoption of procedures for the publication of international tenders; (v) the admission of voluntary contributions to the FOCEM by the States Parties; (vi) facilitating the use of resources for production integration projects, enabling its management by public, mixed or private bodies; and (vii) the application of national and non-discriminatory treatment to bids and bidders belonging to the States Parties or based in them.

The Regulations approved by CMC Decision No. 01/10 incorporated the changes previously sanctioned by the CMC and added several more, especially in the area of institutional organization (Table 18). Thus, for example, the FOCEM will have a Governing Council, a role to be performed by the GMC, in order to evaluate its functioning and orient its priorities, in addition to defining the guidelines for the CRPM and for the executive coordinator of the FOCEM, a figure created by the Regulations and responsible for the management of resources.

The new Regulations also granted autonomy to the FOCEM's Technical Unit, now designated by the acronym UTF and not UTF/SM as in the past. The UTF's structure also was strengthened, with an expansion of the staff and their distribution across four areas (CMC Decision No. 24/2010). There was also a clearer definition of the functions of the CRPM, which will now have a more executive function, as well as the role attributed to other institutions involved in the implementation and monitoring of the projects.

The Regulations also instituted a revolving fund administered by the UTF, which will keep in the Fund a sum of resources sufficient to ensure disbursements, up to a 10% ceiling of annual contributions to the FOCEM. This percentage may be raised at the CRPM's discretion.

[56] The renegotiation was approved by the Paraguayan Congress, but has not yet been assessed by the Brazilian Congress.

Table 18. Main developments in the new FOCEM Regulation

Old Regulation (CMC Decision No. 24/05)	New Regulation (CMC Decision No. 01/10)
Origin of resources	
States Parties' contributions and resources from third countries or international organizations.	The possibility of voluntary contributions from the States Parties is made specified, as well as the resources resulting from remunerated accounts.
Responsibility for project management	
Allocated to the UTNF.	Allocated to the executing bodies, whose functions and responsibilities are clearly established (major decentralization to streamline the execution of projects and avoid a bottleneck of documents at the level of UTNFs).
Institutional table	
Definition of the UTF, the UTNF, and CRPM's functions: incomplete and ambiguous. No Governing Council for the Fund is planned.	Clearer, more systematized definition of the functions and powers of the UTF, the UTNF, and the CRPM. This will enable more streamlined operation and avoid doubts and uncertainties that have sometimes delayed procedures. The creation of a Governing Council, a function to be performed by the GMC, in order to assess the general operation of the FOCEM.
UTF leadership	
This is the responsibility of the director of the SM.	It is passed on to the UTF's executive coordinator, who will be a full-time FOCEM employee.
Supplementation of resources to ongoing projects	
Upper limit of supplementation equal to 10%.	Upper limit of supplementation equal to 30% (important to enable greater flexibility in adjustments needed to accelerate the execution of successful projects).
Procedures for the submission of pluristate projects	
Virtually non-existent.	Well-defined (a definition that will be important to enable the submission of projects by organs of the MERCOSUR structure, e.g. Working Subgroups (SGTs).
Eligible and ineligible spending	
Ambiguity over payments of spending costs and public employees' salaries of the executing body.	It is clearly stated that "additional payments to public employees" and "spending costs" will be considered ineligible expenditure.
Streamlining of project approval procedures	
Absence of deadline for the CRPM to rule on projects that have already received favorable technical assessment from the UTF.	A 15-day deadline for the CRPM to rule on projects already assessed by the UTF. If there is no consensus over the project, the CRPM must submit to the GMC a status report within 15 days indicating the States Parties' positions over the project.
Streamlining of project execution procedures	
Impossibility of altering the financing schedule.	Possibility of altering the financing schedule upon request by the beneficiary State after approval by the CRPM.
Requirement of the provision of accounts and presentation of verification document for all costs.	Presentation not required in the provision of accounts, or the documents relating to non-eligible costs; these need only be "available for consultation".
Non-existence of deadline for review of the provision of accounts by the UTF.	30-day (interruptible) deadline for review of the provision of accounts by the UTF.

Table 18 (CONTINUED)

Old Regulation (CMC Decision No. 24/05)	New Regulation (CMC Decision No. 01/10)
Streamlining of project execution procedures	
Requirement of "non-objection" by the UTF on any contract for more than US$100,000.	Greater flexibility for public works, "non-objection" by the UTF is only required for contracts of over US$2 million.
Requirement to participate in technical inspections by the GAHE.	Removing this requirement. Inspections only by the UTF.
Requirement of annual external audits for each project.	Requirement of an external audit after 50% of execution and at the close of the project.
MERCOSUR preference	
Absence of principles for national treatment and non-discrimination of intrabloc companies in public tenders for FOCEM projects. Preferences of just 5% for intrabloc companies.	Establishment of principles for national treatment and non-discrimination of intrabloc companies, which will now have exclusivity when participating in bidding for FOCEM projects. Establishment of preferences for companies that provide goods originating in MERCOSUR countries.

Source: Taken from *Carta de Montevidéu* No. 13, August 2010, News Bulletin of the Brazilian Delegation in Montevideo.

Last, in addition to national and non-discriminatory treatment for bids and bidders from the MERCOSUR member countries, the Regulations introduced the "MERCOSUR preference," establishing that "the goods, services, and public works bids carried out within the FOCEM set of project may *only* be submitted by natural or legal persons from the MERCOSUR States Parties" [our italics] (Art. 68). Moreover, in the event of a tie or when the price differences between bids do not exceed 10% of the total value of the lowest bid, bidders whose proposals opt more for regional supply will have priority.

Problems with project execution. So far, none of the projects approved by the FOCEM in the scope of Programs I, II, or III has been completed. The review of the 20 (twenty) projects approved in 2007-2008 in the framework of these programs, however, shows that the planned duration for their execution was in most cases less than two years. Even counting the initial delay in the signing of the financing conventions, only possible after the effective constitution of the FOCEM's administrative structure in the last trimester of 2007, the execution of projects is clearly facing difficulties and suffering delays.

The FOCEM budgets corroborate this assessment, there being a significant amount of resources available, but not yet used. Furthermore, the minutes of the FOCEM *Ad Hoc* Group of Experts (GAHE-FOCEM) give account of a high number of projects that, after the first disbursement, failed to renew its request for resources in the maximum 12-month period, in line with the FOCEM Regulations. Last, the amount of resources actually disbursed up to September 2010, slightly over US$38 million, represents less than 30% of the FOCEM's resources (US$130 million), allocated to projects whose financing conventions had been signed up to December 2008 (Table 19).

There is probably no single explanation to justify the delays suffered in the execution of projects. The emergence of a new donor of resources in the region, with financing rules and procedural standards different to those adopted by other more familiar donors (e.g. the World Bank, the Inter-American Development Bank (IDB)) may have demanded an effort to adapt on the part of national executing units.

Table 19. FOCEM-approved projects to September 2010

Data in millions of US$

No.	Country	Approval in the CMC		Project description	Program	Project value	FOCEM resources	Disbursement to 27-09-2010
		Dec. No.	Date					
1	Paraguay	8/07	01-18-07	MERCOSUR-Habitat. Social promotion, strengthening of human and social capital in settlements in conditions of poverty.	III	12.915	7.500	5.618
2	Paraguay	8/07	01-18-07	MERCOSUR-ROGA. Construction of housing and infrastructure in areas of extreme poverty.	III	9.706	7.500	2.564
3	Paraguay	8/07	01-18-07	Greater Asuncion: Rehabilitation and improvements on access routes and ring road.	I	14.860	12.631	5.789
4	Paraguay	8/07	01-18-07	Micro-Enterprise Integral Support Program.	II	5.500	4.250	1.641
5	Paraguay	8/07	01-18-07	Installation of biosecurity laboratory and food control laboratory infrastructure.	II	4.800	4.080	0.047
6	Paraguay	11/07	05-22-07	Rehabilitation of road corridors.	I	16.990	14.442	3.698
7	Regional	8/07	01-18-07	MERCOSUR Foot-and-Mouth Disease-Free Action Program (PAMA).	II	16.339	13.889	4.272
8	Uruguay	8/07	01-18-07	Route 26, Melo-Arroyo Sarandí de Barceló Section.	I	7.929	5.310	5.108
9	Uruguay	8/07	01-18-07	Internationalization of production specialization and technology training in the software, biotechnology, and electronics sectors.	II	1.500	1.275	1.275
10	Uruguay	8/07	01-18-07	Strengthening of local communities via social economy projects	III	1.647	1.400	1.014
11	Uruguay	11/07	05-22-07	Skills and infrastructure development for informal urban waste classifiers.	III	1.882	1.600	1.136
12	Uruguay	11/07	05-22-07	Multiple interventions in settlements in border territories with extreme poverty and health alerts.	III	1.412	1.200	0.662
13	Uruguay	23/07	06-28-07	Route 12 Route 54-Route 55 Connection.	I	4.371	2.928	0.235
14	SM	8/07	01-18-07	CET information System.	IV	0.050	0.050	0.050
15	SM	8/07	01-18-07	Jurisprudence database.	IV	0.050	0.050	0.050
16	SM	39/07	10-25-07	Structural convergence need identification in MERCOSUR.	IV	0.071	0.071	0

Table 19 (CONTINUED)

No.	Country	Approval in the CMC		Project description	Program	Project value	FOCEM resources	Disbursement to 27-09-2010
		Dec. No.	Date					
17	Paraguay	47/07	12-17-07	Construction and improvement to drinking water and basic sanitation systems in small rural and indigenous communities.	I	39.471	28.516	1.556
18	Paraguay	48/07	12-17-07	Paving Route 8. San Salvador-Ramal Rojas Potrero section.	I	6.345	4.903	0.675
19	Paraguay	7/08	06-30-08	Development of competitive tourism products in the Iguazú-Misiones integrated circuit.	II	1.303	0.992	0.647
20	Paraguay	8/08	06-30-08	Paving of Routes 6 and 7. Pte. Franco-Cidrales regional integration corridor.	I	5.847	4.517	0.903
21	Paraguay	9/08	06-30-08	Paving of feeder section on Route 2-Itacurubi-Valenzuela-Gral. B. Caballero regional integration corridor.	I	5.187	4.008	0.562
22	Paraguay	10/08	06-30-08	Resurfacing of feeder section on Routes 1 and 6-Carmen of the Paraná-Graneros del Sur regional integration corridors.	I	4.004	3.093	0.594
23	Paraguay	11/08	06-30-08	MERCOSUR-Yporá. Promotion of access to safe drinking water and basic sanitation in communities in extreme poverty	III	7.589	5.835	0
24	Paraguay	10/09	07-23-09	DeTIEC-Technology, innovation, and conformity assessment development.	II	6.471	5.000	0
25	Brazil	02/09	07-24-09	Establishment of the UNILA Library and the MERCOSUR Institute of Advanced Studies (IMEA), Federal University of Latin American Integration.	III	22.000	17.000	0
26	Uruguay	02/10	08-02-10	Uruguay-Brazil 500mW electrical interconnection.	I	97.780	83.113	0
27	Argentina	03/10	08-02-10	132kV interconnection link in ET Iberá-North Paso de los Libres.	I	19.058	13.117	0
28	Argentina	04/10	08-02-10	Capital goods-exporting SMEs, turnkey plants, and engineering services.	II	0.672	0.553	0
29	Brazil	05/10	08-02-10	Enlargement of the Ponta Porã-MS Sanitation System.	I	6.136	4.496	0

Table 19 (CONTINUED)

No.	Country	Approval in the CMC		Project description	Program	Project value	FOCEM resources	Disbursement to 27-09-2010
		Dec. No.	Date					
30	Paraguay	06/10	02-08 -10	Rehabilitation and pavement of Conception-Port Vallemí Section.	I	99.789	75.309	0
31	Paraguay	07/10	08-02-10	Construction of the Itaipú-Villa Hayes 500kV Transmission Line, Villa Hayes Substation and Enlargement of the Itaipú Right Bank Substation.	I	555.000	400.000	0
32	Argentina	08/10	08-02-10	Integral interventions in Buildings of Compulsory Studies of the General Obligado, Vera, 9 de Julio, Garay, and San Javier Departments.	III	7.934	5.213	0
33	Brazil	09/10	08-02-10	Automotive deepening and follow-up in MERCOSUR.	II	3.929	2.961	0
34	Brazil	11/10	08-02-10	Supplier rating for the oil and gas production chain.	II	3.672	2.849	0
					TOTALS	***991.706***	***739.650***	***38.098***

Source: FOCEM.

In the case of Paraguay, the country with the highest number of projects in the scope of the FOCEM, Arce (2010) identifies two main obstacles: (i) the lack of installed capacity in Paraguayan public administration when the entry into operation of FOCEM, hindering the submission and, above all, execution of approved projects; and (ii) the necessary adjustment of budgetary rules and procedures governing public contracting in Paraguay to the FOCEM's technical requirements, involving a learning process on the part of the national public administration.

The expectation is that the obstacles represented by learning or standards readjustment will be less relevant in the future. On the other hand, changes in the administrative structure introduced by the new regulations, as well as the strengthening of the UTF's Executive Coordination, with the expansion of staff, may also contribute to better project monitoring and promote speedier execution.

Last, it is worth noting that the 550kV transmission line project will be executed by Itaipú Binacional, which, as explained in the company's proposal, has its own standard for tenders, fully consistent with the laws of Brazil and Paraguay, and observes universal legal principles for tendering applicable to public bodies. Itaipú Binacional also adopts international management and corporate governance standards, and has internal and external audits. It is not beyond the imagination, therefore, that the project's execution will face significantly lesser obstacles than in other initiatives financed by the FOCEM. Those considerations are relevant, since the project may be a flagship initiative for the FOCEM's potential.

Production Integration

Background. Since mid-2008, the strengthening of production integration in the region has been gaining ground in MERCOSUR's issue agenda. Indeed, in June this year, the agenda of the MERCOSUR Production Integration Program (PIPM) was adopted, and the MERCOSUR Production Integration Group (GIP) also created to coordinate and implement the PIPM (CMC Decision No. 12/08). In the same period, the MERCOSUR Fund for the Support of Small and Medium Enterprises was created to implement, in a first stage, a system of guarantees for small and medium enterprises involved in production integration initiatives (CMC Decision No. 13/08).

The institution of the guarantees system became a reality six months later, in December 2008, with the creation of the MERCOSUR Guarantee Fund for Micro, Small and Medium Enterprises (CMC Decision No. 41/08). The member countries' initial contribution to the formation of the Fund was set at US$100 million in the following proportions: Brazil 70%, Argentina 27%, Uruguay 2%, and Paraguay, 1%. The Fund can grant guarantees or endorsements not exceeding 80% of the value of the loan or the original guarantee for credit transactions targeting production investments in R&D, technology training and development and in the production and marketing of goods for export. The Fund has not yet been regulated, but Brazil has already submitted a proposal in this area, based on national experiences of guarantee systems managed by such bodies as the Brazilian Support Service to Micro and Small Enterprises (SEBRAE), the Bank of Brazil, and the BNDES. The approval of the Fund's Regulations is therefore likely to become one of the main objectives of the Brazilian *Pro Tempore* Presidency (PPTB) in the second semester of 2010.

The MERCOSUR Business Portal was created in mid-2009 in the scope of the Permanent Regional Observatory on Production Integration in MERCOSUR (CMC Decision NO. 07/09). The Portal's objective is to encourage business associativity and create a tool for public and private actors involved in regional production integration initiatives to exchange information.

Regional production integration initiatives driven in the scope of MERCOSUR can generally be said to have developed along two axes: on the one hand, the initiatives aimed at stimulating and encouraging small and medium enterprises, which rely on the Guarantee Fund for Micro, Small, and Medium Enterprises as their main instrument; on the other, there is a second line based on projects or programs (Program for Supplier Development of the Oil and Gas Sector, Program for Automotive Deepening and Follow-Up in MERCOSUR) lodged in large—especially Brazilian—companies, seeking to develop regional suppliers or specializations divisions. These programs, after the example of the two mentioned above, may eventually receive the support of resources from the FOCEM.

Developments during the period. During 2009, the conclusions of two studies intended to distinguish production complementation initiatives were disseminated. The first of these studies was commissioned by the Brazilian Agency for Industrial Development (ABDI) from an Argentine consulting firm, its main objective being to develop a methodology capable of identifying Brazilian investment opportunities in Argentina (ABECEB.com, 2009).

The study identified three conditions for the selection of sectors with the best business opportunities:

- *The presence of asymmetries between Brazilian and Argentine sectors and companies*. According to the study, strong asymmetries between the two countries in the availability of natural resources, the size of companies, the scale of sectors, technical capacity, and export capacity may be indicators of opportunities for bilateral investment and not obstacles, as the common sense might suggest.

- *The need to strengthen both countries' competitiveness*. The need to enhance the competitiveness in areas threatened by weaknesses that place at a disadvantage in third country markets when dealing with extraregional competitors (e.g. China, etc.) should also be an important factor when identifying opportunities for bilateral investment.

- *Priorities of the respective national development policies*. Identifying opportunities should take account of the sectors defined by national policies as priorities in promoting production and competitiveness.

