



2001 - 2002

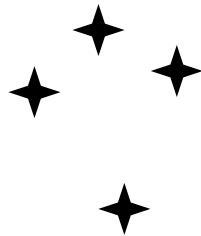
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*Intal*

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

INTER-AMERICAN DEVELOPMENT BANK  
MERCOSUR Report N° 8





REPORT

**MERCOSUR**

2001 - 2002

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

The purpose of INTAL, through the publication of this annual series, is to facilitate access of information to a wide number of readers interested in MERCOSUR, which comprises the public and private sectors and the community of the subregion as a whole. Likewise, in order to promote MERCOSUR within and beyond the subregion, information dissemination oriented towards the international community is fostered through the publication of this report in English, as well as in Portuguese and Spanish, the two official languages of the process.

Report N° 8 covers the second semester of 2001 and the year 2002 and has been prepared by Dr. Ricardo Rozemberg (*rrozemberg@sinectis.com.ar*), economist specialized in international economic negotiations, and Dr. Gustavo Svarzman (*gsvarzman@yahoo.com*), Associate Professor of Economic Development at the Universidad de Buenos Aires, and consultant for different organizations on issues related to export promotion and the North-South negotiations agenda. Dr. Marcelo Onesto, specialist in regional integration, and Dr. Juan Pablo Dicoovski, consultant in issues related to industry and world markets, have also collaborated in various parts of this Report.

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

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



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## EXECUTIVE SUMMARY

The eighteen months from June 2001 to end December 2002 were a period of unprecedented economic crisis within MERCOSUR, stemming from the sharp external shock that, with different characteristics, origins, and consequences in each member country, manifested itself in the bloc's two main economies as the exhaustion of market or voluntary credit. This phenomenon occurred in the context of a world economy with little momentum, one finding it highly difficult to recover the growth rate of the 1990s, and characterized, in particular, by limited flows of liquidity towards emerging markets. Unlike the traumatic events of recent years, this was not a case of mere contagion effect among neighboring and partner countries.

As usual, in both the Brazilian and the Argentine case, the need for adjustment manifested itself early in the financial sector. In the Argentine case, in the latter half of 2001, this took the form of a severe run on the banking system, which ended by sweeping away the convertibility regime that had been in place for over 10 years. In Brazil, it appeared as a steep decline in its bond values – hence the country's sovereign risk – which opened the way to the depreciation of its currency.

For the subregion's two most southern countries, Argentina and Uruguay, where the crisis was more clearly driven through the financial system, it reached the scale of a veritable “disaster,” with a sharp contraction in economic activity, of the order of 10% in 2002, steep devaluation of currency, profound fiscal crisis, marked rise in unemployment, serious social deterioration, and wide-ranging political consequences. In Brazil and Paraguay, there was less impact, although both economies continued to be faced with highly complex situations.

As one would expect, subregional foreign trade continued to contract, in which, intrasubregional trade within MERCOSUR declined vis-à-vis flows with the rest of the world. Nonetheless, a sectoral study of trade demonstrates that not all branches were impacted equally – in the context of the subregional decline in activity - by the “demercosurization” process. In general terms (with the exception of the ever “special” automotive sector), the activities least impacted seem to have been those where intrasubregional trade had developed in balanced fashion, with a pertinent presence of intrasectoral trade; while those most punished by the trade crisis were those where there was clearly one leading supplier country for the rest of the subregion.

### **MERCOSUR in 2001: Swimming against the tide**

Without doubt, the stark and escalating Argentine macroeconomic, financial, and political deterioration throughout 2001, along with the difficulties encountered by Brazil at the time to maintain the parity of the real, and the consequent negative impact on the subregion's economic, financial, and trade context - generated an increasingly complex panorama, in which conflicts of interest, threats – often carried out – of unilateral action, and the nearly daily “media battles” among officials of the different countries and, in some cases, the same country, occupied the attention of the bloc and of the subregion as a whole.

Although the differences – and incompatibilities – between the exchange systems of the bloc's two major partners were a concrete historical reality that would grow more acute throughout 2001, led by the changing international scene as it affected indebted emerging countries, Argentine authorities and a large majority of entrepreneurs, economists, and the public sought to prevent by all possible means a modification of the convertibility regime.

In this context, in which even the Brazilian authorities showed signs of willingness to accept some Argentine policy measures that might temporarily violate the spirit of MERCOSUR, it became

increasingly evident that offsetting the stark imbalances being generated by the inflexibility of Argentine exchange policy and the acceleration of devaluation in Brazil would be a task that would involve much more than ingenuity, effort, and good will on the part of the subregional partners.

### **After the "explosion" in the Argentine economy**

The Argentine collapse in late 2001 – with the subsequent breakdown of the economy and the resignation of President De la Rúa – produced a new political and economic scenario in that country, characterized by strong social tensions, political fragility, and enormous difficulties in managing the main macroeconomic variables.

Whereas on the one hand, the abandonment of convertibility (accompanied by the default on foreign debt instruments, the crisis of the financial system, and the deepening recession, with a drop of over 10% in product), in some way managed to contribute to “solving” the problems of relative competitiveness of sectors chronically problematic in intrasubregional trade, on the other, the well-founded anxieties regarding an imminent contagion effect on the other economies of the subregion (particularly Uruguay and Brazil) began to focus the concerns of subregional policymakers, entrepreneurs, and analysts.

Although fears were expressed in the smaller partner countries that the exchange volatility in Argentina would lead to both an invasion of products of Argentine origin and the deterioration of the subregion’s financial indicators, in the first months of 2002 - echoing the experience of the Brazilian devaluation of 1999 - neither of these effects materialized

Those months were nonetheless characterized primarily by paralysis of trade with Argentina, difficulties in completing operations already in course when the crisis erupted (in particular, collection of letters of credit by Brazilian exporters), and the wait-and-see attitude of the principal agents and operators.

But, despite the fears and short-term trade visions, from a certain standpoint, the end of convertibility was regarded with some optimism in connection with the MERCOSUR negotiations process. The coexistence of the fixed exchange system in Argentina and a flotation regime in Brazil unquestionably had been – particularly since 1999 – among the main factors contributing to the asymmetry between, and macroeconomic disequilibria and conflict among, the bloc’s main partners, from which nearly all problems of relative competitiveness and trade and investment diversion problems emanated.

In that connection, the elimination of the Argentine exchange regime seemed to have cleared the way for “normalization” of intra-MERCOSUR relations, so that the level of conflict would decline, thereby enabling more negotiating resources to be assigned to the “long term” issues, such as the external front (FTAA, EU, etc.) and the intensification of the integration process itself (review of the CET, trade disciplines, harmonization of technical provisions and standards, physical integration, government procurement, etc.), in a more relaxed framework, with less sectoral pressure and greater mutual understanding.

In that context, in the first months of 2002, efforts of the MERCOSUR countries focused, on the one hand, on seeking to “repair” the damage caused by the heightened conflict of the preceding year and, on the other, on ways to “alleviate” the new problems of the Argentine economy through trade measures and on how to prevent the crisis from spreading to the rest of the subregion.

At the same time, an attempt was made on the Argentine side to implement a strategy to “repair” as quickly as possible the damaged relations with the largest subregional partner, a situation that was helped by the departure from the scene of the majority of the officials most confrontational in relations with Brazil, and by the constructive attitude and positive predisposition on the part of the Brazilian federal government and of Brazilian officials with responsibility for managing relations with the subregion.

Thus, the topics of the media wars and media “negotiations,” discussions of some objective points of conflict of interest, and the search for realistic solutions to specific problems began to return to the subregional negotiating table.

### **Towards rebuilding subregional relations**

The marked restoration of Argentine exchange parity with respect to Brazil smoothed part of the way, and rendered superfluous many of the measures introduced by Argentina consequent upon the devaluation of the real in January 1999. Thus, during the first visit of Foreign Minister Ruckauf to Brazil a few days after taking tenure (mid-January 2002), the launch of the progressive elimination of the points of intrasubregional conflict was announced. This process, dubbed "clearing the table," became the focus of Argentine-Brazilian bilateral relations throughout 2002.

As regards MERCOSUR, Argentine negotiators – with the aim of generating markets that might contribute relatively quickly to the recovery of the national economy – focused their efforts on eliminating the causes of the "bogged down" negotiations (or renegotiations) of the MERCOSUR Automotive Policy (MAP), in order to bring flexibility to the balanced trade mechanism, so as to increase exports to Brazil from the virtually idle Argentine automotive plants.

From the outset, Brazilian negotiators indicated that they were open to the possibility of “assisting” an Argentina in crisis by adopting favorable trade measures, among them, definitive amendment and regulation of the MAP. They demanded, however, by way of compensation, the prior elimination of the numerous trade barriers and restrictions, and the subregional preference that Argentina had had in place for different sectors since 1999.

In Brasilia, it was considered – with good reason – that, after the devaluation of the peso, there was no longer any justification for such measures, as they had been merely an imperfect substitute for exchange policy that lacked instruments for flexibility or protection. Among the measures objected to by Brazil were the "convergence factor," reimbursements for intrasubregional exports, most of the anti-dumping procedures, perforations of the CET – corresponding to capital and final consumer goods-, different non-tariff restrictions, minimum reference prices at customs, and others.

Thus, in early February 2002, the Brazilian Minister of Industry, Sergio Amaral, announced his government’s political decision to eliminate all barriers and quotas imposed in the past on the entry of Argentine products into Brazil’s market, with the logical exception of those involving sanitary issues, such as hoof-and-mouth disease, and took the opportunity to express his solidarity with Argentina in its negotiations with multilateral financial organizations and developed countries.

In any event, despite the efforts of officials, the severe recession, exchange and financial instability, and problems of a regulatory nature (ranging from difficulties in implementing and administering the new trade and banking provisions in Argentina to delays in settling operations carried out between Argentine importers and Brazilian exporters in late 2001) would lead to sharp contractions of bilateral trade.

In this context, among the most important milestones of the period was the conclusion of the agreement to bring flexibility to the MAP, announced at the Buenos Aires Presidential Summit (July 2002), but only signed during President Duhalde’s visit to Brazil in September. However, despite progress made in stabilizing the Argentine situation in the latter half of the year, as of the date this report was closed, the process of suspending the antidumping proceedings and other points of controversy had not been concluded, the final decision having yet to be taken in some cases.

Along with bilateral efforts to remove points of conflict, throughout 2002, another constant concern was the possible "exportation" of the Argentine crisis to the rest of the subregion. As might have been anticipated, Uruguay was the country that most felt the force of the "shock wave," in the financial, exchange, and productive areas, from events on the other side of the Río de la Plata. To this were added problems of competitiveness in its sectors producing transactable goods, generated by the steep depreciation of the real.

Thus, in the first half of 2002, Uruguay sought (in vain) to preserve the exchange band regime that had been in effect until that time by imposing restrictive measures on intrasubregional trade, recalling to some extent the Argentine attitude prior to the end of the convertibility regime. Devaluation and, later, the banking sector crisis, were also inevitable.

To summarize, despite these new stimuli and the new climate in the subregion, trade between the major partner countries declined ceaselessly, although at decreasing interannual rates and with some prospects for incipient recovery in some specific sectors

### **A light at the end of the tunnel?**

From the beginning of the latter half of 2002, in a context of a growing trend towards stabilization of the Argentine economy, and the slow normalization of the Brazilian and Paraguayan economic and financial situations, the general panorama was improved, and officials and entrepreneurs from the subregion's countries were more disposed to fulfill and implement the different types of commitment made at the Buenos Aires Summit and to make some progress with certain priority items on the subregional agenda (such as the bloc's institutional structure).

Nonetheless, Brazil's peculiar political situation at the time, with the Cardoso administration in its final months of office, and the transitional character of the Argentine government, made it difficult to achieve new and broader understandings.

After Luiz Ignácio Lula da Silva was elected President as forecast, in the second round of the Brazilian presidential elections, certain questions were cleared up that had hung in the air regarding MERCOSUR's future. Throughout the presidential campaign, the new Brazilian President had pronounced himself strongly in favor of MERCOSUR.

In that context, the complex year 2002 closed with resolute political statements regarding a sort of rebuilding of MERCOSUR (avoiding the "ill-fated and overused" word "relaunch"), the success of which will unquestionably depend heavily on such convergence of ideas as may exist between the new Brazilian government and the new officials taking office in Argentina in May 2003, and on the success of such policies as are implemented by the two countries with a view to recovering growth in their respective economies.

### **Looking ahead**

For MERCOSUR again to become a major theme in the external strategy of the subregion's countries, the rapid return to the subregion of a context of macroeconomic stability and a return to growth are necessary, but insufficient, conditions.

The bloc's strength can only be restored through firm political intent that enables common interests to be renewed and the customs union's main instruments to be adjusted to current subregional and international conditions, so that the integration process again becomes a positive sum game for all countries of the bloc. This means leveling the playing field so that MERCOSUR may again be perceived as a "good bet" for

each of the states involved. If these objectives are not attained, the most likely outcome for the integration process in the coming years is insignificance and/or extinction, as occurred with earlier integration initiatives within the region.

Some of these issues were the focus of study and exchange of views throughout 2002, owing to inclusion on the agenda of items such as the competitiveness forums – intended to promote greater complementation among productive chains at the subregional level -, joint trade promotion in third markets, redefinition of the Common External Tariff for certain “strategic” sectors, and progress in establishing a technical secretariat.

Similarly, returning to a process of intensification of integration means that negotiating efforts must focus on a few thematic areas, according priority to consolidation of the basic principles of the customs union, that is, such efforts must focus first on reorganizing and structuring a new Common External Tariff that the four countries may more readily comply with and more in keeping with current productive needs, in a subregional environment of higher real exchange rates than the 1990s average.

Priority must be also given to eliminating the restrictions that are creating barriers to the development of the free trade area. The exchange disequilibria created by the Brazilian devaluation first, and that of the Argentine peso later, have generated different types of barrier to intrasubregional trade which, in many cases, have hampered the basis itself for the operation of the free trade area. Thus, “clearing the negotiating table” must necessarily include the renewal of negotiations to establish subregional “escape” mechanisms to address possible further changes in internal and external economic conditions in the subregion (in keeping with the preliminary agreements reached in late 2001).

Only by concluding formal MERCOSUR agreements capable of wrestling with the instabilities inherent to developing countries will it be possible strictly and definitively to eliminate unilateral measures of different types that seek to impede – temporarily – free trade which, once the shock that inspired them has been overcome, are difficult to review.

Lastly, the complex international agenda demands further negotiating and technical effort with a view to achieving a rational and “strong” basic MERCOSUR position in the different bodies (FTAA, EU, CAN, Mexico, etc.), a phenomenon that requires much more technical preparation and community policy coordination than has yet been achieved.

From the institutional/operational perspective, this thematic focus should be accompanied by greater focus of and coordination among MERCOSUR’s technical and political organs so that the necessary basic consensus may be reached. To that end, it would be advisable to strengthen those technical groups with direct responsibility for the few topics to which it is decided to accord priority, which would work jointly and expeditiously with the Trade Commission and the Common Market Group to ensure compliance with such commitments and deadlines as may be established.

To summarize, the current crisis of the integration process means that, in the coming year, agenda priorities must be ordered – as must the respective negotiation forums – in respect of tariff, trade, and the basic customs union disciplines, similar to those included on the agenda at the outset of the process (although incorporating certain novel elements, such as strengthening a quadripartite technical authority, issues of facilitation of adjustment of national legislation to MERCOSUR provisions, and positive “management” mechanisms in the entrepreneurial or business complementation areas).

Although this proposal may seem *a priori* to constitute a reversal of the negotiation process, as it means, in practice, returning to a much more simplified and focused agenda and institutional/operational organization, this is merely an acknowledgement and formalization of the existing situation. Resolving this issue depends on such macroeconomic and institutional consolidation as the States Parties manage to achieve in the near future.

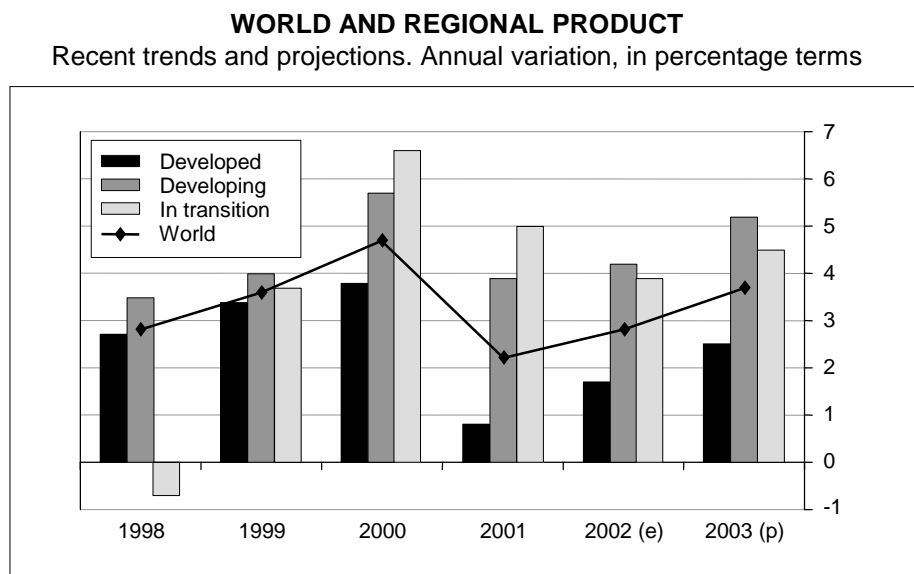


## CHAPTER I. MERCOSUR'S MACROECONOMIC AND TRADE OUTLOOK

### A. The international context in the period

Although 2002 was generally a year of world economic recovery, such recovery was characterized by its lack of vigor. It was, in fact, only partial as, in industrialized and developing countries alike, indicators were mixed.

Estimates were for a slight increase in world economic growth as a whole, of 2.8% for 2002,<sup>1</sup> vis-à-vis a rate of 2.2% for 2001, although vast areas of the world showed declining economic activity in the former year. Where growth rates were positive, they were only modestly so.



Notes: (e) Preliminary estimates. (p) Forecast  
Source: IMF

In such dynamics, the U.S. economy was a principal player, recovering from its stagnation of 2001 (the U.S. GDP grew by 0.3%), with estimates for growth of 2.2% in 2002. However, its recovery is being hampered by the successive shocks now undermining U.S. consumer and company confidence. The events of September 2001 have been accompanied by the far-reaching repercussions of the scandals related to the allegedly fraudulent accounting practices of major corporations.

This contributed to the sustained weakness of a stock market already hard hit first by the need for correction in respect of the unrealistic expectations for the information technology sector and, then, by

<sup>1</sup> Except where otherwise indicated, all economic growth data are taken from the most recent edition of *World Economic Outlook*, prepared by the IMF in September 2002.

deterioration in balance sheet positions linked to the aforementioned "cooling off" after a very long period U.S. economic growth in the latter half of the 1990s.<sup>2</sup>

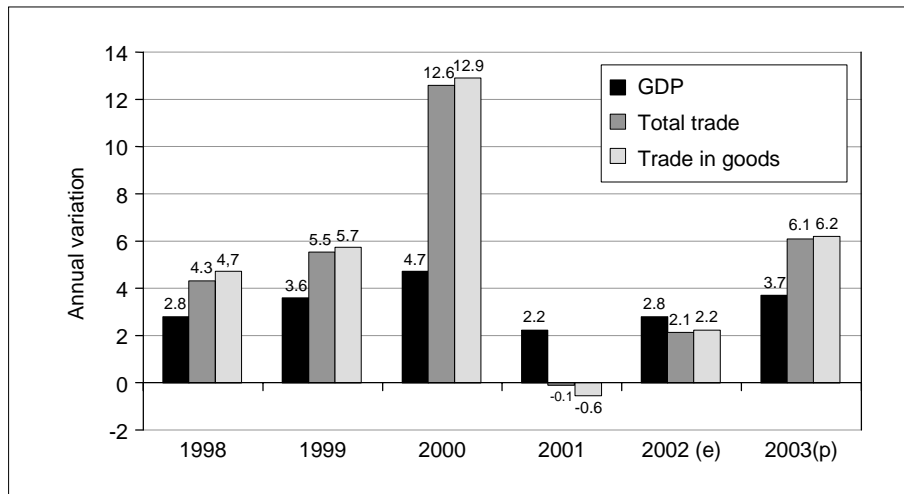
The most recent factor preventing the return of confidence was the threat of another Persian Gulf War. The possible negative economic impact of an unfavorable outcome of such an event is not confined to the inflationary and wealth effects of a rise in oil prices, but includes a further weakening of U.S. public finance, whose recent deterioration has also been of concern to financial analysts and players.

The developed world's two other economic blocs, Japan and Western Europe, for their part, lost momentum with respect to 2001, already an inauspicious year. Recession was again evident in the Japanese economy which, in 2002, contracted slightly, by 0.5%, following a 0.3% contraction the year before. In that country, persisting major concerns involve the health of the banking system, concerns dating back at least as far as the 1997 Southeast Asian crisis. The question faced by the Japanese government is whether to undertake profound financial reform that might, in the short term, exacerbate the recessionary pressures.

In Europe, economic growth slackened in 2002: to 1.1%, after a growth rate of 1.6% in 2001.<sup>3</sup> There remains marked lack of confidence in that region in sustained economic recovery, perhaps revealing more structural concerns regarding Europe's potential economic productivity in view of problems such as excessive regulation of its markets, particularly the labor market, and concerns regarding the crisis of its aging population.

### WORLD GROWTH IN PRODUCT AND TRADE

Annual variation, in percentage terms



Source: International Monetary Fund (IMF).

<sup>2</sup> In the decade 1991-2000, the U.S. economy grew at a cumulative annual rate of 3.2%. If account is taken only of the five-year period 1995-2000, the rate was 4%.

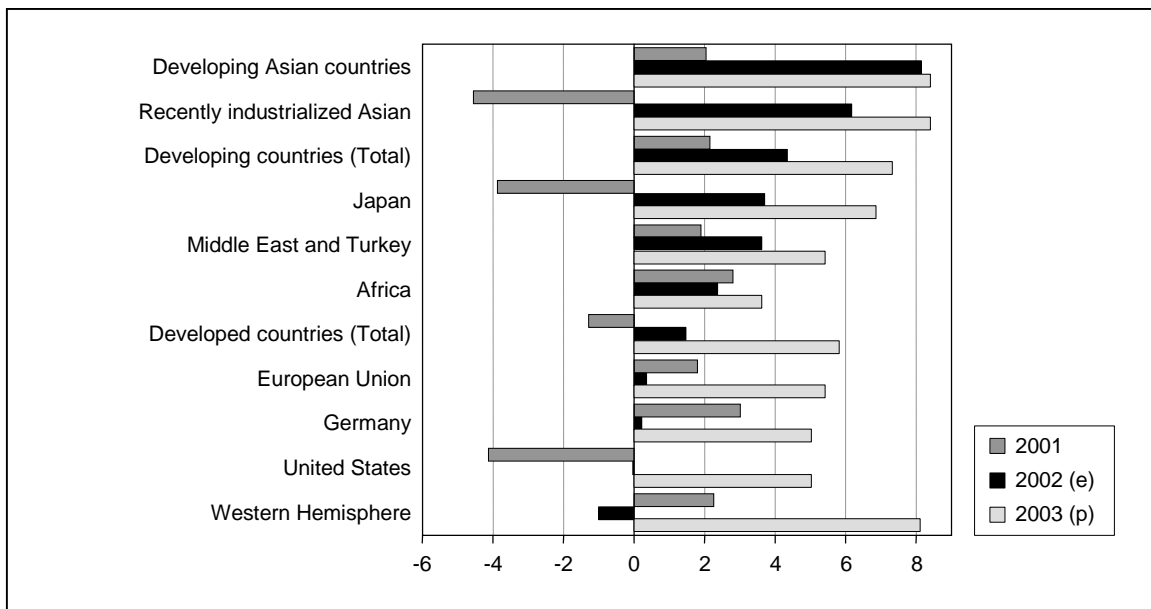
<sup>3</sup> Reflects data corresponding to the European Union's (EU) bloc of fifteen nations.



World trade recovered slightly in 2002, with volume increases of 2.1 and 2.2%, depending on whether figures for total trade in goods and services or only total trade in goods is taken into account. This constitutes a marked improvement over 2001, when, for the first time since 1982, trade volume contracted slightly, by 0.1% of total trade (and by 0.6% if only goods are taken into account).

Despite the renewed expansion of international trade in 2002, not only was momentum considerably less than in the preceding decade, but such trade expanded less than did production. In the 10 years preceding the recession of 2001, flows of goods and services expanded two and a half times faster than did world production. Although it would appear premature to characterize this as a new world scenario, first indications suggest that growth patterns of product and world trade have diverged from those of recent years.

**ANNUAL GROWTH IN TRADE <sup>1</sup>**  
By selected regions, <sup>2</sup> in percentage terms



Notes: (1) Growth in trade is expressed as the simple average of export and import growth rates in the respective regions.

(2) The regions above are not mutually exclusive (for example, *Germany* is included in the *European Union* region, and both *Germany* and the *European Union* belong to the *Developed countries* group).

Source: In-house, based on IMF data

When this trade recovery is studied in the context of regional opening, a marked dispersion is noted, East Asia clearly showing the greatest momentum. This trend is in line with production trends, as the developing countries in this region, particularly China and India, are those with the highest 2002 growth rates. These are heavily export-oriented economies also much affected by the crisis of 2001. This region mainly accounts for the higher growth noted in the emerging nations as a group.

As for trends in developing countries, the recession in Latin America contrasts with the economic expansion of Asia. In the first region, a modest export expansion could not offset the major decline in imports, which, from 2001 to 2002, was over 4%. In that connection, the crisis in the MERCOSUR member

countries (to be discussed more fully in the sections below) and their neighbors was accompanied by poor momentum in the U.S. economy, whose influence is essential to different Latin American countries, first among them Mexico, the area's second largest economy.

The trend in implicit trade prices signified, in 2002, a major return to the deflationary trend, in dollars, of recent years. The price deflator calculated by the IMF for international trade in goods and services rose by 1.3%, the first rise after six consecutive annual declines. The rise was linked mainly to the depreciation of the dollar itself, which declined against the euro by over 6%. This spurred upward trends in the prices of different agricultural and industrial commodities. In any event, it must be borne in mind that although, in 2002, there were significant increases in the prices of widely used products, average 2002 levels for many were only slightly higher than those of the preceding year.

Here, oil is a paradigmatic case as, although from December 2001 to December 2002, its price rose by over 50%, the average price in the latter year was only 0.5% higher than that of 2001.<sup>4</sup> A somewhat broader perspective is provided by the trend in the Commodity Price Index prepared by the Commodity Research Bureau, whose average spot indicator rose by only 1.8% but, in December 2002, showed levels 15.2% higher than those of 12 months earlier.

Private financial flows from developed countries to the developing world in 2002 remained at the low levels – as compared with those of the preceding decade – of 2001. Although, in the first months of the year, there were expectations that some confidence in emerging markets would return, weak economic recovery in the industrialized countries, along with the crisis looming in the financial sector – with the “noise” coming from the stock markets – in the end increased market aversion to all types of risk stocks, so that there was scant interest in channeling savings toward countries with ratings other than Investment Grade.

From a purely financial standpoint, in the United States, asset losses and the decline in profitability of stock investments, along with interest rate reductions for fixed income assets might have led to a search for alternatives outside that country's economy. However, persistent fears of another new recession, together with the stock market declines and prospects for the U.S. labor market – whose indicators are slow to reflect a reversal of economic trends – have undermined consumer confidence and are producing a cautious market when investment decisions are made.

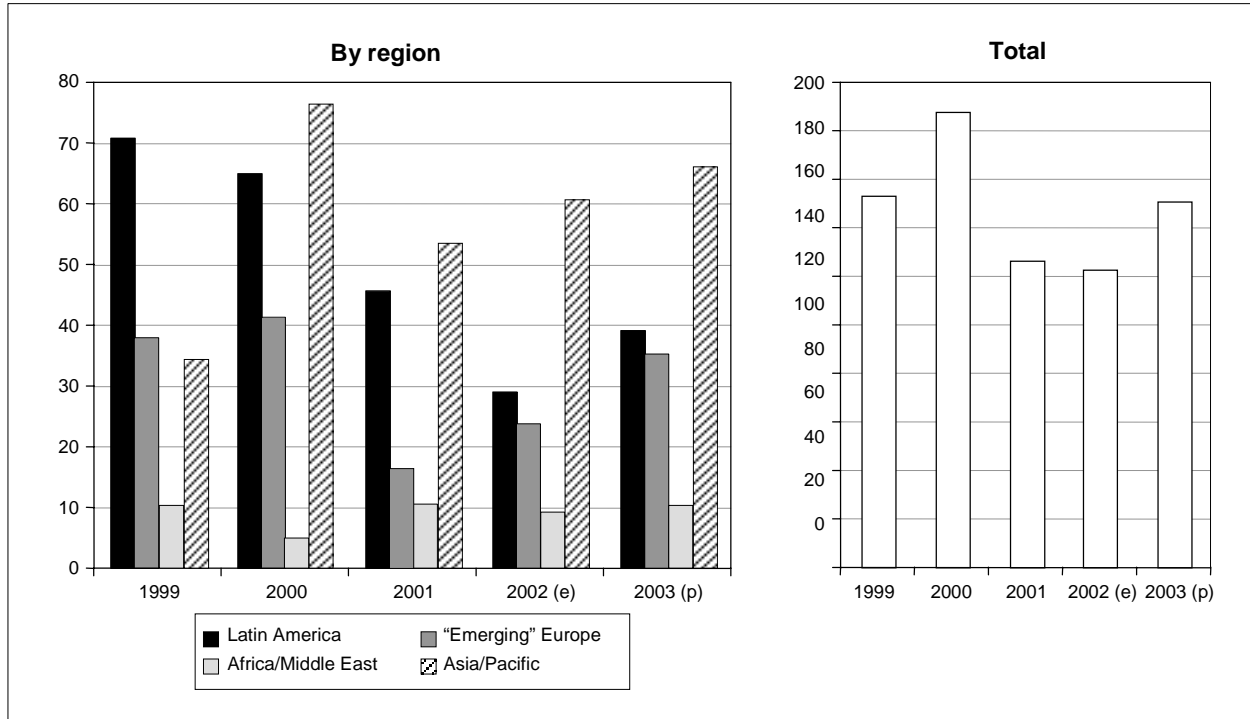
On the side of the net financial flow recipients, factors discouraging such flows – both temporary and permanent - were also emerging. First, in 2002, the political situation deteriorated in several developing countries. In Latin America, the most notorious examples were Argentina, Brazil, Colombia, Uruguay, and Venezuela, and, outside that region, Turkey. From a longer-term perspective, although structural reforms and privatizations continue in different emerging economies, in several, the 1990s pace of these processes has slackened. This may be explained both by the completion of the privatization cycle, by a certain “disenchantment” with this type of policy, and by the fact that the consensus that had earlier surrounded it is no longer present.

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<sup>4</sup> Here, the WTI variety was taken into account, which saw average annual quotations of US\$ 25.90 per barrel in 2001, and US\$ 26.10 in 2002. For Brent crude, the range between extremes was very similar, while the average rose by 2.5%.

## NET FINANCIAL FLOWS TO EMERGING ECONOMIES

In US\$ billions



Notes: (e) estimated (p) projected

Source: Institute of International Finance

Along with their lower levels, financial flows in 2002 toward the bloc of emerging economies were also characterized by selectivity of destination. As indicated above, economic conditions existed in that year to encourage alternative directions in financing but, in the end, the weakness of expectations favored high-quality stocks. In this context, investors discriminated among markets targeted for private financing in favor of regions with better economic performance. While East Asian and the emerging European economies were able more readily to access voluntary financing in the market, the rest of the developing world, essentially Latin America, apart from Chile and Mexico, witnessed a sharp contraction in external credit.

Among the different types of external credit to the developing countries, the most important remains, as it has recently been, foreign direct investment, which accounted for US\$ 113 billion of total credit of nearly US\$ 123 billion extended to emerging economies in 2002.<sup>5</sup> Among such types of credit, however, this category declined most with respect to its 2001 value of US\$ 146 billion. The relative weight of this category is linked to the aforementioned regional distribution of credit as, in Europe and, mainly, the developing Asia/Pacific economies, investment opportunities emerge in the private sector, especially in the form of direct purchase or new productive undertakings.

For the international context in general, growth prospects for 2003 are better than those for 2002, although surely only modestly so, and at a rate lower than previously projected. In addition, different risk factors

<sup>5</sup> These values are taken from the publication *Capital Flows to Emerging Market Economies*, prepared by the Institute of International Finance. The considerations expressed in this section in respect of financial flows towards developing countries are based on data from this organization.

mean that forecasts vary more than usual. IMF activity projections are for world growth rates of 3.7%. The optimism of this projection stems from trends forecast for the developing world, whose economies are expanding at a rate of 5.2%. For the developed countries, projections are more modest, of 2.5% after growth of 1.7% in 2002.

In fact, the slight expansion in the developed economies is based in particular on the recovery of the U.S. economy, based on strengthening its internal demand in the context of continued expansionary policies. For the rest of the developed world, further expansion will essentially depend on external traction.

The aforementioned forecast for the developing countries as a whole is based essentially on continued recovery of the Far Eastern economies, pertinent acceleration in the Middle East and North Africa led by the rise in oil prices, and on a certain return to normalcy in countries that underwent crisis in 2002. However, 3% economic growth still remains well below that of the “golden years” of the 1990s and even of 2000, but constitutes a departure from the recent turbulence in the Latin American countries.

Led by the moderate expansion in economic activity, an increase in physical volumes traded internationally is anticipated, from a 2.1% increase in 2002 to an increase of over 6% in 2003.<sup>6</sup> Expansion in money values would be even greater, especially as measured in dollars, as there would be a 2.7% increase in transacted prices. Expectations for the continued appreciation of U.S. currency mean that this change in rates is somewhat less than that of the currencies of other industrialized countries.

The fall in the value of the dollar, along with economic and trade trends – particularly to the extent that positive forecasts for the Asia/Pacific region are borne out – would lead to a rise in international commodity prices. According to IMF forecasts, the general average for these types of product, exclusive of fuel, would increase by 5.7% and by even somewhat more for agricultural inputs.

With respect to credit for developing economies, prospects for 2003 are for a relatively significant increase in net private flows – reaching US\$ 151 billion from 2002 levels of US\$ 123 billion, although much of this increase would be attributable to the impact of the financial crises on several countries (Argentina and Brazil weighing heavily), which would result in more or less forced restructurings of both public and private debt. However, capital flows to the “star economies” of the developing world would also increase.

Thus, of the nearly US\$ 28 billion by which credit to emerging economies would increase, some US\$ 10 billion corresponds to Latin America, much under the conditions mentioned above, another US\$ 11 billion to the developing countries of Europe, US\$ 5 billion would be destined for the Asia/Pacific region, and the remainder to Africa and the Middle East.

## **B. The subregional macroeconomic situation**

The 18 months from mid-2001 to the end of 2002 was a period severe economic crisis within the MERCOSUR region. While sources are interrelated of the shocks to which the region’s two largest countries were subjected, perhaps emanating from the common factor of exhaustion of voluntary credit to their public sectors, it is equally true that the successive traumatic events had specific and distinct consequences. This was not – as it had been in earlier cases – the “contagion effect” spreading the crisis from one country to the rest, but rather crises largely independent of one another, which inevitably reinforced one another.

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<sup>6</sup> These projections have also been taken from World Economic Outlook, published by the IMF, Sept. 2002. Same source was utilized for the evolution of commodities prices.

## GROWTH IN PRODUCT

Rates of annual variation in GDP, in percentage terms

	1990	1991-1995	1996	1997	1998	1999	2000	2001	2002 (1)
Argentina	-1.9	5.7	5.5	8.1	3.9	-3.4	-0.8	-4.5	-11.6
Brazil	-4.3	3.1	2.7	3.3	0.1	0.8	4.4	1.5	1.1
Paraguay	3.1	3.2	1.3	2.6	-0.4	0.5	-0.4	2.7	-2.6
Uruguay	0.3	3.9	6.0	5.0	4.5	-2.8	-1.4	-3.1	-8.6
MERCOSUR (2)	-3.7	3.7	3.4	4.5	1.2	-0.4	2.9	0.0	-2.1

Notes: (1) IMF and in-house estimates

(2) The aggregate subregional product was obtained based on the respective GDPs in 1997 dollars.

Source: In-house, based on data from the Central Bank of Brazil, Central Bank of Paraguay, Central Bank of Uruguay, INDEC, IMF, CEAL, and others

We may point to a common root of the recent critical macroeconomic trends in the two largest MERCOSUR countries: increasing difficulties in obtaining external public sector credit, in particular, for renewal of the relatively large stock of debt. This factor became particularly crucial in Argentina at the beginning of the period indicated, to such an extent that it finally led the country, in early 2002, to default on its debt instruments and, in part, on its debt held by international organizations in the final months of that year, and also led to difficulties in Brazil, although not as severe, a year later.

The subregion's two smaller economies clearly suffered from contagion effect. In both, the transmission mechanisms were as much financial as real, although they had different impact. Uruguay was the economy most affected and, as a result of events in Argentina, suffered a major run on the banks, in view of the traditional ties, both formal and informal, between the financial systems of the two countries.

### Argentina: A chronology of the crisis

In the second week of July 2001, the Argentine government launched a program immediately to eliminate the public deficit, thereby explicitly admitting that voluntary credit had been completely exhausted. For three months, the sovereign risk of the Argentine debt – measured by the spread of the respective EMBI+ – had been hovering around 1,000 basis points, although by mid-July, it was creeping up towards 1500.

This marked macroeconomic deterioration which, as usual, was having an explosive effect on financial markets, stemmed from a context characterized mainly by: three successive years of economic decline; marked relative appreciation of the national currency with respect to those of the country's largest trading partners, including Brazil; export stagnation; growing deflationary pressures; a rise in the public debt of some 15% of GDP in four years, without any nominal devaluation; and a deteriorated fiscal picture stemming from the expansionary interest burden and dwindling public income owing to economic recession and price deflation.

In addition, the government taking office in late 1999 encountered serious difficulties in recovering its political base in view of the virtual breakdown of the alliance that had brought it to power and of declining support within its own party.

Although the aforementioned program to tailor public expenditure strictly to available funds<sup>a</sup> was enacted and strengthened through an agreement with the IMF, which contributed approximately US\$ 6.3 billion *frescos*, leading a package of some US\$ 8.3 billion, the program could not be implemented, essentially because of plummeting revenues. This decline had been of the order of 7.5% in third quarter 2001, and of 24% in the fourth. The dramatic economic downturn impacted collection, not only because of shrinking tax bases, but also owing to the declining propensity to pay taxes stemming from the critical economic situation.<sup>b</sup>

In that context, a process of restructuring the public debt was undertaken by seeking, through negotiations with the major creditors, to prevent a frank unilateral default. The first step to that end was taken in the first half of November, when debt instruments held by banks and pension fund managers were exchanged for debt certificates backed explicitly by tax revenues.<sup>c</sup>

Meanwhile, growing lack of confidence in the stability of the macroeconomic regime as a whole and, in particular, in public sector solvency, led to an acceleration of the gradual withdrawal of deposits from the financial system, in view of its growing public debt exposure. In July 2001 alone, over US\$ 6 billion was withdrawn from banks, 7.5% of the existing stock at the end of June.<sup>d</sup> Although the tide waned in August, and was partially reversed in September (when total deposits increased by some US\$ 1.7 billion), in the two months that followed, withdrawals again increased. Thus, at the end of November 2001, financial system deposits had shrunk by some US\$ 16.5 billion as compared with 12 months earlier, a drop of 20%.

In this critical situation, in early December, the government established an emergency plan to stop the run on the banks and on foreign currency, consisting essentially of strict limitations on cash withdrawals from banks – set initially at 200 pesos per week per account, although then undergoing a long series of amendments – supplemented by exchange and capital outflow controls. This meant, in practice, the end of the convertibility regime that had been in place for the last 10½ years. Initially, the emergency program was to be in effect for 90 days, after which the status quo ante would be restored.

The aim of this new scheme was to ensure that the vast majority of transactions would be effected by bank payments – checks or debit/credit cards – a change that encountered great resistance from the population, not only because of its excessively hasty implementation for which, in fact, the payment systems were not prepared, but also because it meant recording most commercial transactions in an economic environment characterized by widespread tax evasion. The widespread unease in the middle strata of society was the factor that finally undermined the government, whose fall came very quickly, on December 20.

The impact on the real economy of the events of the second half of 2001 outlined above, which witnessed unusual fluidity of economic policy, particularly in trade and public finance, was extremely negative. Gross product fell by 7.7% with respect to the preceding year. December's industrial production was nearly 18% below that of June (both seasonally adjusted), while economic activity as a whole in the same period fell by 11%.

In those six months, wholesale prices fell by over 4% and retail prices by 1.6%. Imports declined by one-third with respect to the second half of 2000. The private capital account showed net outflows of US\$ 12.7 billion, while reserves fell by nearly US\$ 6.8 billion, 30% of those existing as of June 30, 2001. The unemployment rate, which had stood in October 2000 at 14.7%, one year later had risen to 18.3%.<sup>e</sup>

The new government, which remain in office only a week, formally suspended public debt payments. The formal end to convertibility would come a few days later, after another change of government and a protracted period of bank closure. Initially, this second transitional government would establish a dual exchange regime, soon to be replaced by a single flotation regime more in keeping with the country's unstable monetary situation.

Despite exchange deregulation, exchange and capital outflow regulations were maintained and strengthened to rein in demands for foreign currency.

The profound disturbances of every type generated by the combination of restrictions on access to deposits and the "wealth effect" of the devaluation made evident why ending the convertibility regime had been left until it could no longer be avoided. It should be remembered that in late November 2001, when financial system restrictions were imposed, nearly 70% of deposits and 66% of bank loans were denominated in dollars. Thus, the sharp rise in the exchange rate then taking place – in February reaching a 100% increase over the convertibility rate – greatly impacted the assets of a multitude of economic players.

Evidently, while depositors demanded that the currency in which their placements had originally been made be respected – placements which, moreover, they were unable to dispose of as the restrictions were made permanent in December, lenders alleged that, under the new rules, they would in any event be unable to meet their foreign currency-denominated obligations. In fact, it was clear that, left to their fate, many banking entities were not in a position to meet their obligations to their depositors.

In such a situation, the government decided to take a proactive approach and order the conversion to pesos of virtually all dollar deposits and bank loans, although in "asymmetrical" fashion: while loans would be paid at a parity of one peso per dollar, deposits would be converted at the rate of 1.4 pesos per dollar. Banks would be compensated for the difference in the form of public debt instruments.

It was also established that payment of fixed term dollar deposits would be deferred according to an extended timetable. Payment of the final deposits will be completed in September 2005, staggered by amount deposited. In addition, an indexation coefficient was established for such deposits, one that in fact followed consumer price trends, which was also to be used to update bank loans, although its application in that connection was for the most part deferred and was then partially replaced by another index based on wage trends. For their part, restrictions on cash withdrawals remained in place, although over time they were gradually lifted.<sup>f</sup>

These controversial decisions were, on the one hand, justified in view of a threat of the general collapse of borrowers and, behind them, banking institutions and depositors. On the other hand, however, they signified massive government intervention in private agreements, thereby weakening the security of the entire system of contracts underlying economic activity.

The first distances traveled under this scheme were, frankly, tumultuous, not only owing to the public controversy generated, but also to the notorious difficulties in controlling the value of the currency. Although the shift to devaluation prices was relatively slight, especially as compared with initial projections – wherein weighed heavily the memory of the 1980s of the dollar as the coordinator of inflationary expectations –, the rise in the first months of 2002 had major impact on the purchasing power of large sectors of the population, whose economic situation was already deteriorated owing to the long recession that had begun in 1998.

Thus, achieving control over the exchange rate had become essential, although the conditions in which that objective was to be achieved were adverse. There was an evident need to establish a monetary “anchor,” although this had to be done in the anomalous situation of a run on the banks suppressed through restrictions on the availability of money. In theory, the escape valve had to be adjusted precisely – the permitted cash withdrawals – thereby providing liquidity for productive and trade activities, while preventing a run on the dollar.

If that task were not already in itself difficult enough, it proved impossible in view of the large number of high value judicial orders for cash payment of deposits to savers, who sued the government in connection with its provisions in this area. These who channels taken together – outflows permitted under the regulations and the judicial “amparo” lawsuits – led to a sharp increase in demand for bank liquidity, which was addressed through Central Bank discounts. Thus, the monetary base rose from nearly 12 billion pesos at the close of 2001, to nearly 20.5 billion three months later. Reserves in that first quarter of 2002 again declined, now by US\$ 2.133 billion, as a result of capital outflows of nearly US\$ 3.7 billion.<sup>9</sup> The last working day of March, the 27<sup>th</sup>, the dollar was quoted at 3.0 pesos.

In second quarter 2002, the financial and exchange scenarios were very similar. Bank withdrawals continued, hence, so too did monetary expansion, although the Central Bank attempted to sterilize it by issuing bonds (Lebac). At first, the scope of this step was very limited, but it gained in effectiveness as the months went by.<sup>h</sup> Pressure on the dollar was sustained until, in late June, it reached a quotation of 4 pesos. In consequence, the rate of inflation also rose, peaking in April at 10% in the retail sector and at 20% in the wholesale.

Since the first months of 2002, the Argentine government had been engaged in negotiations with the International Monetary Fund for an agreement which, in the best scenario, would feed fresh funds into Central Bank reserves and would enable the dollar to be stabilized and – behind it – prices. The minimum objective was to prevent Argentina from also defaulting on payments to the international organizations.

In the real sector, a change began to be noted. Although a recovery in production was not yet taking shape, there were at least indications that, from April to May, a floor had been reached. The steep real devaluation had had favorable impact on sectors exporting in recent months, which were the first to show upturns in activity. However, domestic demand remained very depressed. For their part, public accounts gradually began to be replenished – at least on current account – without taking into account the stock effects of devaluation on the debt. This occurred essentially in two ways.

First, inflation increased the value of transactions and taxable assets. Secondly, through the imposition of heavy taxes on imports (“withholdings”), with tariffs of up to 20% for primary commodities (oil, grain, and oleaginous seeds), in addition to the impact on public accounts, an attempt was made to mitigate to some extent the impact of the devaluation on domestic prices.



As of the beginning of the third quarter, the general picture began to stabilize, essentially owing to the trend in deposits, which ceased to decline. Fund withdrawals based on judicial orders fell substantially, which enabled the money supply and, in consequence, capital flight, to be contained. This, together with the large trade surplus, which hovered around US\$ 4 billion per quarter throughout the year, assisted in halting the depreciation of the peso. For much of the second half of 2002, the dollar was quoted at around 3.60 pesos and, at the end of the year, it began to fall from this level.

The price trend was clearly in line with exchange rate dynamics, even though adjustments were noted that still reflected the impact of the devaluation in the first half of the year. Cumulative inflation from June to September was 7% in the retail and 13% in the wholesale sector, well below the rates from March to June, of 19% and 46%, respectively. Bank activity, which had been highly irregular in the preceding months, began very gradually to normalize and, as of September, bank deposits began to some extent to return.

In addition to the steadying of the dollar exchange rate, two other factors contributed to this slight improvement. First, economic authorities gave savers with rescheduled deposits the option of exchanging them for public bonds denominated in dollars. Successive programs were also offered to utilize these immobilized funds to purchase real estate and motor vehicles. Thus, the total amount of these types of deposit declined significantly (by over 25%). The other factor that helped to overcome the run on the banks – contained by the restrictions – was the establishment of a regime of accounts free of restrictions on cash availability for new funds entering the banking system.

For its part, in the second half of the year, a slow increase in economic activity began to be noted, although levels remained below those prior to the collapse in the second half of 2001. Industrial production in last quarter 2002 rose by 5% with respect to the first quarter of that year, although remaining 11% below the levels of second quarter 2001.<sup>1</sup> Apart from exporting sectors, the final months of the year also showed momentum favorable to sectors targeting the domestic market, based on import substitution emanating from the change in relative prices.

However, the general absence of credit and marked weakness of demand remained severe constraints on possibilities for the growth of economic activity. It should also be noted here that, although there was growth in different sectors heavily directed towards external markets, and despite the improvement in the real exchange rate, exports as a whole remained stagnant. At the end of 2002, the Argentine economic picture was slowly normalizing from its situation of extreme upheaval at the beginning of the year. In that connection, the restoration of exchange and price stability, the return of deposits, and some increase in economic activity were the most encouraging signs. The agreement finally reached with the International Monetary Fund in January 2003 also created – despite its limited scope – some room for optimism. Nonetheless, complex issues remained to be resolved. Developments in connection with such issues are crucial for full regularization of the operation of the economic system as a whole.

Among the most pertinent remain those related to allocation of the costs emanating from the crisis, both financial system costs, such as restructuring the public debt, and the treatment accorded large private debts held abroad. Among other such issues are tariffs for utility services provided on a private basis which, in view of the next context, imply a need completely to redesign the corresponding regulatory structure and reformulate infrastructure policy as a whole.

From a more strategic perspective, also to be addressed is the development of a new fiscal regime in keeping with a scenario where there may be no possibility of obtaining credit on international capital markets and where the inevitable real appreciation of the peso may reduce the effectiveness (and,

potentially, the equity) of a structure heavily dependent on withholdings. Lastly, is the issue of converting the current emergency monetary and exchange policy regime to one providing the Argentine economy with some predictability of prices and the relative value of the Argentine currency against those of the rest of the world.

<sup>a</sup> One of the elements with the most far-reaching repercussions was the 13% reduction in wages for a large percentage of public employees and pensioners.

<sup>b</sup> The high interest rates were also an incentive to tax evasion, as credit thus obtained was considerably less expensive than that available from the formal lending circuits. Paradoxically, it was the fiscal shortfalls themselves that were mainly responsible for the rise in the cost of credit, this stemming mainly from increasing public sector pressure on bank lending capacity.

<sup>c</sup> The operation sparked a dispute with different international risk assessors who, thereafter, placed Argentine debt instruments in the "selective default" category, as it was considered that the exchange had not been strictly voluntary, as it did not offer creditors who accepted them any improvement in terms (rate, term, nominal capital, or discount on bonds surrendered). The Argentina government, for its part, claimed that the improvement in terms of the new asset lay in their higher quality, as they were backed by tax revenues.

<sup>d</sup> Approximately half the deposits withdrawn were denominated in pesos although, as the convertibility regime remained in force, the effect on the money supply and bank liquidity was virtually identical to that on the outflows of dollar placements.

<sup>e</sup> Unemployment would reach 21.5% in May 2002.

<sup>f</sup> Deferral of payment of fixed term deposits split the bank problem into two. On one hand, the restrictions remained on cash withdrawals from current accounts and savings banks (typically utilized for transactions), which it was more urgent to bring to an end to restore the most immediate payment capacity of economic agents. On the other were the fixed term dollar deposits themselves (more identifiable with hoarding), which were the primary candidates for capital flight. In economic and financial slang, the first segment was dubbed *corralito*, while rescheduled fixed term deposits were called *corralón*. The distinction was based not so much on their relative sizes, but rather on the degree of restriction – suggesting the image of the corral – to which they were subject.

<sup>g</sup> This includes US\$ 146 million in capital outflows, entered as "errors and omissions."

<sup>h</sup> The first tenders - for periods under two weeks, at very high rates - were issued in March. In that month, paper for a total of 394 million pesos and US\$ 77 million was issued. In August, paper began to be placed at 28 days and the monthly record was reached of 3.47 billion pesos and US\$ 427 million, although rates remained similar to initial rates. In the following months, the amounts absorbed contracted (in December, 1.46 billion pesos and US\$ 244 million), although terms were extended by up to 270 days and rates substantially reduced.

<sup>i</sup> Fourth quarter figures are preliminary. Variations refer to levels not seasonally adjusted.

With these critical episodes at the core of the tumultuous macroeconomic events, the last two years have been decidedly unfavorable for the MERCOSUR subregion. Even using preliminary figures, 2002 appears to have been the worst since the conclusion of the Treaty of Asunción, with an over 2 point-fall in combined product after a year of aggregate stagnation. In the 2002 trend, the Argentine peso was decisive, with steep declines in its value.

For its economy, the decline, which would reach 11.6%, was among the largest in the entire history of Argentina as an organized state, only comparable to that of 1914, at the start of World War I. For Brazil, the decline in the currency had less economic impact, and led only to a deceleration in growth. However, as its economy is of continental proportions, and its population growth has been substantial, recent trends have been barely sufficient to maintain real product per inhabitant at constant levels, a less than satisfactory performance.

A review of the real rates of variation in product in the subregion's four countries can provide an idea of the extent and depth of the crisis suffered by each.

Argentina's virtual "collapse," with a cumulative contraction in GDP of 15.5% in two years and of 19.0% in four, falling to levels lower than that of nine years earlier, was the result of the combination of a breakdown of the monetary regime that had been in effect for 10 years (convertibility), the default on the public debt instruments, restriction on access to deposits throughout the financial system, a profound and disorderly change to the contract system ("pesification"), and a profound political crisis, whose most evident manifestations were the early departure of the government that had taken office in December 1999, the failed attempt at a rapid transition, anticipated to be three months, and the subsequent inauguration of a second provisional government, whose term is - expected - to end on May 25, 2003.

The somewhat less complex outcome in Uruguay also stems from a profound crisis, albeit with three mitigating elements. First, the height of the crisis occurred six to eight months after the crisis in Argentina, so that much of the year was somewhat more positive. Secondly, Uruguay started from a relatively better position: it enjoyed an Investment Grade rating and had already adjusted somewhat the parity of its currency; and, lastly, it should be noted that the crisis itself did not last as long as in Argentina. In Uruguay, too, the exchange regime in force was altered, moving from sliding bands to dirty flotation, but the existing regime was less rigid than that in Argentina, even in terms of its implications for monetary policy.

This change also led to a steep depreciation of the national currency, of relatively less impact than the depreciation in Argentina. Uruguay also suffered a traumatic run on the banks, with cases of forced deferral of the return of deposits, but this episode was resolved in a considerably more orderly fashion, perhaps profiting from experience on the other side of the River Plate, which sought to isolate entities in difficulty from the crisis, and not allow the run to become a general run on the system.<sup>7</sup> The economic turbulence even had considerably less disruptive impact on politics, with the collapse of the governing alliance, than in Argentina, where, along with the complete change of government, there were confrontations among the three branches of government.

