



2007 (SECOND SEMESTER) - 2008 (FIRST SEMESTER)



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

Inter-American Development Bank
MERCOSUR Report N° 13, May 2009





REPORT



MERCOSUR

2007 (SECOND SEMESTER) - 2008 (FIRST SEMESTER)

Inter-American Development Bank
Integration and Trade Sector

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Published in Argentina

Institute for the Integration of Latin America and the Caribbean - IDB-INTAL
MERCOSUR Report N° 13
1^a ed. - Buenos Aires: IDB-INTAL. May, 2009.
184 p.; 28 x 21 cm.

ISBN: 978-950-738-282-6

1. Desarrollo Económico
CDD 338.9

Editing Coordination: Susana Filippa
Editing: Julieta S. Tarquini

PRESENTATION

The achievements and challenges in this ambitious initiative by the Southern Common Market (MERCOSUR), constituted by the Treaty of Asunción in 1991, have been evaluated in annual reports. The report presented here is part of a wider framework of activities that IDB/INTAL, as a unit of the Vice-Presidency of Countries and coordinating its actions with the Integration and Trade Sector of IDB's Vice-Presidency for Sectors and Knowledge (VPS), has been carrying out in connection with the integration processes of Latin America and the Caribbean.

Through this annual report, IDB/INTAL aims to facilitate access to information for a readership potentially interested in MERCOSUR, spanning the public, private, and academic sectors, and the subregional community as a whole. Also, to extend the interest aroused by MERCOSUR in the local to the international community we publish the Report in English, as well as the bloc's official languages of Spanish and Portuguese.

Report 13 covers the second half of 2007 and the first half of 2008. The initial draft of the document was prepared by a team of economists, headed by Ricardo Markwald with the collaboration of Lucía Maduro, Fernando Ribeiro, and Sandra Ríos. The macroeconomic chapter was prepared in INTAL with the collaboration of Rosario Campos, Romina Gayá, and Alejandro Ramos. The Integration and Trade Sector, managed by Antoni Estevadeordal, also collaborated in the design and content of the report. The final draft was coordinated and edited by Ricardo Carciofi and Uziel Nogueira, Director and Senior Integration Economist of INTAL respectively, with the assistance of Rosario Campos, Romina Gayá and Alejandro Ramos.

Ever mindful of living up to the expectations prompted by previous reports, we invite readers to send their comments and/or suggestions on how we can improve the scope and focus of future publications.

GLOSSARY OF ABBREVIATIONS AND ACRONYMS

ABDI	Brazilian Agency for Industrial Development (<i>Agência Brasileira de Desenvolvimento Industrial</i>)
ABICALÇADOS	Brazilian Footwear Industries Association (<i>Associação Brasileira da Indústria de Calçados</i>)
ABIMAQ	Brazilian Machinery Builders' Association (<i>Associação Brasileira da Indústria de Máquinas e Equipamentos</i>)
ABIT	Brazilian Textile and Apparel Industry Association (<i>Associação Brasileira da Indústria Têxtil e de Confecção</i>)
ADB	Asian Development Bank
ADEFA	Association of Automobile Manufacturers of Argentina (<i>Asociación de Fábricas de Automóviles de la Argentina</i>)
ADIMRA	Association of Metallurgical Industrialists of the Argentine Republic (<i>Asociación de Industriales Metalúrgicos de la República Argentina</i>)
AFJP	Retirement and Pension Fund Administrator (<i>Administradora de Fondos de Jubilaciones y Pensiones</i>)
AM	Agricultural Manufacturing
AMPIP	MERCOSUR Agency for the Promotion of Production Integration (<i>Agencia MERCOSUR para la Promoción de la Integración Productiva</i>)
ANCAP	National Administration of Fuels, Alcohol, and Portland (<i>Administración Nacional de Combustibles, Alcohol y Portland</i>)
ANFAVEA	National Association of Automotive Vehicle Manufacturers (<i>Associação Nacional dos Fabricantes de Veículos Automotores</i>)
APEX	Brazilian Trade and Investment Promotion Agency (<i>Agência Brasileira de Promoção de Exportações</i>)
BADLAR	Buenos Aires Deposits of Large Amount Rate
BCB	Central Bank of Brazil (<i>Banco Central do Brasil</i>)
BCP	Central Bank of Paraguay (<i>Banco Central de Paraguay</i>)
BCRA	Central Bank of the Argentine Republic (<i>Banco Central de la República Argentina</i>)
BCU	Central Bank of Uruguay (<i>Banco Central de Uruguay</i>)
BCV	Central Bank of Venezuela (<i>Banco Central de Venezuela</i>)

BEA	Bureau of Economic Analysis
b.p.	Basic points
BRAECLPA	Brazilian Pulp and Paper Association (<i>Associação Brasileira de Celulose e Papel</i>)
BsF	Strong Bolivars
c.a.	Cumulative annual
CADIVI	Commission of Foreign Exchange Administration (<i>Comisión de Administración de Divisas</i>)
CAF	Andean Development Corporation (<i>Corporación Andina de Fomento</i>)
CAIRAA	Argentina Chamber of Refrigeration and Air Conditioning Industries (<i>Cámara Argentina de Industrias de Refrigeración y Aire Acondicionado</i>)
CAM	MERCOSUR Customs Code (<i>Código Aduanero del MERCOSUR</i>)
CAMEX	Chamber of Foreign Trade (<i>Câmara de Comércio Exterior</i>)
CAN	Andean Community of Nations (<i>Comunidad Andina de Naciones</i>)
CCM	MERCOSUR Trade Commission (<i>Comisión de Comercio del MERCOSUR</i>)
CCPAC	Certificate of Common Tariff Policy Compliance (<i>Certificado de Cumplimiento de la Política Arancelaria Común</i>)
CCROM	Certificate of MERCOSUR Origin Regime Compliance (<i>Certificado de Cumplimiento del Régimen de Origen MERCOSUR</i>)
CEB	Buenos Aires Studies Center (<i>Centro de Estudios Bonaerenses</i>)
CEB	Brazilian Business Coalition (<i>Coalizão Empresarial Brasileira</i>)
CEP	Center for Production Studies (<i>Centro de Estudios para la Producción</i>)
CET	Common External Tariff
CG	Capital Goods
CIC	Chamber of the Footwear Industry (<i>Cámara de la Industria del Calzado</i>)
CINDES	Center for Integration and Development Studies (<i>Centro de Estudos de Integração e Desenvolvimento</i>)
CMC	Common Market Council (<i>Consejo del Mercado Común</i>)
CNCE	National Foreign Trade Commission (<i>Comisión Nacional de Comercio Exterior</i>)

CNI	Brazilian National Confederation of Industry (<i>Confederação Nacional da Indústria</i>)
COF	MERCOSUR Structural Convergence Fund Agreement (<i>Convenio del Fondo para la Convergencia Estructural del MERCOSUR</i>)
CPC	Joint Parliamentary Commission (<i>Comisión Parlamentaria Conjunta</i>)
CPI	Consumer Price Index
CPI-GBA	Consumer Price Index for the Autonomous City of Buenos Aires and Greater Buenos Aires (<i>Índice de Precios al Consumidor de la Ciudad Autónoma de Buenos Aires y el Gran Buenos Aires</i>)
CRB	Commodity Research Bureau
CRPM	Commission of Permanent Representatives of MERCOSUR (<i>Comisión de Representantes Permanentes del MERCOSUR</i>)
DDC	Developed Countries
Dec.	Decision
DGC	Developing Countries
DGEEC	General Directorate of Statistics, Surveys, and Censuses (<i>Dirección General de Estadísticas, Encuestas y Censos</i>)
DINAPYME	National Office for Crafts and Small and Medium Enterprises (<i>Dirección Nacional de Artesanías, Pequeñas y Medianas Empresas</i>)
DNCN	National Office of National Accounts (<i>Dirección Nacional de Cuentas Nacionales</i>)
DNI	National Directorate of Industries (<i>Dirección Nacional de Industrias</i>)
€	Euro
ECA	Economic Complementation Agreement
ECLAC	Economic Commission for Latin America and the Caribbean
ELETROS	National Association of Electric and Electronic Products Manufacturers (<i>Associação Nacional de Produtos Eletroeletrônicos</i>)
EPCI	Extended Consumer Price Index
ESRI	Economic and Social Research Institute
EU	European Union
EUROSTAT	Statistical Office of the European Communities
EVE	Economic Variables Expectations
Ext.	Extraordinary
FAO	Food and Agriculture Organization
FCES	Economic and Social Consultative Forum (<i>Foro Consultivo Económico-Social</i>)
FDI	Foreign Direct Investment

FED	The Federal Reserve System
FFR	Federal Funds Rate
FLIR	Short-Term Liquidity Facility with Monetary Regulation Instruments Reporting <i>(Facilidad de Liquidez de Corto Plazo con Reporto de Instrumentos de Regulación Monetaria)</i>
FOCEM	MERCOSUR Structural Convergence Fund <i>(Fondo para la Convergencia Estructural del MERCOSUR)</i>
FOGADE	Deposits Guarantee and Bank Protection Fund <i>(Fondo de Garantía de Depósitos y Protección Bancaria)</i>
FONDEN	National Development Fund <i>(Fondo de Desarrollo Nacional)</i>
FONPLATA	Financial Fund for the Development of the River Plate Basin <i>(Fondo Financiero para el Desarrollo de la Cuenca del Plata)</i>
FTAA	Free Trade Area of the Americas
FTS	Free Trade Space
FTT	Financial Transaction Tax
FUNCEX	Foreign Trade Study Center Foundation <i>(Fundação Centro de Estudos do Comércio Exterior)</i>
GAHB	<i>Ad Hoc</i> Biofuels Group <i>(Grupo Ad Hoc sobre Biocombustibles)</i>
GAHIP	<i>Ad Hoc</i> Production Integration Group <i>(Grupo Ad Hoc de Integración Productiva)</i>
GANAE	High Level Group to Examine the Consistency and Dispersion of the Current Structure of the Common External Tariff <i>(Grupo de Alto Nivel para Examinar la Consistencia y Dispersión del Arancel Externo Común)</i>
GANASIM	High Level Group for the Elaboration of the Strategic Plan to Overcome Asymmetries in MERCOSUR <i>(Grupo de Alto Nivel para la Superación de las Asimetrías)</i>
GANRI	High Level <i>Ad Hoc</i> Group for Institutional Reform of MERCOSUR <i>(Grupo Ad Hoc de Alto Nivel para la Reforma Institucional del MERCOSUR)</i>
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GEIPA	Executive Group for Automotive Chain Production Integration <i>(Grupo Ejecutivo para Integración Productiva de la Cadena Automotriz)</i>
GIP	Production Integration Group <i>(Grupo de Integración Productiva)</i>
GMC	Common Market Group <i>(Grupo del Mercado Común)</i>
HICP	Harmonized Index of Consumer Prices

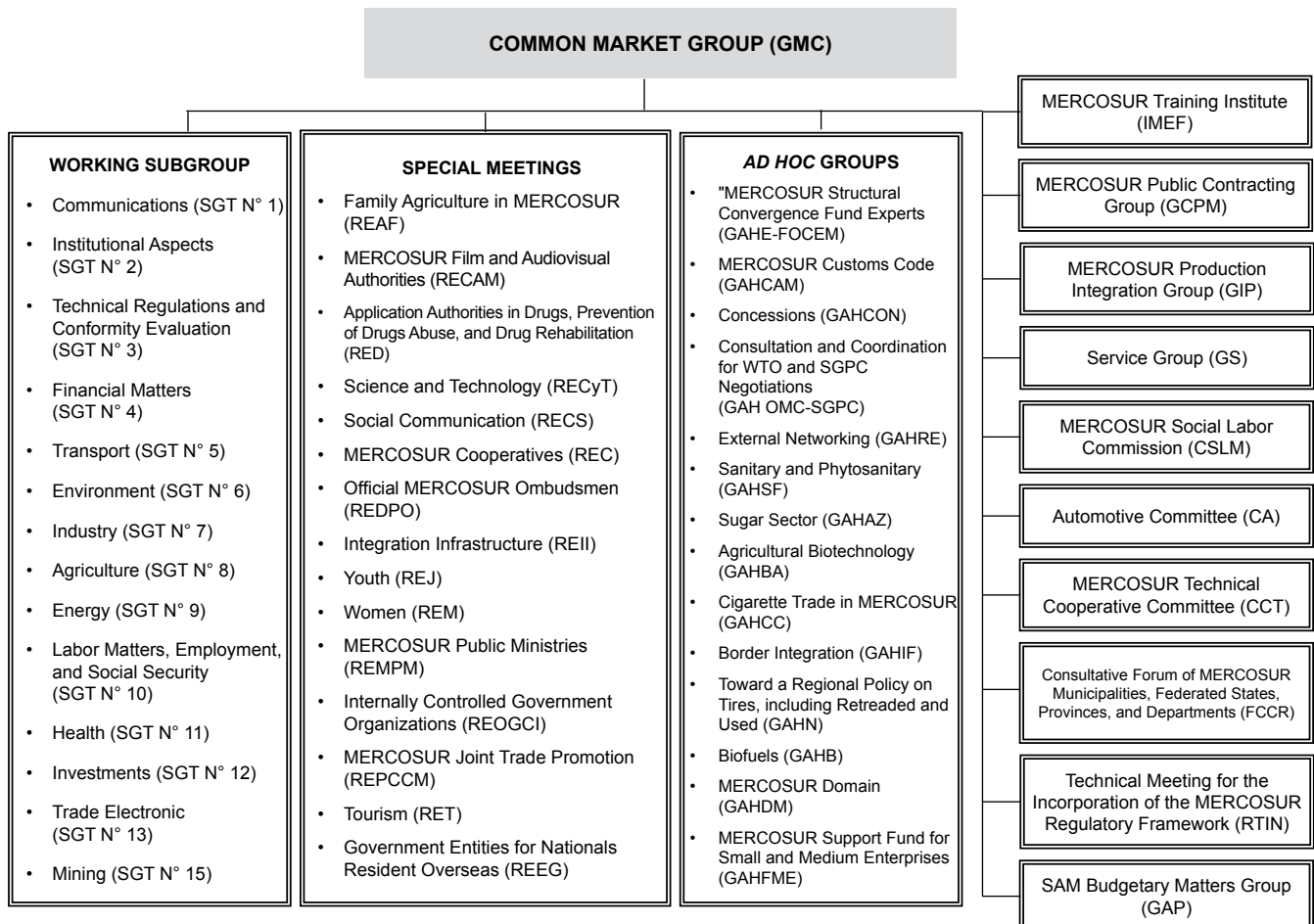
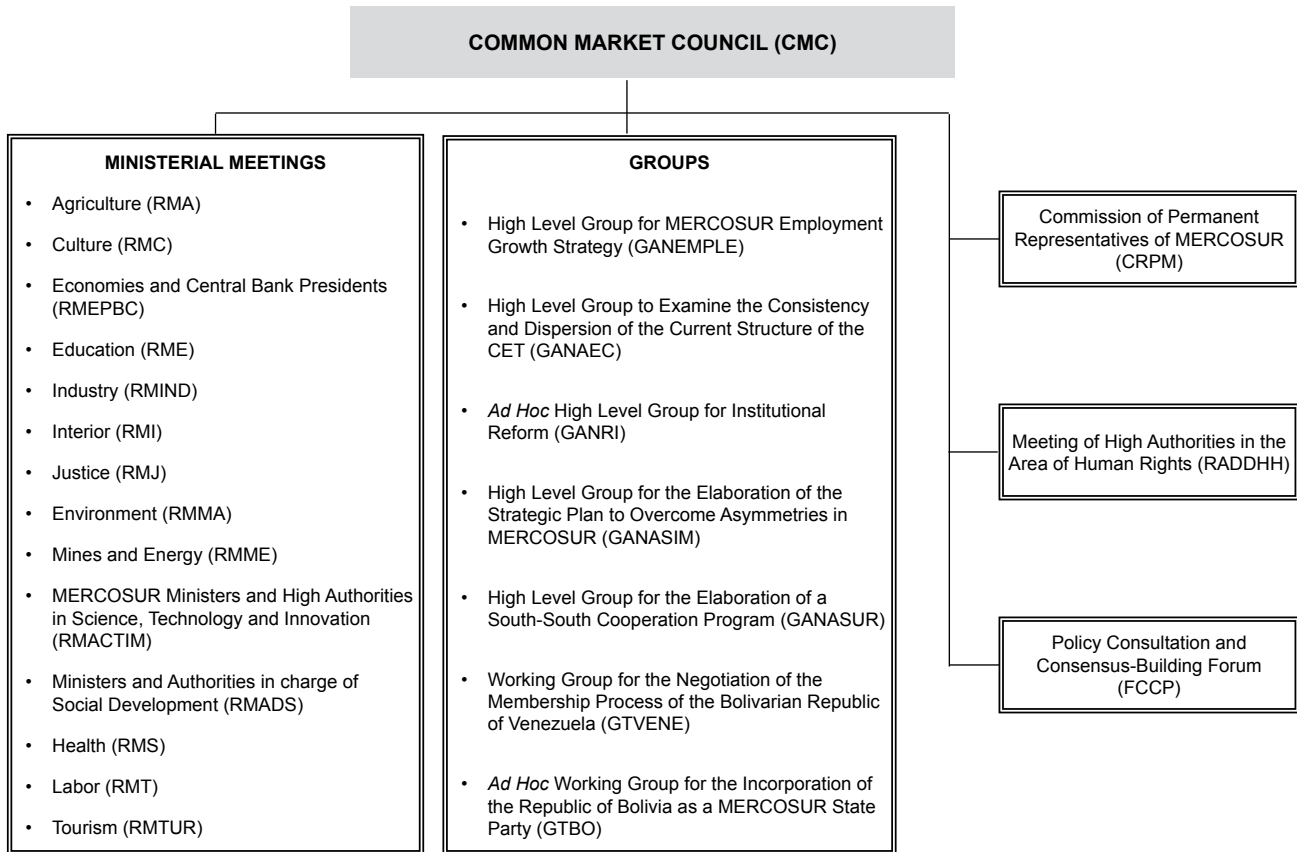
HS	Harmonized System
IBGE	Brazilian Institute of Geography and Statistics (<i>Instituto Brasileiro de Geografia e Estatística</i>)
ICOME	Foreign Currency Purchase Tax (<i>Impuesto a la Compra de Moneda Extranjera</i>)
ICONE	Institute for Studies of International Trade Negotiations (<i>Instituto de Estudos do Comércio e Negociações Internacionais</i>)
ID	Internal document
IDB	Inter-American Development Bank
IDB-INTAL	Institute for the Integration of Latin America and the Caribbean
IIRSA	Initiative for the Integration of Regional Infrastructure in South America
IM	Industrial Manufacturing
IMF	International Monetary Fund
INAN	National Food and Nutrition Institute (<i>Instituto Nacional de Alimentación y Nutrición</i>)
INDEC	National Institute of Statistics and Censuses (<i>Instituto Nacional de Estadísticas y Censos</i>)
INDIRA	Customs Register Information Exchange (<i>Intercambio de Información de los Registros Aduaneros</i>)
INE	National Statistics Institute (<i>Instituto Nacional de Estadística</i>)
INPC	National Consumer Price Index (<i>Índice Nacional de Precios al Consumidor</i>)
INTN	National Institute for Technology, Standardization, and Metrology (<i>Instituto Nacional de Tecnología, Normalización y Metrología</i>)
IPEA	Institute of Applied Economic Research (<i>Instituto de Pesquisa Econômica Aplicada</i>)
IT	Import taxes
ITTG	Information Technology and Telecommunications Goods
IVSS	Venezuelan Institute of Social Security (<i>Instituto Venezolano de los Seguros Sociales</i>)
LAIA	Latin American Integration Association
LD	Legislative Decree
LEBAC	Central Bank Accounts (<i>Letras del Banco Central</i>)
LPG	Liquefied petroleum gas
MAC	Competitive Adaptation Mechanism (<i>Mecanismo de Adaptación Competitiva</i>)