Based on that criterion, the study selected 10 sectors with clear opportunities for bilateral production complementation and ample room for public/private action: oil and gas, mining, shipbuilding (including small craft), railroad equipment, auto parts, machinery for special use (especially agricultural machinery), information technology (especially as applied to agribusiness), biofuels, and civil construction.

The second study, conducted by a Brazilian university institution, validated the choice of those sectors and noted examples of joint ventures to promote competitiveness (greenfield bilateral investment, mergers and acquisitions, cross shareholding, logistics sharing consortiums and networks, and long-term supply agreements) (NIET-EI-UNICAMP, 2009).

The 1st Brazil-Argentina Meeting on Production Integration was held in Buenos Aires, February 2010. The findings of both studies were assessed by those attending the meeting, who chose to define eight target sectors for production complementation, divided into two groups:

- *Sensitive sectors*: wood and furniture, white line goods, wines, and dairy products.

- *Strategic sectors*: oil and gas, auto parts; aviation industry, and agricultural machinery.

A third group (shipbuilding; digital TV, and tourism and local development) was allocated to the "sectors under evaluation" category.

After defining the target sectors, the ABDI defined a ten-stage working method to develop its production complementation actions:

- *A preliminary sectoral meeting*: a meeting with Brazilian sectoral entities to present the Brazil-Argentina Production Integration Program.

- *Sectoral committees*: participation of bodies from both countries to discuss possible joint ventures and draw up lists of interested companies.

- *Internal seminar*: sole participation by Brazilian organizations to promote greater clarity in the direction of the process.

- *Company lists*: joint activity in both countries to identify companies interested in participating in various business scenarios.

- *Consolidation of lists/Matchmaking*: joint activity by both countries designed to bring together the interests identified in the sectoral committees.

- *Business round*: a business event organized by both countries attended by companies, organizations, and governments.

- *Definition of potential projects*: identification of viable projects, identified in the business round.

- *Project structuring*: internal activity, in Brazil's case, bringing together the ABDI, the BNDES, and the Ministry of Development, Industry, and Foreign Trade of Brazil (MDIC).

- *Case analysis/definition of agendas*: internal activity, in Brazil's case, bringing together the ABDI, the BNDES, and the MDIC, and support consultancies.

- *Agenda with official banks*: identifying financing support mechanisms for official bodies (the BNDES, the Bank of Brazil, and the *Caixa Econômica Federal*, in Brazil's case).

Up to September 2010, just two sectors had carried out the joint activity planned for the second stage (sectoral committee), given that both sectors belonged to the group of "sensitives": wood and furniture, and wines.

Two further production integration projects were approved in San Juan in the framework of the FOCEM, the executive coordination of which will be performed by the ABDI: (i) the Program for Automotive Deepening and Follow-Up in MERCOSUR to strengthen the competitiveness of small automotive suppliers in the bloc's four member countries, make viable extrabloc import substitution, and boost exports through technology training and companies' access to business opportunities; and (ii) the MERCOSUR Project for Supplier

Rating in the Oil and Gas Production Chain, which targets small and medium industrial and service enterprises in the bloc that are potential suppliers of the oil and gas production chain.[57]

Any attempt so far to assess the results arising from production integration initiatives is premature. The efforts made by governments toward creating new instruments like the Guarantee Fund for Micro, Small, and Medium Enterprises, mobilizing public credit institutions like the BNDES, BICE, Bank of Brazil, BCRA, or *Caixa Econômica Federal*, attracting "national champions" in certain industrial sectors like Petrobras or Embraer to the objective of developing regional supply chains, as well as defining and implementing a methodology designed to identify and matchmake interests between private sector representatives in various sectors. It is also noteworthy that this is a positive agenda that seeks to go beyond the containment or damage mitigation measures advocated so far by "voluntary" trade administration agreements sponsored by governments in the scope of bilateral monitoring commissions.

The expansion of Brazilian investment in the region will surely contribute to the success of pro-integration initiatives. However, the leading role will undeniably belong to the private sector, from which a degree of entrepreneurship will be required, as well as serious effort in terms of modernization and technological adaptation. This is shown by Brazil's recent experience in promoting local supplier development in the oil and gas sector, which often clashes with the inability of domestic firms to meet the quality and performance requirements required of them by large companies in the sector. These obstacles can be even greater for regional providers.

C. Institutional Aspects

The restructuring of the CRPM and other institutional issues

Background. The CRPM was created in October 2003 as an organization linked to the CMC, with fairly broad powers: (i) to assist the CMC and the MERCOSUR *Pro Tempore* Presidency in all activities required of it; (ii) to submit initiatives to the CMC on matters relating to the integration process, external negotiations, and the formation of the Common Market; and (iii) to strengthen MERCOSUR's economic, social, and parliamentary relations.

In accordance with CMC Decision No. 11/03, the CRPM would be composed of permanent representatives from the States Parties and presided over by "a standout political personality, who is a national one of the States Parties, appointed by the CMC by proposal of the States Parties' Presidents". The mandate of the president of the CRPM has been set at a two-year term and may be extended for a further year.

The qualifications required by CMC Decision No. 11/03 for the position of CRPM president were politically adjusted among the MERCOSUR member countries to enable the appointment of the former president of Argentina, Dr. Eduardo Duhalde (CMC Decision No. 14/03). The political nature of such an arrangement was explicit, so much so that the Argentine government bore the full costs of the CRPM presidency's cabinet.

When Duhalde's mandate finished at the end of 2005, the CMC appointed Carlos Álvarez, former vicepresident of Argentina, as the new president of the CRPM, and the administrative arrangement to cover the costs of the new president's cabinet was maintained. At the end of 2007, Álvarez's mandate was extended for a further year in line with the current provisions.

[57] Both projects have been described in detail in previous editions of the *MERCOSUR Report*.

CMC Decision No. 56/08 to promote the restructuring of the MERCOSUR Secretariat was approved in the second semester of 2008 during the PPTB. However, the rule sanctioned by the CMC clarifies that the process of restructuring "may provide for the incorporation of functions now allocated to the CRPM". On that occasion, Brazil noted its intention not to put forward its own candidate for the post of CRPM president and Álvarez’s mandate was extended "in exceptional circumstances" once again (CMC Decision No. 32/08).

Developments during the period. When Álvarez’s mandate finished at the end of 2009, the CMC decided to alter, albeit apparently temporarily, the functioning of the CRPM. Indeed, CMC Decision No. 33/09 stipulates that it is the responsibility of the permanent representative exercising the *Pro Tempore* Presidency to carry out "the responsibilities for the *coordination* of projects and activities of the CRPM" and that "the CRPM’s operating costs, including those arising from the recruitment of three temporary employees, shall be *temporarily* borne with surpluses from the SM" [our italics].

In short, the figure of the President was temporarily replaced by a system of alternation in coordinating the CRPM’s activities, and an interim administrative arrangement was instituted to ensure its functioning. The precarious nature of such a solution is underlined by the provisions in Article 1 of the Decision, which urges "the efforts to adjust the institutional structure to be stepped up in order that, up to December 31, 2010, agreement be reached on the outlines of a structure to allow the best possible projection of MERCOSUR".

The need to give MERCOSUR of a new institutional structure was also the leitmotiv of the Message from CRPM President, Carlos Álvarez, presented at the close of his term at the end of 2009 as an introduction to the *Report by the Presidency of the CRPM*. In his Message, Álvarez argues that, in order to improve intergovernmental management in MERCOSUR, there is a need for experienced, fulltime employees recognized "at the highest level" by the blocs’ member countries. According to Álvarez, it will be extremely difficult to move forward on issues such as production integration, energy security, alternative energy production, defense of natural resources, and instruction, training, and cooperation in innovation and education, without promoting improvements to MERCOSUR’s institutional capacities.

The text of Álvarez’s Message explicitly defends the setting-up of a General Secretariat, supported by a technical secretariat responsible for areas or programs, acting under GMC supervision. It also stresses that the solution would involve no transfer of sovereignty or change in MERCOSUR’s current decision-making authorities, but would involve an adaptation of the institutional structure to the policy design supported by the member countries. Álvarez ends by stating that it is necessary to bring together political will and technical decisions, and that the lack of progress in strategic issues promotes dispersal, the idle accumulation of organizations, and the total ineffectiveness and invisibility of policies. There is, therefore, a clear stance in favor of the creation of a technical and professional authority in the scope of MERCOSUR.

In April 2010, GMC Resolution No. 06/10 approved the setting-up of a High-Level Meeting for the Institutional Analysis of MERCOSUR (RANAIM), made up of the Acting GMC National Coordinators, or equivalent officials, to advise the GMC and draw up proposals on institutional matters. According to the Resolution, the RANAIM’s proposals should make provision for the following priority areas: (i) the organizational structure of MERCOSUR, possible adaptations, reforms, and the creation and/or elimination of organs; (ii) improvements to the MERCOSUR dispute settlement system and the strengthening of its institutional organs; (iii) the MERCOSUR regulatory system, including the process of development, incorporation, validity, application, and revision of its regulatory framework; and (iv) the MERCOSUR budget.

The minutes of the last two GMC meetings, held under the PPTA, recorded no activity by the RANAIM. However, at the 81st GMC Meeting, held late September, under the PPTB in Manaus, Brazil, the issue of MERCOSUR's institutional strengthening was picked up again. On Brazil's initiative, as reflected in a restricted document, delegations from member countries exchanged views on Draft Decisions intended to create the position of "MERCOSUR High General Representative," as well as High Representatives for specific areas such as cooperation over development, health, and culture. The PPTB is, therefore, likely to direct efforts toward achieve a degree of progress over the issue of the bloc's institutional strengthening.

D. Other Issues on the Internal Agenda

The "pulp mill" dispute: five years of complex negotiations

July 28, 2010, five days before the start of the San Juan Summit, the presidents of Argentina and Uruguay signed a document in Buenos Aires just over one page long, with only four provisions, laying the groundwork for the joint monitoring of "all industrial and agricultural establishments, and urban centers that discharge their effluents into the River Uruguay and its areas of influence".

It is still too early to say whether the agreement represents the final solution to a dispute that has badly affected bilateral relations over the past five years. But it is certain that the understanding reached between the two countries has been a political factor fundamental to the relaxation of MERCOSUR members' positions on various issues blocking the bloc's internal agenda, and has contributed to the relative success of the 39th Meeting of the CMC.

The occurrence of disputes over the joint management of a water resource in a border area should be considered normal in relations between neighboring countries. However, the gravity of the tensions prompted by the dispute, the long duration, and multiplicity of authorities and forums mobilized by the parties to settle their grievances undoubtedly hindered the achievement of understandings in MERCOSUR in various matters outside the dispute, while also promoting the erosion of bilateral relations between Uruguay and Argentina. Proof of this is that monitoring mechanisms not so different from those finally agreed in July 2010 had already been applied in the past, according to statements by the presidents themselves in the meeting that sealed the bases of the understanding, after reading old minutes of the River Uruguay Executive Commission (CARU). It should also be stressed that, in 2006, Argentina had rejected a proposal for permanent joint monitoring on the environmental impact of the pulp mills, very similar to the one finally agreed in July 2010.

There follows a description of the economic, environmental, and legal aspects of the dispute.

Economic aspects of the dispute. *Background.*[58] In the 1980s, Uruguay conducted a series of studies to develop a forest sector in the west of the country, with the aim of furthering the diversification of its economy and, in particular, its export sector. The initiative had the financial support of the World Bank and IDB, and consisted of the establishment of legislation to promote forestry activity, the creation of a certification system for sustainable

[58] For a more detailed account, see IDB/INTAL (2006).

forest management, and investments to improve the road network to ensure the transport of forestry output.

The effort was successful: in 2005 Uruguay had around 800,000 hectares of planted eucalyptus forests and the government's medium-term objective aimed at a total of up to 3 million hectares of forests for the production of wood pulp.

As of 2002, two major European producers, the Spain National Pulp Company (ENCE) and the Finnish group Metsä-Botnia, began to carry out projects to install two pulp mills on the River Uruguay. At the end of 2003 (ENCE) and at the start of 2005 (Botnia), after fulfilling Uruguayan environmental procedures and requirements, the ventures obtained prior authorization to implement and operate of their respective production units. The location chosen for the construction of the plants was the left bank of the River Uruguay, on the border with Argentina, in the vicinity of the Uruguayan town of Fray Bentos, the capital of Río Negro Department, where there are major eucalyptus forests. The two planned production units were just 6km apart.

On the other side of the border, 8km from the river and 30km from Fray Bentos, is the Argentine town of Gualeguaychú, Entre Ríos Province. The two towns are connected by a bridge across the Rio Uruguay (the San Martín International Bridge), of great tourist and trading importance for both countries. It is important to mention that Entre Ríos also has eucalyptus forests and, in the 1980s, the provincial government had striven to attract foreign investment to set up pulp mills.

The investments planned for the installation of the two pulp units on Uruguayan territory were highly significant, totaling US$1.2 billion in Botnia's case and US$500 million in ENCE's. Both ventures applied for financial support from the International Finance Corporation (IFC), linked to the World Bank, as well as various private financial institutions. The Botnia group also applied for guarantees from the Multilateral Investment Guarantee Agency (MIGA), also linked to the World Bank.

Recent developments. Construction of the Botnia plant began in April 2005 and, despite some interruptions caused by the dispute, it finally entered operation in late 2007. The plant is located in the Fray Bentos Duty-Free Zone, a customs exclave that also has a port terminal. The forestry raw material (wood) enters the Fray Bentos Duty-Free Zone as an import from the Uruguayan customs territory and, after processing and transformation into pulp, it is transported to the Nueva Palmira Duty-Free Zone, for reexport abroad. Nueva Palmira Port, located on the bank of the River Uruguay, is currently the second largest in Uruguay, but is the largest in cargo volume. The port serves as an exit for agricultural and forestry production (soy, citrus, wood, pulp), which travels down the River Uruguay and is loaded in Nueva Palmira for external markets.

In December 2009, the Finnish company, UPM, announced the acquisition of 91% of the shares in Botnia's Fray Bentos plant, as well as 100% of the company, Eastern Forestry, specializing in eucalyptus plantations, and owning and managing 180,000 hectares on Uruguayan territory. In return, UPM reported the sale of 30% of its participation in Botnia's head office, while taking on the debt of the operations in Fray Bentos. The agreement had been preceded by a letter of intent signed in July 2009 stipulating the value of the Fray Bentos pulp plant and the Eastern Forestry subsidiary at about US$2.4 billion. On that occasion, it was reported that the plant had a capacity for processing 3.5 million cubic meters of eucalyptus wood to produce 1.1 million tonnes of pulp p.a. At the time of its acquisition, the plant employed over 200 people.

In 2008, Botnia exported US$740 million, its exports dropping to US$585 million in 2009 as a result of the international crisis. Even so, in 2009, UPM (former Botnia) was already the main exporting company on Uruguayan territory, going by exports from the duty-free zones. In 2009, the exported volume was over 900,000 tonnes, more than half of which was for Finland, where the headquarters is based, and the rest (370,000 tonnes) to China.

The ENCE project evolved quite differently, eventually coming to nothing. At the start of 2006, during which the bilateral dispute with Argentina deepened, the Spanish company announced its decision to change the location of its project, eventually settling on Punta Pereira, Conchillas, Colonia Department, as the new site. In May 2009, however, ENCE transferred its project, as well as part of its forestry assets in Uruguay, to a consortium (Montes del Plata S.A.) made up by the Swedish-Finnish company, Stora Enso, and the Chilean company, Arauco. More recently, in August 2010, the consortium confirmed its intention to sign a memorandum of understanding with the Uruguayan government and start carrying out feasibility studies for the installation of a plant with an initial output of 1.5 million tonnes of pulp/year, needing investments in the order of US$2.3 billion, at the site previously chosen by ENCE (Punta Pereira).

In short, from an economic point of view, the dispute involved a successful, long-term production and export diversification and foreign investment attraction government policy, with a relevant impact for an economy the size of Uruguay's.

Environmental aspects of the dispute. *Background.* [59] The environmental dispute, initially revolving around the simultaneous and extreme geographical proximity of the two projects (ENCE and Botnia), was about three issues: (i) the choice of site for the plants; (ii) the choice of production technique; and (iii) the measures and technologies referred to in the plans for the treatment of liquid effluent, gas emissions, and solid waste management. There was, however, a more general argument permeating these objections: the omission and consistent lack of consideration of the potential negative impacts of transboundary ventures, in both the environmental studies and the projects' processing and approval by the Uruguayan authorities.

Indeed, the potentially negative impacts of the establishment of the pulp mills might affect not just the shared water resource, but also areas located in Argentine territory, on the right bank of the River Uruguay, where there are significant tourist investments. In fact, the town of Gualeguaychú, in the Province of Entre Ríos, had, in the last few years, successfully developed startup ventures that, in the high season, attract a contingent of tourists whose numbers exceed the resident population several times over. One of those tourist attractions, the Ñanduboysal spa resort, stands on the right bank of the River Uruguay, opposite the UPM (former Botnia) plant.