Finally, two important elements of the Argentine crisis were not present in the Uruguayan. These were the default on public debt instruments and the state intervention in the currency in which contracts were denominated. In addition, a stabilizing element enjoyed by Uruguay was the support of the international lending institutions.

Brazil and Paraguay are the two economies showing "normal" variations in their gross product, although these were not satisfactory in either case. In fact, neither of them had to undergo the extreme circumstances of virtual collapse of the economy described in the paragraphs above. In the Paraguayan case, the sources of its steep contraction, of 2.6%, the largest in nearly 20 years, were both domestic and external. One was the delicate subregional context, which had impact on both the weak activity in its neighboring countries and on the relative appreciation of the guaraní, by 78% against the Argentine peso and by 8%<sup>8</sup> against Uruguayan peso.

Two factors negatively impacted domestic primary production. A major drought affected in particular cotton and corn production, while, towards the end of the year, livestock suffered an outbreak of hoof-and-mouth disease. It should be noted that agricultural added value accounts for 22% of the Paraguayan product. A third, mixed, factor undermining production was the financial sector difficulty, stemming in

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<sup>7</sup> To be noted in that connection was the fact that in resolving the banking sector difficulties in Uruguay, credit was made available by the International Monetary Fund, an organization with which that country always maintained an agreement in force, and by the United States, which provided liquidity for the system to reopen its doors after the periods of bank closure of early August.

<sup>8</sup> Between average annual levels of 2001 and 2002, with 11-month data for the latter, according to own estimated based on figures from the database of *the Instituto de Pesquisa Económica Aplicada* (IPEADData).

part from the problems related to the Argentine crisis and in part from the deterioration in assets in view of the severe domestic recession.

Lastly, Brazil was the subregion's only country whose 2002 annual average product increased – estimated at a marginal 1.0%, although, as was the case in four of the last five years, the country continued to find it extremely difficult to direct its productive apparatus towards the path of sustained growth. Although the country did not undergo episodes of collapse of the functioning of its basic macroeconomic regime, in the latter half of 2002, it was subject to strong pressure on international capital markets, with severe problems in obtaining sufficient external credit.

Such pressure was even more acute than that experienced in the second half of 1998 in the months leading up to the devaluation of January 1999, and stemmed from a combination of political uncertainty regarding the advances in the polls – eventually confirmed at the ballot – of a candidate allegedly of populist hue in the view of international financial analysts, and significant amounts of public debt reaching maturity in the near future.

#### **Brazil: fears concerning the debt and the change of government**

At the end of July 2002, the EMBI+ spread indicator, reflecting Brazil's sovereign risk in connection with its federal debt, broke the psychological barrier of 2000 basis points, where it would remain for the next five weeks. This financial market event marked the height of the loss of confidence, coming in conjunction with a committed schedule of mature public debt, the sustained advanced of the *Partido Trabalhista* candidate in the polls, and fallout from the Argentine economic catastrophe. From a less circumstantial perspective, financial markets appeared to react vis-à-vis an economy with current account deficits consistently above 4% of the country's product, even in years of modest growth, and whose public debt had risen by over 20 percentage points of GDP since 1997, in the direction opposite to certain more reticent and selective international financial markets.

Based on the fiscal and external sector issues, the move by the large international creditors towards less exposure in Brazil shook the entire macroeconomic regime in place since the abandonment in January 1999 of the fixed rate of exchange. One measure of the shock that the Brazilian economy had to face is the US\$ 7 billion capital and financial account deficit generated from July to November,<sup>a</sup> even after the IMF disbursement of some US\$ 8.5 billion in June.

The result of this move was a nearly 30% depreciation of the real against the dollar in three months<sup>b</sup> and, in consequence, a rise in inflation. Initially, the reaction of monetary authorities was to interpret the phenomenon as purely speculative and temporary, and therefore to try to offset the devaluation's recessionary effect by means of interest rate reductions.

Subsequently, the price rises and monetary expansion generated by the difficulties encountered in renewing the internal debt, which were paid for by issuing money, obliged the authorities to revise their views.<sup>c</sup>

In fact, from April to September, base money expanded by 30%, twice the rate of the 12 preceding months, stabilizing in the months that followed. Inflation, for its part, could not be stabilized, impacting in particular the wholesale sector. While, for example, the average monthly Broad Consumer Price Index (IPCA) from the first to the second half of the year rose from 0.5% to 1.4%, the Wholesale Domestic Availability Index (IPA-DI) rose from 0.7% to 4.7%.

In any event, possibly what led the Central Bank to alter its strategy was the notion that expanding base money was creating additional pressure on the exchange rate and that successive depreciations of the real would ultimately undermine bond market expectations still further, as much Brazilian public debt is currently tied to the exchange rate. This link between exchange rate levels and expectations for Brazilian state solvency set up a dangerous vicious circle, as the decline in confidence led to capital outflows and new depreciation pressures on the real.

In any event, the monetary “handshake” produced results as, although the rate of inflation could not be reduced, it was possible to stabilize the exchange rate and lower the level of sovereign risk which, from mid-October to mid-January 2003, when this report was closed, had fallen by over 1000 basis points and was hovering around the 1200 level. In addition, in November, the government succeeded in renewing all mature domestic public debt.

One element contributing to controlling the situation was a certain “honeymoon” on the political scene, as questions began to be answered regarding policies that might be altered by the potential *Partido Trabalhista* government for the 2003-2006 term.

Another factor contributing to reducing the spike in speculative pressure was the evident economic improvement beginning in the latter half of the year. Although the 2002 average was slightly higher than that of 2001, production trends in the two years were downward. While in 2001, trends declined, they were reversed in the following year. In the case of industry, for example, November 2002 activity was 6% higher than that of December 2001.<sup>d</sup>

The reversal may in part be explained by exports, which had considerable momentum in the latter half of the year. In this context, it was possible to control public accounts and improve the balance of payments position while noting that, although imbalances persisted, Brazil was able to return to the path of fiscal and external solvency.

At the end of 2002, the panorama was somewhat calmer, even reflecting some optimism based on the inauguration of the new government and the appearance of encouraging signs, such as rising international prices, improved competitiveness of the Brazilian economy itself, taking shape in the trend in the trade balance, and some progress in the area of taxation, which was easing pressures on the complex fiscal front.

Nonetheless, the issue of the heavy public debt remains, with its concentration of maturities at a time hardly propitious to attract the financial markets of the developed countries, along with other issues of an essentially fiscal nature, such as reform of the public employee social security system. Finally, the last question regarding Brazil’s macroeconomic trends involves the capacity of its new government to manage a complex situation in the context of a certain anxiety to expand appreciably its electoral base.

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a Most recent data available.

b Equivalent to a 40% rise in the exchange rate.

c The year 2002 began with the Monetary Policy Committee (COPOM) setting the reference rate at a target of 19% per year. At a meeting in late February, and again at a meeting in late March, COPOM reduced the rate by 0.25%. On July 17 – during the crisis – it was again reduced, to 18%. This target was maintained in the August 21 decision, which emphasized the expansionary intent in the economic context, thus establishing a downward trend, which would create the possibility of a further reduction, although this did not in the end take place. In a special meeting of October 14, COPOM revised its position, with a resounding three percentage point rise, reinforced by subsequent rises in November (to 22%), December (to 25%) and, in January 2003, at the close of this report, the reference rate stood at 25.5%, the highest since May 1999. Although it began to play a central part on the Brazilian macroeconomic scene in 1999 with the establishment of the inflation-targeting scheme, COPOM has met once each month, around the 20<sup>th</sup>, since mid-1996, under the chairmanship of the head of the Central Bank. The meeting of October 14 was the third special meeting in its history, the first two being those of October 1997 and September 1998.

<sup>d</sup> Variation between levels not seasonally adjusted, based on data from the *Boletín Estadístico* of the Central Bank of Brazil.

The move inevitably had repercussions for Brazilian exchange rates, whose depreciation had impacted the real sector through both a steep rise in inflation and the rise in the cost of credit. This was accompanied by other factors negatively impacting economic activity. One was the lack of momentum in the developed countries – the NAFTA area, the European Union, Japan, China, and Korea together account for nearly 60% of Brazilian external sales, which led to downward trends in export prices.

The last economic factor that may be mentioned is the extremely steep drop in demand from Argentina which, until 2001, had been Brazil's second largest trading partner. Its imports fell by nearly 60%, very much in line with the trend in that country's total exports.

In any event, to review the complete macroeconomic pictures, in the period from late 2001 to the end of the following year, a series of common patterns may clearly be distinguished. First to be noted in the four MERCOSUR member countries was a significant decline in capital inflows. While the four aggregate capital and financial accounts in 2000 showed a positive balance of US\$ 35.5 billion, 2002 closed nearly US\$ 7.4 billion “in the red.” This despite the fact that in 2000, there were net returns to the International Monetary Fund and other institutions that had provided exceptional credit of over US\$ 9 billion,<sup>9</sup> while in 2002, this flow generated a net income of somewhat over US\$ 14 billion.<sup>10</sup> As for 2001, the aggregate account balance deteriorated by some US\$ 27 billion.<sup>11</sup>

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<sup>9</sup> The excellent performance of the Brazilian economy at that time enabled the country to return much of the exceptional aid package it had received the preceding year after the devaluation of the real.

<sup>10</sup> All figures given in this passage were taken from ECLAC's *Balace preliminar de las economías de América Latina y el Caribe, 2002*. Those for 2002 are preliminary.

<sup>11</sup> It fell from a positive balance of US\$ 19.8 billion to a negative balance of US\$ 7.4 billion. This includes flows owing to IMF credits and others of an exceptional nature. If these are not taken into account, it would have deteriorated somewhat less, by some US\$ 25.2 billion.

**BRAZIL'S SOVEREIGN RISK**  
Spread of EMBI+ Brazil in basis points



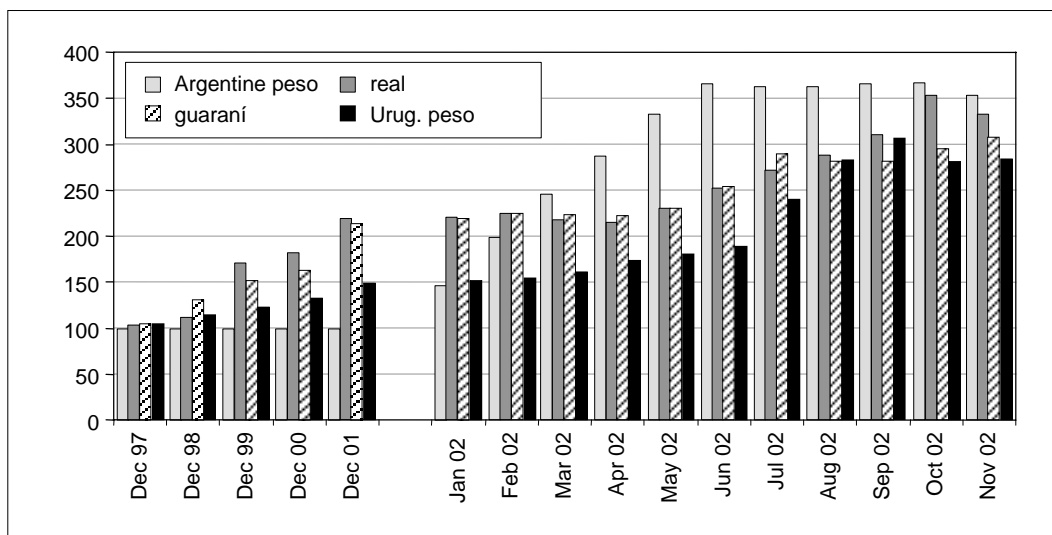
Source: J.P. Morgan

One of the most important consequences of this balance of payments pressure was the steep nominal and real depreciation of the subregion's four currencies. In fact, as mentioned above, two of the areas' four countries (Argentina and Uruguay) witnessed the collapse of their exchange regimes in the context of capital outflow pressure.

Clearly, the most spectacular case was Argentina which, after the official abandonment of convertibility in early 2002 and a failed attempt to establish a dual exchange rate regime, suffered a six-month rush in which its nominal exchange rate rose by up to some 300% although, at the end of the year, it was 249%, with a downward trend. From December 2001 to December 2002, the dollar increased by 54% against the Brazilian real, although the steepest increase occurred in the third quarter of the year. Uruguay abandoned its sliding band scheme in July and showed an exchange rate increase between extremes of approximately 95%. The slightest increase was seen in Paraguay, where the dollar rose by some 43% against its currency.<sup>12</sup>

<sup>12</sup> Measured in terms of the respective local currencies, movements from December 2001 to December 2002 signified declining values – depreciations – of approximately 71% for the Argentine peso, 35% for the real, 30% for the guaraní, and 48% for the Uruguayan peso.

### NOMINAL RATE OF EXCHANGE 1997 indices = 100



Source: Central Bank of the Argentine Republic and Ipeadata

These movements implied rises in inflation in the four countries, along with upward adjustments in relative prices of transactable goods. In each of the subregion's economies, both wholesale and consumer prices rose at a faster pace.<sup>13</sup> While the consumer price range throughout the year was 41% in Argentina and 12% in Brazil, the range for wholesale prices was 118% in Argentina and 33% in Paraguay.

Despite the width of the ranges, the origin of price movements in devaluation may be clearly seen from the fact that in the four MERCOSUR countries, the scale of inflation for wholesale prices was from two and a half to three times greater than that for retail prices.<sup>14</sup> In general terms, these inflationary rises stemming from the impact of depreciation of the national currency rather than from endogenous dynamics emanating from the issuing of money or demand pressures.

Thus, the reference period may be characterized as one of readjustment of price levels to the new parities, as distinct from the historic inflationary episodes. In any event, the "imponderable" in this connection arises in Brazil, where the link between devaluation and the weight of public debt service is threatening the separation of the fiscal picture from monetary policy, which in the end might "endogenize" the money supply, thereby threatening price stability.

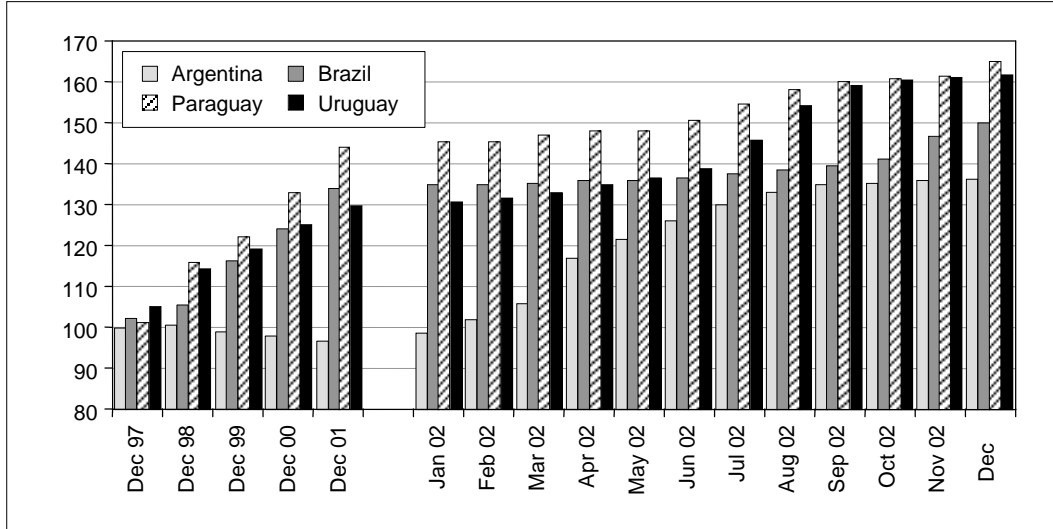
<sup>13</sup> In the Argentine case, the upward movement generated by devaluation of the peso followed a year of wholesale price deflation and three consecutive years of decline in consumer prices.

<sup>14</sup> The wholesale inflation/retail inflation ratio was 2.9 in Argentina, 2.8 in Brazil, 2.6 in Uruguay, and 2.4 in Paraguay.



## CONSUMER PRICE INDICES

1997=100



Note: \* Data estimated for Uruguay and Paraguay.

Source: In-house, based on INDEC, Ipeadata, and ECLAC data

### Paraguay: the domestic elements of recession

In 2002, the Paraguayan economy underwent its third economic decline in five years. In this case, the decline in the GDP would hover around 2.6%,<sup>a</sup> greatly surpassing the scale of the declines of 1998 and 2000, both of 0.4%. Although the severity of the recession may largely be explained by the severity of the subregional crisis in view of the numerous links with Paraguay's partners and neighbors, especially the River Plate countries, certain domestic factors also played a part. Along with the decline in external demand, not only for goods but also, for example, the decline in Argentine tourism revenue, and declining internal demand, the recession also stemmed from supply factors and factors of an institutional nature.

First was the impact of adverse climatic conditions, which led to a steep decline in the production of different key Paraguayan agricultural goods. A drought in early 2002, followed by excessive rainfall, resulted in much smaller yields and area harvested. The best-known case was cotton, whose yields were half the average for the last six seasons.

Nature also took its toll on corn and soybean yields. The first declined by 8% with respect to the preceding year because of the much smaller area harvested, while the latter declined by 6% stemming from the decline in per hectare yields. At the end of the year, there was a fresh outbreak of hoof-and-mouth disease, which led to trade disputes with neighboring countries and a drop in cold storage activity.

Parliament's decision to postpone privatization indefinitely, together with the legislative failure of the tax and banking reform law, were the reasons why Paraguay was unable to conclude a standby agreement with the IMF, which would have provided it with disbursements of some US\$ 200 million.

This too may be considered a recessionary factor as it acted, as a disincentive to private investment, in that an agreement with the international organization would have improved macroeconomic stability, and in that it had negative impact on public finance.

The third element that may be cited among domestic factors leading to the Paraguayan recession of 2002, in addition to the external, was the Central Bank's decision to prevent major fluctuations in the value of the guaraní. Although depreciation pressures, generated initially by the controversy surrounding COPACO and, later, by the situation in Brazil, were unsustainable and the nominal exchange rate rose by over 50% during the year, for much of it, monetary authorities sought to support the value of the local currency. The guaraní in fact appreciated, in both nominal and real terms, against the Argentine and the Uruguayan pesos.

In an attempt to control the run on the currency and inflation, strict monetary policy was maintained, through which the inter-annual growth in base money was maintained at below 5% until October, rising to 9% in November. The two policy decisions accorded higher priority to the objective of monetary stability (exchange and inflation) than to mitigating its recessionary effects on economic activity.

Thus, along with the difficult subregional context Paraguay had to face in 2002, the combination of domestic factors ranging from natural disasters, to political difficulties emanating from the proximity of presidential elections, to monetary policy decisions, finally resulted in the most severe recession in the recent history of the Paraguayan economy.

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<sup>a</sup> According to unofficial preliminary estimates.

As noted above, despite price rises in the subregion's four countries, these did not sustain their respective nominal exchange rates, which led to a general reduction in prices of the subregion's products in dollar terms or, put in more orthodox fashion, there was a general rise in the real rate of exchange in the subregion. Accordingly, in 2002, Argentina joined the trend towards real devaluation that had begun in 1998 with Paraguay, and continued the following year in Brazil.

Evidently, the way in which the Argentine peso plummeted after the collapse of convertibility – along with the relatively good inflationary behavior, with a lower pass-through than in anyone's expectation – led to Argentina's recent recovery of much of its "lost ground" in terms of competitiveness. Thus, the Argentine peso was not only the MERCOSUR currency most depreciated in real terms in 2002 with respect to 2001, but it was so, even taking account of the period since 1998.

## REAL RATES OF EXCHANGE BETWEEN MERCOSUR COUNTRIES

Variation in real exchange rate\* in the currency of country A  
With respect to that of country B, in percentage terms

**2002/2001**

		Country B			
		Argentina	Brazil	Paraguay	Uruguay
Country A	Argentina		113.4	78.5	81.6
	Brazil	-53.1		-9.4	-15.9
	Paraguay	-44.0	10.4		-6.6
	Uruguay	-44.9	19.0	7.6	

**2002/1998**

		Country B			
		Argentina	Brazil	Paraguay	Uruguay
Country A	Argentina		33.6	53.7	70.5
	Brazil	-25.2		24.8	26.7
	Paraguay	-34.9	-19.9		2.2
	Uruguay	-41.3	-21.1	-1.4	

Note: \* Variations between annual averages. Deflated by CPI.

Source: In-house, based on INDEC, Central Bank of the Argentina Republic, and Ipeadata data.

When it has been explained that MERCOSUR's recent past has been characterized by major capital outflows and the resulting depreciation of the different rates of exchange, in both nominal and real terms, it is unsurprising that the final element of the external picture is a steep trend towards current account surplus along with a decline in international reserves. For the first time since the late 1980s, the aggregate MERCOSUR area current account was positive (by some US\$ 700 million),<sup>15</sup> even when its largest economy showed a deficit of some US\$ 8.6 billion, which was more than offset by the impressive Argentine surplus.

This result contrasts not only with the 1998 figure, a deficit balance of nearly US\$ 50 billion, but also shows a strong reversal of trends as recent as 2001, when the deficit balance was some US\$ 28 billion.

In any event, this aggregate current account result did not manage to cover capital outflows, so that total international reserve assets in 2002 showed net declines of US\$ 6.7 billion, in addition to losses of US\$ 8.5 billion the preceding year.

With respect to 2002 current account trends, although there was strong movement towards surplus in all countries of the region, here an important distinction must be drawn, to be discussed in greater detail in the following section, in particular between the two largest MERCOSUR economies. Throughout the year, both Argentina and Brazil showed strong positive trade balances, resulting from a combination of factors,

<sup>15</sup> Figures taken from ECLAC's preliminary balance sheet for the economies of Latin American and the Caribbean, 2002.

among them, the abovementioned real depreciation of their currencies. However, the difference lies in export behavior as, while in Brazil, there was a short term reaction in response to relative price movements stemming from the fall in the real,<sup>16</sup> Argentine external sales showed an inter-annual decline of some 6% in the first 10 months of 2002.

Despite the critical situation, the public sectors generally succeeded in maintaining acceptable fiscal results. To some extent, this was possible through a combination of a rise in inflation in a recessionary context, as rising prices helped to offset the impact of the recession (or deceleration) on income, while the low level of economic activity, with rising unemployment, helped to contain, at least in part, upward pressures on expenditure. In any event, both Argentina and Brazil resorted to increasing the tax burden.

In Argentina, this burden took the form of steep increases in export taxes which, although generalized, were imposed mainly on primary products, while in Brazil, this was in the form of improvements in collection mechanisms and new pension fund and fuel levies. Clearly, Argentina would not have seen such relatively good fiscal account results throughout 2002 had public debt service not been suspended.<sup>17</sup>

### **Uruguay: The bank run unleashes the crisis**

On Tuesday, July 30, 2002, the Uruguayan monetary authorities closed the banks for four days. A month earlier, they had abandoned the sliding exchange rate regime that had been in place for many years, and replaced it with a floating exchange rate regime. Almost immediately, the price of the dollar in Uruguayan pesos rose by 30%, and continued to rise in the following months, to reach approximately 50%. These episodes culminated in a major run on the banks and foreign exchange, one that had begun in early 2002 as a spin-off to a similar crisis in Argentina in the latter half of 2001, which had led to a massive freeze on deposits and abandonment of the convertibility regime.

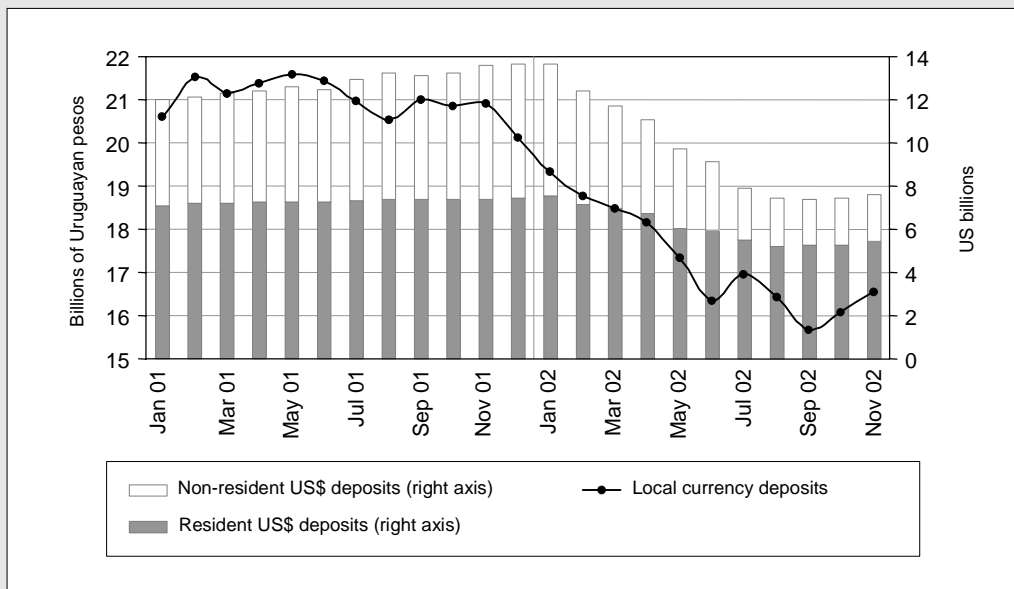
Deposits flowed out of banks on a truly enormous scale. In the six months prior to the bank closure, 42% of bank foreign currency deposits and 12% of local currency deposits were withdrawn from the system.<sup>a</sup> Of the latter, the proportion held by non-residents, mainly Argentinians, shrank by 60% of stocks as of January 31. In six months, total Uruguayan financial system deposits fell from US\$ 15 billion to US\$ 8.6 billion.<sup>b</sup>

This trend had a correlate effect on the balance of payments, which showed net private sector capital outflows of US\$ 2.9 billion – one fourth of the 2002 Uruguayan GDP – in the first half of the year alone, whereas throughout 2001, they had amounted to only US\$ 200 million.<sup>c</sup> A virtually neutral current account balance and assistance in the form of international organization credits to the government succeeded in limiting the drop in reserves to US\$1.6 billion, somewhat over half the existing reserves as of end 2001. At this point, the exchange rate was freed, although there is evidence that this was more than strictly a stop loss attempt. From June 30 to August 15, the height of the crisis, reserves would fall by another US\$ 900 million, to a critical level of some US\$ 550 million.

<sup>16</sup> From July to November 2002, Brazilian exports exceeded by 21% those of the same period in 2001. The four months prior to July 2002, the Brazilian real exchange rate had risen by 24% against the U.S. dollar.

<sup>17</sup> In 2002, the Argentine state stopped making both principal and interest payments on its bond debts and guaranteed loans. Only interest is mentioned here as, among debt service payments, only interest is included in the fiscal deficit. According to official data as of June 30, 2002, the amount in arrears was US\$ 7.463 billion, of which US\$ 5.236 billion corresponded to principal and US\$ 2.227 billion to interest. The latter figure, representing only six months arrears, as the default had begun in January 2002, was equivalent to 2.2% of the product, while for 2002 as a whole, the deficit represented 1.8% of total GDP.

**BANK DEPOSITS IN URUGUAY**  
**END OF MONTH BALANCES**  
 In billions of Uruguayan pesos and US\$ billion



This stemmed from the fact that the bank run continued, in particular, the run on dollar deposits, so that there was sustained demand for reserves. All the more so when, after six months of an outflow of deposits on the scale indicated above, the individual response capacity of many banks was virtually exhausted. It was at this point that the currency exchange “holiday” was imposed, with the financial assistance of multilateral organizations and the U.S. Treasury, and a program was implemented essentially designed to restore liquidity to the system, although longer term objectives were established for its reorganization.

The program was based on three premises. One was to preserve the payment chain by providing full backing for transaction deposits (in current accounts and savings banks) throughout the financial system, including for the banks in difficulty: the state banks *Banco de la República Oriental del Uruguay* (BROU) and *Banco Hipotecario del Uruguay* (BHU), and four private banks.<sup>d</sup> A second was generally to restructure the state banks, to include deferral of payment of its dollar term deposits. The last was to address the problem of suspended banks that would not remain in operation when the system reopened.

Specifically, the two cornerstones of government action were obtaining assistance package of US\$ 1.5 billion to provide liquidity for all entities; and congressional enactment, on August 4, one day after the banks reopened, of a law that established the Bank System Stability Fund (BSSF). In addition to allocating fresh funds from the organizations, which were immediately available thanks to a U.S. Treasury bridging loan to the new Fund, the said law provided for deferred payment of term dollar deposits<sup>e</sup> by state banks in difficulty. Thus, the external credit was utilized mainly to back transaction deposits in the two state and four private banks in difficulty – which remained suspended – and to reestablish confidence in the banking system as a whole.

In the short term, the objective of halting the bank run and restoring confidence was attained, as deposits stabilized in September and, in the months that followed, began to flow back on a small scale.<sup>f</sup> In last quarter 2002, marked stability was noted in the exchange rate, at levels even somewhat below the peaks of September 2002. Among specifically banking-related questions, one raised by the events discussed above involves the future of the suspended banking entities, for which alternatives are being studied, such recapitalization by shareholders and/or creditors (even depositors), stock package sales, mergers, or, possibly, liquidation.

From a broader perspective, whether the solvency of the Uruguayan financial system is consolidated will depend on a series of factors, among them redefinition of its ties with capital flows from and to Argentina, the traditional source of Uruguayan credit, reestablishment of a predictable exchange regime, genuine progress with committed reforms to international organizations in respect of reorganization of the public banking sector and, essentially, restoration of the activity of an economy that, if it remains in recession in 2003, will have been decelerating for five full years.

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<sup>a</sup> As of January 31, 2002, the dollar sector accounted for 91% of all financial system deposits.

<sup>b</sup> These two amounts include deposits in Uruguayan pesos converted at the respective dollar quotations as of January 31 and July 31. It must thus be noted that the difference of these US\$ 6.4 billion, about US\$ 0.5 billion does not correspond to outflows from the system, but rather to the effect of the depreciation of the peso between those dates.

<sup>c</sup> The figures given here, such as private sector capital flows, include "errors and omissions," which normally includes unrecorded capital movements.

<sup>d</sup> Some days after the currency exchange "holiday", the Central Bank suspended the activities of the Banco de Montevideo because of solvency problems and suspected fraudulent practices. With the establishment of the "holiday," the activities of the Banco La Caja Obrera, Banco Comercial, and the Banco de Crédito were also suspended.

<sup>e</sup> For those deposits, a higher than market rate was also established, while securitization of those deposits was implemented through negotiable certificates of deposit, which may be used to amortize loans with the state banks themselves, thereby generating a secondary markets for this type of instrument.

<sup>f</sup> From September to November, the last month for which official information was available, growth of 5.6% in peso deposits and of 3.1% in those denominated in foreign currency was noted.

Thus, although at this point, relatively good public finance results were in fact observed in all countries of the subregion, the public debt burden increased dramatically, as much of it is denominated in dollars or, as in the case of Brazil, there are clauses for adjustment in line with the U.S. dollar rate. Although the dollar value of the public debt fell in the four countries owing to the proportion denominated in local currency, the debt burden with respect to the aggregate MERCOSUR product increased over the last two years by some 7.5 points of GDP per year, rising from 35% to 50% from 2000 to 2002.

As for world economic prospects, those for the MERCOSUR subregion are not particularly optimistic, although if there are no unpleasant surprises, it is very likely that there will be a return to the path of (very modest) growth. In the second half of 2002, in both Brazil and Argentina, the trend of the different economic variables (including product) was in fact upward.

In that connection, enhanced competitiveness since the depreciations of 2002 and recovering external demand would be having a positive impact. One sign of recovery includes primary commodity prices,<sup>18</sup>

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<sup>18</sup> In its *World Economic Outlook* of September 2002, IMF project a rise of nearly 6% in 2003 for primary inputs, excluding fuel.

which weigh heavily among the area's exports. For the two MERCOSUR countries that underwent major shocks to their financial systems (Argentina and Uruguay), a certain normalization thereof would also contribute to the rise in activity, first noted in the final months of 2002, with a restoration of confidence in the bank entities evidenced by a return of deposits.

However, to complete the picture of subregional growth, factors of uncertainty are playing no less important a part. First, the political scenarios in MERCOSUR's two largest partners, although markedly different, leave questions unanswered regarding the economic policy paths they will take. In addition, although in both the real sector and the world context, steps are being taken to foster recovery in the partner economies, everything would indicate that the international financial market will remain rather unpropitious in the short and medium-terms, at least for this subregion.

In such a framework, and in keeping with private projections, the subregion as a whole in 2003 would show growth in product of some 1.6%, with the novel characteristic, in contrast to the recent past, of less dispersion in the performances of the four MERCOSUR member countries.

### The trend in foreign direct investment within MERCOSUR

Highly uncertain economic conditions and the close of the high intensity phase of privatization implemented in the subregion in the 1990s, first in Argentina and then in Brazil, led to another major decline in foreign direct investment in 2002. Thus, the amount of FDI hovered around US\$ 15.1 billion in that year, slightly over half of the US\$ 28.7 billion in 2001.<sup>a</sup>

#### NET FOREIGN DIRECT INVESTMENT \* IN US\$ BILLION

	1999	2000	2001	2002
Argentina**	22,633	10,654	3,304	1,500
Brazil	26,888	30,498	24,894	13,402
Paraguay	89	74	152	74
Uruguay	238	274	319	168
<b>TOTAL</b>	<b>49,848</b>	<b>41,500</b>	<b>28,669</b>	<b>15,144</b>

Notes: (\*) Corresponds to direct investment in the declaring economy, after deducting direct investment of residents of that economy abroad. Includes reinvestment of profits.

(\*\*) The 1999 column includes the value of the REPSOL investment in YPF. Part of that investment corresponds to purchases of shares from non-residents, which were counted as portfolio investments.

Source: ECLAC

In fact, the only country that sustained a pertinent amount of foreign direct investment was Brazil, which accounted for nearly nine in ten dollars reaching MERCOSUR under that item. In that country's capital and financial accounts, this item was the only one in positive territory, if the exceptional credit granted by the IMF and international organizations is excluded. In fact, the net amount of foreign direct investment entering Brazil was the lowest since 1996, when the privatization process was in full swing.

For its part, Argentina's recession was not as deep, as trends in investment flows had already declined markedly since 1999 after the major global purchase operation for the country's main oil company. The amount entering in 2002, one fifteenth of that three years earlier, can be attributed

solely to the continuation of certain projects begun earlier. Although, in that year, the steep devaluation left the value of much of Argentina's productive assets and costs at, by international standards, very low levels, thereby creating a business opportunity for foreign entrepreneurs, the fact that decisions were not taken regarding certain key aspects of the macroeconomic picture, as well as the depressed domestic market, meant that, in the best of cases, it was too early to undertake purchase operations or to establish new firms.

For Paraguay, along with the subregion's already very delicate emerging conditions was the prolonged delay, ending in suspension, of the privatization of the state telephone company which, moreover, had been committed in the International Monetary Fund's assistance program to that country.

Thus, 2002 was a year of very adverse conditions for the emergence of productive undertakings, whether of foreign or domestic origin. An improving macroeconomic scene might begin to improve this picture, especially after the steep change in relative prices that occurred throughout the area.

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<sup>a</sup> The data herein are taken from ECLAC's 2002 preliminary balance sheet for the Latin American and Caribbean economies.

### **C. Trends in foreign trade within MERCOSUR**

The trend in trade flows within the MERCOSUR subregion reflected the stagnation therein. In 2002, the oscillating trend that had begun in 1999, intensified after the upward trend ended in 1998 that had persisted until then in the 1990s. Perhaps the most notable characteristic of subregional trade in 2002 was the steep decline in intrasubregional trade, which fell by over a third with respect to that of 2001,<sup>19</sup> thus completing what was a truly adverse cycle in the trade in goods within the integrated economic area: in 2002, it was only 55% of its 2000 value.

Extraregional trade also contracted, although at a much lower rate, nearly 10%, driven by the fall in imports, which greatly exceeded the rise in exports. Since the establishment of MERCOSUR, this was the third time that trade in goods with the rest of the world had declined for the entire year.

In 2002, trade among member countries declined in relative importance, something that had already occurred in 1999 and 2001. In the three cases, this took place in the context of declining activity and the general rise in real exchange rates. In 2002, the gap between the variations in intrasubregional and extraregional trade was the largest (-10% and -36%, respectively), which may have stemmed from the more severe recession and the real depreciations in the four economies of the subregion, whereas in the two aforementioned years, this had only occurred in Brazil, with its great weight and, evidently, Paraguay.

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<sup>19</sup> At the close of this report, complete data were available for the first 10 months of 2002. The comment on the trend in that year is based thereon, and on comparisons with the same period in 2001.



## TRADE WITHIN MERCOSUR

In US\$ millions

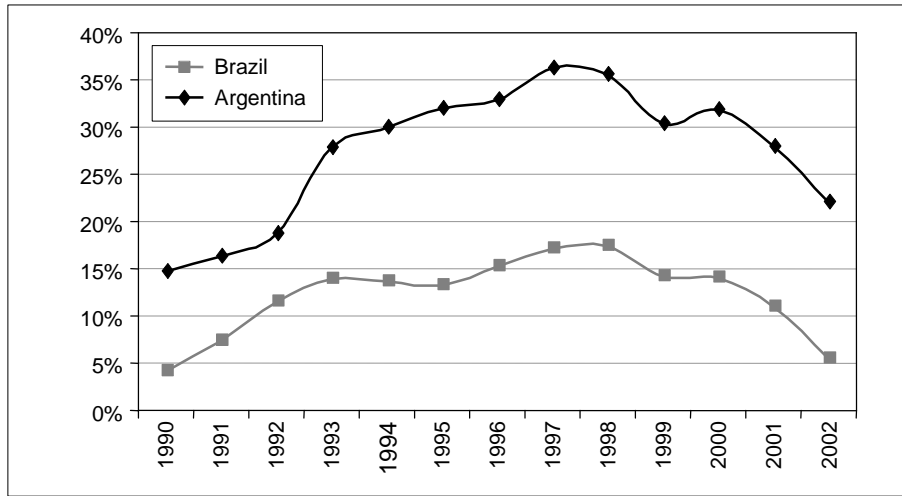
	Annual totals			January – October		
	2000	2001	Var. as %	2001	2002	Var. as %
Total exports	84,590	87,881	3.9	74,536	73,445	-1.5
- Intrasubregional	17,722	15,171	-14.4	13,215	8,418	-36.3
- Extrasubregional	66,868	72,709	8.7	61,321	65,028	6.0
Total imports	86,580	80,944	-6.5	70,183	50,139	-28.6
- Intrasubregional	17,604	15,380	-12.6	13,362	8,539	-36.1
- Extrasubregional	68,976	65,564	-4.9	56,821	41,600	-26.8
Total extrasubregional trade	135,844	138,274	1.8	118,142	106,627	-9.7

Source: In-house, based on data from INDEC, Secex, SGT 14 of MERCOSUR, INE (Uruguay), Banco Central del Paraguay, Banco Central de Brasil, and others.

The “demercosurization” of trade in difficult years has begun to suggest a pattern and thus now poses a challenge to the States Parties as, in times of crisis, it becomes difficult to focus on the common problems of the integration process, not only owing to each government’s focus on domestic issues, but also to the diminished economic pertinence of the process.

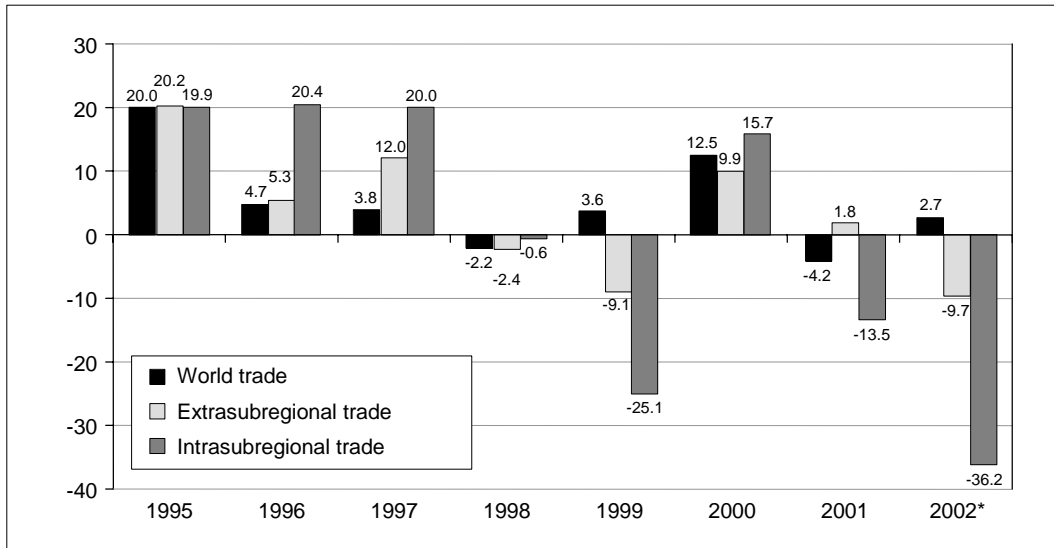
Another feature of the trend in subregional trade is its recent increasing disparity in momentum with world trade, which appears to have begun in 1999 at the end of the subregion’s sustained growth phase. In the last two years, this phenomenon was particularly evident as annual variations in subregional trade with the rest of the world and total world trade are moving in opposite directions. This divergence may be explained precisely by the deepening of the crises stemming from external financial shocks, which are dividing the economic trends of the developed world from those of the emerging economies in crisis. Thus, in a year when the world economy as a whole grew slightly faster than it had the preceding year, the MERCOSUR subregion moved from stagnation to recession.

**MERCOSUR'S SHARE IN THE EXPORTS OF  
THE BLOC'S MAIN PARTNERS**  
Exports to MERCOSUR / Exports to the world, in percentage terms



Source: INDEC and Secex.

**WORLD AND MERCOSUR TRADE**  
Rates of annual variation, in percentage terms



Source: IMF, SGT No. 14, INDEC, and others.

The balance of trade in goods between MERCOSUR and the rest of the world was affected by the external adjustment process discussed at length above. Both the low level of activity and the rise in the real exchange rate in 2002 generated a very large surplus. This exceeded US\$ 23 billion in only the first 10 months of the year, implying substantial widening of the gap with respect to the full preceding year, when the surplus was US\$ 7.1 billion. One very complete measure of the scale of the region's 2002 trade surplus is shown by the fact that it represented over a third of extrasubregional exports in that period.

**TRADE BALANCE TREND 2000-2002**  
**BY ECONOMIC REGION**  
 In US\$ millions

<b>Exports</b>						
	Annual data			January-October		
	2000	2001	Var as %	2001	2002 (2)	Var as %
<b>Total</b>	<b>66,868</b>	<b>72,709</b>	<b>8.7</b>	<b>61,321</b>	<b>65,233</b>	<b>6.4</b>
- European Union	19,931	19,954	0.1	17,093	17,390	1.7
- NAFTA	19,707	20,694	5.0	17,132	18,709	9.2
- Chile	4,026	4,310	7.0	3,181	3,310	4.1
- Rest S. America (1)	3,172	3,839	21.0	3,622	3,636	0.4
- China, Japan, Korea	5,460	6,244	14.4	5,459	6,081	11.4
- Rest	14,572	17,669	21.3	14,835	16,107	8.6
<b>Imports</b>						
	Annual data			January-October		
	2000	2001	Var. as %	2001	2002 (2)	Var as %
<b>Total</b>	<b>68,976</b>	<b>65,564</b>	<b>-4.9</b>	<b>56,821</b>	<b>41,746</b>	<b>-26.5</b>
- European Union	20,697	20,154	-2.6	17,460	13,213	-24.3
- NAFTA	21,068	19,508	-7.4	16,868	12,052	-28.6
- Chile	2,557	1,879	-26.5	1,629	1,309	-19.6
- Rest S. America (1)	1,674	1,464	-12.6	1,275	744	-41.7
- China, Japan, Korea	8,105	8,127	0.3	7,063	4,963	-29.7
- Rest	14,875	14,433	-3.0	12,525	9,465	-24.4
<b>Balance</b>						
	Annual data			January-October		
	2000	2001	Difference	2001	2002 (2)	Difference
<b>Total</b>	<b>-2,108</b>	<b>7,145</b>	<b>9,253</b>	<b>4,500</b>	<b>23,487</b>	<b>18,987</b>
- European Union	-766	-200	566	-368	4,177	4,545
- NAFTA	-1,362	1,186	2,548	264	6,657	6,393
- Chile	1,470	2,430	961	1,552	2,001	449
- Rest S. America (1)	1,498	2,375	877	2,347	2,892	545
- China, Japan, Korea	-2,645	-1,883	762	-1,605	1,118	2,722
- Rest	-303	3,236	3,538	2,310	6,643	4,333

Notes: (1) Includes Bolivia, Colombia, Ecuador, Peru, and Venezuela.

(2) Preliminary figures

Source: In-house, based on data from INDEC, Secex, SGT 14 of MERCOSUR, INE (Uruguay), Banco Central del Paraguay, Banco Central de Brazil, and others

Although the trade balance was positive with all large economic blocs with which the subregion has appreciable trade, the developed world accounts for much of the marked expansion in the aggregate

balance. As occurred in much of the world, the U.S. economy was the major net purchaser of 2002. It is thus not surprising that NAFTA is the bloc with which the balance of trade expanded most.

That region alone accounts for a third of the worldwide improvement in MERCOSUR's balance of trade. Also significant was the expansion of the positive balance with the European Union and the large eastern economies. In fact, in the dynamics of trade balances with the developed countries, not only are demand factors influential – the aforementioned greater U.S. momentum with respect to Europe and Asia - but also the composition of supply.

In its exports, MERCOSUR has historically manifested a certain geographic specialization, wherein Brazil is more oriented towards the United States, and the rest of the countries – with a more “agointensive” export profile – are more oriented towards the European Union. This, together with the greater weight of the largest MERCOSUR partner, also explains why the North American region accounts for the largest part of the surplus balance.<sup>20</sup>

In contrast, the subregion's neighboring countries were those contributing least to the increase in the positive trade balance. In the first 10 months of 2002, the trade surplus with the rest of South America was US\$ 4.9 billion, "only" US\$ 1 billion more than the same period in 2001. However, in the case of Chile, with which MERCOSUR maintains a trade preference, imports from that country fell at a markedly lower rate than those of all other origins,<sup>21</sup> while exports grew at a rate (of nearly 4%) which, although lower than that of total extrasubregional sales, was considerably higher than that of the rest of South America (0.4%).

Still taking account of figures for the first 10 months, the breakdown of the 2002 extrasubregional trade balance among export and import flows shows that the decline was greater in the latter. Purchases abroad fell by nearly 27% with respect to 2001, with very similar behavior for all economic blocs. The exceptions were Chile, discussed in the preceding paragraph, and the rest of South America, whose 42% decline was considerably higher than that of the others.

Extrasubregional exports grew by 6%, a rate slower than that of the two preceding years, a particularly slight expansion if it is borne in mind that growth took place in a context of low domestic absorption and clear improvement in real parities. The opening of external sales to different countries reflected the dynamics of the global activity map, with East Asia as the most expansionary market for MERCOSUR products, particularly those of Brazil and Uruguay, the next most expansionary being the NAFTA area.

The yawning trade gap occurred in a context of mixed trends – although with a slightly negative average – in the terms of trade, which indicated that the exchange rate impact and the powerful effect of the domestic recession had had a more decisive impact on trade flows than did international price movements. Brazil suffered most from international price trends, with a drop of over 5% in prices for its exports, vis-à-vis a decline of only 1.5% in imports. Non-durable consumer goods had the largest negative effect on the Brazilian export profile.<sup>22</sup>

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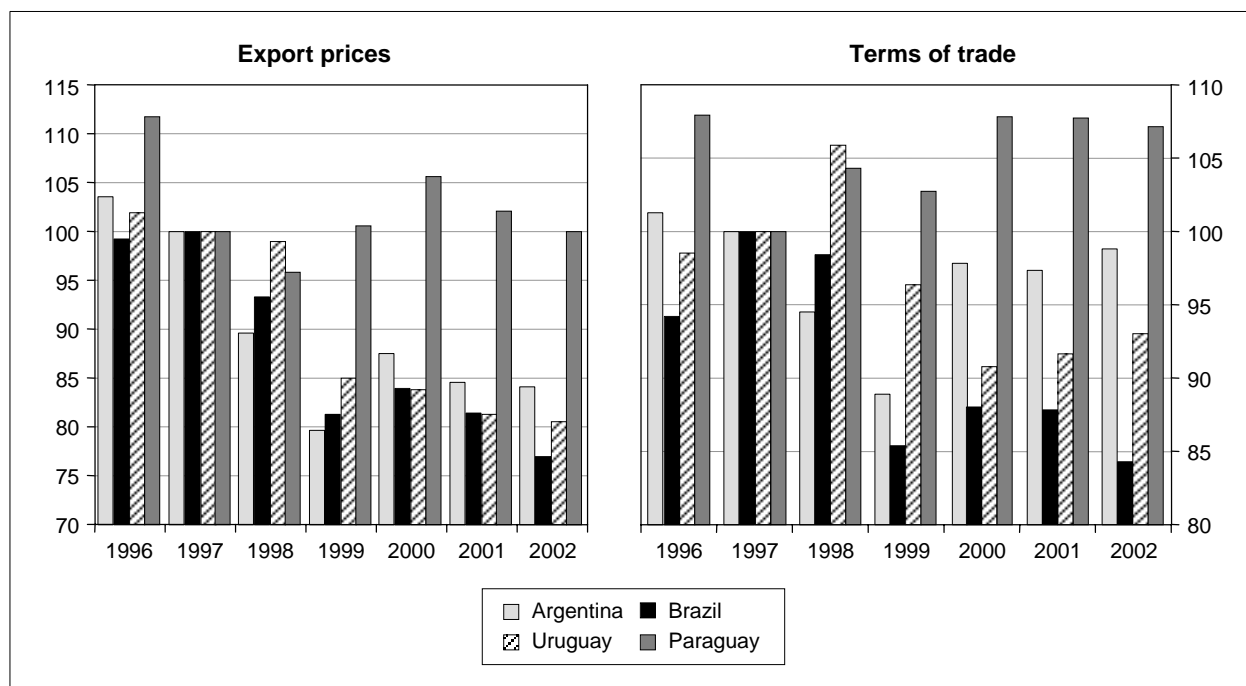
<sup>20</sup> Imports are not mentioned here, as there is certain "parity" within MERCOSUR among those originating in the European Union and those originating in NAFTA. Of all extrasubregional purchases in 2002, 32% originated in the former and 29% in the latter. This pattern is repeated in three of the four countries. In Argentina, purchases from the European bloc and NAFTA respectively represent 23% and 22% of the world total. In Brazil, in both cases these figures are around 26.5%; and in Paraguay, they are 11% and 9%. Uruguay is the exception to the rule, with 19% and 11%.

<sup>21</sup> From January through October 2002, purchases from Chile fell by 19.4% with respect to the same period in 2001, while the total extrasubregional average fell by 26.5%.

<sup>22</sup> Examples are the negative trends in coffee and sugar prices, whose 2002 average prices fell by approximately 12% and 15%, respectively with respect to 2001.

Paraguay also experienced a slight deterioration of its terms of trade, while for Argentina and Uruguay, the terms of trade improved by approximately 1.5%, in both cases owing to greater declines in unit values of imports than in those of exports.

### EXPORT PRICES AND TERMS OF TRADE Indices 1997=100



Sources: INDEC, Banco Central del Paraguay, Banco Central del Uruguay, IPEAdata, ECLAC

#### *Trend in trade by country*

Despite the expectations that might have been generated for Argentine export potential by the steep real depreciation of the peso, 2002 was another year of stagnation, in fact, of slight contraction, in that country's sales abroad. Although official information is unavailable for the last month, the total for the year would be approximately US\$ 25.7 billion, below the ceiling of US\$ 26.5 billion that the country had been hitting since 1997, which would imply an annual reduction of some 3%.

The context of high uncertainty in every area, but especially regarding relative prices, prevalent particularly in the first half of the year, together with banking system difficulties not confined to the virtual disappearance of credit, and included problems of availability of funds, were among the main explanations for the performance of exports. Another important factor also linked to price uncertainty, including the value of the dollar and financial system restrictions, was the propensity of many agricultural producers to maintain high stocks and to sell only what was needed to obtain working capital.

In addition, some recessionary effect may be attributed to the fall in dollar prices for different products, which normally occurs after a major devaluation as a means of "sharing the profits" thereof between local

sellers and foreign buyers. The last of the major reasons for the poor momentum of Argentine exports was the increase in fraudulent practices in recording amounts (prices or quantities) dispatched, stemming from the taxes imposed generally on large-volume exports.

Iron and steel products and oils were the only sectors of the Argentine economy with good export performance, while the automotive, grain, and petroleum sectors were among those accounting for much of the fall in external sales. This sectoral distribution also shaped the dynamics of exports among the different markets. While sales to Argentina's MERCOSUR partner countries declined by over 25%, shipments to the rest of the world grew by some 3%. To be noted here was the expansion of exports to the European Union, which rose by 12%.

Despite the slight decline in total exports, the 2002 trade balance was at absolute historic levels of over US\$ 16.5 billion<sup>23</sup> - two thirds of the year's exports, owing to the plummeting levels of imports. On average, the value of purchases from abroad was only some 40% of that of the preceding year, showing, in March and April, declines of up to 70%. Consumer and capital goods were those suffering most, while intermediate goods showed less drastic declines, of around 40%. While much of the reduction stemmed from the extremely steep drop in internal demand, this was accompanied by an incipient import substitution process, stemming from the rise in the real rate of exchange.

Brazil also showed a steep increase in its trade surplus, which rose from US\$ 2.64 billion in 2001 to over US\$ 13 billion in 2002. Most of this change corresponded to imports, which declined by some 15% in the year. However, in contrast to events in Argentina and Uruguay, this trend seemed to be in response to the change in relative prices, which stemmed from the devaluation of the real, and a change in the composition of aggregate demand – a shift away from investment and towards exports – rather than from the decline in economic activity as a whole. It should be recalled that, in contrast to the countries mentioned, Brazil's product increased slightly.