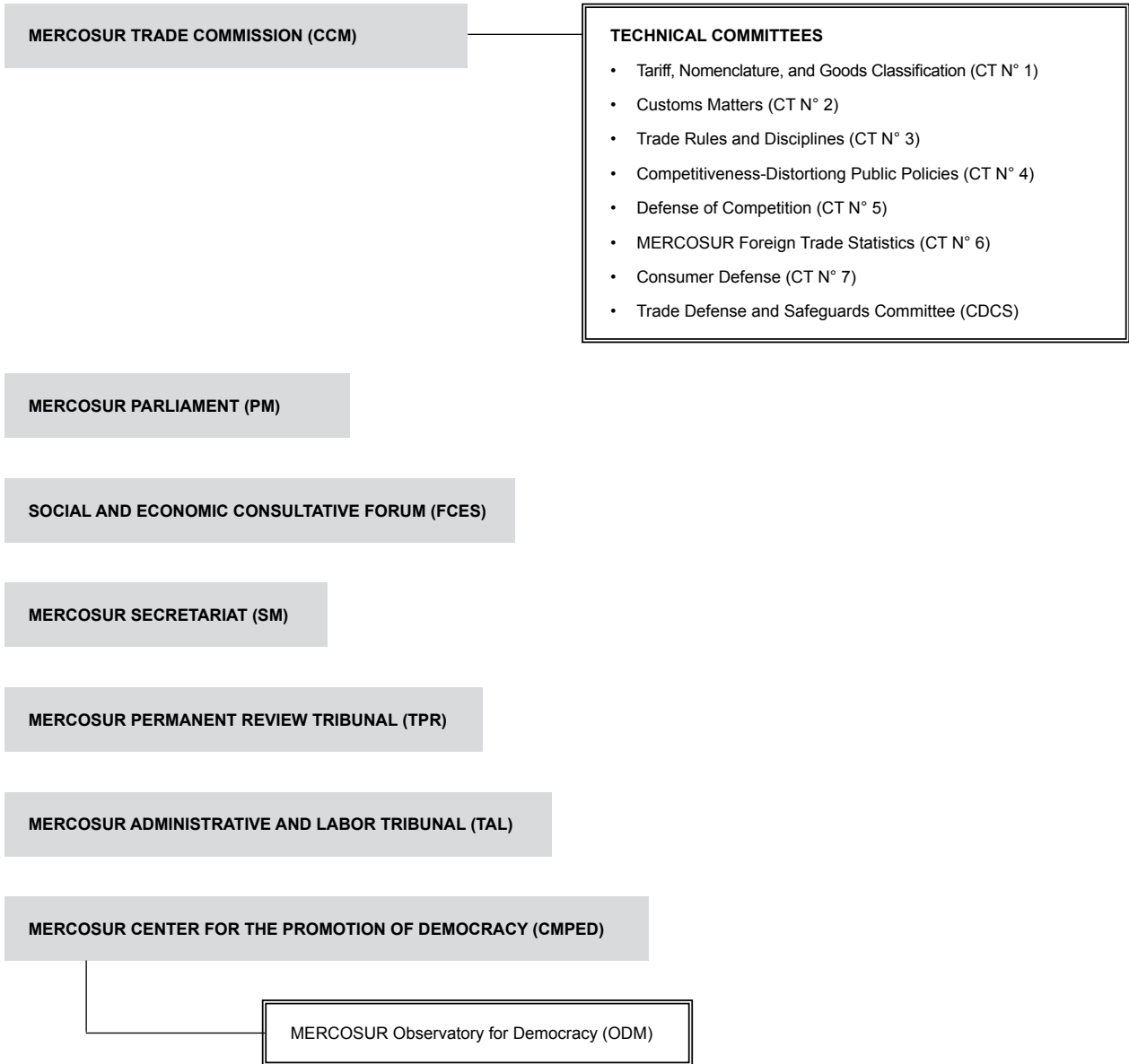
MDIC	Ministry of Development, Industry, and Foreign Trade (<i>Ministério de Desenvolvimento, Indústria e Comércio Exterior</i>)
MECON	Ministry of Economy and Production (<i>Ministerio de Economía y Producción</i>)
MEyP	Ministry of Economy and Production (<i>Ministerio de Economía y Producción</i>)
MERCOSUR	Southern Common Market (<i>Mercado Común del Sur</i>)
n.a.	Not available
NAFTA	North US Free Trade Agreement
NAMA	Non-Agricultural Market Access Negotiations
NBS	National Bureau of Statistics of the People's Republic of China
NOBAC	Central Bank Notes (<i>Notas del Banco Central</i>)
OECD	Organisation for Economic Cooperation and Development
ONCyT	National Science and Technology Bodies (<i>Organismos Nacionales de Ciencia y Tecnología</i>)
ONIP	National Organization of the Petroleum Industry (<i>Organização Nacional da Indústria do Petróleo</i>)
ORPIP	Permanent Regional Observatory on Production Integration in MERCOSUR (<i>Observatorio Regional Permanente sobre Integración Productiva en el MERCOSUR</i>)
OTDS	Overall Trade-Distorting Support
PAC	Common Automotive Policy (<i>Política Automotriz Común</i>)
PAC	Common Tariff Policy (<i>Política Arancelaria Común</i>)
PCPM	Constitutive Protocol of the MERCOSUR Parliament (<i>Protocolo Constitutivo del Parlamento del MERCOSUR</i>)
PCRPM	Presidency of the Commission of Permanent Representatives of MERCOSUR (<i>Presidencia de la Comisión de Representantes Permanentes del MERCOSUR</i>)
PDVSA	Venezuela Petroleums Inc. (<i>Petróleos de Venezuela Sociedad Anónima</i>)
PICE	Argentina-Brazil Integration and Economics Cooperation Program (<i>Programa de Integración y Cooperación Económica Argentina-Brasil</i>)
PIPM	MERCOSUR Production Integration Program (<i>Programa de Integración Productiva del MERCOSUR</i>)
p.p.	Percentage point

PPT	<i>Pro Tempore</i> Presidency
PROMINP	Mobilization Program for the National Petroleum and Natural Gas Industry (<i>Programa de Mobilização da Indústria de Petróleo e Gás</i>)
PSND	Public Sector Net Debt
RAM	Recently-Acceded Member
REACH	Registration, Evaluation, Authorisation and Restriction of Chemical Substances
RECyT	Specialized Science and Technology Meeting (<i>Reunión Especializada de Ciencia y Tecnología</i>)
Res.	Resolution
S&P	Standard & Poor's
SACU	South African Customs Union
SAGPyA	Secretariat of Agriculture, Livestock, Fishing, and Food (<i>Secretaría de Agricultura, Ganadería, Pesca y Alimentos de la República Argentina</i>)
SEBRAE	Brazilian Service of Support for Micro and Small Enterprises (<i>Serviço Brasileiro de Apoio às Micro e Pequenas Empresas</i>)
SECEX	Secretariat of Foreign Trade (<i>Secretaria de Comércio Exterior</i>)
SELIC	Special System for Settlement and Custody (<i>Sistema Especial de Liquidación y Custodia</i>)
SENACSA	National Service of Quality and Animal Health (<i>Servicio Nacional de Calidad y Salud Animal</i>)
SENAI	National Service of Industrial Learning (<i>Serviço Nacional de Aprendizagem Industrial</i>)
SENAVE	National Plant and Seed Quality and Health Service (<i>Servicio Nacional de Calidad y Sanidad Vegetal y de Semillas</i>)
SEPYME	Undersecretariat for Small and Medium Enterprise and Regional Development (<i>Subsecretaría de la Pequeña y Mediana Empresa y Desarrollo Regional de la República Argentina</i>)
SICA	Central American Integration System (<i>Sistema de Integración Centroamericana</i>)
SM	MERCOSUR Secretariat (<i>Secretaría del MERCOSUR</i>)
SMEs	Small and Medium Enterprises
SML	Local Currency Payment System (<i>Sistema de Pagos en Moneda Local</i>)
SSG	Special Agricultural Safeguard
TRP	Permanent Review Tribunal (<i>Tribunal Permanente de Revisión</i>)
TU	Technical Unit

UN	United Nations
UNASUR	Union of South American Nations
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
VAT	Value Added Tax
WESP	World Economic Situation and Prospects
WG	Working Group
WP	Working Paper
WS	Working Subgroup
WTA	World Trade Atlas
WTO	World Trade Organization
YOY	year-on-year

MERCOSUR INSTITUTIONAL FRAMEWORK





Source: MERCOSUR Official website <http://www.mercosur.int> (own translation).

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EXECUTIVE SUMMARY

In spite of the international context affected by the financial and credit crisis triggered in the US mortgage market, integration of the Southern Common Market (MERCOSUR) has continued to move forward, mainly in the internal agenda, where member countries reached certain agreements. In the period covered in this report (June 2007 to June 2008), trade volumes grew in an expanding context for the bloc's economies. On the external front, the negotiating dynamic has seen less tangible results. The worsening of the international financial crisis in the last quarter of 2008 creates an adverse context for the bloc's economies in the coming year. This scenario contemplates a downturn in world growth and a contraction of the main consumer markets, such as the United States, the European Union, and Japan. Below are the main conclusions of this 2007-2008 MERCOSUR Report.

Macroeconomic outlook: The gross domestic product of the bloc's five member countries grew on average 7.3% in 2007 and may reach 6.9% in 2008, according to the latest forecasts available. Although imports were highly dynamic, the growth of the five economies (Argentina, Brazil, Uruguay, Paraguay, and Venezuela) was supported by a great expansion of exports, helped along by the strong demand and high price of commodities. GDP growth was based on rising investment in production sectors and robust private consumption as a result of rising incomes and the availability of credit, mainly in Brazil. The dynamism of the economies was an aspect of a macroeconomic situation characterized by positive fiscal balances (except Venezuela) and surpluses in the Brazilian, Argentine, and Venezuelan trade balances.

The unemployment rate fell across all five countries, reaching an average rate of 8.1% of the economically active population. Again, on the social level, there was progress in terms of lower poverty levels. The rate of inflation was the main challenge for the monetary authorities, due to the sharp increase in food and energy prices. Average inflation of the five countries was thus 10% in 2007* and was expected to rise above this level by late 2008.

For 2009, the outlook for growth is subject to great uncertainty. In fact, the depth and extent of the slowdown of the global economy will be the main variable to determine MERCOSUR's potential for growth. The bloc's economies will be negatively affected through trade and access to international credit, phenomenon that has already began to stand in the way of trade financing. In terms of exports, a dual impact will be felt, occasioned by the fall in demand and leading commodity prices (agricultural produce, minerals, and oil).

It remains to be seen whether the slowdown in global growth can be offset through anticyclical monetary and fiscal policies across the five countries of the bloc. Governments will attempt to maintain employment levels, incomes, consumption, and investment. The lesser role of inflationary pressure that characterized late 2007 and early 2008 will be an important factor in achieving this purpose. The forecasts for the bloc's growth rates of 4% p.a. in 2009 are consistent with the above premises.**

* Simple average for the year-on-year variation of consumer price indexes in December 2007.

** The projection is a simple average of the median of Market Expectations in Argentina, Brazil, Paraguay, and Uruguay. In the case of Venezuela, it corresponds to ECLAC forecasts. The most recent IMF forecasts (11/06/08) indicate growth below 4% for the simple average of the five economies.

Trade and foreign direct investment: In 2007-2008, the trade balance continued to be a dynamic factor in the bloc: global exports reached US\$129.1 billion in the first half of 2008, 27.5% up on the first half of 2007. Imports reached US\$115.8 billion, a 50.7% increase. Intrazone trade also saw robust growth, with imports of US\$19.8 billion in the first half of 2008. The pace of commerce was accompanied by foreign direct investment in the bloc of US\$41.5 billion in 2007. Investment reached US\$19.3 billion in the first half of 2008, 13.2% down on the same period in 2007. This drop reflects the negative impact of the financial crisis. For an estimated value of US\$7.1 billion in 2007, Brazilian companies carried on investing in the bloc's economies, mainly Argentina.

Internal agenda: The bloc's *Pro Tempore* Presidency was held by Uruguay in the second half of 2007 and Argentina in first half of 2008. Reflecting the these countries' priorities, the emphasis in the case of Uruguay was placed on the second stage implementation of CMC Resolution 54/04, whose main objectives are to establish a MERCOSUR Customs Code and define a mechanism for the distribution of customs revenue. In spite of the Uruguayan authorities' diplomatic efforts, it proved impossible to achieve the desired objective. In the case of Argentina, the proposed objective of defining a Production Integration Program was accomplished, an issue of especial importance in strengthening regional production chains and one that aims to overcome the asymmetries existing within the bloc. For 2009, the internal agenda will have to pursue the efforts in the two areas mentioned, and in the activation of several consultation mechanisms to avoid trade intrabloc conflicts.

Sectoral and trade disputes: Where sectoral conflicts and trade dispute negotiations are concerned, in spite of the rise in Brazil's trade surplus with other partners in the bloc, the period was relatively quiet. This can be explained by the growth of the five economies, the appreciation of the Brazilian real in relation to the other partners' currencies (mainly the Argentine peso), rising Brazilian investments in the region, and the efficiency of the Bilateral Trade Monitoring Commissions. In terms of the Common Automotive Policy, setting a timeframe for free trade between Brazil and Argentina was the main achievement of the bloc's industrial integration agenda. The satisfactory settlement of the dispute caused by the installation of a cellulose plant in Fray Bentos, Uruguay, remains a major challenge for Uruguayan and Argentine diplomacy in 2009.

External agenda: MERCOSUR's external agenda saw scant progress during the period analyzed, despite the various negotiation fronts opened by the bloc in recent years. Notwithstanding the less favorable international climate for trade liberalization movements, the bloc is encountering difficulties over the convergence of interests between its partners in relation to the projects of international insertion. On the one hand, Uruguay is seeking authorization to move ahead in bilateral talks, independent of MERCOSUR. Argentina, on the other hand, has little incentive to commit itself in new trade liberalization movements, as this would mainly affect its manufacturing sector. Brazil, for its part, concentrated its efforts on the multilateral negotiation of the Doha Round, which is still at a standstill. In 2009, the external agenda will be even more defensive in light of the adverse international scenario. Much of the external effort will be concentrated on the WTO, trying to maintain access to global markets.

CHAPTER 1. MACROECONOMIC OVERVIEW

A. The international scenario

The new world economic context¹

The outbreak of a major financial crisis with epicenters in the developed countries (DDCs) during the northern summer of 2007² increased uncertainty over the strength and permanency of the factors that had been stimulating growth and world trade since 2003. The disruption initially only affected certain segments of the US mortgage market, once the real estate bubble burst at the start of 2007. However, the crisis spread until it became a systemic threat, blocking key credit markets, increasing stock market and foreign exchange volatility, and creating both inflationary and contractive trends (Box A). A recent scenario forecasts that world GDP and trade in 2008 will expand by 2.7% and 4.9% respectively, as against 3.7% and 7.2% in 2007. There would be a substantial slowdown in 2009, as trading would rise by just 4.1% and activity by 1.9%. The USA and the Euro Zone would grow by a mere 0.1% and 0.2%, while China would see its rate of expansion fall to a lesser degree, from 9.7% in 2008 to 9.3% in 2009. These forecasts are, nevertheless, marked by a high degree of uncertainty.³ It is worth noting that, although the depth of the crisis beginning in mid-2007 is unheard-of in recent times, its initial impact on world growth was weak. This is explained by two main factors. On the one hand, until mid-2008, the emerging economies (those of MERCOSUR among them) maintained steep rates of expansion, while the brunt of the slowdown was borne by the developed economies (Graph 1). On the other hand, the DDCs' authorities implemented a set of measures to curb contractive and deflationary trends, such as massive injections of liquidity, interest rate cuts and tax incentives. In the USA, GDP growth in 2007 was 2% (2.8% in 2006) and 2.3% in the first half of 2008. It should be noted, however, that these increases combine a marked drop in the aggregate of durable consumption and residential investment (6.1% in the first half of 2008) with strong growth in exports of goods and services (10.5% in the same period), stimulated by the real depreciation of the dollar seen until mid-2008.⁴ On the other hand, imports of US goods and services tailed off during 2007, contracting by 1.4% in the first half of 2008. Although this situation helps correct one of the imbalances that beleaguer the world economy, it also brings about a reduction in one of its sources of dynamism. The US economy's troubles are more pronounced in terms of labor demand: while on average during 2006-2007, 133,000 jobs were created per month, between January and September 2008, 85,000 jobs were lost per month.