The environmental dispute developed on two levels. At the more strictly "technical" level, the environmental dispute was initially confined to World Bank agencies (the IFC and the MIGA), where they handled applications for financing and guarantees submitted by the project holders. Against this background, the dispute focused on the environmental impact reports and studies prepared by independent consultants in response to requests from the

[59] For a more detailed account, see IDB/INTAL (2006).

agencies themselves, which, observing the rules of procedure in force in the World Bank, suffered a strong response and objections from various non-governmental institutions, environmental defense organizations, and even private individuals. At the second stage, after the opening of the Botnia plant in late 2007, the focus of the dispute shifted to technical objections to environmental monitoring reports that began to be circulated by various different institutions following or involved in the dispute.

The dispute environmental also took the form of a social protest, with the consistent and widespread mobilization of the population residing in areas close to the project site, and the participation of Argentine and Uruguayan environmental organizations. These mobilizations, especially on the Argentine side, promoted the blockade of roads and international bridges, severely affecting the flow of goods and persons for long periods of time, and damaging economic activity and tourism, especially in Uruguay.

In the scope of the World Bank, the IFC and MIGA ombudsman first appeared on the scene in November 2005 in response to a complaint signed by over 39,000 people—Argentines and Uruguayans alike—recommending uniformity in both agencies' assessment criteria, full public access to information, and absolute observance of the rules and procedures in force in the World Bank. The following month a preliminary draft of the cumulative impact study commissioned by the IFC from two private consultants was published, and, in April 2006, the findings of a panel of Canadian experts convened to assess both the environmental impact study and the criticism of the preliminary draft was announced.

The panel emphatically stated that "the opinions expressing concern that the plants will cause catastrophic environmental damage are unfounded, are not reasonable, and ignore the experience of many other modern bleached kraft pulp plants". However, it also admitted that "some comments, suggesting improvements in certain aspects of the plants' design, definitions of operational procedures, and monitoring of environmental discharges aspects are valid and worthy of implementation".

The panel's conclusions were once again subject to criticism, and the IFC, therefore, postponed its final report for some months. But, at the start of October 2006, the report was released, stating the conclusion that emissions from the pulp mills would have no detrimental effect on the quality of the River Uruguay's water. On the subject of air quality, the report said that human health would not affected, although it admitted the possibility of odors occurring in areas close to the plants—notably Fray Bentos—between four and ten times a year. Shielded by the final report's conclusions, the World Bank approved a US$170 million loan to Botnia in November 2006, as well as US$350 million in credit guarantees. The initiative was approved by 23 of the 24 board members.

At the level of social mobilization, the first expressions of opposition to the establishment of the pulp mills in Uruguay were exclusively domestic and occurred before 2003. They had the support of the leftwing Broad Front coalition, and Uruguayan trade union groups and environmental organizations, who criticized the legal framework designed for the installation of the plants, as well as the risks of environmental pollution. In 2003, residents from the neighboring town of Gualeguaychú joined in the protests and, in October that year, there was a demonstration against the construction of the plants on the San Martín International Bridge, attended by Uruguayans and Argentines alike.

In October 2004, however, Tabaré Vasquez won the presidential elections and immediately expressed his support for the installation of the pulp mills, signaling a shift in the Broad Front's position and trade union groups, which had hitherto opposed the ENCE and Botnia projects.

April 30, 2005, the San Martín International Bridge was occupied by around 40,000 people—Argentines and Uruguayans—and the dispute made national and international headlines. The Gualeguaychú Citizens' Environmental Assembly was also formed in this period, which embarked on a course of permanent opposition to the installation of the two plants.

The dispute deepened over 2005, becoming extremely serious in December that year, when the Gualeguaychú Assembly began systematically blocking the passage of vehicles on their way to Uruguay. More intransigent sectors of opposition began to propose the simultaneous blockade of three international bridges (Fray Bentos-Gualeguaychú, Salto-Concordia, and Paysandú-Colón) over the River Uruguay.

In the first trimester of 2006, two of the international bridges were effectively blocked, prompting a sharp reduction of the flow of tourists and seriously damaging goods transport. In April 2006, the Uruguayan government criticized the Argentine government lack of action, declared that the blockades were contrary to international law, specifically the Treaty of Asunción, and launched a claim against Argentina in the MERCOSUR dispute system. A few days later, in May 2006, Argentina filed a claim against Uruguay in the ICJ in the Hague. The rest of 2006 saw marches, protests, and road and bridge blockades. In November 2006, when the World Bank announced financing for Botnia, the Gualeguaychú Assembly set up an indefinite blockade on Route 136, which provides access to the San Martín International Bridge.

Recent developments. Social mobilization, protests, and blockades were kept up for the next three years. In certain points, particularly the summer months of 2007 and Easter in April 2007, the three international bridges suffered simultaneous blockades, with increasing losses for the Uruguayan tourism sector. The interruption of traffic on the bridge connecting Gualeguaychú to Fray Bentos was kept almost uninterruptedly until June 2010, two months after publication of the ICJ decision.

From 2009, various Argentine government authorities had been issuing statements against the blockades of roads and bridges. However, it was only in June 2010, in response to pressure from the Argentine government, which had initiated criminal proceedings against some of its leaders, that the Gualeguaychú Citizens' Environmental Assembly decided, by 402 votes to 315, to free up vehicle traffic, while remaining on alert at the side of Route 136.

On the other hand, as mentioned above, after the opening of the Botnia plant in November 2007, the dispute based on technical arguments focused on the monitoring reports that had begun to appear. The first of these was produced by the non-governmental organization (NGO), Green Cross, an institution founded by Mikhail Gorbachev, and was released in January 2008. According to the report, measurements were carried out on the Argentine side River Uruguay, but no concentrations of sulfur dioxide were detected in the air that might be cause for concern. The data released agreed with the monitoring carried out by the Uruguayan government's National Directorate for the Environment (DINAMA), and also by Botnia itself. However, these were rejected by the Gualeguaychú Assembly, which argued that that the plant was operating at just 15% of its capacity.

In January 2009, the head of Argentina's National Industrial Technology Institute (INTI) issued a statement saying that bimonthly studies since August 2008 recorded no environmental pollution, sparking controversy and subsequent denials.

It will be strictly necessary to await the publication of the first reports of the CARU's Scientific Committee, a joint monitoring body recently agreed by Presidents José Mujica and

Cristina Fernández de Kirchner to provide a less controversial assessment of the real environmental impacts resulting from the operation of the UPM (former Botnia) plant. The first report will only be published in November 2010.

To summarize, the environmental matter involves issues complex and controversial enough to fears and mobilize citizens and NGOS in both countries. In light of the technical information available so far, there has certainly been a disproportionate radicalization of the dispute, aggravated by the uncertainty created by the implementation of projects to develop tourism on the Argentine side of the River Uruguay. It is also worth underlining the fact that the dispute has involved transnational investments in a productive sector that is the object, at an international level, of objections and monitoring by governments and environmental organizations.

The legal bases for the dispute and its development in the International Court of Justice and the MERCOSUR Dispute System. *Background.*[60] In February 1975, Uruguay and Argentina signed the Statute of the River Uruguay, a legal instrument designed to establish "common mechanisms necessary for the optimum and rational exploitation" of the River Uruguay. This instrument created the CARU, comprising an equal number of delegates from both countries.

The Statute states that, if one party plans "construction works large enough to affect navigation, the river flow, or water quality," it must notify the CARU, with the relevant technical information, so that the Commission can determine whether the project may cause any "sensitive damage" to the other party. In the event of a dispute, deadlines are set by the procedural rules of the Statute and grant the party affected the right to apply for additional information, inspect the works, or even suggest changes or modifications to the projects. Should any misunderstandings persist, the Statute recommends direct negotiation between the parties. Should the application fail, after 180 days, any of the parties may refer the case to the Hague-based ICJ, which is the agreed forum for dispute settlement.

The misunderstandings between the neighboring countries began in late 2002, when the Argentine government became informally aware of the possible installation of pulp mills on the left bank of the River Uruguay, in the Fray Bentos region, and called for explanations from the Uruguayan government to provide relevant information. Apparently, according to an Argentine government’s statement, the information provided by Uruguay was incomplete or was not processed through the channels provided under the Statute. The picture did not alter over the next two years, when ENCE (October 2003) and Botnia (February 2005) obtained the respective authorizations to set up their businesses from the Uruguayan environmental authorities.

The dispute deepened in April 2005 due to increasing pressures on the Argentine authorities by the Entre Ríos provincial government and the constitution of the Gualeguaychú Citizens’ Environmental Assembly, coinciding with the increase in social mobilization against the installation of the plants. Accordingly, in May 2005, under the provisions of the Statute, a High-Level Technical Group (GTAN) was set up to find a solution to the dispute through direct negotiations. The GTAN, however, held 12 meetings between August 2005 and February 2006 without the countries reaching an understanding. The Argentine delegation’s final report insisted that Uruguay had violated the rules of the Statute, reiterated its concern over the possibility of environmental damage, and registered Uruguay’s refusal to consider the Argentine proposal to suspend the works until the projects’ accumulated environmental impact, still being examined by the World Bank, had been adequately assessed.

[60] For a more detailed account, see IDB/INTAL (2006).

Over the next two months, there were fresh mobilizations and blockades of roads, until, in early May 2006, Uruguay decided to turn to the MERCOSUR dispute settlement mechanism. Despite claiming losses of US$500 million as a result of the blockade of international bridges, the Uruguayan claim was not for economic damage, but for the Argentine State's failure to take appropriate measures to guarantee the free movement of goods and persons between the two countries, in violation of the Treaty of Asuncion.

The following day, as previously announced, Argentina submitted its claim in the ICJ, arguing that Uruguay had acted unilaterally and violated various provisions of the Statute of the River Uruguay, failing to fulfill both substantive obligations (protecting and preserving the aquatic environment and preventing its pollution) and procedural obligations (authorizing the construction and operation of the two pulp mills without prior notification). The Argentine claim also included an application for a precautionary appeal to suspend the construction of the plants, arguing irreparable social and economic damage.

The Uruguayan suit in the scope of MERCOSUR was processed rapidly. Indeed, under the provisions of the MERCOSUR dispute settlement system, an *Ad Hoc* Tribunal was set up to issue the arbitration award in the period of a few months (September 2006). The arbitrators, in a unanimous decision, partially favored the Uruguayan claim, recognizing that the Argentine government had not taken the due diligence to prevent, manage, or correct the blockades, in violation of the commitment, consubstantiated in the Treaty of Asuncion, to guarantee the free movement of goods and services among the territories of the MERCOSUR States Parties. The Tribunal expressed its understanding of the Gualeguaychú population's sense of alarm, but said that the protests had lost legitimacy with accumulated acts of aggression toward others' rights. The arbitration award also recognized that the blockades "promoted undeniable disadvantages, affecting both Uruguayan and Argentine trade," but rejected Uruguay's request for the Tribunal to rule on Argentina's future conduct in the event of any further blockades. The arbitrators understood that, under the circumstances, it was not legitimate to promote such rulings.

Soon after, the MERCOSUR's Permanent Review Tribunal turned down an Argentine appeal against the arbitration award.

The ICJ then took almost four years to reach its verdict. In July 2006, it issued a first verdict rejecting Argentine's request for precautionary measures designed to suspend construction work on the pulp mills. The ICJ based its decision on the lack of persuasive evidence for imminent or irreparable damage to the environment or to the economic or social interests of the populations living in the vicinity of the River Uruguay. In January 2007, the ICJ adopted a similar decision in response to Uruguayan precautionary measures to prevent the blockades of international roads and bridges connecting the two countries. On this occasion, the Court also concluded with the non-existence of imminent risk or irreparable harm to Uruguay's rights.

Recent developments. The ICJ's decision was announced in April 2010. The Court ruled on three points. Where procedural obligations were concerned, the Court's decision found, by a majority of 13 to 1, that Uruguay had breached the rules laid down in the Statute, imposing an obligation to make prior consultations before granting any authorization for the installation of the plants. The Court's decision emphasized that Uruguay ought to have sent the notifications via the CARU and that it should not have authorized the construction of the plants during the consultation period, thus not respecting the cooperation mechanism envisaged under the Statute of the River Uruguay. The Court found that the explicit recognition of these facts by the tribunal was in itself a satisfactory measure for Argentina.

Regarding the substantive obligations, the Court ruled, by a majority of 11 votes to 3, that no clear evidence had been submitted to the effect that Uruguay had not acted with due diligence, or that the plant's effluent discharges had caused environmental damage or affected the ecological balance since the start of its operations.[61] The Court accordingly found that Uruguay had not failed to fulfill its substantive obligations. It also unanimously rejected other claims by the parties, including Argentina's request for it to rule on the relocation of the UPM (former Botnia) plant, provided the dismantling of the plant would not, from the Court's point of view, constitute an adequate solution to the failure to comply with procedural obligations.[62] Finally, the Court urged the parties to continue to cooperate in the framework of the CARU and to allow it to exercise its powers to monitor the quality of the river.

The Court's decision came 50 days after the swearing-in of new Uruguayan president, José Mujica, and facilitated the resumption of bilateral dialogue. Nevertheless, in addition to the two presidents' decisive involvement, four meetings were needed with the submission of proposals and counterproposals in order for the River Uruguay joint monitoring agreement to be concluded and signed by the end of July 2010, on the eve of the San Juan Summit,.

The agreement signed by the presidents established: (i) the setting-up, under the CARU, of a scientific committee composed of two scientists from each country to monitor the River Uruguay and any industrial or agricultural establishments, or urban centers that discharge their effluents into the river and its areas of influence; (ii) the responsibility of both countries' environmental authorities to collect duplicate samples on their respective sides of the river and deliver them immediate to the scientific committee; (iii) the setting of a maximum 12 (twelve) times a year for the monitoring of each establishment, starting with the monitoring of the UPM plant and the confluence of the Gualeguaychú and Uruguay Rivers; and (iv) the publication of the results of the monitoring and their submission to the CARU authorities for the implementation of any relevant measures or actions.

In September 2010, the two countries appointed their representatives for the scientific committee and it was estimated that the findings of the first monitoring might only be published in November that year.

Final considerations. *MERCOSUR Report No. 11*, published at the end of 2006, stated that the erosion promoted by the "pulp mill" dispute was excessive and that it could be considered, at least in part, as a symptom of the weaknesses and shortcomings that characterize MERCOSUR. That assessment remains valid.

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[61] It is worth drawing attention to the joint dissenting vote of two judges, expressing a more favorable stance over Argentina's allegations, which refer to substantive obligations. Indeed, the judges' votes claimed that the Court had missed a unique opportunity to show the international community its capacity and preparedness to tackle complex scientific disputes, using the most advanced knowledge available. According to them, this was an exemplary case of Environmental Law, involving alleged cross-border pollution. The judges felt the Court had assessed the scientific evidence presented with a defective methodology and forced to Argentina to bear the burden of proof. According to the judges, the Court ought to have sought the advice of experts in the field, as is done in other international organizations, like the WTO. Last, the judges also questioned the insufficient link-up between procedural and substantive obligations, since respect for procedural obligations in this area takes on considerable importance and can be a vital indicator of the violation or non-violation of the substantive obligations.

[62] As reported by the ICJ, April 20, 2010: *The Court considers that "its finding of wrongful conduct by Uruguay in respect of its procedural obligations per se constitutes a measure of satisfaction for Argentina" (Para. 269). It is the Court's view that ordering the dismantling of the Orion (Botnia) mill would not constitute an appropriate remedy for the breach of procedural obligations, since Uruguay was not barred from proceeding with the construction and operation of the mill after the expiration of the period for negotiation and since it breached no substantive obligation under the 1975 Statute (Para. 275).*

The Report noted shortcomings in three areas. First, it highlighted the MERCOSUR member countries difficulties had agreeing a common policy to attract foreign investment. Two facts were highlighted to support the idea that competition over attracting foreign investments was an important ingredient in the dispute,: first, the adoption of standards to attract investment by Entre Ríos Province in 1990, specifically targeting the paper pulp sector; second, Uruguay's reluctance to provide the information requested by the Argentine government in the scope of the CARU, which only could be understood as an expression of fear in the event of its neighbor lodging objections that might delay or render non-viable large-scale foreign investment resulting from an explicit government policy launched in the 1980s. The ICJ's unanimous ruling, stressing the Uruguayan authorities' failure to comply with its procedural obligations in the scope of the CARU, seems to support that assumption.

The second shortcoming highlighted in *MERCOSUR Report No. 11* referred to the weakening of MERCOSUR as a natural forum for defining the dispute in the political arena. Uruguay attempted to bring the dispute within the scope of MERCOSUR, but Argentina's rejection was full-on. It consistently insisted on the bilateral nature of the dispute, refusing to admit the mediation of Brazil and weakening its leadership.

The third shortcoming involved the fragility of the rules and institutions governing MERCOSUR, whose credibility is called into question by the mistrust permeating the attitude of the member countries themselves whenever these rules and institutions have to be put into action. *MERCOSUR Report No. 11* accordingly highlighted the validity of the Framework Agreement on the Environment, as well as the existence of a system of dispute settlement and a Permanent Review Tribunal, which could have been activated to settle the dispute. While Argentina's decision to refer the dispute to the ICJ was entirely legitimate, being provided for in the 1975 Statute of the River Uruguay, it nevertheless said a good deal about the bloc's institutional limitations.