Exports also contributed to the widening trade gap, which was growing by nearly 4% per year. Brazilian export behavior in 2002 was marked by a major reaction in the second half of the year in response to the need for external adjustment in the form of depreciation of the national currency. The dollar rose from 2.4 *reais* in February to 3.8 *reais* in October, thereby generating an increase of over 50% in the real rate of exchange.<sup>24</sup> Thus, while in the first half of 2002, Brazilian external sales fell by over 13% with respect to the same period in 2001, in the second half of that year, they increased by over 20%.

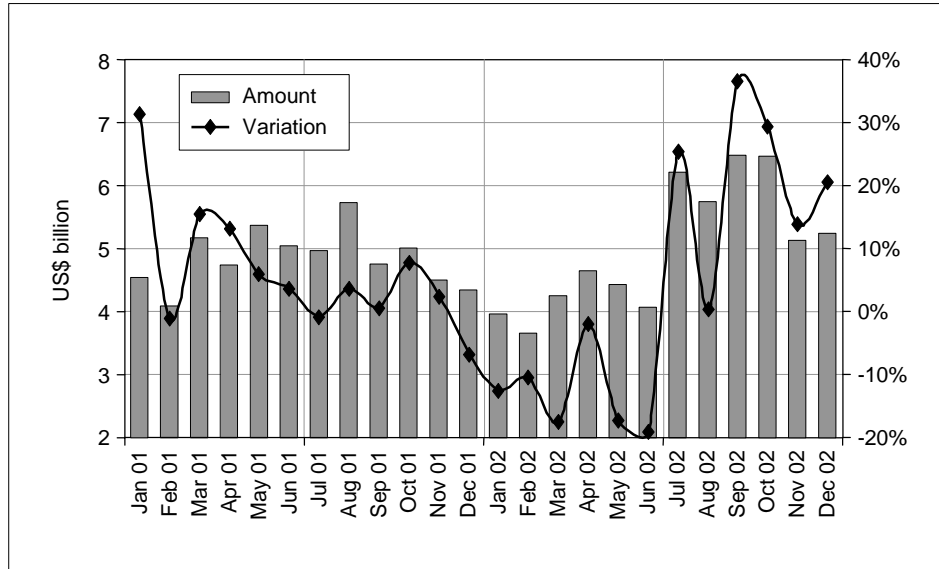
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<sup>23</sup> Estimated figure, as data from December 2002 is not available.

<sup>24</sup> Against the U.S. dollar, deflated by consumer prices.

## EXPORTS FROM BRAZIL

Amount in US\$ billions, and annual variation in percentage terms



Source: Secex

Spearheading the export recovery were primary products as, in the second half of the year, their sales increased by over 35%. Notable among these were meat, soybeans, soybean oils and soy pellets. Among industrialized products, manufactured and semi-manufactured goods showed similar increases, of some 13%. Fuel, wood, and wood products (excluding furniture), chemicals, iron and steel, and their derivatives contributed most to the takeoff in the export sector.

Although in 2002, among the MERCOSUR economies, Paraguay's showed the poorest results – it is estimated that it closed that year with a deficit of some US\$ 600 million, it, like its partners, showing a marked improvement in trade balance, even in the context of declining exports. Paraguayan external sales fell by 3.5%, not such a disappointing performance if it is borne in mind that it has the subregion's most concentrated export profile (from 50% to 60% of its exports are made to the subregion).

Paraguay's performance is still less disappointing if account is taken of the climatic disturbances that affected the production of exports such as cotton, and the fresh outbreaks of hoof-and-mouth disease, which affected meat shipments. Although the latter had relatively little impact – in fact, meat exports increased by 1% for the year ended November 2002 – it seems to have been the factor that led to the failure of Paraguay to see some improvement by the end of the year, as some of its MERCOSUR partners had done.

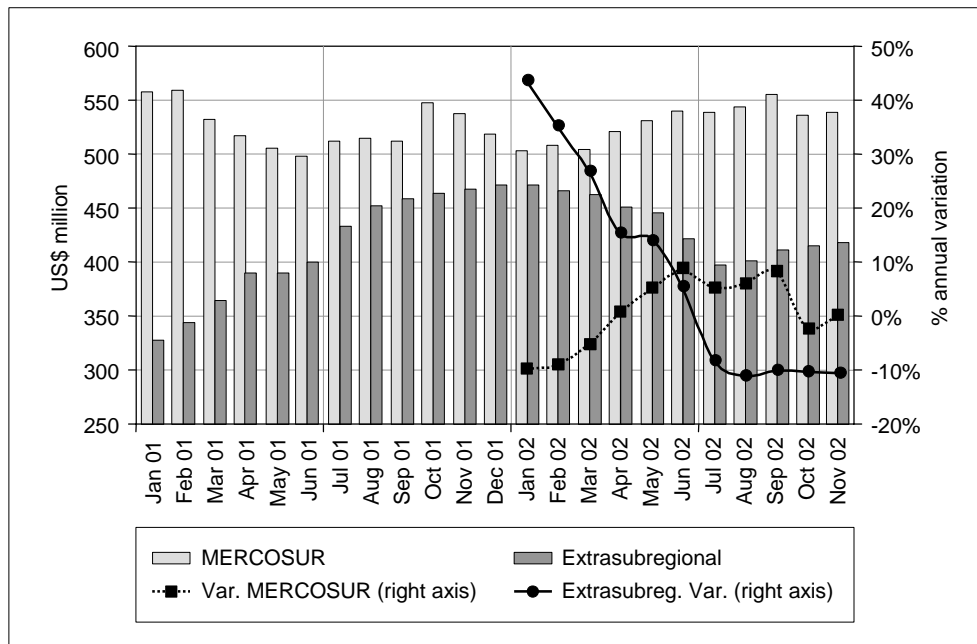
In fact, Paraguayan exports to the other MERCOSUR member countries grew by over 4%, surpassing extrasubregional exports, which fell by nearly 13%. In this, the demand of Brazil predominated, as exports thereto expanded markedly, which offset the steep declines in exports to Argentina and Uruguay.<sup>25</sup> As regards products, there were marked increases in exports of soybean oils, soy meal, soybean pellets, live animals, and essential oils. Set against this were the declines in cotton fiber exports, which accounted for over 8% of all Paraguayan in 2001, while soybeans, corn, and wood exports fell by 56% as a result of the drought.

<sup>25</sup> In the first 11 months of 2002, exports to Brazil rose by 27%, while those to Argentina fell by 45% and to Uruguay by 13% with respect to the same period in 2001.

## PARAGUAYAN EXPORTS BY DESTINATION

Cumulative 12 months

In US\$ million and by % variation with respect to the same period the preceding year



Source: Banco Central de Paraguay

Taking account of trends until November 2001, imports declined by 23% with respect to 2001, essentially because of the low levels of income and activity. Although the real value of Paraguay's currency declined significantly against those of the developed countries, while appreciating somewhat in real terms against those of the subregion's three other countries, both extrasubregional and subregional imports declined at rates closely approximately the average.

Uruguay's trade balance also experienced strong equilibrium pressure, mainly on the side of imports, which fell by over a third with respect to their 2001 values, essentially as a result of the marked decline in domestic activity. Thus, the balance, which had been negative since the launch of MERCOSUR, fell to some US\$ 150 million in 2002 from its US\$ 1 billion levels the preceding year.<sup>26</sup>

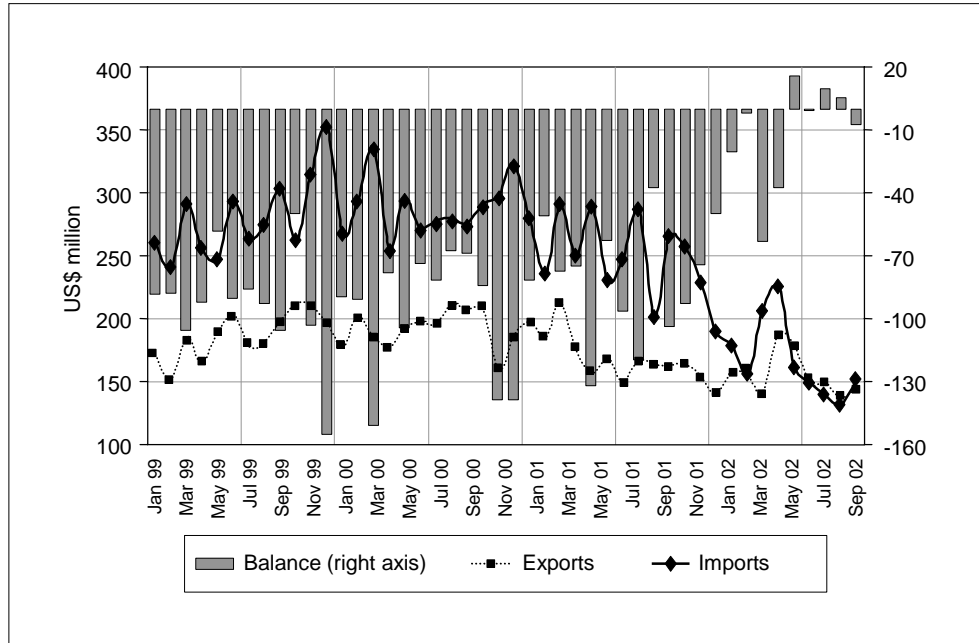
In the first 10 months of 2002, exports showed a 12% decline with respect to the same period in 2001, stemming essentially from the low levels of demand from the MERCOSUR partner countries, which account for approximately 40% of Uruguayan exports. Intrasubregional sales fell by 30%, while those to the rest of the world rose slightly, driven by exports to the European Union.

<sup>26</sup> At the time of drafting this report, official information was only available for the first 10 months of 2002. The balances mentioned are estimates for the year as a whole.



## TRADE BALANCE OF URUGUAY

In US\$ million



Source: Banco Central del Uruguay

With respect to the momentum of the different product groups, the "traditional products" as classified by Uruguay itself were in general those that suffered least, with substantial increases in frozen and processed meats (corned beef), and in grain and oils. In contrast, in 2002, the value of "non-traditional products" - with greater penetration in neighboring countries - was only three quarters of their 2001 value, owing essentially to the declining importance of textiles and processed foods.

### *Sectoral trends in trade between Argentina and Brazil*

In the first 11 months of 2002, in view of the conditions of external adjustment mentioned above, most Argentinian and Brazilian trade corresponded to extrasubregional exports which, for the two countries, totaled some US\$ 70.5 billion, while their combined extrasubregional imports were somewhat under US\$ 44 billion, thereby generating a US\$ 26.5 billion surplus. The value of trade between the two countries<sup>27</sup> was approximately US\$ 6.5 billion, while the value of flows with the rest of the MERCOSUR countries totaled US\$ 2.8 billion, of which the value of exports exceeded that of imports by somewhat over US\$ 500 million.

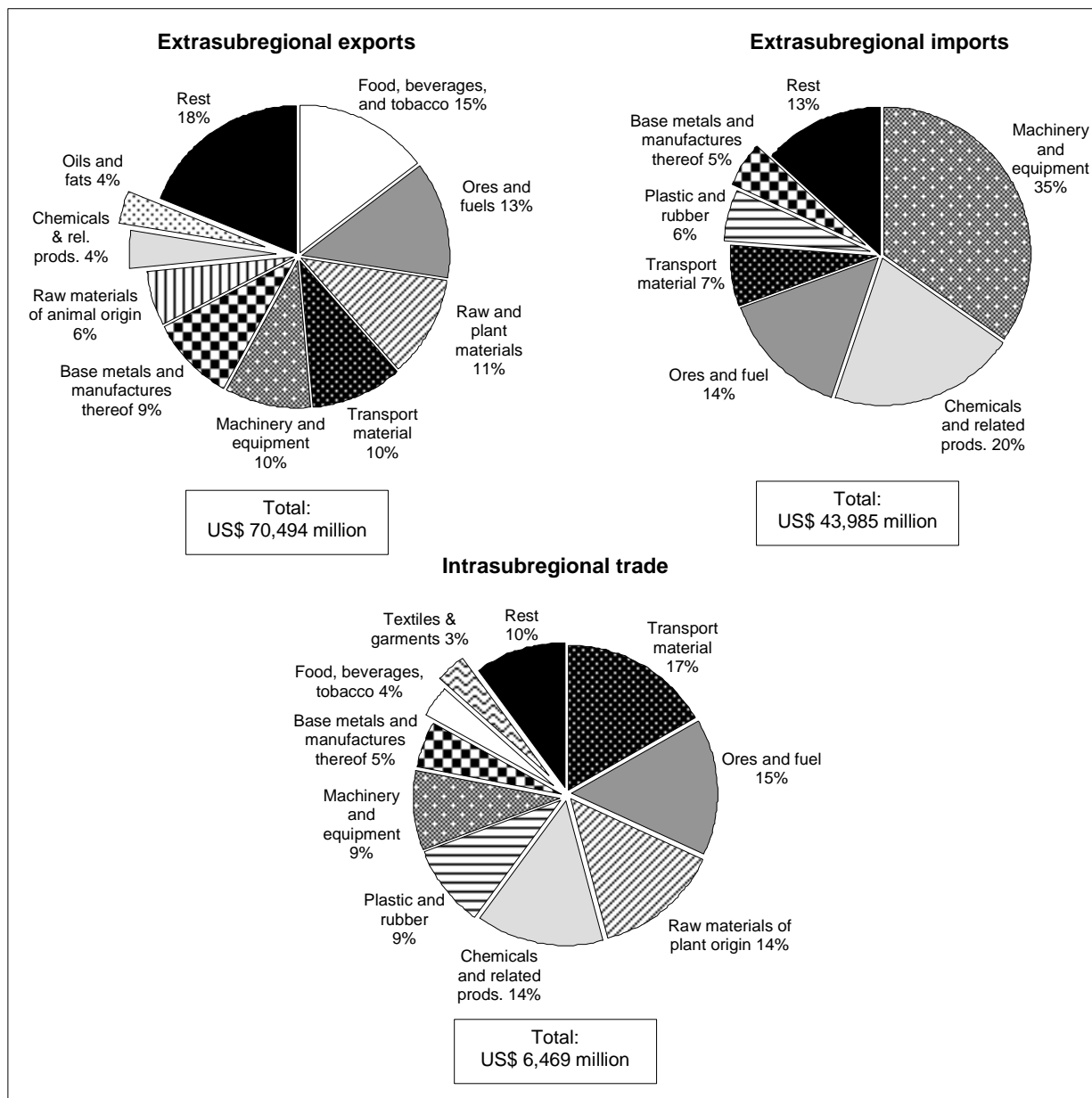
In examining the sectoral composition of these flows, a first consideration is that only a few sectors have a significant presence therein. Only *mining and fuel* accounts for over 10% of such flows,<sup>28</sup> of which both extrasubregional fuel exports and imports for the two countries account for pertinent percentages, as does internal trade in crude oil (from Argentina to Brazil) and iron (Brazil to Argentina). The percentages

<sup>27</sup> Here, total trade between the two countries means the sum of Argentine exports to Brazil (according to Argentine data) plus Brazilian exports to Argentina, according to Brazilian data. In general, these figures do not depart significantly from those that would be produced by the possible alternatives.

<sup>28</sup> Section V of the Nomenclature.

accounted for by this sector are very similar – from 13% to 16% - in the four trade flows considered. *Machinery and equipment* and *transport material* are the two other sectors with a relatively significant weight in all flows. The percentage of the first is very high among imports from outside MERCOSUR, 35%.<sup>29</sup> In the other three groups of flows considered, figures range from 7% to 10%.

### SECTORAL COMPOSITION OF ARGENTINIAN AND BRAZILIAN TRADE



Source: INDEC and Secex

<sup>29</sup> As the decline in investment is taken into account, machinery imports have diminished in importance. The percentage mentioned is the lowest in recent years, in which they averaged 37%. The decline is particularly marked in Argentina, where, from 2001 to 2002, this sector declined from 35% to 25% of total extrasubregional imports.

The highest figures for *transport material* occur in trade between Argentina and Brazil, with levels of 17%, which have declined by several points in recent years. The share of this category in extrasubregional trade is larger for exports (10%) than for imports (7%).

The sector accounting for the largest share of extrasubregional exports is *food, beverages, and tobacco*, which, at US\$ 10.4 billion, hovers around 15% of the binational total. The two countries export large amounts of oilseed meal products (essentially soybean pellets and soy meal). Also to be noted are Brazilian exports of sugar and other confectionary.

Two other sectors weighing heavily among extrasubregional exports are *raw materials of plant origin and base metals and manufactures thereof*. Oilseeds (soybean and sunflower) account for over half of the first. It should be noted that Brazil and Argentina are, respectively, the world's second and third largest exporters of soybeans, accounting for nearly 40% of the amount transacted internationally. Argentine grain and Brazilian coffee exports rank second in this category. Basic iron and steel products account for somewhat over half of exports of *base metals and manufactures thereof*. Also important in this category are metal products and aluminum.

As mentioned above, *machinery and equipment* account for the largest share of extrasubregional imports, followed by *chemicals and related products*, which, at US\$ 9 billion, account for approximately 20% of total extrasubregional purchases. These two categories, *together with ores and fuel*, alone accounted for nearly US\$ 7 of every US\$ 10 imported from outside the region in 2002.

- Extrasubregional sectoral trends in trade and trade balances -

Taking account of the first 11 months of 2002, Argentine and Brazilian extrasubregional exports together increased by 7%, while imports declined by over 25%. Therefore, in one year, the total extrasubregional trade balance nearly quintupled, reaching US\$ 26.5 billion in 2002.

Among exports, the most dynamic category was *base metals and manufactures thereof*, which expanded by over 20%, increasing sharply in both Argentina and Brazil, spurred by iron and steel and their "downstream" products (other than machinery or transport material). It should be noted that this positive trend occurred in the context of marked world overproduction in this market, which even led developed countries to adopt protectionist measures. One positive factor was the rise in oil prices, which increased demand for seamless tubes, supplied by the subregion in large quantities.

*Basic ore and fuel* exports also increased considerably, essentially the latter, as Brazilian iron ore exports remained constant. The rise in fuel exports may be linked to the lack of momentum of Brazilian activity and its marked decline in Argentina, which led to exportable surpluses owing to depressed domestic demand.

The value of exports of *oils and fats* rose by 37%, owing to a substantial rise in prices, of some 20%. *Food* exports showed very moderate increases although, in view of their volumes, they had considerable impact on the positive trend in total exports. Exports of *machinery and equipment* expanded by nearly 11%, all of which may be attributed to the industrial production of Brazil, as it accounts for 92% of extrasubregional exports in this category. Moreover, such exports from Argentina declined by 5%. Exports of wood, wherein Brazil predominates broadly, also increased substantially.

## EXTRASUBREGIONAL EXPORTS FROM ARGENTINA+BRAZIL

Principal sectors (1), by absolute increments from 2001 to 2002

In US\$ Million

Sector	Annual			11 months		
	2000	2001	Var. in percentage terms	2001	2002	Var. in percentage terms
<b>Total</b>	<b>65,294</b>	<b>71,040</b>	<b>8.8</b>	<b>65,709</b>	<b>70,494</b>	<b>7.3</b>
<i>Total selection</i>	55,583	61,204	10.1	56,496	61,185	8.3
XV Base metals and manufactures thereof	6,746	5,919	-12.3	5,412	6,588	21.7
V Ores	7,324	8,737	19.3	8,106	9,098	12.2
III Oils and fats	2,024	2,164	6.9	1,922	2,625	36.6
XVI Machinery and equipment	5,919	6,713	13.4	6,102	6,760	10.8
IV Food, beverages, tobacco	9,042	10,744	18.8	9,937	10,373	4.4
I Raw materials of animal origin	3,346	4,184	25.1	3,861	4,201	8.8
IX Wood, cork, wickerwork	1,472	1,493	1.4	1,374	1,689	22.9
VI Chemicals and related products	3,069	2,819	-8.1	2,602	2,883	10.8
VII Plastic and rubber	1,354	1,332	-1.6	1,216	1,409	15.8
XIII Construction materials	713	709	-0.6	649	824	26.9
XVII Transport material	7,457	7,880	5.7	7,216	6,938	-3.9
II Raw materials of plant origin	7,117	8,511	19.6	8,096	7,797	-3.7
<i>Rest</i>	9,711	9,836	1.3	9,213	9,309	1.0

Note: (1) Sectoral opening corresponds to sectors of the harmonized system.

Source: INDEC and Secex

However, the positive trend in *chemicals* and *plastics and rubber*, with growth of 11% and 16%, respectively, may be attributed to the sectors of both countries. Lastly, another sector that contributed significantly to the increase in extrasubregional sales was *raw materials of animal origin*, spurred in Brazil by the expansion of white meat and pork and, in Argentina, by the reopening of several international markets for its beef products, although this was partially offset by the decline in exports of fish products from that country through the imposition of conservation measures after several years of overfishing.

The categories that saw the largest declines in exports were *transport material* and *primary materials of plant origin*, in both cases, of nearly 4%. In the first case, the decline occurred despite the increase in motor vehicle exports (18%), which was more than offset by the 27% decline in *air navigation equipment*. Decisive in the decline in primary agricultural product exports were the steep decline in *grains*, which tended to be displaced by oilseed crops, which fetch better prices, and the more moderate decline in *coffee*, stemming from steep falls in international prices.

Among extrasubregional imports, from 2001 to 2002, sectors generally declined. The steepest drop occurred in *machinery and equipment*, contracting by some US\$ 7.1 billion, that is, nearly 50%. The trend for *transport material* was similar, declining by 45%.

In both cases, along with the downward trend in internal demand and the rise in relative prices was the impact of financial factors in a year characterized by rising interest rates, or the direct impact, as in the case

of Argentina, of the virtual disappearance of credit, which translated into high levels of uncertainty affecting demand for capital or consumer goods of high unit cost (such as motor vehicles or large electrical appliances, which belong to the categories mentioned).

In general, among the other sectors, the largest declines occurred in consumer products, such as *textiles and garments*, which declined by 50%, *furnishings and toys* (by nearly 90%), and *food, beverages, and tobacco* (by 45%). More moderate declines occurred in intermediate goods, notable among them *chemicals* (-17%) and *ores and fuel* (-15%). The categories *pulp, paper, and cardboard* and *base metals and manufactures thereof*, which declined by 80% and 40% respectively, seem to have departed from this pattern, although it must be said that both include many consumer goods.

### EXTRASUBREGIONAL TRADE BALANCE OF ARGENTINA+BRAZIL

Selected sectors (1)

In US\$ millions

Sector	Annual			11 months		
	2000	2001	Differ.	2001	2002	Differ.
<b>Total</b>	<b>-3,863</b>	<b>4,967</b>	<b>8,830</b>	<b>6,748</b>	<b>26,509</b>	<b>19,762</b>
<i>Total Selection</i>	<i>-5,695</i>	<i>2,966</i>	<i>8,661</i>	<i>4,871</i>	<i>24,221</i>	<i>19,350</i>
XVI Machinery and equipment	-19,007	-17,874	1,133	-16,325	-8,543	7,782
XV Base metals and manufactures thereof	3,449	2,608	-841	2,447	4,462	2,015
V Ores	-1,322	417	1,739	1,004	2,909	1,905
VI Chemicals and related products	-8,609	-8,849	-240	-7,947	-6,134	1,813
XVII Transport materials	1,921	3,190	1,269	2,926	3,968	1,042
VII Plastic and rubber	-2,429	-2,094	336	-1,843	-1,046	797
III Oils and fats	1,864	2,047	184	1,821	2,532	711
IV Food, beverages, tobacco	8,144	9,908	1,764	9,195	9,861	666
XVIII Optical and precision instruments	-2,246	-2,339	-93	-2,114	-1,532	582
XI Textiles and garments	-901	-336	564	-296	218	514
X Pulp, paper, cardboard	505	523	18	1,020	1,456	437
I Raw materials of plant origin	2,866	3,782	916	3,513	3,935	422
XX Furnishings and toys	-132	39	172	42	463	421
IX Wood, cork, wickerwork	1,345	1,392	48	1,287	1,634	347
VIII Skins and leather	1,353	1,459	106	1,341	1,426	85
XII Footwear	1,325	1,385	60	1,284	1,309	25
II Raw materials of plant origin	6,181	7,707	1,526	7,517	7,303	-215
<i>Rest</i>	<i>1,831</i>	<i>2,000</i>	<i>169</i>	<i>1,877</i>	<i>2,289</i>	<i>412</i>

Note: (1) Sectoral opening corresponds to sectors of the harmonized system.

Source: INDEC and Secex

The category of Argentine-Brazilian extrasubregional trade with the largest surplus was *food, beverages, and tobacco*, of US\$ 9.8 billion in the first 11 months of 2002. Of the four categories that also showed surpluses of over US\$ 3 billion, two others were also agointensive categories, while the remaining two are typically industrial. Among the agointensive categories is *primary materials of plant origin*, which showed a positive balance of US\$ 7.3 billion. However, this was the only large category whose balance declined, as

its results were some US\$ 215 million below those of 2001, stemming mainly from the aforementioned decline in exports.

The other category directly linked to agriculture is *primary materials of animal origin*, with a surplus of US\$ 3.9 billion. *Base metals and manufactures thereof* also showed a trade surplus, of US\$ 4.5 billion, approximately 80% higher than that of 2001, while *transport materials* showed a surplus of US\$ 4.0 billion.

Only four categories showed pertinent deficits. The category with the largest was *machinery and equipment*, of US\$ 8.5 billion for the first 11 months of 2002. Nonetheless, its balance showed the most positive trend, as its deficit declined by some US\$ 7.8 billion over the last year. The *chemicals and related products* category deficit was the second highest, US\$ 6.1 billion. Although it too declined with respect to recent years, this was by much less than the decline for machinery, by some US\$ 2 billion. The other two categories with negative balances are *optical, precision, medical, watch making, and musical instruments*, (with negative balances of some US\$ 1.5 billion, for total trade of US\$ 2.3 billion), and *plastics*, with a deficit of US\$ -1.05 billion.

The *textiles and garments* category had the smallest imbalance in its trade, as its exports were of the value of US\$ 1.15 billion and its imports of US\$ 930 million, thus showing a positive balance of only US\$ 220 million. Another sector showing slight imbalance in the year was *ores and fuel*, with a surplus of US\$ 2.9 billion, for total extrasubregional flows of US\$ 15.3 billion. Another noteworthy case of this type is *plastic and rubber*, as its deficit (of US\$ 1.05 billion), is somewhat less than 30% of the total trade therein.

#### - Trend and balance of sectoral trade between Argentina and Brazil -

Total trade between Argentina and Brazil in 2002 was characterized first by a significant decline in total flows, both in terms of absolute value, which fell by nearly 40%, and as a percentage of their trade with the rest of the world.<sup>30</sup> Although the larger decline occurred in Brazilian exports to Argentina (which fell by 56%), in view of the severe crisis in Argentina that year, Argentine exports to Brazil also declined significantly, by 25%.

In consequence, there was an evident widening of the Argentine surplus. Although this was the direction of trade between the two countries in recent years, in 2002, the imbalance reached a record level of some US\$ 2.3 billion.<sup>31</sup>

In studying sectoral trends from 2001 to 2002 in total trade flows (exports plus imports), we note that in all categories but one the trend was downward, ranging from, at one extreme, *footwear*, which declined by nearly 90%, to, at the other, *chemicals and related products*, which declined by 13%. In the first case, this is one of the categories with the least intrasectoral trade, as nearly all trade between the two economies is composed of Brazilian exports.

In contrast, trade in chemicals is one of the most balanced in the economic area under consideration.<sup>32</sup> The bilateral balance in this category remained in surplus for Brazil, although it declined slightly. Although

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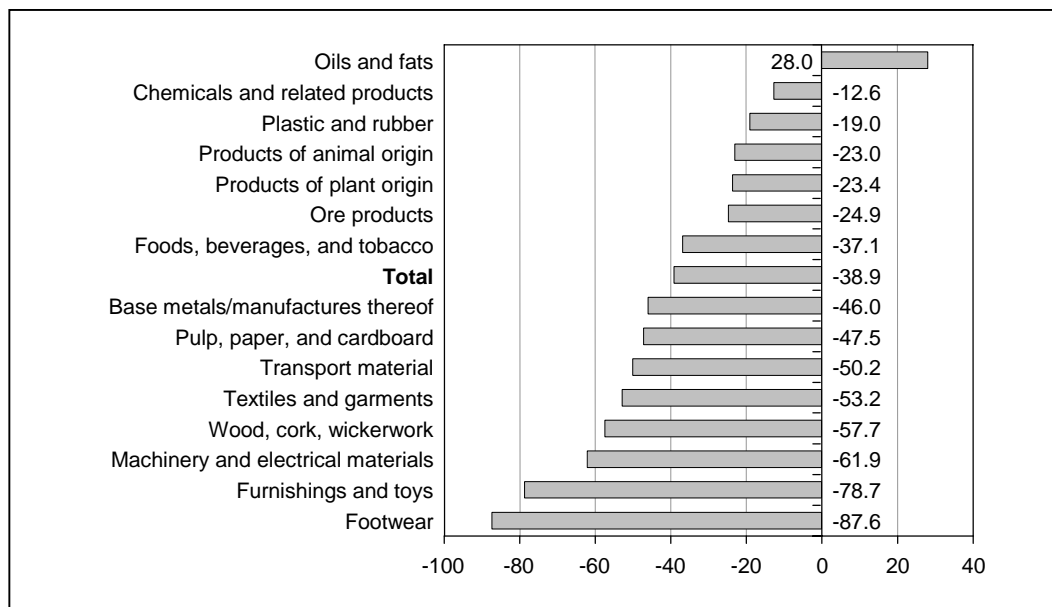
<sup>30</sup> The process of "demercosurization" of trade is discussed more fully at the beginning of this section.

<sup>31</sup> At the time of drafting this report, only provisional data was available. The figure provided here is from an Argentine source (INDEC).

<sup>32</sup> For this sector as a whole, the amounts exported from Brazil to Argentina account for 56% of trade. The study of trade by chapter still shows a high degree of intraindustrial trade. Among the six most important (accounting for 86% of the sector's trade), the highest share of Brazilian exports in bilateral trade is 65%, inorganic chemicals; while the highest share of Argentine exports is 54%, miscellaneous products (chapter 38).

exports to Argentina declined at a somewhat faster rate than those to Brazil, in both cases, variations were rather similar (-14% and -11% respectively).

**2002/01 GROWTH OF TRADE BETWEEN ARGENTINA AND BRAZIL \***  
By sector. In percentage terms



Note: (\*) Total trade is defined as the sum of Argentine exports to Brazil (according to Argentine data) plus Brazilian exports to Argentina (according to Brazilian data).

Source: INDEC and Secex

The category accounting with the largest share of the decline in bilateral trade is *transport material*, as it fell by the largest amount, some 50%. However, this major sector, not only in terms of value, in Argentine-Brazilian economic relations has the noteworthy characteristic that its balance moved in the opposite direction from trade as a whole, thereby reducing the Argentine US\$ 669 million surplus to US\$ 489 million.

The sector contributing second most to the decline in trade between the two countries was *machinery and equipment*, which declined by some US\$ 1 billion, or 62%, of its 2001 value. This decline is clearly asymmetrical, as the flow from Brazil to Argentina fell by 74%, in contrast to the 34% decline in the flow from Argentina to Brazil. Paradoxically, this virtual plummet in Argentine purchases meant that this sector was one of the most balanced trade sectors, whereas it historically had been among those most favorable to Brazil.

Other sectors whose declines contributed significantly to the weakening of trade between the two economies were *ores and fuel* and *primary materials of plant origin*. In both, the rate of decline was similar in both directions of trade although, as these are categories where Argentina has traditionally had a large surplus, this declined significantly in the year.

The only exception to the reduction in Argentine-Brazilian trade was *oils and fats*. Trade therein expanded by nearly 30% although, as this is a category where both countries have a high degree of specialization in international trade, the values transacted internally were insignificant.

## TRADE BETWEEN ARGENTINA AND BRAZIL

January-November 2002. Selected sectors \*

In US\$ million and percentage variations

Sector	Argentine exports to Brazil			Brazilian exports to Argentina			Balance ** (Arg + / Bra -)	
	2002	Variation 2002-01		2002	Variation 2002-01		2002	Var.2002-01
		%	Absolute		%	Absolute		
<b>Total</b>	<b>4,364</b>	<b>-25.3</b>	<b>-1,475</b>	<b>2,105</b>	<b>-55.7</b>	<b>-2,643</b>	<b>2,095</b>	<b>1,254</b>
<i>Total selection</i>	<i>4,282</i>	<i>-24.8</i>	<i>-1,411</i>	<i>2,042</i>	<i>-55.6</i>	<i>-2,559</i>	<i>2,074</i>	<i>1,230</i>
XVII Transport material	782	-44.6	-631	295	-60.7	-456	489	-180
XVI Machinery and equipment	298	-34.4	-156	270	-74.0	-768	9	567
V Ores and fuel	837	-23.9	-263	144	-29.8	-61	649	-174
II Raw materials of plant origin	869	-23.2	-262	46	-27.2	-17	816	-245
XV Base metals and manufactures thereof	142	-4.4	-7	179	-59.9	-267	-64	281
XI Textiles and garments	108	-32.5	-52	101	-64.8	-185	5	136
X Pulp, paper, and cardboard	73	-15.7	-14	104	-58.5	-147	-46	145
IV Food, beverages, tobacco	148	4.6	6	98	-60.7	-151	46	196
VII Plastic and rubber	368	-2.6	-10	237	-35.7	-132	128	146
VI Chemicals and related products	393	-11.3	-50	509	-13.6	-80	-156	24
XII Footwear	1	-49.5	-1	16	-88.0	-114	-16	116
XX Furnishings and toys	6	-10.4	-1	14	-83.9	-74	-9	79
I Raw materials of animal origin	178	7.5	12	22	-76.9	-72	154	88
IX Wood, cork, wickerwork	17	-6.3	-1	6	-83.8	-30	11	31
III Oils and fats	62	39.3	17	2	-60.1	-3	59	21
<i>Rest</i>	<i>82</i>	<i>-43.8</i>	<i>-64</i>	<i>62</i>	<i>-57.2</i>	<i>-83</i>	<i>21</i>	<i>24</i>

Notes: (\*) Sectoral opening corresponds to harmonized system categories.

(\*\*) The balance shown corresponds to Argentine data (exports to Brazil less imports from Brazil). Therefore, it does not coincide exactly with the difference between flows shown.

Source: INDEC and Secex

The study of the sectors above mentioned makes it evident that trade has declined most significantly where the majority of trade was destined for Argentina, as that country suffered the largest economic contraction. However, certain sectors, such as chemicals or plastics and rubber, where trade is more balanced, with a high presence of intraindustrial (and possibly intra-company) trade, performed better than others, even sectors of high Argentine surplus, such as primary products of plant or animal origin, fuel, or leather.



		Argentina					Brazil					Paraguay					Uruguay				
		1998	1999	2000	2001	2002	1998	1999	2000	2001	2002	1998	1999	2000	2001	2002	1998	1999	2000	2001	2002
<b>LEVEL OF ACTIVITY</b>																					
GDP - total	(US\$ billion)	299.1	283.4	285.0	268.7	102.3	787.9	531.1	594.2	503.9	450.9	8.6	7.7	7.7	6.9	4.6	22.5	21.1	20.1	18.6	12.0
GDP - total	(% annual variation)	3.9	-3.4	-0.8	-4.5	-11.6	0.1	0.8	4.4	1.5	1.1	-0.4	0.5	-0.4	2.7	-2.6	4.5	-2.8	-1.4	-3.1	-8.6
Industrial production	(% annual variation)	2.1	-6.5	-0.3	-7.6	-12.2	-2.0	-0.7	6.6	1.5	2.1	1.0	0.0	1.0	1.3	N/a	5.5	-8.6	2.0	-7.2	-12.6
Gross fixed domestic investment	(%GDP)	19.9	18.0	16.2	14.2	11.1	19.7	18.9	19.3	19.4	18.8	22.1	22.1	20.9	18.8	17.4	15.2	14.5	13.2	12.1	9.6
Unemployment rate	(%)	12.8	14.2	15.1	17.4	19.4	7.6	7.6	7.1	6.2	7.3	6.6	9.4	10.0	10.8	N/a	10.1	11.3	13.6	15.2	15.9
<b>PRICES AND EXCHANGE RATE</b>																					
CPI	(% variation Dec-Dec)	0.7	-1.8	-0.7	-1.5	41.0	1.7	8.9	6.0	7.7	12.5	14.5	5.5	8.6	8.5	14.6	8.6	4.2	5.1	3.6	24.7
WPI [IPIM]	(% variation Dec-Dec)	-6.3	1.2	2.4	-5.3	118.2	1.5	28.9	12.1	11.9	35.4	18.2	6.9	10.5	8.6	32.8	3.4	-0.3	9.5	3.9	64.5
Nominal exchange rate	(% variation Dec-Dec)	0.0	0.0	0.0	0.0	350.0	8.2	52.9	6.5	20.4	53.5	22.2	16.6	6.8	32.1	51.0	8.2	7.6	7.3	13.1	93.4
Real exchange rate	1997=100	100.6	104.0	108.6	112.8	279.7	103.7	157.0	151.6	187.1	217.8	113.9	124.7	132.3	149.2	188.1	102.4	106.6	111.0	121.0	165.8
Terms of trade	1997=100	94.6	88.9	97.8	97.3	98.8	98.4	85.4	88.0	87.8	84.3	104.3	102.7	107.8	107.7	107.2	105.9	96.4	90.7	91.6	93.1
<b>PUBLIC SECTOR AND INTEREST RATES</b>																					
Total result. Public Sector	(%GDP)	-1.4	-1.7	-2.4	-3.0	-1.8	-5.4	-6.8	-3.1	-3.7	-6.3	-5.2	-3.4	-4.2	-1.0	-1.5	-1.2	-3.8	-4.0	-4.4	-4.2
Primary result. Public Sector	(%GDP)	0.9	1.2	0.9	0.6	0.3	0.6	2.3	1.9	1.8	1.7	N/a	N/a	N/a	N/a	N/a	0.2	-2.0	-2.0	-1.9	-1.0
Borrowing rate	(Av. annual nominal %)	7.9	9.4	9.4	17.2	39.3	29.0	25.9	17.4	17.4	19.2	15.3	16.6	15.4	16.0	20.9	15.1	14.2	12.1	14.3	33.5
<b>EXTERNAL SECTOR</b>																					
Exports	(% annual variation)	0.0	-11.8	13.2	0.7	-3.2	-3.5	-6.1	14.7	5.7	3.7	-11.3	-26.9	17.3	13.9	-3.5	1.6	-19.1	2.6	-10.5	-9.8
Imports	(% annual variation)	3.1	-18.8	-1.0	-19.5	-55.7	-3.0	-15.0	13.0	0.0	-15.0	-20.3	-30.2	18.8	-3.0	-23.2	2.2	-11.9	3.2	-11.7	-28.9
Exports	(US\$ billion)	26.4	23.3	26.4	26.6	25.7	51.1	48.0	55.1	58.2	60.4	1.0	0.7	0.9	1.0	1.0	2.8	2.2	2.3	2.1	1.9
Imports	(US\$ billion)	31.4	25.5	25.2	20.3	9.0	57.7	49.3	55.8	55.6	47.2	2.5	1.7	2.1	2.0	1.0	3.8	3.4	3.5	3.1	2.2
Trade balance	(US\$ billion)	-5.0	-2.2	1.2	6.3	16.7	-6.6	-1.3	-0.7	2.6	13.2	-1.5	-1.0	-1.2	-1.0	0.0	-1.0	-1.1	-1.2	-1.0	-0.3
Current account	(US\$ billion)	-14.5	-11.9	-8.8	-4.4	9.3	-33.5	-25.4	-24.3	-23.2	-8.6	-0.2	-0.1	-0.3	-0.1	-0.1	-0.5	-0.5	-0.5	-0.5	0.1
Current account	(%GDP)	-4.9	-4.2	-3.1	-1.7	9.1	-4.2	-4.8	-4.1	-4.6	-1.9	-1.9	-1.1	-4.1	-1.4	-2.2	-2.1	-2.4	-2.7	-2.8	1.0
Foreign direct investment	(US\$ billion)	5.0	22.6	10.7	3.3	1.5	26.0	26.9	30.5	24.9	13.4	0.3	0.1	0.1	0.2	0.1	0.2	0.2	0.3	0.3	0.2
Total gross external debt	(US\$ billion End period)	141.9	145.3	146.3	139.8	132.9	241.6	241.5	236.2	226.1	228.7	1.6	2.1	2.2	2.2	0.0	5.2	5.6	6.1	5.9	7.0
Reserves	(US\$ billion End period)	26.2	27.3	26.9	14.9	10.5	44.6	36.3	33.0	35.9	35.6	0.9	1.0	0.8	0.7	0.6	2.4	2.4	2.6	3.0	0.8



## CHAPTER II. THE GLOBAL CONTEXT OF NEGOTIATIONS WITHIN MERCOSUR

The 2001-2002 biennium was without doubt one of the most complex and troubled periods in the 11 years since the establishment of MERCOSUR. Although in earlier years, the bloc had had to face different times of crisis and conflict, most of which had been precipitated by the devaluation of the real in January 1999 and Argentina's inability to offset the abrupt change in bilateral parity through fiscal or exchange policy mechanisms, such episodes had finally been resolved – or at least processed – through the use of different types of mechanism.

Nonetheless, in this rather unpropitious climate for headway to be made with the regular items on the integration agenda – such as government procurement, technical regulations, services, institutional design, etc. - it was evident that most such ad hoc solutions constituted a sort of “flight forward,” with the idea (or in the “hope”) that once the bloc's two largest economies had attained a “reasonable” level of financial stability and economic growth, more appropriate conditions would ensue in which to pursue stable and/or in-depth solutions to the bloc's problems – both sectoral and of institutional design – or in which to seek new bloc instruments.

Without doubt, the stark and escalating Argentine macroeconomic, financial, and political deterioration throughout 2001, along with the difficulties encountered by Brazil in maintaining the parity of the real, a phenomenon which in turn fueled trade tensions with Argentina, Paraguay, and Uruguay – and the consequent negative impact on intrasubregional trade flows - generated an increasingly complex panorama, in which conflicts of interest, threats – often carried out – of unilateral action, and the nearly daily “media battles” among officials of the different countries and, in some cases, of the same country, occupied the bloc's attention.

In this context, the complex outcome of the situation in Argentina in late 2001 – with the consequent crisis of its economy and the resignation of President De la Rúa – created the conditions for a new political and economic scenario characterized by social tension, political fragility, and enormous difficulties in managing the main macroeconomic variables. On the one hand, the abandonment of convertibility, the default on foreign debt instruments, the crisis of the financial system, and the deepening recession in some form contributed to “solving” the problems of relative competitiveness of sectors chronically problematic in intrasubregional trade, but on the other, the well-founded fears of the contagion effect on the other economies of the subregion (particularly Uruguay and Brazil) began to focus the concerns of subregional policymakers, entrepreneurs, and analysts.

Thus, while in the first half of 2002, the Argentine crisis seemed bottomless (in a context characterized by public questioning of most of the institutional system, fears of still worse financial disaster, certain prospects of hyperinflation, social chaos, and the general collapse of business and the banks), the Uruguayan financial system showed signs of near breakdown, and Brazil seemed on the verge of default, in the context of an election campaign in which the candidate with the best prospects did not appear to elicit the trust of financial operators and analysts.

However, despite the alarming mid-year forecasts, the latter half of the year showed appreciable improvement in the subregional situation, with Argentina increasingly putting financial and monetary chaos behind it, with some clear signs of recovery in the real sector, with Uruguay seeming to have slain – with external assistance – the specter of financial crisis, and with Brazil where the newly elected government seemed to have acquired some legitimacy and political fortitude that would allow it – *a priori* – reasonable initial room to maneuver in seeking to direct its economy towards the path of growth and social development.

## A. Ministerial replacements

The resignation of José Luis Machinea as Argentine treasury minister in early March 2001, and the appointment of Ricardo López Murphy – an eminent economist – in his place, and statements by some of his closest colleagues regarding the need to begin individual negotiations with the United States and/or NAFTA generated in Brazilian political and diplomatic circles different versions of events.

Thus, while some Brazilian officials (among them, the Vice President of the Brazilian Congressional Commission on MERCOSUR) expressed their fears that Argentina, "with this new Minister, will draw closer to Chile than to Brazil" (*Ambito Financiero*, March 7, 2001), the Itamaraty Palace issued a press release which indicated that Argentine Foreign Minister Rodríguez Giavarini had spoken by telephone with his colleague Celso Lafer to assure him that "the change of minister would in no way alter the priority accorded by Argentina to MERCOSUR" (*Página 12*, March 7, 2001).

But López Murphy's sudden removal and his replacement with Domingo Cavallo in late March 2001<sup>33</sup> again altered the subregional scene. Thus, along with the implications of that appointment for Argentina's domestic policy problems, two possible stances regarding MERCOSUR seemed likely for the new Minister to take. On the one hand, Minister Cavallo did not appear, in the view of different analysts, to have been an enthusiastic promoter of integration with Brazil,<sup>34</sup> although much of the negotiations that finally in 1995 led to the implementation of the customs union had been conducted – with his backing – in his times of greatest influence on Argentine political life. On the other hand, conditions in the Argentina of 2001 – and the foreign policy itself of the government in office - differed from those of the early and mid-1990s.

In this context, the new Argentine Minister made a clear assessment that emerging from the nearly three years of Argentine recession depended largely on its ability quickly to reverse the existing exchange lag in the parity of the peso with respect to the other currencies, without altering its nominal value.

In other words, in the view of the new economic team, major gains in competitiveness had to be made – of the order of 20-25% - without modifying the general convertibility regime framework in place since 1991. Thus, only a few days after assuming his functions, the Minister put forward, at the highest level of government, the need "immediately" to implement a series of fiscal and trade measures to promote relatively quickly the reactivation of the competitiveness of the sectors producing transactable goods and some of the services related thereto.

In that context, one of the first tariff measures announced by the Argentine Ministry of Economy created tensions in MERCOSUR by establishing – unilaterally and before obtaining approval from the subregional partners – a reduction from 14% to zero of the extrasubregional tariff for most capital, information technology, and telecommunication goods, and an increase to 35% (the maximum allowed by the WTO) for a wide range of consumer goods.

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<sup>33</sup> Cavallo had held that position during the presidency of Carlos Menem from March 1991 to July 1996.

<sup>34</sup> For details on the negotiations that finally led to the signature of the Protocol of Ouro Preto in late 1994 and participation by the Argentine Minister of Economy Domingo Cavallo therein, see Campbell, Rozenberg, and Svarzman [1999].

Thus, the first of the new provisions worked to the detriment of Brazilian machinery and equipment producers-exporters<sup>35</sup> (who thus lost their preference in the Argentine market with respect to their third country competitors), while the second made it more likely that trade would be diverted in favor of MERCOSUR producers of end goods.

The way in which these measures were announced via Ministry of Economy Resolutions 08/2001 and 27/2001, before a waiver, even an informal one, had been obtained from the other member countries, as well as Minister Cavallo's later statements regarding the doubtful utility of MERCOSUR's Common External Tariff, were a harbinger of different conflicts, a situation particularly evident in the case of the bilateral relations with Brazil.

In addition, subsequent statements by the aforementioned official defining MERCOSUR as a "free trade area expanding to include a much more integrated space, based on efficient infrastructure" (*Cronista Comercial*, March 22, 2001) were interpreted by many analysts as part of a strategy to regain Argentina's autonomy in managing its trade policy instruments, thereby again reopening "earlier" discussion of the intent of Argentine authorities to keep alive the idea of the customs union.

This debate had obvious implications for Argentine economic policy and for MERCOSUR's operation, and was even more pertinent in respect of the bloc's external relations with the major world powers, as both the FTAA negotiations and those under way with the EU were based on the existence of a single trade policy for the bloc. In other words, possible questioning of the customs union would also have important repercussions for the strategies to be followed regarding the major players in the world economy.<sup>36</sup>

In any event, the subsequent meeting of economic and foreign ministers of Argentina with the Brazilian Foreign Minister Celso Lafer held in Brasilia, and the message conveyed that "It is Brazil's expectation that the measures proposed by Argentina will assist in renewing its growth and will increase investor confidence" (*La Prensa*, March 23, 2001) seemed to break up the clouds, in view of the willingness of the largest partner country to collaborate in overcoming the Argentine crisis.

In any event, the Minister of Industry Alcides Tapias, explaining Brazil's intent to limit Argentine discretion in establishing tariffs, expressed the need for the new measures to be of limited duration, stating that his country "is willing to support a temporary exception regime (...), an exception because of the situation in our neighboring country" (*La Prensa*, March 23, 2001).

The Uruguayan government, on the other hand, through its Minister of Industry, Sergio Abreu, conveyed its unhappiness with the new measures, arguing that they would tend to transform the Common External Tariff into an increasingly meaningless instrument: "I wonder whether this is the end of the MERCOSUR customs union" (*Clarín*, March 23, 2001). In any event, he left it open for his country to make some complaint in that respect in the months that followed.

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<sup>35</sup> It should be noted in this connection that in 1993 and during his earlier tenure as Argentine Minister of Economy, Minister Cavallo had already implemented similar measures for capital goods. In any event, no less important was the fact that at the time, trade between the partner countries was not fully deregulated, nor had a common trade policy regarding third countries yet been agreed.

<sup>36</sup> As will be seen below, during his visit to Brazil in July 2001, European Commissioner Pascal Lamy would explicitly indicate that negotiations with the European Union would only be feasible in the framework of a consolidated MERCOSUR bloc, with the corresponding Common External Tariff.

## B. Conflict rapidly reaches its height

In this scenario, the two largest partners agreed to hold, in early April 2001, a special summit of ministers of the bloc, which would grant "on an exceptional and temporary basis until December 31, 2002" a waiver to Argentina to apply tariffs other than the CET for extrasubregional imports for some 866 tariff items classified as capital, information technology, and telecommunication goods (reduction to zero) and for another 1,600 products classified as sensitive consumer goods (rising to a maximum of 35%).<sup>37</sup>

However, the peace would last less than a week. The inclusion by Argentina of cell phones, telephones, and computers, and the components thereof in the universe of products for which tariffs on extrasubregional trade were reduced to zero until the end of 2002<sup>38</sup> led to an angry complaint by Brazilian authorities – and entrepreneurs<sup>39</sup>, a complaint that would cause President Cardoso – who was visiting the United States – to telephone his counterpart De la Rúa directly, the latter promising to instruct his Minister immediately to accede to the partner country's demand. Accordingly, Argentina undertook to submit an alternative proposal.

As a result of this situation, and of the complaints made in due course by Brazilian companies interested in this matter (pressure increased by the story circulating in Brazil that Argentina was conducting negotiations for investments by Korean firms to establish a focus of investment in that sector to compete with companies already established in Brazil), the Argentine government reversed itself on this point, and indicated in the press that "we have decided to reinstate the tariff formerly in effect for information technology and telephony goods"<sup>40</sup> (*Clarín*, April 6, 2001).

A few days later, on the eve of the hemispheric Ministerial Summit held in Buenos Aires in April 2001, the Argentine Minister of Economy acknowledged to the Brazilian press that "I am not very optimistic regarding the FTAA, because the negotiations are very complex" and, therefore "the bilateral negotiations of the United States with other countries will move ahead much more quickly" so that MERCOSUR "should consider negotiations of four plus one, three plus one, or even two plus one"<sup>41</sup> (*Cronista*, April 9, 2001).<sup>42</sup> To reflect clearly his thoughts in this area, he indicated to a well-known current Brazilian periodical that the bloc's two largest partners "should study the advisability of undertaking free trade negotiations with the United States (...), which could be conducted country-by-country, or jointly by Brazil and Argentina (...) The two countries could work together without major difficulties. But, for MERCOSUR, with two countries so different in size and characteristics as are Uruguay and Paraguay, evidently, joint negotiations would be more difficult" (*Veja*, April 9, 2001). In that connection, the reply of Brazilian Foreign Minister Celso Lafer was much more cautious: "if any action is taken, it must be taken jointly (...) as MERCOSUR" (*Cronista Comercial*, April 9, 2001).

Subsequently, in the framework of a meeting held in Sao Paulo with some 600 Brazilian entrepreneurs and bankers, convened to explain the new economic and financial measures implemented by Argentina

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<sup>37</sup> Which would later be Decision CMC 1/01 on exceptional tariff measures.

<sup>38</sup> Minister Cavallo originally sought for this reduction to remain in force until the end of 2003, a notion that was openly rejected by Brazil.

<sup>39</sup> The main suppliers of the Argentine market of cellular telephones and telephones.

<sup>40</sup> Which were, for the most part, of 14% *ad valorem*.

<sup>41</sup> In a clear reference to the possibility of an understanding between Argentina and Brazil on one side, and the United States on the other.

<sup>42</sup> This statement contradicted several prior MERCOSUR CMC Decisions (e.g., Decision 32/00), regarding the impossibility of the partner countries individually entering into fresh trade negotiations with third parties.

in connection with the business community of its trading partner, Minister Cavallo reaffirmed his idea of promoting measures designed to "eliminate obstacles to investment and promote sectoral competitiveness plans" – awash with fiscal and tariff incentives<sup>43</sup> -, which "will leverage" rapid recovery from the recession that had lashed the Argentine economy since late 1998.

In addition, with the aim of preventing import sub-invoicing maneuvers, in May, the Argentine customs authority issued an administrative resolution which established a system of advisory reference values for certain products, categorized by country of origin. This mechanism included an obligation to furnish prior guarantees for the release of imports for which a lower than reference value was declared. This system affected some 4,500 products and approximately 75% of the reference values affected goods of MERCOSUR origin. Although the partner countries did not object to the system itself, Brazil objected to the reference values established.<sup>44</sup>

### **C. Asuncion 2001: Another Summit in difficult times**

On the eve of the MERCOSUR Presidential Summit to be held in Asuncion in mid-June, spokespersons for the Brazilian Treasury Minister let it be known that the Minister's tolerance for the attitudes of his Argentine counterpart were "reaching its limit" and that his country would not permit the imposition of new barriers to intrasubregional trade. In that connection, he stated "We do not want integration at any cost. If Argentina wants to introduce a tariff to protect sectors of its economy from Brazil, there will be a reaction on the part of Brazil" (*Ambito Financiero*, June 19, 2001).