¹ Text concluded October 20, 2008.

² See *MERCOSUR Report 12* [2007], p. 3.

³ World growth rate corresponds to an aggregation through market exchange rates. IMF [2008c], p. 2. See also the United Nations (UN) forecasts in UN [2008], which includes a range of scenarios, and those of UNCTAD [2008], p. 2.

⁴ Between January 2007 and June 2008, the dollar depreciated 9.0% in real effective terms. The trend was reversed between June and September, with an appreciation of 4.0%. However, in the medium-term outlook, it is value noting that, between January 2002 and September 2008, the depreciation recorded was 19.9%.

Box A
KEY EVENTS IN THE FINANCIAL CRISIS 2007-2008

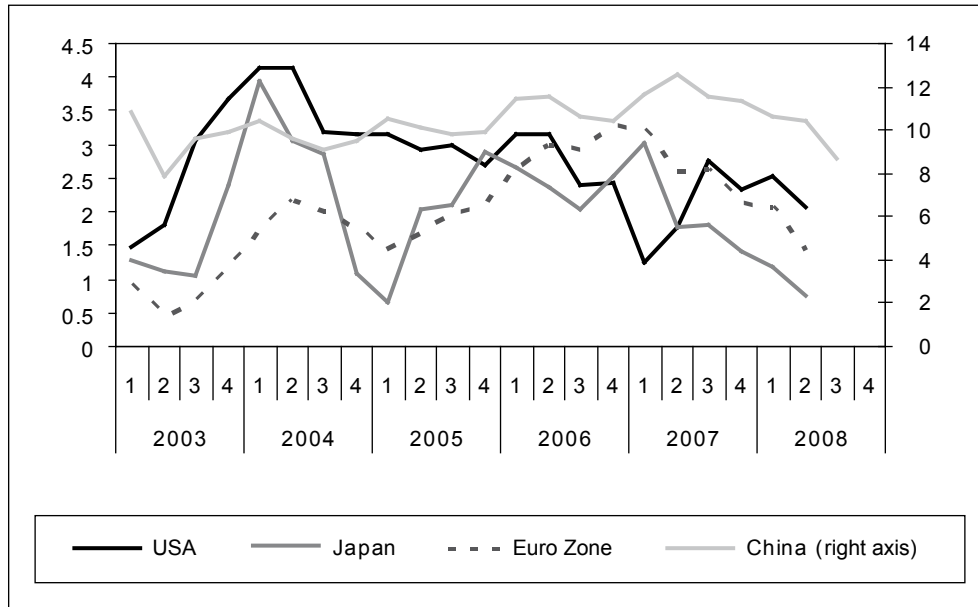
Date	Event
2007	
17-07	Bear Stearns subprime mortgage hedge fund crash makes headline news.
19-07	The Dow Jones reaches a record high of 14,164 points before starting a downward spiral.
03-08	Bear Stearns describes the state of the market as the worst in 22 years.
09-08	BNP Paribas announces the freezing of "dynamic funds" exposed to subprime mortgages. The European Central Bank, the Federal Reserve and other monetary authorities set in train emergency operations to inject liquidity into the financial market.
16-08	The Dow Jones reaches a relative low of 12,846 points as a result of the panic triggered by the subprime crisis; Countrywide Financial, a major US mortgage operator requires liquidity loans.
17-08	In an emergency statement, the Federal Reserve extends liquidity facilities for entities in trouble, reduces one of its discount rates by 50 basic points (b.p.), but keeps the federal funds rate (FFR) at 5.25%.
18-09	The Federal Reserve cuts the FFR 50 b.p. to 4.75%.
09-10	Driven up by slack monetary policy, the Dow Jones reaches a record 14,165-point high and then begins to fall in tail off with lows in January, March, and October 2008.
31-10	25 b.p. cut in the FFR to 4.5%.
01-11	Citigroup announces it has to raise US\$30 billion extra capital; its share price collapses.
27-11	Abu Dhabi's sovereign fund announces investments in Citibank.
11-12	The Federal Reserve announces a cut of just 25 b.p. in the FFR to 4.25%.
12-12	The Federal Reserve announces the implementation of the Term Auction Facility, intended to alleviate the liquidity problems of depository banks; the auctions get started on December 17.
2008	
17-01	Issues of recession in the USA increase when a disheartening report from the Federal Reserve comes to light.
22-01	A relative 11,971-point low for the Dow Jones. Emergency 75 b.p. cut in the FFR to 3.5%. Société Générale announces heavy losses, attributed to an operator.
30-01	Further 50 b.p. cut in the FFR to 3% that boosts the stock market.
27-02	The Dow Jones reaches a relative high of 12,694 points, before beginning abruptly to deteriorate again.
10-03	The Dow Jones reaches a relative low of 11,740.
11-03	The Federal Reserve announces the implementation of the Term Securities Lending Facility, which enables investment banks and other "primary dealers" to exchange asset-backed papers relating to the mortgage market for Treasury notes; the auctions get started on March 27.
14 a 17-03	The Federal Reserve announces a bailout for Bear Stearns, which includes credit facilities for a buyout by US investment bank, J.P. Morgan Chase, and cuts one of its discount rates by 25 b.p.
18-03	75 b.p. cut in the FFR to 2.25%. The stock market reacts favorably.
30-04	25 b.p. cut in the FFR to 2%. According to provisional data, US GDP saw moderate growth in the first quarter.

Box A (CONTINUED)

Date	Event
07	Over July the prices of various commodities peak, then begin to tail off. This marks the close of the "inflationary phase" of the crisis.
07-09	The US government takes control of mortgage giants, Freddie Mac and Fannie Mae, whose debt is of systemic importance.
15-09	Lehman Brothers declares bankruptcy.
17-09	Bailout of the insurance giant, American International Group, Inc (AIG).
21-09	Goldman Sachs and Morgan Stanley convert to bank holding companies.
28-09	Nationalization of the Dutch/Belgian financial group, Fortis, and the British mortgage bank, Bradford & Bingley.
29-09	US Congress throws out a mammoth bailout plan for the financial system. The Dow Jones sees a 4.8% drop of 777 points.
03-10	The US Congress approves a US\$700 billion financial bailout, but the stock markets continue to fall.
06-10	The Dow Jones closes 9,000 points down.
08-10	50 b.p. cut in the FFR to 1.50%.
10-10	The Dow Jones closes at 8,451 points after eight consecutive falls in which it loses a total of 2,399 units (22.1%). It is a crash of historic proportions.
14-10	After a meeting of the G7, it is announced that, to recapitalize a wide range of financial institutions, the US Treasury will make "voluntary purchases" of preferred shares. Deposit protection is extended and a plan is outlined to assist with liquidity in exchange for asset-backed papers with a three-month maturity.

In the other developed economies, the new climate imposed by the financial crisis resulted in a more marked slowdown than in the USA. Japan and the Euro Zone's GDP growth reached just 1% and 1.7% respectively in the first half of 2008, as against 2% and 2.6% in 2007. The cooling of these economies is linked first to a deterioration in export performance (related as it is to the aforementioned real depreciation of the dollar) and second, to a weakening of capital formation. In some countries, like Japan and Germany, the export expansion seen from 2003 had led to an explosion of investment in machinery and equipment. This lost momentum in the new climate. In other countries, like Spain and Ireland, dynamic investment in construction was linked to an inflation of real estate assets, a situation that was reversed when the credit market hardened. On the other hand, in the context of China's steady accumulation of capital over the first nine months of 2008, GDP growth dropped to 9.9%, as against 11.8% in 2007. More conspicuous was the downturn in the markets of destination of China's exports, as reflected in the fall in its 30% expansion rate in the first half of 2007 to 21% in the same period of 2008. In contrast, in the same periods, imports increased 18.2% and 30.9% respectively, mainly reflecting the significant price rises in raw materials.

GRAPH 1
GROWTH OF MAIN ECONOMIES 2000-2008
 (% variation in real GDP against the same quarter the previous year)^{a/}



Note: ^{a/} 2008: Preliminary figures. The Euro Zone figures correspond to an aggregation in dollars with purchasing power parities.

Source: Authors' own elaboration based on BEA (USA), OECD, EUROSTAT, ESRI (Japan), ADB, and NBS (China) data.

The development of the international financial crisis

The prime destabilizing factor of the financial crisis has been the devaluation of US real estate assets. Prices began to slow in 2006, when monetary policy became tougher, and then to fall early in 2007. In July 2008, the house price index was 17.5% below the same month in 2007.⁵ This deflationary process put heavy pressure on the balances of mortgage holders and several financial entities. Both agents suddenly faced spiraling arrears and a devaluation of support assets, with a subsequent sharp rise in the relative burden of liabilities. By mid-2007, the decapitalization seen in various investment vehicles belonging to major international financial institutions closed the door on borrowing in short-term and interbank markets, which fell into crisis. Since then, there have been three episodes of stock-market panic⁶ (in August 2007 and in March and September/October 2008) triggered by the apparent weakness or insolvency of key financial entities. The depreciation of stock-market assets that began to accompany the devaluation of real estate assets added a second deflationary factor to the crisis: in the first half of October 2008, the Dow 30 was 30.5% down on July 2007. Furthermore, while remaining positive, private funding flows of the US current account deficit fell noticeably. Whereas, between 2003 and the third quarter of 2007,

⁵ S&F/Case-Shiller Index (20 metropolitan areas) for residential property prices; it is mobile averages quarterly.

⁶ In a state of panic, much of the market not only takes a bearish selling stance ("future prices will be lower than present ones"), but believes there will be a generalized cessation of payments. This leads to a mass sale of assets and credit restriction, the purpose of which is to raise individual liquidity. Historically, there have been many occasions when the panic spread to the banking system, causing runs on deposits and widespread bankruptcy among financial institutions, a phenomenon that was contained after 1929 in developed countries. Other classic texts on these phenomena include Bagehot [1968], Pigou [1927], and Kindleberger [2000].

they represented on average 2.6% of GDP, between the fourth quarter of 2007 and the second quarter of 2008 they stood at just 0.6%. This incipient sign of distrust toward US assets had a correlate in the greater willingness to place capital in other markets, including emerging markets, in spite of the general increase in uncertainty. This factor has been extremely relevant in the evolution of several MERCOSUR countries' balance of payments.

The response of the world's monetary authorities has had three stages. The first panic in August 2007 set in train heavy injections of liquidity in several DDCs, the cut in the Federal Reserve interest rate, and the implementation of a fiscal stimulus package in the USA, equivalent to approximately 1.1% of GDP. The second panic, in March 2008, was contained by means of a specific bailout operation, namely, the sale of Bear Stearns organized by the Federal Reserve. The third episode, involving government control of crucial entities in the mortgage market and the elimination or reorganization of the main investment banks in the USA, required legislative approval for a systemic bailout plan of depreciated mortgage assets by exchanging them for quality government instruments for around 5% of US GDP. The inadequacy of this approach, as manifested in the stock-market crash of October⁷ and the weakness of the credit market, led to the US government tabling the possibility of buying shares from financial entities. The UK had already implemented this form of recapitalization, extended to other European countries.

The transmission channels of the crisis to MERCOSUR

From the point of view of the evolution of raw materials prices, key for MERCOSUR countries, the crisis has developed in two differentiated phases. Between August 2007 and June 2008, the prices of several of these products -in particular petroleum, certain cereals, and oleaginous seeds- rose significantly. This first phase of the crisis, in which inflationary features prevailed, had direct consequences for the variables of the MERCOSUR countries' balances of payments, and indirect ones for their internal price indicators, as also occurred in the developed economies (Graph 2 and Box B). Between July 2007 and 2008, the prices of goods exported by Latin America and the Caribbean⁸ rose 40.3%, excluding petroleum. The petroleum price grew 86.3%. The prices of soya and corn went up by 80.2% and 81.2% respectively during the period. The market panic of August 2007 and the measures intended to ease monetary conditions stimulated the reallocation of portfolios to more secure assets (such as US Treasury notes),⁹ but also to emerging countries' assets and, notably, commodities. The depreciation of the dollar,¹⁰ the currency in which these goods are quoted, contributed to rising prices, as did the fact that the world economy continued in positive growth.

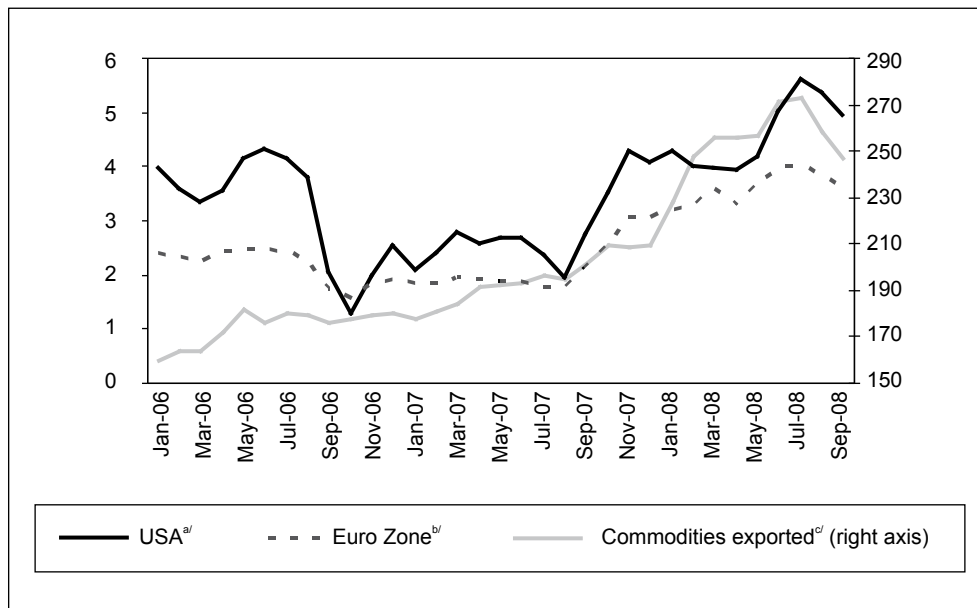
⁷ Between October 1 and 10, 2008, the Dow Jones fell 22%.

⁸ Index estimated by ECLAC with a representative basket of products exported by the region.

⁹ The 10-year yield of the bill went from 5.10% in June 2007 to 3.51% in March 2008.

¹⁰ See Note 4.

GRAPH 2
MONTHLY DYNAMICS OF SELECTED PRICE INDICATORS 2006-2008
 (% and level variation against the same month the previous year)



Notes: ^{a/} IPC; ^{b/} IAPC; ^{c/} Exported Commodities Index for Latin America and the Caribbean, excluding petroleum and derivatives; Average 2000 = 100.

Source: Authors' own elaboration based on BEA, EUROSTAT, and ECLAC data.

In July 2008, however, the trend in several of these factors shifted and the commodities markets began to weaken as a result. On the one hand, the cooling of activity in the Euro Zone and Japan was reflected in a dollar rise that had begun after the "trust effect" brought about by the bailout of Bear Stearns.¹¹ Although the implementation of tax assistance in the USA kept up activity levels, inflationary pressures began to reduce demand, as in other DDCs. Significantly, in July there was a weakening of demand for petroleum in OECD countries that impacted on their price. In September, the price of commodities exported by the region (excluding petroleum) was 8.9% down on June.¹² The evidence of a further decline in activity indicators and the persistent devaluation of real estate assets led to the market panic of September and October, in which capital flow no longer went toward commodities, but was concentrated in US Treasury notes and other more liquid assets, with immediate repercussions for the region's foreign exchange markets.¹³ The development of the phase beginning in July ended up dovetailing with the third episode of the financial crisis mentioned above, which led to an abrupt outflow of capital that affected the economies of MERCOSUR and particularly Brazil. The domestic credit circuit thus bore the brunt and added a negative factor to the decline in export prices. These parameters will no doubt condition economic activity in what remains of 2008 and 2009.

¹¹ An effect also reflected in the market indicators (the Dow Jones rose 6% between the end of March and mid-May) and in the 10-year yield of Treasury notes (going from 3.51% in March to 4.10% in June).

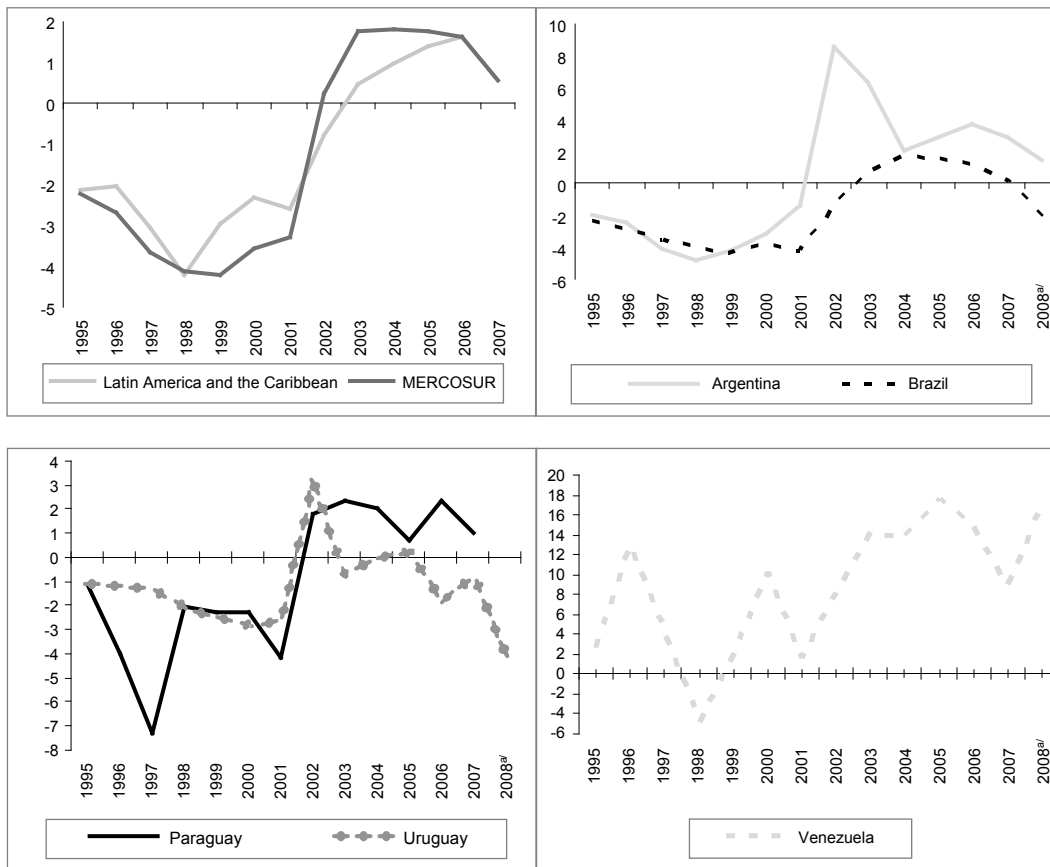
¹² International Energy Agency [2008], p. 4.