Last, it is worth nothing that the settlement of the dispute has been achieved through diplomatic and political channels, and that it required the direct and decisive participation of the presidents of Argentina and Uruguay. It should be remembered that the decision of MERCOSUR's *Ad Hoc* Tribunal had little relevance and, moreover, the ICJ's verdict did not provide a definitive resolution to the dispute, for all that it had the merit of urging the parties to seek a solution to their differences based on the negotiating and dialogue mechanisms provided for in the Statute of the River Uruguay. A diplomatic and political solution was, therefore, the only one remaining. And, this time, presidential diplomacy was effective, unlike recent experience, when it was not only ineffective, but indeed amplified the tension and volume of the dispute.

Quota management

The GMC (Resolution No. 31/10) approved adopted the Quota Management and Distribution System Granted to MERCOSUR by Third Countries or Groups of Countries (SACME). The System aims to manage and distribute quotas granted to MERCOSUR in trade agreements concluded with third countries or groups of countries, ensuring transparency, security, and publicity via a computer program that allows access to updated data on the use of quotas and their surpluses.

The same Resolution approved the distribution of quotas for MERCOSUR's Agreements with Colombia and Israel.

Framework Cooperation Agreement for the Creation of Joint Transnational Illegal Network Investigation Teams

The MERCOSUR member countries, and the Associated States of Bolivia, Ecuador, and Colombia signed the "Framework Cooperation Agreement for the Creation of Joint Investigation Teams" establishing a cooperation instrument for the formation of teams to investigate transnational illegal networks. CMC Decision No. 22/10, approving the text of the Agreement, defines these illegal networks as drug-trafficking, corruption, asset laundering, people trafficking, migrant trafficking, arms trafficking "and all those making up so-called international organized crime, as well as acts of terrorism".

Under this agreement, a country's competent authorities responsible for a criminal investigation may apply to another signatory country's competent authorities to have a Joint Investigation Team (ECI) set up whenever the wording or scope of the investigation recommends it. The JIT will have the power to act within the territories of its constituent countries, but its creation will have to be preceded by the signing of a specific cooperation instrument. Unless otherwise agreed, the costs incurred by the investigation will be covered by the applicant country. In the event of a country choosing to refuse an application to participate in a JIT, the refusal must always be substantiated.

The Guaraní Aquifer Agreement

At San Juan, the MERCOSUR States Parties signed the Guaraní Aquifer Agreement, negotiations for which had begun in 2004. The signatory countries each have a given percentage of the aquifer in their territories, the most significant stretch of which, around 850,000km², is in Brazil. As the world's largest transboundary aquifer, with a total extension of 1,196,500km², according to Rebouças (2004), the need for multilateral regulation was deemed urgent.

According to Medeiros (2010), the above agreement, a result of the Environmental Protection and Sustainable Development of the Guaraní Aquifer System Project, was based on Resolution No. 63/124 of the United Nations General Assembly on the Law of Transboundary Aquifers and on Resolution No. 1803, again by the General Assembly, on permanent sovereignty over natural resources.

The Agreement contains just 22 articles. In Articles 1 to 3, the four MERCOSUR countries affirm their absolute sovereignty over resources for the Aquifer, an aspect of the utmost importance, as provides legal protection for the region from any outside interference that may arise in the future. Furthermore, Articles 9, 10, and 11 deal with the establishment of a mechanism of checks and balances for any measures that may adversely affect the Aquifer's resources in any of the States Parties. The States Parties may, therefore, request information from other States Parties, when they feel that measures adopted by any of them may cause significant harm. Such information may include any available technical data, with the results of an assessment of the environmental effects. Article 12 stipulates that the parties establish cooperation programs with the aim of expanding technical and scientific knowledge about the Guaraní Aquifer System, promoting information exchange on management practices, as well as developing common projects (Medeiros, 2010).

Article 15 of the Agreement envisages the creation of a Commission, based on Article VI of the 1969 Treaty on the River Plate Basin, whose objective will be the coordination of the cooperation efforts to implement the Agreement's objectives and principles. Any disputes are to be resolved through negotiations, at the end of which, in the event of there being no agreement, the Commission may, at the parties' request, assess the situation and make recommendations.

As a complement to Article 15, Article 19 provides for the development of an arbitration procedure for dispute settlement in an additional protocol to the Agreement. Such a procedure, however, has not yet come into existence. Article 20 stipulates that reservations to the Agreement are not admitted and, last, Article 22 states that the parties may terminate the Agreement, but the complaint shall only take effect one year after notification is received and on the proviso that "the complaint shall not exempt the Party that formulates it from obligations in disputes provided for in the present Agreement".

The Agreement was accompanied by a joint declaration from the MERCOSUR presidents, in which they stressed the importance of the Aquifer, which they consider one of the main reserves of freshwater in the world.

E. Final Considerations

The balance of the recent San Juan Summit is undeniably positive. Indeed, the PPTA can congratulate itself on some progress over issues on the internal agenda, which had been on the list of priorities of the MERCOSUR member countries for over two years. In some cases, however, the results were less significant than originally claimed: the elimination of double CET levying, as well as the establishment of a customs revenue distribution mechanism are issues still lacking more precise definition. Some general principles were agreed upon, but resolution of the more complex issues was again postponed. And the new schedule is uncomfortably wide-ranging.

In the case of the CAM, a more definitive assessment will only be possible after the six-month period envisaged for the implementation of consultations and negotiations among member countries with the aim of ensuring effective and efficient implementation in their respective legal systems. The opinion of customs experts will also be relevant, given the high number of provisions that require the approval and validity of regulatory standards.

The most positive results were seen in the field of the FOCEM. The number of projects approved at San Juan underlines well-focused initiatives of real importance. It is important, however, for the amount of resources actually disbursed to also reach significant values, and it is important, in this respect, for the member countries to expedite their tender mechanisms and internal procedures.

The resumption of more fluent political dialogue among MERCOSUR member countries is probably the most positive balance of the San Juan Summit. The direct involvement of presidents deserves highlighting too: this time round, the political investment was truly effective.

There are many standout issues on MERCOSUR’s internal agenda: eliminate exceptions, agreeing common import regimes, promoting effective liberalization of trade in services, setting the criteria for effective elimination of double CET levying, establishing the customs revenue distribution mechanism, and, above all, strengthening technically and improving the quality of the bloc’s institutions. Shortening deadlines and promoting effective progress in these areas are certainly the main challenges ahead.

CHAPTER IV. SECTORAL DISPUTES AND THE TRADE ENVIRONMENT

A. Overview

The major impacts of the international economic crisis were felt in the MERCOSUR countries' exports. The contraction of international demand for the bloc's products, coupled with the shortage of international credit lines for companies, had a negative and widespread impact on the region's export performance. Consequently, the region's economies used a varied range of economic policy measures to attempt to cushion the impact of the sharp fall in foreign demand.

Paraguay and Uruguay concentrated their measures on increasing public spending (especially investments in infrastructure in Uruguay's case), tax relief to encourage private investment, and expansion of the credit supply to small and medium enterprises. In general, the two countries did not deploy import protection measures, not least because the performance of their respective balances of payments was positive.

In Brazil, falling external sales were aggravated by financial problems in some large exporter companies taken by surprise by the sudden devaluation of the exchange rate and suffering heavy losses in forward markets. In Argentina, the fall in prices and export volumes stepped up the movement of net capital outflow. However, this did not destabilize the external sector.

Three key elements pointed to the way out of the crisis for Brazil: the public credit expansion policy, the relaxation of fiscal policy, involving tax cuts in industrial sectors applied to the production of consumer durables, and the impulse provided by the internal market and founded on maintaining workers' real wage levels. More frequent trade defense measures only began to appear in Brazil from the second trimester of 2010.

In Argentina, the range of countercyclical measures included plans for public works, steering credit toward consumption, and cutting taxes in labor-intensive sectors. Defensively geared trade policy also played an important role. The pre-crisis policy of regenerating the industrial base gained new momentum, partly explaining the deepening of trade disputes within MERCOSUR in the first semester of 2009, since import control measures were also applied to the bloc's partners.

The second semester of 2009 remained a period of controls and sectoral difficulties, especially between the two largest partners. But the atmosphere of recovery from the crisis and the good prospects for economic growth allowed the MERCOSUR countries to start 2010 in a climate of improving trade relations, as a look at the figures for the evolution of intrabloc trade will show. Furthermore, as discussed in Chapter I, between the second semester of 2009 and the first of 2010, the strong movement toward the recovery of activity levels in the more recent period contributed to the design of a scenario more conducive to the development of economic and trade relations within MERCOSUR.

Table 20 compares the evolution of intra-MERCOSUR exports over the last four years using accumulated data for January-June. According to these figures, intrazone trade has already virtually recovered its pre-crisis levels.

Table 20. Intrazone exports in MERCOSUR, accumulated January-June of each year

Billions of US$

Year	Exports
2007	14.193
2008	20.019
2009	13.914
2010	19.857

Note: 1 - FOB Values.

Source: ALICE-web MERCOSUR/MDIC, Brazil.

Considering the scale of Brazil-Argentina trade, Argentina again occupied poll position in both exports and imports in the rankings of Brazil's main partners, only surpassed by China and United States. Argentina's share in total Brazilian exports made progress, with the predominance of industrialized products in both directions. In the first semester of 2010, sales to Argentina accounted for 8.8% of total Brazilian exports to the world, whereas, in the same period in 2009, they accounted for 7.6%. Argentina's market share in Brazilian imports for January-June was 8.2% in 2010, and 8.9% in 2009.

Brazil's share in Argentina's foreign trade has traditionally been significant. In the first six months of 2010, the country's market share in Argentine imports was 31.3%, as against 28.8% in 2009. In parallel, Brazil's position in Argentine exports was stronger. In January-June 2010, Brazil's share of Argentina's total exports was20.9%, whereas, in 2009, it was 17.8%.

Characterized by the expansion of bilateral flows and the construction of a positive agenda geared to "production complementation", this situation certainly helped to lessen the burden of trade disputes in the two countries' relations. The move toward more integrated production chains is gaining ground within MERCOSUR institutions and the Brazil-Argentina Bilateral Commission,[63] while also gathering a natural momentum with the expansion of Brazilian investments in Argentina in the recent period. These investments follow a general trend of internationalization in Brazilian companies and emerge as an alternative to cope with the difficulties of growing Brazilian exports to Argentina as a result of the sectoral dispute. Brazilian investments in sectors like textiles and footwear helped to mold a new pattern of production, and have influenced the resolution of trade issues between the partners.

Another factor in the MERCOSUR partners' agglutinating interests is due to China's growing importance in world—and especially MERCOSUR—foreign trade. The advance of China's share in extrazone trade flows is a leitmotif in the region's agenda of concerns. The predominance of commodities and semi-manufactured goods in exports, and of high value-added products in imports, affects Argentina and Brazil in the same way, giving rise to claims and demands for antidumping measures from both countries' traditional industry sectors.

[63] Commission for monitoring trade relations between MERCOSUR's two main partners.

B. The Role of Trade Administration Measures

2009 was marked by the high number of trade disputes between Brazil and Argentina. In trade administration measures taken as a whole, "voluntary export agreements"[64] had played an important role in containing Argentine imports from Brazil. Negotiation and implementation difficulties, however, demonstrated the instrument's obsolescence for certain sectors of the industry, e.g. white line goods (stoves, refrigerators, and washing machines) and paper, which suspended their respective voluntary agreements. On the other hand, the footwear sector signed a new agreement in June 2009, valid for 2009 through 2011, to reduce export volumes by 17% by 2008. Other sectors, like powdered milk, and brakes and clutches, also tried this channel of understanding in order to ensure a speedy release from NAL.

Before the pressures caused by the economic crisis and the concern over any adverse impacts from the evolution of the bilateral real exchange rate (there was a telling devaluation of the Brazilian real between late 2008 and early 2009), the Argentine government stepped up the approval of "non-automatic import licensing", thus comprehensively affecting Brazilian exports.

Non-automatic import licensing

Over 2009, NAL began to fulfill a role as a containment instrument for Argentine imports, as shown in the high number of settlements issued by the Production Ministry, and the Industry and Tourism Ministry.[65]

From the start of 2009, sectors like furniture, cutlery, harvesters, tractors, optical scanning discs, and tires appeared on the list of products subject to NAL, an instrument that had long been extended to footwear, toys, and paper. The bilateral trade dispute created by the adoption of NAL reached high levels of tension in July 2009, and the claims of the sectors of Brazilian industry concerned prompted frequent meetings between the two countries' trade officials.

In the second semester of 2009, use of the instrument became even more intense, with the inclusion in the regime of 135 products, such as natural and artificial yarns and fabrics, iron or steel tubing accessories, tools and cutlery, electric fans, wallpaper, wood veneers, blenders, and batteries. By the end of 2009, NAL affected 412 8-digit NCM positions. Considering Argentina's imports from the world, this group of products represented 7.3% of total purchases that year.

Brazil and China were the main targets of Argentine NAL. Imports of products subject to NAL from Brazil represented 10.5% of the country's total imports in 2008, and 8.5% in 2009; in China's case, the shares were 19.3% and 17.0% for the same two years (Table 21).

[64] "Voluntary restraint agreements" are understandings between private sectors aimed at voluntarily limiting exports of certain products to the partner country's market via requests to the competing internal sectors. There is no commitment between governments; only the discussion of suitable quotas in the sphere of the Brazil-Argentina Bilateral Commission. These instruments are not recognized by the WTO, but have been used to support negotiated solutions to trade disputes between Brazil and Argentina, also backing up government commitments for the swift release of NAL on imports.

[65] Ministry of Production Resolutions Nos. 26/2009, 61/2009, 121/2009, 123/2009, 139/2009, 165/2009, 251/2009, and 337/2009, and Ministry of Industry and Tourism Resolutions Nos. 13/2009 and 24/2009.

Table 21. Argentine imports: products subject to NAL

Billions of US$

Period	Products	Argentine imports								
	NAL *	World			Brazil			China		
		Total	NAL Products	*% share*	Total	NAL Products	% share	Total	NAL Products	*% share*
2008	412	57.462	4.914	*8.6*	17.687	1.855	*10.5*	7.104	1.374	*19.3*
2009	412	38.781	2.838	*7.3*	11.819	1.007	*8.5*	4.823	819	*17.0*
January-June										
2008	412	28.178	2.376	*8.4*	8.670	0.918	*10.6*	3.245	0.639	*19.7*
2009	412	17.367	1.323	*7.6*	4.954	0.430	*8.7*	2.125	0.410	*19.3*
2010	412	24.803	1.622	*6.5*	7.760	0.608	*7.8*	2.901	0.450	*15.5*

Note: * The product vector for the gathering of import data refers to NAL products in December 2009, unaltered in 2010.

Source: (a) NAL: Table of NCM stock with NAL in September 2010, Industry Ministry webpage/Argentine Subsecretariat for Trade Policy and Administration: *http://www.comercio.gov.ar/web/index.php?pag=93&btn=161#lic_no_aut*
(b) Trade: Compiled by NEGINT/CNI based on information from WTA.

As mentioned earlier, a significant number of products was added to the NAL list in the second semester of 2009, especially in Brazilian exports. The conclusion is that, from Argentina's point of view, NAL was "necessary". The import levels of these products from Brazil could be even higher, had the measures not been adopted.

The Brazilian government's reaction to claims by the industrial sector over Argentina's move to expand the number of products under the NAL regime was, for some time, one of caution. In October, after countless bilateral meetings—including at ministerial level—the Brazilian government adopted similar measures to tackle the issue by targeting Argentine agribusiness perishables. In the absence of a solution to reestablish clear and predictable rules for trade in the scope of the Brazil-Argentina Bilateral Commission, the reaction was channeled into a list of products, including such perishables as apples, pears, garlic, wheat flour, etc.

With truckloads of perishables being held at the border (*O Estado de São Paulo*, 2009), official understandings evolved to include a more fluid release from licensing in both senses. At the end of 2009, Argentine NAL on Brazilian exports was being eased and the Brazilian government lifted deductions at the border.

In 2010, there are no records of any fresh NAL. December's stock remained the same, with no products being included in or withdrawn from the regime. Nevertheless, the recent evolution of Argentine imports was highly favorable to Brazil. NAL affected 7.8% of imports from Brazil and 15.5% of those from China in the first semester of 2010.

Table 22 shows the evolution of imports from Argentina (the first semester of 2010 against the first semester of 2009), differentiated by origin (world, Brazil, and China), and subdivided into products affected and not affected by NAL, as well as the total. The growth of Argentina's imports from Brazil (56.6%) is higher than the country's total import growth (42.8%). Argentine purchases of products from Brazil not subject to NAL climbed more steeply (58.0%) than imports from the world of the same group of products (44.5%). Total purchases of products affected by NAL were up 22.6%, and those from Brazil by 41.4%.

Meanwhile, Argentina's imports from China grew less than its total imports. Imports not affected grew by 42.9%, still below Brazil's, but those subject to the NAL regime grew just 9.7%. In this very different scenario to the one in the first semester of 2009 (characterized by a drop in Argentina's imports from the world and from its two partners against the first semester of 2008), the most intense effects of licensing appears to be on Argentina-China trade, while there are signs of relaxation in the Argentina-Brazil sphere.