For his part, the Uruguayan President sought to mediate the disputes, complaining that "the two countries of greatest weight have in place policies that work counter to one another, which the small countries feel work to their detriment (...). Brazil, through the ongoing devaluation of its currency and Argentina, in establishing administrative barriers, are making it difficult for Uruguayan products to access their respective markets." Nonetheless, he proposed a constructive solution: "Let us see how we can reach agreement to ensure that MERCOSUR is a genuine arena for sustainable growth (...) and not a sphere where every day we encounter new difficulties" (*La Prensa*, June 13, 2001).

For his part, the President of the Paraguayan Association of Industrialists also expressed his disillusionment: "in the 10 years of the effectiveness of the MERCOSUR Treaty, Paraguay has only met difficulties, not reaped benefits. It must, therefore, withdraw from the bloc" (*La Prensa*, June 18, 2001), while the Paraguayan foreign minister argued that should Argentina and Brazil refuse to authorize compensation for the smaller partners, "Paraguay will be forced to move forward with a package of unilateral measures that has been under study by a team of experts for some time" (*BAE*, June 21, 2001).<sup>45</sup>

Lastly, the Twentieth Summit of Ministers and Presidents would, in that connection, resolve to establish a high-level group (GAN) with responsibility for studying the consistency and dispersion of the CET; evaluating a possible reduction in levels of protection and dispersion for the capital, information

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<sup>43</sup> These plans benefited companies that registered with them by exempting them from payment of minimum income and interest taxes, and allowed them to calculate the payment of standard contributions to the VAT account. In also urged the provinces to eliminate, insofar as possible, inequitable tax levies, and additional measures were promoted, in some cases detailed, such as certain benefits regarding the fuel tax in the Freight Transport Plan or measures related to the payment of intellectual property levies in the case of the Agreement to Promote Competition for Cultural Industries, among others. Companies, for their part, undertook to retain their workforce for the life of these agreements.

<sup>44</sup> In consequence, in September 2001, Brazil would lodge a complaint with the CMC (*Comisión de Comercio del MERCOSUR*).

<sup>45</sup> For further detail on this topic, see Chapter III of this report.

technology, and telecommunication goods chains (Decision 5/01);<sup>46</sup> an increase in tariffs for the extrasubregional products suspected of dumping; studying the Argentine proposal to move forward with deregulation of intrasubregional trade in motor vehicles; and postponing until January 2002 the reduction in the Common External Tariff defined in 1997, when – in other circumstances – the countries would have agreed a temporary increase therein of three points.<sup>47</sup>

A few days later, in the context of the escalating recessionary crisis in Argentina and increasing deterioration in bilateral exchange parity, the leadership of the Argentine Union of Industrialists again "gambled heavily" and requested the government to re-establish the intrasubregional trade adjustment regime which would mean, in other words, abandonment of the customs union and intrasubregional free trade that had been in effect since January 1995 for nearly the entire tariff universe: "if macroeconomic policies cannot be harmonized, it is fair to restore the adjustment regime to enable the most sensitive sectors to open more slowly," the Union's President stated to BAE (BAE, July 3, 2001).

This stance also reflected the stark differences within the Argentine industrial community, as some major companies and associations representing the most concentrated sectors had steadfastly refused to back the Union's final document. In that connection, the head himself of the manufacturers' association acknowledged such disagreement, indicating that "these are sectors that wish to preserve MERCOSUR at all cost because they represent foreign companies, with a low aggregate level of production, generating little employment, and whose production is complementary to that of Brazil" (BAE, 03/07/01).

#### **D. Brazilian understanding dwindles**

The first months of Minister Cavallo's tenure as Argentine Minister of Economy had enjoyed some degree of support and understanding on the part of Brazilian authorities in contributing to the rapid and sustained revival of the Argentine economy, but the Brazilian perception of the prospects of success of its partner country's strategy and of its "commitment" to make sacrifices in the pursuit of that objective appeared towards the beginning of the latter half of the year to have been for the most part dispelled.

A few days after the acceptance by the rest of the partner countries of the "exchange convergence factor" – which altered the effective exchange rate for all Argentine foreign trade operations and meant not only the loss of preferences for bloc members, but also a direct incentive to intrasubregional exports,<sup>48</sup> Argentine Ministry of Economy Resolution 258/01 was issued, which modified the effective extrasubregional tariffs for imports of motor vehicles, capital, information technology, and telecommunication goods, and provided that when the tariff exceeded the difference that would arise from application of the exchange rate based on the convergence factor, only the first would be payable, and that when the effective subregional tariff was less than that difference, the excess payable would be the difference determined by the convergence factor.

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<sup>46</sup> Proposals were in the first instance to be submitted to the GMC prior to November 30, 2001, respecting the maximum level of 20%, and only providing for higher levels for agricultural products subsidized in third countries. The group was also to propose a timetable for and method of reducing the temporary three-point increase in the CET, which was to be definitively eliminated in late 2002.

<sup>47</sup> Brazil had promoted it because of problems stemming from its exchange lag and large trade deficit, and Argentina owing to the call from the WTO to reduce drastically the level of statistical tax on imports.

<sup>48</sup> Implementation of the convergence factor implied not only a sort of duty on imports from the world, including Brazil, but also additional profit – unprecedented since 1995 – on sales to the market of the neighboring country. Similarly, exports to Brazil began to be eligible to benefit from the general reimbursements for Argentine sales to the world. Although Decision CMC 10/94 authorized Argentina to be able to continue to apply to intrasubregional sales as well the general reimbursement regime that had been in place since 1992, its use within MERCOSUR had been eliminated since the very beginning of the customs union in 1995.



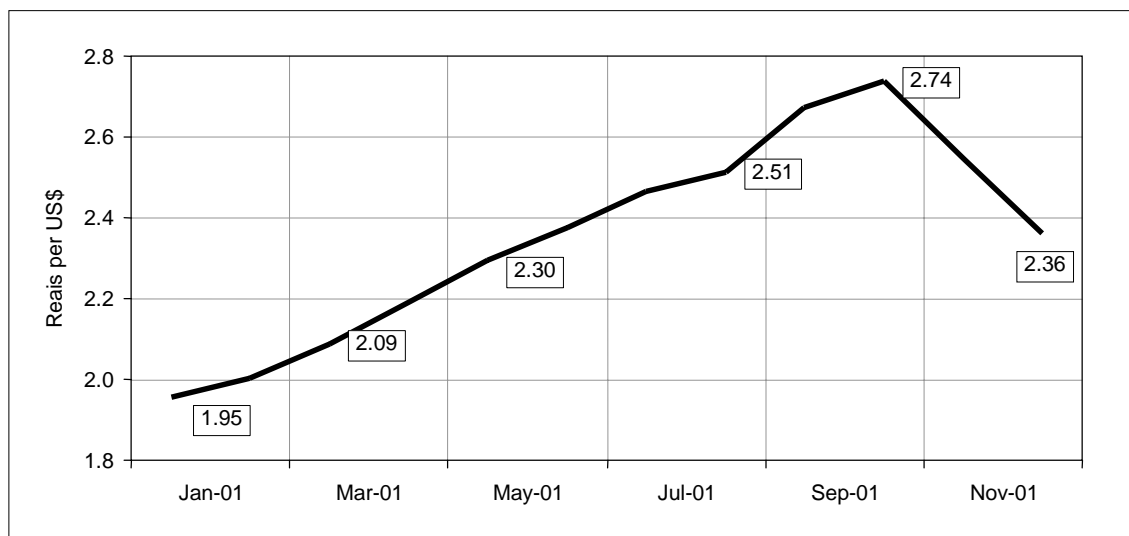
The resulting effect was a deterioration in the relative preference for products imported from MERCOSUR countries which, with the zero import tariff, were now affected by the tariff surcharge implied in the circumstances by the convergence factor (*Intelligence Trade Report*, 2001), which severely undermined the MERCOSUR preference.

In response thereto, Itamaraty announced the suspension of bilateral negotiations on the automotive regime and Common External Tariff, indicating possible "drastic measures against Argentina" (*Folha de São Paulo*, July 6, 2001), and suggested the possibility of suspending wheat and oil imports from Argentina<sup>49</sup> should Argentina not withdraw Resolution 258 as a matter of urgency, forcefully stating that "the loser here is Argentina. It is sufficient to note the trade balance: Argentina has a US\$ 600 million surplus in its trade with Brazil" (*Clarín*, July 10, 2001).

At the same time, the Paraguayan government also announced the imposition of an intrasubregional tariff of 10% for a list of 322 products, arguing that "the latest economic measure adopted in the region have considerable impact on the competitiveness of Paraguayan products" (*Ambito Financiero*, July 12, 2001).<sup>50</sup>

But the ongoing depreciation of the real against the U.S. dollar in August 2001, in the context of the mounting financial difficulties of the Argentine economy, again added to tensions in bilateral relations between Argentina and Brazil. Thus, in the framework of a meeting of businessmen held in Buenos Aires at the *Fundación Invertir* in early September, harsh criticism again was leveled at Brazilian exchange policy, and it was proposed to implement "maximum ranges between the real and the peso, with application of trade safeguards in case of non-compliance" (*Clarín*, September 13, 2001).

**TREND IN BRAZIL'S NOMINAL EXCHANGE RATE, 2001**



Source: In-house, based on IPEA [2002].

Many Argentine entrepreneurs defended the changes in trade policy promoted by Minister Cavallo as a means of offsetting the changes in euro vis-à-vis U.S. dollar quotations, and essentially, the devaluation of

<sup>49</sup> Which represented annual trade of approximately US\$ 2 billion.

<sup>50</sup> For further detail on this topic, see Chapter III of this report.

the real which, from January to September, according to UIA calculations, had declined by 30%. In addition, they again demanded transitory measures "enabling this bilateral crisis to be overcome without eroding the trade bloc's foundations, such as the restoration of the adjustment regime or urgent sectoral agreements" (statements of the UIA President, *BAE*, September 20, 2001).

In this context, Brazilian officials countered that, despite business community fears and those of some sectors of the Argentine government, imports from Brazil had fallen significantly (by 18% from January to December 2001 with respect to the same period in 2000), while Argentina's trade surplus expanded by 59%, to reach nearly US\$ 930 million.

Thus, a document prepared by the Embassy of Brazil in Argentina concluded that bilateral trade is more affected by the economic activity of the two countries than by the depreciation of the real. The study also established that, in the first half of 2001, the Brazilian devaluation did not affect the competitiveness of all Argentine products, but only of some, such as footwear (*La Nación*, October 4, 2001).

#### **E. A scenario characterized by a loss of consensus and anxiety**

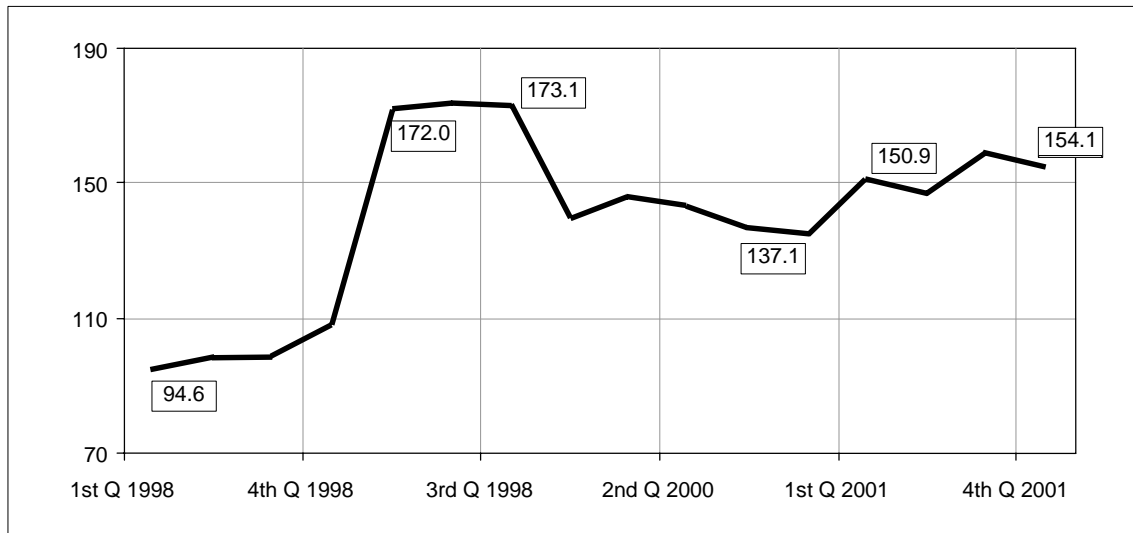
From the outset of the MERCOSUR process, members of the Argentine business community leadership had been less than enthusiastic regarding the very idea of subregional integration, but the positive results that the bloc and the Argentine economy were able to show from 1991 to 1997 greatly curtailed the scope and extent of complaints and trade disputes.

However, the crisis in Argentina since late 1998 and the strong trend toward devaluation of the real since January 1999 had led to the burgeoning of the group of entrepreneurs resisting the integration concept, a group drawn essentially from traditional light industry sectors and those with large small business representation. Nonetheless, despite the questioning, the political consensus existing in Argentina in respect of preservation of exchange parity with the U.S. dollar remained broad among both political and business community leadership.

Thus, after the highest leadership of the Argentine Union of Industrialists suggested to the press that that body would officially request temporary suspension of the integration process, in September, certain less august bodies – representing the sectors most affected by the exchange imbalance and domestic recession – took up that initiative with renewed vigor.

In that context, in mid-September, the Association of Argentine Metallurgical Industrialists (ADIMRA) indicated that "if steps are not taken, the number of losing Argentine producers will rise dramatically" and that "MERCOSUR is a good project, but calling a temporary halt would be a good idea if it is to be preserved" (*La Prensa*, September 28, 2001). The leader of that Association stated that "the Argentine trade surplus with Brazil achieves through wheat and oil exports, as if primary products are excluded, the trade balance is clearly in deficit" (*Clarín*, September 30, 2001).

### TREND IN ARGENTINE/BRAZILIAN UNIT LABOR COST, 1998-2001



Source: In-house, based on Lucángelli [2002]

#### The footwear sector: a “chronic” case in point

The Argentine footwear sector encountered major difficulties of competitiveness throughout the life of the convertibility regime. The first protective measures for the sector were implemented in 1994, in the form of minimum import tariffs for extrasubregional products. Then, such measures were adopted under the WTO system of safeguards, and the range of protected products was expanded.

Within MERCOSUR, trade was also restricted for a considerable time, as Argentina included much of the sector first under the exception regime and then under the adjustment regime. Only when the latter had expired (January 1999) could footwear of MERCOSUR origin freely enter Argentina.

This coincided with the steep devaluation of the real, which facilitated Brazilian footwear’s rapidly increasing penetration of the Argentine market. In consequence, after the introduction of technical and quasi-tariff measures, the Argentine and Brazilian productive sectors entered into an agreement to limit Brazilian sales on the Argentine market through a quota mechanism. When this agreement expired after a year, it was not renewed as difficulties were encountered in ensuring adequate oversight of commitments. Since that time, an attempt has been made to organize a scheme to promote complementation and specialization of the subregion’s factors, so that the footwear sector was among the first to be included in the “productive chain forums.” However, it was not possible to reach any specific agreement.

Meanwhile, Argentina extended the WTO safeguard for sports footwear, and established for the rest of the products minimum tariffs within the maximum permitted by the WTO (35%), in view of what was permitted at the time under the CET exception regime. In January 2001, these exceptions lapsed; however, the effectiveness of the Common External Tariff in Argentina was of short duration, as in March 2001, footwear was included in the general tariff increase affecting consumer goods, which was subsequently admitted in the MERCOSUR framework under the legal umbrella of a waiver.

The continued existence of restrictions applicable to footwear of extrasubregional origin on the Argentine market and the expiration of the private agreement between Argentinian and Brazilian producers led to a sharp diversion of Argentine imports towards products manufactured in Brazil. Thus, in 2001, while imports from the rest of the world declined by 18%, those of Brazilian origin increased by 3% in the same period. In 2001, Brazilian footwear accounted for 70% of footwear imported by Argentina and, according to private estimates, this was approximately one third of the Argentine footwear market.

In last quarter 2001, in a context of a general productive crisis, and in the perception that the special system of intrasubregional safeguards then being negotiated (among which Argentine footwear was a major candidate for benefit) was inadequate and that application thereof was a lengthy procedure, representatives of labor and management of the Argentine footwear sector demanded in early December 2001 – taking an extreme position unparalleled in any other productive sector – “*the immediate prohibition of imports of footwear from Brazil,*” a demand coinciding with a demonstration – in mid-December – of businessmen and workers of the sector that marched to the headquarters of the Argentine Foreign Ministry, at whose doors were thrown thousands of pairs of shoes in repudiation of a policy they considered “too complacent” in the face of Brazilian competition.

After that, owing to the end of convertibility, and the subsequent steep devaluation of the Argentine currency, the intensity of these demands waned, as imports became much more expensive. In addition, as in April 2002, the tariff increase permitted under the waiver was suspended and the remaining WTO safeguards were rescinded by the courts, a reduction in the extent of the diversion of Argentine footwear imports in favor of Brazilian producers may be anticipated for the future.

Days later, in the framework of a meeting with President De la Rúa, the leadership of the manufacturers’ association submitted a document that persisted with the argument: “the value of our currency has fallen against the Brazilian by 45% in the last four years, and nothing has been done. This must change as, should it not, MERCOSUR will perish (...) for MERCOSUR to survive, the impact must be offset, at least for the most affected sectors, by suspending the tariff advantages until the disequilibrium is resolved.” The Argentine government’s counterproposal to the industrialists was to monitor jointly the most affected sectors in order to identify the most urgent situations and propose specific measures and/or solutions thereto at the ministerial meeting to be held in Sao Paulo in mid-October 2001.

## **F. Seeking a solution to exchange disparities not involving devaluation**

The differences – and incompatibilities – between the exchange systems of the bloc’s two major partners had existed since at least early 1999, but the inclination of Argentine authorities, and of a large majority of entrepreneurs, economists, and the public, was to prevent by all possible means an alteration of the convertibility regime. In that context, offsetting the imbalances stemming from the situation in the Brazilian economy seemed a task that would involve much more than ingenuity, effort, and good will.<sup>51</sup>

This being the case, the announcement of the convocation of a Meeting of Economic Ministers and Central Bank Presidents, to be joined by the foreign ministers, scheduled for October 8, in Montevideo,

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<sup>51</sup> It is timely, in that connection, to note that during the Argentine parliamentary elections of October 14, 2001 (that is, two and a half months after the abandonment of the convertibility system), nearly all candidates that eventually were had expressed their support elected during their respective campaigns for preserving the “one-to-one” system.

generated expectations that an institutional negotiating authority would be established for the evidently central issue: the differences in relative real exchange rate parities, accentuated in recent months by the ongoing nominal devaluation of the peso at a faster pace than of the real.

As the governments had rejected the proposal to suspend the customs union put forward by the UIA, the Argentine government arrived at that meeting with different proposed compensation mechanisms to "manage" the difficult bilateral trade relations.

Whereas the objective of one of proposals was to apply corrective sectoral measures (safeguard-type clauses), the other provided for implementation of a general "exchange rate trigger" if the real rose above the top of an exchange band that would be established by mutual agreement. In other words, whereas the first proposed the application of import quotas or duties for specific products whose prices rose steeply and implied injury for the activity of the other country, the second meant the general establishment of some type of reimbursement and tariffs generally applicable in bilateral trade, should the depreciation of the real exceed a pre-established maximum.

Lastly, at their meeting, the highest political leadership of the two countries rejected the use of any type of general exchange rate "trigger" (because of the steadfast refusal on the part of Brazil) and the decision was announced to resolve the problems of the trade agenda and to establish, within two weeks, a temporary bilateral safeguard mechanism based on WTO rules. Thus, Brazil, for the first time since implementation of the Customs Union in 1995, accepted the possibility of introducing formal restrictions in intrasubregional trade, a topic that, since the first half of 1999, had been the source of acrimonious disputes between the two largest partners.<sup>52</sup> These safeguards were to be based on a quota or tariff system, and a streamlined system had to be designed to that end that would enable the mechanism to be used only in cases where it could be demonstrated in some – as yet undefined – way that there had been injury to national production.

In that connection, the Brazilian foreign minister made it clear that his country would not accept general mechanisms or trade protection regimes not in keeping with agreed criteria for verification of their pertinence: "the safeguard may only be applied if it is demonstrated that imports from Brazil have serious negative impact on Argentine production" (*Página 12*, October 12, 2001).

Whereas the Argentine side demanded a tool of quick and expeditious use, with no need to wait for demonstration of the injury imports from the neighboring country were causing to national activity, Brazil stipulated, from the outset of negotiations, that such measures as might be adopted would follow the procedural aspects established by the WTO, that is, among other things, the requirement of demonstration of injury prior to any application of measures. These issues, and others related to establishing how long the instrument would be in force, which institutions would have responsibility for its application and administration, and whether other specific sectors would be excluded, were left for consideration by the working group responsible for follow-up of and administration of this instrument.

The sectors most benefited through the use of the mechanisms agreed would be those most sensitive to bilateral trade and would have been most affected by further penetration by Brazilian products on the Argentine market as a result of the exchange policy implemented in Brazil since January 1999. It was thus assumed that the potential beneficiaries of this instrument would be Argentine producers of footwear, furnishings, textiles, chicken, pork, toys and, possibly, paper. On the other hand, companies injured by the

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<sup>52</sup> For further detail regarding the incidents in 1999 in connection with this issue and Argentina's attempt to utilize the safeguard system provided for in LAIA Resolution 70, see Informe BID-INTAL [2000]

depreciation of the real through the loss of part of the Brazilian market or through the insertion of third countries would not be eligible – under the agreement reached – for any type of action. The decision to move ahead with the design of this mechanism was ambiguously received by Brazilian entrepreneurs: "We must be flexible, although only temporarily, and give Argentina some time to recover. We cannot consider quotas for Brazilian exports or the elimination of the CET, but we may consider the temporary suspension of the zero tariff for bilateral trade in some products" (statements by the President of FIESP, *La Prensa*, October 10, 2001).

On the Argentine side, in the industrialists' view, the agreement reached was "absolutely inadequate," as the safeguard mechanism could only be applied in specific cases, after an administrative proceeding that could last up to a year and whose cost would be too great for small and medium-scale enterprise to bear (*La Nación*, October 17, 2001).

The Unión Industrial's disagreement would be set out formally in an announcement published in all Buenos Aires newspapers, under the title: "The use of safeguards is inappropriate in correcting MERCOSUR's exchange asymmetries." The announcement stated that "Argentina's currency is tied to the dollar and Brazil devalued its currency in real terms by 71% from December 1998 to July 2001. In such conditions, there can be no customs union: if the macroeconomic asymmetries are not eliminated – as the Treaty of Asunción provides – they must be offset (...) Argentina is seeking to correct the exchange asymmetry through implementation of a system of safeguards, which is absolutely inappropriate. Safeguards are specific measures designed to resolve specific problems temporarily in order to offset or prevent potential damage to sectors affected by steep increases in imports. They do not solve the problems of Argentine producers exporting to Brazil nor those of Argentine industry in general, which must compete on clearly unequal terms." Lastly, it was proposed that "to prevent sharp distortions in trade flows and investment allocation, the exchange problem should be attacked directly with an automatic measure that addresses the cause of the distortion itself: the ongoing devaluation of the real. The solution to the exchange problem is a tariff band and reimbursements which, based on an equilibrium exchange rate, fluctuates automatically with fluctuations of the real" (...) and that "without a system that automatically corrects exchange asymmetry within MERCOSUR, the injury to industry will be irreparable and the effect on employment devastating" (Unión Industrial Argentina announcement in all Buenos Aires newspapers, October 18, 2001).

In Uruguay, President Batlle agreed that safeguards were not good instruments for the resolution of asymmetries, and added "we cannot fail to note that customs unions are much undermined where macroeconomic policy is not harmonized among the parties comprising them" (*BAE*, October 26, 2001).

In this complex scenario, the countries – in keeping with the decision taken at the meeting of October 8-9, 2001 – officially exchanged their proposals for mechanisms for corrective (safeguard-type) measures; at the same time, although informally and in an unplanned way, the Argentine government circulated to the Brazilian authorities a proposal for an alternative instrument – a macroeconomic adjustment factor, in which it again insisted on a regime of general application to offset exchange lag, a proposal that had been flatly rejected by Brazil at the Meeting of Presidents of early October.

### **Similarities and differences in the safeguard instruments proposed by Argentina and Brazil**

1. The Argentine proposal provided for the possibility of applying corrective measures for the entire universe of products included in the MERCOSUR Common Nomenclature, making exceptions in a rather vague way for different types of product,<sup>a</sup> commodities with international price quotations. The Brazilian initiative, however, covered the tariff universe without exception.
2. Whereas the Argentine proposal provided for the alternative of application of corrective measures “on own initiative” – along with those required by the private sectors affected – the Brazilian proposal did not provide for this possibility.
3. As regards the details of the compensatory measures, Argentina proposed to apply, as a first step,<sup>b</sup> an ad valorem tariff lower than the CET. However, as a second step, it provided for the establishment of specific import or ad valorem tariffs that might exceed the extrasubregional tariffs. Alternatively, it promoted the imposition of quantitative or other restrictions that might be appropriate, depending on the case, to prevent or redress injury. The Brazilian proposal, for its part, provided for possible imposition of ad valorem surcharges (always to be lower than the extrasubregional) or quotas with a zero tariff.
4. In the Argentine view, measures could be implemented when a reduction of over 7% of the weighted average FOB export prices had been established and/or when a volume increase was noted, and/or when an increase of three percentage points occurred in the ratio of quantities imported to national production. In all cases, the comparison period referred to the 1998 average vis-à-vis the average for a minimum period of six-months – and a maximum period of 12 months – ending 90 days prior to application of the measure. Under this criterion, demonstration of injury would be left to a second stage. The Brazilian proposal, on the other hand, provided for demonstration of injury as a requirement for the imposition of any type of measure, for which there had to be observation of the trend in volume imported in the triennium 1998-2000, possible changes in price in this period, degree of penetration of the affected market, level of national production, capacity utilized, level of employment, and external trade performance with respect to third markets.
5. Length of mechanism and periods of effectiveness of measures: the Argentine proposal provided that the mechanism would remain in force until the end of 2004, while each measure adopted would remain in force for two years, with the possibility of extension if circumstances so justified.
6. The Brazilian proposal was very restricted in both these areas, and provided for a maximum effectiveness of one year for the measures and for the mechanism itself (until December 31, 2002).
7. Lastly, the Brazilian proposal differed in two important respects from that of Argentina: the need for the quadripartite GMC to approve ex ante the application of any measure (in a Resolution) and the requirement that establishment of the adjustment mechanism be accompanied by a restructuring program for the affected sector.

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<sup>a</sup> Although the safeguard clauses apply to tariff positions, that is, to specific well-defined products, the Argentine proposal to except specific goods from application of the mechanism was expressed through groups of activities, classified by the International Standard Industrial Classification (ISIC Rev.3). Thus, products normally exported by Argentina to Brazil, such as fuel and agricultural products, were excluded from the mechanism.

<sup>b</sup> The stages involve the possibility of immediately implementing measures on a provisional basis and then initiating the pertinent consultations (30 days) and the demonstration of injury (60 days).

Although the safeguard proposals presented by Argentina and Brazil had major differences of approach and methodology, they were a first basis for discussion and negotiation, with a view to reaching consensus among all parties on a common mechanism. However, owing to disagreements regarding other proposals to address the exchange asymmetry, little progress would be made at bilateral meetings held on October 25 and 26.

### **G. The final phase of the safeguard negotiations**

Since mid-November, the parties' positions had been growing closer together and there was speculation that at the December meeting of the GMC and CMC, consensus would finally be reached regarding a safeguard mechanism for intrasubregional trade. In that connection, the proposal submitted by Argentina to that body stipulated that only the private sectors affected would be authorized to submit a request for application of measures – eliminating the possibility of their application on own initiative – and incorporated the requirement of demonstration of injury for the application of such measures, although the provision remained regarding possible adoption, but only for 180 days, of temporary measures based on the admissibility of the request, which would be consistent in establishing guarantees of ad valorem import tariffs never higher than those in effect for extrasubregional imports.

The definitive measure might provide for the establishment of quotas with preferential tariffs and the application of the extrasubregional tariff for imports made outside the quotas. To that end, the importing State Party could raise extrasubregional import tariffs up to the maximum allowed by the WTO. The quota, for its part, would take into account the average physical volumes imported over the last three years representative of the historical trade flow.

It was stipulated that the adjustment mechanism would expire as of December 31, 2003, and that measures were to be in effect for a maximum of two years – although with the possibility of renewal if circumstances so required. Lastly, the proposal established that investigations would be carried out by the application authorities of the country affected, although it defined a mechanism for consultation and information exchange prior to establishment of the definitive tariffs.

#### **The macroeconomic adjustment factor**

The Argentine proposal provided for application, to imports from Brazil, of a macroeconomic adjustment factor equal to the minimum between the extrasubregional import tariff and a factor equivalent to the product of the quotient of the value of the real quoted in U.S. dollars at the time of the transaction and the value of the real quoted in U.S. dollars as of December 1, 1999 (R\$1.91/US\$), and the quotient of the simple average of the CPI and the WPI of Brazil in December 1999 and the simple average of those prices in the last period considered, minus one.

The factor so calculated was to be multiplied by the CIF value of imports in U.S. dollars, giving the amount that importers had to upon bringing the goods into the country. A similar calculation was defined for Argentine imports from Paraguay and Uruguay. In all cases, it was provided that the mechanism would remain in force until macroeconomic convergence among the partner countries was achieved.

Despite the economic climate – and some stories that spoke of an intent on the part of some Brazilian officials and entrepreneurs to agree at the end-of-year regional summit that an impasse had been reached



in the integration process (particularly regarding the CET) in order to move forward more readily in their bilateral negotiations with Mexico, the highest political authority of the largest South American power remained willing to “invest” negotiating energy and effort in MERCOSUR.

In this context, and after the MERCOSUR Trade Commission outlined in December, in Montevideo, a preliminary agreement on some of the items on the internal agenda,<sup>53</sup> the crisis in the Argentine economy ceased to worsen and become generalized. The sudden cancellation of the meeting of the CMC and the MERCOSUR Presidential Summit and the withdrawal of the Argentine delegation in Uruguay on the afternoon of December 20, 2001 – after confirmation of the resignation of President De la Rúa, and while Argentine governors, politicians, and parliamentarians discussed forms and mechanisms for institutional succession, President Cardoso, having just arrived in Montevideo to participate in the thwarted subregional Summit, met with his Bolivian, Chilean, Paraguayan, and Uruguayan counterparts to affirm his "support for a democratic outcome" in Argentina while Foreign Minister Lafer stated to the press that "at this difficult time, Argentina has, as ever, the absolute solidarity and support of Brazil" (*La Nación*, December 21, 2001). At that time, President Cardoso also suggested what he felt might be the future for subregional integration: "Brazil's trade relations with Argentina, which were already going badly, may completely flounder in the short term. But in the medium to long term, they will be revived" (*Clarín*, December 22, 2001).

Rumors of the imminent abandonment of convertibility and confirmation of the dramatic heightening of Argentina's political and social crisis – and the consequent fear of a contagion effect on the rest of the subregion – drastically altered both the subregional panorama and the order of priorities on the bloc's negotiating agenda.

A few days later, the Argentine exchange regime having been modified, with new – although unstable – bilateral parities and – essentially – another pyramid of priorities, and urgent and burning issues for the different players, the 2002 MERCOSUR agenda would differ greatly – in many aspects – from its predecessor.

## **H. MERCOSUR in 2002: time to generate new fora for dialogue**

*After the "explosion" in the Argentine economy*

In 2002, the Currency Board regime (convertibility) collapsed that had been in place in Argentina for over a decade. Although fears were expressed in some partner countries – particularly the smaller – that the exchange volatility in Argentina would lead to both an invasion of products of Argentine origin and deterioration of the subregion's financial indicators, in the first months of 2002, neither of these materialized.<sup>54</sup>

The first two months of 2002 were characterized primarily by paralysis of trade with Argentina, difficulties in completing operations already in course when the crisis began (particularly, collection of letters of credit by Brazilian exporters), and the wait-and-see attitude of the principal agents and operators. But, despite the fears and short-term prospects, from a certain point of view, the end of convertibility –

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<sup>53</sup> To be noted was a mechanism for the temporary operation of intrasubregional safeguards and an increase in extrasubregional tariffs for food products and food benefiting from subsidies in developed countries.

<sup>54</sup> In any event, no less important was the drastic decline in income from Argentine summer tourism suffered by Uruguay and Brazil, and, to a lesser extent, by Chile.

forecast by different private analysts of the subregion in the second half of 2001 – could be regarded with certain optimism from the standpoint of the MERCOSUR negotiations process.

Without doubt, the coexistence of the fixed exchange system in Argentina and a flotation regime in Brazil had been – particularly since 1999 – one of the main factors contributing to the asymmetry between and macroeconomic disequilibria of the bloc’s main partners, from which nearly all problems of relative competitiveness and trade and investment diversion problems emanated.

In any event, the change in the Argentine exchange regime succeeded in clearing a path towards the “normalization” of intra-MERCOSUR relations, through which the level of conflict would decline, thereby enabling more negotiating resources to be assigned to the “long term” issues, such as the external front (FTAA, EU, etc.) and the intensification itself of the integration process (review of the CET, trade disciplines, harmonization of technical provisions and standards, physical integration, government procurement, etc.), in a more relaxed framework, with less sectoral pressure and greater mutual understanding.

This view minimized to some extent the true importance of the convertibility-Currency Board as a means of operating the Argentine economy towards its own interior. In fact, convertibility had served as the foundation of and reference point for all contracts, public, private, and public-private. Thus, its elimination led to the sudden collapse of many pre-existing commitments. In consequence, in the first half of 2002, Argentine policymakers’ central task was how to “allocate” in political terms the asset losses that resulted from the abandonment of convertibility, seeking to minimize the damage and introduce mechanisms designed to produce a new context of “greater normalcy of operation of economic ties among local players.”<sup>55</sup>

In any case, as might have been predicted, in January, in the context of growing social discontent among savers, entrepreneurs, and shopkeepers affected by the stagnation of economic activity and a public opinion highly critical of the political class as a whole, the Argentine economy was virtually paralyzed, with frequent and lengthy currency exchange “holidays” towards the end of April. To summarize, the abandonment of convertibility was an extremely traumatic event for the Argentine economy – and society – with marked depressive effects on levels of activity in nearly all sectors.<sup>56</sup>

In that context, in the first months of 2002, efforts of the MERCOSUR countries focused, on the one hand, on seeking to “repair” the damage caused by the heightened conflict the preceding year and, on the other, on ways to “alleviate” the problems of the Argentine economy through trade measures, thereby seeking to prevent the crisis from spreading to the rest of the subregion. At the same time, a strategy was implemented to repair the damaged relations with the largest subregional partner, a situation that was helped by the constructive attitude and positive predisposition of Brazilian officials.

Thus, battles, some objective points of conflict of interest, and the search for realistic solutions to specific problems moved from the pages of the newspapers and magazines to the bilateral and quadrilateral negotiating table, around which sat officials with responsibility for the different issues at hand.

In that respect, an eminent expert on subregional integration topics and Argentine-Brazilian bilateral relations reflected on the need to restore the spaces for cooperation with the main South American economy:

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<sup>55</sup> This expression was frequently used by the Minister of Economy, Jorge Remes Lenicov, to refer to the need for Argentine economic agents to “get used to” operating in an economy with a flexible exchange rate.

<sup>56</sup> In fact, the final collapse of activity began in mid-2001, in anticipation of the possible consequences in the collapse of convertibility, which had been in place for over ten years. For further detail on this topic, see Chapter I of this report.

"none more than our neighbors are interested in the recovery of the Argentine economy" as "a neighbor in crisis is a potential source of instability" (Roberto Bouzas, *Clarín*, January 1, 2002).

### *How to begin again?*

The sudden restoration of Argentine exchange parity with respect to Brazil smoothed part of the way, and rendered superfluous many of the measures introduced by Argentina owing to the devaluation of the real in January 1999. During the first visit of Foreign Minister Ruckauf to Brazil a few days after taking tenure (mid-January 2002), the start of the progressive elimination of intrasubregional disputes was announced. This process, dubbed "clearing the table," proved to be the focus of Argentine-Brazilian bilateral relations throughout 2002.

Thus, the new Argentine officials with responsibility for international economic relations focused their efforts simultaneously on two areas. They first sought to link requests for emergency financial assistance from the developed countries to further opening of markets (arguing that "instead of loans and financial assistance, we want greater opening of markets"). At the same time, they sought to generate conditions so that Argentine exporters might profit as soon as possible from the gains in competitiveness that would naturally emanate from the steep and accelerating devaluation of the peso. In that connection, the new official with responsibility for the Foreign Ministry's international economic negotiations, Martín Redrado, indicated in late January that his objective was to achieve "intelligent integration with the world, to move into new markets that will have to open to our products" (*BAE*, January 22, 2002).

As regards MERCOSUR, and with the same aim of generating markets that might contribute relatively quickly to the recovery of the national economy, Argentine negotiators focused their efforts on removing the obstacles to negotiations regarding the MERCOSUR Automotive Policy (MAP), with a view to lending flexibility to the compensated trade mechanism so as to increase Argentine motor vehicle exports to Brazil.

From the outset, Brazilian negotiators indicated that they were open to the possibility of "assisting" an Argentina in crisis by adopting favorable trade measures, among them, definitive amendment and regulation of the MAP.<sup>57</sup> They requested, however, by way of compensation, prior elimination of the numerous trade barriers and reductions, and the subregional preference that Argentina had had in place for many sectors since 1999 when the problems of competitiveness stemming from the growing exchange asymmetries between the two countries had generated alternative formulae in the regulatory and trade areas.

Thus, in early February 2002, the Brazilian Minister of Industry, Sergio Amaral, "on express instructions from President Cardoso," announced the elimination of all barriers and quotas imposed in the past on the entry of Argentine products into its market, with the logical exception of those involving sanitary issues, such as those related to hoof-and-mouth disease, and availed himself of the opportunity to express his solidarity with Argentina in its complex negotiations with multilateral financial organizations: "Brazil seeks by this gesture to indicate to the international community that it is truly urgent to hasten assistance to Argentina" (*Clarín*, 08/02/02).

However, the context of growing exchange instability, the serious banking system difficulties, the "return" of inflation, and certain prospects that a hyperinflationary process (with unpredictable political and social implications) might be "just around the corner" made it impossible both to assess the true scale of the

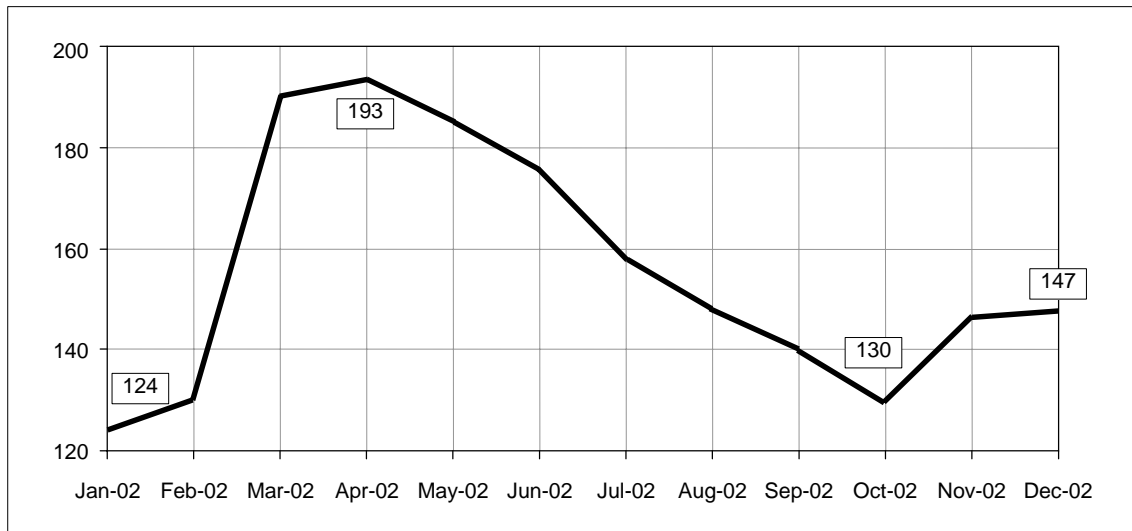
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<sup>57</sup> In that connection, the Brazilian foreign minister in February indicated in February, during a trip to Washington, that "Argentina is our neighbor and our partner, and we are trying to assist in the trade and the finance areas, and also by sharing our own experience" (*Clarín*, February 1, 2002).

devaluation and to make decisions on topics not related to the day-to-day situation, to which were added legal and administrative obstacles to terminating abruptly the many antidumping proceedings under way since the preceding biennium in connection with imports from the neighboring country, as Brazilian authorities expected.

### ARGENTINA-BRAZIL REAL RATE OF EXCHANGE IN 2002

Basis: average real exchange rate 1999/2001=100



Source: Ministry of Production (Argentina).

Based on the Brazilian initiative, it was decided to work to create conditions for complementation of production at the subregional level (development of subregional productive chains and sectoral competitiveness forums),<sup>58</sup> in order to facilitate exports of subregional products to third country markets. To that end, a need was again expressed for the development of the "MERCOSUR trademark," and it was resolved to give further impetus to the initiative - which had been put forward the preceding year - of conducting joint trade missions towards third country markets. As a first step, the Argentine Minister of Production was invited to participate - along with entrepreneurs from that country - in a Brazilian trade mission to China scheduled for April, while the first MERCOSUR business trip was confirmed, to be made to South Africa in May by firms from the four countries.<sup>59</sup>

But, despite the political statements and statements of the parties' intent, the difficult political and economic situation in Argentina in the first half of the year stymied prompt decision-making regarding the elimination of the measures demanded by Brazil. In addition to the efforts made by the two countries' officials, the severe recession, exchange instability, and problems of a regulatory nature (ranging from difficulties in implementing and administering the new trade and banking provisions in Argentina to delays in settling operations carried out in late 2001 between Argentine importers and Brazilian exporters)<sup>60</sup> led to steep and accelerating declines in bilateral trade.

<sup>58</sup> For further detail on the steps taken in this area in 2002, see Chapter IV of this report.

<sup>59</sup> For further detail on this mission, which was finally carried out in late June, see Chapter V of this report.

<sup>60</sup> Which, according to the Brazilian Foreign Trade Association, amounted to some US\$ 500 million by May 2002.

Thus, towards the middle of April, it was learned that Argentina had fallen from second to fourth place in the ranking of destinations for Brazilian products, while Brazil was losing its position as the principal buyer of Argentine goods. In any event, Brazilian negotiators continued to gamble heavily on the integration process: "the bloc is not dead. It is only trade that is ill, stated Ambassador Botafogo in early July in Buenos Aires" (*La Nación*, July 3, 2002).

The economic climate aside, and in view of press stories that the Argentine government would take the political decision to suspend many of the special regimes for control of access and investigation proceedings of dumping under way against Brazilian exporters in different sectors in order to facilitate negotiations on priority topics, the Argentine Association of Pork Producers sent a letter a letter to the Minister of Economy indicating that if an order were issued to suspend the antidumping proceedings under way for the sector regardless of the deadlines stipulated in law, the authorities involved in that decision would be failing in their duties as public officials (which would be grounds for prosecution).<sup>61</sup>

### *Some good news*

The major milestone of the period was the conclusion of the agreement to relax the MAP, announced at the Buenos Aires Summit (July 2002), but only signed during President Duhalde's visit to Brazil in September.<sup>62</sup> However, despite progress made since that time and the stabilization of the Argentine situation in the latter half of the year, at the time of this report was closed, the process of suspending the antidumping proceedings and other points of controversy had not been concluded, the final decision having yet to be taken in some cases.<sup>63</sup>

At the same time, the Argentine Secretariat of Industry reported that in the pork sector, the WTO did not find evidence of dumping, that in the chicken sector, it would continue to investigate, but without applying trade restrictions, and that in the textile sector, the compromise had been reached that private parties would voluntarily negotiate trade volumes. The entities representing poultry and pork producers rejected the measures. The Argentine Association of Pork Producers condemned them, indicating that "with this agreement, production is put at risk and investments of over US\$ 100 million to transform and improve the sector are jeopardized" (*Página 12*, July 14, 2002), while the poultry producers expressed their despair at the fact that "the country is again erring in protecting inefficient sectors from unfair trade practices at the expense of sectors that are efficient" (*Página 12* and *Ambito Financiero*, July 14, 2002).

In any event, in addition to formal problems with possible negative impact on the speed of the "clearing the negotiating table" process agreed with Brazil, in fact, it is very likely that many of the difficulties in moving ahead in these areas emanate from both the problems of the Argentine economy and the stark asymmetries of productivity in certain branches of production, in particular, sectors such as chicken and pork. Such disparities, evident prior to 1999, had recently in many cases continued to grow.<sup>64</sup>

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<sup>61</sup> As WTO provisions establish that investigations must be pursued to their conclusion.

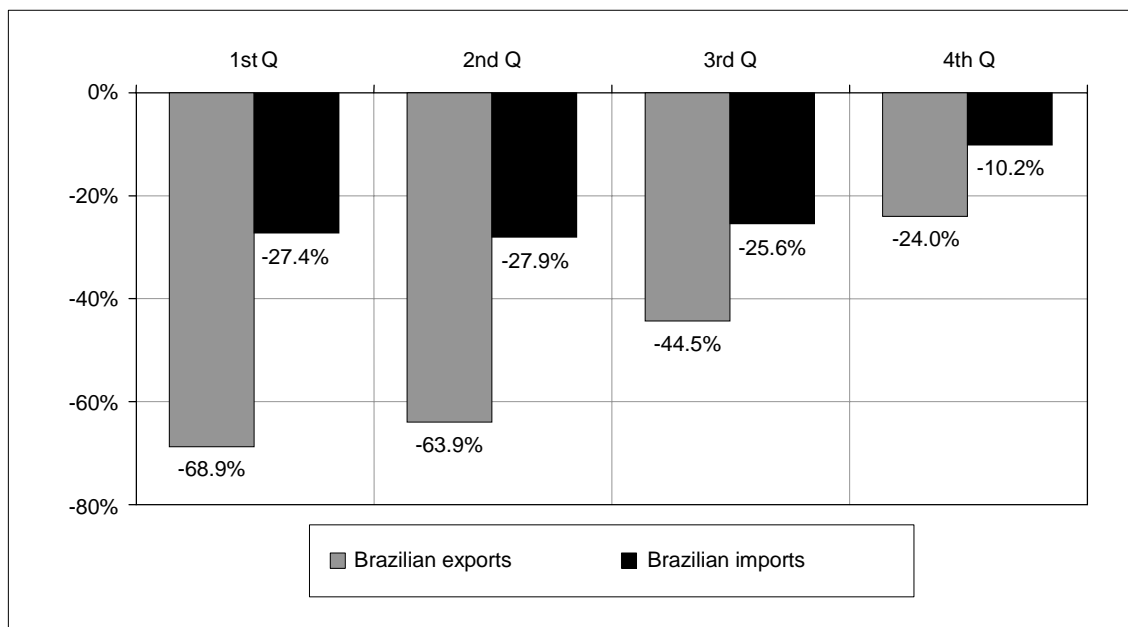
<sup>62</sup> For further detail on this topic, see Chapter III of this report.

<sup>63</sup> It is worth noting by way of example that both the waiver for capital goods imports and for reimbursements for intrasubregional sales remain in effect in Argentina in early 2003.

<sup>64</sup> In that connection, of great significance is Brazil's takeoff in recent years in the production and worldwide export of chicken and pork.

In line with bilateral efforts to resolve conflict, possible "exportation" of the Argentine crisis to the rest of the subregion was a constant concern throughout 2002.<sup>65</sup> Uruguay was the country that most felt the force of the "shock wave" from events on the other side of the Río de la Plata. The crisis was transmitted via the strong trade and financial ties between the two countries. Thus, in the first half of 2002, Uruguay sought to preserve the exchange band regime in effect until that time by imposing restrictive measures on intrasubregional trade, mimicking to some extent the earlier Argentine attitude at the end of the convertibility regime. Devaluation and, later, the banking sector crisis were also inevitable.<sup>66</sup>

**BRAZILIAN-ARGENTINE TRADE, 2002**  
Interannual variation, as a percentage



Source: MDIC (Brazil)

Regardless of these new motivations and the new climate in the subregion, trade between the major partner countries continued to decline, although at decreasing interannual rates and with some prospects for recovery in specific sectors.<sup>67</sup>

*In the pursuit of a new era of consensus*

From the beginning of the latter half of 2002, in a context of a growing trend towards stabilization of the Argentine economy, and the slow normalization of the Brazilian and Paraguayan economic and financial situations, the general panorama was improved and the disposition of officials and entrepreneurs from the subregion's countries was better for fulfilling and implementing the commitments made at the Buenos Aires Summit and for a degree of progress to be made with some priority items on the subregional agenda.

<sup>65</sup> Such concern was also reflected in steps taken by MERCOSUR as an instrument to amplify Argentine requests for assistance from international financial organizations. For further detail on the subregional impact of the Argentine financial and economic crisis on the other economies of the subregion, see Chapter I of this report.

<sup>66</sup> *Ibid.*

<sup>67</sup> For further detail on the bloc's trade trend throughout the period of study, see Chapter I of this report.

Thus, in the latter half of 2002, headway slowed and a temporary impasse was reached in connection with negotiation agenda items not related to the economic climate, in part owing to Brazil's peculiar current political situation, with the Cardoso administration in its final months in office<sup>68</sup> and in part, on the Argentine side, to the altered political climate as of July, as the handing over of authority to the new elected officials had been moved forward to May 2003 (originally slated for December 2003). In this situation, in view of the growing stabilization on the macroeconomic front, the main focus of the Argentine government shifted to determination of possible successors, an activity that also contributed to some sluggishness of negotiations.

After Luiz Ignácio Lula da Silva was elected President in the second round of the Brazilian presidential elections, certain questions were cleared up that had hung in the air regarding MERCOSUR's future. Throughout the presidential campaign, the new Brazilian President had pronounced himself strongly in favor of MERCOSUR ("for us, MERCOSUR is essential," the then-candidate had said during his visit to Buenos Aires, *Clarín*, July 19, 2002).

In that context, 2002 closed with staunch political statements regarding a sort of rebuilding of MERCOSUR (avoiding the "overused" word "relaunch"), which will unquestionably depend on such convergence of ideas as may exist between the new Brazilian government and the new officials taking office in Argentina in May 2003, and on inclusion of the authorities of Paraguay and Uruguay in that dialogue.

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<sup>68</sup> In that connection, some of the topics related to fulfillment of the implicit timetables of the FTAA and MERCOSUR-European Union negotiations obliged the bloc's countries to take major decisions, which took up much of the "final" negotiation efforts of the Cardoso administration in Brazil.





### CHAPTER III. AN APPROACH TO THE MAIN SECTORAL AND HORIZONTAL TOPICS IN INTRASUBREGIONAL TRADE

#### A. Sectoral topics

*The lengthy negotiations on the Automotive Regime are finalized*

Decision CMC 29/94 had provided that a common MERCOSUR automotive regime would be established by January 1, 2000; it would replace the intrasubregional quota-based and/or balanced trade regime established in the bilateral agreements that had governed up to that date. The Decision stipulated that the new regime would have a Common External Tariff and intrasubregional trade would be unrestricted and without any type of quantitative limitation.

However, in late 1998, when certain differences in respect of the agreement<sup>69</sup> were already making it difficult to meet the previously agreed upon deadlines, the four countries decided to add a period of transition to subregional free trade for the first five years of the 21st century, during which intrasubregional trade would continue to be managed.

This agreement notwithstanding, the crisis sparked by the devaluation of the real led to new and specific difficulties and, in general, more antagonism in Argentine-Brazilian bilateral negotiations, with the result that the new common automotive regime could not be finalized on the date stipulated.

In March 2000, the two parties announced the general terms of a transitional regime that would remain in effect until December 31, 2005, after which time automotive trade would be conducted in a context of free intrasubregional trade. The new common automotive policy would govern trade in vehicles in general (automobiles, light commercial vehicles, buses, trucks), self-propelled machinery (farm and roadway equipment), and their parts.

The agreement established a CET with various levels, depending on the product:

Vehicles in general	35%
Self-propelled machinery	14%
Vehicle parts	18% to 14%
Parts for self-propelled machinery	8%
Non-manufactured parts	2%

However, the agreement granted Argentina the possibility of applying ascending schedules for vehicle parts (from 7.5% to 9.5% in 2000) until reaching the CET in 2006. Argentina would also apply an ascending schedule for external tariffs on buses, trucks, and trailers, vans, from a level of 14% to 18% in 2001, also to converge on the CET (35%) in 2006. For its part, Brazil would apply an ascending schedule for vehicle parts, from a level of 9.1% to 11.7% in 2000, converging on the CET in 2006. In the case of machinery, Brazil would use a descending schedule from a base of 18% in 2000, until converging on the CET (14%) in 2001.

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<sup>69</sup> The main differences included determination of the CET for heavy trucks and auto parts, neutralization of the asymmetries generated by investment incentives, the treatment accorded Paraguay and Uruguay, and the existence of national content within subregional content.

The common regime established a 60% minimum level of subregional content in parts and components. In addition, until 2005, Argentina could require a minimum national content of 30% for light vehicles and 25% for trucks (the so-called “superlocal” content), a point that had been the subject of grueling discussions throughout the entire negotiating process.

Bilateral trade would be exempt from tariffs, provided it remained balanced. For purposes of the regime, the balance of trade would be calculated in global terms (that is, taking into account the entire universe of products) in dollars. Provision was made for some imbalances, in keeping with a criterion that would increase over time. This rule, called “flex,” established that the maximum allowable deviation was 3% of the volume of trade for 2000, a percentage that would rise until reaching 10% in 2003, leaving for the future the determination of the flex percentage for 2004 and 2005.

It took some months more to bring Paraguay and Uruguay into the agreement, thus enabling it to be included under the MERCOSUR legal “umbrella.” In each case, specific clauses had to be established owing to the specificities of the automotive industry in each of the countries.