¹³ On October 8, the Brazilian real was quoted at 2.39 per dollar, 53.5% up on the August 1 exchange rate.

B. Evolution of the balances of payments

The international financial crisis impacted on MERCOSUR countries' balances of payments in a variety of ways. The evolution of export and import prices, and the availability of financial capital shaped the dominant trends in these countries' international transactions unevenly. In 2007, the credit balance of the bloc's balance of payments current account (excluding Venezuela) was down 1.6% on the previous year to 0.6% of GDP, a result similar to Latin America and the Caribbean as a whole (Graph 3). In Argentina, Brazil, Paraguay, and Venezuela the surplus fell, whereas Uruguay recorded a lower deficit that year. In the first half of 2008, the trends of 2007 continued in Argentina and Brazil, bringing about a current account deficit in the latter, while the debit balance expanded in Uruguay and the surplus grew in Venezuela. No recent information is available for Paraguay.

GRAPH 3
MERCOSUR: EVOLUTION OF THE CURRENT ACCOUNT BALANCE
(In % of GDP, at current prices)



Note: ^{av} Estimate for the first half of the current account balance and nominal GDP.

Source: Authors' own elaboration based on ECLAC data and official sources.

- Argentina -

In Argentina, the deterioration in the current account balance from 3.7% to 2.7% of GDP between 2006 and 2007 has different causes during the period: the turning point was mid-2007. Until then, goods imports

grew more than exports, translating into the steady erosion of this balance.¹⁴ From that time on, there was a relative acceleration of exports, explained by growth in commodity prices during the inflationary phase of the international crisis. These trends extended throughout the first half of 2008, when Argentina enjoyed improved terms of trade of 14.4%. Whereas the 12-month moving average for growth of external sales of goods was 14.7% in June 2007, a year later it reached 31.6%. International "food inflation" benefitted Argentina's external accounts. Although imports also experienced a sharp acceleration, the net result of these movements was a rising surplus in the goods balance, which helped shore up the current account surplus. The decline in the first half of 2008 originated first in the steep growth of net income payments and, second, in a rise in the services deficit. During the first half of 2008, Argentina saw an outflow of financial capital¹⁵ equivalent to 2.9% of GDP in a scenario of greater uncertainty caused by a taxation dispute between the government and the agricultural sector in a context of the rising international prices of certain raw materials.¹⁶

- Brazil -

Brazil saw a persistent acceleration of imports from mid-2007 due to a rise in its activity levels and the appreciation of its currency. In June that year, the 12-month moving average for the growth rate of external purchasing was already a robust 26.5%, and reached 44% a year later. As exports did not experience a similar dynamic, in spite of rates of about 19% during the period, the balance surplus in goods fell significantly. This decline in trade in goods, added to a sharp rise in income payments, led to the country beginning to see a current account deficit from the fourth quarter of 2007. For the year as a whole, the surplus was 0.1% of GDP (1.3% in 2006). The debit balance expanded in the first half of 2008, representing 2% of GDP. The change was very swift. Apart from the aforesaid internal causes, this result had to do with the international financial crisis, which translated into a strong inflow of capital into Brazil. In 2007, the net income from financial capital and net foreign direct investment was equal to 6.8% of GDP: the first heading accounted for 4.6% of GDP.¹⁷ In the first half of 2008, these figures were 4.3% and 3.3% respectively. The impact of the international financial instability was initially favorable then for Brazil in this period. Despite the episodes of panic involving specific outflows of capital, the country remained a destination for financial investments due to the wide differential in interest rates and the still predominant trend of appreciation of the real in a context of the weakening availability of private capital to finance the US deficit.¹⁸ However, during the panic of September and October 2008, this situation underwent a sudden reversal, triggering capital outflows and

¹⁴ For more detail about trade in MERCOSUR countries, see Chapter 2.

¹⁵ The concept of capital for all countries includes the net capital balance, the financial balance (excluding foreign direct investment), and any errors and omissions.

¹⁶ Triggered as they were by the application of export taxes based on the international prices ("mobile withholdings") of certain agricultural products. The resolution was rejected by the Senate in July.

¹⁷ The concept of foreign direct investment (FDI) used in this Report corresponds to the familiar definition of the balance of payments (IMF [1993]): it consists of investments by an entity resident in an economy ("direct investor") to obtain lasting interest in a business resident in another economy. Lasting interest implies the existence of a long-term relationship and a significant degree of influence by the "direct investor" over the running of the business (10% or more of the ordinary shares or of the devoted power). For further detail on FDI flows in MERCOSUR see Chapter 2.

¹⁸ In recent years, Brazil has acted as a destination for "carry trade", financial arbitration transactions from countries with low interest rates and "weak" currencies like Japan.

a rapid depreciation of the real. But, while it held up, the strong influx of capital into Brazil brought about a relative depreciation of imports and weakened its credit balance in goods.

- Paraguay -

Like Argentina, Paraguayan export prices in 2007 rose with "food inflation," although the country also experienced the negative effects of the rising petroleum price. It thus saw only a slight improvement in its goods balance. This improvement was, however, counteracted by the worsening of incomes, transfers, and services balances, especially in transport. In 2007, Paraguay had a surplus in its current account equivalent to 1.1% of GDP, quite a way below the 2.4% of 2006. As with Brazil, the combination of financial and foreign direct investment was extremely important in 2007, representing 5% of GDP, with 3.5 p.p. corresponded to the second heading.

- Uruguay -

In Uruguay, the current account deficit fell from 1.9% of GDP in 2006 to 1% in 2007. Although the country benefitted from low petroleum prices in the first half and an acceleration in exports toward the end of the year, the annual result was a slight increase in the deficit of the goods balance, more than offset by higher income in the services and incomes balance. In the first half of 2008, the rising petroleum price hit the goods balance very hard: imports were up 82.5% on the same period the previous year and the current account deficit was estimated at 4% of GDP. This balance was covered by abundant inflows of direct investment and financial capital, equivalent to 5.8% and 9.6% of the product respectively.

- Venezuela -

The current account balance of Venezuela's balance of payments was determined by the significant fluctuations in the petroleum price. In 2007, the surplus of this account stood at 8.8% of GDP, well below the 14.7% reached in 2006. The decline was due to the contraction of the petroleum price during the first half of 2007 (the world average for crude was down 1.3% on the same period the previous year), while imports grew steadily all year, around 41% annually. However, one of the consequences of the crisis erupting in mid-2007 was the extraordinary rise in the petroleum price: 76.6% up in the first half of 2008 on the same period in 2007. The current account surplus reached 17.2% of GDP in the first half of 2008, which is explained by the rising petroleum price and a slowdown of imports, which grew 12.7%.

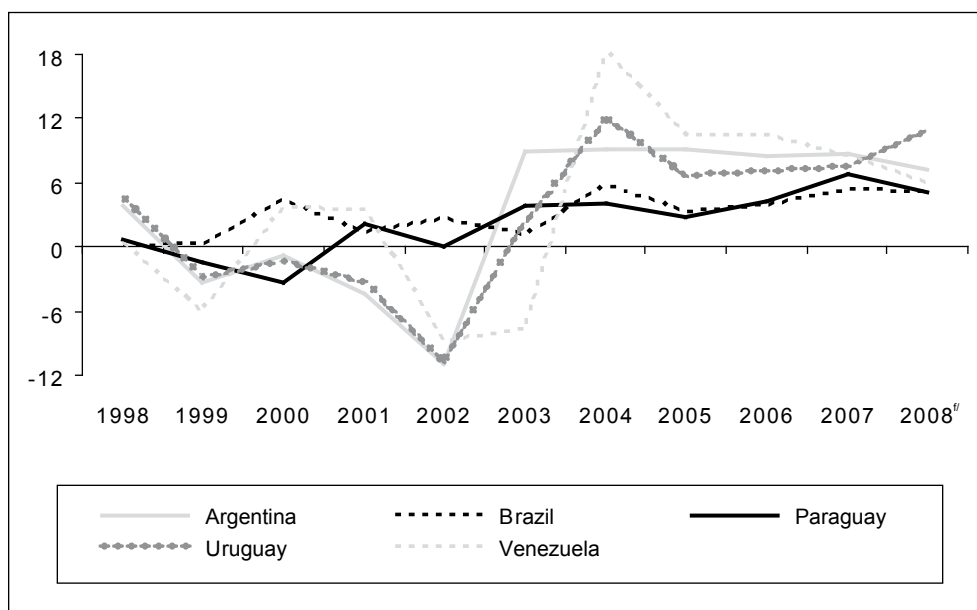
In all these countries, levels of international reserves remained high and relatively stable between the second half of 2007 and the first half of 2008. Measured in months of imports, the reserves in that period were equal to 11.1, 15.1, 4.5, 7.5, and 8.2 for Argentina, Brazil, Paraguay, Uruguay, and Venezuela respectively. These figures represent slight reductions in Argentina and Uruguay against the level of the indicator in the preceding year, and a more significant fall in the case of Venezuela. The indicator rose in Brazil and Paraguay, however.

C. The macroeconomic evolution of MERCOSUR¹⁹

GDP and elasticities

The MERCOSUR countries' average GDP expanded²⁰ 7.3% during 2007.²¹ Something of a slowdown was seen in 2008 in all the bloc's economies except Uruguay, which was up on the previous year.²² Indeed, the average increase in GDP would reach 6.9% during 2008 according to the forecasts available (Graph 4). Although the expansion phase beginning in 2003, since 2007 some changes in the sources of growth are seen. To identify them the product elasticity²³ of certain spending components (private consumption, investment, exports and imports of goods and services) was calculated, comparing the two periods, 2005-2006 and 2007-2008 (Graph 5).²⁴

GRAPH 4
MERCOSUR: GROSS DOMESTIC PRODUCT
(Real YOY % variation)



Notes: ^f Forecasts.

Sources: DNCN (Argentina), BCB (Brazil), BCP (Paraguay), BCU (Uruguay), and ECLAC.

¹⁹ Unless otherwise indicated, the forecasts and estimates in this and the following section correspond to the median of the private expectations survey carried out by the central banks (Argentina, Brazil and Uruguay) and to calculations by ECLAC (Paraguay and Venezuela). The forecasts correspond to the September 2008 publications in the case of the BCRA Market Expectations Report and the BCP Survey of Economic Expectations. The BCU Economic Expectations Survey and Selective Survey of Inflation Expectations correspond to October 2008. The BCB publication, *Focus - Relatório de Mercado*, is from October 17, 2008.

²⁰ Simple average for the five countries.

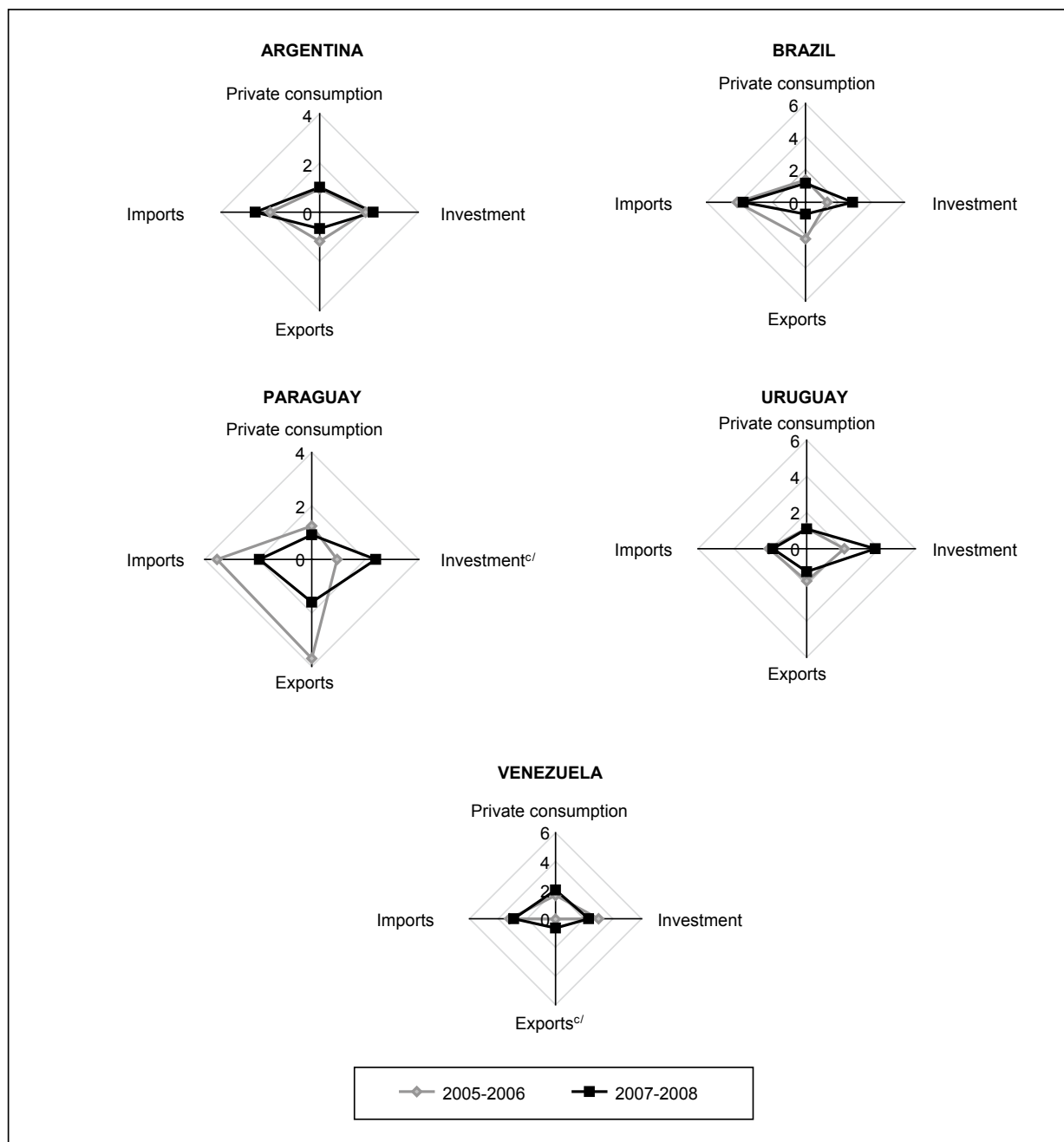
²¹ According to a recent official statement (BCP [2008]), Paraguay's national accounts underestimate the value of GDP, as the activity of binational hydroelectric entities (Itaipú and Yacyretá) is not included. According to press information this underestimate, in 2007, would represent 8% of the product.

²² Aided by production from the Botnia pulp mill.

²³ The product elasticity of a given aggregate (e.g. investment) is the ratio of the rate of variation of the aggregate and that of the product in the same time period. It measures the relative intensity of the growth of the various different spending components against the increase in GDP.

²⁴ The first half of 2008 is considered.

GRAPH 5
MERCOSUR: PRODUCT ELASTICITY OF THE MAIN SPENDING COMPONENTS^{a/}
 (2005-2006 and 2007-2008)^{b/}



Notes: ^{a/} Product elasticity is the ratio between the average rate of variation of the aggregate and GDP in the same period. It measures the relative intensity of growth for the different spending components in terms of the increase in GDP.

Investment: Gross fixed capital formation + Stock variation.

Exports and imports: includes goods and services.

^{b/} The data for 2008 are from the first half.

^{c/} This graph shows product elasticity in absolute values. N.B. The product elasticities for investment in Paraguay in 2005-2006 and for Venezuelan exports are negative in both periods. See Table A1.3 in Annex I.

Source: Authors' own elaboration based on data from DNCN (Argentina), IBGE (Brazil), BCU (Uruguay), BCP (Paraguay), BCV (Venezuela), and ECLAC.

With the exception of Argentina and Venezuela, the GDP of the MERCOSUR economies grew more in the second than in the first of the periods in question. In terms of the sources of growth, two trends in 2007-2008 should be highlighted: on the one hand, the increase of product elasticity of investment in all countries except Venezuela and, on the other, the decrease of export elasticity in the five economies. This means that there was an increase in the importance of gross capital formation as an engine of growth, while the negative contribution of net exports was higher in the second stage.²⁵ Import elasticity increased in Argentina, whereas in the other countries it fell. It has to be remembered that, in Brazil, the sensitivity of imports to variation in GDP remained high, at around 3.8.

In **Argentina**, GDP grew 8.7% in 2007 and a 7.2% rise is foreseen in 2008. The elasticity of private consumption rose slightly during 2007-2008, but remained close to the unit. In 2007, this was driven by rising real wages, employment, and credit, but slowed during the first half of 2008. On the one hand, this evolution is explained by a decline in consumer confidence related to inflation levels and the fallout of the dispute between the government and the agricultural sector. On the other hand, the lower growth of total wages owing to lower levels of job creation also impacted on the dynamism of family spending in the first half of 2008. The above increase in investment product elasticity was in response to the growth of durable production equipment (mainly imported), partially offset by a certain downturn in construction.