Table 22. Evolution of Argentine imports by products affected and not affected by NAL

Percentage changes accumulated over same period last year
(1st semester 2010-1st semester 2009) as %

2010/2009	Imports from Argentina by product		
	Not affected by NAL	Affected by NAL	*Total*
World	44.5	22.6	*42.8*
Brazil	58.1	41.4	*56.6*
China	42.9	9.7	*36.5*

Source: (a) NAL: Table of NCM stock with NAL in September 2010, Industry Ministry webpage/Argentine Subsecretariat for Trade Policy and Administration: *http://www.comercio.gov.ar/web/index.php?pag=93&btn=161#lic_no_aut*
(b) Trade: Compiled by NEGINT/CNI based on information from WTA.

Although it is impossible to say how much Brazilian exports of affected products might grow if fully released, NAL's protectionist role in Brazil-Argentina trade seems to have eased somewhat over 2010 compared to the previous year.

Trade defense measures

The set of antidumping, countervailing, and safeguard measures represents another mechanism that affects bilateral relations between MERCOSUR's two largest partners, but generally with less coverage and fewer political implications than import licensing.

Table 23 shows a comparison between the number of such measures adopted by Brazil and Argentina in relation to their partner and to China.

Table 23. Brazil and Argentina: imported products subject to trade defense measures January-June 2010

Millions of US$

Argentina						
Partner	Total		Defense (144 products)			% share
	No. of products	Value	No. of products	No. of products with trade	Value	
Brazil	7,959	7,759.6	30	30	47.8	0.62%
China	7,376	2,900.8	85	79	67.5	2.33%

Table 23 (CONTINUED)

Brazil						
Partner	Total		Defense (95 products)			% share
	No. of products	Value	No. of products	No. of products with trade	Value	
Argentina	2,348	6,711.9	2	2	3.6	0.05%
China	5,413	10,762.4	71	60	308.6	2.87%

Source: Compiled with information from MDIC and WTA.

Argentina applies trade defense measures (including antidumping and countervailing duties, safeguards, and price commitments) to a group of 144 NMCs in positions valid to July 7, 2010, not counting repetitions of products in cases of ongoing investigation against different countries with different measures.

In 2009, 107 products were subject to these measures, again, not counting repetitions. This is a reflection of the momentum of trade defense measures throughout 2009, especially in the second semester, following the world trend toward the expansion of protectionism.

An anatomy of the first semester of 2010 shows that these measures affect 30 Brazilian and 79 Chinese products. Chinese products have been the main focus of Argentina's trade defense measures. Sales of products subject to the regime represent 2.3% of Argentina's imports from that country.

Where the other MERCOSUR partners are concerned, the Argentine measures affect two Uruguayan export products: trays and ceramic sanitary ware. The antidumping measure on the latter product, which also affects Brazil and was under review, was renewed in June 2010 for five years.

In 2010, Brazil had a total of 95 NCM positions subject to this system, as against 93 in 2009. Measures targeting Argentina were implemented in just two products, the main target being imports from China. This behavior was virtually the same as in previous years. The products affected by trade defense measures in January-June 2010 represent almost 3% of Brazil's imports from China and have an insignificant share of Argentina's purchases.

The "criterion value" regime

In terms of prices, the "criterion value" system (a measure applied by Argentine Customs since 2005) has also prompted discussions within the Brazil-Argentina Bilateral Commission. It involves a benchmark price defined by the supplier country for selected imports under the NCM, and other technical details. Countries exporting products to Argentina under the regime fall into 26 different groups, including the MERCOSUR partners.

This instrument requires twice the amount of taxes affecting the release of imports to be collected, including value-added tax (VAT) and the "income tax advance", when the price applied by the operator is below the one defined by the customs authority. The mechanism makes access to the Argentine market difficult insofar as "values" for the same products often differ according to the origin of the merchandise, differentiated in groups of countries. So, for example, the MERCOSUR countries, along with Chile, Colombia, and Ecuador, make up

Group 1 (GR1), together with other countries. China alone makes up Group 4 (GR4), while also being part of other groups. Group 8 (GR8) includes Korea, Indonesia, India, etc.

Below is an example of two products whose "criterion values" are set at the highest level when they are from MERCOSUR countries (GR1), as compared to other origins, like China (GR4) or Korea (GR8):

- 1604.13.10 *Sardines in oil*. 1.75 (US$ FOB value) Kg. GR1 NE91/08.
- 1604.13.10 *Sardines in oil*. 1.73 (US$ FOB value) Kg. GR4 NE91/08.
- 8516.40.00 *Electric iron with generating device*. 9.00 (US$ FOB value) 1 GR1 NE 100/08.
- 8516.40.00 *Electric iron with generating device*. 8.00 (US$ FOB value) 1 GR8 NE 100/08.

The potential diversion of trade caused by the instrument has been discussed in the Brazil-Argentina Bilateral Commission, and with the other two MERCOSUR partners, particularly Uruguay. Brazil also applies a "minimum price" system that is compulsory—i.e. importation is not authorized below the limit—but this targets primarily imports from Asia and is not applied to purchases from other origins.

Table 24 shows the greater impact of the "criterion value" mechanism on Argentina's imports from China. Purchases of products affected accounted for 17.0% of Argentina's imports from China in 2009, as against less than 2.0% of imports from Brazil. A comparison of the first semesters of 2009 and 2010 shows similar situations.

Table 24. Argentine imports: products subject to the "criterion value" regime

Millions of US$

Years	World		Brazil	China	Criterion value					
					Brazil			China		
	No. of products	Value	Value a	Value b	No. of products	Value c	% share c/a	No. of products	Value d	% share d/b
2009	8,692	38,781	11,819	4,823	53	137	1.16	240	819	17.0
January-June										
2009	7,503	17,367	4,954	2,125	54	54	1.08	240	368	17.30
2010	7,554	24,803	7,760	2,901	54	119	1.53	240	413	14.23

Source: Compiled from information of WTA.

C. Summary of the Main Sectoral Trade Disputes

The main sectoral issues involving the MERCOSUR countries are in the area of trade relations between Brazil and Argentina, specifically disputes involving the smaller partners. The main sectors affected are textiles (yarns, fabrics, and garments), footwear, white line electrical goods, paper, tires, and furniture. There are also Brazilian measures that affect Argentina and Uruguay in the dairy sector.

Textiles

The textile sector has been the main target of Argentina's NAL and "criterion value". Many products had already been included in the NAL regime since 2007, but the sector has been more extensively affected from 2009. Two resolutions by the Production Ministry[66] in the first semester of 2009 and two in the second semester[67] led to the sector being affected in 116 NCM items in textile products and 83 positions in yarns and fabrics.

Table 25 shows import data for items subject to NAL and criterion value. A look at the data from 2008 and 2009 shows Brazil's loss of share in Argentine imports (with NAL and criterion value) to China. The issue of trade diversion was on the discussion agenda of the Argentine and Brazilian authorities and business communities for many months.

In the biannual assessment, the situation is the reverse. The first months of 2010 show an improvement in Brazil's market share in imports of these products (with NAL and criterion value) at the expense of China. This evolution is explained by the more favorable treatment granted to products from Brazil in terms of NAL release in the recent period.

Table 25. Argentine textile and clothing imports, NCMs relating to products under NAL and "criterion value"

Millions of US$

Countries	Years				January-June			
	2008		2009		2009		2010	
	Value	% share	Value	% share	Value	% share	Value	% share
Brazil	296	31.5	163	25.4	78	23.7	84	27.2
China	277	29.4	210	32.9	118	35.8	94	30.2
Others	368	39.1	267	41.7	133	40.6	132	42.6
Total	*941*	*100.0*	*640*	*100.0*	*329*	*100.0*	*310*	*100.0*

Source: INDEC.

Footwear

The footwear sector was for years the target of several "voluntary export agreements". These agreements proved rather difficult to manage at various different times, according to each country's sectoral bodies. At the end of the first semester of 2009, an agreement was signed to reduce the volume exported in 2008 by 17.0%, valid for 2009-2011 (corresponding to annual Brazilian exports of 15 million pairs).

The sector is widely covered by import licensing in Argentina as a means of supporting the control system via "export agreements". However, release from licensing was stepped up in the closing months of 2009. This did not prevent Brazilian exports falling below the level agreed for the year.

[66] MP 26/09, 61/09, 123/09.
[67] MP 251/09 and Ministry of Industry and Tourism Resolution 13/09.

Table 26 shows that, in 2009, Brazilian exports stood at almost 14 million pairs. Brazil's market share fell gradually over the three years from 2007 to 2009, while other countries' shares, especially China's, were up. Argentina opened an antidumping investigation against Chinese footwear in July 2009.

Table 26. Argentine footwear imports

Millions of US$ and millions

Countries	Years									January-June		
	2007			2008			2009			2010		
	Value	Pairs	% share pairs	Value	Pairs	% share pairs	Value	Pairs	% share pairs	Value	Pairs	% share pairs
Brazil	180	18.2	62.3	201	18.5	59.5	149	13.9	57.2	62	3.7	46.8
Others	100	11.0	37.7	126	12.6	40.5	121	10.4	42.8	54	4.2	53.2
Total	*280*	*29.2*	*100.0*	*327*	*31.1*	*100.0*	*270*	*24.3*	*100.0*	*116*	*7.9*	*100.0*

Source: INDEC.

Electrical white line goods

This sector has been included in the NAL regime since 2004. However, for years, understandings between private sectors have been enough to manage the flow of trade. Brazil traditionally holds poll position in the list of Argentina's suppliers. Attempts at recent understandings (2009) toward a "voluntary restraint agreement" have been unsuccessful, and the Brazilian private sector is still demanding greater flexibility in NAL release.

Looking at the trade data for the first semester of 2010, it can be seen that Chinese imports were up from US$4.5 million to US$7.9 million over the same period in 2009, an increase of over 75%. The growth of Brazilian sales was meager, but the level of trade is far higher than China's.

Table 27. Argentine imports of white line appliances January-June each year

Millions of US$

NCM		2009				2010			
		Brazil	China	Others	*Total*	Brazil	China	Others	*Total*
73211100	Stoves	3,014	100	846	*3,960*	1,767	62	241	*2,070*
85166000	Electric stoves	1,563	2,863	3,949	*8,375*	1,432	5,818	3,628	*10,878*
84183000	Freezers	1,817	8	50	*1,875*	1,310	1	3	*1,314*
84501100	Washing machines	5,052	1,142	5,739	*11,933*	4,546	1,978	6,792	*13,316*
84182100	Refrigerators	2,477	364	57	*2,898*	1,484	32	2	*1,518*
84181000	Refrigerators	26,326	71	4,133	*30,530*	30,667	1	3,727	*34,395*
Total		*40,249*	*40,249*	*4,548*	*14,774*	*59,571*	*41,206*	*7,892*	*14,393*

Source: INDEC.

Wooden and plastic furniture

The furniture sector was incorporated in the NAL regime in 2009. In the first semester of that year, the sector was one of the main issues in the meetings of the Brazil-Argentina Bilateral Commission, which sought an understanding to accommodate Brazilian private sector demands.

NAL had the desired effect, limiting trade in the sector, especially in plastic furniture. A "voluntary restraint agreement" was signed in mid-2009, aiding the recovery in Brazilian sales and encouraging regular NAL release in the sector.

The delay in releasing NAL on wooden furniture is still a cause of claims from the Brazilian private sector. In 2010, the Argentine government established the adoption of "criterion value" in furniture and plastic chair imports via General Resolution 2,781 of 26/2/2010.

Dairy Products

Argentina and Uruguay's claims for greater openness in the dairy sector target Brazil, which has been protecting the sector since 2001. In that year, Brazil began to protect the dairy industry by imposing a minimum price for powdered milk imports from Argentina.

International dairy prices rose in 2003, rendering this measure harmless. Prices fell with the global crisis of 2008, but the international price remained above the minimum imposed by Brazil. In 2009, with falling Brazilian production and rising internal consumption, there was a major expansion of Brazilian imports from Argentina and Uruguay, provoking a reaction from the Brazilian dairy sector.[68]

Brazil started applying NAL on Argentine imports, and a "voluntary restraint agreement" was signed in June 2009. Such an understanding was not possible with Uruguay. Brazil went on to adopt a 10,000-tonne quota for imports from Uruguay up to the end of that year.

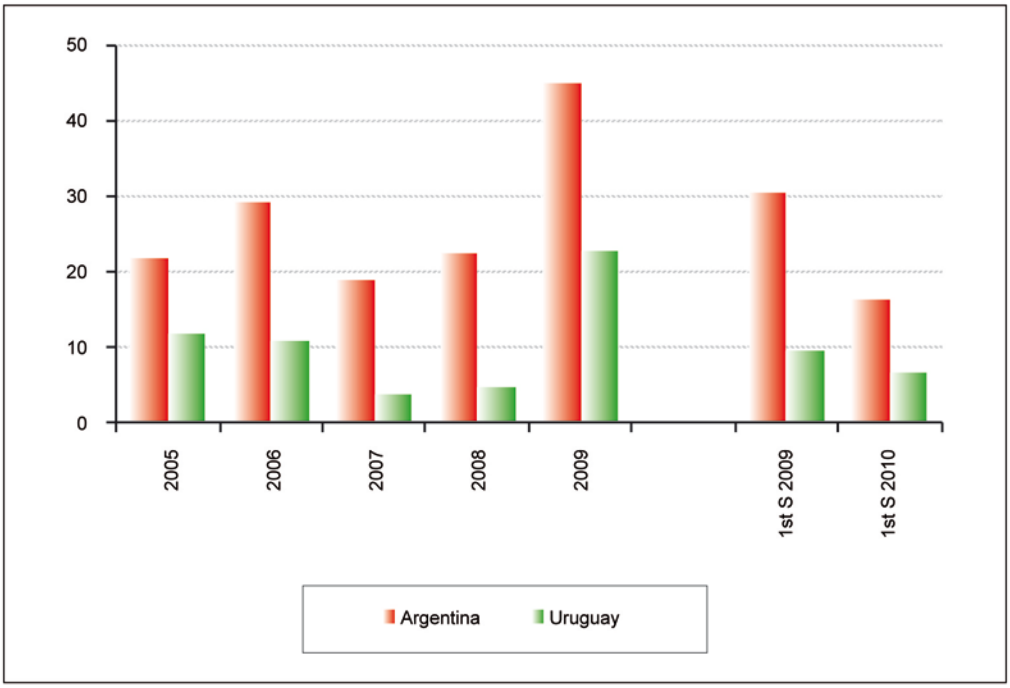
In April 2010, another "voluntary restraint agreement" was signed with Argentina for a further year, starting in May 2010, for around 3,300 tonnes per month. The two countries are working toward parallel economic complementation in the dairy industry with meetings of the Dairy Production Integration Board. Uruguay obtained a modification of the import regime from Brazil, by adopting automatic licensing without quotas, in return for releasing the entry of Brazilian chickens to the Uruguayan market.

Brazilian imports of this product in the first semester of 2010 were down on the same period a year earlier. Graph 27 shows the annual behavior of Brazilian purchases from its MERCOSUR partners in 2005 to 2009.

[68] This year, Brazil produced 473,000 tonnes of powdered milk, 17.3% down on the previous year, despite the fact that internal consumption has reached 525,000 tonnes, 2.5% up. The shortfall was covered mainly by imports from Argentina and Uruguay. Products from those countries provided 8.6% and 4.3% of the Brazilian market respectively, sharply up on their share in 2008 (4.4% and 0.9%).

Graph 27. Brazilian powdered milk imports

Thousands of tonnes



Source: ALICE-web.

Other sectors

The paper sector has been targeted by NAL since 1999. The latest positions in the sector entered the regime in 2008 and cover 17 positions in NCM Chapter 48. The sector successfully established "voluntary restraint agreements", which are renewed and administered by private bodies.

The tire sector first joined the NAL regime in January 2009.[69] The sector's positions[70] display intraindustrial-type behavior in trade. Brazilian exports to Argentina were higher than imports, but, under NAL, trade almost found an equilibrium. Brazilian companies submitted their list of NAL retained for deadlines of over 60 days to the Brazil-Argentina Bilateral Commission. However, in January-June 2010, Brazil's sales were once again up on Argentina's compared to the same period a year earlier.

The CCM minutes for May 2010 still feature the adoption of prior import licensing by Paraguay on personal hygiene products, cosmetics, and perfume. This issue was first brought up by Argentina as consultation to Paraguay at a CCM meeting in November 2009.

[69] MP Resolution No. 26/09.
[70] Especially positions 4011.10.00, 4011.20.90, 4011.61.00, 4011.92.10, and 4011.92.90.

D. Closing Remarks

The trade disputes agenda displayed cyclical behavior in the period under analysis. The second semester of 2009 saw deepening tensions and trade disputes in the wake of the economic crisis and the expansion of import control measures in Argentina. The first semester of 2010, however, was marked by the recovery of the bloc's economies, favoring the expansion of intra-MERCOSUR trade flows.

As pointed out in the introduction to this chapter, intrabloc trade in the first semester of 2010 practically returned to levels prior to the global financial crisis at the end of 2008. Although the controls remain active, the expanding business environment is solely responsible for the easing of pressures and the creation of a more positive atmosphere between the partners.