In late February 2001, the incorporation of the smaller partners was nearly finalized, under the CET regime already stipulated in the Argentina-Brazil agreement. In the case of Uruguay, it was determined that until December 31, 2005, an initial external tariff of 23% would apply to vehicles, while for imports of sets of parts, the applicable tariff would be 2%. The subregional content percentage required in Uruguayan products would be 50%, less than the 60% agreed to between Argentina and Brazil, and bilateral quotas were established for tariff-free trade.<sup>70</sup>

Paraguay acceded to the agreement only in July 2001. It had to comply with an importation reduction schedule for used automobiles until total elimination in January 1, 2006. Although Paraguay does not produce motor vehicles, zero tariff export quotas were established from Paraguay to the remaining MERCOSUR countries, the objective being to provide an incentive to locate motor vehicle warehouses in the country.

Thus, in October 2001, the MERCOSUR Automotive Policy (MAP) protocol was finally formalized with LAIA. However, demands for its early amendment began several months prior to that date. Argentina had hardly implemented the bilateral agreement with Brazil in Decree 660/00 (August 2000) when problems began. Dispute arose because Argentina’s decree provided that “superlocal” content would be calculated component by component, while Brazil felt that it should be calculated subset by subset of components. According to Brazilian complaints (shared by the warehouses located in Argentina) the “component by component” method increased the Argentine content from the originally agreed upon level of 30% to nearly 45%.

However, the main differences arose when strong criticism of the MAP began to emerge from within the Argentine government itself, as it was being perceived that the balanced trade established did not allow Argentina to increase its automotive exports to Brazil.<sup>71</sup> It should be noted that the clauses on the management of intrasubregional trade led to insistent demands from the Argentine negotiators throughout the negotiations in an effort to prevent, according to their analysis, the possible extinction of the Argentine automotive industry if it had to compete, without any form of protection, with Brazilian vehicles produced in a larger-scale, more integrated industry.<sup>72</sup>

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<sup>70</sup> By then, the decision had been made to expand the 2001 flex margin for trade between Argentina and Brazil from 5% to 10%.

<sup>71</sup> For further detail on this subject, see Chapter II of this report.

<sup>72</sup> *Ibid.*

However, the prolonged economic depression affecting Argentina since 1998, which had worsened as of second quarter 2001, was drastically reducing the demand for imports from Brazil, even for those products included in the MAP. Thus, the quota on Argentine exports to Brazil as determined by the flex was beginning to represent a severe constraint. Accordingly, after the Presidential Summit held in Asunción in June 2001, Argentina's then-Minister of the Economy announced, somewhat to the surprise of both Argentines and Brazilians, that the MAP would be renegotiated in two months, so that subregional trade would be conducted under the rules of free trade.<sup>73</sup> Although, as explained above, this was an "old" demand on the part of the Brazilian negotiators, under the circumstances, Brasilia's response to the initiative was between skeptical and cold.

Although it had been formally announced, the renegotiations did not actually begin during the remainder of 2001. Owing to the flood of bilateral disputes that arose in the latter half of that year, the negotiating "climate" was light-years away from optimal. In principle, Brazil rejected a "temporary" solution (the Argentine proposal involved free trade for two years, followed by a return to managed trade flows) and countered that any reopening of the MAP should include permanent changes so that they would be compatible with the long-term perspectives on which investment decisions in this sector are based, exactly as the Brazilian negotiators were emphasizing at the time. In addition, the Brazilian government wanted any reopening of the MAP to be another element of overall negotiations intended to reduce the mountain of bilateral trade disputes that appeared only to grow higher.

In early July 2001, after learning of the Argentine government provision that permitted deduction of the "convergence factor" from tariffs applicable to extrasubregional imports of capital, telecommunication, and information technology goods, and vehicles eligible for inclusion as "capital goods," Brazil decided to suspend all negotiations of the MAP. In addition, with Argentine exports to Brazil increasingly exceeding the established flex margin, fears were rapidly mounting regarding application of the fines established in the agreement for such cases,<sup>74</sup> an eventuality that the authorities in Brasilia took it upon themselves to repeat with singular frequency.

Thus, shortly after the change in the Argentine administration and the subsequent abandonment of convertibility, there were indications from Brazil that negotiations might be launched to introduce changes in the MAP, in a context where such a step might be interpreted as a gesture of assistance to alleviate the Argentine general economic collapse.

Nonetheless, despite the enthusiasm generated by this announcement, the negotiations would not be without difficulties. From the outset, Brazil reiterated its position that it would not accept "temporary" formulas and again began to push for elimination or reduction of the Argentine "superlocal" content. Apart from that, all renegotiations would involve a commitment to "clear all conflict from the negotiating table" and to achieve other bilateral agreements such as reestablishment of the Reciprocal Credit Agreement. From the Argentine point of view, the main (and virtually only) point of concern was to expand the flex to a 50% level (that is, a ratio of 3 dollars exported for every dollar imported) or even 60% (4 to 1 ratio) by 2001, replacing the 15% in effect under the first expansion agreed in December 2000. The goal was to loosen the straitjacket implied

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<sup>73</sup> The Argentine government was also interested in excluding from the MAP buses, trucks, and machinery, as they were "capital goods." The policy then being followed in Argentina was to eliminate tariffs on capital goods imports in order to promote investment spending which, in the case of the aforementioned products, could not be done precisely because they were included in the MAP universe.

<sup>74</sup> The fine would be some 70% of the CET calculated for excess exports.

by the balanced trade regime in view of the export potential of the Argentine automotive industry in Brazil, in the context of the terrible depression in the Argentine market.<sup>75</sup>

The basic negotiations could only be completed by mid-2002. At the Presidential Summit held in Asunción in July, the main elements of the agreement reached were announced. These included:

- Reduction by one year of the schedules for ascending convergence towards the CET for extrasubregional auto parts imports (for both Argentina and Brazil).
- Increase of the flex to 33.3 % (a 2 to 1 ratio, consistent with Brazil's position), with an ascending schedule until reaching 45% in 2005. In order to avoid the fines that would have applied, a flex of 23% was established retroactively for 2001.
- The balanced trade calculation would not take into account trade in auto bodies or self-propelled machinery (a long-standing Brazilian desire, as the balance of trade in these products was positive for Brazil).
- The Argentine "superlocal" content would be maintained although, in contrast to the original stipulation (a constant percentage for the life of the agreement), it would apply only to automobiles and light utility vehicles. In addition, a decreasing schedule was established for this content, at 20% for 2002 and 2003, falling to 10% in 2004 and 5% in 2005.

Another distinctive aspect of this agreement (which was finally formally concluded in September 2002) was the inclusion of a clause to promote, in the medium term, specialization of the warehouses on both sides of the border, so that they could develop different platforms and, by that indirect means, prevent excessive concentration of the auto parts industry in only one of the countries.

#### *The poultry sector: ten years of disputes*

Since the dispute that arose in 1991 regarding the importation of baby chicks from Brazil, the well-known economies of scale and the productivity of the Brazilian poultry sector have constituted mounting pressure for Argentine poultry farming.

Thus, in 1997 Argentine chicken meat producers asked the Argentine government to begin applying protective measures against the increasing imports from Brazil. In principle, an attempt was made to contain the problem through a "private" arrangement under which Brazilian exporters would voluntarily restrict their sales to Argentina by establishing export quotas.

In view of the evident lack of effective controls of compliance, this arrangement failed miserably. Therefore, when it lapsed in March 1999, it was not renewed. From that time on, and in a context of increasing conflict in bilateral relations stemming from the recent devaluation in Brazil, Argentine producers collectively as the Association of Poultry Processing Companies (*Cámara de Empresas Procesadoras Avícolas* - CEPA) formally requested that an antidumping proceeding be brought against Brazilian poultry

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<sup>75</sup> Despite this, in 2002, Argentine automobile exports showed a marked decline in their "exposure" on the Brazilian market: while in 2000, Brazil's share in Argentine auto exports was 81%, in 2002, this share declined to 51%. The marked increase in shipments to Mexico largely accounts for this situation: whereas in 2000, Argentine shipments to the Mexican market accounted for only 3% of external auto sales, in 2002, that share increased to 25%.

exporters. In July 2000, the evidentiary period ended with the imposition of minimum prices of US\$ 0.92 and US\$ 0.98 per kilo, depending on the company, for imports of Brazilian whole chickens.<sup>76</sup>

After this measure was imposed, the number of whole chickens entering the Argentine market from Brazil fell significantly. In August 2000, the Brazilian government decided to have recourse to the MERCOSUR dispute settlement system, under the provisions of the Protocol of Brasilia, taking the view that the Argentine decision was not in keeping with the MERCOSUR agreements. An Ad hoc Tribunal was constituted in March 2001 and issued its decision in May of that year.

The Tribunal ruled that it was not its role to resolve differences regarding the requirements established for application of antidumping duties, i.e., it was not its purpose to establish: (1) whether the prices constituted dumping, (2) whether Argentine poultry production had been injured, and/or (3) the causal relationship between those prices and possible injury, as common legislation did not exist in this area.

However, the decision of the Tribunal did address the question of whether, in applying the disputed criteria, the Argentine authorities had manifestly exceeded their authority in such a way as would indicate that the antidumping measure had been used for the purpose of obstructing trade within the customs union, which would have contravened existing MERCOSUR provisions regarding the unrestricted flow of intrasubregional goods.

The arbitrators concluded that the criteria employed by the Argentine officials were reasonably acceptable, as no substantial departure from normal practice in procedures of this type could be seen. Accordingly, they rejected the Brazilian complaint that sought to eliminate application of the antidumping duties established by Argentina against chickens of Brazilian origin. After Brazil requested clarification regarding the decision, on June 19, 2001, it was made final.

As the decision made evident the lack of specific provisions at the MERCOSUR level in the area of antidumping procedures, the Brazilian government decided that the grounds for the dispute (the pertinence of the measure) should be resolved in the framework of the World Trade Organization (WTO), since it felt that the Argentine government, in establishing the antidumping measure, had failed to comply with the procedures on unfair trade practices stipulated in the Agreement of the Organization.

Thus, proceedings under the WTO Dispute Settlement System were instituted in November 2001 through a request for consultation on the matter.

Despite the “clearing the negotiating table” process begun after the Argentine devaluation, Brazil decided to persist with the proceedings before the WTO, requesting, in early March 2002, that a panel be set up on the matter. In fact, the Brazilian attitude was a natural response to the domestic legal difficulties faced by the Argentine government in rescinding rapidly the antidumping measure previously established. Despite this step, the two governments then indicated that the measure did not undermine the continuity of the bilateral negotiations process for a negotiated settlement of the case. The panel was formally constituted in early April 2002.

In early July, Argentina and Brazil agreed, along with the outline of changes to the MERCOSUR Automotive Policy, to rescind within 60 days the antidumping measure affecting the entry of Brazilian chickens to the Argentine market.

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<sup>76</sup> In addition, in the period of study of the measure, producers in the Argentine province of Entre Ríos obtained via the courts the immediate imposition of import quotas on Brazilian chicken, which were accompanied by stricter enforcement of health controls by the Argentine government (INTAL [2000]).

As a result of this understanding, the Argentine government decided to reopen the antidumping measure on its own initiative. At the same time, the private sectors of both countries made efforts to launch negotiations for the establishment of intrasubregional quotas, efforts that were unsuccessful.

The deadlines stipulated in the memorandum of understanding could not be met, so the WTO procedure went forward. However, in mid-November the Foreign Trade Commission of Argentina found that the injury to the Argentine poultry industry from imports from Brazil had not yet been redressed, although the measures taken had been useful at the time, also finding that if the measures were lifted, there might be further injury.

This decision further complicated the legal issues involved in the probable rescission of the antidumping measure by the Argentine authorities. Thus, at the time this report was closed, the dispute remained active, with the prospect that it could only be resolved through the procedure instituted with the WTO.

The dispute made evident the lack of common rules in the area of trade protection measures, thus leading to adoption of WTO provisions in this area within the MERCOSUR body of law. On that basis, it will be possible to resolve disputes related to the propriety of antidumping procedures applied to intrasubregional trade through an Arbitration Tribunal.<sup>77</sup>

#### *Pork: the antidumping that wasn't*

Among the first disputes that broke out after the major Brazilian devaluation of January 1999 and the new foreign exchange policy in that country was that related to fresh pork. Prior to those events, Argentine producers had already been petitioning their government, alleging that Brazil had mechanisms in place to subsidize pork production and exports.

Accordingly, the Argentine government decided to have recourse to the arbitration body established in the Protocol of Brasilia. In November 1999, the Arbitration Tribunal rejected the Argentine complaint. Despite the adverse decision, the complaints of Argentine producers did not abate. Negotiations between the private sectors of the two countries did not find a solution acceptable to both parties.

In that context, the producers pushed for an increase in the CET and stricter enforcement of sanitary controls which, although they were used to limit purchases from third country markets (basically Spain and Chile), could do nothing to restrict the entry of products of Brazilian origin.

With the competition thus displaced, Brazilian cuts gradually increased their share of Argentine pork imports: while external purchases represented about 30% of the pork supply on the Argentine market, Brazil's share of that percentage was close to 75% (2001 data). A large percentage of the Brazilian shipments consisted of fresh meat to be used as an input by the Argentine pork cold cuts industry.

This situation led Argentine producers to change strategy and to push for institution of an antidumping proceeding against Brazilian meat processing plants exporting pork. In November 2001, after several months of repeated complaints, the proceeding was officially instituted. The Argentine producers sought the application of countervailing duties of up to 60%.

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<sup>77</sup> However, at the same time, the WTO case remained active. When the Protocol of Olivos comes into force, it will not be possible to pursue proceedings simultaneously in two jurisdictional bodies, so that the proceedings before one of them would have to be abandoned.

After the end of convertibility, the pork dispute, like other restrictions on bilateral trade that arose between January 1999 and December 2001, was included in the “clearing the negotiating table” process begun by Argentina and Brazil in first quarter 2002.

For this reason, when renegotiation of the common MERCOSUR automotive policy was concluded in early July 2002, Argentina undertook to resolve the restrictions established on imports of Brazilian origin in the pork area as well as resolving the chicken and textiles issues.

In the case of pork, the lack of evidence of injury was the technical reason that led to the closing of the antidumping proceeding without the application of countervailing duties. Subsequent to that decision, the Argentine government tried to promote negotiations among the private sectors of the two countries, but efforts to hold a meeting in Rio de Janeiro in July 2002 were unsuccessful.

Based on recent sectoral studies, it is expected that, with the protection provided by the current Argentine real exchange rate, the sector may “gain time” to complete the reconversion under way therein since the 1990s. Such a transformation is based largely on increased productivity, greater economies of scale, and an increase in the extent of vertical integration of the chain (producer/meat processing plant). This would make it possible to compete successfully with one of the largest players in the international pork market, Brazil.

#### *Argentine wheat and the Brazilian market*

With average annual sales of US\$800 million, wheat is one of the most important items of trade between Argentina and Brazil (after automobiles, wheat is the largest Argentine export heading to the Brazilian market). Along with its quantitative importance, the grain has certain characteristics that increase its trade “sensitivity” because of the wide range of flour-based foods that account for much of the food expenditure of large segments of the population, particularly the lower-income. Thus, it is no surprise that the market and governments give such special consideration to the price terms and supply of this grain.

Since the establishment of MERCOSUR, Argentina has been consolidating its position as Brazil’s principal supplier of wheat. Brazil imports approximately 70% of the wheat it consumes, and buys 90% of its total wheat imports from Argentina (i.e., Argentina provides approximately 65% of the wheat consumed in Brazil). In addition, the Brazilian market accounts for a significant share of Argentine wheat exports, averaging 70% of total exports. These figures indicate the major importance of this trade flow in terms of both imports and exports.<sup>78</sup>

Consolidation of this trade pattern has been facilitated not only by the preferences granted by the CET, but also by the freight charges collected by Brazil on extrasubregional shipments and, evidently, by the lower freight cost made possible by the proximity of Argentine shipping ports. On average, this price difference is split between the Argentine exporters and the Brazilian importers. That is, while Argentine wheat is cheaper on the Brazilian market than wheat of other origin, on the Argentine market, sales to Brazil offer better prices than those in other markets. This makes the consolidation of this trade flow “doubly advisable” in terms of both supply and demand.

However, the “split” of the margin of preference is only possible through negotiating contortions, repeated from year to year. In this regard, each year the Brazilian flour milling industry (grouped under ABITrigo)

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<sup>78</sup> In other words, it might be noted that, as regards wheat production, Argentina has “specialized” in being the principal supplier of Brazilian demand.

pushes for the Brazilian government, for different reasons, to reduce or eliminate the CET, so that, faced with the possibility of stiffer competition, Argentine exporters will agree to lower the price of their wheat.

For the last two years, wheat has been the focus of different disputes. In mid-2001, after the Argentine government's decision to introduce a convergence factor discount on extrasubregional imports of capital, information technology, and telecommunication goods, warnings filtered through from Brazil that it might reduce or eliminate the margin of preference provided by the CET, warnings that were promptly denied.

New storm clouds appeared in August 2001 when Brazil's Ministry of Agriculture changed the technical regulations regarding the characteristics of wheat to be sold as of January 2002, provoking loud complaints from the Argentine side. The complaints focused on the change in the type of "sieve" to be used in classifying the grain. The sieve is a physical mechanism that separates larger from the smaller grains, the latter being discarded for milling. The higher the percentage of small grains in the wheat, the lower the price paid for the grain.

The new regulation stipulated that a sieve with 35 mm<sup>3</sup> holes would be used, whereas sieves with 15.2 mm<sup>3</sup> holes were used in Argentina. Thus, the new Brazilian sieve would automatically yield higher percentages of "small wheat" (small discarded grains) than the Argentine sieves, which the consequent price impact. Bilateral negotiations led to the postponement of application of the new regulation until January 2003, and it was agreed that the two countries would conduct a technical study of the issue in the first four months of 2002. Ultimately, the negotiations were successful and the problem was resolved satisfactorily when Brazil undertook to adjust its regulation to that used in Argentina until a definitive agreement was reached.

The financial and exchange crisis unleashed in Argentina in December 2001 led to numerous difficulties in the conduct of foreign trade in general, and in trade in grain in particular. For that reason, wheat exports were virtually paralyzed for nearly a month, creating fears of under-supply in Brazil. This constituted a fresh opportunity for the Brazilian milling industry association again to renew the aspect of its demand involving the reduction or elimination of the CET on wheat. When shipments returned to normal during the second half of January 2002, the fears of an under-supply were dispelled, removing the basis for the complaint.

In April, with the deepening of the financial crisis, transactions involving Argentine grain were again impeded. On that occasion, in addition to a prolonged bank "holiday," grain exporters demanded a change in the method of collecting taxes on exports (withholding). Again there were calls for elimination of the CET, but the Brazilian government maintained it in effect.

However, in July a precedent in this area was established within MERCOSUR. In Uruguay, after abandonment of the exchange band policy and the ensuing devaluation of the Uruguayan peso, it was decided to include wheat in the lists of exceptions to the CET to alleviate the ceaseless increases in the price of this basic foodstuff (which is marketed in dollars) by increasing as much as possible the number of potential suppliers. The marked rise in the international price of wheat after mid-2002 was another reason for again raising in Brazil the topic of the CET for wheat.

In addition, in the latter half of 2002, complaints began to intensify regarding the export tax regime applied in Argentina since the beginning of that year. Although the complaints that these taxes made the product more expensive abroad were unfounded (they actually generated a discount for the Argentine producer, as the external price is determined on the international market), the complaints were pertinent that distortions were generated by the different tax rates applied. For example, while exports of wheat and wheat flour were taxed at a rate of 20%, the rate applied to flour derivatives was 5%.



This differential increased the effective protection of Argentine flour processing industries (production of breads, biscuits, etc.) because inputs could be purchased in the internal market at prices below import parity prices, and this could be interpreted as a subsidy for those sectors. For that reason, complaints were lodged (at the CMC and CMG level) by Uruguay and Brazil regarding the export tax regime applied in Argentina. In addition, sources in the Brazilian milling sector indicated that these Argentine regulations encouraged an unusual increase in Argentine exports of “premixes” (flour derivatives used in the bread-making industry that consist essentially of flour with the addition of salt, leavening agent, and other additives) as a means of evading the higher tax applied to flour exports.

At year-end, the Brazilian government finally resolved to modify the CET for wheat, reducing it from 11.5% to 10%, deciding in this case not to implement the decision to maintain the increase of the remaining 1.5 percentage points of the general CET increase (of 3 percentage points) that had been decided in 1998.

## **B. “Horizontal” constraints on intrasubregional trade: "resuscitating" the adjustment lists**

### *Uruguay “defends itself” from the regional crisis*

As one of the “smaller partners” in MERCOSUR, Uruguay was particularly hard hit by the crisis in the subregion that began in mid-1998. It should be noted that, in that year, MERCOSUR accounted for 44% of Uruguayan imports, and 55% of Uruguay’s exports, a perfect reflection of the magnitude of the impact that regional vicissitudes were having on the Uruguayan economy.

With its competitiveness severely affected by depreciation of the real, Uruguayan patience seemed to give out when Argentina introduced the convergence factor, a measure that, as mentioned above, by establishing a “special dollar” for foreign trade, amounted to introducing tariffs on intrasubregional trade.

When this occurred, the Uruguayan government took a reading of reality, which led it to conclude that the Argentine measure was a type of “open door” for the unilateral introduction of measures that would create barriers to intrasubregional trade. This was abundantly evident in the statements of high Uruguayan government officials themselves: “Uruguay is compromised by a difficult internal and regional climate, and will now move actively to defend our productive sector; we want to stop being taken for fools,” maintained Minister of Industry, Sergio Abreu, in July 2001.

Thus, the first step taken at the time was to introduce a 3% rate to be applied to all imports, including those from within MERCOSUR, as a Banco de la República “service charge.” At the same time, the Uruguayan government began to apply an onslaught of trade protection measures: a provisional antidumping measure against Argentine edible oils, the launch of antidumping investigations of other imports of Argentine origin (disposable diapers, table bread, and mayonnaise), and stiffer requirements for clothing and footwear imports (basically of Brazilian origin).

In turn, the heightening of the crisis was helping to diminish the Uruguayan government’s enthusiasm for the subregional integration process. There was no lack of references to an alleged Uruguayan interest in starting trade negotiations with the U.S., either in the “4 + 1” context or unilaterally.<sup>79</sup>

After the abandonment of convertibility in Argentina, Uruguay grew even more concerned. In view of the fear of a possible “invasion” of products of Argentine origin, in April 2002, the Uruguayan government, in

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<sup>79</sup> For further detail on this topic, see Chapter V of this report.

Decree 113/02, introduced financial restriction measures on imports from Argentina in order to “protect domestic production from the unfair trade competition generated by devaluation of the Argentine peso,” as the Uruguayan government reported at the time. The decree was intended to “mirror” similar restrictions that the Argentine government had established on all imports entering that country, in the context of the exchange controls imposed following the devaluation.

The measure provided that credit extended to Uruguayan importers of Argentine goods must have a minimum term of 45 days from the date of shipment, increasing to 90 or 180 days for products on special lists. Goods that would have a minimum finance period of 90 days included some milk products, textiles, footwear, garments, leather and rubber manufactures, vegetables, and fruit. Products with a minimum finance period of 180 days included oils, wheat chain foods, other milk products, paint, sanitary and household articles, and plastic manufactures. The decree excepted Argentine goods imported under the temporary admission regime, goods imported under special importation regimes, capital and information technology goods, medications and medical supplies, fish products, and oil and oil products.

For Argentine exporters, the Uruguayan requirement of documenting importation operations for certain products with a “letter of credit through the banks” introduced a real and effective barrier to trade, stemming both from the cost imposed on the operation and from its incompatibility with the customary method of sales to the Uruguayan market from Argentina: regular supply on a short-term basis.<sup>80</sup>

Then, in Decree 137/02 of April 24, coming into force on December 31, 2002, Uruguay established specific tariffs (ST) on imports, applicable even to intrasubregional imports. The measure was based on the need to neutralize the effects of the “regional economic climate” on domestic production and to enable the ST to be applied to 175 items in the MCN [MERCOSUR Common Nomenclature] when prices were distorted by that situation through prices below the price levels of export flows from Uruguay and the prices of representative flows of imports whose prices had not been affected by the situation. In late May, Order of Business 63/2002, issued by the Uruguayan National Customs Office, was published in the Uruguayan *Diario Oficial*. It established specific duties for 38 tariff positions. The equivalent ad valorem tariffs resulting from the application of these ST were in 20 cases higher than 15%, rising to a maximum of 35%.

In Argentina’s view, these Uruguayan measures violated different MERCOSUR provisions, among them Article 1 of the Treaty of Asunción and Article 1 of the Annex thereto, which provided for the circulation of goods free of tariffs and other restrictions on reciprocal trade by January 1, 1995. Thus, Argentina asked Uruguay to begin the procedures established in the Protocol of Brasilia. Brazil joined this request as well. Direct negotiations were conducted on June 14, 2002 in Montevideo, but a satisfactory agreement could not be reached among the parties.

The dispute was later discussed at the Twenty-fifth Special Meeting of the CMG (July 22, 2002), where it was decided to keep the matter under consideration, pursuant to Article 6 of the Protocol of Brasilia. The Uruguayan delegation indicated that, at the request of the other delegations, it would refer to its authorities the question of whether trade with MERCOSUR would be excluded from the measures in dispute. Thus, in December, the CMG disbanded its complaint body for this matter, as it had not been able to reach an agreement satisfactory to the parties.

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<sup>80</sup> In mid-July 2002, after the lifting of the exchange band policy and the subsequent devaluation of the Uruguayan peso, the Uruguayan government issued a decree excluding Argentine exports of oils, flour, and milk products from the requirements established in Decree 113/002.

### **The Uruguayan complaint in connection with the Industrial Development Regime in Argentina**

In February 2002, Uruguay formally lodged a complaint with the MERCOSUR Trade Commission against Argentina. The complaint related to the industrial development regime in effect in the Argentine provinces of Catamarca, La Rioja, San Luis, and San Juan. In the Uruguayan view, that industrial regime contained provisions that implied tax discrimination, access restrictions, and export incentives.

A Technical Committee, in the CMC framework, comprising experts from Argentina, Brazil, and Uruguay studied the matter. The position of the Uruguayan expert was that the Argentine industrial development regime violated provisions of the Treaty of Asunción and Decision CMC 10/94 by establishing VAT treatment-related tax benefits that amounted to non-tariff and discriminatory tax restrictions on imported products. However, the Argentinian and Brazilian experts agreed that the use of the incentives in intrasubregional trade could not be studied in the context of trade restriction disciplines, but rather in the context of the specific MERCOSUR provisions in this area.

As no consensus could be reached, the matter was referred to the CMG. In that body, the original positions were reasserted and, therefore, in July 2002, the CMG declared its involvement concluded. Subsequently, in mid-January 2003, the Uruguayan government decided to lodge the case formally with the MERCOSUR Arbitration Tribunal.

The dispute also involved the reintroduction in Uruguay of a “consular fee” that had been rescinded in 1991. In Decree 70/02 of February 28, 2002, the consular fee was set at 2% of the CIF value of the imported goods, with the exception of goods under the temporary admission regime and imports of capital goods and crude oil.

The dispute arose because the Treaty of Asunción excludes from the “tariff” concept fees reflecting the cost of services rendered. However, under the percentage calculation method adopted by Uruguay, the amount of the consular fee did not reflect the cost of services rendered, as the cost of consular service should be the same as for formally similar importation procedures. However, under the method adopted (a percentage of the value of the shipment), different amounts imported are in practice taxed differently. This fact would invalidate the argument that the fee reflects the cost of services rendered.

#### *Paraguay’s restrictions on intrasubregional trade*

In mid-2001, in Decree 13.835/01, the Paraguayan government unilaterally established a Temporary Special Measure on Imports (METI), consisting of imposing, until December 31, 2002, a 10% import tariff on 332 CMN positions, which was to be applied even to imports from the MERCOSUR countries. In Decree 14.527/01, the number of positions affected by the METI was increased to 369.

After the abovementioned amendment, the method of applying the Special Measure had the effect of a threshold or minimum tariff as, when the effective customs tariff was greater than or equal to the 10% METI tariff; only the customs tariff applicable to the taxable value of the goods would be applied. Otherwise, when the 10% METI tariff was higher than the applicable customs duty, only the tariff established by the METI would be applied.

This method of application generates a reduction or, in some cases, the straightforward elimination of the subregional margin of preference for the affected products. As the applicable tariff for intrasubregional imports is 0%, the METI applies only to intrasubregional trade. However, for those products that are imported from outside the subregion, with a tariff above 10%, the measure is without effect, as payment of the METI does not apply.<sup>81</sup>

This measure originated from the strong pressure exerted by a segment of Paraguayan entrepreneurs (associated with the local industrial sector) for the application of compensatory measures in view of the depreciation of the real, which substantially reduced the competitiveness of Paraguayan production. Complaints gathered strength after the unilateral increase in tariffs adopted by Argentina in March 2001 and the introduction of the convergence factor.

The Paraguayan measure was rejected by the other MERCOSUR partner countries, which alleged that it violated MERCOSUR provisions establishing free intrasubregional trade (*inter alia*, Article 1 of the Treaty of Asunción) and also violated the commitments made by Paraguay in the context of the Regime for Final Adjustment to the Customs Union (Decisions CMC 5/94 and 24/94 and Resolution CMG 48/94). It should be recalled, in that connection, that the States Parties agreed to eliminate the tariffs imposed on reciprocal trade between December 12, 1994 and December 31, 1995 in the case of Paraguay (Article 1 and related articles of Annex One to the Treaty of Asunción) and that, in CMC Decision 24/94, the States Parties established the Regime for Final Adjustment to the Customs Union, with Paraguay committing to eliminate intrasubregional tariffs as of January 1, 2000. All this led Argentina and Brazil to conduct consultations in the context of the CMC, while Uruguay lodged a complaint in the CMG framework, as provided under the Protocol of Brasilia.

For its part, Paraguay argued that the measure was justified by the lack of macroeconomic coordination at the subregional level and the special consideration necessary for MERCOSUR's less developed countries and regions.

### **C. Discussion of the decisions of MERCOSUR's Arbitration Tribunal**

In the period between July 2001 and December 2002, four decisions were issued by ad hoc Arbitration Tribunals in keeping with the provisions of the 1991 Protocol of Brasilia, a number equal to all previous decisions. This clearly demonstrates the growing use of this mechanism as the "normal" route for resolving trade disputes, thus avoiding "abuse" of "presidential diplomacy" or other political methods of dispute resolution. Each of the decisions is reviewed below.

#### *Argentina against Uruguay: on verification of the rules of origin for bicycles*

In 2000, representatives of the Argentine bicycle industry began to question bicycle shipments from the Uruguayan firm, Motociclo, alleging that these products did not conform to MERCOSUR's rules of origin. In fact, it was suspected that the company was merely assembling parts imported from China and Taiwan. By mid-2000, this Uruguayan firm's share in the Argentine market amounted to a significant 25%.

In that year, the Argentine government instructed the Argentine Customs Administration to investigate what by then was a suspected violation of the rules of origin regime. Subsequently, the Argentine government instructed the Argentine National Institute of Industrial Technology (*Instituto Nacional de*

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<sup>81</sup> As only nine of the 369 positions included in the decree have a tariff of less than 10%, this would demonstrate that the measure targeted primarily at subregional trade.

*Tecnología Industrial de Argentina - INTI*) to perform a technical inspection of the Uruguayan company in order to verify on site the origin of the inputs used by Motociclo.

After a period of unproductive informal bilateral negotiations, in October 2000, the Argentine government imposed a 25% tariff on one Motociclo model, treating it as an extrasubregional product as, in its view, it did not conform to the requirements of the MERCOSUR rules of origin regime. In January 2001, this tariff was increased to 35% and expanded to include all Motociclo products.

In May 2001, Uruguay formally communicated its decision to have recourse to MERCOSUR's arbitration procedure, challenging Argentina's imposition of restrictions of access by bicycles produced in Uruguay to the Argentina market.

In the grounds for its complaint, Uruguay argued by that opening up a complex and imprecise process of questioning the origin of one, and ultimately all, Motociclo, S.A. bicycle models, Argentina had diverged from and flagrantly violated the applicable MERCOSUR provisions on origin. In addition, Uruguay claimed that Argentina's provisions for monitoring the customs value of goods violated the common regime for shipment and customs valuation of goods.

Argentina countered that its actions in this case were consistent with the rules of origin, basing them on the right of verification. Argentina also justified the application of selective criteria for checking customs value by arguing that this did not involve the referential value procedures but rather a preliminary check intended to verify whether or not the declared value was consistent with customary values for identical and/or similar goods.

The Arbitration Tribunal issued its decision in late September 2001, ruling in favor of the Uruguayan complaint. The decision was based on the determination that the measure imposed by the Argentine government had been adopted without adequately following the procedures established in the MERCOSUR rules of origin. The decision specifically noted that neither the direct investigative activities carried out by the Argentine authorities with the exporter as to the veracity of the certificates of origin nor their extension to the exporter's declaration were procedures consistent with the common provisions in the area of origin. Beyond the procedural grounds, the Tribunal did not find that the facts as presented conclusively pointed to the existence of a violation of the rules of origin by the Uruguayan company.

Another aspect of the decision was the extension of the sanction by Argentina to all bicycle models of the Uruguayan company. In the Tribunal's view, the Argentine authorities themselves (which were focused on one model in particular) did not justify the sanction imposed on all Motociclo models. Accordingly, the Tribunal did not consider that there was justification for the Argentine government to have expanded the sanction to include all Motociclo bicycle models. In addition, the determination made by Argentina was not consistent with the provisions of the MERCOSUR rules of origin, which only establish a procedure for challenging the authenticity of certificates of origin, these being specific documents that refer to the origin of a particular good.

Therefore, the decision reestablished the intrasubregional goods status of the bicycles of Uruguayan origin, required Argentina to allow their free access to the internal market, and ordered the immediate rescission of the restrictive measure.<sup>82</sup>

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<sup>82</sup> Uruguay's complaint also contained a general objection to Argentina's application of a selective system to monitor customs valuations. The Tribunal's decision makes no reference to this aspect, as restoration of the product's intrasubregional status prevents any customs valuation action in that, in this case, a zero tariff would be applicable.

After a request for clarification of the decision from both of the parties involved, the Tribunal fully reaffirmed all aspects of the decision.

*Uruguay against Brazil in respect of retread tires: defining “used” goods*

A dispute arose between Uruguay and Brazil in third quarter 2000 regarding the trade in retread (remolded) tires. The first elements of the case date back to May 13, 1991, when the Brazilian Foreign Trade Department Directive No. 8/91 prohibited imports of used consumer goods. In practice, however, importation of retread tires continued. This situation changed as of September 25, 2000, in Directive No. 8/00. In this measure, the Foreign Trade Secretariat of the Ministry of Development, Industry, and Foreign Trade (SECEX) provided that import licenses would not longer be granted for “*retread and used tires, whether as consumer goods or raw materials, classified under position 4012 of the Common Nomenclature – MCN.*” This position includes both used and retread tires.<sup>83</sup>

In Uruguay’s view, Directive 8/00 constituted a barrier to the free circulation of goods within MERCOSUR (up to that point there had been a substantial export flow of retread tires from Uruguay to Brazil), and thus constituted a violation of MERCOSUR provisions. Uruguay therefore decided to lodge a complaint against Brazil in this connection in the context of the Protocol of Brasilia. After going through the prior phases without result, the matter was taken to the arbitration stage. The ad hoc Arbitration Tribunal was established on September 17, 2001.

The Uruguayan position was based essentially on the fact that during the period between the prohibition contained in Directive 8/91 and the entry into force of Directive 8/00, imports of retread tires were permitted in the usual way by Brazil, and it pointed to the existence of numerous administrative provisions consistent therewith. In addition, Uruguay felt that the new prohibition contravened Decision CMC 22/00, under which the MERCOSUR States Parties had to refrain from introducing new restrictions on reciprocal trade.

In brief, Brazil argued that “retread” tires had all along been considered “used” and thus subject to the provisions of CMG Resolution 109/94, which allowed the States Parties to continue applying their respective domestic laws for the importation of used goods until such time as common regulations were adopted in this area.

On January 9, 2002, the Tribunal issued its decision, ruling unanimously in favor of the Uruguayan position. The decision concluded as follows:

- That in the 1990s, specifically as of 1994/95, there was a trade flow of retread (remolded) tires from Uruguay to Brazil that was compatible with Brazil’s domestic legislation applied as of Directive No. 8/91;
- That, based on conclusive records of different Brazilian government agencies, it had been demonstrated that retread tires were not considered used, and thus were not included in the prohibition of the importation of used tires;
- That Decision 22/00 requires that the States Parties refrain from adopting restrictive measures on existing reciprocal trade; and

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<sup>83</sup> That position is in turn separated into 4012.10 (retread tires) and 4012.20 (used tires), a division on which Uruguay based its argument that the latter did not include the former.

- Resolution CMG 109/94 was an exception to the regime of Article 1 of the Treaty of Asunción, subject to the provisions of Decision CMC 22/00 which, in this case, limited the scope of the aforementioned resolution in respect of used goods admitted under reciprocal trade scheme existing at the time the resolution was adopted.

Based on all the above, the decision ruled that Directive 8/00 was incompatible with the MERCOSUR provisions and granted Brazil 60 days to adjust its domestic law in view of that incompatibility.

### **Used tires: trade and the environment**

The dispute regarding retread tires is closely tied environmental issues. Used tires are considered an “undesirable” element given the difficulty of disposing of them (it can take centuries for them to degrade naturally). The disposal of used tires is a major problem in the developed countries because of the excessive numbers accumulated in dumps and the highly toxic gases produced on incineration.<sup>a</sup> Although there are some options for recycling tires for other uses, the costs are high.<sup>b</sup> Thus, some countries create incentives for reusing tires by retreading them as a way to prolong their useful life.

The problems arise with international trade. Many countries (such as Brazil and Argentina)<sup>c</sup> restrict imports of retread tires in the belief that such shipments are often nothing more than the disguised export of hard-to-manage waste.

In the specific case of Brazil, the prohibition contained in Directive 8/00 is essentially intended to prevent imports from the developed countries, basically the European Union.<sup>d</sup> In view of the exemption of the MERCOSUR countries from that prohibition, the EU has threatened to submit a complaint to the WTO if Brazil continues its “discriminatory treatment” by rejecting the European product after accepting tires from MERCOSUR.

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<sup>a</sup> In tropical countries like Brazil, these problems are exacerbated as, when discarded tires fill with rainwater, they become ideal breeding grounds for the mosquito that spreads dengue fever.

<sup>b</sup> Among other uses, used tires can be used for the distillation of fuels in partial substitution for petroleum.

<sup>c</sup> On August 8, 2002, the Argentine Congress enacted Law 25.626 prohibiting the importation of retread and used tires from any country.

<sup>d</sup> Exportation is the end use of 11% of Europe’s used tires. In the U.S., this figure is 5%.

In Directive 2 of March 11, 2002, Brazil authorized the resumption of imports of retread tires provided they were of MERCOSUR origin. Nonetheless, the trade flow remains problematic, in view of the continued effectiveness of a Brazilian Ministry of the Environment provision (Decree 3919 of September 17, 2001), which established fines for the marketing of imported retread tires. Thus, in November 2002, within the CMG framework, Uruguay requested Brazil to take the necessary steps to again accept export flows of retreads from Uruguay to Brazil. Paraguay, which also benefited indirectly from the decision, as it also exported products of this type to Brazil, joined Uruguay’s concerns regarding adequate compliance with the arbitration decision.

#### *Argentina against Brazil regarding phytosanitary products: The problem of internalization of provisions*

In December 2001, Argentina decided to institute an arbitration proceeding against Brazil in the framework of the Protocol of Brasilia in connection with existing barriers to the entry of Argentine phytosanitary products to

the Brazilian market. The essential significance of the decision in this case was that it discussed issued regarding the failure to internalize community provisions, which has become a “chronic” problem in some areas. Also pertinent were the restrictions established in the decision on the application of exceptions based on the sanitary provisions of Article 50 of the Treaty of Montevideo, which established LAIA.

There were essentially three grounds for the Argentine complaint: (1) failure to incorporate into the Brazilian legal system the resolutions adopted by the CMG in 1996 that established an expedited registration system<sup>84</sup> within MERCOSUR for similar phytosanitary products (in contrast, Argentina, Paraguay, and Uruguay had done so); (2) the imposition of barriers to the free circulation of such products; and (3) violation of the principle of reciprocity established in the Treaty of Asunción, as Brazil had not correctly met its obligation to incorporate in its national legislation the MERCOSUR provisions in this area.

The Brazilian position, however, pointed to the toxic nature of phytosanitary products and, based on Article 50 of the 1980 Treaty of Montevideo, argued that it was not violating the principle of free trade as that provision allowed restrictions to be imposed on the grounds of protecting human, plant, and animal health.

In addition, Brazil argued that its government’s conduct regarding the incorporation of provisions in question was consistent with the provisions of Articles 38, 40, and 42 of the Protocol of Ouro Preto which, while establishing the obligation to incorporate, do not stipulate deadlines for meeting this requirement. Brazil also alleged that, in issuing Decree 4074/02 in January 2002, it had begun the task of incorporating the resolutions involved in the dispute.

On April 19, 2002, the Arbitration Tribunal ruled unanimously in favor of the Argentine position. The Tribunal ruled that, by not incorporating the MERCOSUR agreement on phytosanitary registers in its legislation within a reasonable period, Brazil was not complying with the provisions of Article 40 of the Protocol of Ouro Preto.

In addition, the decision did not accept Brazil’s argument that the obligation to incorporate had no fixed deadline, but left compliance to the will of the party subject to the requirement. The Tribunal indicated that, based on the principles of *pacta sunt servanda*, good faith, and reasonableness, Brazil’s delay in incorporating the MERCOSUR provisions prevented the implementation by all States Parties of the expedited Register of Phytosanitary Products regime. The Tribunal considered unreasonable a delay of nearly six years in the satisfying the incorporation requirement and felt that the pertinent deadlines had more than lapsed, thereby constituting failure on the part of Brazil to comply with the obligation contained in Articles 38 and 40 of the Protocol of Ouro Preto.

With respect to the application of Article 50 of the Treaty of Montevideo, the decision indicated that the general invocation of sanitary protection could not exempt Brazil from the requirement to comply with the specific obligation to incorporate the CMG resolutions. The Tribunal affirmed that failure to incorporate these resolutions constituted, on the trade level, a non-tariff barrier to the circulation of goods. Sanitary restrictions, like any other, had to be exceptional, specific, and restrictively interpreted, and the country invoking sanitary protection provisions had to give evidence of the facts justifying the restriction, which Brazil did not do.

The decision set a deadline of 120 days from the date of notification for Brazil to take the corresponding steps and issue the corresponding legal provisions. In August, Brazil informed the MERCOSUR Administrative Secretariat that under Inter-Ministerial Regulatory Directive No. 49 and Decree 4074 of January 2002, it was incorporating in its legislation the CMG resolutions concerning registration of phytosanitary products.

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<sup>84</sup> The MERCOSUR expedited registration system seeks to facilitate the registration of similar phytosanitary products through agreement on technical evaluation requirements. However, the Brazilian legislation in force does not differentiate between new (unknown) products and products similar to those already registered, imposing the same type of requirements in the two cases.



However, in the Argentine government's view, the new Brazilian provisions are far from complying with the MERCOSUR provisions. Accordingly, in late October it informed the Brazilian government that should the situation persist, it would take the steps provided in the Protocol of Brasilia for failure to comply with decisions, that is, retaliatory measures. Brazil, on the other hand, feels that the measures adopted constitute full compliance with the provisions of the arbitration decision.

*Paraguay against Uruguay over cigarettes: recalling "national treatment"*

The procedure was instituted through a complaint lodged in November 2000 by Paraguay with the MERCOSUR Trade Commission (MTC) against Uruguay. In it, Paraguay argued that when the Specific Domestic Tax (IMESI) was applied to cigarettes in Uruguay, products of Uruguayan origin were discriminated against twice.

**The cigarette trade: in the "shadow" of smuggling**

In most of the world, cigarettes are among the products most heavily taxed. Their harmful effects on health and the public expenditure needed to remedy such effects are generally the justification for such heavy taxation. It is precisely the large tax component of the final price that makes the illicit sale of these products so attractive. When this trade crosses national borders, it is defined as "smuggling."

In many cases, the practical difficulties of effective cross-border control of smuggling lead countries to apply other measures. One of them is to impose restrictions on the exportation of cigarettes and other tobacco products. The rationale behind this measure is that, as exports are exempt from any tax component, there is a great incentive for them to "return" as contraband, primarily when shipments have been sent to bordering countries (with correspondingly low transport costs).

To summarize, trade in cigarettes is usually subject to distorting measures that, as "second best" policy, seek to combat the scourge of smuggling. In MERCOSUR, there are copious examples of such measures. One clear example of this type of measure is the 150% tax imposed by Brazil on exports of tobacco, tobacco derivatives, and inputs for manufacturing cigarettes, which would lead to a complaint from Uruguay.<sup>a</sup>

In an effort to address the problem comprehensively, in February 2002, Brazil submitted a proposal within the CMG framework to establish within MERCOSUR an ad hoc group on trade in cigarettes, comprising customs and tax authorities to study customs and tax problems in the subregional context related to products of this type. Background for this was a presentation made in 1998 by Uruguay on the same topic and Decision CMC 3/01, which established a MERCOSUR Action Program to Combat Crime in International Trade, a program which, at the time, had not yet been implemented.

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<sup>a</sup> Uruguay also lodged a complaint against Brazil in connection with measures restricting access of cigarettes to the Brazilian market because of alleged discrimination in tax treatment and prohibition of the sale of imported cigarettes under brand names not existing in the market of origin.

The argument underscored that, although the same rate of tax was applied (66.5 %) regardless of the origin of the cigarettes, the discrimination arose with the application of the taxable base for imported cigarettes

through the establishment of “notional prices,” i.e., reference values determined on the basis of the value of the highest quality cigarette of Uruguayan origin. There were, in turn, two taxable bases for application of the IMESI for imported cigarettes: for products originating in bordering countries (e.g., Argentina and Brazil) the notional price was multiplied by 1.3, whereas for products originating in non-bordering countries (the rest, including Paraguay), the notional price was multiplied by two.

In its complaint, Paraguay alleged discrimination both in the treatment accorded imported vis-à-vis Uruguayan cigarettes (absence of “national treatment” in applying an internal tax) and in the treatment it received as a “non-bordering country,” in violation of MERCOSUR provisions.

As no satisfactory resolution of the complaint could be reached within the CMC framework, in March 2001, in keeping with the procedure provided in the Protocol of Brasilia, the matter was submitted to the CMG for consideration. At the Twenty-first Special Meeting of the CMG, the question was discussed and, as no agreement was reached, the CMG concluded its involvement. Paraguay decided to bring the dispute before the arbitration body. The ad hoc Tribunal was established on March 18, 2002 and issued its decision on May 21 of that year.

The decision indicated that the method of applying the IMESI was incompatible with MERCOSUR provisions in that it treated Paraguayan products as extrasubregional and this (discriminatory) situation, recognized even by Uruguay, violated the “national treatment” provided for under the MERCOSUR, LAIA, and WTO provisions. Moreover, the Tribunal felt that the application of the IMESI was doubly discriminatory with respect to Paraguayan cigarettes because it imposed a relatively higher tax burden on them than on similar products from bordering countries, which constituted a contravention of the MERCOSUR provisions.

Accordingly, the Tribunal decided that Uruguay should change the method of applying the IMESI so as to accord “national treatment” to Paraguayan cigarettes, thereby eliminating the existing double discrimination. The Tribunal granted Uruguay a period of six months to comply with this decision.

## CHAPTER IV. A REVIEW OF MERCOSUR'S INTERNAL AGENDA

### A. An overview

In recent years, MERCOSUR has found it very difficult to make headway in formulating common policy in different disciplines and in ensuring effective implementation of rules already in place. Such difficulties have been attributed to the subregion's macroeconomic crisis, changing international financial conditions, the weakness of the bloc's institutions, and the configuration thereof.

Regarding the impact of the macroeconomic crisis on the negotiations impasse, as one eminent Argentine expert in a recent work succinctly put it: "MERCOSUR's problems predate the crisis in its member countries and are more deep-rooted. Overcoming that crisis will make it easier to regain the momentum of the subregional integration process, but this will not by any means be sufficient. As the experience of 1995-1998 demonstrated, a favorable macroeconomic context and the rapid expansion of intraregional economic ties went hand-in-hand with a period of great regulatory ineffectiveness." (Bouzas [2002]).

Put otherwise, economic stability is a precondition for headway to be made in subregional negotiations, but it does not ensure or replace government interest in directing effort towards consolidating and reinforcing the integration process.

From the institutional point of view, the lack of effective mechanisms to ensure compliance with community provisions and arbitration decisions, and the problems inherent in adjusting domestic legislation to the common disciplines as progressively defined are considered factors undermining MERCOSUR's credibility and discouraging any type of initiative that seeks to generate new and more wide-ranging agreements and/or commitments in the subregional arena. Here too, legal security and institution-building would appear necessary to emerge from the current regulatory crisis, but the contributions thereof do not detract from the importance of other factors contributing to the negotiations crisis.

In any event, explanations and/or assessments of the status of the MERCOSUR process aside, undeniably, the efforts of the States Parties in these years to move towards perfecting the free trade area and the – incomplete – customs union have led to agreements of only limited scope and, for the most part, of little content or practical application.

Whereas until 1997-1998, MERCOSUR's internal agenda had focused, more or less successfully, on consolidating agreements already concluded (in respect of tariffs, trade topics, etc.) and on intensifying the process, the incorporation of new issues, such as services, government procurement, protection of competition, etc., the Brazilian devaluation of January 1999 and the change in international and regional financial and economic conditions would quickly reorder government priorities.

Thus, 1999-2000 would be marked by a search for an arrangement to enable the complex trade relationship between partner countries to be "managed" and the sharp discrepancy in relative exchange parities partially to be offset. Macroeconomic coordination exercises, along with negotiations for an escape mechanism or the conclusion of agreements among private parties to limit the potentially disruptive effects of exchange disparities seemed the solution to all problems. The "traditional" agenda, for its part, maintained its own dynamics, although, evidently, remaining somewhat in the background.

The MERCOSUR Relaunch Program, adopted in 2000, and promoted politically in a context of further changes of government in Argentina and Uruguay and in a regional and international scenario that appeared to hold fewer prospects for the MERCOSUR countries, was another attempt to upgrade the

integration process, while different factors (notable among them the intensification of the Argentine macroeconomic and political crisis and further currency devaluations in Brazil) would gradually enfeeble it and relegate it to second tier. Macroeconomic coordination and establishment of convergence guidelines for different variables, one of the pillars of the said program as a – somewhat “magic” – mechanism to counteract what were essentially exchange disparities, in a context of sharp disequilibria would rapidly become "dead letter."

Understandings between Argentine and Brazilian private parties in 1999-2000, after the failure to reestablish a trade safeguard instrument within the bloc, would ease pressures – temporarily – on the negotiating process, while awaiting some improvement in the region’s macroeconomic conditions to enable more structural and longer-term solutions to be found.

Whereas, after a sort of "armed peace” noted in 2000, 2001 would be marked by a renewed search for mechanisms to offset exchange disparities and proliferating unilateral action by partner countries, which emanated from the worsening Argentine crisis and the increasing pace of the devaluation of the real, the year 2002 would again see on the negotiating table some of the integration process’ structural problems, owing to the abandonment of convertibility in Argentina and the critical subregional economic/financial and social situation.

Thus, intrasubregional safeguards and macroeconomic policy coordination were to gradually relegated to second tier on the negotiations agenda and old item of discussion within MERCOSUR were reintroduced that stemmed from the natural and artificial asymmetries among the subregion’s economies and their different productive configurations. Therefore, most of the negotiations have focused on items related to the search for long-term solutions for the sensitive sectors of subregional trade based on promotion of value chains and competitiveness forums, or to tasks carried out with a view to activities to promote trade as a whole and to renewing discussion of levels of protection based on the Common External Tariff, particularly, but not exclusively, for capital, information technology, and telecommunication goods, or to eliminating non-tariff barriers to intrasubregional trade ("clearing the table").

Similarly, institutional reform, reform of the dispute settlement system, and the incorporation of provisions for gradually transforming the Administrative Secretariat into a technical body would now become the pillars of the agenda. The remainder of that agenda, for the consolidation and intensification of the MERCOSUR process, would have dynamics of its own, as described in the section below.

## **B. Development of the main items on the internal agenda**

### *Common External Tariff*

In mid-2001, owing to different factors, the Common Market Council (CMC) decided, after the Common External Tariff had been in force for over six years, to establish a high-level group to make a comprehensive review of the CET structure. However, by late 2002, there had been minimal progress in this respect.<sup>85</sup>

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<sup>85</sup> It should be noted that the total inability to move forward in this area dated back at least to the 2000 MERCOSUR Relaunch Program, in which the countries had undertaken to study possible timely amendments to the CET, the possibility of establishing a regime for capital goods not produced in the subregion, resolution of the issue of double imposition of the CET, assessment of the reduction of levels of protection and tariff dispersion in the chain of capital, information technology, and telecommunication goods, among others. The establishment of the high-level group resulted from the difficulties that the CMC was encountering in addressing these topics.

Upon expiration of some of the convergence schedules established at Ouro Preto and in view of the changes in the subregional and international macroeconomic/productive context, the Group had been established to study the consistency and dispersion of the tariff structure.

Despite the persistent "holes" in the CET since its implementation on January 1, 1995, stemming from the bilateral agreements remaining in place in the framework of the Latin American Integration Association (LAIA), the existence of special importation regimes differing from one State Party to another, and certain unilateral modifications of the tariffs at the national level established by different partner countries, etc., the Common External Tariff was – and is still – acknowledged to be one of the fundamentals of the subregional integration process.

Similarly, the CET constitutes a basis for the negotiation MERCOSUR's broad and complex external agenda, so that the perfection thereof would appear to be a priority if there is to be headway in the different negotiation spheres with third countries or regions.