In **Brazil**, GDP accelerated in 2007 (5.4% YOY) and is forecast to reach 5.2% during 2008. In 2007, the Brazilian economy underwent marked reheating, while the reduction of the pace of expansion foreseen for this year originates in the external sector, while internal demand holds steady. The elasticity of private consumption fell slightly over the periods analyzed, holding slightly above the unit, after the leap seen during the second quarter of 2006. Private consumption grew faster in 2007-2008 due to the increase in employment, real wages, and readier access to credit. The nominal appreciation of the real until July 2008 invigorated private consumption and also contributed to the significant rise in investment through the importation of capital goods. Construction also expanded, fuelled by greater access to mortgage loans. Investment elasticity thus rose from 1.3 in 2005-2006 to 2.9 in 2007-2008.

In **Paraguay**, GDP growth accelerated in 2007 (6.8% YOY) and a 5.1% increase in 2008 is foreseen. The main momentum came from the agricultural sector, which expanded 24.1% in 2007 and 11.3% YOY during the first half of 2008. While the elasticities of private consumption, exports, and imports were down over the periods analyzed, investment elasticity reached 2.4 in 2007-2008.

In **Uruguay**, GDP grew 7.4% in 2007 and a rise of 10.8% is foreseen for 2008. With the exception of investment, all the spending components analyzed showed a downturn in product elasticity during the second period. On the supply side, the expansion of activity was headed by services (transport, storage, and communications; trade, restaurants, and hotels) and manufacturing due to the entry into operation of the Botnia pulp mill, the activity of the National Administration of Fuels, Alcohol, and Portland (ANCAP), and the growth of the refrigeration industry.

The GDP of **Venezuela** slowed to 8.4% in 2007 and a 6% rise is expected in 2008. It is worth remembering that a sharp tailoff in the pace of growth was seen in the first three months of 2008, partially offset during the following quarter. Investment and import elasticities fell, while export elasticity, which is negative, rose in absolute terms. Furthermore, the elasticity of private consumption stood at 2 in 2007-

²⁵ The negative contribution to growth of the external sector implies that imports are growing more than exports.

2008, the maximum level within the bloc. The improvement in its terms of trade allowed Venezuela to raise consumption and investment far above GDP. This had its correlate in the high negative contribution of its net exports. Last, differentiated behavior is seen between petroleum and non-petroleum activity: whereas the former shrank 4.2% in 2007 and rose 3.2% in the first half of 2008, the latter grew 9.5% and 6.5% respectively.

D. Economic policy: instruments and results

Inflation

Between the second half of 2007 and the first half of 2008, the main macroeconomic problem of the members of MERCOSUR was inflation. This phenomenon is similar to that in many other countries and is associated with certain characteristics of the international financial scenario explained above. During 2007, the increase in retail prices averaged 10%²⁶ and a larger rise is foreseen for 2008 (Graph 6).²⁷ In all cases, inflation originated both in internal and external factors. Within the last group, the international rise in the price of food (Box B) and fuels was particularly remarkable. In any event, it is worth pointing out that the fall in commodity prices from July 2008, fuelled as it was by investors unwinding positions in real assets, the deepening financial crisis, and the prospects of world economic slowdown, has begun to mitigate inflationary pressures.

According to official figures, the variation in the consumer price index (IPC-GBA)²⁸ in **Argentina** was 8.5% during 2007 and would stand at around 9.1% in 2008. Other official indicators,²⁹ however, suggest larger increases. Among the main internal factors fuelling inflation are, on the one hand, the pressure of demand stimulated by income policy, and the acceleration of public spending, and on the other, the adjustments of certain regulated prices (transport, certain public services). In the context of heavy external inflationary pressures, Argentina has applied a variety of sectoral measures, particularly in energy and food, in an attempt to separate the behavior of internal from external prices.

In **Brazil**, retail inflation, as measured by the IPCA, stood at 4.5% during 2007 (3.1% in 2006) and would rise to 6.2% this year, while still staying within the target (4.5% with a margin of ± 2 p.p.). This acceleration stemmed largely from the reactivation of internal demand, encouraged by the depreciation of credit and the influx of external capital prevailing until September. On the other hand, although the appreciation of the real helped to mitigate inflation by anchoring inflationary expectations and containing the price of the imported goods, it also fuelled the rise in internal demand precisely via imports and the price of tradables actually continued to accelerate.³⁰ Other factors also fuelling inflation were the expansion of total wages, the international rise of raw materials prices, and the adjustments of certain regulated prices (public transport, education).

²⁶ Simple average for the five countries.

²⁷ Argentina, Paraguay and Venezuela implemented various different changes in the methodology for calculating the CPI in 2008. This is why recent inflation rates may not be strictly comparable with previous ones.

²⁸ Consumer Price Index for the Autonomous City of Buenos Aires and Greater Buenos Aires.

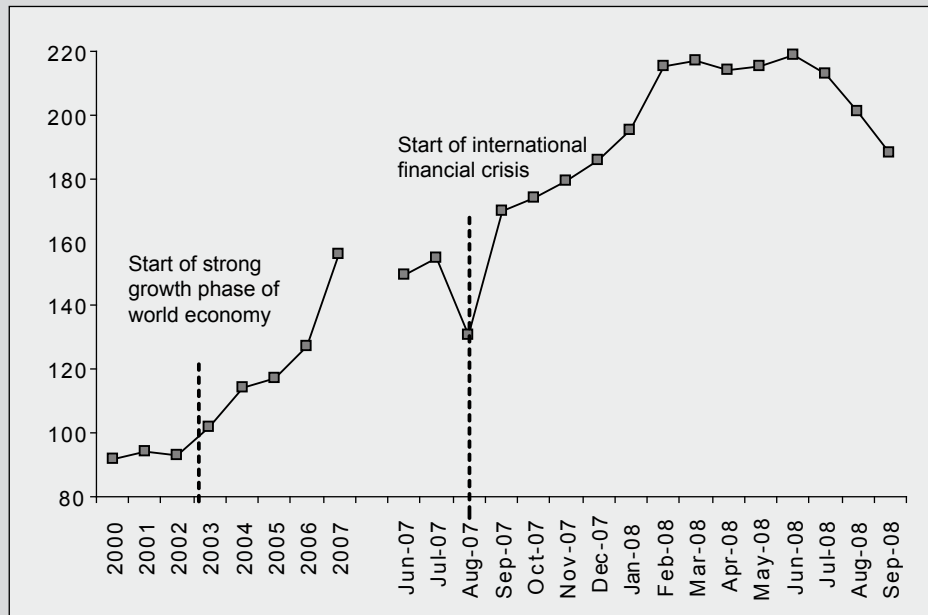
²⁹ The national CPI, wholesale prices, GDP implicit prices.

³⁰ The price of tradable goods increased at growing YOY rates between April and September 2007, and December 2007 and June 2008.

Box B STRUCTURAL AND SITUATIONAL CAUSES OF FOOD INFLATION

Over the last half a decade the prices of raw materials rose significantly as a result of the expansion of world demand. Food, which had lagged quite a way behind fuels and metals, rose substantially in price throughout 2007 and the first two months of 2008. Last June, they were 67% above the average level for 2006. In the context of the international financial crisis beginning in August 2007, inflation became a serious global macroeconomic problem until at least July 2008, when commodity prices began to fall. In the case of food, prices fell 14% between June and September.

FOOD PRICE INDEX^{a/}
(Average 1998-2000=100)



Notes: ^{a/} Includes 55 raw food materials.

Source: FAO.

Various factors have contributed to rising food price in recent years. On the demand side, the main momentum has come from the rapid growth of developing countries (DGCs), particularly China and India. This not only directly drove up the total amount of food consumed, but the improvement in the quality of life in these economies through the incorporation of higher proportions of proteins in the diet (found in meat and dairy products) has indirectly increased demand for certain grains for livestock fodder.

Another relevant factor is the use of certain crops in biofuel production, encouraged by the subsidies granted for this purpose in the DDCs in the face of high energy prices, which reduces the supply available for food, as well as that of other crops competing for land. More recently, an important factor in explaining the price rise is the speculative demand for agricultural commodities, one of the expressions of the international financial crisis during the second half of 2007 and the first half of 2008.

On the other hand, certain structural questions have limited the increase in food supply. These include climate change, urban development restricting land and water use, and the impact of the rising petroleum price on the price of fertilizers, energy, and transport costs. DDCs' protectionist policies is also a contributing factor in this sense, as they replace the traditional forms of aid, which stimulated increased production through subsidies that bear no relation to the amount produced. In the short term, the supply has also been affected by climatic conditions and epidemics, as well as restrictions on exports in some big producer countries. In short, the increase in food prices is explained by a steady increase in demand that exceeds the capacity to meet supply, giving rise to a reduction of world stocks and generating a bullish trend aggravated by financial and situational factors.

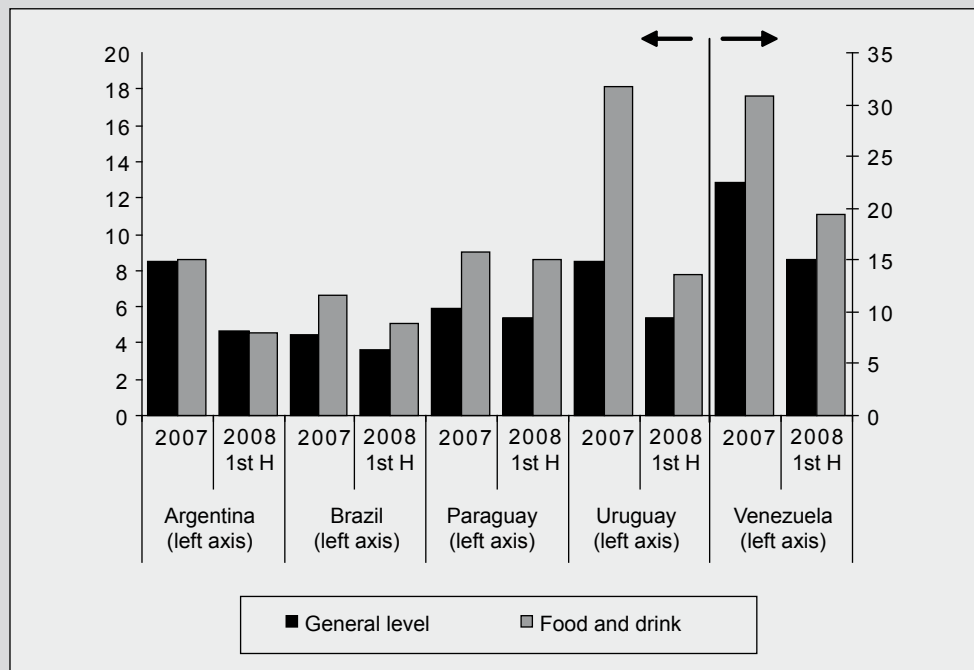
"Food inflation" has been a concern for economic policy the world over, particularly in DGCs, where a higher proportion of income is spent on food. Indeed, whereas food and drink in DDCs impact inflation by less than 15%, in the MERCOSUR economies the figure is about 30% (except for Brazil, where the weighting is as high as 22.1%). Although, from July 2008, a considerable reduction was seen in raw materials prices, decompressing inflationary pressure, these remain at record highs.

Box B (CONTINUED)

During 2007 and the first half of 2008, retail inflation under the food and drink heading exceeded the rise in the general level of prices in all MERCOSUR countries with the exception of Argentina, where the variation was practically identical. Thus, while in the two largest economies this heading accounted for almost a third of total inflation, in Paraguay and Uruguay it contributed over half of the increase, and in Venezuela 44.2%.

In the framework of anti-inflationary policy, MERCOSUR governments adopted a variety of different measures geared specifically to containing food prices. These include the liberalization and/or simplification of imports of certain key products (Brazil, Paraguay and Uruguay), the reduction or suspension of value added tax (VAT) or other taxes on certain foods (Brazil, Uruguay and Venezuela), agreements and other price controls (Argentina, Paraguay, and Uruguay), quantitative prohibition and restrictions certain exports (Argentina), increased duties on agricultural exports (Argentina), and compensation for producers (Argentina). To curb rising prices without reducing external sales, Brazil launched a program to stimulate the production of sensitive foods through soft loans, guaranteeing the payment of minimum prices.

RETAIL INFLATION
(2007 and first half of 2008^{a/})



Note: ^{a/} Cumulative to June.

Sources: INDEC (Argentina), IBGE (Brazil), BCP (Paraguay), INE (Uruguay), and INE (Venezuela).

In **Paraguay**, retail inflation stood at 6% during 2007, within the 5% target range (with a margin of ± 2.5 p.p.). The largest increases were seen during the first half, as a result of price rises in fruit and vegetables due to certain import restrictions. After a slowdown in the second half of 2007, inflation rose again in 2008, fuelled by other foods. This factor, like higher energy prices, would push inflation up to around 9.7% by the end of the year, above the 4.5% target with a ± 2 p.p. margin of tolerance.

The consumer price index (IPC) in **Uruguay** was up 8.5% in 2007, 2 p.p. above the ceiling of the target range (4.5-6.5%). The main inflationary factors came from tradables, especially fuel and food. In the

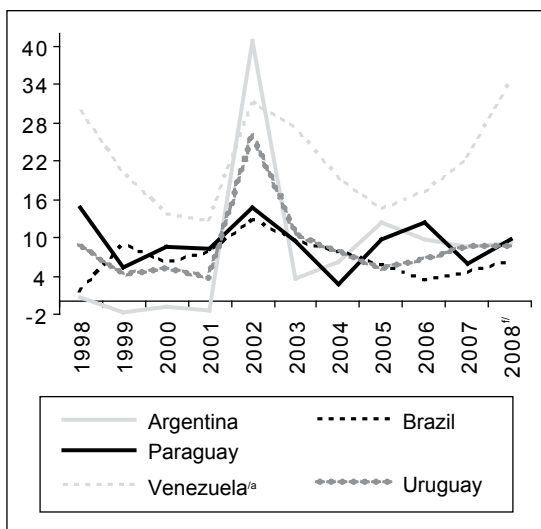
latter case, aside from the international rise, prices were driven up by poor climatic conditions affecting the production of meat, fruit, and vegetables. In 2008, retail inflation would remain at the same level as the previous year, again above the target maximum. Certain fiscal measures were implemented to ease inflationary tension: a fund was set up to subsidize the price of collective urban transport and a cut stipulated in tariffs on fuel, telephony, and electricity, and the health quota, the elimination of the foreign currency purchase tax (ICOME) paid by public sector companies and the exemption from value added tax (VAT) for poultry.

Retail inflation in **Venezuela**, as measured by the National Consumer Price Index (INPC), accelerated in 2007 (22.5%) and the first half of 2008 (15.1% cumulative between January and June). The monetary authorities' forecast for 2008 was revised to 19% from an initially expected 11%, although it may be higher, as YOY variations of over 30% were seen between June and September 2008. Among the main explanatory factors were rising food prices, the shortage of certain essential products and the rise of the unofficial exchange rate in the second half of 2007 in a context of some policy uncertainty.

Monetary policy and exchange

As mentioned above, the inflationary acceleration seen during 2007 and the first half of 2008 was the main challenge facing monetary policy in MERCOSUR countries. This responded in various ways, hardening conditions in the monetary markets. In certain cases, the Central Bank also had to contend with the pressure of appreciating currencies (Graph 7).

GRAPH 6
MERCOSUR: CONSUMER PRICE INDEX
(% YOY variation in December each year)

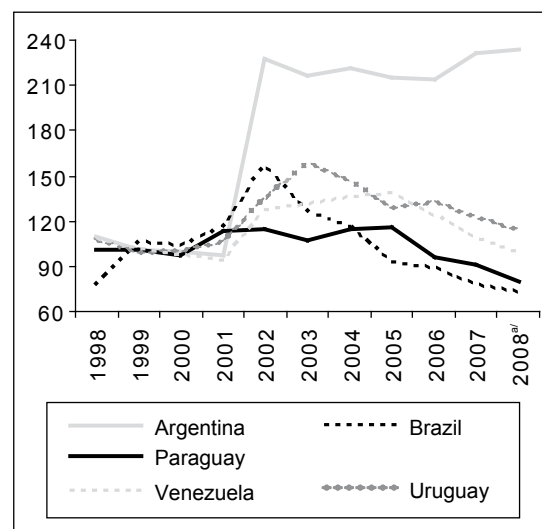


Notes: ^f Forecasts.

^a The data for 2008 corresponds to the YOY variation in September.

Sources: INDEC, IBGE, BCP, BCU, INE, and ECLAC.

GRAPH 7
MERCOSUR: REAL EFFECTIVE EXCHANGE RATE
(2000 = 100 Index - End of period)



Note: ^a June.

Source: ECLAC.

- Argentina -

Between 2007 and 2008, policy centered on maintaining exchange competitiveness and the preventive accumulation of international reserves began to be eroded by inflationary pressures. In particular, during the second quarter of 2008, the above agricultural dispute brought about a deterioration in expectations, which translated into a fall in the price of government securities, deposit levels, and liquidity in the banks. In order to contain the loss of trust reflected in the foreign exchange market, the BCRA sold foreign currencies and boosted the nominal appreciation of the peso, while interest rates increased. In June 2008, these reached the maximum for the last five years, although they remain at moderate levels and are, in some cases, negative in real terms.³¹ The BCRA subsequently provided the banks with liquidity through various monetary instruments. The exchange intervention in the period of instability translated into a fall in international reserves from US\$50.5 billion in March 2008 to US\$47.5 billion by the end of June. Even so, they were 10.1% higher than a year ago. In September 2008, the government announced the use of US\$6.7 billion of international reserves to pay off the debt with the Paris Club, though, in the context of the international financial crisis, it was stated by mid-October that payment would be made in as yet undefined stages.