This stage of lower tension in trade and greater mutual understanding—which is not to say there were no commercial claims in daily trade—appeared, in 2010, to create a window of opportunity for the development of a positive agenda. The issue of "production complementation" is high on the Argentine agenda within the bloc and was submitted for discussion to the GMC and the Brazil-Argentina Bilateral Commission.

In more traditional sectors accustomed to trade administration, like textiles and footwear, there has to be debate about the "China factor" and domestic restructuring programs to enhance efficiency and competitiveness. Brazilian investments have to have a bearing on a new production set-up and help to overcome trade disputes in these areas.

The main sectors targeted by production complementation programs and projects are: auto parts, agricultural machinery, oil and gas, aircraft, wood and furniture, white and brown line goods, wines, and dairy products. Leaving aside the two oil and gas complexes, and aviation, which have Brazilian proposals to integrate the bloc's partners in their respective "value chains" with investments planned in Brazil, the others involve sectors also affected by trade disputes.

In reality, the expansion of Brazilian investments in partner countries has helped to create an environment conducive to a discussion on "production complementation". The climate of economic growth in 2010 has also helped to overcome the recent economic difficulties. However, progress in this positive agenda will require the identification of common sectoral interests, the promotion of ties in creating added value and in efforts toward technological breakthroughs, and a reduction of asymmetries in the policies adopted by the partners' (Bouzas & Kosacoff, 2009).

Contents

CHAPTER V. THE EXTERNAL AGENDA

From the second semester of the current decade, MERCOSUR had faced increasing difficulties in concluding preferential trade agreements with third countries. The eruption of the international financial crisis made it even more difficult to move ahead with trade liberalization, be it in the multilateral, regional, or bilateral fields.

While the dreaded resurgence of trade protectionism was not as intense as many analysts were predicting, there was a proliferation of unilateral, competitiveness-distorting measures adopted by the major players in world trade (e.g. production subsidies, bailouts, preferences for local products and services in government procurement, subsidized credit supply, etc.).

In spite of efforts by WTO Director General, Pascal Lamy, to resume and conclude the Organization's Doha Round, and the commitments in the G-20 Declarations to reach agreement by 2010, there was no relevant movement in multilateral understandings. At the next G-20 meeting in Seoul in early November, the countries are expected to reassess the state of the Doha Round, from which fresh political momentum may arise for the restart of negotiations.

Furthermore, throughout September, tensions arising from the disalignment of exchange rates and different exchange rate regimes have been mounting. With the lack of effective action by China to curb the appreciating yuan, several countries, including Japan, Switzerland, and Thailand, moved to adopt active policies to devalue their currencies. Other countries, like United States, are threatening to impose trade measures.

There are some policy-makers, and even experts in international trade, who argue that manipulating the exchange rate is tantamount to export subsidies and that adopting countervailing measures is legitimate if it counters the adverse effects on economies that adopt floating exchange rate regimes. In this climate, the risks of resurgent protectionism that lay in store immediately after the outbreak of the international crisis in late 2008 may very soon become a reality.

However, in the recent period, there has been some movement in MERCOSUR toward seeking new bilateral agreements that may represent improvements in market access conditions for countries in the region. The resumption of negotiations with the EU and the signing of the agreement with Egypt in July 2010 are the main evidence for this.

The first extraregional trade agreement signed by MERCOSUR was with Israel. Negotiated in 2007-2008, the agreement underwent a lengthy legislative process in the bloc's countries, only enacted in Brazil in April 2010. Its importance—lower in market terms—derives from the fact that it is the first extraregional FTA signed by MERCOSUR to incorporate an automatic, linear tariff elimination methodology.

A. Extraregional Negotiations

Given the impasse in the Doha negotiations and an international climate that is hardly conducive to comprehensive trade liberalization moves, two priorities stood out on MERCOSUR's extraregional negotiating agenda: the conclusion of the agreement with Egypt and the resumption of negotiations with the EU.

MERCOSUR's first extraregional agreement was signed with Israel in 2007[71] and entered into force in the first semester of 2010. The agreement with Egypt represented a further step in the bloc's efforts to broaden the scope of relations with Middle Eastern countries. In addition to the agreements signed with Israel and Egypt, trade negotiations are ongoing with Jordan, Morocco, and the countries of the Gulf Cooperation Council (GCC): Saudi Arabia, Bahrain, Qatar, United Arab Emirates, and Oman).

MERCOSUR-Egypt: the bloc's second extraregional agreement

The MERCOSUR-Egypt Free Trade Agreement was signed during the MERCOSUR Summit in San Juan, 2 August 2010, closing a negotiating process that began in 2004. It was the second extraregional FTA signed by MERCOSUR.

The MERCOSUR-Egypt Framework Agreement was signed in July 2004, having been approved by Decision No 16/04, which defined the negotiation in two stages: the signing of a fixed preference agreement and subsequent free trade negotiations.

In 2009, that direction was altered with the evolution of understandings toward an FTA. The elimination schedule agreed with Egypt follows the general methodology adopted by MERCOSUR for extraregional free trade negotiations:

- Category A: immediate elimination.
- Category B: elimination in 4 years.
- Category C: elimination in 8 years.
- Category D: elimination in 10 years.

There is also a Category E, which, in the Egypt Agreement, indicates products left out of the offer, whose import duties and equivalent effect rates must be eliminated in a direction to be defined by the Joint Committee (the body responsible for implementing, administrating and reviewing the Agreement.

The agreement is limited to the opening of goods markets, but contains a clause on possible future understandings on market access in services and investments. There are no specific provisions for countervailing or antidumping measures. The countries must make use of their national laws, which have to be compatible with WTO rules. The text of the agreement also mentions that the goods used are excluded from the benefits of the agreement.

The negotiation of the chapter on rules of origin was one of the most controversial, with Egypt intending to eliminate the negotiations' specific requirements and MERCOSUR's private sector demanding they be maintained. The text of the agreement eventually incorporated compliance with specific requirements—either tariff jump or added value—as

[71] The main features of MERCOSUR-Israel FTA are described in IDB/INTAL (2008b).

criteria of origin, since the value of non-original inputs must not exceed 45% of the ex-works price of the end product (55% for Paraguay).[72]

A "de minimis clause" was also included, under which any products traded between Uruguay and Egypt, or between Paraguay and Egypt, that do not comply with the "tariff jump" will be acknowledged to have made the "jump" if the total value of non-original inputs used in manufacturing does not exceed 10% of the end product's ex-works price. Such a device is not valid for products subject to "tariff jumps" demanded by specific origin requirements, nor for products from the textile complex of NCM Chapters 50 to 63.

The agreement's safeguard mechanism provides for the temporary suspension or reduction of the preferential treatment for a specific product laid down under the Agreement, the importing of which damages or threatens to damage local industry. "Preferential quotas" may be set, or a reduction of the preference not exceeding 50%. The measure's term of application is two years, including the force of temporary measures. The measures may be implemented by MERCOSUR as a whole or by individual countries.

Tables 28 and 29 below set out MERCOSUR's offers to Egypt and *vice versa*, and identify the number and percentage of products allocated to each category in the tariff reduction schedule.

Table 28. MERCOSUR's offer to Egypt

Thousands of US$

Categories	Product		Imports (2006-2008)	
	8-digit HS	% share	MERCOSUR from Egypt	% share
A	2,821	28.8	134,764	79.7
B	671	6.8	23,046	13.6
C	3,058	31.2	3,342	2.0
D	3,160	32.2	7,873	4.7
D (**)	3	0.0	0	0
E	96	1.0	0	0
Bilateral concessions	480	4.8	76,220	45.1
Total	*9,810*	*100.0*	*169,025*	*100.0*

Source: Compiled with information from the MDIC.

[72] The benchmark of the MERCOSUR rules of origin for products incorporating materials not originating in the agreement's signatory countries adopts two general rules: the "*tariff shift*," which views the original product when the end product is classified in a different position on the MERCOSUR Common Nomenclature (NCM) to all the positions of any non-original materials used in its manufacture, or, if it is impossible to meet this criterion, when the *CIF price of the non-original materials* does not exceed 40% of the FOB price of the end product. In the case of the Egypt agreement, the ex-factory price was adopted, and the percentage was, accordingly, 45%. There are also *specific rules* for certain products: these incorporate a combination of the two general rules, in addition to other elements (e.g. descriptions of production processes) and override the general rules.

Table 29. Egypt's offer to MERCOSUR

Thousands of US$

Categories	Product		Imports (2006-2008)	
	8-digit HS	% share	Egypt from MERCOSUR	% share
A	1,496	31.0	1,002,104	64.3
B	624	12.9	32,285	2.1
C	1,546	32.1	384,121	24.6
D	964	20.0	24,302	1.6
E	75	1.6	81,551	5.2
Bilateral concessions	116	2.4	34,938	2.2
Total	*4,821*	*100.0*	*1,559,301*	*100.0*

Note: The trade value statistics were based on the average of the values of trade between the countries in 2006-2008.

Source: Compiled with information from the MDIC.

MERCOSUR's offer to Egypt in Baskets A to D—elimination in up to 10 years—represents 94.2% of the tariff sample, with 25.8% of tariff lines subject to immediate elimination and the remainder distributed in the liberalization categories in eight to ten years. In terms of trade value, 49% of the bloc's imports have a 100% preference in up to four years.

It is striking, however, in the value coverage of MERCOSUR's offer that 45% of imports from Egypt have received bilateral treatment. Various elimination categories were granted by the bloc's partners to a group of 470 tariff lines corresponding to a significant portion of Egyptian exports to MERCOSUR.

Considering the offers made by the bloc's two major partners in this product group, the trade value can be said to display various different results in individual terms. The distribution of these products in the offers of Argentina and Brazil under the agreed categories was as follows:

- Category A—Argentina 8 products, Brazil 286.
- Category B—Argentina 43, Brazil 58.
- Category C—Argentina 197, Brazil 50.
- Category D—Argentina 121, Brazil 76.
- Category E—Argentina 101, Brazil 0.

The three products appearing in Category D (**) are sugars and are subject to a special import regime in Argentina, not having been included in the country's offer to Egypt. The products in Basket E—excluded from liberalization—include goods also left out of the Argentine offer in the Israel agreement. Since that agreement contains a clause to the effect that, in the event of these products being offered in trade negotiations with other countries, they should also be offered to Israel, Argentina requested exclusion for Egypt. Many of the products in this category are from the chemical sector. The group of products with bilateral concessions in the Argentine offer includes 101 products in Category E and a further 121 in Category D.

Egypt's offer to MERCOSUR covers 98.4% of the tariff sample and is distributed fairly uniformly across the four elimination categories. The products available on the exceptions list of the Egyptian offer include certain items in the meat, horticultural, alcoholic beverages and tobacco, leather, and paper sectors, and some products in the automotive sector. In terms of trade value, Egypt's offer covers 66.4% of the value of imports for liberalization in up to four years, and there are exempted products that correspond to 5.2% of Egypt's total imports of the bloc's products. Bilateral concessions cover 116 tariff lines with less weight in trade terms. These include two products subject to tariff quotas and seven others negotiated with fixed preferences to one of the partners' benefit, as against Category E for the rest.

MERCOSUR's offer to Egypt emphasizes the liberalization of mineral fuels, aircraft, manures and fertilizers, organic and inorganic chemicals, minerals, and live animals and plants. Over 60% of tariff lines in Chapters 01, 06, 26, 27, 29, 31, and 88 will see immediate elimination (Basket A).

Egypt's offer to MERCOSUR, on the other hand, places greater emphasis on the liberalization of manures and fertilizers, live animals, aircraft, rubber and resins, cereals, fish and shellfish, toys, textiles, food waste, and processed meat and fish. Over 70% of tariff lines in Chapters 01, 03, 10, 13, 31, 88, and 95 will see immediate elimination (Basket A) and over 70% of tariff lines in Chapters 16, 23, 56, 58, 59, and 60 will see tariffs eliminated in up to eight years (Basket C).

Egypt is a minor country in MERCOSUR's foreign trade, despite showing a growing share in the bloc's exports in recent years (1% of total external sales in the first semester of 2010). while MERCOSUR imports from Egypt have grown at highly significant rates, they are still negligible (just 0.07% of its total imports). As a result, the bilateral trade balance continues to record significant surpluses for MERCOSUR (Table 30).

Table 30. MERCOSUR-Egypt trade

	Exports			Imports			Balance
	Millions of US$	% growth	% share	Millions of US$	% growth	% share	Millions of US$
2007	1,862.7	-	0.83	88.8	-	0.05	1,773.8
2008	2,586.4	38.9	0.92	341.9	284.9	0.14	2,244.5
2009	2,099.6	-18.8	0.97	152.4	-55.4	0.09	1,947.2
1st S 2009	1,193.2	-	1.18	32.0	-	0.04	1,161.2
1st S 2010	1,281.7	7.4	1.01	80.4	150.9	0.07	1,201.3

Source: ALICE-web MERCOSUR/MDIC.

The agreement may give a fresh impetus to bilateral trade, particularly as it provides for the elimination of tariffs on the main products exported by MERCOSUR to Egypt. However, Egypt is a relatively minor country in the international market and the agreement is not expected to promote substantial changes in the trade standard between the two parties.

Ongoing extraregional negotiations

The FTA between MERCOSUR and Egypt was the main success story of the bloc's external agenda during the period covered by this Report (the second semester of 2009 and the first semester of 2010). However, another important success story was the resumption of negotiations with the EU, which had been at a standstill since the end of 2004. This is certainly the most important initiative on MERCOSUR's external agenda, which also contains several other ongoing negotiating initiatives.

The resumption of trade negotiations between MERCOSUR and the EU. Amid the worsening of the economic crisis in the Eurozone and in an international climate hardly conducive to moves toward liberalization, the announcement of the restart of negotiations toward a Partnership Agreement between MERCOSUR and the EU still came as a surprise. After six years of deadlock, the two blocs' supreme authorities announced, May 17, 2010, the aim of concluding an ambitious and balanced agreement between the two regions forthwith.

Although the possibility of restarting trade negotiations between the two regions has been under discussion since the second semester of last year and there has been a strong expectation that the announcement would be finalized at the EU-MERCOSUR Summit in Madrid, the international situation gave no cause for optimism. This perception was reinforced by the circulation of a letter in early May, signed by 10 EU member countries led by France, expressing their opposition to the restart of negotiations, arguing that "this move would send a highly negative signal to the European farming sector, which is already facing great challenges" (*Valor Econômico*, 2010a).

In spite of the resistance of the European countries most politically sensitive to the farming issue, there is interest in other European production sectors in the negotiations with MERCOSUR. European exports to the MERCOSUR countries had been growing by 15% p.a. in the period prior to the outbreak of the crisis in 2008. European investments in the region totaled €165 billion, outweighing European investments in China, India, and Russia together. The argument was used by the European Commission itself, when, in early May, it announced its readiness to resume understandings with MERCOSUR (European Commission, 2010).

Reasons for the resumption. Against the background of a worsening economic context in Europe, with the growing devaluation of the Euro, the prospect of gaining trade preferences in MERCOSUR markets—especially Brazil's—proved extremely attractive for European industry. Also, the sound results of European direct investments in the region, in many cases, also helped to offset losses in the European market.

This helps to explain the move by the EU President, supported mainly by the head of the Spanish Government, to approve the restart of negotiations between the two regions and meet the resistance of the group of 10 farming countries to drive through the agreement with MERCOSUR.

On MERCOSUR's side, it was the PPTA's greater willingness that contributed to the resumption of the negotiations. During the first semester of 2010, it sought to inject fresh impetus into MERCOSUR's external relations, after a period of diminished Argentine enthusiasm over the bloc's external agenda.

In the private sector, the resumption of negotiations was received with caution by Brazilian and Argentine industry. The outlook for the European economy is no cause for any great optimism where the growth of MERCOSUR exports to Europe is concerned. And there is growing concern at the significant rise in imports, particularly in Brazil, which creates greater resistance to new moves toward trade openness.

Recent developments. After the announcement of the resumption of negotiations, the 17th Meeting of the Biregional Negotiations Committee (CNB) was held in Buenos Aires, June 28 through July 2. The meeting was predominantly organizational. The 11 working groups, which had been stalled since 2004, were reconvened, the starting points for the understandings on each item of the negotiations were defined, and areas pending were identified.

The EU Commissioner for Trade, Karel De Gucht, visited Brazil and Argentina, September 14 and 15. It was hoped that a political message would emerge from the visit that would cast light on the possibility of making effective progress toward concluding the agreement. While, at the restart of the negotiations, there were expectations for the negotiations to be concluded by the end of 2010, during his MERCOSUR visit, Commissioner De Gucht noted his intention to close the agreement by mid-2011.

This deadline would be ideal for the European negotiators, since the discussion on the reform of the EU's Common Agricultural Policy (CAP), as of the second semester of 2011, would have to be at an advanced stage and presidential elections would be under way in France, where the issue of the negotiations with MERCOSUR and its impacts on local farming is highly controversial. This scenario means that the second semester of the coming year would hardly be conducive to meaningful progress in negotiations between the two blocs (*Valor Econômico*, 2010b).