Hence the concern and interest on the part of the bloc's highest authorities in bringing greater consistency and sustainability to that agenda by adjusting it to the situation as of mid/late 2001.

To that end, efforts had to focus on preserving the 20% tariff ceiling, taking particular account of the production chain for capital, information technology, and telecommunication goods, which had been a source of controversy since the launch of the process itself (the reason for their inclusion among the more longer-term exceptions established at Ouro Preto), and whose policy coordination at the subregional level had had to be redesigned beginning in early 2001 owing to its complexity, with the unilateral reduction by Argentina on import tariffs for these types of product.<sup>86</sup>

The other sector of concern to the subregion's governments, which had to be studied with particular care, was agriculture – highly competitive within MERCOSUR, but with sharp international price distortions generated by the wide range of subsidies for production and exportation in place in much of the developed world.

Lastly, for the remainder of the tariff universe, the high-level group had to make a thorough general review, study both nominal and effective protection based on the structure in force, and formulate reform proposals.<sup>87</sup>

In the negotiations conducted throughout the latter half of 2001, the countries exchanged different proposals to redesign the protective structure of the chain of capital, information technology, and telecommunication goods. Thus, whereas Brazil proposed to work on capital goods not produced within the subregion and sought to impose its regime of temporary tariff reductions in which such products entered at a 4% tariff, Argentina, Paraguay, and Uruguay promoted the idea of ending the – ascending - convergence schedule for such products (also to include information technology and telecommunication goods), and proposed reaching consensus on "entry" tariffs lower than those originally agreed.

In that connection, the ongoing devaluation of the real constituted an element of "rapprochement" among the parties. In fact, the relative increase in the cost of investing in Brazil was cause for concern among elements of Brazil's public and private sectors which, for the first time in many years, permitted renewed

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<sup>86</sup> Although in principle, Minister Cavallo's tariff reform in Argentina had eliminated import duties on capital, information technology and telecommunication goods, Brazil's strong reaction led to the imposition of this reduction solely on the capital goods sector. With this "adjustment," the unilateral modification was "mercosurized" after the fact in the form of a temporary waiver granted to Argentina.

<sup>87</sup> Minister Cavallo's tariff reform had also included an increase in import tariffs on final consumer goods up to the WTO's maximum level (35%), thereby once again utilizing trade policy as a substitute for the exchange rate "anchor."

discussion of trade policy for that productive sector. In any event, the existence of different – even contradictory – views within the Brazilian government would make it difficult to reach further consensus regarding the treatment of this sector.

In Argentina - and in Paraguay and Uruguay - deterioration of macroeconomic and financial conditions in the latter half of 2001, along with several consecutive quarters of disinvestment, led to the renewal of such demands, now made with greater urgency. The abandonment of convertibility and the onset of one of Argentina's most severe macroeconomic crises intensified still further the disinclination to invest, now accompanied by serious difficulties in obtaining credit and steep increases in the cost of all types of machinery and equipment – which was, for the most part, of foreign origin.

However, despite the degree of exchange convergence achieved in 2002 in Argentina and Brazil - "a very high exchange rate" - no consensus whatsoever was reached regarding trade policy for the sector, it only being agreed to retain temporarily the MERCOSUR waiver for Argentine policy – of reducing to zero tariffs on capital goods imports.

Something similar occurred with the general review of CET structure, although in this case neither criteria nor study methodologies were even discussed. Although exchange convergence was able to bring the positions of the larger countries closer together, and although the Brazilian President *pro tempore* had made it one of his highest priorities, no headway was made in discussion or study of the consistency or the dispersion of the regime in force.

In the end, although in December 2001, proposals had been exchanged for mechanisms to apply the CET to agricultural goods whose prices were distorted (consisting essentially in increasing import tariffs on such products above the 20% ceiling),<sup>88</sup> the abandonment of convertibility and greater Argentine concern to maintain the stability of food prices, along with the increasing pace of depreciation of the real throughout 2002, caused this mechanism – about which a high degree of consensus had been reached among the partner countries in late 2001- to be shelved for the time being.

To summarize, in the 18 months from the establishment of the high-level group until the end of 2002, discussions advanced little. This was also true for discussions on the general review of the CET and discussions on the agricultural and capital, information technology, and telecommunication goods sectors.

The higher exchange rates in the subregion than those of the preceding decade should be the basis for reformulating the subregion's protection regime, thereby enabling MERCOSUR's productive system to position itself more competitively. The current environment would thus appear to afford an opportunity to evaluate possible tariff reductions – especially on commodities and investment goods – and to reduce the discretionary use of trade policy. However, the likelihood that the different negotiation entities envisaged on MERCOSUR's external agenda will, in the medium term, enter a commitment implementation phase appears to be a factor that will surely favor the status quo in this area – at least in the short term - provided that “adjustments” to the protection regime now in force can be negotiated ("in exchange for") and not made in unilateral fashion.

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<sup>88</sup> The Argentine proposal in this area included application, at the request of any State Party, of a temporary increase in the CET for agricultural products whose prices were distorted, while not exceeding the levels agreed with the WTO. To that end, a request would have to be made identifying the tariff positions involved, the increase sought in the CET, the period it would be in effect, the policies leading to the distortion and a quantification thereof, and the existence of subregional production of the affected products.

## **The Common External Tariff: General issues in this period**

### *A 3% increase in the temporary CET (implemented in 1997)*

Although this increase was to be eliminated in late 2000, in December of that year, it was decided to reduce it by only half a point. In late 2001, it was further decided to reduce it by one additional point, so that a 1.5% increase remained in effect. Although this percentage was supposed to disappear by the end of 2002 (as the regulatory framework so provided and as this is what the subregional economic reality, with higher exchange rates, would suggest), the Common Market Group (GMC) decided to extend the phase-out by one year (until December 31, 2003).<sup>a</sup>

### *Exceptions to the CET*

In view of the completion in January 2001, for Argentina, Brazil, and Uruguay, of convergence to the CET of the basic list of exceptions, and the need to maintain tariffs other than those agreed in 1994 for some products, the CMC issued Decision 68/00, which enabled each State Party to retain for a two-year period a list of 100 Nomenclature positions as exceptions to the CET – their elimination being slated for end 2002. Nonetheless, the GMC decided to extend them until December 2003. It also authorized inclusion on the Brazilian list a reduction in tariff for corn imports (to 2%, for up to a maximum of 600,000 tons) until February 28, 2003.

### *Waiver for Argentina to import capital goods at zero tariff<sup>b</sup>*

The tariff reduction for capital goods purchases established in early 2001 by Minister Cavallo lapsed in late 2002. However, Argentina requested a one-year extension. An extension until June 2003 was finally agreed. In this period, it was decided to move forward in defining sectoral aspects so that common policy might be established within MERCOSUR. Among such aspects were:

- Establishment of a common procedure for capital goods not produced;
- Design of a more effective procedure for treatment by the Parties of capital goods not produced or with problems of supply;
- Intensification of discussion in the high-level group of tariff policy for capital, information technology, and telecommunication goods;
- Consideration of establishing a specific common policy for capital, information technology, and telecommunication goods that addressed, *inter alia*, tariff aspects, and financial, technological, and productive integration issues.

### *Controversy over the Argentine convergence factor<sup>c</sup>*

Although the Brazilian demand in early 2001 for the – unilateral – Argentine reduction of tariffs on capital, information technology, and telecommunication goods had finally been absorbed in the form of the waiver adopted for capital goods and the reversal of the reduction applied to the remaining products, the sanction established in Resolution No. 258/2001 (exception to the convergence factor) again created a source of conflict in bilateral relations, as it implicitly reduced the effective tariff on imports of information technology, telecommunications, and capital goods and inputs for the oil and gas sectors. In fact, the exception to the application of the convergence factor for these goods led to the lodging by Brazil of a complaint against Argentina, which became the subject of consultations among the Parties in the GMC in late 2001. However, the change in Argentine exchange policy as of 2002 meant that this instrument was not implemented and the complaint was therefore set aside.

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<sup>a</sup> Excepted from this temporary tariff increase were, in the case of Argentina, capital, information technology, and telecommunication goods (provided these were new) and products subject to specific tariffs. In the Brazilian case, the exceptions were capital, information technology, and telecommunications goods not produced. For Paraguay, the exceptions were capital, information technology, and telecommunications goods, the automotive sector, and certain primary materials and inputs; Uruguay, for its part, excepted capital, information technology, and telecommunication goods and a short list of additional products.

<sup>b</sup> For further detail on the political implications and difficulties of negotiations in this area, see Chapter II of this report.

<sup>c</sup> *Ibid.*

### *Macroeconomic coordination*

While for much of the 1990s, the international economic and financial context and convergence in the global orientation of the domestic policies of Argentina and Brazil contributed to concealing the lack of explicit coordination (established as an objective in the Treaty of Asunción itself), the changes noted in the dynamics of the international economy as of the Asian crisis and, in particular, the Brazilian devaluation of January 1999 and the abandonment of convertibility in January 2002, again began to underscore the lack of progress of the integration process in terms of macroeconomic agreement.

In reality, events subsequent to the crisis in the emerging countries as a whole and the impact thereof on the subregion's economies again pointed to the fact that macroeconomic stability was a necessary condition for progress in MERCOSUR's economic and institutional development.

In this context, the 2000 MERCOSUR Relaunch Program of 2000 included an ambitious commitment by the partners to move forward in establishing convergence goals for the main economic variables (fiscal, price, and debt, among others), which rapidly proved inadequate and incapable of addressing the major disequilibria that the subregion's countries had recently suffered.

Argentina's abandonment of convertibility and the deterioration in international and subregional financial and macroeconomic conditions gave rise to new and creative coordination proposals at times when there were virtually no genuine prospects for the "supply" of coordination.



Thus, President Duhalde had hardly taken office in early 2002, when Argentina pushed for the creation of a MERCOSUR Monetary Institute to work towards strengthening cooperation among the central banks and formulating concrete macroeconomic coordination proposals.

### **The proposed MERCOSUR Monetary Institute**

In the Argentine proposal to establish a MERCOSUR Monetary Institute, that body was to be subordinate to the Common Market Council and would comprise representatives of the central banks, ministries of economy, foreign ministries, and such other government agencies as the States Parties considered pertinent.

The proposed Institute was to assume the coordination of all tasks identified in fostering macroeconomic coordination and such other types of coordination as deemed pertinent in respect of monetary, financial, and exchange affairs. In particular, the Institute would be authorized to present proposals that might contribute to intensifying the convergence process and establishing a common MERCOSUR currency. In addressing the latter objective, it was proposed to establish a virtual network among such research centers as each State Party might designate to that end.

The proposal was for the Institute to evolve and assume new coordination functions as the process of macroeconomic convergence intensified.

Argentina also proposed to adjust the convergence goals and mechanisms for the variables committed in due course and to define new and broader “arrangements” in indicators related to the exchange rate, the external sector, and the financial system.

In addition, in early 2002, Argentina presented a working proposal for financing development within MERCOSUR. The proposal involved conducting a survey and study of finance mechanisms available in the partner countries, for example, FONPLATA, and of the need to seek alternatives or options in order to provide MERCOSUR with its own instrument. Although Brazil agreed regarding the advisability of a subregional mechanism to finance productive projects for small and medium-scale enterprise, there was little support for the proposal and it was dropped from the most immediate negotiations agenda.

Along with recognition of the importance of progress with "commitment technologies" to strengthening domestic and external ties of the subregion's countries, in the 18 months from July 2001 to December 2002 the results in this area were fairly inconsequential, and merely involved continuing the process of harmonizing certain indicators, the exchange of statistics, and the drafting of a MERCOSUR status report.

In that connection, at the CMC's most recent meeting, it was recommended to the Meeting of Economic Ministers and Central Bank Presidents that it ask the Macroeconomic Monitoring Group to study the inclusion in the macroeconomic convergence process of other indicators and mechanisms to ensure fulfillment of such targets as might be established.

#### *Sector competitiveness forums*

In the transition period to the customs union (1991/1994), Working Subgroup 7–Industry organized different business community meetings which, coordinated by government representatives, made progress in exchanging ideas and views among the private sectors of each branch of production regarding its status at the national, subregional, and international levels. The objective of these meetings was to promote greater

awareness of the integration process' actual players, their problems, strengths, and challenges, and to explore possible common productive specialization activities, develop suppliers and customers, further integrate value chains at the subregional level, etc.

Attempts to continue these types of forum after the end of the transition period have been as repeated as they have been fruitless. The devaluation of the real in early 1999 and the end of the "honeymoon" phase of the integration process underscored the need to develop some type of initiative for greater understanding among the subregion's private sectors.

Whereas the voluntary entrepreneurial arrangements implemented throughout 1999 were "emergency" measures, as of mid-2001, the idea of formally reopening the competitiveness forums again figured among government priorities, with a view to studying the sectors' conditions of competitiveness and the prospects for cooperation among the Parties.

In any event, the different observations exchanged in 2001 on the original proposal regarding the advisability, or lack thereof, of promoting government participation in different forums or the possibility of expanding the sectors to be involved – the original proposal only included manufacturing – delayed until late 2002 the adoption of an agreement in this area. In fact, at the Twenty-third Meeting of the MERCOSUR Council, held in Brasilia, December 5-6, 2002, Decision 23/02 was adopted, defining how such initiatives would be implemented, and the arena for this. Under this provision, the Competitiveness Forums Program would be among the activities of the Working Subgroups (SGTs) and other MERCOSUR organs, while the Program's policy orientation would be established by the meetings of ministers, which would be able to establish specific forums for each productive chain, to comprise representatives of the official areas involved in each chain and entities representing business and labor.

### **Support for the development and complementation of subregional productive chains**

One anticipated result of implementation of a trade preference agreement among two or more countries is the qualitative modification of productive structures through the change in relative prices that, in each of the participating economies, emanates from the new tariff situation. Thus, in the absence of exogenous distortions, it may be expected that integration will lead to some type of efficiency-seeking change in the allocation of productive resources towards the interior of the integrated economic space, with expansion and contraction of productive sectors and activities in keeping with the respective comparative advantages of the different areas involved.

However, although the situation described above refers to a "world" where markets operate with relative efficiency, where information is distributed normally among the different agents, where the ups and downs of countries' domestic politics are merely secondary factors in the decision-making process, where domestic prices of goods and factors are sufficiently flexible to promote progress with in reform processes, and where market failures are exceptions to the economy's general rule, the realities of the Western Hemisphere's different integration processes of the last twenty years have departed significantly from what might be suggested by such regimes (Rodrik [1995]).

Thus, in contrast with the contextual conditions that may be anticipated under international trade theory models, the restrictions and barriers that the subregion's different countries have had to address have led their governments to adopt – fairly regularly – "second best" policies, in which they have had to resort more often than desirable to trade-offs between alternative "evils" and "temporary" situations.

It is not, therefore, mere chance that promotion of subregional production chains and specific regional development policy have been accorded less priority on the MERCOSUR agenda during the phases of greatest “confidence” in the free and spontaneous action of markets, only to be accorded more space and priority during the phases of macroeconomic crisis and/or difficulties in the political management of the process – phases when the tendency of the parties increases to engage in zero sum games.

Thus, the perception that disparities in the level of development of the member countries is one of the main sources of distributive conflict in the framework of integration schemes (Valenciano [1992]), and that the continuity and sustainability of pro-integrationist efforts involves equitable distribution among the participants of its costs and benefits (ECLAC [1994]), has led different types of public, private, and plurilateral entity to make efforts to retain these items on the subregional agenda, even at times of golden opportunity for integration and for the economic programs of the subregion’s economies.

Thus, supplying economically effective and politically feasible solutions to the challenges involved in the necessary balancing of interests among the parties to the integration process would appear to be one of the main difficulties in consolidating MERCOSUR’s institutions and bringing them to maturity.

#### **The economic rationale of subregional chains of value**

One of the public policy objectives of the different countries is promotion of greater aggregation of value at the national level. Thus, a similar objective may now be conceived for those responsible for the integration process – in this case, interpreting “national market” to mean the sum of the countries comprising the integrated area.

There are different alternatives for cooperation among the sectors of a single branch of production within an integration process. First, eliminating barriers to reciprocal trade may promote trade in end goods or services of a single productive complex. One example is trade in motor vehicles, where each participating country specializes in specific models – which are sold on the internal subregional market and, possibly, to the rest of the world – and imports other finished vehicles from the partner country. Similar possibilities might exist for sectors such as petrochemicals, steel, or plastics manufacturing.

It is hoped that intensification of integration will at the same time encourage producers from one country to include among their usual suppliers manufacturers of inputs or components of a partner country, or that such end producers will include companies from the other country in outsourcing some of their activities, on terms that may include joint development of new products, adaptation of processes to new competitive conditions on international markets, cooperative utilization of productive or commercial infrastructure resources, or even implementation of joint ventures in specific niches.

Thus, the objective of the idea of creating an instrument to foster the generation or intensification of subregional value chains is to promote all such cooperation alternatives, thereby seeking to prevent or minimize geographic concentration and relocation of activities.

One of the advantages of promoting this type of strategy is that it may benefit companies of limited size and scope. In fact, integration of subregional chains may permit the development of integrated

productive networks, which bring together small and medium-scale enterprise of the different countries, in each case producing on a more nearly optimal scale and terms. It may also permit the coexistence of large companies with networks of relatively smaller suppliers and customers, regardless of location.

Activities to be fostered to that end may include establishing a joint lobby at the subregional level, external market studies, joint trade promotion, participation in trade fairs abroad, and investment in industry-specific infrastructure. Other vitally important contributions to that end are providing assistance in expanding exports of customers and/or suppliers through new financial instruments and providing support, in the form of corporate and institutional know-how, in insertion abroad.

The development of such value chains at the subregional level may also – in certain conditions – promote and foster a greater presence of transnational companies or corporations interested in locating in the different economies participating in the integration scheme, in order to benefit as much as possible from the comparative advantages of each (availability of natural resources, specialized labor, proximity to centers of consumption, etc.). In such cases, incentives to attract these types of company may include complementary activity by governments to provide support infrastructure, institutions, and networks, sources of technological assistance, etc., designed on the basis of national and subregional criteria.

Government intervention in promoting the creation or intensification of subregional value chains may be justified by the existence of market failures (UNCTAD [2001]), which may potentially be corrected by the joint action of the authorities of the different integration processes. Among these are lack of pertinent information, entrepreneurial “myopia,” inadequate provision of public goods, and lack of coordination of intra-company horizontal or vertical relationships.

Owing to all these factors, government activity to assist in strengthening subregional value chains through provision of both public goods and infrastructure, pertinent information, etc., and of mechanisms tending to facilitate or “lubricate” the coordination of relations between firms may be essential to the success of the different projects. It is in such a context that global competitiveness of the companies of a given sector may be greater than the sum of the results that would be obtained if each of the parties acted in isolation.

### *The status of service negotiations*

In December 1997, the Protocol of Montevideo was concluded, establishing the commitment to deregulate trade in services in the subregion by no later than 10 years from the entry into force of that instrument. The Protocol provides for annual negotiation rounds with a view to gradual incorporation into free intrasubregional trade of all the different services through the use of positive sectoral and horizontal lists.

Although three negotiating rounds regarding specific commitments have thus far been conducted (and the launch of the fourth is under way), the Protocol has not yet come into force, and has only been ratified by Argentina, in the latter half of 2002, ratification by at least three countries being required for entry into force. Apart from the different efforts made in 2001 and 2002 with a view to adoption of that instrument

by the parliaments of the States Parties (the topic was high on the agenda of the relaunch and of the most recent Argentine presidency *pro tempore*), there has been little progress.

The significance of this Protocol involves not only the possibility of expanding subregional enterprise to include the services market, but also the fact that the topic is on the agenda for the bloc's different international negotiations (WTO, FTAA, European Union). Thus, an implemented intrasubregional trade liberalization regime would improve the position of the subregion's entrepreneurs in addressing expected future challenges.

Despite these difficulties, the Services Group has moved ahead with specific sectoral commitments, it being expected that the fourth round will have to conclude the agreements for the sectors discussed at the third, complete the process of consolidating the lists and clarifying existing limits in all affected sectors, and move forward in deregulating the circulation of people.

In a related vein, since early 2002, a MERCOSUR visa proposal has been a topic of discussion within the GMC. This would facilitate the movement of physical persons providing services within the subregion. The proposal, not yet agreed among the four Parties, would eliminate, for example, Brazilian restrictions on authorizations for service providers from its partner countries to enter and remain in the country (such as the requirement to provide proof of economic need or the ratios of foreign to national personnel permitted for certain categories of employment).

The MERCOSUR visa would also simplify procedures for authorization to enter and remain in the host country, as the pertinent provisions establish that all such procedures are to be carried out with the Consular Office with jurisdiction over the place of residence of the party concerned.

However, in some sectors of the Brazilian executive branch there is resistance to approving the MERCOSUR visa, as to do so would detract from the authority now residing in the Ministry of Labor conferred by Brazilian labor law to deny entry to the staff of companies that do not satisfy the "two-thirds" rule (stipulating that the total number of foreign workers and the total wages paid to them may not exceed one third of the total).

#### *The government procurement regime*

Negotiations for a subregional agreement in this area would appear to have been, for at least the last five years, another effective priority in the integration process. In fact, since December 1997, an ad hoc group has been working to develop a community instrument that would eliminate all forms of discrimination in tenders conducted by government entities of the different countries for the procurement of goods or to contract for services.

Although the target date for conclusion of negotiations was December 1998, this has had to be extended on numerous occasions, the most recent at the last GMC meeting, in December 2002.

The three main points of conflict among the Parties under these years may be summarized as:

- The agreement's coverage (whether it affects only the federal level of the States or also includes provincial and/or municipal government agencies). Further, whether it covers procurement by decentralized entities, mixed public/private entities, and public enterprise;
- Whether to establish preferences over suppliers from outside the subregion; and

- Inclusion of concessions.

With respect to the last, although Argentina has proposed on numerous occasions the inclusion of concessions within the government procurement regulatory framework in order to cover public works and privatization plans for different services, the other partner countries opposed this proposal, arguing that the state expenditure could not cover concessions. Thus, in 2000, the GMC created a specific ad hoc group to address these issues.

With respect to the Agreement's coverage, Brazil has been arguing that it is impossible for such principles as may govern government procurement in MERCOSUR to be extended automatically to state government, as national executive branches may only make commitments for federal government.

Argentina, for its part, in view of the importance of public works and procurement within the state sphere, has supported the inclusion of all levels of government (even where the executive branch of that country may be subject to the same limitations as the Brazilian as regards the actual possibilities of including the provinces under the provisions of the Agreement).

A similar problem arises over the inclusion of public and/or mixed enterprise under these provisions, in view of their autonomy. While much of business may be classified as this type of enterprise, it is highly unlikely that it will be covered by future subregional provisions.

Lastly, the topic of preferences in international tenders for MERCOSUR firms has been much batted about. The draft agreement contained a clause which provided, in principle, that if a MERCOSUR supplier quoted up to 3% more than a bidder from the rest of the world, it could be awarded the contract, which made it more likely that tenders would be awarded to subregional suppliers.

However, over time, fiscal restrictions and a certain aversion on the part of some of partner countries to encouraging the inclusion of non-local suppliers of inputs led to reconsideration of the original idea. In that connection, some partners, particularly Brazil and Paraguay, supported the MERCOSUR preference in case of tie between the bids of subregional and international suppliers (which would give the MERCOSUR company an opportunity to improve its bid when it is up to 3% more than that of the extrasubregional bidder); while the position of others, such as Uruguay, is that there should be no preference whatsoever.<sup>89</sup>

In any event, apart from progress made in this area, establishment of the agreement, which is now in the hands of the GMC, was postponed until 2003, in response to the request in late 2002 by Paraguay and Uruguay that this step not be taken. In that connection, the Paraguayan President *pro tempore* undertook to convene in early 2003 another meeting of the ad hoc group on government procurement, and stipulated that the delegations exchange in advance the lists of each countries' entities, goods, services, and public works that would come under the agreement. In particular, study of the topic of mutual recognition of the lists of suppliers will also continue at that meeting.

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<sup>89</sup> In the case of Argentina, the "buy Argentine" provision establishes a preference that enables national bidders to submit bids up to 5% higher than those of foreign companies, rising to 7% if they are SMEs. In Uruguay, there is a preference of 10%, while Brazil does not have this type of benefit.

### *Intrasubregional and extrasubregional trade protection*

Since implementation of the customs union in January 1995, negotiations to define common protection policies against unfair trade practices in connection with third country imports have taken a prominent place on the governments' agenda. In fact, after implementation of the Common External Tariff, MERCOSUR was expected to move forward rapidly in adjusting – to the provisions emanating from the Uruguay Round – the MERCOSUR regulations in this area enacted in 1993. Provision was also made to conclude a broad and complete Competition Protection Protocol, which would eventually regulate intrasubregional trade practices, thus replacing any national anti-dumping and anti-subsidy instruments at the subregional level.

In other words, the "ideal" customs union implied that it would be possible to agree on common trade protection policy vis-à-vis third countries, while competitive conditions in the enlarged market would be subject to the usual practice for regulating internal trade (that is, competition protection policy).

However, the difficulties noted throughout these years in the regulatory and institutional design of common mechanisms of this type and, thus, the continued use of national instruments for protection against unfair intrasubregional trade practices had been shifting the focus of dispute and concern towards discussion of "disciplining" procedures used in each State Party to that end.<sup>90</sup>

Thus, to the traditional Brazilian position of eliminating the possibility of establishing anti-dumping and countervailing duties in trade among the partner countries (mechanisms that Argentina had been utilizing with some intensity) was added a more "realistic" proposal – in view of the status of the integration process – designed to limit discretion in the application of such measures.

In consequence, in the framework of the 2000 MERCOSUR Relaunch Program, the countries agreed on a procedure to bring discipline to the processes of investigating and applying such measures in the intrasubregional sphere, to include greater information exchange among the partners – prior to application of action - and the possibility of reaching price agreements after the final decision had been issued, among other steps designed to lend greater transparency to and reduce the "unilaterality" of such measures as might be issued.

This procedure was never implemented in practice, despite Brazil's insistence, owing to the growing exchange disparities among the partner countries and the macroeconomic difficulties in Argentina. The request for its review made by Argentina in mid-2001, in a context in which that country had been moving ahead with unilateral changes to the community rules of the game – modification of the CET, application of the convergence factor for intrasubregional sales and purchase, etc., led to a direct confrontation with Brazil.

In that connection, it was decided to continue efforts to improve the procedure for greater transparency, while Brazil also proposed to include in MERCOSUR provisions the anti-dumping agreement and the agreement on subsidies and compensatory measures based on the GATT Uruguay Round (incorporated in due course in the national legislation of the different States Parties).

Thus, the Brazilian government sought to ensure that legislation and other forms of regulation of unfair trade practices that might be applied within the MERCOSUR framework would follow the guidelines established by GATT/WTO in this area. At the same time, incorporation of these multilateral regulations

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<sup>90</sup> Negotiations of the common regulations continue in the framework of the subgroup studying institutional issues and in the Trade Commission. Similarly, the Competition Protection Protocol, enacted in 1996, remains inoperative and evaluation of regulatory and procedural aspects continues. In late 2002, the GMC put before the CMC for its consideration draft regulations to the said Protocol.

within Community provisions would enable the dispute settlement mechanisms established within MERCOSUR to be activated – together with those established within the World Trade Organization.

The abandonment of convertibility and the steep change in relative prices in Argentina caused Brazil to step up pressure to "clear the negotiating table of conflict" and to agree on some type of "discipline" regarding these topics. In addition, based on the new exchange parity in Argentina, trade policy was further liberalized, a phenomenon that enabled some consensus to be reached throughout 2002 regarding these issues.

In fact, Decisions CMC 13/02 and 14/02 incorporated in MERCOSUR provisions the WTO's dumping and subsidies agreements, while Decision CMC 22/02 clarified the scope of commitments associated with intrasubregional investigations in these areas.

### *The issue of the bloc's institutional structure*

As a result of the experience gained in these years in implementing the dispute settlement mechanism established in the Protocol of Brasilia and the intent noted among the States Parties to move forward in establishing relatively more institutionalization of this procedure, in February 2002, the Protocol of Olivos was signed which, when it comes into force, will govern dispute settlement within MERCOSUR.<sup>91</sup>

The philosophical and practical basis of this Protocol is the same as that of its predecessor, while it makes different types of innovation. For example, in cases of controversy among the states, in contrast with the prior mechanism, the only mandatory stage is that of direct negotiations among the partner states involved, while GMC intervention becomes optional, thereby enabling the timetable to be shortened for moving to the arbitration stage.

Similarly, Olivos establishes a Permanent Review Tribunal, perhaps the main institutional change since 1991, to serve as a sort of body for the review of arbitration decisions. In other words, since the implementation of the Protocol of Olivos, the decisions of the Ad hoc Tribunals may be subject to motion for clarification and motion for review. It is also provided that, for any dispute, if the parties so agree, there may be direct recourse to the Permanent Tribunal.

Another of Olivos' major modifications, related to the recent difficulties of adequate enforcement of arbitration decisions, is the establishment of a post-decision monitoring authority, to which recourse may be had in cases of partial or total failure to comply on the part of the state against which the complaint was brought.

The Protocol also contains provisions for future establishment of expeditious mechanisms for the resolution of disputes on technical aspects regulated through common trade policy instruments.

Lastly, Olivos provides that, in bringing complaints initiated in private proceedings, the National Section of the GMC that has declared the complaint admissible must initiate consultations with the state to which the violation is attributed, thereby reducing – to some extent – the mechanism's discretionary authority.

To summarize, although the Protocol of Olivos is based on its predecessor's provisions for the dispute settlement mechanism, it incorporates important elements in the system not present in the original

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<sup>91</sup> The Protocol of Olivos will come into force 30 days after the deposit of the fourth instrument of ratification. Thus far, only Argentina has completed this procedure (Law 25.663 of October 9, 2002).



instrument, and seeks to rectify some of the main defects thereof. The three major aspects soon to be incorporated in the MERCOSUR judicial system will be discussed in further detail below.

(i) The first is the inclusion of provisions regarding the forum before which disputes will be settled, an element not included in the Protocol of Brasilia and which would, for example, have enabled Brazil, when it did not obtain the results expected in its complaint brought against Argentina – within the MERCOSUR framework – regarding the application of antidumping measures for chicken imports, to submit the matter to the WTO Dispute Settlement Body.

In that connection, Olivos provides that if a dispute meets the conditions for submission to both the MERCOSUR and the WTO dispute settlement system,<sup>92</sup> the complainant state must choose one of these mechanisms – or agree with the other party – thereby automatically and definitively excluding itself from the other forum.

(ii) The second is the strengthening of the binding nature of the final decision and applicable measures tending to ensure compliance with decisions. Although the Protocol of Brasilia had already established the principle of the binding nature of decisions – and provided for the adoption of temporary compensatory measures in the case of non-compliance - such as suspension of concessions or similar measures, Olivos develops its own mechanisms to ensure compliance, and also provides that adoption of these types of retaliatory measure do not exempt the State Party from its obligation to comply with provisions of decisions.

Evidently, whatever the subject of the dispute, only in exceptional cases may arbitration tribunals adopt on their own initiative measures to ensure compliance with their decisions. In other words, it would appear that government action is always necessary to implement and enforce the decisions. Hence the importance of establishing a clear procedure to prevent circumvention in practice of the spirit and scope of decisions when implemented. To that end, Olivos provides that the post-decision body will be used both to monitor effective measures taken to ensure compliance with such decisions and to study possible compensatory measures that the complainant state may take.

To summarize, although the Protocol of Olivos maintains the authority to take unilateral retaliatory measures to address possible non-compliance with decisions, it establishes certain limits and conditions thereon, and seeks to avoid an increase in arbitration proceedings stemming from decisions considered not to have been observed and from retaliatory measures considered excessive.

However, it has not been possible to find a solution to the fact that adoption of retaliatory measures as the only way to promote compliance with decisions may lead the integration process to "level off at a lower level" in terms of eliminating benefits and/or implementing restrictive measures in response to decisions not observed. Nor was a solution found regarding the fact that this "eye for an eye" principle is particularly disadvantageous to the smaller countries, which have less capacity to ensure that their "retaliations" force the larger countries to comply with decisions.

(iii) The third innovation of the Protocol of Olivos involves the quest for a uniform interpretation of MERCOSUR's regulations. One of the main criticisms of the Ad hoc Tribunals – vis-à-vis permanent tribunals – has been that they do not make enable genuine community jurisprudence to be developed that enriches and even intensifies the integration process, so that contradictory interpretations of the same issues may be generated, with negative impact on the legal security of the process.

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<sup>92</sup> Or other preferential trade regime to which the States Parties may individually be Party.

Among the improvements of Olivos in that connection are:

- Greater tenure of the arbitrators presiding over the Ad hoc Tribunals, so that their ongoing participation in different disputes may facilitate consistency of interpretation. Neither should it be forgotten that MERCOSUR provisions are not usually drafted with absolute precision, so that greater experience on the part of the judges and greater continuity in their knowledge of such subregional provisions and the “spirit” thereof may become a key element in evaluating disputes.
- Establishment of a Permanent Review Tribunal with the capacity to adjudicate appeals brought before it. The Tribunal must evaluate points of law involved in the different disputes and legal interpretations developed in the Ad hoc Tribunals, so that it can uphold, amend, or overturn the decisions in such cases and reaffirm or dispute the legal foundation thereof. Its decision is final and cases may be reopened only upon motion for clarification.

The greatest innovation of the Protocol of Olivos is the Permanent Review Tribunal. Although the Protocol of Brasilia established the Ad hoc Tribunals as the sole jurisdictional level – probably intending to ensure rapid resolution of disputes, experience has shown not only that the procedure was not “as” dynamic, but that a review level was needed both to enable appeals to be lodged against decisions and to unify interpretation of the “vague” provisions and application of MERCOSUR’s judicial mechanisms.

If the parties agree, the Permanent Tribunal may also operate as the sole jurisdictional level, governed by the provisions applicable to the Ad hoc Tribunals, thereby becoming what might constitute a path towards a single tribunal system.

It should also be noted that four of the five arbitrators comprising this body will be able to retain their offices for up to six years, while the fifth will be appointed for a three-year term. This too will doubtlessly contribute to uniform interpretation of community provisions. Lastly, and although it has not been possible to so determine at this stage, Olivos establishes the possibility of creating mechanisms to request consultative opinions from the Permanent Review Tribunal.

- Transformation of the Administrative Secretariat to the Technical Secretariat -

The lack of an independent technical authority has been one of MERCOSUR’s most evident institutional lacunae. The establishment of working subgroups and/or technical committees with officials of different ranks from the countries’ different public entities does not appear to have been effective in designing quadripartite instruments after the transition period. It appears that it was not possible to “extract” the specialists from their national political offices, thereby restricting the scope of the necessary subregional consensuses.

However, in overcoming current limitations, the creation of an independent technical body may be a necessary, but insufficient, condition, as its recommendations would not be binding and would thus be subject to the political decisions of the representatives of the States Parties.<sup>93</sup> In any event, it may be considered that a new technical MERCOSUR body might make a significant contribution to the preparatory work for the negotiations with third countries and regions, and to the preparation of technical proposals regarding items on the internal agenda where there may be common interests (and therefore where political differences ought not to be as marked).

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<sup>93</sup> According to Peña [2002], in special circumstances, such as instruments to lend flexibility to free trade and foreign trade policy commitments, its opinion should be binding, except in the case of “negative consensus” opinions of the partners.

A first attempt may be found in the recent launch of the process to transform MERCOSUR's Administrative Secretariat into a Technical Secretariat adopted by the Common Market Council at its meeting of December 2002. The agreement reached will make it possible to establish within the Secretariat, as of early 2003, an advisory services area, with the technical functions of providing support for the different organs, following up on and evaluating implementation of the integration process, conducting studies on topics of interest in the integration process, and monitoring the legal consistency of the acts of and provisions emanating from the different MERCOSUR authorities.<sup>94</sup>

- Incorporation of provisions

MERCOSUR's specific institutional conception of MERCOSUR means that the "rules of the game" agreed at the subregional level must be incorporated in the national legislation of each State Party. This has led to numerous difficulties and, according to available statistics, only 38% of the MERCOSUR provisions have been incorporated by the four member countries.

Although the efforts of technical subgroups of representatives of the different public sector agencies and participation by the legislators of the four countries through the Joint Parliamentary Committee were intended to facilitate the legislative adjustment process, it has been found, in practice, that such adjustment is an extremely complex process.

In consequence, the group to study institutional topics has discussed different alternatives to move forward in eliminating this barrier to intensification of the integration process. To that end, at the December 2002 meetings, a more streamlined procedure was adopted to incorporate the MERCOSUR provisions in the countries' legislation. Under this system, draft provisions must be studied in advance by the different national entities involved to ensure that after their adoption at the MERCOSUR level, they will not encounter difficulties of incorporation in national provisions.

*Other market access topics*

- Regulation of Article 50 of the Treaty of Montevideo, which established LAIA -

In the framework of negotiations to eliminate non-tariff barriers affecting intrasubregional trade, the States Parties agreed in due course to continue to accord them treatment distinct from that accorded health and safety restrictions and other measures covered by the aforementioned provision.<sup>95</sup>

In other words, not all instruments may be eliminated that are used by the countries to regulate the entry of products that, for very different reasons, may cause difficulties for national companies. In the best scenario, the partner countries may work to harmonize such mechanisms with a view to the greater standardization thereof.

In practice, however, many of these provisions are utilized discretionally to justify the imposition of different types of barrier to free trade. In consequence, the MERCOSUR countries have agreed to move forward in regulating the application of measures adopted under Article 50 in order to restrict their arbitrary use.

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<sup>94</sup> Decision CMC 30/02, adopted at the recent Summit of Brasilia (December 4-5, 2002).

<sup>95</sup> Among other matters in connection with which the aforementioned article authorizes the adoption of import restrictions are those intended to protect public morality, protect national artistic, historical, or archaeological heritage, and those involving the importation of gold and silver, radioactive products, etc.

To that end, since early 2001, proposals for the regulation of such measures have been exchanged, although consensus has not yet been reached thereon. In the view of Brazil, regulation of these types of barrier to trade – for justified reasons – must be comprehensive and take a broad view – provided it is not inconsistent with MERCOSUR provisions.

In the Argentine view, limiting discretion means authorizing the exercise thereof on an exceptional basis, and according it a specific and limited nature. Accordingly, the Argentine proposal suggested different conditions for the imposition of restrictions under this provision, such as stipulating that their imposition be in keeping with the WTO's principles and disciplines or that they could not constitute unjustified or arbitrary discrimination. Argentina also indicated that there should be substantiated technical justification for such imposition; that the impact on trade flows should be minimized; criteria, firm deadlines, and reasonable processing costs should be defined; and that the imposition of restrictions should be preceded by prior notification and prior consultations at the subregional level.

In any event, the impossibility of moving ahead with effective regulation of Article 50 of the Treaty of Montevideo led, at different points, to repeated extensions of the agreed timetables, most recently at the last meeting of the CMC in December 2002. At that meeting, a new deadline of June 2003 was established for completion of work, although the Argentine delegation indicated that perhaps consideration should be given - in view of the difficulties faced – to possible suspension of discussion of the topic.

There are two pertinent reasons for the persisting disagreement in this area. The first is the continued refusal, evidently most adamant on the part of Brazil, to agree to transparent and unequivocal language regarding invocation of Article 50 as the basis for imposition of restrictions on intrasubregional imports. The second is the bloc's inability, again in view of Brazilian opposition, to find a valid negotiation alternative, which is essentially a reflection of the collective difficulty in resolving definitively the issue of non-tariff measures and restrictions as the main element of the effectiveness of the subregional free trade area (*Intelligence Trade Report* [2002]).

- Administrative procedures -

Trade operations in each State Party include procedures, deadlines, controls, and different types of administrative procedure. These are not harmonized and, frequently, constitute trade restrictive elements.

From the outset of the process of transition to the customs union, the topic has been discussed in trade negotiations with a view to limiting the number of procedures and prior permits, pre-embarkation inspection deadlines, import licenses – automatic and non-automatic, etc.

Along with the interest on the part of the partner countries at some point to establish similar administrative procedures for external trade and, insofar as possible, ones common to the four countries, Argentina's main intent in this area (and also of Paraguay and Uruguay) was to shorten non-automatic prior intervention periods in order to prevent their use as a trade restrictive element. Thus, while Argentina proposed that these periods not exceed 48 hours, the Brazilian authorities advocated periods ranging from 10 to 90 days, depending on the case. In that country's view, such a period would be justified by the small number of laboratories controlling specific aspects of different products, the geographic distribution thereof, and the number of border posts set up to handle trade between States Parties.

It should be noted that these types of procedure address very specific issues and even the peculiarities of the States Parties, so that the harmonization thereof is an arduous task with which, thus far, little headway has been made. It has therefore been subject to successive delays, the most recent of which, until June 2003, was adopted at the December 2002 meetings.

### *LAIA's Reciprocal Payment and Credit Agreement (CCR)*

This Agreement, concluded in 1982 by the central banks of the LAIA countries, provides for a settlement arrangement for international payments made under trade operations among the region's countries (if private operators so request), so that at the end of every four months, only the net balance of each country's operations with the others is transferred or received.

This mechanism comprises a multilateral settlement system, a system of guarantees (including convertibility of national currencies, transferability, and reimbursement to the exporting country's central bank), and a temporary credit mechanism for multilateral settlement balances (operated via a bilateral line of credit agreed between the central banks involved).

In Argentine-Brazilian trade relations, the operations conducted in the framework of the Agreement were usually marginal (in relation to total volume of trade), as the two countries' central banks only authorized operations up to the value of US\$ 100,000 (without guarantees). Moreover, the operations of pertinent sectors of regional trade – such as the automotive – were conducted outside the Agreement.<sup>96</sup>

Thus when, from time to time, Brazil implemented restrictions on trade credit, some members of the Argentine government sought to expand the Agreement's operation to channel more trade thereunder (and to some extent “evade” such restrictions). When convertibility was abandoned, it was the Brazilian authorities who took steps to that end.

In this case, Brazilian interest in channeling more operations under this Agreement could be described, among other things, as obtaining guarantees from the Central Bank of Argentina for payments to Brazilian exporters, thereby freeing themselves of responsibility for problems that the Argentine commercial banks or private operators might encounter in fulfilling their payment obligations vis-à-vis their own Central Bank.

The Brazilian government also sought to include in the Agreement operations already effected prior to the Argentine financial crisis in order to obtain some type of guarantee of repayment to exporters of the neighboring country.

To that end, the possibility was studied of raising the ceiling on permitted operations to US\$ 200,000 and expanding the Agreement to include the automotive sector.

Although in principle, the central banks resisted modifying the scope of the Agreement, especially in respect of including completed operations and automotive sector operations, in mid-August 2002, there appeared to be a breakthrough in this area, after the meetings of the technical and political authorities of the two central banks held in Brazil.

Finally, it was agreed to raise to US\$ 200,000 the ceiling on operations not subject to guarantees between Brazil and Argentina under the Agreement. In addition, it was established that also eligible for inclusion in this mechanism would be commercial debt refinance instruments for goods and services with firm purchase orders – from Argentine importers – issued up to December 31, 2001. The ceiling for such operations as a whole was set, in principle, at US\$ 200 million.

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<sup>96</sup> For example, in 2001, exports to Brazil made under the agreement were only slightly over 1% of total sales to that country. In the case of imports from Brazil, in that year, the percentage was 2%.

### *Border integration*

In late 2001, stemming from the many recurring problems that had arisen in recent years along the borders between partner countries, Brazilian authorities began to propose the establishment of an ad hoc group on border integration.

Although border problems have been studied and discussed in different MERCOSUR forums (from the perspectives of customs, labor/migration, and sanitary and phytosanitary security, among others), the objective of the Brazilian proposal was to bring responsibility for this complex topic under a single entity, whose purpose was to draft the MERCOSUR border statute.

Argentina, for its part, supported the establishment of this entity, although it raised certain objections to the idea of moving forward with the statute. On the Paraguayan side, concerns in this area involved simplification of border trade. In fact, in December 2001, that country had submitted a draft Decision on simplified border trade, with a view to replacing the Border Traffic Regime (which sought to address the supply needs of settlers in border areas by providing them with certain exemptions for basic products not traded on a commercial basis).

Finally, in mid-2002, at the Twenty-second Meeting of the CMC, it was decided to establish the Ad hoc Group on Border Integration with a view to generating instruments to further the integration of border communities.

### *MERCOSUR symbols*

At its most recent meeting of December 2002, the CMC adopted a Decision on "MERCOSUR symbols" (name, abbreviation, emblem/logotype, and flag), which replaced Decision CMC No. 1/98 on the same topic. The new framework takes as its premise the appropriateness of permitting the use of MERCOSUR symbols by physical and legal persons of the States Parties, provided that they do so in a manner compatible with the objectives of MERCOSUR.

However, the prohibition remains against registering MERCOSUR symbols as trademarks and/or utilizing them to designate bodies or institutions that may be confused with the organs of MERCOSUR (Council, Group, Commission, Tribunal, Committee, Working Group, or Forum).

Commercial companies, for their part, may use the word "MERCOSUR" not in isolation, but rather as part of their company or registered name, provided it does not lead to errors or ambiguities in connection with official MERCOSUR organs.

### **C. A view to the future: one possible path toward intensification of the MERCOSUR integration process**

For the MERCOSUR regime again to constitute state policy within the subregion that promotes further economic, political, and social development among the partner states than they could achieve in the absence thereof, the return to the subregion of a context of minimal macroeconomic stability is a necessary, although insufficient condition.

However, the bloc's strength can only be restored through firm political intent that enables common interests to be renewed and the customs union's main instruments to be adjusted to current regional and international conditions, so that the integration process again becomes a positive sum game for all countries of the bloc. This means leveling the playing field so that MERCOSUR may again become a

“good bet” for each of the states involved. If these objectives are not attained, the most likely outcome for the integration process is insignificance and/or extinction, as occurred with earlier integration initiatives within the region.

Some of these issues were the focus of study and exchange of views throughout 2002, owing to inclusion on the agenda of items such as the competitiveness forums – intended to promote greater complementation among productive chains at the subregional level –, joint trade promotion, and the need to redefine the Common External Tariff for certain “strategic” sectors.

Similarly, returning to a process of intensification of integration means that negotiation efforts must target a few thematic areas, according priority to consolidation of the basic principles of the customs union, that is, such efforts must focus first on reorganizing and structuring a new Common External Tariff that the four countries may more readily comply with and that is more in keeping with current productive needs, in a subregional environment of higher real exchange rates than the 1990s average.

Priority must be also given to eliminating the restrictions that are creating barriers to the development of the free trade area. The Brazilian devaluation first, and that of the Argentine peso later, have generated numerous tariff and non-tariff barriers that are impinging upon the very basis for the operation of the free trade area.

“Clearing the negotiating table” must inevitably include the renewal of negotiations to establish subregional “escape” mechanisms to cope with possible further changes in internal and external economic conditions in the subregion (in keeping with the preliminary agreements reached in late 2001). Only by concluding formal MERCOSUR agreements designed to wrestle with the instabilities inherent to developing countries will it be possible seriously and definitively to eliminate unilateral measures of different types that seek to impede – temporarily – free trade which, once the shock that inspired them has been overcome, are difficult to review.

Lastly, the complex international agenda requires further negotiating and technical effort with a view to achieving a rational and strong basic MERCOSUR position in the different bodies (FTAA, EU, CAN, Mexico, etc.), a phenomenon that requires much more technical preparation and community policy coordination than has yet been achieved.

From the institutional/operational perspective, this thematic focus should be accompanied by greater focus of and coordination among MERCOSUR’s technical and political organs so that the necessary basic consensuses may be reached. To that end, it would be advisable to strengthen those technical groups with direct responsibility for the few priority topics, which would work jointly and expeditiously with the Trade Commission and the Common Market Group to ensure compliance with such commitments and deadlines as may be established.

To summarize, the crisis of the integration process implies that, in 2003, agenda priorities must be ordered – just as must priorities in the respective negotiation forums – in respect of tariff, trade, and the basic customs union disciplines, similar to those included on the agenda at the outset of the process (although incorporating certain novel elements, such as strengthening a quadripartite technical authority, issues of facilitation of adjustment of domestic legislation to MERCOSUR provisions, and positive “management” mechanisms in the entrepreneurial or business complementation areas).

Although this proposal may seem to constitute *a priori* a reversal of the negotiation process, as it means, in practice, returning to a much more simplified and focused agenda and institutional/operational organization, this is merely an acknowledgement and formalization of the existing situation. The solution thereto and consolidation thereof imply that the negotiations agenda must focus on the customs union’s “hotter” topics and on a temporary “adjustment” of the activity of the technical and political organs in pursuit of that objective.





## CHAPTER V. THE EVOLUTION OF MERCOSUR'S EXTERNAL AGENDA: HEADWAY THROUGH THE STORM

### A. An overview of the agenda

As were the topics relating to the member countries' macroeconomy and the bloc's internal agenda, the period from the second half of 2001 to the end of 2002 was increasingly turbulent and complex. The bloc's external relations then moved to a much calmer and constructive scenario in which progress with the principal items on the agenda continued—generally speaking—according to the timetables originally envisaged.

Nonetheless, this does not mean that MERCOSUR's external agenda remained impervious to the many difficulties and conflicts affecting the States Parties in the abovementioned 18-month period. Along with the different obstacles to carrying out the ambitious and, in retrospect, unrealistic, commitments and timetables in the ostentatiously entitled "Relaunch Agenda" of mid-2000 and to making headway with some "chronic" issues in the bloc's external relations (such as transforming the bilateral partial scope agreements with the CAN countries into a free trade agreement between the two blocs, or negotiating with Mexico on a "4+1" basis), in mid-2001 some disturbing signs appeared in connection with the option of launching bilateral or quadrilateral negotiations with the U.S. in the context of the "resuscitated" 1991 Rose Garden Agreement.

In any event, "high-level policy," facile diplomatic solutions and/or games aside, progress with the principal items on MERCOSUR's external agenda continued in 2001 and 2002 in a reasonably well-organized fashion, thus entering—for the first time since North-South negotiations began in the mid-1990s—a phase of concrete definitions and specific commitments in the area of trade.<sup>97</sup>

In that connection, although the vicissitudes of the economies of the world's major economic players, some "disillusionment" regarding the results of globalization in many countries and regions, a marked decline in net capital flows to the developing countries (DCs), and difficulties in moving ahead with a new round of multilateral negotiations were creating some doubt as to the ultimate outcome of the great North-South trade liberalization projects (FTAA, MERCOSUR-EU, and others), the recent consolidation of the free trade agreement between Chile and the United States (and the Chile-EU agreement in September 2002) nonetheless promised to provide a new impetus for the trade negotiations "game" within the subregion.

Similarly, the installation of Brazil's new government—together with Argentina's uncertain political future—opened up new questions as to what the ultimate role and attitude of the great South American power would be vis-à-vis the two "mega" integration projects in which Brazil is a participant (FTAA and MERCOSUR-EU).

At the same time, in the context of the principal MERCOSUR countries' intent<sup>97</sup> to move ahead more energetically and decisively than in the past to open up and diversify markets for their exports, in 2002, an attempt was made to give fresh impetus to negotiations for a free trade agreement with Mexico, while efforts continued in the search for a trade agreement with South Africa and the countries of the South African Customs Union (SACU). In that connection, both the joint trade mission sent by the four MERCOSUR countries to South Africa in June 2002 (the first undertaking in this area) and the Argentine Mission to Mexico in December 2002 must be understood as part of a healthy intent to coordinate and

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<sup>97</sup> Despite these important advances, it must be underscored that doubts and uncertainties have not diminished as to whether the negotiations on formation of the Free Trade Area of the Americas will be successful in time and form. In fact, in the context of the single undertaking, all agreements and consensuses already reached on the different topics are only provisional understandings, with a view to a final agreement that will satisfy the problematic need to be perceived as favorable and beneficial to all parties involved. A similar observation may be made regarding the Association Agreement between the European Union and MERCOSUR.

supplement trade negotiations policy with more aggressive activity to promote exports to non-traditional and/or little developed markets.

Similarly, depending on the future course of the main items on the agenda for the regional and international negotiations, negotiations still in much more incipient and exploratory phases—such as those with India, CACM, CARICOM, ASEAN, Russia, Israel, EFTA, or Korea—could, in the short or medium term, come to take greater priority in the bloc's external relations.

In any event, the start of a new FTAA negotiations phase (with substantive negotiations for market access envisaged by 2003), the ambitious schedule of tasks planned in the context of the EU-MERCOSUR Agreement, the different initiatives launched in recent months and years on the subregional and/or bilateral level (an agreement with CAN, negotiations with South Africa and Mexico, and the possibility of launching negotiations with new countries and blocs, etc.), and the Fifth WTO Ministerial Conference (scheduled for September 2003 in Cancun) are all elements that presage a year full of internal and external challenges and definitions in the area of external negotiations.

## **B. In the midst of crisis, hopes and reality: “4 + 1” with the United States**

In early April 2001, a few days after taking tenure as Minister of Economy in Argentina's Alianza government, Minister Cavallo held a working meeting with the U.S. Trade Representative, Robert Zoellick, resulting in a possible refloat of the then “forgotten” Rose Garden Agreement of June 1991, in which the four countries of the then “brand new” MERCOSUR agreement had agreed with the government of George Bush, Sr. to establish an institutionalized forum—consultative in nature—in which to discuss and address trade and investment topics with the U.S.<sup>98/99</sup>

In any event, in order to give major impetus to MERCOSUR after the doubts—among other reactions—raised by Minister Cavallo's comments in early April 2001 regarding Argentina's readiness to negotiate agreements on a bilateral basis if necessary (*Revista Veja*, April 7, 2001), and at the same time to signal the enthusiasm that this initiative generated for the bloc, a leak emerged in subregional political and diplomatic circles to the effect that “a figure of international prestige” would be mutually agreed upon to head up the negotiations with the U.S.<sup>100</sup>

Shortly thereafter, at the meeting of the Common Market Council in Asunción in June 2001, the Council adopted Decision CMC 08/01 on negotiations with third countries. This measure provided for the reactivation of the agreement for a Trade and Investment Council among the Governments of the Argentine Republic, the Federative Republic of Brazil, the Republic of Paraguay, and the Eastern Republic of Uruguay

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<sup>98</sup> It should be noted that this agreement appeared as a MERCOSUR “group presentation,” in the context of the four countries' intent to reincorporate themselves as quickly as possible in the international economic and financial community after the crisis of the 1980s. In this context, it is not surprising that this initiative would be forgotten in view of the progress made both in the consolidation of MERCOSUR and in relations with other countries and blocs.