During 2007 and the first half of 2008, the means of payment (M2)³² rose by 17.9% and 16% YOY respectively, fuelled by loans to the private sector. On the supply side, the purchase of foreign currencies was one of the most important sources of money creation until the first quarter of 2008, whereas the public sector, fixed-term deposits, and Repos were the main contractive factors. As in previous years, the BCRA partially sterilized monetization from the external private sector via LEBAC and NOBAC placement. However, as mentioned earlier, from the second quarter of 2008, Central Bank securities contributed to increasing the money supply. Deposits continued to increase (16.2% YOY in June 2008), fuelled by non-index-linked current account fixed-term investments.

The nominal dollar exchange rate, on the other hand, depreciated 2.6% in 2007. Although inflation was higher than that of the main trade partners, the nominal appreciation of the Brazilian real up to the October crisis helped to raise the real effective exchange rate 8.2% in 2007 and 1.1% during the first half of 2008.

- Brazil -

To contain inflation the Central Bank of Brazil (BCB) gradually raised the Special System for Settlement and Custody benchmark interest rate (SELIC) from 11.25% in March 2008 to 13.75% in September, allowing the nominal appreciation of the real (16.9% in 2007 and 9.4% up to June 2008), although it bought foreign currencies in any event. Reserves were up 110% during 2007 and by mid-2008 stood at 36.5% above the level of June 2007.

During the first half of 2008, M2³³ was up 27.6% YOY. The intervention of the BCB in the foreign exchange market was the main source of money creation. The operations with federal government securities and the expansion of deposits contributed along the same lines, while the National Treasury was a contractive factor.

³¹ In June 2008, the main interest rates stood at 9% (Central Bank's 7-day Repo rate), 13% (30-44-day fixed-term peso deposits), 17.5% (Buenos Aires Deposit Large Amount Rate, or BADLAR, for private banks, for 30-35-day operations over AR\$1 million), and 11.8% (12-month Central Bank Bills, or LEBAC).

³² Bills and coins + peso current account deposits + peso deposits in savings accounts.

³³ Bills and coins + current account deposits + deposits for investment + savings account deposits + private securities (fixed-term deposits, bills of exchange, mortgage payments and real estate payments).

The demand for money, on the other hand, was fuelled by the dynamism of credit, explained by the interest rates cuts between late 2005 and early 2008. Thus, in mid-2008 loans represented 36.6% of GDP, the highest level in over thirteen years.

The Brazilian real appreciated 13.5% in real terms during 2007 and 6.6% in the first half of 2008 in relation to its main trade partners. In 2008, to alleviate the negative effects on activity, the Government suspended the levying of the Financial Operations Tax (IOF) on exports, eliminated the obligatory repatriation of export-derived foreign currencies, and created an IOF for certain applications of foreign investors in order to discourage the influx of speculative capital.

- Paraguay -

The Central Bank of Paraguay (BCP) continued to be geared to mitigating the pressure on price levels via the inflation targets system and to containing the appreciation of the guaraní.

The inflows of foreign currencies from Binational Entities (Yacyretá and Itaipú) and from the increase of public and private deposits in the financial system fuelled the nominal appreciation of the guaraní against the dollar (11% during 2007 and 15.7% in the first half of 2008), in spite of the BCP's significant intervention in the foreign exchange market.

The purchase of foreign currencies by the monetary authority constituted the main source of money creation and, in June 2008, reserves were 48.5% up on a year ago. In order to sterilize monetization and contain its inflationary effect, the BCP increased the placement of securities and raised interest rates. A new instrument, the Short-Term Liquidity Facility with Monetary Regulation Instruments Distribution (FLIR), was also approved.

In real terms, the guaraní appreciated 5.8% during 2007 and 12.4% in the first half of 2008. Although Paraguay's rate of inflation is higher than those of several of its trade partners, the fall in the real effective exchange rate was not serious due to the revaluation of the real.

The rise in interest rates was transferred to the rest of the financial system at the start of 2008, stimulating the growth of deposits (29% YOY in June 2008), particularly in local currency. Foreign currency placements continued to rise in spite of the appreciation of the guaraní.

- Uruguay-

The Central Bank of Uruguay (BCU) decided to shift the focus of monetary policy away from pursuing M1 to setting the interbank interest rate (call), which went from 5% in September 2007 to 7.75% in October 2008. Faced with inflationary pressure and given that the margin for increasing rates is narrow, the BCU increased reserves for short-term deposits and raised the inflation tolerance range from 4-6% to 3-7% in 2008. In spite of this, as previously mentioned, this year CPI variation would be over the target.

The BCU's intervention in the foreign exchange market was more limited than in other countries in the bloc. The capital inflow stemming from rising interest rates and the higher inflows of foreign currency due to exports translated into a nominal appreciation of the peso of 11.3% in 2007 and 10.1% until June 2008. The real effective exchange rate was down 3.3% during 2007 and 7% in the first six months of 2008.

The M1 monetary aggregate expanded 32% in 2007 and 28% YOY in June 2008, fuelled by the dynamism of demand deposits. In a context of foreign exchange appreciation, peso placements expanded steadily, while foreign currency deposits fell, although they still represent 78% of the total.

- Venezuela -

As of February 2007, Venezuela began to implement an anti-inflationary program that includes price controls, a slowdown in public spending, and a contractive monetary policy, via the sale of structured notes (packages of assets in dollars acquirable in local currency), the increased supply of foreign currencies by the Commission of Foreign Exchange Administration (CADIVI), the transfer of US\$1.5 billion from the reserves to the National Development Fund (FONDEN), increased reserves, higher interest rates, dollars payments of liabilities by the Government, and the increase of the minimum limits of active rates. Whereas in the first half of 2007, the bills and coins in circulation grew at an average effective rate of 22.1%, they did so at 9.3% in the same period of 2008. Between May and June an average real contraction of 2.8% was seen in this aggregate. In mid-2008, the reserves of the Central Bank came to US\$33.56 billion (10.1 months of imports).

In January 2008, a monetary reconversion was implemented, by means of which three zeros were docked from the bolívar, which was replaced by the strong bolívar (BsF). The official exchange rate remains fixed at 2.15 BsF per dollar, and the regime of foreign currency management and the restrictions on the outflow of capital remain in place.

Fiscal policy

During 2007 and the first half of 2008, MERCOSUR countries, with the exception of Venezuela, continued to see primary surpluses. In the first half of 2008, Argentina and Paraguay obtained financial surpluses, while this result in Brazil and Uruguay was slightly negative. In all MERCOSUR countries, the share of the public debt in GDP continues to fall as a result of GDP growth (Table 1).

- Argentina -

Argentina's primary surplus reached 3.2% of GDP over 2007. Primary spending in the public sector grew faster than revenues (37.1% and 32.3% YOY respectively). If one excludes the transfer of stock accumulated in individual capitalization accounts as a result of the 2007 social security reform, the primary result for 2007 would be 2.2% of the product. During the first half of 2008, the primary surplus represented 4.1% of GDP, 3.8% up on the same period the previous year. The rise is explained by the Central Bank's advance on profits during May and June 2008. A surplus of 3.5% of the product by 2008 is forecast.³⁴

During the first half of 2008, revenue rose 38.3% and primary spending 37.4% YOY. Collection increased in all tax categories, notably VAT, income tax (both linked to levels of activity and inflation), and export duty (fuelled by the increase in aliquots and commodities prices). Last, the higher revenues due to social security are explained by rising numbers of contributors, a result of the social security reform, and to rising nominal

³⁴ If the stock of the above capitalization accounts is excluded, the primary result would be 3.9% during the first half of 2008 (3.0% during the same period in 2007).

wages. The increase in spending during the first half of 2008 stems mainly from subsidies to the private sector (energy, transport), which were up 64.9% YOY, at around 1% of GDP.

TABLE 1
MERCOSUR: MAIN FISCAL INDICATORS
(% of GDP)

Country	Period	Primary Result ^{a/}	Interest ^{a/}	Financial Result ^{a/}	Public Debt ^{b/}
Argentina	2007	3.2	2.0	1.1	56.1
	2007 1 st H	3.8	1.7	2.1	59.3
	2008 1 st H	4.1	1.4	2.7	48.8
Brazil	2007	4.0	6.2	-2.3	42.7
	2007 1 st H	5.8	6.4	-0.6	44.1
	2008 1 st H	6.2	6.4	-0.1	40.4
Paraguay	2007	1.8	0.8	1.0	23.2
	2007 1 st H	4.2	0.8	3.4	n.a.
	2008 1 st H	4.4	0.7	3.7	20.6
Uruguay	2007	3.6	3.6	0.0	70.7
	2007 1 st H	3.2	4.4	-1.1	66.7
	2008 1 st H	1.3	1.4	-0.1	61.5
Venezuela	2007	-1.0	1.6	-2.6	23.2
	2007 1 st H	n.a.	n.a.	n.a.	17.8
	2008 1 st H	n.a.	n.a.	n.a.	18.0

Notes: n.a.: not available.

^{a/} Argentina: Central Government. As of 2007, due to a change of methodology, coparticipable resources and derived spending are excluded. Brazil and Uruguay: Consolidated Public sector. Paraguay: Central government. Venezuela: Restricted Public sector.

^{b/} Argentina: Total Gross National Public Sector Debt. Not including US\$30.612 billion corresponding to debt with creditors who did not accept the exchange (holdouts) equivalent to 10% of GDP in the first half of 2008. To calculate GDP the average of the last four quarters was taken. Brazil: Public Sector Net Debt (PSND). It differs from the previous report owing to changes in the original source. Paraguay: Non-Financial Public Sector Debt. The data from 2008 is an annual forecast by the IMF based on official data and staff estimates. Uruguay: Gross Global Public Sector Debt, including BCU debt. Venezuela: Gross public debt.

Sources: Authors' own elaboration with data from Treasury and Finance Secretariats (Argentina), Treasury Ministry, IPEA (Brazil), BCP, Treasury Ministry, and IMF (Paraguay), Economy and Finance Ministry (Uruguay), and the Ministry of the Popular Power for Economy and Finance (Venezuela).

The public debt as a proportion of GDP continued to fall during 2007 and the first half of 2008, reaching 48.8%. This decrease is due to GDP growing at levels higher than the debt, the latter rising in absolute terms: in June 2008 it came to US\$150 billion, 5 billion more than December the previous year. As already mentioned, in September 2008, it was announced, on the one hand, that the Paris Club debt (approximately US\$6.7 billion) would be paid making use of Central Bank reserves and, on the other, that the restructuring of government bonds

(amounting to US\$30.6 billion) for creditors who did not join the exchange of the debt in 2005 ("holdouts") would be reopened. However, the deadlines for the two operations have not yet been defined.³⁵

- Brazil -

In Brazil, the primary surplus of the consolidated public sector represented 4% of GDP and the financial deficit 2.3% of the product during 2007. There was a notable increase in the primary surplus during the first half of 2008, which stood at around 6.2% of GDP (5.8% in the same period the previous year). This surplus covered almost all interest, resulting in a nominal deficit of just 0.1% of the product. The central government's higher surplus, partially offset by the reduction of the surplus of regional governments and state companies, contributed to the increase.

The central government's total income grew 16.7%, while primary spending rose by just 9.8%. Tax collection expanded in all categories, fuelled by the dynamism of economic activity. On the one hand, the collection of income tax rose due to higher company profits and the increase in total wages, as did tax on industrialized products due to higher manufacturing production (especially, the automotive industry) and import tariffs due to higher levels of external purchasing. On the other hand, revenues rose due to contributions to social security funding, the social contribution on net earnings (whose aliquot was increased), and the social integration program. It should be stressed that the tax on financial operations offset any collection losses from the elimination of the provisional contribution on financial movements ("check tax") in December 2007. The slowdown of primary spending, on the other hand, is due to the delay in the approval of the budget in March 2008. Capital spending rose faster than total expenditure in the framework of the Growth Acceleration Program.

In June 2008, the net public sector debt represented 40.4% of GDP, as against 42.7% in December the previous year.

- Paraguay -

In 2007, fiscal income grew more than spending (13.1% and 10% YOY respectively) and the global result represented 1% of GDP, continuing the surplus trend since the signing of the IMF agreement in 2003. In this framework, fiscal policy in Paraguay retains the main features of previous years: low tax pressure, offset partly by revenue from the Itaipú and Yacyretá hydroelectric power stations (3.3% of GDP in 2007), and public spending, where current expenditure predominates (three quarters of total disbursements in 2007).

During the first half of 2008, public revenues grew 16.6%, fuelled by VAT collection and income tax from the strong performance of activity levels. Revenue from import duties fell due to the appreciation of the guaraní. Total spending grew 13.6% during the first half of 2008 due to the increase of expenditure under personnel.

³⁵ In mid-October, the government announced a new reform of the social security regime, consisting of the nationalization of the private system (AFJP). In the event of receiving legislative approval, this will have a positive short-term impact on government finance, as both the stocks accumulated in the individual capitalization accounts and future contributions will come under state control.

The public debt represented 23.2% of GDP in 2007 and could reach 20.6% of GDP by the end of 2008. Between December 2007 and June 2008, it fell slightly in absolute terms.

- Uruguay -

The primary result in 2007 represented 3.6% of GDP in Uruguay. This figure was equivalent to interest on the debt, as a result of which the global result balanced. During the first half of 2008, there was a significant fall in the primary surplus, equivalent to 1.3% of GDP. This lower surplus is explained by the expansion of spending, due mainly to transfers to the private sector, and by the expansion of the public sector deficit. On the other hand, interest dropped to 1.4% of GDP, giving rise to a global deficit of 0.1% of the product.

The public debt represented 70.7% of the product in December 2007 and fell to 61.5% in the first half of 2008 due to the rise in GDP, while the debt grew in nominal terms.

- Venezuela -

In Venezuela, the sign of the primary restricted public sector result³⁶ was reversed, with a deficit of 1% of GDP (0.6% surplus in 2006). In terms of interest on the debt, the global deficit represented 2.6% of the product. It should be stressed that the slowdown of both total revenue and spending during 2007 contributed to their reduction as a percentage of GDP. The slowdown in revenue is explained by weaker flows due to utilities, dividends, and commissions, associated with the lower petroleum price up to August 2007. The lowest growth in spending comes from falling purchases of goods and services and from more moderate transfers to public organizations.

The public debt represented 23.2% of the product during 2007 and 18% during the first half of 2008 respectively. The falling ratio is due to rising GDP, as the debt also grew in absolute terms.

E. Incomes and employment

MERCOSUR countries' *per capita* GDP rose 6.1% on average in 2007 and a variation of 5.6% in real terms is expected in 2008.³⁷ Uruguay should have the best performance in 2008, with a rise of 10.7% of the product per inhabitant, followed by Argentina (6.2%) and Venezuela (4.2%). In Brazil (3.8%) and Paraguay (3.1%), *per capita* GDP should once again rise less than in the other partners, as in recent years (see Tables AI.8 in Annex I). These two countries' GDP per inhabitant should remain below the MERCOSUR average.

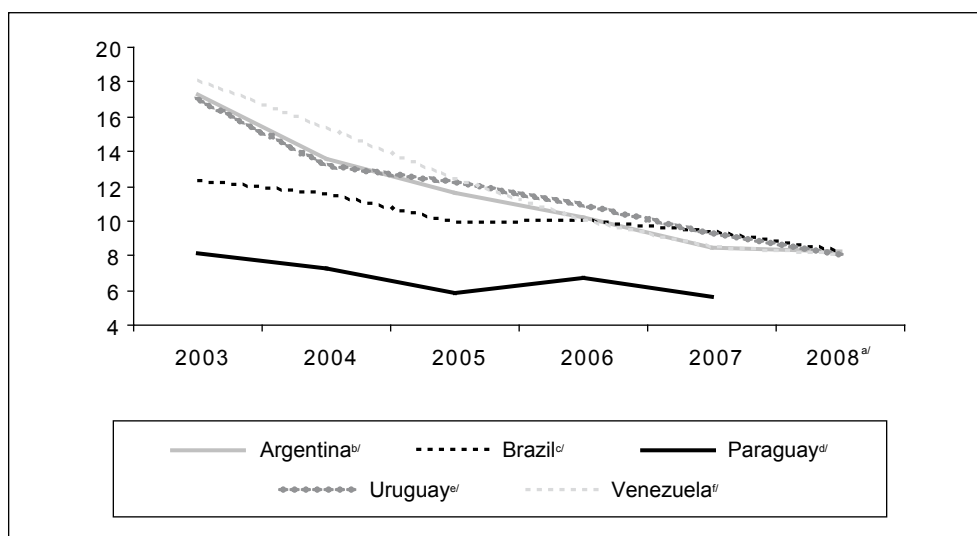
Economic growth continued to fuel the rise in total wages in MERCOSUR countries during 2007 and the first half of 2008, both via new job creation, with the notable performance of formal employment, and improved pay. Unemployment rates fell in all countries in the bloc and currently stand at minimum levels

³⁶ The restricted public sector is made up of the Budgetary Central Government, Venezuela Petroleums Inc. (PDVSA), the Sample of Non-Financial Public Companies, the Venezuelan Institute of Social Security (IVSS), and the Deposits Guarantee and Bank Protection Fund (FOGADE). It does not include the social action programs or "missions."

³⁷ Simple average for the five countries. The figures to 2007 correspond to constant price measurement for 2000. Source: ECLAC. The forecasts are the Authors' own elaboration.

of recent years (Graph 8). Unemployment in MERCOSUR on average³⁸ affected 8.1% of the economically active population (EAP) in 2007.

GRAPH 8
MERCOSUR: RATE OF UNEMPLOYMENT
(As % of EAP)



Notes: ^{a/} Data corresponding to the first half. The data for Paraguay is not available.

^{b/} Urban areas. The beneficiaries of social plans performing related labor considerations are considered employed.

^{c/} Six metropolitan areas.

^{d/} Total population (urban and rural). The figures do not coincide with the previous report, as rural areas were not included before 2006.

^{e/} In 2006, the National Survey of Households was expanded to also include rural areas. The figures from this year are therefore not comparable with previous years (urban total).

^{f/} National total.

Sources: INDEC, IBGE, INE, DGEEC, ECLAC.