During his trip to Brazil, the Trade Commissioner met with representatives of Brazilian industry from the National Confederation of Industry (CNI), who expressed caution over the desirability of concluding an agreement in the short-term (*O Estado de São Paulo*, 2010d). The deterioration of the economic climate in Europe and the sound performance of the MERCOSUR economies contributed to the recent imbalance in trade flows between the two regions, and are the reasons behind the more defensive stances of Argentine and Brazilian industry.

Table 31 below shows the recent imbalance in the evolution of trade flows. In 2008, MERCOSUR exports to the EU were up 20.3%, while imports rose by 32.6%. In 2009, when there was a significant contraction in global trade, trade between the two regions also fell, but MERCOSUR exports did so more sharply than imports from the EU. In 2010, the trade flows grew again, but the differences in the rates of change widened.

Table 31. MERCOSUR-EU trade

	Exports			Imports			Balance
	Billions of US$	% growth	% share	Billions of US$	% growth	% share	Billions of US$
2007	51.528	-	23.08	34.727	-	20.06	16.801
2008	62.005	20.33	22.14	46.067	32.65	19.02	15.938
2009	45.105	-27.26	20.93	36.617	-20.51	20.77	8.488
1st S 2009	21.417	-	21.19	16.226	-	20.71	5.190
1st S 2010	25.315	18.20	19.93	22.398	38.03	19.91	2.917

Source: ALICE-web MERCOSUR/MDIC.

While the EU's share as a destination for MERCOSUR exports has experienced a downward trend since the middle of the decade, its share as the source of the bloc's imports has remained relatively stable. In the first semester of 2010, the European bloc's share in MERCOSUR's foreign trade was 19.9% in both exports and imports.

Although the trade balance between the two blocs still showed a surplus for MERCOSUR, its positive balances show a clear downward trajectory. The most likely scenario being that the European economies will continue to grow at rates substantially lower than those of MERCOSUR, recent developments tend to persist, with declining surpluses for the southern bloc.

The second biregional meeting was held in Brussels, October 11 through 15, 2010. A schedule was agreed up to mid-2011. In the trade pillar, there were group meetings in market access for goods, rules of origin, technical barriers to trade, sanitary and phytosanitary measures, intellectual property and geographical indications, dispute settlement, trade defense, competition policy, customs (trade facilitation), services, and government investments and procurement.

The broadening and deepening of the MERCOSUR-India agreement. The Fixed Preference Agreement between MERCOSUR and India came into force on June 1, 2009, six years after being signed. The characteristics and provisions of the Agreement are described in detail in *MERCOSUR Report No. 13*.

In spite of the length of time between the signing of the Agreement and its entry into force, the MERCOSUR countries had already assessed the slight effect on trade potentially generated by such an initiative, considering its limited scope in terms of product coverage and negotiated preference margins. MERCOSUR negotiators had already indicated to India their interest in deepening and broadening preferences, but the Indian government insisted that negotiations on that aspect only could start after the agreement's entry into force.

To pave the way for future negotiations with India, the MERCOSUR countries agreed on a proposed modality for expanding and deepening the agreement, in an internal meeting held at the end of June 2006. It included the following: (i) the existing 10% and 30% preferences in the Agreement would be expanded to 30% and 50% respectively; and (ii) the minimum 20% preference margin would be granted on 50% of the tariff sample via the exchange of request lists. After defining lists of offers, priority products would be indicated by each side for the reciprocal deepening of the preference margins.

This strategy was subsequently simplified, after developments in the General System of Trade Preferences (GSTP) negotiations.[73] The new proposal includes the possibility of linear broadening of the Agreement with a minimum 30% preference on at least 70% of tariff lines that do not have a zero tariff, lists of sensitive products, and reciprocal preferences between 50% and 100%.

With the Agreement's entry into force in June 2009 in mind, the MERCOSUR governments resumed the consultation process in December 2009 to develop request lists and bring continuity to the above plans to broaden the Agreement. A fresh round of talks was held, June 16-17, 2010, to review lists of sensitivities and the aforementioned new negotiating modality. MERCOSUR submitted a list of requests with 1,265 codes in the Indian nomenclature. India has not yet submitted its request list.

[73] Additional information on these negotiations is presented later in this *Report*.

Free trade negotiations with Jordan. At its meeting on July 30, 2008, MERCOSUR's CMC adopted the Framework Agreement between MERCOSUR and Jordan, providing for negotiations to set up a free trade area between the bloc and the country. The first round of negotiations took place in Amman, October 13, 2008.

The process of drawing up proposals for tariff reductions and for specific origin requirements for the negotiations in the scope of the future FTA, which is to cover all products in the tariff sample, began in the first semester of 2010.

Following the methodology agreed by the MERCOSUR partners for their extraregional negotiations and adopted in the Egypt agreement, tariff elimination is to be carried out by classifying the products offered under the following categories:

- *Basket A*: full and immediate elimination.
- *Basket B*: full elimination in 4 years.
- *Basket C*: full elimination in 8 years.
- *Basket D*: full elimination in 10 years.

Other ongoing negotiations. *MERCOSUR-GCC:* The Framework Agreement between the MERCOSUR countries and the Gulf Cooperation Council, signed May 10, 2005, provided for a commitment to achieve a free trade agreement. After several rounds of talks and an intense exchange of offers and requests, deadlock was reached, caused, among other things, by the resistance of the MERCOSUR chemical sector to open the bloc's market to GCC products. No further movement has been seen on this negotiating front since 2007.

MERCOSUR-Morocco: The Framework Trade Agreement between Morocco and MERCOSUR, was signed November 26, 2004, and came into force April 29, 2010. Negotiations were initially directed at a fixed preference agreement. Rounds of talks were held in 2005, but there was no progress. Understandings have been suspended since 2006, and are now at the stage of redefining methods and procedures. In principle, MERCOSUR would be interested in framing the agreement with Morocco along the same lines as the ones already negotiated with Israel and Egypt, and under way with Jordan.

MERCOSUR-Turkey: The Framework Agreement between MERCOSUR and the Republic of Turkey, approved by MERCOSUR's CMC at its 35th Regular Meeting, held July 30, 2008, provided for negotiations for the creation of a free trade area. In that month internal consultations began in MERCOSUR toward the development of the list for immediate elimination, as well as an indication of products sensitive to that market.

MERCOSUR-Pakistan: The Framework Trade Agreement between MERCOSUR and Pakistan was signed at the MERCOSUR Summit in Cordoba, Argentina, July 2006, having been approved by CMC Decision No. 07/06 on the same month of July. The Agreement laid the foundations for the start of negotiations for a preference agreement that will progressively lead to an FTA. The Agreement establishes the creation of a Negotiating Committee, whose function is to exchange information on tariffs and market access conditions, while also establishing criteria for the negotiation of a Free Trade Area. Pakistan sent a list of exports of interest to it (1,024) in order to improve market access conditions in MERCOSUR, indicating that it may offer reciprocity in treatment. The negotiations, however, came to nothing.

GSTP: The São Paulo Round. The São Paulo Round was launched at the 11th Meeting of the United Nations Conference on Trade and Development (UNCTAD), June 2004, with the aim of deepening trade liberalization commitments among the countries participating in the GSTP.[74] Not all GSTP member countries joined the Round; just 18 countries and MERCOSUR are taking part in the ongoing talks.

The Round had made little progress by December 2, 2009, when, in a Ministerial Declaration, the participants identified the following basic modalities for market access:

- A minimum linear reduction of 20% in import tariffs applicable to 70% of the sample of products subject to import tariffs through a process of requests and offers, and/or voluntary sectoral negotiations.

- A linear reduction on the most favored nation (MFN) tariff, applied at the time of importation. In exceptional circumstances, countries may apply the linear cut on the MFN in force when the third round of negotiations is concluded (tariff base).

- The countries pledged to review the rules of origin for products not wholly produced or obtained in the System's partners, with the aim of concluding the talks by the end of September 2010.

- The countries pledged to submit their offers up to the end of May 2010 in the format also approved by the Ministerial Decision.

- In the next 4-month period, the countries may review their concessions through request and offer exercises, but countries must notify the GSTP Secretariat of their final lists of concessions by September 30. The concessions will be implemented upon internal ratification of the Agreement and of the ratification instruments' deposits for a specific number of countries yet to be defined.

Initially, countries negotiated on an individual basis, but this situation was reversed and now all commitments are expressed in terms of a joint MERCOSUR position.

The MERCOSUR list of offers observed the following guidelines:

- Assessment of industrial sectors deemed sensitive.

- Current CET levels.

- GSTP countries' share of imports in total MERCOSUR imports and competitiveness levels.

[74] The GSTP is a mechanism via which developing countries negotiate trade concessions with the aim of expanding trade between them. The agreement that formed the system was signed in 1976, but only came into force in 1989.

MERCOSUR's offer was submitted in compliance with the May deadline, and the list of sensitive products, which corresponds to 30% of products excluded from the offer, consists of 2,756 tariff lines.

The rule of origin for non-produced products, or products entirely obtained in the countries of the agreement (i.e. products using inputs from third countries) stands at 50% added value, comparing the price of the imported input with the FOB price of the end product. Products marketed under Sectoral Agreements within the GSTP may have specific rules of origin in those agreements.

The Brazilian government has devoted its efforts to moving the São Paulo Round forward, apparently as part of Brazil's strategy to strengthen its economic and political ties with developing countries. It can also be seen as an alternative way of encouraging developed countries to engage in negotiations for the conclusion of the WTO's Doha Round.

Duty-Free, Quota Free: unilateral concessions for LDCs. During the WTO's Ministerial Meeting in Hong Kong, December 2005, the developed countries pledged to eliminate all tariff and quantitative restrictions (duty-free, quota free) affecting the exports of Least Developed Countries (LDCs).[75] Although the commitment is limited to the developed countries, developing countries that were in a position to do so were encouraged to participate in the initiative.

The Brazilian government announced its intention to join the initiative and embarked on a long debate with the private sector to develop a "duty-free, quota free" implementation proposal. India and China joined Brazil in announcing their intention to join the program. The three other MERCOSUR members are not taking part in the initiative.

The government's intention met with strong resistance in Brazilian industry, particularly the textile sector, which feared competitions from some LDCs, particularly Bangladesh. While the textile sector expressed itself most vehemently, other sectors also expressed their misgivings over risks of triangulation. Although these countries are extremely poor, there was a fear that other countries that had effective conditions of production and competition with Brazilian products might use the initiative to export to Brazil from one of the LDCs.

This concern made the issue of the program's origin regime a crucial one. Moreover, an excessively demanding rule of origin could cancel out potential beneficiary countries' chances of reaping the benefits of the program's concessions.

Internal negotiations were suspended for a period of time, until Brazil's Federal Government issued Provisional Measure 482, February 10, 2010. This document dealt with measures to suspend concessions or other obligations relating to intellectual property rights in the event of breaches of obligations in the WTO (which is studying retaliatory action over the Brazil-United States cotton dispute). The government introduced the "duty-free, quota free" issue in Article 12, the last article of the Measure.

Article 12 was excluded from the subsequently approved law due to efforts by the private sector during a debate in the Chamber of Deputies. Its purpose was to amend Law 3,244 of August 14, 1957, establishing the conditions for the unilateral amendment of Brazilian

[75] The 49 countries making up the group of LDCs are, with the exception of Haiti, African and Asian.

customs tariffs. The Provisional Measure sought to include the concept of unilateral concessions for developing countries under the Brazilian Tariff LDC Concession Program.

The issues up for discussion in the scope of the Program are as follows:

- *Coverage*: 100% of tariff lines from the NCM.
- *Origin regime*: 60% tariff jump or value added. MERCOSUR's specific requirements may be suspended when the Program comes into effect.
- *Textiles and clothing*: specific rule of origin with requirements for inputs originating in Brazil or the exporting country covered by the Program.
- *Monitoring and review mechanism*.
- *Anticipation of 3 safeguard mechanisms*: a general safeguard, a special safeguard for textiles and garments, and a special safeguard for family agriculture products.

India's program has been in place since 2009 and China will be implementing its own in the near future.

Brazil's trade with these countries represents just 0.4% of its total, including oil. If oil is taken out of the equation, the share is even smaller. This duty-free, quota-free mechanism benefiting the poorest countries is regarded as another instrument in Brazil's foreign policy of matchmaking with the countries of the South.

At the end of August, Brazil's CNI sent a letter to the Foreign Ministry, and the Development, Industry, and Trade Ministry, requesting the project's temporary suspension, given the adverse conditions in world trade, the trend toward exchange rate appreciation, and the high rate of imports in Brazil during 2010. In response, Brazilian government representatives pledged to redouble their efforts over the program's origin regime and the safeguard mechanisms, but made no commitment to suspending the initiative.

Tariff preferences on textile products from Haiti. Brazil has been heading a multinational interim force in Haiti for over six years: the United Nations Stabilization Mission in Haiti (MINUSTAH), set up on January 1, 2004, "to restore security and stability, promote political progress, strengthen government institutions, and promote and protect human rights." In an unprecedented attitude, Brazil agreed to send soldiers to Haiti and coordinate troops on behalf of the UN, a decision that caused some controversy and criticism at home. The country attaches great importance to the mission's success, for, among other things, it fuels the expectation that it can be decisive in strengthening its aspiration to hold a permanent seat on the UN Security Council.

CMC Decision No 14/10 was adopted in San Juan at the instigation of Brazil. The Decision authorizes the MERCOSUR member countries to grant preferential tariff margins of up to 100% on textile products from Haiti shipped directly from ports in that country and Dominican Republic. The products will be selected from Chapters 61 and 62, and Position 63.02 of the NCM, with Haiti submitting an annual indicative list of products to which it plans to apply the preferences. The list must be submitted to the State Party willing to grant unilateral preferences, and must also provide the other member countries with all information on the regime established to implement it. Rules and procedures of origin are not allowed to be more favorable than those in the MERCOSUR regulations, and any tariff concessions granted will be valid to December 31, 2019.

Haiti, it should be remembered, does have a labor-intensive manufacturing base of sorts in the textile sector. And the country is benefiting from free access to the US market for some textiles and clothing by virtue of preferences granted under the 2008 Haitian Hemispheric Opportunity through Partnership Encouragement Act (HOPE II) program. To take advantage of preferences in the US market Haiti had to create the figure of an independent Ombudsman in labor matters, and institute a program, monitored by the International Labor Organization (ILO), designed to ensure respect for certain core labor standards. Domestic textile and clothing producers have to take part in the ILO program and ship their products at ports in Haiti and/or Dominican Republic.

Brazil is willing to grant Haiti tariff preferences in the Brazilian market and also stimulate Brazilian investments in that country that can make the most of the US market access facilities granted under HOPE II. The almost 10-year term established by CMC Decision No 14/10 opens up just such a possibility.

Granting trade preferences to Haiti clashes with the obligations established in GATT Article I, and their implementation will therefore require an application for a WTO waiver.

The approval of CMC Decision No 14/10 was accompanied by a declaration from the MERCOSUR presidents favoring the adoption of measures aimed at attracting investment, job creation, and fiscal strengthening of the Haitian State.

B. Subregional Negotiations

UNASUR and the evolution of Economic Complementation Agreements (ECAs) in the scope of LAIA

The dynamic of UNASUR has confirmed the forecasts already published in previous *MERCOSUR Reports* that it is a forum primarily devoted to political coordination of the region's countries. Although the issues relating to economic integration are among its many objectives, they have not featured on the institution's agenda.

Between the second semester of 2009 and the first semester of 2010, the institution's agenda was given over to discussions about the candidacy of former Argentine president, Néstor Kirchner, for Secretary General of UNASUR, the political situation in Honduras, aid to Haiti and Chile after the severe earthquakes in both countries, the solution to disputes between Colombia and Venezuela, and, more recently, the internal disputes in Ecuador.

Regardless of UNASUR's lack of attention to economic and trade issues, there were no relevant results in terms of deepening and broadening trade agreements between MERCOSUR and countries in the region. Nevertheless, some developments do deserve to be mentioned:

MERCOSUR-Peru (ECA No. 58): The 2nd Administrative Meeting for ECA No. 58 was held July 1, 2010. It discussed the possibility of deepening and refining the Agreement. The MERCOSUR countries' main objective in this movement is to avoid the adverse effects of preference erosion resulting from the various extraregional agreements signed by Peru with countries with significant economies and high risks of creating trade diversion.

MERCOSUR-Colombia, Ecuador, and Venezuela (ECA No. 59): The 4th Meeting of the Agreement's Administration Commission was held June 29 and 30, 2010, when all countries except Venezuela agreed to step up formalities for the entry into force of eight Additional Protocols already negotiated. A particularly sensitive issue on the agenda of ECA No. 59 was the question of rules of origin, given that, when the Agreement was signed, a definitive solution to the rules of origin for various products remained pending, with only temporary solutions having been found. Another issue worthy of note is the negotiation of the Additional Protocol for Trade in Services between MERCOSUR and Colombia, which is in the final stages of negotiation.

MERCOSUR-Chile (ECA No. 35): The Protocol on Trade in Services of ECA No. 35 was signed May 27, 2009. The Protocol includes commitments on market access and national treatment in important sectors like professional services, services to companies, engineering, distribution, transport, and tourism. It is the first agreement on services with another country to be signed by MERCOSUR. The 53rd Additional Protocol to ECA No. 35 will come into bilateral force between Chile and the MERCOSUR partners, 30 days after notification of the instruments of ratification. According to LAIA's webpage, Brazil was the only country to ratify the Protocol. Special attention deserves to be drawn to the fact that in the talks to incorporate investments in ECA 35, Brazil and Chile began negotiations toward a bilateral agreement on investments. As Brazil is the only country in MERCOSUR without an effective investment protection agreement, the discussions with Chile signal a new phase in the Brazilian government's tackling of this issue.