<sup>99</sup> In order to provide perspective on the logic and institutional meaning of that agreement, it is timely to recall a comment made in mid-2001 by one of the Argentine participants in those negotiations: “The United States resisted the idea that the agreement was with MERCOSUR. In its view, “4+1” was equal to five. But MERCOSUR imposed the view that “4 + 1” is equal to two [as] the Council can only meet if the four partners are present. This was symbolized in the first of the meetings in Washington in November 1991. The MERCOSUR delegation replaced the original five-sided table with a two-sided table. Both the negotiation of the agreement and the initial meetings were exercises in joint negotiation, with the coordinating country acting as the spokesperson and prior meetings held to prepare the positions to be defended.” (Felix Peña, *La Nación*, April 9, 2001).

<sup>100</sup> In that connection, it was leaked that a formal invitation had been made by the bloc to the President of the Inter-American Development Bank, Enrique Iglesias, to be the Principal Advisor to the Negotiating Group, a move that—as was to be expected—he quickly rejected as being incompatible with his duties at the IDB.

and the Government of the United States of America, signed in June 1991 between MERCOSUR and the U.S. Thus, the President *pro tempore* was given the mandate to convene the Consultative Committee on Trade and Investment, as provided in Article 1 of the Agreement, to study the possibility of initiating bilateral negotiations under the “4+1” format with a view to reaching agreements on improvement of access to the respective markets.

The Argentine government was very willing to “gamble” on the initiative. Thus, President De la Rúa himself publicly announced at the opening ceremony of the Rural Society Exposition in August that “before the end of this year, I hope to be able to report that Brazil, Uruguay, Paraguay, and Argentina are ahead of the FTAA era in reaching agreement between MERCOSUR and NAFTA on the formation of the largest free trade market in the world.” (*La Nación*, August 5, 2001).

In this context, in one of the tensest moments during the Argentine government’s negotiations with the International Monetary Fund and the U.S. for financial assistance to avoid default, the news was learned—originally from the U.S. official, John Taylor—that the agreement would include an initiative for MERCOSUR to begin conversations with the U.S. on the liberalization of trade under a “4 + 1” format.

Finally, the simultaneous announcement of the agreement between Argentina and the IMF to increase the existing stand-by loan for that country to US\$ 8 billion and Zoellick’s statement regarding his willingness to meet with his MERCOSUR colleagues to discuss trade topics in the “4 + 1” context, led to new discussions within the bloc.<sup>101</sup> However, the fact that the announcement was made at the headquarters of the Fund itself and that the Fund’s statement mentioned the trade negotiations conveyed to some players (particularly financial players) that there was a direct relationship between the two topics and/or an explicit signal from the U.S. government establishing a link between the trade negotiations and the new financing program to assist Argentina.

Uruguayan President, Jorge Batlle, did not conceal his enthusiasm at the news<sup>102</sup> and the Argentine government interpreted the tone of the announcement as a strategic success (“the bloc has achieved a fundamental milestone: the establishment of a clear consensus, supported at the broadest political level, for 4+1” and “for the first time economic growth is linked with financial assistance,” stated the Argentine Foreign Affairs Minister to the *BAE* on August 23, 2001). The Brazilian Minister of Foreign Affairs was more skeptical, stating that “if the U.S. offers MERCOSUR the possibility of gaining access to its market, the bloc must take advantage of the opportunity,” and summed up by stating that “it is not within the competence of the IMF to establish links between financial assistance to Argentina and “4 + 1” (*BAE*, August 23, 2001).

In the same vein, Brazil’s Secretary of Agriculture, Vinicius Pratini de Moraes, indicated to the Brazilian press that “if the U.S. offers MERCOSUR the opportunity to access its agricultural market and eliminate subsidies, why shouldn’t we negotiate?” although “for us, what is fundamental is the negotiations with the European Union, which consumes nearly half of our agribusiness sector exports.” (*O Estado de São Paulo*, August 24, 2001).

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<sup>101</sup> At that time, some analysts correctly pointed out that, unlike what had happened on other occasions where the push for negotiations came exclusively from MERCOSUR, this time there was also a specific indication, from a high-level U.S. official, of support for the initiative. It can thus reasonably be asserted that such statements were made in the context of U.S. interest in accelerating the process of FTAA negotiations through bilateral negotiations with countries or groups of countries in the hemisphere and that, in this specific case, the conversations with MERCOSUR would help to moderate the presumably stronger opposition to the acceleration of hemispheric integration found in Brazil (see for example, *Intelligence Trade Report*, No. 67, August 2001).

<sup>102</sup> In this connection, it should be noted that, some months earlier, Uruguay had also indicated that it intended to “speed up” its negotiations with the U.S., and had even indicated its intent to do so on a bilateral basis.

But apart from these exchanges of view, the initial contact among the parties would ultimately take place at a “working breakfast” at Punta del Este in early September—taking advantage of the visit by the U.S. Trade Representative (USTR), Robert Zoellick, during the twenty-second ministerial summit of the Cairns Group—which was the initial step toward reactivating the Trade and Investment Council established ten years earlier. The items proposed by MERCOSUR for inclusion in the Council’s future agenda were:

- Progress made with and difficulties encountered in FTAA negotiations;
- Strengthening of the Trade and Investment Council established in 1991;
- Establishment of four working groups in the areas of trade in industrial goods, trade in agricultural goods, investment development, and electronic commerce; and
- Discussions regarding the new WTO Round and the Doha Summit.

In order to push ahead with discussions of these topics, late that same month the four foreign ministers again met with Zoellick in Washington, in a high-level working meeting (one of the few trade meetings that was not suspended after the terrorist attacks two weeks earlier). Agreement was reached on the general outlines and terms of reference for the Council’s four working groups, and it was decided that the first formal meeting of the “4 + 1” coordinators would be held in December 2001.

Nonetheless, the USTR took it upon himself to lower expectations—particularly in the Argentine press—as to what might result from the future meeting, stating publicly that the MERCOSUR-U.S. negotiations would not necessarily lead to a free trade agreement in the short term, contrary to most interpretations expressed after the start of discussions was announced. Zoellick stated that the U.S. intended to profit fully from each of the various negotiating fronts in which it was involved—multilateral (WTO), regional (FTAA), and bilateral (with Chile and MERCOSUR).

However, at the official level, Argentina did not reject the notion that this meeting would act as a catalyst for other negotiation initiatives in the area of international trade, such as the FTAA. From this perspective, it maintained that direct MERCOSUR-U.S. negotiations would yield more effective results on the topics of greatest interest to Argentina and Brazil, such as the difficulties they faced in placing both their agricultural and industrial exports in the U.S. market.

In this context, in December 2001, the above-mentioned meeting of the (“4 + 1”) coordinators of the MERCOSUR-U.S. Trade and Investment Council was finally held in Montevideo. The meeting dealt with topics relating to the WTO negotiations, progress made in the FTAA process, and topics involving the working group on trade in agricultural goods.

Subsequently, in April 2002, the second meeting was held. At that meeting the bloc suggested that the agenda of agriculture and industrial goods-related topics should be expanded to include items related to the problems that certain MERCOSUR products faced in accessing the U.S. market, so that solutions to these problems could thus be sought.

Notable among the topics discussed were the FTAA agenda (negotiation methods and procedures) and the WTO agenda. MERCOSUR proposed the topic of agricultural export subsidies and the need to move ahead in the area of additional disciplines for internal agricultural support measures. In connection with this topic, the USTR’s response was that his government agreed with the inclusion of these topics, but that they should be harmonized at the WTO level. In other words, his government was not in a position to make concessions in the FTAA framework for which there was no equivalent for the major WTO players.

### **Some trade components of the “new” Argentina-U.S. bilateral agenda**

#### *(i) Establishment of the Argentina-U.S. Trade and Investment Council*

As part of Argentine diplomatic efforts to obtain international assistance to cope with its financial and economic crisis, in late January 2002 the Argentine Foreign Trade Secretary, Martín Redrado, and the Assistant USTR, Peter Allgeier, agreed to the launch of the Council.

An objective of the Council is to constitute an effective tool in seeking way to resolve existing bilateral trade problems. The principal items thus far included on the agenda are: meat, honey, citrus fruit, peanuts, quebracho extract, sanitary and phytosanitary issues, the Generalized System of Preferences, intellectual property, and steel, particular progress having been made in 2001 with the latter three items.

#### *(ii) Review of concessions in the context of the Generalized System of Preferences (GSP)*

In early 1997, as reprisal for what the U.S. saw as Argentina’s reluctance to “amend” its domestic legislation in the area of patents, and based on the provisions of Special Section 301 of the U.S. Trade Act on protection of intellectual property rights, the USTR unilaterally withdrew 50% of the positions (117 in total) of those from which Argentina benefited under the Generalized System of Preferences (GSP) in its access to the U.S. market.

Subsequently, in view of some changes adopted by the Argentine Congress in this area, Argentina began to seek to reestablish the eligibility of some products affected by the withdrawal of preferences. Nonetheless, USTR authorities never formally considered such demands for waivers and the redesignation of products.

In February 2002, in the context of the recent establishment of the U.S.-Argentina bilateral Trade and Investment Council, and in order to open up a channel that would allow for increased trade flows between the two countries, Argentina assigned special priority to obtaining trade support from the U.S. through—among other instruments—the GSP.

Accordingly, after different efforts made by Argentine officials, in April 2002 the USTR agreed to consider Argentina’s requests regarding the designation and redesignation of its products.

Thus, when, in August, the new GSP was adopted and renewed by the U.S. Congress—with retroactive effect to September 2001, to expire in December 2006—President Bush announced the opening of a Special Review (5-month) process to evaluate requests for product designation made by Argentina, Turkey, and the Philippines.

In the case of Argentina, 14 products were considered, including certain types of cheese, caramelized condensed milk, various peanut items, grape juice and must, calcium, silicon, and ball bearings. Thus, in early September, an Executive Order redesignated 57 products for which Argentina had submitted requests in 2001, including three products suspended in 1997 owing to the aforementioned intellectual property rights issue.

With respect to the work of the “4 + 1” technical groups, the following meetings were held:

- (i) Working group on MERCOSUR-U.S. trade in agricultural goods (Washington, October 2001 and Buenos Aires, May 2002): topics of common interest were discussed in the areas of agriculture, sanitary measures, and specific market access problems (basically meat, dairy products, and fruit), and information was exchanged on the participants' positions in international agricultural forums. At that forum, the MERCOSUR countries indicated their concerns regarding the distorsionary effects of the Farm Bill that, at the time of the second meeting, had just been enacted by the U.S.
- (ii) Working group on MERCOSUR-U.S. electronic commerce (Buenos Aires, March 2002): a presentation was given on opportunities created by the use of this tool for SMEs.
- (iii) Working group on trade in industrial products: meetings were held in June (Washington) and October (Geneva) 2002, with an agenda focusing on technical barriers to trade and business facilitation. In addition, MERCOSUR indicated its concern regarding certain anti-terrorist protection provisions affecting trade.

As of late 2002, the working group on investments had not yet held its initial meeting.

In the latter half of 2002, the Brazilian Chair showed less interest in promoting the Council as a means of resolving certain trade issues. Although it was agreed that a third meeting of the committee of "4 + 1" coordinators would be held in October (prior to the FTAA Ministerial Meeting in Quito), ultimately this meeting did not take place owing to difficulties regarding the agenda. From that point on, progress with the mechanism stagnated.

#### **Approval of the 2002 Farm Bill (Farm Security and Rural Investment Act)**

In March 2002, the U.S. Congress passed the new 2002 Farm Bill (*Farm Security and Rural Investment Act*), replacing the 1996 law that was to expire in September 2002. The new law, to remain in force for six years, represents an increase in face value of US\$ 45 billion (an increase of 80%) over the levels of support contained in the earlier law. The increased amounts are intended primarily for producers of traditional commodities (wheat, corn, soy, cotton, and peanuts), who will receive US\$ 31.2 billion more than under the previous scheme.

Some of the principal changes in comparison with the earlier law are:

- Re-establishment of target prices (a unit value set by Congress to support farmers' income);
- Reduction of the support price for soy in order to bring it into line with the price of corn and thus offset the greater relative incentive that existed for planting soy;
- An increase of US\$ 9 billion to fund conservation programs;
- Establishment of a system to provide payments to oilseed producers equal to those earned through production contracts;
- Establishment of a national support program of some US\$ 1.3 billion for the dairy sector;
- Introduction of changes to the operation of the peanut program through a support system similar to those for the other products and compensation for producers with quotas, at an estimated cost of US\$ 4 billion;

- Re-establishment of support programs for honey and wool;
- Implementation of new programs to support apples and leguminous plants; and
- The imposition of country of origin labeling requirements for meat, fruit, vegetables, and fish products (initially voluntary and becoming mandatory within two years).

In addition, the bill maintains all the resource transfer elements contained in the 1996 law, such as:

- Flexible production contracts, i.e., those not associated with production; and
- Support prices and marketing loans at levels similar to those provided for in the 1996 law.

Products such as legumes, rice, cotton, honey, sugar, milk, peanuts, fruit, and vegetables will see increased minimum prices. At the same time, legumes have been added to the products subsidized by the U.S.—grain and oilseed.

In this context, the Cairns Group quickly issued a press release repudiating the initiative of May 15, 2002. For its part, the MERCOSUR Federation of Rural Associations, in a statement made in May 2002, asked the authorities of the four countries to make the continuation of negotiations on the FTAA subject to a review of US agricultural policy and to denounce this series of measures with the WTO.

### **C. A story (as yet) without end: The “4 + 4” negotiation between MERCOSUR and CAN**

The Framework Agreement for the establishment of a free trade area between MERCOSUR and the member countries of the Andean Community of Nations was signed in Buenos Aires on April 16, 1998.

That agreement provided for two phases of negotiations: whereas the first phase would focus on multilateralizing the bilateral agreements in force in the LAIA framework, the purpose of the second phase would be to incorporate the rest of the tariff universe in the agreement, a task for which it would be necessary to define tariff reduction schedules to establish the free trade area under the “4 + 4” format.

After extensive negotiations failed to conclude the first phase satisfactorily, first Brazil (April 1999) and then Argentina (a few months later) signed fixed preference agreements under the “4 + 1” format, the idea being that these agreements would be used as the basis for entering the second phase of negotiations in which progress could be made toward an agreement under the “4 + 1” format within a reasonable period.<sup>103</sup>

It should be noted that in the context of the new agreements, over 90% of Andean exports to Argentina and Brazil received preferential tariff treatment, while only 50% of exports from the two largest MERCOSUR partners to the CAN countries received equivalent treatment.

At the same time, in the context of the 2000 Relaunch Agenda, the Ministers of the MERCOSUR countries resolved at mid-year to reactivate negotiations for a joint agreement with the CAN countries to replace the bilateral agreements in force, their goal being to conclude the agreement before December

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<sup>103</sup> Paraguay and Uruguay, for their part, retained their respective bilateral agreements.

2001, at the same time setting June 2003 as the expiration date for the bilateral preferences that might be in effect at the time.

In this context, in early April 2001, during an official visit to Brazil and after meeting with Fernando H. Cardoso, President Chávez issued a public statement indicating his interest in “Venezuela becoming associated with the Southern Common Market before the end of the year, as negotiations between MERCOSUR and CAN are moving ahead at an astonishingly slow pace.” (*La Nación* and *Clarín*, April 4, 2001). A few weeks later, the Venezuelan President sent a personal letter to President De La Rúa indicating his “decision to initiate preliminary negotiations for formal admission to the Southern Common Market.”

This statement led to a series of technical consultations at the MERCOSUR level regarding Venezuela’s status if included in the bloc (whether as a full partner with rights and obligations equal to the other States Parties, or as an Associate Member in a scheme similar to that in effect for Bolivia). In any event, the growing complexity of the bloc’s and the region’s political agenda as of the latter half of 2001 helped to relegate this initiative quickly to second tier.

Subsequently, at the sixth negotiation meeting held in Lima in late November 2001, it was agreed that prior to February 1, 2002 the parties would exchange their respective lists of sensitive products, specifying the periods, schedules, and calendars for tariff reduction proposed in each case. These periods were subsequently extended owing to the political crisis in Argentina in late 2001 and early 2002.

#### **A fresh “relaunch” of the Andean Community of Nations**

The Presidential Summit of the member countries of the Andean Community of Nations (CAN) was held in Bolivia on January 30, 2002. As a result of that meeting, a 32-point agreement was signed, the stated purpose being to move towards a subregional free trade area and reaffirm the strategic objective of building a common market in the future.

The principal commitments made by the parties included agreements not to impose new restrictions on intrasubregional trade; and to review the subregional origin regime within 60 days; harmonize sanitary and phytosanitary requirements; implement measures to facilitate intrasubregional customs procedures; liberalize trade in agricultural goods as of December 2005; apply the Common External Tariff as of December 2003 (with 0%, 5%, 10%, and 20% levels); equalize export incentives and special trade regimes; harmonize macroeconomic policies and establish criteria for macroeconomic convergence within a period of two years; apply the special safeguard system against competitive devaluations in the member countries; continue efforts to achieve a renewal and expansion of the Andean Trade Preference Act (ATPA) by the U.S.; and reaffirm the need to maintain a common strategy in the context of the FTAA.

The agreement achieved is of the highest importance for the entire subregion, given the “virtual” nature characteristic of CAN for many years. CAN is probably the subregional group with the most complete community legislation, perhaps comparable only to that of the EU but, nonetheless, with virtually no record of compliance with that legislation. <sup>a</sup>

Subsequently, in mid-October 2002, the Ministers of CAN meeting in Lima agreed on a common external tariff for 62% of the subregional tariff universe (4,170 positions), to take effect in January 2004, the immediate objective being to present it in the framework of the hemispheric negotiations on the



dates committed to therein. Although in December the other 38% (essentially grain, oilseed, machinery, equipment, chemicals, textiles, and plastics) remained pending definition, the high level that was imposed—at the request of Colombia—for some agricultural inputs and goods, together with retention of a large portion of the price band system, led to tough questions from some of the subregion's economic and industrial sectors, particularly in Peru.

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<sup>a</sup> *Intelligence Trade Report*, No. 60, Buenos Aires, January 2002.

Thus, at the Fifth Meeting (finally held in Buenos Aires in May 2002), CAN provided information supplementing information it had already submitted in due course regarding the trade liberalization program, including:

- Sensitive products, including the tariff reduction periods proposed by each of the Andean countries.
- Proposed schedules for sensitive products from CAN, Paraguay, and Uruguay. For each of the periods (15- and 20-year), three tariff reduction schedules with different initial preference margins were included.
- Treatment of historic heritage: CAN, presented a list of Ecuador's historic heritage products with Paraguay and Uruguay for which it would review the concessions granted, and, presented a list of Peru's historic heritage products with Uruguay, for which it would review the concessions granted.

In addition, CAN indicated that the historic heritage products included on the list of sensitive products would be accorded two different treatments within the periods defined: (i) historic heritage products would be frozen until the corresponding tariff reduction schedule reached them, or (ii) a new schedule would be defined with an initial preference margin equal to that for historic heritage products, observing the final period for tariff reduction defined for the list of sensitive products.

As for the general tariff reduction schedule, CAN agreed that the tariff reduction periods would be eight years for Argentina and Brazil, and 10 years for CAN, Paraguay, and Uruguay, except for products on the sensitive products, historic heritage, and immediate tariff reduction lists.

For its part, MERCOSUR indicated that the maximum period for tariff reduction on sensitive products could not be extended to exceed fifteen years, that the acceptable difference for the tariff reduction period for the historic heritage of Argentina and Brazil vis-à-vis that of CAN, Paraguay, and Uruguay could not exceed two years, that with respect to historic heritage, no backward movement in terms of preference would be accepted, and that the Andean Price Band System should be subject to negotiation with a view to eliminating it in biregional trade. It was also indicated that it would not be acceptable to include special safeguards for the agricultural sector.<sup>104</sup>

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<sup>104</sup> It can generally be stated that while Argentina and Brazil have common interests and a common view regarding the approach to be taken in negotiations, Uruguay is very interested in preserving its historic heritage, its main concern being to obtain preferences on products currently affected by the price bands applied by the Andean countries. Paraguay's position is focused on obtaining special preferences based on its status within LAIA as a relatively less developed country. For their part, the Andean countries do not have a common position. The preservation of preferences in the intra-Andean market vis-à-vis the two large MERCOSUR members is generating concerns among officials and business leaders in Colombia and Venezuela. For its part, Peru maintains an extremely rigid position with respect to maintaining the price band system, while Ecuador is concerned about retaining the preferences received in the historic heritage framework.

Successive working meetings in general studied drafts of the agreement, the origin regime, safeguards, and sanitary and technical provisions. Other than the efforts made by the parties, no consensus has yet been reached on any of the topics. In particular, in the area of safeguards, the CAN countries are proposing making a distinction between a general regime and a regime applicable to the agricultural sector, a proposal unacceptable to MERCOSUR.

Within MERCOSUR, the priority item of negotiations involves the Trade Liberalization Program (which in the case of the CAN countries, Paraguay, and Uruguay could be extended up to 15 years), which would make it possible to define the framework for the treatment of products that would constitute the topic of the agreement and the scope of the provisions necessary to establish the appropriate legal and institutional framework.

In that connection, MERCOSUR's immediate objective was to define a general schedule that included differential periods and margins for Argentina and Brazil, on the one hand, and Paraguay, Uruguay, Colombia, Ecuador, Peru, and Venezuela on the other; an accelerated bilateral schedule for historic heritage; an immediate tariff reduction schedule for "normal" products, and another schedule for sensitive sectors and products. Similarly, the objective was for sensitivities to affect only a minimum percentage of trade in historic products, with the tariff reduction schedule for historic heritage taking precedence over the schedules defined for sensitive products and the liberalization schedule for the remaining products.

To summarize, the principal points of divergence between the two blocs now focus on the following topics:

- Periods and rates of tariff reduction for sensitive products;
- Agricultural topics: products declared sensitive, application of Andean Price Band and Agricultural Safeguards Regime;
- Rules of origin and dispute settlement;
- Special treatment in addressing existing asymmetries in respect of some of the countries, particularly Ecuador and Paraguay;
- Unwillingness on the part of the CAN countries to set a deadline for consolidation of the expanded free trade area, in view of the number of products that they will seek to include on the list of sensitive products, particularly in the agro-food sector (where it is proposed to retain products or sectors outside the liberalization schedule);
- Regarding the previous point, the Andean Community is seeking to maintain its price band systems in force and not to apply such tariff preferences as may possibly be decided in connection with the variable duties arising from them.<sup>105</sup>

In any event, by late 2002, seven negotiation rounds had been held between MERCOSUR and CAN (four in 2001). The first was held on April 27, 2001 in Asuncion and the last in Rio de Janeiro in late November 2002, with no discernible sign that a definitive agreement would be reached among the parties.

As the bilateral agreements lapsed in late 2001, they were successively extended (in principle, until mid-2002, and again extended until the end of that year). However, in view of the difficulties encountered in moving ahead under the "4 + 4" format, at the recent meeting in Rio de Janeiro, the CAN delegation

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<sup>105</sup> It should be noted that, on earlier occasions, inflexibility in the handling of these items ultimately shut down the negotiations under the "4 + 4" format.

suggested the possibility of indefinitely extending the current understandings (ECA 39 for Brazil-CAN and ECA 48 for Argentina-CAN) until negotiations under the 4+4 format had been concluded.

However, MERCOSUR felt that it was advisable to extend the current agreements only until June 30, 2003, in order to avoid an indefinite delay of negotiations. In that connection, it should be recalled that, in keeping with the deadlines established in Common Market Council Decision 32/00, negotiations were to be concluded by December 31, 2001.<sup>106</sup> Obviously, this deadline has been extended, although the provision in that Decision indicating that, if the negotiations under the MERCOSUR format were not concluded, the current bilateral preferences “may only be retained until June 30, 2003” did remain in effect.<sup>107</sup>

At the last meeting of the two blocs, held in Rio de Janeiro (November 21-22, 2002), the Brazilian delegation proposed—as a way to unblock the negotiations—that if a “4 + 4” agreement were not reached by June 30, 2003, that an “umbrella” agreement be signed to allow negotiations to continue independently, depending on each country’s effective intent to negotiate (that is, a more flexible format would be accepted, which would not necessarily be “4 + 4”).

For their part, the existing “4 + 1” agreements (which expired in late 2002) were extended until December 2003, as a way to allow time for the final step in the negotiations, while an initial meeting was held between MERCOSUR and Peru in December 2002.

Lastly, at the MERCOSUR Presidential Summit held in Brasilia in early December 2002, the Framework Agreement with the Andean Community of Nations was signed (Decision 31/02). It replaced the goal of moving toward a free trade area between the blocs as stipulated in the original 1998 Framework Agreement with the—more realistic, but less ambitious—idea of forming a free trade area “based on the convergence of the trade liberalization programs that will be negotiated by the contracting or signatory parties,” which in diplomatic language creates the option of some CAN countries negotiating to accede individually in MERCOSUR.

In any event, it was also resolved that all existing partial scope agreements would be extended until the end of 2003.

#### **D. Despite difficulties and uncertainties, the FTAA remains on course**

In the 18 months from mid-2001 until end 2002, FTAA negotiations proceeded in keeping with the objectives and timetable adopted at the previous hemispheric Ministerial Meeting (Buenos Aires, April 2001). In consequence, consensus was reached on a second draft of the agreement, methods and procedures were approved for negotiations on market access—agricultural goods, industrial goods, services, investment, and government procurement—and objectives and periods were defined for the final phase of negotiations chaired jointly by Brazil and the U.S.

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<sup>106</sup> CMC Decision 32/00 reaffirmed the commitment of the States Parties to negotiate jointly trade agreements with third countries or groups of extrasubregional countries in which tariff preferences were granted. In addition, that Decision contains a commitment not to, after June 30, 2001, enter into new preference agreements or agree to new trade preferences in agreements in effect in the LAIA framework that had not been negotiated by MERCOSUR. The provision thus established that preferences based on bilateral agreements in effect in the LAIA framework could only be maintained until June 30, 2003. The States Parties were thus prevented from individually entering into new bilateral trade negotiations with third countries or groups or countries, it being possible only to develop such agreements jointly as MERCOSUR.

<sup>107</sup> Nonetheless, the bilateral agreements in effect with the Andean countries have been extended from the end of 2002 until the end of 2003, in contravention of the provisions of the aforementioned Decision 32/00.

With respect to the general results of the negotiations, some of the major agreements reached in this period were:<sup>108</sup>

- Adoption of a timetable of negotiations for market access, committing the participating countries to present their initial offer lists by February 15, 2003.<sup>109</sup>
- Inclusion of the topic of agriculture in the Ministerial Declaration of Quito, providing for comprehensive and non-discriminatory treatment of agriculture in the FTAA negotiations.
- Inclusion of the topic of trade protection in the Ministerial Declaration of Quito, reaffirming the goal—already stipulated in the Declaration of Buenos Aires—of achieving a mutual understanding in the FTAA that would make it possible to improve WTO provisions and disciplines in respect of the operation and application of antidumping legislation and legislation on countervailing duties.<sup>110</sup>
- Ratification of the principle of equilibrium and balance as the goal of FTAA negotiations, not only in respect of the final results of the negotiations but also in the negotiating process itself.

#### *The status of negotiations on market access*

In the course of the four TNC [Trade Negotiations Committee] meetings held in the period under study (Managua, September 2001; Isla de Margarita, April 2002; Panama, May 2002; and Santo Domingo, late August 2002), the countries of the hemisphere agreed on the following guidelines and work procedures:

- (i) Launch in May 2002 of negotiations on market access in the five negotiating groups with direct competence in this area: market access, agriculture, services, investment, and government procurement.
- (ii) The entire tariff universe would be subject to negotiation, with provision made for a four-phase tariff reduction schedule: immediate tariff reduction; tariff reduction within no more than five years; tariff reduction within no more than ten years; and tariff reduction over periods longer than ten years. The first immediate tariff reduction group should provide a “significant” offer of products from the parties, while tariff reduction over periods of more than ten years should be on an exceptional basis and for a very limited list of products.
- (iii) The methods to be used in the area of market access and agriculture were broadly established, covering not only tariffs but also non-tariff measures, rules of origin, the treatment of agricultural export subsidies, and other measures of equivalent effect that distort trade within the region.
- (iv) The base tariff would be the MFN tariff applied as of the date of notification, to occur between August 15 and October 15, 2002. Nonetheless, provision was made for three exceptions to this general rule:

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<sup>108</sup> It is timely here to note that this occurred in early November 2002, in the context of the Trade Promotion Authority (TPA) “newly obtained” by the Bush administration, and the start of the phase in which the Trade Negotiations Committee would be chaired jointly by two of the major players in the process: Brazil and the U.S.

<sup>109</sup> Nonetheless, shortly after taking tenure, the new Brazilian foreign ministry officials indicated that they would seek to extend the deadlines stipulated in due course for submitting the offer lists in the context of the hemispheric negotiations. In that connection, the new Minister of Foreign Affairs, Celso Amorim, indicated to the visiting Robert Zoellick the need for “more time for discussions with Congress and the business community, and to study in detail the proposal prepared by officials in the previous administration ” (*Cronista*, January 7, 2002).

<sup>110</sup> The delegations from MERCOSUR and Chile were the main promoters of inclusion of this paragraph in the Declaration, in opposition to the position of the U.S., which was very reluctant to include commitments in the agreement that might require some type of change to its domestic legislation.

- CARICOM was authorized to notify its base tariff up to December 14, 2002 and, for a limited list of products, could include its tariff agreed with the World Trade Organization (WTO).
- Subregional groups with a CET—as in the MERCOSUR case—would notify this tariff for purposes of the base tariff, even if some countries were utilizing temporary exceptions to the CET. However, the possibility of adjusting it was maintained until April 15, 2003, when it would be notified for purposes of the base tariff.
- For groups of countries that are developing a common external tariff—as in the Andean Community case—the base tariff would be taken as the tariff in effect as of January 1, 2004, which would be equal to the one notified as of April 15, 2003. The latter would include adjustments to the base tariff initially notified.

### **Notification of the MERCOSUR base tariff**

Despite significant differences within the bloc, the partner countries were finally able to establish the MERCOSUR base tariff for these negotiations, which was notified to the General Secretariat in mid-October 2002, on an indicative basis. For 65% of the positions, this notified base tariff reflected the MERCOSUR Common External Tariff currently in effect.

The remaining 35%, including *inter alia* some information technology and telecommunication goods (346 positions); some capital goods (920); some automotive regime goods (165); some agricultural products (62); some products in Chapter 28—inorganic chemicals, Chapter 29—organic chemicals, and Chapter 30—pharmaceutical products (727); chemical industry products (50); textiles (679); and footwear (20), was prepared in keeping with common criteria agreed in due course by the four countries.

In that connection, at the CMG meeting held in late November 2002, it was agreed that each of the States Parties should send the Brazilian Chair its proposed offer regarding access to industrial, agricultural, services, government procurement, and investment markets by December 16, 2002. The Chair would be responsible for consolidating the submissions by January 6, 2003, and forwarding them to the Paraguayan Chair, with a view to their discussion at the four-country level at a specific meeting to be held in late January 2003,<sup>a</sup> to arrive at a definitive decision in this area at the final meeting in mid-March.

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<sup>a</sup> See note 14.

- (v) In the non-tariff area, November 15, 2002 was set as the date for submission of an initial report prepared on the basis of the process of notification and counter-notification of non-tariff measures in effect among the countries. In addition, the Negotiating Group was instructed to develop a method for eliminating, reducing, redefining, reordering and/or preventing non-tariff measures, to be completed by February 15, 2003.
- (vi) The initial offers in the area of services and investments were to be broad and consistent with laws and regulations in force in the countries, it being immaterial whether proposals on trade presence—third service supply mode—were presented in one or the other group, or in both. In this context, and for purposes of achieving uniform treatment of this topic, provision was made for the possibility of joint meetings of negotiators from the two groups.

- (vii) One country's access to the offers made by the other countries would only be effective once it had submitted its own offer. It was also established that tariff liberalization should be linear, with allowance for some exceptions.
- (viii) Finally and with respect to negotiations in the area of government procurement, broad coverage was envisaged, in terms of presentation of offers that met the requirement of including central or federal level government agencies, while also allowing for the inclusion of agencies included in other categories of government.

**Declaration of the Members of the FTAA Trade Negotiation Committee  
regarding the terrorist attacks of September 11, 2001**

“The Vice-Ministers responsible for Trade in the 34 FTAA countries, meeting in Managua, Nicaragua, on the occasion of the IX Meeting of the Trade Negotiations Committee of the Free Trade Area of the America (FTAA), strongly repudiate the terrorist acts perpetrated on September 11, 2001, against the United States of America in New York, Washington, D.C., and Pennsylvania. This act resulted in great loss of human life and material damage, which has left the international community of nations deeply appalled.

They underscore that these terrorist acts undermine the very foundation of civilized coexistence among nations and seriously upset international peace and security. They vigorously and categorically condemn terrorism in all its forms, regardless of the political, ideological, ethnic, religious or other motivations.

They reaffirm their commitment to the FTAA process and to completing the schedule of meetings established in April 2001 by the FTAA Ministers Responsible for Trade, in Buenos Aires, Argentina.

They reiterate that these events will not disrupt the economic agenda and trade integration within the [Western] Hemisphere, as they are the foundation for the economic and social development of the Americas.”

*Other pertinent definitions from the Quito Summit*

Although the Quito Summit did not yield any results other than those anticipated, the very fact that it ended with a consensus declaration, plus the attainment of the objectives set for the “politically hectic” phase since the Buenos Aires meeting, were not a negligible basis for the launch of the substantive negotiations scheduled for 2003, particularly if account is taken of the complex political and economic situation in some Latin American countries. In this regard, the Declaration referred to the progress made in this phase “despite the deterioration in current global and hemispheric economic conditions and the heightened international tensions in the political and social arenas that have been evidenced in recent times.”<sup>111</sup>

The Declaration also confirmed that “the result of the FTAA negotiations shall constitute a comprehensive single undertaking that incorporates the rights and obligations that are mutually agreed for all member countries” (...) and the importance of “making continuous, balanced, and substantial progress in all subject

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<sup>111</sup> Point three of the Ministerial Declaration.

areas under negotiation.”<sup>112</sup> This issue is not a minor detail not only because it confirms, once again, the principle of a single undertaking, but also because it warns—as the MERCOSUR countries had suggested—about the imbalances effectively seen in the level of progress made by the different negotiating groups.

In that connection, to the extent that this phenomenon is not favorably resolved—particularly in the groups directly involved with tariff reduction—there was increased risk that, at the end of the process, the overall balance of partial concessions granted and obtained by the countries with less negotiating power would be perceived as negative, whether they in fact were. In other words, consolidation of imbalance in the progress made on the different topics for negotiation could ultimately destroy (or at least erode) in practice the single undertaking principle.<sup>113</sup>

### **Approval of Trade Promotion Authority (TPA)**

On August 6, 2002, President George W. Bush signed Public Law 107-210, an omnibus bill, which includes as one of its components the Trade Promotion Authority that enables the Executive Branch to negotiate trade agreements, which Congress approves or rejects without being authorized to make any amendment. This Authority is valid for all agreements signed until June 1, 2005, or until June 1, 2007 if an extension is sought, accompanied by a report from the President indicating that the law’s objectives have been attained.

The legislation enacted does not cover the TPA alone, but also foreign trade-related different topics such as the extension and renewal of the Andean Trade Preferences Act (ATPA), the Caribbean Basin Initiative (CBI), and the African Growth and Opportunity Act (AGOA)—all of which are agreements under which the U.S. grants unilateral preferences and benefits to the countries of those regions, primarily in the textile sector—, and renewal of the Generalized System of Preferences.

The law is also the result of an arduous congressional negotiating process, including initial approval in the House of Representatives in December 2001, initial approval in the Senate in May 2002, and the text of a bill developed in bicameral conference, which was passed by the House in July 2002—by a vote of 215 to 212—and finally by the Senate in August 2002.

Enactment of the law was made possible by—among other things—the inclusion of a subsidy fund of over US\$ 10 billion over 10 years to compensate workers who lost their jobs for reasons related to international trade. In addition, negotiations between the Executive Branch and Congress resulted in the inclusion of provisions designed to increase Congressional participation in the negotiating process and to limit the authority of negotiators in the areas of trade protection, intellectual property, and dispute settlement.

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<sup>112</sup> Point 5 of the Ministerial Declaration.

<sup>113</sup> *Intelligence Trade Report*, No. 70, November 2002.

Congressional participation will be effected through the Congressional Oversight Group, comprising five permanent members from the Senate and an equal number of Representatives from the Ways and Means Committee. There will be alternating participation in discussions on topics within the areas of their competence by other Senators and Representatives and members of other committees with competence in the areas to be discussed at each negotiating session.

In addition, the law specifies particular areas of negotiation—such as agriculture, textiles, fishing industry, unfair trade practices legislation, and labor standards—in which there are special mechanisms for consultation with the Congress. In such areas, the President must be advised by the International Trade Commission, which must submit to the Congress a detailed report, before any agreement is signed, on current conditions regarding each of the issues in each country involved, along with a report on the effects that enactment of the agreement in question would have on the U.S. economy. Of particular note is the fact that in the case of unfair trade practice legislation, the report must discuss the changes to these laws that might result from enactment of an agreement.

To summarize very briefly the implications for hemispheric negotiations, it can be said that the bill that was passed:

- (i) Does not contain any sectors or products that are excluded, *a priori*, from the negotiating table.<sup>a</sup>
- (ii) Does not provide for the imposition of trade sanctions for alleged failure to comply, in U.S. partner countries, with labor standards contained in trade agreements.
- (iii) Does not obstruct negotiations for trade protection measures, although it establishes limitations on the activity of negotiators.<sup>b</sup>
- (iv) Does not provide for Congressional review of trade agreements.
- (v) Reaffirms the commitment to conclude the World Trade Organization multilateral round by January 2005, and to seek, in multilateral, regional and bilateral negotiations, the broadest possible market access.
- (vi) Promotes support of the Doha Declaration on the TRIPS Agreement and Public Health. However, it is highly restrictive in the area of intellectual property in that it establishes that trade agreements must reflect a protection status similar to that provided for under U.S. law, with protection standards that are significantly higher than those provided in the multilateral framework.
- (vii) Makes such specific concessions as negotiators may make to some extent contingent upon Congressional approval. Thus, any concessions on agricultural, textile, and clothing items and on unfair competition legislation must be the subject of specific consultation with Congress. On the latter point, particularly noteworthy is the intention of the U.S. to impose (at least *a priori*) the provisions of its domestic legislation in trade agreements to be negotiated.



(viii) In the case of negotiations pertaining to agriculture, it is established that the President cannot reduce the tariff on agricultural products to more than 50% below that agreed to in the Uruguay Round and that, in order to initiate negotiations in this sector, the President must first consult Congress as to whether it is appropriate for the U.S. to agree to a tariff reduction.

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<sup>a</sup> It should be noted here that in the case of the fast track bills under the Clinton administration, negotiations included side-letters or partial concessions that withdrew some agricultural products from the negotiations: peanuts, tobacco, wine, citrus fruit, and others.

<sup>b</sup> Nonetheless, the law establishes that negotiated trade agreements must avoid decreasing the effectiveness of national and international disciplines in this area and correct “distortions of market operation that lead to dumping and the use of subsidies.”

The document approved in Quito reaffirms the member countries’ commitment to meet the deadlines adopted by the WTO at Doha (completion of the Round in January 2005), reaffirms the “integral and non-discriminatory treatment” of agriculture within the FTAA, and reaffirms “the hemispheric commitment to the elimination of export subsidies affecting trade in agricultural products in the Hemisphere and to development of disciplines to be adopted for the treatment of all the other practices that distort trade in agricultural products (...) and to make substantive progress in the market access negotiations.” Accordingly, the recognition that the topic of agriculture must be approached as a whole in hemispheric negotiations—and not be reduced to the topics of market access and export subsidies—can be seen as a victory for the position of the MERCOSUR countries.

In any event, the Declaration “warns” the countries of the hemisphere most concerned with the topic of agriculture that, in the FTAA framework, it will be impossible to achieve in-depth solutions to the problem of subsidies: “we must also take into account the practices by third countries that distort world trade in agricultural products. We ... recognize that our respective evaluation by country or group of countries, of the results in the market access negotiations in agriculture in the FTAA will depend on the progress we can reach in other subjects that are part of the agriculture agenda.”<sup>114/115</sup>

The Declaration also includes two important elements in respect of the “old topic” of recognition of differences in the size and level of development of the FTAA economies. Different passages in the document refer to the topic, reflecting more firm and definite proposals from the small economies in recent months, particularly the “combative” posture adopted by the CARICOM countries at the TNC meetings in Panama and Santo Domingo. In view of this, the said commitment was explicitly incorporated, and the guidelines accepted approved by the TNC as “one of the general principles of the methods and modalities for the negotiations in the areas of market access, agriculture, investment, services, and government procurement.” These guidelines include:

- A flexible framework for considering the needs and characteristics of FTAA member countries;

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<sup>114</sup> Point 15 of the Ministerial Declaration.

<sup>115</sup> It is interesting to note in this connection that, in the same period, organizations representing the U.S. private sector issued a statement identifying as sensitive sectors a sizeable number of agricultural products (notably including apple sauce, canned pears, chilled and dried apricots, fresh tomatoes, orange juice, dairy products, sugar, honey, flour, and vegetables, and other products), arguing that there was unfair competition in the Latin American countries owing to lack of regulation on labor, sanitary, environmental, and health standards.

- Transparent, simple, and easily-applied measures, acknowledging the heterogeneity of the hemisphere's economies;
- Determination of measures in each Negotiating Group or, in the case of "cross-cutting" topics, in the TNC;
- Possible determination of measures on a case-by-case basis, including treatment by sectors, countries, and topics;
- Possible inclusion of transitional measures supported by technical cooperation programs;
- Consideration of the market access conditions in effect in the countries of the hemisphere; and
- Lastly, consideration of longer deadlines for meeting obligations arising out of the Agreement.

In addition, a Hemispheric Cooperation Program (HCP) was approved, whose purpose is "to strengthen the capacities of those countries seeking assistance to participate in the negotiations, implement their trade commitments, and address the challenges and maximize the benefits of hemispheric integration, including productive capacity and competitiveness in the region."<sup>116</sup> The launch of this program unquestionably was a response to long-standing calls for technical assistance expressed by the representatives of the smaller economies, which up to that point had not been adequately addressed.

Finally, on a "formal" level, the new officers were nominated for the TNC, the negotiating groups, and other FTAA bodies, and three meetings of the TNC were convened, to be held prior to the upcoming Ministerial Meeting (to be held in the cities of Port-of-Spain, San Salvador, and Puebla) and two Ministerial Meetings were convened (for last quarter 2003 in Miami, U.S., and in 2004 in Brazil). In addition, Puebla, Mexico was confirmed as the new headquarters for the Administrative Secretariat for the final phase of the negotiations.

Other important issues involve the labor and environmental clauses, both of which had been very controversial topics at the earlier Ministerial Meeting in Buenos Aires—when the U.S., Canada, and Chile headed up the position most inclined to establish a link between these issues and hemispheric trade. As regards the first, the need was reiterated to ensure the observance and promotion of basic internationally recognized labor provisions, and the International Labour Organization (ILO) was recognized as the body with competence in this area. As for environmental issues, the general objective of mutual support for environmental policies and trade liberalization was reaffirmed and the use rejected of environmental and labor provisions for protectionist purposes, repeating the assertion that many Ministers<sup>117</sup> recognized that environmental and labor issues should not be utilized to impose conditions nor should they be subject to disciplines so that, in cases of non-compliance, trade restrictions or sanctions might ensue.

Other highly important issues involved agricultural subsidies and negotiation methods based on the submission of the countries' offer lists. As for the first point, discussions prior to the Ministerial Meeting revolved around the controversy generated by the two divergent positions. On the one hand, the U.S. suggested dividing the handling of the agricultural negotiations into two fronts: the hemispheric front and the WTO front. MERCOSUR took an opposing position, which held firm on retaining on the hemispheric agenda the commitment to negotiate the dismantling of agriculturally export subsidies and measures of equivalent effect. The issue was ultimately resolved in favor of the MERCOSUR position, as the document

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<sup>116</sup> Point 18 of the Ministerial Declaration.

<sup>117</sup> The reference to "many Ministers" instead of "the Ministers" clearly suggests the lack of consensus on this subject, particularly indicating dissent on the part of the U.S. and Canada.

expresses the recognition that “in a global market, we must have significant results in the negotiations on agriculture, in both the FTAA and the WTO.”

As regards procedures, the Most Favored Nation (effective MFN) criterion was finally approved as the base tariff for formulating tariff reduction offers. This point is particularly important because in the weeks prior to the Quito Meeting, there had been renewed discussion about the possibility of adopting the consolidated WTO tariff as a concession to the small economies.

#### **E. MERCOSUR-EU: Progress or “flight forward”?**

Since their launch in mid-1999, trade negotiations between the two blocs had been conducted in the framework of the Bi-regional Negotiations Committee (BNC). Since that time, work has been conducted in three working groups: WG1 (tariffs and non-tariff topics; agriculture; technical standards; rules of origin; customs issues, trade protection instruments); WG2 (services, intellectual property, and investment and capital movements); and WG3 (government procurement, competition policy, and dispute settlement). The BNC has met eight times, first in April 2000, and most recently in Brasilia in November 2002.

The BNC meeting held in Montevideo in July 2001<sup>118</sup> marked an important turning point in the discussions sustained up to that time. Thus, while progress was made in developing draft agreements on various chapters on the agenda, the EU formally submitted its tariff offer for liberalization of trade in goods, services, and government procurement. As a general principle, it was also agreed to include the entire tariff universe in negotiations, taking a reference tariff as the basis for negotiating the tariff reduction and a “base tariff” for applying the reduction percentages when tariff reduction actually began to take effect.

Nonetheless, serious differences remained regarding the key issues in the negotiations. While the MERCOSUR position was that tariff reduction should use the equivalent *ad valorem* tariff as a reference, regardless of the form that tariff took in each of the structures, the EU view was that only the *ad valorem* rates should be used, unless otherwise specified. Similarly, the conditions of the offer made by the EU mentioned that the reduction percentages would refer to the nominal tariffs taken as reference, “unless they contravene the entry prices, in which case the specific tariffs in effect for these circumstances shall apply.”

For its part, these arguments aside, MERCOSUR, after overcoming some internal difficulties,<sup>119</sup> submitted its offer at the next BNC meeting, held in Brussels, in October 2001.<sup>120</sup>

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<sup>118</sup> It is important to bear in mind that this meeting occurred only a few months after the Summit of the Americas in Quebec confirmed the timetables proposed for the FTAA negotiations and President Bush took up his domestic political offensive to obtain Congressional authorization to negotiate trade agreements with third countries or blocs. In this context, it was no accident that the EU would seek to give new impetus both to the negotiations with MERCOSUR and the negotiations it was conducting at the same time—and would manage to conclude—with Chile.

<sup>119</sup> It should be pointed out in this regard that during the process of consultation with the private sector in Argentina in the months preceding the presentation of MERCOSUR’s offer in the area of goods, the Argentine Association of Industrialists sent a note to the government asking that it “not step up negotiations until Argentina’s economic situation could ensure minimum conditions for the survival of domestic production and a business environment in line with that enjoyed by European companies” (...) and noting that “seeking at this time to conclude a free trade agreement with the EU in an adverse economic environment will eliminate more jobs and make it impossible for industry to compete on an equal footing with European companies, which are supported by a system of subsidies and also obtain financing at interest rates no higher than 4% per annum.” (*La Prensa*, August 7, 2001)

<sup>120</sup> In that connection, only a few months earlier, in mid-2001, the MERCOSUR Common Market Council had recommended to the CMG—in CMC Decision 08/01 on negotiations with third countries—that negotiations with the European Union be stepped up.

## Presentation of initial offers

### (i) *The community offer in the area of goods*

The European offer proposed deregulation of “a considerable proportion of trade between the parties” within 10 years, contingent upon balanced commitments, effective access to the MERCOSUR market, and an agreement on standstill and rollback in tariff areas.<sup>a</sup>

The proposal consisted of four categories of linear tariff reduction over zero, four, seven, and 10 years (A, B, C, D, and a fifth, E, assigned to tariff positions for which the reduction periods and procedures had not as yet been defined). No less importantly, the proposed tariff reduction encompassed only *ad valorem* tariffs, and excluded specific and seasonal tariffs and quantitative barriers.<sup>b</sup>

According to European Commission officials, its offer covered “89% of the tariff universe” (9,166 positions of a total of 10,273 positions making up its official nomenclature). Given that the EU’s annual imports from MERCOSUR in the 1998-2000 period averaged nearly US\$ 19 billion, the European offer covered trade of a value of some US\$ 11 billion, leaving aside (for the moment) some US\$ 8 billion (40% of the trade). Nonetheless, of the US\$ 8 billion not included in the offer, US\$ 6 billion currently entered with a 0% tariff and part of the rest, another US\$ 1.3 billion, entered through the quota system.<sup>c/d</sup>

In Buenos Aires, EU Farm Commissioner, Franz Fischler, indicated in October 2001, that one of the most serious problems faced was the lack of a single spokesperson (*Clarín*, October 20, 2001), in that the relationship was one-to-one, not one-to-four (*Cronista*, October 16, 2001). In any event, regarding the recurrent MERCOSUR complaint in connection with subsidies and internal support measures for European agriculture, the community official indicated that certain rules were in place for free trade negotiations (...) but that discussion should be avoided of how the EU handled its agriculture policy and how MERCOSUR handled its own. With respect to the offer made by the EU some months earlier, he stated that the elimination of 90% of the agricultural tariffs was the starting point for negotiations. (*Cronista*, October 16, 2001).

### (ii) *MERCOSUR’s offer in the area of goods*

MERCOSUR’s proposal took as its starting point an initial basic preference equal to the difference between the WTO consolidated tariffs and the Common External Tariff for all products whose CET was lower than the consolidated tariff. This included some 8,800 positions.

MERCOSUR’s proposal covered nearly 40% of the positions comprising the tariff universe, distributed in five lists (from A to E) with periods no longer than 10 years. These items represent 32% of average imports from the European Union (some US\$ 7.3 billion).

Total immediate tariff reduction was proposed for the products included in Category A. These represented imports from the EU of a value of US\$ 1.9 billion (8.5%). Tariff reduction was proposed for the products included in Category B over an 8 year-period; these represented imports of a value of US\$ 1.1 billion (4.9%). The products in Categories C, D, and E would have total tariff reduction over 10 years, with different rates of preference. These categories covered imports of the value of US\$ 4.3 billion (19%).

At the sectoral level, most of MERCOSUR's offer benefited industrial sectors, which already had substantial flows of trade to the subregion. Notable among these were machines and electrical materials, chemical and pharmaceutical products, tractors, aircraft and ships, and optical instruments and equipment. In the agricultural sector, MERCOSUR offered to liberalize 40% of current trade, and requested in that connection the elimination of subsidies on agricultural exports to the subregion and neutralization of the distortionary effects of internal European supports.

The grace periods assigned for the effective start of tariff reduction in categories B, C, D, and E were an attempt to give effect to special and differentiated treatment in view of the different level of development in the two blocs. Trade not included in the proposal covering lists A to E involved another series of products subject to negotiation, but whose inclusion in the different categories of the tariff reduction process would "be examined and decided upon based on the progress of negotiations." Accordingly, MERCOSUR excluded from its offer MERCOSUR imports from the EU of a value of US\$ 15.2 billion (67.8%, or some 5,700 positions).

In MERCOSUR jargon, this universe was called "products included in the offer for which no tariff reduction timetable was proposed." Paraguay and Uruguay therefore made their agreement to the submission of the initial MERCOSUR offer contingent on efforts being made to include such products in the tariff reduction timetable, as they naturally hoped for the deregulation of a sizable universe of products that had not thus far been offered.

As Argentina had sometimes been the MERCOSUR country most reluctant to open its market, the remaining members of the bloc publicly indicated their desire for Argentina to make a significant effort to improve the MERCOSUR offer in the subsequent phase.

*(iii) Offers in the area of services, dispute settlement, and government procurement*

The two parties agreed that the chapter on services should be based on GATS [General Agreement on Trade in Services] principles (national treatment, market access, four supply modes, transparency, mutual recognition, domestic regulation). However, the scope of the liberalization commitments would only be known when discussion began on procedures for and methods of liberalization, and subsequently, when the lists of specific commitments were negotiated.

As regards procurement, the basic principle supported by the two blocs was to grant national treatment to companies in the two blocs that might participate in bidding, and they agreed on the basic rules to govern bidding processes to ensure adherence to this principle. As in the case of services, the actual scope of the commitments would only be known when the lists of entities, goods, services, and public works to be covered by the chapter's disciplines were negotiated.

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<sup>a</sup> This meant that neither party could increase its tariffs in order to improve its negotiating position and, should it do so, it had to notify the other party and justify the change. Any tariff increase would be taken back to the lowest level since the increase was applied, at least until the agreement was put into effect.

<sup>b</sup> In this regard, MERCOSUR's position was that the dismantling of non-tariff barriers was a requirement for tariff reduction. In contrast, for the EU, no conditions were proposed for one or another trade instrument.

<sup>c</sup> In the case of wine, the European proposal had a specific chapter wherein it was established that the tariffs would gradually be eliminated in the framework of a specific agreement that included exclusive and reciprocal protection of geographic indications, protection of traditional expressions, and a positive list of enological practices.

<sup>d</sup> It should thus be noted that if in the EU's offer the positions consolidated at 0% are excluded—since they were tariff-free for all WTO members—the "additional" deregulation that MERCOSUR would be offering would only be 33%. However, since MERCOSUR had no positions consolidated at 0% and most had been consolidated at 35% levels, this bloc was offering a concession to the EU for each of the positions offered that had not been made to any other WTO member.