In Brazil, Uruguay, and Venezuela, the dynamism of activity levels meant greater job creation. Employment product elasticity³⁹ stood at 0.6 in Brazil and Venezuela during the first half of 2008, slightly lower than in Uruguay during 2007. In Paraguay, elasticity reached a level close to the unit in 2007. In Argentina, however, expansion created fewer jobs than in previous years. Employment-product elasticity fell at 0.2 during the first half of 2008 (see Table A.I.9 in Annex I).

Real wages continued their upward trend in all countries in the bloc with the exception of Venezuela, where they fell 2% YOY during the first half of 2008 due to the rising rate of inflation. In Brazil, Paraguay, and Uruguay, the pace of growth of real remunerations slowed. Argentina, on the other hand, saw a higher increase in real wages over previous years if the IPC-GBA is used as a deflator. Nevertheless, the adjustment based on other official indexes (like the National CPI or GDP implicit prices) and on private estimates suggests a slowdown (see Table A.I.10 in Annex I).

³⁸ Simple average for the five countries.

³⁹ Variation in the number of employed in relation to variation in GDP.

F. Conclusions

The MERCOSUR economies have kept up high growth rates and continued to show falling unemployment indexes. Between 2007 and 2008, there was a deepening of the shift in growth factors from net exports, which prevailed in the initial stages of recovery after the crisis, toward internal demand and, in particular, investment. With the appearance of the first financial tremors in the second half of 2007, external inflationary pressures joined the scenario of internal dynamism. The increase in international food and energy prices affected all countries in the bloc and largely determined economic policy actions.

Halfway through 2008, however, the impact of the international crisis, now in full swing, is changing the focus of the macroeconomic situation. First, as external inflationary factors have been tailing off due to the change in the prices of raw materials, the main macroeconomic problems have come to be related to the variables of the balance of payments and the pace of activity. In the new context, external demand is weakening due both to prices and quantities, while competition from third markets is on the increase. The new scenario could also have negative consequences in several MERCOSUR countries in terms of fiscal collection in the medium term.

Second, the flow of external funding both private and public, which did not in general undergo net contractions due to the international crisis up to July 2008, will probably show greater volatility. The monetary and fiscal tools must aim simultaneously to preserve the sustainability of the external and fiscal balances. On a favorable note, and despite still warranting the attention of the bloc's economic authorities, it is worth noting that the respective financial institutions' capital position has been less exposed to the toxic assets that have affected global finances.

Last, the impact of a common external shock presents a favorable occasion for the macroeconomic coordination of MERCOSUR countries. The significant depreciation of the Brazilian real in September-October 2008 in a context of the country's trade surplus with the rest of its partners will probably, among other issues, become a reason for dialogue among the authorities.

ANNEX I

TABLE AI.1
MERCOSUR: GROSS DOMESTIC PRODUCT
 (Real YOY % variation)

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela ^{a/}	MERCOSUR ^{b/}
1998	3.9	0.0	0.6	4.5	0.3	1.9
1999	-3.4	0.3	-1.5	-2.8	-6	-2.7
2000	-0.8	4.3	-3.3	-1.4	3.7	0.5
2001	-4.4	1.3	2.1	-3.4	3.4	-0.2
2002	-10.9	2.7	0.0	-11.0	-8.9	-5.6
2003	8.8	1.1	3.8	2.2	-7.8	1.6
2004	9.0	5.7	4.1	11.8	18.3	9.8
2005	9.2	3.2	2.9	6.6	10.3	6.4
2006	8.5	3.8	4.3	7.0	10.3	6.8
2007	8.7	5.4	6.8	7.4	8.4	7.3
2008 ^{f/}	7.2	5.2	5.1	10.8	6.0	6.9

Notes: ^{a/} The figures for 2003-2006 differ from the previous, as there was a change in the data from ECLAC, which takes official data from Venezuela.

^{b/} Simple average for the five countries.

^{f/} Forecasts. For Argentina, Brazil, Paraguay, and Uruguay, forecasts correspond to the market expectations survey carried out by the Central Banks, while in Venezuela's case this was produced by ECLAC.

Sources: DNCN (Argentina), BCRA (Argentina), IBGE (Brazil), BCB (Brazil), BCP (Paraguay), BCU (Uruguay) y ECLAC.

TABLE AI.2
MERCOSUR: TERMS OF TRADE
 (Indexes 1998 = 100)

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela	MERCOSUR ^{a/}
1998	100.0	100.0	100.0	100.0	100.0	100.0
1999	94.0	86.8	94.1	91.9	129.1	99.2
2000	103.5	89.4	92.6	95.8	195.2	115.3
2001	102.7	89.2	92.8	99.6	160.5	109.0
2002	102.4	87.9	89.5	98.2	171.0	109.8
2003	111.8	86.7	93.9	99.1	192.7	116.8
2004	113.5	87.1	96.6	95.7	230.5	124.7
2005	111.3	87.9	90.2	86.9	301.4	135.5
2006	118.0	92.5	88.5	85.0	359.9	148.8
2007	122.3	94.5	92.7	86.6	394.6	158.1

Notes: ^{a/} Simple average for the five countries.
 n.a.: not available.

Source: ECLAC.

TABLE AI.3
MERCOSUR: PRODUCT ELASTICITY^{a/} OF DIFFERENT
AGGREGATE DEMAND COMPONENTS
(Average for the period)

Country / Bloc and aggregate demand component	YOY variation		Product elasticity	
	2005-2006	2007-2008	2005-2006	2007-2008
<i>MERCOSUR^{b/}</i>				
GDP	6.6	7.8		
Private consumption	8.4	9.5	1.3	1.2
Investment ^{c/}	12.5	21.6	1.5	2.7
Exports ^{d/}	8.6	6.0	1.8	0.7
Imports ^{e/}	18.3	19.6	3.0	2.6
Net exports ^{f/}			-1.2	-1.9
<i>Argentina</i>				
GDP	8.8	8.3		
Private consumption	8.3	8.4	0.9	1.0
Investment ^{c/}	16.5	18.0	1.9	2.2
Exports ^{d/}	10.4	5.5	1.2	0.7
Imports ^{e/}	17.8	21.6	2.0	2.6
Net exports ^{f/}			-0.8	-1.9
<i>Brazil</i>				
GDP	3.3	5.7		
Private consumption	4.5	6.6	1.4	1.2
Investment ^{c/}	4.4	16.3	1.3	2.9
Exports ^{d/}	7.4	4.1	2.2	0.7
Imports ^{e/}	13.7	21.6	4.2	3.8
Net exports ^{f/}			-1.9	-3.1
<i>Paraguay</i>				
GDP	3.6	7.5		
Private consumption	4.5	6.9	1.3	0.9
Investment ^{c/}	-3.4	18.0	-0.9	2.4
Exports ^{d/}	13.3	12.1	3.7	1.6
Imports ^{e/}	12.8	14.7	3.5	2.0
Net exports ^{f/}			0.2	-0.4
<i>Uruguay</i>				
GDP	6.8	10.3		
Private consumption	7.7	11.2	1.1	1.1
Investment ^{c/}	14.1	38.9	2.1	3.8
Exports ^{d/}	12.2	13.0	1.8	1.3
Imports ^{e/}	14.2	19.3	2.1	1.9
Net exports ^{f/}			-0.3	-0.6

TABLE AI.3 (CONTINUED)

Country / Bloc and aggregate demand component	YOY variation		Product elasticity	
	2005-2006	2007-2008	2005-2006	2007-2008
<i>Venezuela</i>				
GDP	10.3	7.2		
Private consumption	16.8	14.4	1.6	2.0
Investment ^{c/}	31.0	16.6	3.0	2.3
Exports ^{d/}	-0.4	-4.6	-0.0	-0.6
Imports ^{e/}	33.1	21.0	3.2	2.9
Net exports ^{f/}			-3.2	-3.6

Notes: ^{a/} Product elasticity is the ratio between the average rate of variation of the aggregate and GDP in 2005-2006 and 2007-2008. Variables measured at constant prices for 2000. The data for 2008 correspond to the first half, with the exception of Paraguay, where they correspond to the first quarter.

^{b/} Simple average for the five countries.

^{c/} Investment: gross domestic capital formation=gross domestic fixed capital formation + variation in stocks.

^{d/} Exports: includes goods and services.

^{e/} Imports: includes goods and services.

^{f/} Net export elasticity calculated as the difference between export and import elasticities.

Source: Authors' own elaboration with DNCN (Argentina), IBGE (Brazil), BCU (Uruguay), BCV (Venezuela) and ECLAC data.

TABLE AI.4
MERCOSUR: CONSUMER PRICE INDEX
(YOY % variation)

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela	MERCOSUR ^{a/}
1998	0.7	1.7	14.6	8.6	29.9	11.1
1999	-1.8	8.9	5.4	4.2	20.0	7.3
2000	-0.7	6.0	8.6	5.1	13.4	6.5
2001	-1.5	7.7	8.4	3.6	12.3	6.1
2002	41.0	12.5	14.6	25.9	31.2	25.1
2003	3.7	9.3	9.3	10.2	27.1	11.9
2004	6.1	7.6	2.8	7.6	19.2	8.7
2005	12.3	5.7	9.9	4.9	14.4	9.4
2006	9.8	3.1	12.5	6.4	17.0	9.8
2007	8.5	4.5	6.0	8.5	22.5	10.0
2008 ^{b/}	9.1	6.2	9.7	8.5	34.5	13.3

Notes: ^{a/} Simple average for the five countries.

^{b/} Forecasts for Argentina, Brazil, Paraguay, and Uruguay correspond to the market survey carried out by the Central Banks; while for Venezuela it is the YOY variation to September 2008.

Sources: INDEC (Argentina), BCRA (Argentina), IBGE (Brazil), BCB (Brazil), BCP (Paraguay), BCU (Uruguay), and INE (Venezuela).

TABLE AI.5
MERCOSUR: REAL EFFECTIVE EXCHANGE RATE
 (2000 Indexes = 100 - end of period)

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela	MERCOSUR ^{a/}
1998	110.2	76.9	101.5	107.0	109.0	100.9
1999	100.4	105.4	101.0	98.7	100.9	101.3
2000	99.2	103.8	97.2	99.8	97.5	99.5
2001	97.2	116.1	113.2	106.0	94.0	105.3
2002	227.9	156.8	114.9	134.9	127.4	152.4
2003	216.1	126.3	107.2	158.0	130.6	147.6
2004	221.4	115.5	115.2	145.8	135.9	146.8
2005	214.9	91.9	115.7	128.8	137.9	137.8
2006	214.0	89.0	96.2	132.1	123.2	130.9
2007	230.8	77.0	90.6	121.8	108.0	125.7
2008 ^{b/}	233.4	71.9	79.4	113.3	98.6	119.4

Notes: ^{a/} Simple average for the five countries.
^{b/} First half.

Sources: ECLAC.

TABLE AI.6
MERCOSUR: NET INTERNATIONAL RESERVES
 (US\$ Millions. December averages)

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela
2005	28.077	53.799	1.297	3.078	29.636
2006	32.037	85.839	1.658	3.091	36.672
2007	46.176	180.334	2.462	4.121	33.477
2008 ^{a/}	47.709	200.827	3.196	6.101	31.625

Note: ^{a/} June average.

Sources: BCRA (Argentina), BCB (Brazil), BCP (Paraguay), BCU (Uruguay) and BCV (Venezuela).

TABLE AI.7
MERCOSUR: PER CAPITA GDP
 (Real YOY variation, at constant 2000 prices)

Year	Argentina	Brazil	Paraguay	Uruguay	Venezuela	MERCOSUR ^{a/}
1999	-4.4	-1.2	-3.6	-3.4	-7.7	-4.1
2000	-1.8	2.8	-5.3	-1.8	1.8	-0.9
2001	-5.4	-0.2	0.0	-3.6	1.5	-1.5
2002	-11.7	1.2	-2.0	-11.0	-10.5	-6.8
2003	7.8	-0.3	1.8	2.2	-9.4	0.4
2004	8.0	4.2	2.1	11.9	16.2	8.5
2005	8.1	1.5	0.9	6.6	8.4	5.1
2006	7.4	2.3	2.4	6.8	8.5	5.5
2007	7.6	4.0	4.9	7.2	6.6	6.1
2008 ^{f/}	6.2	3.8	3.1	10.7	4.2	5.6

Notes: ^{a/} Simple average annual variation.
^{f/} Forecasts.

Sources: ECLAC and Authors' own elaboration forecasts.

TABLE AI.8
MERCOSUR: UNEMPLOYMENT INDEX
(As % EAP, annual average)

Year	Argentina		Brazil ^{b/}	Paraguay ^{c/}	Uruguay ^{d/}	Venezuela ^{e/}	MERCOSUR ^{f/}
	a1/	a2/					
2003	17.3	22.7	12.3	8.1	16.9	18.0	14.5
2004	13.6	18.1	11.5	7.3	13.1	15.3	12.2
2005	11.6	14.8	9.8	5.8	12.2	12.4	10.4
2006	10.2	12.3	10.0	6.7	10.9	10.0	9.6
2007	8.5	9.4	9.3	5.6	9.2	8.5	8.2
2008 ^{g/}	8.2	8.6	8.3	n.a.	8.0	8.0	8.1

Notes: n.a.: not available.

^{a1/} Urban areas. Beneficiaries of social plans performing related labor considerations are considered employed.

^{a2/} Urban areas. People whose main occupation comes from a social plan are considered unemployed.

^{b/} Six metropolitan areas.

^{c/} Total population (urban and rural). The figures do not coincide with the previous report, as rural areas were not included before 2006.

^{d/} In 2006, the National Survey of Households was expanded to also include rural areas. The figures from this year are therefore not comparable with previous years (urban total).

^{e/} National total.

^{f/} Simple average for the five countries. For Argentina, the rate corresponding to note ^{a1/} is taken.

^{g/} First half.

Sources: INDEC (Argentina), IBGE (Brazil), INE (Uruguay), INE (Venezuela) and DGEEC (Paraguay).

TABLE AI.9
MERCOSUR: EMPLOYMENT-PRODUCT ELASTICITY
(Ratio of YOY variation in employed population and the real YOY variation in GDP)

Period / Country	Argentina	Brazil	Paraguay	Uruguay	Venezuela
2006	0.5	0.6	-0.6	n.a.	0.4
2007	0.3	0.6	0.9	0.7	0.4
2008 ^{a/}	0.2	0.6	n.a.	n.a.	0.6

Note: ^{a/} First half.

Sources: Ministry of Economy (Argentina), IBGE (Brazil), INE (Uruguay) and INE (Venezuela).

TABLE AI.10
MERCOSUR: REAL REMUNERATIONS
(YOY variation. Nominal wage index, adjusted for consumer price indexes)

Period / Country	Argentina	Brazil	Paraguay	Uruguay	Venezuela
2006	6.3	4.0	1.3	4.4	5.1
2007	10.8	3.2	0.7	4.8	1.5
2008 ^{a/}	14.3	2.3	n.a.	4.1	-2.0

Note: ^{a/} First half.

Sources: INDEC (Argentina), IBGE (Brazil), BCU (Uruguay), INE (Uruguay) and BCV (Venezuela).

CHAPTER 2. THE EVOLUTION OF TRADE AND FOREIGN DIRECT INVESTMENT

During 2007 and the first half of 2008, the foreign trade flows of MERCOSUR countries continued to perform exceptionally well. Since 2003, exports and imports of the members of the bloc have in fact been growing at fairly high rates, and this period has been the region's most prosperous, at least since the bloc was created in 1991. Argentina, Brazil, Paraguay, and Uruguay have enjoyed a favorable international climate, both in terms of an increase in the volume of world trade or of the increase in the prices of the goods exported by the countries, especially agricultural and mineral commodities. Instead of keeping pace with world trade, these countries' exports have outstripped it, which has enabled a continuous increase in their market share of world imports. The context has also been quite favorable in terms of FDI flows.

A. Total MERCOSUR trade⁴⁰

The MERCOSUR exports countries⁴¹ totaled US\$224.2 billion in 2007, which meant growth of 17.8% in relation to the previous year. The fifth consecutive year of growth in the bloc's external sales, a period in which the value exported increased 2.5 fold, equivalent to an average annual growth rate of 20.3%. As underlined later on, it is a good idea to observe the evolution of MERCOSUR trade while paying attention to the events of the last decade. Graph 9 clearly shows the contrast between recent performance and the situation in 1998-2002, when the bloc's exports grew just 1.4% c.a.

Imports have been showing greater dynamism, with higher rates than exports. In 2007, they reached US\$176.6 billion, 31% up on the previous year, and in the last five years their growth was 24.2% c.a., tripling their value. This performance also contrasts sharply with the 9.3% c.a. fall seen in the previous five-year period. The bloc's trade flow thus reached a total of US\$400 billion in 2007, with 23.3% growth that year and 21.9% c.a. in the last five years.

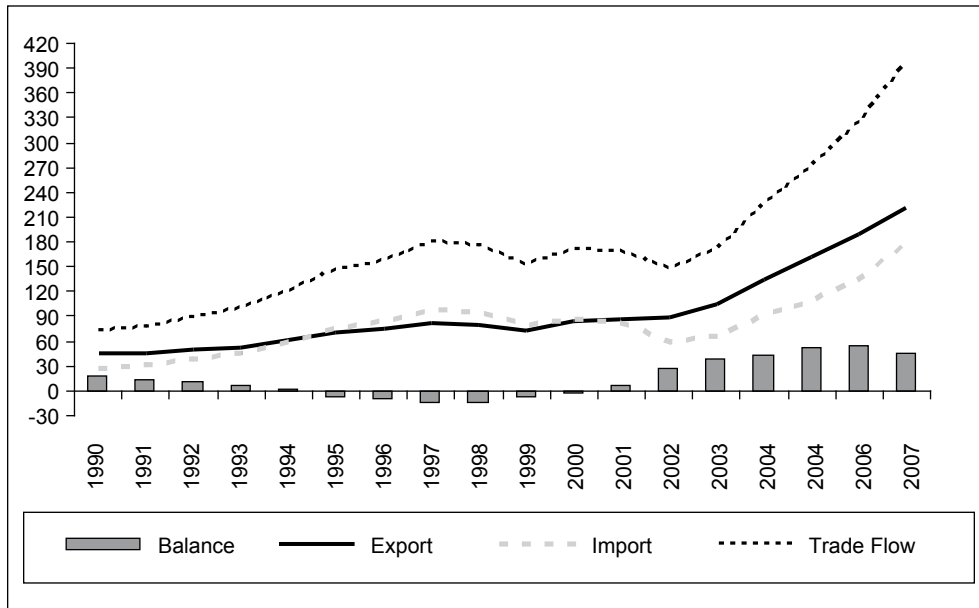
Much faster import growth in 2007 in comparison with exports meant that the trade balance for the year was 14.2% down on 2006, a fall of US\$7.9 billion in absolute terms. Even so, the bloc recorded a US\$47.6 billion surplus. Graph 9 shows that the bloc's trade balance fell for the first time since 1998.