Brazil-Mexico: fresh efforts toward an FTA

In 2007, the Brazilian private sector began a wide-ranging process of dialogue with the Mexican private sector and the Brazilian government, seeking to start negotiations toward a deeper and more comprehensive trade agreement than ECA No. 53[76] to govern preferences between the two countries. This process, described in *MERCOSUR Report 13*, gathered new momentum in August 2009 with the visit of Mexican President, Felipe Calderón Hinojosa, to Brazil.

The Joint Communiqué signed by the two countries' presidents recorded the willingness of their governments to analyze all forms of economic matchmaking, including free trade. A further bilateral meeting was held in Cancún, February 2010, in parallel to the Latin America and Caribbean Summit. The Joint Communiqué indicates both parties' interest to move toward a Strategic Integration Agreement.

The governments continue to pursue bilateral understandings and consultations with their respective private sectors. The last bilateral meeting, in Mexico City, May 11 and 12, concluded the agreement's "Terms of Reference," which must go beyond a Free Trade Agreement. The objective is to sign a wide-ranging Economic Integration Agreement to support cooperation in several areas.

The general principles of the Terms of Reference are as follows:

1. *Full coverage*: the agreement must have full coverage and incorporate chapters on goods, services, government procurement, and intellectual property.

[76] It should be remembered that ECA No. 53 is compatible with ECA No. 54, which governs relations between MERCOSUR and Mexico, and that Uruguay and Mexico already have a bilateral free trade agreement in force.

2. *Sensitivities*: special treatment will be given to both sides' sensitivities.

3. *Effective market access*: a flexible mechanism will be assessed to ensure priority access to the respective markets, even during the transition process.

4. *ECAs Nos. 53 and 55*: the starting points for tariff reduction will be the existing agreements, including the full "historical heritage" of LAIA. In addition to ECAs Nos. 53 and 55, LAIA's Regional Tariff Preference Agreement (PTR) will also be considered.

5. *Single undertaking*: nothing is agreed until everything is agreed.

6. *Speed*: the substance will determine the speed of the negotiations. The Brazilian government wishes to move fast in these negotiations, but not at the expense of content.

7. *Private sector dialogue*: this issue is considered vital by both governments.

In spite of the Brazilian and Mexican negotiators' efforts to move ahead in bilateral understandings, an FTA between the two countries will be no small task. The history of trade negotiations between the two countries is marked by negative experiences and broken expectations. And Mexico's industrial sector has steadfastly resisted a bilateral FTA.

C. Venezuela's Adherence to MERCOSUR

After a long period of processing and firm commitment from representatives of the Foreign Ministry, Brazil's Federal Senate approved Draft Legislative Decree 430/08, December 15, 2009, on the Protocol of Adherence of the Bolivarian Republic of Venezuela to MERCOSUR, signed in Caracas, July 4, 2006. The Legislative Decree was published in Official Journal of the Union No. 241, on December 17, 2009, and marked the end of almost three years of processing the Protocol in the Brazilian Congress.

After Brazil's approval of the Venezuelan Protocol of Adherence (35 votes to 27 in the Federal Senate), there remains its ratification by Paraguay; Argentina, Uruguay, and Venezuela already having approved it.

The Brazilian Congress's review process for Venezuela's adherence to MERCOSUR became an important incentive to step up negotiations in various outstanding technical aspects of the draft. During the last stage of processing the Draft, the Federal Senate introduced several demands for clarification and additional information on commitments to be made by Venezuela in the balance of rights and duties outlined in the Protocol of Adherence. Apart from contributing to the transparency of the process, the need to provide information to the Senate was an important argument used by the Brazilian Executive for progress in negotiations with Venezuela over bilateral trade liberalization commitments.

A chronology of proceedings toward the Venezuelan Protocol of Adherence in the Brazilian Congress

- Message 82, February 22, 2007: the Executive submits the text of the Protocol to Congress.
- The Draft Legislative Decree is approved by the Chamber of Deputies Plenary, December 17, 2008.
- The project is approved by the Brazilian contingent in the MERCOSUR Parliament, February 18, 2009.
- The Project is received in the Senate in the Foreign Affairs and National Defense Commission, March 12, 2009.
- The Commission convenes five public hearings: April 16, April 30, June 9, and the last two, July 9, 2009, attended by leading representatives of civil society, former ambassadors, former ministers, the Roraima State Governor (interested in rapprochement with Venezuela), diplomats, and government authorities.
- During processing in the Senate's Commission for Foreign Relations, three requests for information were submitted to Foreign Affairs Minister, Celso Amorim, in May, July, and September 2009, all answered by the Minister.
- Consideration of the Protocol of Adherence of Venezuela, its annexes, public hearings, and information received from the Executive support to the reflections of the Brazilian Senate, structured along three lines: the fact that this is a political decision by Brazil and its peers in MERCOSUR according to political, economic, and strategic interests; the need for a technical and legal examination of the issue; and the assessment of Venezuela's internal politics and their impacts on the region.
- The Rapporteur for the issue in the Senate's Foreign Affairs Commission, Senator Tasso Jereisati, was against approving the Protocol of Adherence of Venezuela to MERCOSUR.
- After the submission of several separate votes, December 15, 2009, the Senate approved the Protocol of Adherence of Venezuela to MERCOSUR by 35 votes to 27: an eight-vote victory.

Market access negotiations between Brazil and Venezuela have been at a standstill since March 2007. The 5th Meeting of the Working Group (GT) set up by Article 11 of the Protocol drew up its Final Report this month. The Report was evaluated by the CMC and approved by Decision 12/07 (Article 1), May 22, 2007.

Also created by Article 2 of the same CMC Decision was the *Ad Hoc* Working Group "in order to continue the remaining tasks mentioned in the Final Report and its Appendices I-V, and to deal with any other matter required for the conclusion of Venezuela's adherence to MERCOSUR."

In a Joint Communiqué signed in Salvador, May 2009, on the occasion of the Venezuelan President's visit to Brazil, the Heads of State registered the decision to convene the *Ad Hoc* Group in order to tackle the Regulatory Heritage, the NCM, and the CET. A note dated June 9, 2009, to the MERCOSUR *Pro Tempore* President from the Brazilian coordination in the GMC requested the group be convened. No records are available of the Group's work after that date.[77]

[77] According to information obtained from Brazilian negotiators on September 17, 2010, the Group was not convened and there is no prospect of convening it in the short term.

The slim chances for progress over this issue in the Paraguayan Congress, the last formal step before the Protocol's entry into force—coupled with the Venezuelan economy's growing difficulties—are surely behind the country's waning incentive to conclude trade negotiations. The expressions of Paraguayan politicians against Venezuela's adherence were blunt on several occasions, after the Protocol's approval in Brazil.

In any event, the negotiating methodology with Venezuela, adopted by the GT under Article 11 of the Protocol of Adherence, organized the work in four pillars: (i) schedules for free-trade implementation between the original partners and Venezuela, adjusting the deadlines in accordance with LAIA's MERCOSUR-CAN Partial Scope Agreement in force (ECA No. 59); (ii) schedules for adherence to the regulatory heritage; (iii) schedules of adherence to the CET; and (iv) Venezuela's adherence to the agreements signed or under negotiation with third countries.

Treatment of the first pillar was not concluded by the GT, but was subsequently carried out in the scope of Bilateral Meetings. The following two pillars were remitted for finalization in the scope of the *Ad Hoc* Group and never convened. Where the last pillar on negotiations with third countries was concerned, the GT's Final Report stated the need for categorization and prioritization of any international agreements and instruments concluded by MERCOSUR, and the organization of consultations with countries or groups of countries over their willingness to negotiate Venezuela's adherence to such agreements. The prevailing perception is that this issue is low on Venezuela's list of priorities, given that there are so many other challenges faced by the country in its negotiations for MERCOSUR membership.

Venezuela's trade negotiations with Uruguay and Paraguay were concluded. ECA No. 64 was signed August 16, 2008, through which Paraguay's exportable supply came to have free access to the Venezuelan market with full and immediate elimination of customs duties. In Uruguay's case, ECA No. 63 was signed on August 17, 2008.

The negotiation of the Brazil-Venezuela Trade Liberalization Program was the subject of four bilateral meetings over 2008. The fifth meeting was held in Brazilia, May 19 and 20, 2009, and continued in Salvador, May 26. The adjustments of ECA No. 59's tariff reduction schedules to the deadlines set by the Protocol of Adherence at the Salvador meeting marked the completion of an important stage in the adherence process.

The main direction focused on the need to respect the 2010 and 2012 deadlines of the schedules for the elimination and free entry of products in Brazil and Venezuela respectively, under the Protocol of Adherence, and to observe the 2014 sensitive products deadline. 2009 was considered a starting point to this effect; it will, naturally, be adjusted when these decisions are implemented.

The following tariff elimination schedules were agreed between Brazil and Venezuela, as well as lists for immediate elimination when the Adherence Protocol enters into force:

1. Four general schedules, two being granted by Brazil to Venezuela (full elimination in 2009 and in 1 year) and a further two by Venezuela to Brazil (both with elimination in 3 years, but with initial margins other than 77% and 54%).

2. Two for products from the "historical heritage" in ECA No. 59, with full elimination granted by Brazil to Venezuela in 2009 and elimination in 3 years with a minimum preference of 60% granted by Venezuela to Brazil.

3. Three for products deemed sensitive with or without "historical heritage," two being granted by Brazil to Venezuela, both for 5 years, but with initial preferences of 50% and 42%, and the other granted by Venezuela to Brazil, with an initial preference of 40% or with the preference in force in 2009 frozen and moving to 100% only by the deadline of January 2014 set by the Protocol of Adherence.

June 24, 2009, Venezuela sent the proposal for a review of the tariff items' distribution in the new schedules. A comparison of that proposal, covering about 6,500 items against the preferences and deadlines defined in ECA No. 59 gives the following results:[78]

1. It foresees total exemption for 4,301 tariff codes (66.17% of the total).

2. It ensures an improvement in the preference received by Brazil in 2009 for 1,925 codes (29.5%).

3. It maintains the elimination deadline for 1,904 codes (29.29% of the total).

4. It maintains the tariff preference in 2009 for 4,270 codes (65.5%).

5. It extends the deadline for full elimination for 233 codes (3.58% of the total).

6. It involves a reversal in the preference applied in 2009 for 147 codes (2.8%).

Regarding tariff elimination, the meeting between the Brazilian and Venezuelan presidents in Salvador, May 2009, enabled understandings over the need to set up an "Adjustment Regime" for Venezuela, cast in the mold of the one created for the original MERCOSUR partners in the bloc's early days.[79]

Such a regime should be analyzed by the unconvened *Ad Hoc* Group. But the idea is to create a new period of transition for Venezuela's adjustment to free trade (from 2014 to 2018), thus breaking the deadlines set by the Protocol of Adherence. In any event, the products applicable for such treatment would only be those labeled sensitive by Venezuela and placed on the schedules reserved for that category in each bilateral negotiation.

Trade negotiations between Argentina and Venezuela are rather blurry. Despite the rapid approval of the Protocol of Adherence in the Argentine Congress, no records are available on the definition of the Argentina-Venezuela Trade Liberalization Program adjusted to the deadlines.

Where the pillars of adherence to MERCOSUR's regulatory heritage and the CET are concerned, the state of the negotiations is still that agreed in the scope of the Working Group set up by Article 11 of the Protocol of Adherence. Keeping in mind the fact that the subsequently created *Ad Hoc* Group was never convened, the results in those areas dated 2007 are as follows:

1. *Venezuela's schedule for adherence to MERCOSUR's regulatory heritage*

[78] Official Letter No. 18 dated July 29, 2009: reply by Minister Celso Amorim to Information Request No. 596 by the First Secretary of the Federal Senate, Senator Heráclito Fortes.
[79] Assessment conducted in April 2007 by the Brazilian CNI.

The adherence schedule provides the following phases:

- 1st phase: up to six months from the Protocol of Adherence's entry into force;
- 2nd phase: until the first year after the Protocol's entry into force;
- 3rd phase: until the second year after the Protocol's entry into force;
- 4th phase: until the third year after the Protocol's entry into force; and
- 5th phase: until the fourth year after the Protocol's entry into force;

Of the total of 783 rules identified by the Working Group, there are 169 where no deadlines were set for their incorporation. This means there is still no indication of when Venezuela will adopt a set of rules representing 21.58% of the bloc's regulatory heritage.

Important rules, such as those on CET implementation and NCM adoption, financial matters, adjustment of the Automotive Regime, rules of origin, special customs regimes, transport of goods, and the implementation of liberalization commitments in the service sector, are awaiting the indication of adherence deadlines and methods by Venezuela.

In addition to the pending rules, 123 rules representing 15.7% of the heritage have already been classified in the 5th stage: in other words, they may be adopted by Venezuela only at the end of the transition period.

2. CET adoption schedule

The GT set the deadlines and percentage of products for which Venezuela is to adopt the CET, but not the lists of products that will enter at each stage, which should have been submitted by 2 September 2007. The agreed deadlines for elimination are as follows:

- Up to 60 days, at least 3% of NCM tariff lines are to be adjusted to the CET.
- As of the second year, at least 20% of NCM tariff lines are to be adjusted to the CET.
- As of the fourth year, the remaining tariff lines are to be adjusted to the CET.

There is no commitment over gradual convergence of Venezuela's tariffs with the CET, in the event of any hikes or reductions, as was the case with the tariff adjustment regime implemented by the MERCOSUR partners. There are only commitments over dates and numbers of tariff lines for adjustment to the CET, without schedules being set for the submission or identification of tariff lines to be included in each group.

Much of the effort of adjustment is to be transferred to the end of the transition period: up to 77% of NCM tariff lines may be adjusted to the CET by Venezuela as late as year four. There is, moreover, the expectation that Venezuela will submit a formal request for a list of CET exceptions, corresponding to 10% of the tariff sample (1,100 products).

The approval process of the Protocol of Adherence of Venezuela to MERCOSUR in the Brazilian Congress was unprecedented. For the first time, a detailed examination and an intense interaction between various different sectors of Brazilian government and civil society were seen in discussions in the Legislature over the technical aspects of an international agreement. This effort by the Congress became functional to the Brazilian negotiators, who succeeded in moving ahead in understandings with Venezuela on issues pending.

The final decision regarding the new member's entry to MERCOSUR is now down to the Paraguayan Senate. The recent debate in that country suggests no cause for highly optimistic forecasts over the possibility of a speedy resolution to the process. Indeed, there seems to have been a cooling of the various parties' interest in this initiative. This suggests the project may remain on hold over the coming year.

D. Outlook for the MERCOSUR External Agenda

Over the coming year, movement in MERCOSUR's external agenda may be limited by two main factors, already apparent in the second semester of 2010:

i. An international environment marked by protectionist pressures and unilateral trade restriction measures as a result of the difficulties of coordinating the exchange rate regimes among the major players in the world economy, and shrinking activity levels in the developed countries' economies.

ii. An internal environment in which there is a trend toward investment in the negotiating mindset in Brazil and Argentina, with a greater willingness to negotiate from the Argentine government, determined as it is to reestablish its international relations, and greater withdrawal from Brazil, facing growing deficits in its balance of payments current account and demands for protection from the domestic industrial sector.

The atmosphere in the international arena is still fairly unconducive to trade negotiations aiming at trade liberalization and investment. There is little likelihood of the efforts of WTO Director General, Pascal Lamy, actually resulting in the resumption of the Doha Round talks, or of concluding a multilateral agreement on trade in 2011.

The pressures in the US Congress to adopt countervailing trade measures against imports from China, and the recent competitive foreign exchange devaluations implemented by several countries have been added to a context now highly unfavorable to trade negotiations, which has prevented an earlier conclusion to the Doha Round and the implementation of trade agreements of any significance in recent years.

In MERCOSUR, the Argentine Government is mainly concerned to move forward its external agenda, having played a decisive role in the resumption of negotiations with the EU. The Brazilian government too, which had been playing a more proactive role in this area, has suffered claims from the private sector to avoid trade concessions to partners that may increase competitive pressure on internal markets. The continuing appreciation of the Brazilian real and the maintenance of an accelerated rate of internal absorption have promoted strong import growth, fueling demands for intervention by the Brazilian Government with measures to protect local industry.

The combination of trends in the external and internal environments makes it unlikely that there will be any significant progress involving the developed economies (e.g. the EU Agreement) or even more ambitious agreements with emerging economies (e.g. India and Mexico). This scenario also lessens Uruguay's chances of attracting United States' attention in the negotiation of a bilateral agreement, a project the country has been nurturing for some years.

On the other hand, this may be an opportune time for MERCOSUR to invest in deepening and improving its agreements with South American countries. The incorporation of services and investments in subregional agreements, and the convergence of trade agreements in the scope of LAIA are still pending on the MERCOSUR external agenda.

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