As regards the general conditions to which the MERCOSUR proposal was subject—under the single undertaking criterion—the proposals made by the bloc were:

- Liberalization should be based on the criterion of special and differentiated treatment for the MERCOSUR countries;
- Tariff reduction had to include *ad valorem* tariffs, whether specific or mixed, and any other tariff of equivalent effect;
- Tariff protection mechanisms “necessary to maintain nascent MERCOSUR industries” had to be implemented;
- Effective access to the European market for MERCOSUR products had to be assured, with immediate access for products with total tariff elimination in the first year and products with increasing quotas in the transition period for products with progressive tariff reduction schedules;
- European commitment to eliminate the entry price regime for MERCOSUR products;
- Reduction of so-called tariff “peaks” to the equivalent average *ad valorem* level with respect to the base tariff;
- Acceleration of negotiations for bilateral agreements on equivalency of sanitary and phytosanitary measures and prompt establishment of a product certification mutual recognition system;
- Offset of the distorsionary effects on biregional trade of internal support measures. Non-application of export subsidies or measures of equivalent effect. Measures and practices with equivalent effect, such as food supports or domestic support systems for farmers—could be dealt with at a later phase of the negotiations; and
- Design of a bilateral safeguard mechanism applicable to preferential trade, establishing an exception for application of the special agricultural safeguard.

Once the process of presenting the respective offers had been completed, the negotiations phase as such began, as of that point. The blocs undertook to redefine their sensitive products (or what amounts to the same thing, improve their initial offers). Although, owing to evident reasons of political timing, Argentina indicated in late January 2002 that it would not be in a position to improve its tariff offer in the first half of 2002, a technical meeting was held in late February to study and clarify aspects of the offers and begin work on moving forward more or less rapidly with implementation of a package of measures in the business facilitation area.

At that meeting, as was to be expected, the European Community officials indicated that the conditions indicated in the MERCOSUR offer were issues that for the most part had to be resolved in the WTO framework. However, regarding export subsidies, they expressed their willingness to conduct an economic study that would provide solutions satisfactory to both parties.

At the same time, business facilitation efforts revolved around the MERCOSUR proposal that included customs, sanitary, and phytosanitary issues, technical standards, and electronic commerce, topics that had been suggested by the MERCOSUR-EU Business Forum (MEBF) held some months earlier in Buenos Aires (December 2001) and that would be set again out explicitly at the following meeting of that body (Madrid, May 2002).

In this context, after the Seventh Meeting of the Bi-regional Negotiations Committee, held in Buenos Aires, in April, some progress was made in defining the business facilitation measures that the parties would seek to implement, making use of the MERCOSUR countries' experience gained in recent years in the FTAA environment.<sup>121</sup>

Subsequently, the Second European Union-Latin America and the Caribbean Summit was held in May 2002, in Madrid.<sup>122</sup> At that summit, despite the fact that Argentina's aspirations with respect to the meeting had more to do with obtaining political support in its dealings with international financial organizations than the trade negotiations with the EU themselves, the Heads of State and Government of the Fifteen and the four MERCOSUR Presidents reaffirmed their commitment to trade negotiations, as reflected in the text documents agreed upon at meeting: the Joint Communiqué and the business facilitation document.

However, no less importantly, and apart from pressures from MERCOSUR, the Communiqué contained no specifics regarding the existence of any deadline for conclusion of negotiations.<sup>123/124</sup> In that connection, President Aznar indicated to the Spanish news agency EFE that "what is important is that we have decided to resume (the negotiations) and not the date when they might conclude, although we hope that they will proceed as quickly as possible" (*La Prensa*, May 20, 2002).

In any event, another Ministerial-level meeting was convened to "encourage the economic-trade negotiations" to move ahead "quickly and conclude as soon as possible" with the pending topics. However, in short, although agreements were signed on business facilitation measures, defense of democracy, and cooperation in the fight against drug trafficking and terrorism, and on cooperation in customs, agricultural, and sanitary and phytosanitary measures, the substance of the trade agenda was deferred to a subsequent meeting, to be held in Rio de Janeiro the following July.

The Declaration also made explicit reference to the socioeconomic disparities between the two geographic areas, which is important in that it clears the way for the inclusion of special and differentiated treatment in future negotiations. In addition, progress was made on two important aspects: negotiations in the area of wine and spirits—a topic of interest to the European Union—and negotiations on the agreements in the sanitary and phytosanitary area—a topic of interest to MERCOSUR. At the same time, agreement was reached on 37 business facilitation measures, covering the areas of customs, technical standards, electronic commerce, and sanitary and phytosanitary matters.

In that context, in keeping with what was envisaged, two months later the MERCOSUR foreign ministers and ministers of trade and the European Commissioners in charge of External Relations, Christopher Patten, and the European Commissioner responsible for Trade, Pascal Lamy, agreed in Rio de Janeiro on a work plan designed to intensify and step up negotiations between the two blocs.

In that connection, it was agreed to a rapid conclusion (first quarter 2003) of negotiations on methods and procedures for market access for goods, including agricultural products, and the definition of methods and

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<sup>121</sup> In order to give greater impetus to the negotiating process, at this meeting, MERCOSUR proposed moving forward only with trade disciplines. The European Union rejected the idea, claiming that in those months much of European Community officialdom was looking to conclude the negotiations with Chile.

<sup>122</sup> It should be noted in this regard that although 2005 had been mentioned at different times as the date for implementation of the agreement (in parallel with the FTAA), such a commitment was never made explicit in any official text.

<sup>123</sup> The Summit's Declaration only speaks of "concluding negotiations as soon as possible."

<sup>124</sup> However, one week after the Summit, European Commissioner Pascal Lamy himself told the press that "although there are specific deadlines for concluding the negotiations, the date of 2004, cited in some earlier documents, should be attainable."

procedures for negotiations on services—a task completed in late 2002—as well as implementation—based on a process that would start in first quarter 2003—of the action plan on business facilitation measures adopted at the Madrid Summit in May 2002.

At the same time, the asymmetries in the development of the two geographic areas were formally acknowledged through the inclusion of special and differentiated treatment in favor of MERCOSUR. It was agreed that civil society participation would be promoted through meetings of MERCOSUR's Economic and Social Forum and the European Economic and Social Committee (held for the first time in Brussels in April 2003). It was also decided that in February 2003 the parties would exchange new offer lists in the area of goods <sup>125</sup> —“compatible with the WTO” —<sup>126</sup> and that in second quarter 2003—after the Ninth BNC meeting to be held in late March in Brussels—a new ministerial-level summit would be held to evaluate progress made in the process and define guidelines for the final phase of negotiations.

In the same vein, at the MERCOSUR CMG Meeting in early December 2002, it was agreed that the four countries would send their new offers on market access for goods to the Brazilian Chair before mid-December 2002, so that he could consolidate them by January 6, 2003 and pass them on to the Paraguayan Chair.<sup>127</sup> Based on this timetable, these lists would be studied at an intra-bloc meeting to be held in late January and formally sent to the European Commission by February 28, 2003. Subsequently, the plan was to hold another intra-MERCOSUR meeting in March to study the new European offer.<sup>128</sup>

With a view to future negotiating steps and as agreed in the context of the BNC meeting in Rio, a new period would be opened from April 15 to May 15, 2003 for the submission of requests for improvement of offers in the area of goods, definition of methods and procedures for the negotiations on government procurement and investment, initial discussions on rules of origin, proposals for a framework SPS agreement, and proposals for an agreement on wine and spirits.

## **F. Amidst progress and dispute: The ECA 35 between MERCOSUR and Chile**

Until 2000, trade disputes and differences between the two parties had been channeled through the Administrative Commission of the ECA 35 but, in 2001, in the context of a bilateral (Argentina and Chile) agenda characterized by growing controversy (access to the Chilean oil and flour market, increased tariffs on consumer goods to 35% and introduction of the convergence factor, imposition of safeguards for

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<sup>125</sup> It should be noted here that, in contrast with the principle adopted in the FTAA framework, pursuant to Decision 22/94, MERCOSUR negotiates based on its Common External Tariff and all such amendments thereto as may have been introduced as of the date when definitive tariff negotiations begin.

<sup>126</sup> The EU argued that while MERCOSUR's tariff offer covered only one-third of bilateral trade, its proposed tariff reduction [did not] meet the requirements of Article XXIV of the GATT for free trade areas in terms of covering “substantially all trade.” For their part, the MERCOSUR countries have argued that if the products that already have a zero tariff under the WTO and/or those that are being phased out to zero are eliminated from the European offer, the EU would not meet that requirement either, their offer covering only 60% of trade. In that connection, the CMG, meeting in December 2002, decided that the countries would urgently ask their respective Missions in Brussels to conduct a technical study on the terms of GATT Article XXIV with respect to interpretation of the phrase “substantially all trade.”

<sup>127</sup> In that connection, it should be noted that at the meeting between Presidents Duhalde and Lula da Silva in Brasilia in mid-January 2003, the Brazilians indicated their desire to delay the presentation of offers to the European Union—as had been proposed a week earlier in the case of the FTAA—so that the new authorities could do a more detailed study of the work done by the previous administration in this area. At the same time, the new Brazilian Minister, Celso Amorim, stated that (as compared to the FTAA) “the possibilities for accelerating the negotiations with the European Union are even more problematic,” owing to the existence—in this case—of the problem of trade in agricultural goods (*O Estado de São Paulo*, January 1, 2003).

<sup>128</sup> In any event, it is still unclear whether the European Commission will present a new offer or will continue to maintain that, as its initial offer meets WTO requirements for trade agreements, only MERCOSUR should improve on its initial offer.



three years for Chilean imports of canned peaches,<sup>129</sup> and introduction by Argentina of sanitary restrictions for the entry of white meat, etc.), the two parties frequently resorted to bilateral authorities to address specific topics and to the exchange of notes between the respective ministries and embassies.

### **The dispute between Argentina and Chile over the agricultural price band system**

After various unproductive bilateral complaints, in March 2001, Argentina<sup>a</sup> lodged a formal complaint with the WTO over Chile's imposition (since 1999) of a price band system—variable tariffs—and special safeguard measures<sup>b</sup> on vegetable oil, wheat and wheat flour (which according to Argentine negotiators in many cases involved *ad valorem* tariffs on the order of 80% or 100% for such products).

In November 2001, the two parties submitted their counter-claims and replied to the panel's questions. In May 2002, the final decision was issued, finding in favor of Argentina<sup>c</sup> on virtually all points. However, the Chileans lodged an appeal with the appellate body (basing on points of law its argument that the mechanism was compatible with its WTO commitments). This generated numerous criticisms and complaints on the part of different private entities in Argentina, which claimed damages of the order of US\$ 120 million per year.

In late September 2002, the WTO appellate body again decided in favor of Argentina, ruling that Chile could not again appeal, and that it should replace its price band system with another import regime compatible with the provisions in effect under the WTO agreement on agriculture.

In view of the sensitivity for Chile in November 2002<sup>d</sup> of this issue in political and trade terms (particularly in the context of the final phase of its bilateral negotiations with the U.S., which also had recourse to the WTO panel to obtain improved terms of access to the Chilean temperate zone agricultural product market), in November and December 2002—within the 45-day period established by the WTO for conclusion of an implementation agreement between the parties before moving to the arbitration system—several working meetings were held between the officials of the two ministries in an effort to find a solution or “adjustment mechanism” satisfactory to all parties involved.

In view of the parties' failure to reach agreement on effective implementation of the decision, in early December 2002, Chile asked the WTO Dispute Settlement Body to arrange for arbitration to establish the “prudential period” for that country to put recommendations into effect. That arbitration was installed by the WTO in mid-December and promised to issue a ruling within 90 days.

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<sup>a</sup> With the participation of Australia, Brazil, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Japan, Nicaragua, Paraguay, and the United States, with the EU and Venezuela as third parties.

<sup>b</sup> Such restrictions consist of imposing variable tariffs, in addition to the general tariff, on imported oil, wheat and wheat flour, through the so-called Price Band System. This results in the imposition of effective tariff levels several times higher than the maximum allowed by the WTO.

<sup>c</sup> It should be noted that this would be the first formal dispute (panel) in the WTO context that would rule in Argentina's favor.

<sup>d</sup> In that connection, in late November 2002 the Foreign Ministry of that country issued an official statement—with the signature of the Director General for International Economic Relations, Osvaldo Rosales—entitled “Chile has not undertaken to eliminate price bands after the WTO ruling.”

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<sup>129</sup> A subject on which Chile formally lodged a complaint with the WTO in December 2001, with the EU, Paraguay, and the U.S. as third parties.

In any event, by about January 2002, most of the tariff preferences established in the Partial Scope Economic Complementation Agreement between Chile and MERCOSUR (ECA 35) had reached the 85% level, and were scheduled to reach 100% in 2004—with the exception of the products included on the sensitive products list, whose liberalization would only take effect in 2014, in keeping with the provisions agreed in due course in Chile’s association agreement with MERCOSUR.

Thus, after a certain period marked by the “discouragement effect” of frustrated efforts at certain diplomatic and political levels to achieve Chile’s full membership in MERCOSUR in 2000, in 2002, some significant progress was made under Economic Complementation Agreement No. 35, both in respect of including new products<sup>130</sup> in the mechanism to expand bilateral preferences (August and November 2002), in respect of incorporating the automotive sector (including auto parts) into the agreements.

To that end, in September 2002, Argentina and Chile agreed on a 100% preference for bilateral trade in vehicles, trucks, and buses, with an initial quota—in the case of trade with Argentina—of 27,000 cars, 300 trucks and 400 buses for Chile (increasing each year to 36,000 vehicles, 500 trucks, and 400 buses in 2005) and 9,000 vehicles, 300 trucks, and 400 buses for importation by Argentina (reaching 12,000 vehicles, 500 trucks, and 400 buses in 2005). In all cases, free sectoral trade is envisaged by 2006. In the case of auto parts included in the list annexed to the agreement, a preference on the order of 100% of the MFN tariff in effect for the two countries was established, in keeping with the stipulated tariff reduction schedule.

In this context, at the Administrative Commission’s last meeting in 2002, held in Montevideo in November, Chile indicated its interest in opening the service sectors, while Argentina pointed to the need to move ahead with improving the disciplines on market access, technical provisions, and sanitary standards.

#### **G. In search of new trade horizons (I): Reactivation of negotiations between MERCOSUR and Mexico**

The first version of the Argentina-Mexico Bilateral Economic Complementation Agreement (ECA 6) was signed in 1986, in the LAIA framework. Since that time, the parties have made different efforts and held various meetings with a view to increasing and diversifying the bilateral trade flows covered under that instrument. To date, the countries have signed 14 additional protocols to ECA 6, notable among them Additional Protocol No. 11, whereby Mexico, owing to its entry into NAFTA, extended trade advantages to Argentina under Article 44 of the Treaty of Montevideo.

Formal negotiations between MERCOSUR (as a bloc) and Mexico began in mid-1995. However, they were interrupted in December 1997 owing to a lack of agreement on how to continue the process and because Mexico was seeking to negotiate a free trade area, while MERCOSUR proposed signing a broad fixed preference agreement that would multilateralize the preferences agreed upon in due course in the respective bilateral agreements without perforating the ECA and without encroaching on WTO provisions.<sup>131</sup>

In this context, as the parties’ positions could not be reconciled, the MERCOSUR partner countries decided to give themselves the option of extending their respective bilateral agreements according to their own criteria, on the basis of which Argentina, Paraguay, and Uruguay extended their agreements in 1997 while Brazil allowed its bilateral agreement to lapse, so that it remained in force only in terms of an automotive trade quota.

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<sup>130</sup> Including chemicals, petrochemicals, and pharmaceutical products.

<sup>131</sup> It should be noted that the major difficulties included Brazil’s refusal to include information technology and telecommunication products and Mexico’s objections to negotiating the opening of its agriculture sector.

In June 2000, CMC Decision 32/00 authorized the MERCOSUR member countries to conclude new preferential bilateral agreements—or to extend the existing ones—in the LAIA framework, up to June 30, 2001, “for the purpose of regulating preferential trade relations with that country.” To that end, the CMG was given the mandate to begin negotiations to conclude an agreement establishing a free trade area with Mexico.

Negotiating rounds were held between late 2000 and late 2001 to complete the renegotiation of a bilateral agreement between Argentina and Mexico. The agenda for the meetings held between the two countries in this period included expanding the preferential coverage of ECA 6 and amending provisions relating to trade disciplines. In that context, in March 2001 agreement was reached on three new additional protocols to ECA 6.

Notable among them were expansion of tariff preferences for sectors such as chemicals and petrochemicals, measuring tools and equipment, a chapter on technical regulations, another on sanitary and phytosanitary disciplines, and a new dispute settlement system.

Additional Protocol No. 14 established a special bilateral agreement for the automotive sector that would remain in effect until the MERCOSUR-Mexico understanding took effect for the entire sector. In this case, consideration was given to reciprocal authorization of a quota of 18,000 units per year with a preferential tariff of 8%—for two years—which took effect as of the latter half of 2001.

As the bilateral framework in force provided that either party could unilaterally authorize an additional quota for the other party if the original quota had been reached, in April 2002, and against a backdrop of active private sector participation in the two countries,<sup>132</sup> Mexico indicated its willingness to increase the annual quota in effect to 50,000 units as a “gesture of solidarity with Argentina.” This quota, which would become effective in the latter half of 2002, represented a significant contribution to the continuation and preservation of activity at different terminals in Argentina that had been seriously affected by the sharp decline in internal sales over the previous two years.

At the same time as these developments, Mexico and Uruguay agreed on (asymmetrical) trade of 7,000 units with zero tariff in 2002, rising to 14,000 units in 2005, while Brazil—which days earlier had entered into a partial scope agreement with the NAFTA member country (ECA 53)<sup>133</sup>—agreed on a trade schedule ranging from 119,000 vehicles in the first year to 174,300 in the fourth, and entering into a free trade arrangement starting in the fifth. This agreement—unlike the agreements with Argentina and Uruguay—also established quotas on trade in utility vehicles (from 21,000 units per year at the outset to 35,700 in the fourth year) and decreasing preferential tariffs—without a quota—for agricultural machinery, together with special preferences for trade in a broad universe of auto parts.

At the same time, as established by the CMC in mid-2000 with respect to the goal of transforming into a free trade agreement under the “4 + 1” format the bilateral partial scope agreements that each of the MERCOSUR member countries had signed in due course with Mexico, during the visit made by President Vicente Fox of Mexico to Argentina on July 4-5, 2002, the MERCOSUR-Mexico Economic Complementation Agreement (ECA 54) was finally signed.

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<sup>132</sup> ADEFA of Argentina, ANFAVEA of Brazil, and AMIA of Mexico.

<sup>133</sup> In the days prior to the Buenos Aires Summit, President Fox signed in Brasilia the bilateral complementation agreement with Brazil, the only MERCOSUR member that did not have a bilateral agreement. That agreement includes reciprocal concessions by product and covers about 800 tariff items, 50% of which have a 100% tariff preference, with the remaining items at levels between 60% and 20%. In terms of sectors, one-third of the products pertain to the chemical industry sector and the rest are distributed among the electrical machinery, food and beverage, plastics, and optical and photographic instruments industries.

This instrument, signed by the Presidents and foreign ministers of the five countries, proposes intensifying<sup>134</sup> trade relations between the major economies of Latin America which, if historically they had not reached quantitatively significant levels of trade, found themselves even farther apart when Mexico joined NAFTA in the mid-1990s.<sup>135/136</sup>

That understanding, whose explicit purpose was to form a bilateral free trade area based on the convergence of progress made in the bilateral agreements that the MERCOSUR member countries had or might enter into with Mexico, included as annexes both the agreements concluded or to be concluded between Mexico and the MERCOSUR States Parties in the LAIA framework and the agreements concluded for the automotive sector, on which there is a specific chapter in each case.

In addition, in response to the different demands and disputes made by Argentine businesses in different sectors, the Argentina-Mexico Trade and Investment Council was established. It creates coordination mechanisms between the two countries' areas responsible for export promotion with a view to promoting increased reciprocal trade. It also provides for the establishment of working groups or groups of experts to address matters of mutual interest, the goal being to maintain a dialogue that will enable them to find solutions to facilitate and increase trade relations between the two countries and eliminate restrictions on access to the respective markets in specific sectors.

Subsequently, in order to expand and diversify their export pattern and identify new trade opportunities for subregional companies, the MERCOSUR countries decided to begin talks at the bilateral level with a view to negotiations on products, mindful of the particular sensitivities of each of the members. Technical meetings thereon began in Buenos Aires on November 4-5 to move forward with negotiations for a free trade agreement between Argentina and Mexico,<sup>137</sup> which—if successful—would be conducted under the MERCOSUR-Mexico Framework Agreement.

A few days later, a MERCOSUR-level meeting was held to define regulatory aspects of the agreement, the idea being that it would in the short-term serve to provide greater transparency and predictability in trade operations between the two areas.

Thus, in parallel to the Argentine Trade Mission to Mexico (comprising some 90 national companies), a bilateral meeting was held on December 10-11, 2002 to begin to address market access and the regulatory aspects to be contained in a possible free trade agreement between the two countries, which would consolidate a more transparent framework for bilateral trade operations.

With respect to format, the Mexican proposal presented at this meeting focused on matters relating to market access and was divided into two chapters: trade in goods in general and trade in agricultural

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<sup>134</sup> The said agreement established a quota of 50,000 units per year with zero tariff for 2002-2005, reaching free trade in 2006. For the first two years of the agreement, it established, within the quota, an exclusive segment of 5,000 units reserved for companies not established in the two parties, which would be eliminated as of 2004.

<sup>135</sup> It should be noted here that in its quest to diversify its trade flows vis-à-vis the U.S., Mexico signed 32 free trade agreements in the 1990s, including among its partners the European Union and Chile.

<sup>136</sup> Argentine exports to Mexico fell from 2% of the value of Mexican imports in 1985 to the current approximately 0.2%, primarily concentrated in primary products and manufactures of agricultural origin (oilseed and sunflower oils) and, to a lesser extent, some industrial products negotiated under Economic Complementation Agreement No. 6.

<sup>137</sup> According to indications from the Argentine negotiators, Argentina's immediate objective in that negotiation was to achieve immediate tariff-free access for the products that have generated trade in recent years, and to equal—at least—the tariff conditions currently enjoyed by international competitors in the Mexican market—countries such as Chile, Uruguay, Colombia, Brazil, and others—for products of pertinence in the Argentine export supply.

products. Argentina suggested that it would be advisable to combine these in a single chapter, with the chapter on trade in goods to include aspects related strictly to trade in agricultural goods. Mexico indicated its willingness to consider the suggestion.

Argentina, for its part, submitted a draft plan as follows: immediate tariff elimination; tariff reduction over five (5) years, ten (10) years and, for a small list, over more than ten (10) years. The offer “baskets” comprising the different schedules would be:

- Immediate elimination: products negotiated under Argentina-Mexico Economic Complementation Agreement No. 6, with preferences equal to or above 50% that had generated trade in a period of prior years to be defined and new products of interest to the parties.
- 5-year tariff reduction schedule: products negotiated under Argentina-Mexico ECA No. 6, with preferences below 50% that had generated trade in recent years, products with preferences over 50% that had not generate trade in recent years, and products benefiting from the RTP [regional tariff preference] that had also generated trade.
- 10-year tariff reduction schedule: remainder of the tariff universe, except for sensitive products (which would, in principle, remain on a sort of “waiting list”).

The Mexican delegation indicated its agreement in principle with the proposal and noted that the final decision in this regard would take account of the results of consultations held with the Mexican private sector. Argentina indicated the need to establish guidelines for the tariff treatment of goods imported temporarily for inclusion in productive processes leading to re-export of goods. In that connection, it proposed not excluding from the agreement’s tariff preferences goods entering under this type of system to the extent that they satisfied the conditions of origin established in the future agreement.

The Mexican proposal also provided for elimination of export tariffs on reciprocal trade, except for a list of products included in an annex. Argentina explained its system, its fiscal rationale, and the constitutional basis thereof. In addition, it indicated its interest in having Mexico specify and justify its objections on the matter with a view to demonstrating the operation’s effect on reciprocal trade. Argentina proposed that products for whose preparation the temporary admission regime was used should enjoy the preferences of the agreement, provided they satisfied the origin requirements ultimately established in the agreement, a topic particularly pertinent in this connection.

With respect to origin and customs procedures, there was agreement in a draft of the new MERCOSUR-Mexico automotive agreement on a text on this topic (with a transition period ending in mid-2011), since it was considered an important basis for moving ahead in this phase. The most important negotiations will take place when the time comes to define the conditions to be met, in determining origin, by the universe of products to be included in the agreement.

In respect of dumping and safeguards, Mexico presented a proposal that would allow for the adoption of preferential safeguards on an exceptional basis. In due course, Argentina presented comments on Mexico’s proposal, in which the major point of divergence is the advantages created when a safeguard is applied. As regards dispute settlement systems, a document was signed on this topic in March 2001, but did not become effective because Mexico did not complete the incorporation of its provisions into domestic law.

In coming months, in the context of Argentina’s stated intention of engaging in “intensive negotiations” as quickly as possible, a round of negotiations is planned with the Mexican government to explore the possibility of achieving a trade agreement that would reenergize trade relations between the two areas.

In keeping with the agreed schedule, another meeting of negotiators was held in Buenos Aires, in early February 2003, followed by an exchange of offer lists late that month. These offers would be analyzed at a further meeting held in mid-March in Mexico. In that context, it was agreed that in mid-April 2003, there would be an evaluation in Buenos Aires with respect to the course and status of negotiations, in order to confirm or rectify the steps taken and assess prospects for attaining the objective of concluding a free trade agreement between MERCOSUR and Mexico in the latter half of 2003.

#### **H. In search of new trade horizons (II): Negotiations between MERCOSUR and South Africa**

Under CMC Decision 36/00, the MERCOSUR Council of Ministers authorized the CMG to begin negotiations with South Africa with a view to concluding an agreement to create a free trade area between that country and MERCOSUR. To that end, in December 2000, in Florianopolis, Brazil, the parties signed a framework agreement intended to “strengthen existing trade relations between the parties, promote increased trade, and establish the conditions for creating a free trade area between the parties.”

Accordingly, a Negotiating Committee was established, holding its first meeting in October 2001, in Montevideo. The first exchanges of trade and tariff statistics occurred at that meeting. MERCOSUR proposed the establishment, at a first stage, of fixed preference agreements by defining baskets of products for which reciprocal tariff benefits would be granted, in keeping with Article 3 of the Framework Agreement. South Africa accepted the proposal as a basis for exploring mechanisms designed to expand trade, including the possibility of granting reciprocal tariff reductions. In that connection, the parties agreed to study how such mechanisms would be applied in the WTO context.

With respect to the WTO format of the possible agreement, MERCOSUR’s position was to invoke—at least initially—the Decision on differentiated and more favorable treatment and reciprocity for developing countries (better known as the Enabling Clause), allowing countries to grant more favorable treatment to DCs without being required to do so with respect to the other contracting parties and without the requirement that the agreement encompass substantially all trade or that the tariff necessarily be zero.

This would leave to a second phase the intensification of negotiations for a free trade agreement in keeping with Article XXIV of the GATT-WTO, which should include not only a trade liberalization program for the entire tariff universe, but also a schedule for the elimination of quantitative barriers, improvement of the agreement’s rules of origin, sanitary and technical provisions, safeguard and dispute settlement regimes, etc.

Accordingly, the first technical meeting of the Agreement Negotiating Committee was held in Montevideo in October 2001. The meeting outlined the pertinent topics to be addressed in the future and reviewed existing possibilities for interaction, particularly in respect of technical and commercial cooperation and guidelines for conducting upcoming meetings. Subsequently, each party undertook to submit information on trade statistics for the last three years, so that in February 2002, a document could be completed detailing the sectors and products of interest to each of the parties.

Subsequently, in August 2002 (although originally planned for March), the Second Meeting of the Negotiating Committee for the MERCOSUR-South Africa Framework Agreement was held in Brasilia. Information was exchanged at that meeting, in connection both with the economic situation of the member countries and progress made with their respective integration processes.

South Africa underscored the fact that the integration process in which it is involved with other countries in its region (SACU) is in a process of general restructuring, which the countries hope to

complete by the end of 2003. In that connection, future meetings with MERCOSUR should include the member countries of SACU.

MERCOSUR indicated, in view of the need to determine procedures for conducting those negotiations, that it would be advisable to study that topic at the following meeting, as the Framework Agreement had been signed in due course with South Africa, without including the other members of SACU. It was thus agreed that all the members of SACU would be invited to the next meeting of the Negotiating Committee.

With respect to procedures for the negotiations, South Africa accepted MERCOSUR's proposal to conduct negotiations initially for a fixed preferences agreement for the first phase of the agreement. This was one of the most important points where consensus was reached at the meeting. MERCOSUR also presented a draft agreement and agreed to submit before the next meeting a proposal containing the chapters on the origin regime, safeguards, and the dispute settlement system.

#### **MERCOSUR's first joint trade mission to South Africa (June 24-28, 2002)**

From June 24 to 28, 2002 as part of the activities agreed upon in due course in the context of MERCOSUR's specialized joint trade promotion group, the first joint trade mission of the four MERCOSUR countries was conducted. Comprised of 90 companies (large, medium-scale, and small) from the member countries, it visited Johannesburg, where it carried out an intensive program of activities. Both the scheduling and the organization of the mission were the responsibility of the MERCOSUR's national joint trade promotion coordinators; Argentina serviced as General Coordinator, as it was President *pro tempore*. The parties characterized the results as very positive, and underscored the business opportunities that were generated based on contacts and trade ties established through the mission.

In its eagerness to lend continuity to progress made, MERCOSUR suggested exchanging lists of products by late September 2002, and holding the following meeting of the Negotiating Committee in early November 2002. South Africa responded that its own consultation process with its private sector and its political decision-making would take at least until late October, for which reason it countered with the proposal that lists be exchanged in November 2002, but that the working meeting be held in 2003.

MERCOSUR insisted on the advisability of keeping the process going and made a counter proposal—accepted by South Africa—to begin consideration of the lists of products and the proposals related to the text of the agreement on fixed preferences, for which reason a new (third) working meeting was scheduled for November in South Africa.

In that connection, the two parties agreed to exchange the following information by late September 2002:

- macroeconomic and trade data on each participating country;
- trade statistics covering the period 1999-2001, by product, country of origin, and use;
- pertinent foreign trade legislation; and
- CET status, including amendments and exceptions in force.

South Africa agreed to provide information regarding the its Customs Tariffs Nomenclature, a detailed list of tariffs in effect (*ad valorem*, specific, mixed, and other import duties), and details of trade agreements signed with third countries.

MERCOSUR asked for information on the South African importation regime, particularly with respect to specific duties and the import-licensing regime. South Africa proposed establishing a working group to address this subject, a suggestion that was not accepted by MERCOSUR, as it merely a question of exchange of legislation. South Africa explicitly demanded inclusion of the topic of sanitary and phytosanitary regulations, and it was thus resolved to provide for the participation of experts in these areas at the next meeting.

At the third meeting, held in Pretoria, in early December 2002, the Brazilian government, as President *pro tempore*, presented a proposal on aspects of trade, sanitary, and agricultural policy, and also made requests for preferential access for a list of products, among them vegetable oil, grain, plastic manufactures, dairy products, and auto parts. The parties agreed to study the respective documents prior to the following meeting, scheduled for March 2003.



## **CHAPTER VI. REGIONAL INFRASTRUCTURE AND PHYSICAL INTEGRATION**

Regional economic infrastructure comprises different networks facilitating the circulation of goods and people (transport network), energy (energy network), and information (telecommunications network) among the member countries of an integration process, or simply among neighboring countries.

As regional networks benefit all interconnected countries, their externalities cannot be absorbed by only one of the parties, as they constitute a regional public good whose proper supply cannot be delegated solely to the national level. Thus, the efficiency of regional infrastructure can only be enhanced through cooperation in project planning and coordination among all nations involved.

The harmonization, linking, and development of infrastructure among neighboring countries facilitates communications and the physical circulation of goods and people, and promotes the development of the most peripheral economies, thereby constituting a key instrument in effecting an area's economic and social cohesion.

In Europe, the importance of regional infrastructure was recognized in the 1957 treaty establishing the European Community and, from the outset, consideration was given to trans-European transport, energy, and telecommunications networks. Since that time, the definition of these networks has been a priority objective in attaining the twin goals of ensuring harmonious operation of the internal market and supporting the area's growth.

Thus, the said treaty sought to encourage the interconnection of transport, telecommunications, and energy networks so that all areas, including the insular, isolated, and peripheral, could benefit from the advantages ensuing from the establishment of a region without borders.

The political will of European authorities to promote and finance projects to create such trans-European networks was consolidated in the White Book (1993), which sets out the benefits of such networks and their impact on growth, competitiveness, and employment generation.

In the MERCOSUR case, the Initiative for the Integration of Regional Infrastructure in South America (IIRSA) emanated from the First Meeting of South American Presidents held in 2000. The Action Plan adopted at that meeting<sup>138</sup> contains proposals and suggestions for expansion and modernization, over a 10-year period, of transport, energy, and telecommunications infrastructure, with a view to making the region a more competitive area and developing the South American space.

The structural reforms (including regional integration) implemented in the region's countries in the 1990s contributed to major advances in the development of regional infrastructure. The opening of the economy to neighboring countries and the resulting greater interdependence have increased demand for this regional public good and, at the same time, have enhanced the response of the public and private sectors.

The abovementioned reforms included modifications to the traditional supply models for infrastructure and its services - which had previously been provided almost exclusively by the state -, thereby opening the way for a substantial increase in the private sector's share in investment in and management of these areas.

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<sup>138</sup> The Action Plan for the integration of South American infrastructure was prepared by the Inter-American Development Bank (IDB) and the Andean Development Corporation (CAF), with the collaboration of other international organizations working in the region and some South American countries.

However, in view of the nature of the public good and the sector's market failures, such as externalities, economies of scale, and indivisibilities, and the existence of national and/or regional initiatives whose economic and social benefits are not sufficiently attractive to private investors, in many cases the market response is less than optimal and can lead to undersupply of the public good. As a result, the planning and implementation of regional infrastructure projects cannot be delegated exclusively to private hands, it being advisable – in some cases even necessary - for the state to intervene in some sectors.

In the European case, the European Parliament and European Council are responsible for adopting community policy for the development of regional infrastructure and for establishing criteria for the selection and financing of projects of common interest. At the same time, the EU promotes public-private partnerships in the financing of the different networks.

In the MERCOSUR case, the IIRSA framework establishes cooperation mechanisms among governments, multilateral financial institutions, and the private sector to coordinate the political and strategic vision of the subregion's infrastructure, investment plans and programs, and the priority assigned to the different projects.

In December 2000, at the meeting of Ministers of Energy, Telecommunications, and Transport of South America, held in Montevideo, the final version of the Action Plan for the integration of regional infrastructure, prepared by the IDB, CAF, and FONPLATA was presented.

The Plan is based on the concept of integration hubs and implementation of the sectoral processes necessary to optimize the competitiveness and sustainability of the logistical chain. Activities target three thematic areas: coordination of investment plans, compatibilization and harmonization of regulatory aspects, and the establishment of innovative public/private finance mechanisms.

With a view to moving forward with the Action Plan, an Executive Steering Committee (ESC) was established, comprising high-level representatives, appointed by the governments, with responsibility for coordinating the activities envisaged in the Plan, based on technical studies conducted by the Executive Technical Groups (ETGs), which are administratively subordinate to the ESC. To supplement this, a Technical Coordination Committee was established, organized by the IDB, CAF, and FONPLATA, with a view to providing the ESC with technical and financial assistance.

The first meeting of the Executive Steering Committee was held in April 2001, and it was decided to establish the working groups to reflect the priority hubs established in the Action Plan. Details of the groups having to do with MERCOSUR – or with one of its States Parties – and the progress made thus far in each, are given below.<sup>139</sup>

#### **A. MERCOSUR-Chile/Talcahuano-Concepción-Neuquén-Bahía Blanca hub**

In the framework of the ETG for this hub, the project profiles presented by the governments were updated and progress was made with the preliminary design of the business concept. Discussion of them will continue at the upcoming ETG meeting.

The preliminary business concept for the MERCOSUR-Chile hub indicates that there is a reasonable infrastructure network for virtually the entire area, with “bottlenecks,” but with virtually all links in place. Accordingly, the hub has a large number of projects for strengthening existing infrastructure, and a smaller number of “structuring” projects that may solve problems of continuity and bring about changes in the network's configuration.

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<sup>139</sup> This section is taken from aide-memoires of the ETG meetings contained in a summary of a report in INTAL's possession.

The MERCOSUR-Chile hub projects considered “structuring” are those that would assist in providing new transport options for the junction between the Río de la Plata and the Andes (the Colonia-Buenos Aires Bridge and the Central Trans-Andean Railroad) and facilitate river transport on the Paraguay, Paraná, and Uruguay Rivers; new hydroelectric exploitation on the Paraná and Uruguay Rivers; in the energy sector, international electroducts and gas pipelines; and, in the communications sector, laying of new international fiber optic cable and installation of satellite service.

In the Talcahuano-Concepción-Neuquén-Bahía Blanca hub, the key structuring project is the Southern Trans-Andean Railroad. Also being developed for that hub are tourist circuit projects on the Chilean side that might supplement the aforementioned project.

In general, the road transport projects, with the exception of the structuring projects, strengthen the existing network and reduce the cost of international transport by improving route conditions (uniform loading gauges, bridge capacity, etc. throughout the hubs) and include circumferential roads so that transit through city centers can be avoided, while also facilitating access to them. Rail transport projects are preparing to compete for the region’s bulk shipments or to profit from certain comparative advantages by sharing multimodal solutions, such as the Central Trans-Andean Railroad between Argentina and Chile, which could facilitate the passage through the Andes for more days during the winter months.

In the telecommunications area, the countries of this hub are promoting the development of the Information Society, along with e-government programs, in a framework of deregulation, market competition, and international integration. Programs under way include measures to facilitate public access to cable television and fixed and cellular telephony services, including the universalization of telecommunication services in the health and education areas.

## **B. The Interoceanic hub**

The Executive Technical Group (ETG) for the Interoceanic hub has met on three occasions, most recently in October 2002. The concerns of the different countries participating in this hub, presented throughout the work of the Group, are summarized below.

Bolivia is advocating moving forward with the South Central Corridor. It is thus requesting that this be included in the IIRSA project portfolio, and pointing to the benefits of the connection of Brazil and Paraguay with the Departments of Tarija and Potosí in Bolivia, to then reach Chile and the Pacific Ocean through southern Bolivia (an area with a notorious lack of transport interconnections and with the largest gas reserves in South America). Thus, Bolivia’s interest in this hub involves, among other factors, achieving in its gas reserves further incorporation of added value; the gas would then be marketed through the projected South Central Corridor.

Chile, for its part, in the framework of the hub has manifested particular interest in generating services. In that connection, it has made improvements in the land connection between Arica and Tambo Quemado, and new investments in the ports of Iquique and Arica and in the Arica Airport in order to provide improved national and international services in the interoceanic context. Thus, Chilean interest involves benefiting from investments already made or under way, and in possible new investment with a view to effective structuring of the hub.

Peru began to participate in the meetings of the Group in late 2002, owing to the interest in each of the hubs that the IIRSA’s new coordinator in that country had expressed. In particular, in the framework of the Interoceanic hub, Peru has paved the 359 km of road from the Port of Ilo, although completion of the

work did not lead to a substantial increase in vehicular traffic thereon. Hence that country's interest involves the potential increase in the use of that road that might be generated as the connections of the Interoceanic – and other – hubs are built.

Brazil, in the transport area, is making major investments to enlarge the Port of Rio Grande which, along with those made to link Cáceres with the border with Bolivia, would enable Bolivian grain to be transported to the Atlantic ports at a competitive cost. In the energy area, private investments under way would initially enable 190 MW to be generated in Cuiabá, with subsequent increases that would reach 540 MW, utilizing gas pipelines with Bolivia. In telecommunications, three companies would launch five satellites by 2005, thereby significantly increasing communication capacity in Brazil and within the hub. To that end, Brazil, in the framework of the Group, is advocating moving forward in the regulatory area to facilitate the use of international roaming and to make international and local communication available in border areas.

Paraguay's interest in the IIRSA initiative involves developing services in connection with different projects, and establishing multimodal or service stations in Paraguay's three borders areas along the Paraná River: Ciudad del Este, Foz de Iguazú, and Puerto Iguazú. Development of the station over the Hidrovia would also enable railroad, roadway, port, and waterway services to be integrated. In the gas area, the Paraguayan government is according priority to the gas pipeline that would link Bolivia, Paraguay, and Brazil.

Paraguay is also interested in merging the Interoceanic hub and the Porto Alegre-Asunción-Jujuy-Antofagasta hub, linking Boquerón with Jujuy and with Villamontes, and also in seeking to implement the first interoceanic railroad.

In general, the countries' visions for the Interoceanic hub seem to reflect more the sum of individual interests rather than a joint strategy. In that connection, an attempt is being made by the countries to ensure that the Group tends to take advantage of existing assets for the purpose of generating new profit, as the infrastructure issues and hubs development established as original objectives are long-term objectives. In that sense, the projects presented and the path taken are the result of pre-existing inertia. Thus, additional points will have to be clarified in order to prioritize such forms of complementation as may generate new structuring projects.

To that end, the Group agreed on the need to prepare jointly a georeferenced map of the hubs, an effort to which the countries are to contribute by making available databases on the realities of the area, along with support for the administration of such databases; by preparing maps showing the "bottlenecks" and missing links; and by giving consideration to the area's priority projects in each of the IIRSA sectors.

### **C. The Porto Alegre-Asunción-Jujuy-Antofagasta hub**

In the framework of this ETG, technical missions were launched to compile information on the countries comprising the hub. In view of the status of those efforts and their anticipated progress in the coming months, it is expected that the first meeting of the ETG for this hub will be held in the second half of 2003.

Some preliminary aspects that would form part of the proposed business concept for the hub, to be studied in the framework of the ETG meeting, are given below.

As regards structuring infrastructure projects in the road transport area, although the hub's current network is adequately designed to handle current and short- and medium-term anticipated road transport needs, the network would require further modernization and recycling. Such a process would mainly involve maintenance, conservation, and modernization of the road infrastructure to incorporate advances in

technology and to adapt it to the size of vehicles now circulating in the region, which are now causing roads to deteriorate markedly. Modernization would also involve the construction of circumferential or ring roads to make it possible to avoid transiting cities and towns, whose current road design reflects the antiquated hub network and prevents the implementation of modern traffic flow designs.

As regards rail transport, the existing network allows for an adequate level of operation in Brazil and Chile. However, in Argentina and Paraguay, both the network and equipment are very poorly maintained and in very poor operating condition. As a whole, these networks together could become an adequate means of handling the wide variety of freight in the region that lends itself to rail transport (stone, crushed ores, lime, cement, grain, charcoal, and fuel).

In the area of transport via navigable waterways and ports, although the project to improve and modernize the Paraguay-Paraná Hidrovia is not part of the hub, it is one of the most significant in terms of integration and cross-cutting influence on the Porto Alegre-Asunción-Jujuy-Antofagasta hub. This project, in turn, supplemented by the Tiete-Paraná Hidrovia project, could establish river interconnection between Buenos Aires and Sao Paulo. As these projects advance, major improvements in port infrastructure in the form of a multimodal freight transfer complex in the hub's river ports, principally in the Clorinda-Puerto Falcón and Corrientes-Chaco nodes (Port of Barranqueras), would make it possible to access the aforementioned Hidrovias by different modes of transport.

As regards electrical energy, transport of major electricity flows in both directions (west to east and east to west) are planned, depending on the circumstances, over existing interconnection lines and lines under study (the Northeast Argentina-Northwest Argentina [NEA/NOA] line and supplemental transmission lines to boost capacity – which initially would enhance the reliability of the Argentine system. West-east transmission would take place from SING in Northern Chile and northwest Argentina and from there to the south-southeastern Brazilian market and, in years of abundant hydraulicity in that country, secondary energy would be transmitted, presumably at favorable prices, from east to west.

As regards gas and hydrocarbons, significant flows of gas are also envisaged, which would be transported west to east from the oilfields in northwestern and northern Argentina, where there are major proven reserves, with gas eventually added from Bolivia, via gas pipelines now under study (for example, GASIN) running through the Paraguayan markets, the region between the Paraná and Uruguay Rivers in northeastern Argentina, destined finally for the great potential Brazilian market.

As regards the transport of information, except for connections reinforcements via fiber optic cable where demand trends so indicate, the hub has a telecommunication infrastructure that could handle anticipated growth needs. Regulatory harmonization for the participating countries, and the search for standardization of provisions and access facilities are the objectives to be attained, and are being studied as part of the IIRSA sectoral processes.

Potential economic activities or activities for future development are based on current predominant activities, in particular, mining, energy production from large deposits, and production of primary materials, which would bring together regional comparative advantages and creativity so as to achieve differentiated products. Some of these are:

- Production of metal and non-metal ores
- Copper in lower "La Alumbreira" (Argentina)
- Gas extraction
- Generation of electricity from gas

- Hydroelectric energy generation
- Production of vegetables, fruit, forest products, oil seeds, etc. of different quality (organic certification, denomination of origin, traditional specialties, HACCP, good manufacturing practices, etc.)
- Agroindustrial production (varietal wines – *Torrontés*);
- Production of wood as construction material
- Production of cellulose and paper
- Tourism

Most currently dynamic centers are showing a trend towards growth and expansion. This trend must be confirmed in the conclusions drawn during development of the business concept, including investigation into operators in local areas (authorities, economic agents, civil society, and scientific and technical environment).

#### **D. Amazonian multimodal hub**

On November 20, 2002, the first meeting of the ETG for this hub was held in Manaus, Brazil. At the meeting, a presentation was given on the hub's business concept, followed by a series of presentations given by participating countries.

The presentation of Colombia reiterated the importance of initiatives promoted in the framework of the Treaty for Amazonian Cooperation, in particular, those related to border development. The Tumaco-Puerto Asis-Belém corridor project proposal was also presented, for which alternatives are now being studied for the critical stretch connecting Pasto and Mocoa.

Peru, for its part, gave a presentation on the status of the network and of transport projects, including operational details of the north, central, and southern corridors, usage profiles, traffic volumes, passengers per km, tons per km, investment needed, and details of needs contained in 30 project files. In addition, reference was made to the pertinence and difficulties in defining transnational priorities and the importance of creating a database on transport flows. Also presented were the status of the network and of energy projects, and the proposed interconnection between Pucallpa (interconnected to the Peruvian network) and Cruzeiro do Sul (isolated system, second largest city Brazil's Acre state).

In the case of Ecuador, a presentation was given on the country's road network, taking an infrastructure investment opportunity approach, particularly for the most used sections, and giving estimated internal rates of return. In addition, the Binational Plan with Brazil was presented, and the delivery was announced of a Napo River navigability study and of an Andean product market opportunity study. Also presented were small hydroelectric stations (SHS) project files and an updated Napo River study, which discusses more appropriate location of intermodal terminals and technological support for river navigation, and the respective investments required.

Brazil gave a presentation on communications, which accorded highest priority to seeking convergence of media, particularly of regional satellite links. Also underscored were rule-making processes for services, initiatives to facilitate border traffic, and creative export solutions for small and medium-scale enterprise. The presentation also included the status of and expansion plans for the regional power network, which underscored the importance of the Solimões watershed as an energy source (gas from Urucu), and emphasized investment opportunities in micro and small hydroelectric exploitations, biomass (logging and

palm production residues), and the case of Cruzeiro do Sul in respect of its planned interconnection with the national system by 2020.

Lastly, a historical retrospective was given of the plans for the settlement of Amazonia, migration generated by the availability of land and of transport infrastructure, environmental degradation, and abandoned and depressed areas. In that context, the need was noted for gradual and judicious project implementation policy.

As regards the business concept, reference was made to the complementary character of the predominant economic activities among the areas to be integrated: on the one hand, the coast and the Andes and, on the other, the area of influence of the transnational river transport system of the Amazon River and its tributaries, underscoring the cases of foodstuffs in general, both coastal and, in particular, those produced in temperate and cold climates. In addition, construction materials, fabric and garments, additives and fertilizers are being produced on the Atlantic side, and electrical and electronic products, motorcycles, paper and cellulose, aluminum, and soybeans on the Pacific.

It was also noted that there was a Amazonian identity common to all rainforest spaces for such potential economic activities as might be directed towards the world market for services and sustainable Amazonian products, in particular, environmental services, genetic resources, eco-tourism, wood and non-wood products, environmental monitoring and surveillance certificates and systems, and for businesses and activities that must be organized in the form of information and communication networks. There is also a reasonable possibility that the hub might be utilized as a bi-oceanic transport corridor for Asian products and inputs, of lower value and/or greater volume, to northern Brazil, and eventually, to the entire South Atlantic area, as well as the reverse.

#### **E. Venezuela-Brazil-Guyana-Suriname hub**

The first meeting of the ETG for the Venezuela-Brazil-Guyana-Suriname hub was held on November 19, 2002, in Manaus, Brazil. It was noted that the technical missions carried out only partially attained the objectives initially set for this first phase of implementation of the hub. In consequence, the initial business concept was developed based on secondary information obtained from different public and private sources and on-site visits, and will have to be validated at a later date.

At this preliminary stage, two integration spaces were identified which, as conceived, validate the configuration of the hub. However, it was suggested that the role of the Amazonas State influence area be discussed, more specifically, the Manaus duty free area. It was also suggested that there be discussion of the treatment to be given to the relationship with French Guyana, as that country is not participating in the IIRSA initiative but, owing to its geographic location, is the inevitable transit route and, therefore, an essential element in the process of linking Amapá State to the rest of the hub, a point whose study remains pending.

As regards country presentations, Brazil described the infrastructure projects whose execution is deemed priority in the framework of national development and Brazil's regional integration strategy. A presentation was also given to describe the multisectoral projects being considered by private initiative for implementation, which would integrate Roraima State with the Republic of Guyana and international markets via the Atlantic Ocean. These projects remain at a very preliminary stage of development.

Guyana gave a presentation underscoring the importance attached by that country to participation in the IIRSA initiative and its commitment to continue to support it. Reference was also made to trade relations and current agreements to which Guyana is party or for which it is engaged in negotiations with the other

countries of the hub, as well as integration projects existing or in formulation, underscoring in particular integration projects with Brazil.

As regards Suriname, an analysis was made of the potential and limitations of the main roadways existing in and projected for the country, in view of current geographic, demographic, trade, and economic conditions. In that connection, it was noted that among government priorities is rehabilitation and modernization of the southern east-west corridor, which runs parallel to the coastal or northern corridor, as it would facilitate the exploitation of important natural resources in sectors such as agriculture, logging, mining (bauxite), and aluminum production. Also underscored were the great expectations generated by implementation of the integration projects announced for the northern arc of Brazil with Guyana and French Guiana, and the Venezuela-Guyana integration road, as they would then be linked with major markets that they cannot now access.

In the case of Venezuela, the National Development Plan 2001-2007 was outlined, with reference to national and international economic, social, and political objectives and strategies. Among the objectives mentioned was the occupation and consolidation of national territory in balanced fashion through the development of a strategy for territorial balance (decentralization and deconcentration), based on which four development hubs were identified (western, coastal, Orinoco-Apure, and eastern), as were deconcentration scenarios.

As regards the ETG's work plan, it was decided that it should be structured based on the objectives and goals to be attained in a particular timeframe, and that that timeframe would be determined by the date of the next meeting of the ESC. By that time, it should be possible to point to significant progress in the implementation of the hub in terms of business concept and project inventory.

## **F. Peru-Brazil-Bolivia hub**

On November 21, 2002, the first meeting of the ETG for the Peru-Brazil-Bolivia hub was held in Manaus, Brazil. The background provided on the hub included the main events of the efforts to connect Brazil and Peru by road. The period discussed started with the late 19<sup>th</sup> century, when the natural cork exploitation or boom began in response to demand for the product on international markets. With respect to the geographic environment, reference was also made to the political demarcations contained in the hub's area of direct influence, the relation of each political area with the natural regions and transport modes, and certain characteristics of each such area.

As regards the status of infrastructure, there was discussion of the most salient problems which, from the roadway standpoint – owing to the type of paving, masonry or concrete structures, and level of maintenance – are to be found on the “western” side of the hub, in Peruvian territory. As regards energy, reference was made, for the three countries, to the geographic scope of the interconnected electricity grid and to natural gas deposits.

Also discussed were environmental aspects, noting the protected areas (national parks and reserves, indigenous territories, historic sites, etc.) contained within the hub's area of influence.

As regards the hub's current business concept and commercial activities, it was noted that border trade, from a legal standpoint, does not exist as, in the last five years, there are no records of such trade in the Puerto Maldonado customs office. However, it is thought that trade operations of low value in the informal sector often take place.

Among the hub's weaknesses, it was noted that the central, or MAP, area – comprising the Department of Madre de Dios (Peru), Acre State (Brazil), and the Pando Department (Bolivia) - has historically been



marginalized from the economic and political centers of the respective countries, and is characterized by isolation, scant investment, financial dependence on central government, logging-based development, social indicators below national average, and poor quality and high cost of transport, energy, communications, and social services.

Among “bottlenecks,” reference was made to the deficient state of infrastructure and of road transport service, especially on the western side of the hub. Noted among deficiencies were the lack of bridges; impassable roads in the rainy season; lack of capacity of bridges and structures, which cannot support weights over 20 tons; lack of road safety and security, etc.

As regards potential trade activities, there was discussion of possible trade operations that might be generated involving products considered “traditional” in each of the departments or states comprising the area of influence, products believed to have the most export potential owing to the strategic location and quality of the product offered. Possible trade operations were studied for different productive sectors: agriculture, fishing forestry, agro-industry, hydrobiology, mining, manufacturing, crafts, machining, textiles, energy, and tourism.

Based on the analysis of existing productive activities, a preliminary list was drawn up of products that might potentially be marketed via the hub.

Based on the analysis made at the meeting, the ETG’s immediate work plan would focus on finalizing the business concept through national and sectoral technical meetings in Bolivia, Brazil, and Peru, reviewing secondary sources (Web pages, libraries, statistics, etc.), and field research, research, and on-site interviews. In that connection, the importance of the events held in Manaus (Brazil), Arequipa (Peru), and Cobija (Bolivia) was underscored.



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