During the last ten years, MERCOSUR's trade balance has been through three separate phases. The first, from 1998 to 2002, was characterized by serious macroeconomic instability in all countries in the bloc, added to a highly convulse international atmosphere. Indeed, between 1998 and 2002, the economies of MERCOSUR went through a period of deep crisis that led to a stagnation or fall in activity levels, foreign exchange depreciations, and, in certain cases, to serious social crises. The world economy also underwent a fairly unstable period, with the Asian crisis and the recession of the US economy in 2001, as well as the negative impact of the terrorist attacks of September 11. MERCOSUR thus saw virtual stagnation of exports and shrinkage of imports, which meant the trade balance went from a deficit of around US\$14 billion in 1998 to a surplus of US\$29.2 billion in 2002.

⁴⁰ Methodological clarification: as Venezuela MERCOSUR membership process is still underway, any references made in this text to the bloc's trade flows cover only the four original partners. Specific observations are, however, made about Venezuela.

⁴¹ Includes intrabloc trade.

GRAPH 9
TOTAL MERCOSUR FOREIGN TRADE^{a/}
 (1990-2007 - US\$ Billions)



Note: ^{a/} Includes intrabloc trade.

Sources: INDEC (Argentina), SECEX-MDIC (Brazil), BCP (Paraguay), and BCU (Uruguay).

The second phase, from 2003 to 2006, was characterized by extremely positive scenarios, both in the international market and on the internal front, and, once again, MERCOSUR countries showed sustained growth. Exports increased sufficiently fast to deal with the expansion of imports. This in turn enabled the bloc's trade surplus continued to rise until it reached a record US\$55.5 billion in 2006.

The most recent phase, taking in 2007 and the first half of 2008, was characterized by the sustained high pace of growth in internal demand in the bloc and by a still favorable international scenario, especially where the increases in international commodity prices was concerned, which far exceeded their historical average. However, the trade surplus still fell in 2007 and again in the first half of 2008, 45.4% down on the same period for 2007, a reduction of US\$11.1 billion. Apparently, this trend will continue for the rest of the year.

The deterioration in MERCOSUR countries' trade balances over the first half of 2008 cannot be explained by the weak performance of exports, which, at US\$129.1 billion, were 27.5% up on the same period the previous year. The cause of this, however, was the exceptional growth in imports during that half, a staggering 50.7% up on the same period for 2007. Exports reached US\$115.8 billion, more than what the bloc imported in the whole of 2005. Analysis of the data for each country, presented in detail in the following section, shows that much of that growth was due to the rise in the import prices of products with a significant bearing on MERCOSUR countries' pattern of trade, products such as petroleum, fertilizers, and mineral inputs. A similar phenomenon occurred in exports, considering that the growth in external sales was mostly based on the rising prices of agricultural products, which make up a significant part of MERCOSUR's export basket.

Trade flows by country

Brazil was responsible for slightly over 70% of total MERCOSUR exports in 2007, with US\$160.6 billion. Argentina had a 25% share (US\$56.2 billion), and Paraguay and Uruguay together exported US\$7.3 billion, slightly over 3% of the total. Table 2 shows that, compared to 2006, Paraguay performed best with a 46.1% increase, while Uruguayan exports grew just 12.9%. Argentina expanded its exports by 20.8% and Brazil grew 16.6%, slightly lower than the rise in the bloc's total external sales.

The situation was similar in the first half of 2008, Brazilian exports performed worst in the bloc, up 23.8% on the first half of 2007, which meant a 2.1 p.p. drop in Brazil's share in the bloc's total sales. Growth was more significant in the case of Paraguayan and Uruguayan sales (85.7% and 43.6% respectively), while Argentina's performance (34.3%) also exceeded the increase in the bloc's total exports.

This recent evolution contrasts with 2003-2007, when Brazil raised its share in the bloc's external sales by 3.7 p.p. This increase at the expense of Argentina's share, which fell by 3.8 p.p. The annual average growth of Argentine exports in the last five years was the lowest in MERCOSUR at 17%. In this period, Paraguay's share increased slightly (+0.2 p.p.) and Uruguay's fell 0.1 p.p.

It is worth remembering, however, that 80% of the MERCOSUR population lives in Brazil and that it produces almost 70% of the bloc's GDP (excluding Venezuela). To offset the difference of scale between the countries, it is important to analyze the evolution of exports per inhabitant. Two main facts stand out. First, Argentina and Uruguay had the highest coefficients of exports per inhabitant in 1998-2007. Second, although Brazil's exports per inhabitant were the most dynamic, this indicator also shows more rapid acceleration in the other partners. Between 1998 and 2007, it was up 2.8-fold in Brazil, 2.3 in Paraguay, 2 in Argentina, and 1.6 in Uruguay.

Regarding imports, Table 2 shows that Brazil was responsible for 68.3% of the bloc's total external purchasing in 2007, with US\$120.6 billion. Argentina's share was similar to that for exports (25.4%) and the greatest difference emerged in the shares of Paraguay and Uruguay, both with 3.2%. The growth rate between 2006 and 2007 was higher in Brazil (32.1%) and Argentina (31.1%), and below average in Paraguay (24.2%) and Uruguay (17%). In the first half of 2008, imports accelerated substantially in all countries in the bloc, especially Uruguay, where they increased a staggering 92.6%. Paraguay recorded growth of 54.9%, Brazil 50.7%, and Argentina 45.3%.

Between 2002 and 2007, Brazil's share in total MERCOSUR imports fell by 10.8 p.p., while Argentina's grew by 10.3 p.p. The increase reflected annual average growth of 37.9% in this country's external purchasing, but it is worth remembering that the basis for comparison is for 2002, a year when its imports suffered a deep contraction due to the grave economic crisis following the end of the foreign exchange convertibility regime. In fact, Argentina's current share in MERCOSUR imports is still well below that seen in 1998, which was 32.9%.

The trade surplus recorded by MERCOSUR in 2007 reached US\$47.6 billion, US\$40 billion of which correspond to Brazil, i.e. over 80% of the total. Argentina's share was US\$11.5 billion, while Paraguay and Uruguay had deficits of US\$2.8 billion and US\$1.1 billion respectively. The balance evolved unfavorably in all countries in comparison with the previous year, especially in Brazil, whose surplus fell by 13.9%

(US\$6.4 billion), and Uruguay, whose deficit grew 38%. The trend continued during the first half of 2008, when the trade balance of all countries deteriorated in comparison with the same period the previous year. In this sense, Brazil once again stands out for having suffered a 44.9% reduction in its surplus, as does Uruguay, whose deficit rose 438%.

TABLE 2
TOTAL MERCOSUR TRADE FLOWS AT SELECTED TIMES
(US\$ Millions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{al}	2008 ^{al}	% Var.
<i>Exports</i>	81,336	88,901	190,268	224,178	17.8	101,251	129,119	27.5
Argentina	26,434	25,651	46,569	56,246	20.8	24,751	33,237	34.3
Brazil	51,120	60,439	137,808	160,649	16.6	73,214	90,645	23.8
Paraguay	1,014	951	1,906	2,785	46.1	1,227	2,278	85.7
Uruguay	2,769	1,861	3,985	4,498	12.9	2,060	2,959	43.6
<i>Imports</i>	95,375	59,705	134,757	176,567	31.0	76,789	115,755	50.7
Argentina	31,379	8,988	34,150	44,781	31.1	19,346	28,113	45.3
Brazil	57,714	47,243	91,343	120,621	32.1	52,637	79,310	50.7
Paraguay	2,471	1,510	4,489	5,577	24.2	2,454	3,802	54.9
Uruguay	3,811	1,964	4,775	5,588	17.0	2,352	4,530	92.6
<i>Trade Balance</i>	(14,039)	29,195	55,511	47,611	(14.2)	24,462	13,364	(45.4)
Argentina	(4,946)	16,662	12,419	11,465	(7.7)	5,405	5,124	(5.2)
Brazil	(6,595)	13,196	46,465	40,028	(13.9)	20,577	11,335	(44.9)
Paraguay	(1,457)	(560)	(2,583)	(2,792)	8.1	(1,228)	(1,524)	24.1
Uruguay	(1,042)	(103)	(790)	(1,090)	38.0	(292)	(1,571)	438.0

Note: ^{al} First Half.

Sources: INDEC (Argentina), SECEX-MDIC (Brazil), BCP (Paraguay), and BCU (Uruguay).

In short, recent evolution shows a reversion in terms of 2002-2006, when there was an improvement in the bloc's trade balance that certainly included the above Argentine anomaly, the 2002 crisis being accompanied by an extremely sharp contraction of imports, resulting in an abnormally high surplus that year.

Recent evolution of intrazone trade

Intrazone exports, equivalent, by definition, to intrazone imports, grew by a significant 25.7% in 2007 to reach US\$32.4 billion (Table 3). In fact, intrazone exports have been seeing a more favorable evolution than extrazone exports in recent years. Between 2002 and 2007, intrazone exports saw annual average growth of

26%, a higher rate than that seen in exports to the rest of the world (19.5%). This trend continued during the first half of 2008, when intrazone exports were up 39% on the same period in 2007.

TABLE 3
MERCOSUR INTRAZONE AND EXTRAZONE TRADE FLOWS AT SELECTED TIMES
(US\$ Billions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{a/}	2008 ^{a/}	% Var.
<i>Intrazone</i>								
Exports ^{b/}	20.4	10.2	25.8	32.4	25.7	14.3	19.8	39.0
<i>Extrazone</i>								
Exports	61.0	78.7	164.5	191.8	16.6	87.0	109.3	25.6
Imports	75.0	49.4	109.4	144.0	31.6	62.4	95.6	53.2
<i>Total</i>								
Exports	81.3	88.9	190.3	224.2	17.8	101.3	129.1	27.5
Imports	95.4	59.7	134.8	176.6	31.0	76.8	115.8	50.7
Balance	(14.0)	29.2	55.5	47.6	(14.2)	24.5	13.4	(45.4)

Notes: ^{a/} First half.

^{b/} By definition, equal to Intrazone imports.

Sources: INDEC (Argentina), SECEX-MDIC (Brazil), BCP (Paraguay), and BCU (Uruguay).

Consequently, intrazone exports show an increase in their share in the bloc's total sales from 11.5% in 2002 to 15.3% in the first half of 2008. However, Graph 10 shows that this share is still well below the 25% high of 1998. It can safely be said that, although an effective rise in trade integration is seen among MERCOSUR countries, in relative terms this only represents the recovery of the space lost between 1998 and 2002. At any rate, it is worth remembering that, in extrazone exports, commodities have a greater bearing in comparison with intrazone sales. In this context, whereas the prices of raw materials in 2008 were high, in 1998, they recorded a historic low. The share of intrazone trade in the total is therefore underrepresented, in spite of its recent and significant expansion.⁴² Recent evolution has been different for imports. Purchases from countries outside MERCOSUR rose 31.6% in 2007, a rate higher than the one seen for intrazone imports. Graph 10 shows that the share of intrazone imports over the bloc's total imports has been gradually falling since 2003, reaching 17.4% in the first half of 2008.

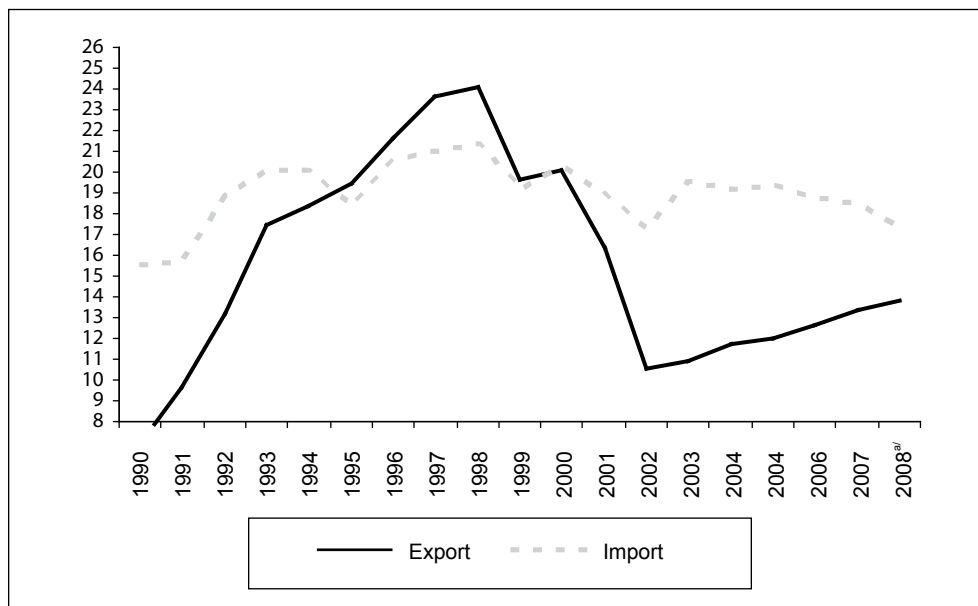
Table 4 shows the composition of intrazone trade flows, discriminated by country. In 2007, Brazil exported US\$17.3 billion to its neighbors and its share was 53.6% of total intrazone exports. Argentina exported US\$12.4 billion (38.4% of the total); Paraguay, US\$1.4 billion (4.2% of the total), and Uruguay, US\$1.2 billion (3.8% of the total). In relation to 2006, Paraguay's intrazone sales are notable, with an increase of

⁴² For an estimate of the evolution of trade in South America at constant prices, see Carciofi and Gayá [2007], especially Section B.

49.9%, a rate well above the one recorded by the intrazone exports of Uruguay (32.4%), Argentina (25%), and Brazil (24.1%).

The situation in terms of imports is quite different. Argentina was the country that imported most in comparison with its MERCOSUR partners (US\$16 billion, or 49.2% of the total), while the shares of Paraguay (7.5%) and Uruguay (7.6%) were much higher than those of exports. Brazil, on the other hand, was responsible for just 35.7% of intrazone imports. In terms of the evolution of imports, Paraguay was once again prominent, 45.7% up on 2006, growth well above that recorded for the intrazone imports of Brazil (29.7%), Argentina (27.7%), and, especially, Uruguay, (13.4%).

GRAPH 10
RATIO OF INTRAZONE TRADE FLOWS AND
TOTAL TRADE FLOWS IN MERCOSUR
1990-FIRST HALF 2008
 (% of nominal figures)



Note: ^{a/} First half.

Sources: INDEC (Argentina), SECEX-MDIC (Brazil), BCP (Paraguay), and BCU (Uruguay).

Brazil's high share in intrazone exports and its rather lower share in imports naturally implies high trade balances in its favor. In fact, Brazil continues to be the only country in the bloc to record intrazone trade surpluses. In 2007, the balance reached US\$5.7 billion, approximately US\$700 millions up on 2006. Argentina had a deficit of US\$3.6 billion, up US\$1 billion in relation on the previous year. Paraguay had a deficit of US\$1.1 billion, and Uruguay US\$1.2 billion.

The situation changed considerably in comparison to a few years ago, when Argentina was the only country with an intrazone trade surplus. The change reflected the fact that Brazil's intrabloc exports grew almost

40% c.a. between 2002 and 2007, compared to Argentina, Paraguay, and Uruguay's rises of between 15% c.a. and 20% c.a. of exports. In the same period, Brazil's intrazone imports grew 15.7% a year, while in the other countries this growth fluctuated between 21.3% (Uruguay) and 40.8% c.a. (Argentina).

The recent trend deepened in the first half of 2008, as Brazil's surplus with its partners increased by 43%, whereas the other countries increased their deficits, especially Argentina, whose imbalance was up 63.5% by approximately US\$1 billion. Argentina's intrazone deficit in six months of 2008 was already higher than that for the whole of 2006. Uruguay also experienced a severe worsening of its intrazone deficit, which rose 43.2%, whereas Paraguay's loss balance remained relatively stable.

TABLE 4
INTRAZONE TRADE FLOWS IN MERCOSUR BY COUNTRY AT SELECTED TIMES
(US\$ Millions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{al}	2008 ^{al}	% Var.
<i>Exports^{bl}</i>	20,355	10,189	25,785	32,401	25.7	14,259	19,814	39.0
Argentina	9,415	5,718	9,940	12,426	25.0	5,527	7,421	34.3
Brazil	8,877	3,311	13,986	17,354	24.1	7,596	10,459	37.7
Paraguay	531	553	917	1,374	49.9	608	1,164	91.4
Uruguay	1,532	607	942	1,247	32.4	528	770	45.8
<i>Imports^{bl}</i>	20,393	10,300	25,394	32,602	28.4	14,348	20,125	40.3
Argentina	7,930	2,895	12,555	16,037	27.7	7,167	10,103	41.0
Brazil	9,428	5,615	8,968	11,630	29.7	5,204	7,037	35.2
Paraguay	1,383	845	1,689	2,461	45.7	995	1,566	57.4
Uruguay	1,652	944	2,182	2,474	13.4	981	1,419	44.6
<i>Trade balance</i>								
Argentina	1,485	2,823	(2,615)	(3,611)	38.1	(1,640)	(2,682)	63.5
Brazil	(551)	(2,304)	5,018	5,723	14.1	2,392	3,422	43.0
Paraguay	(853)	(293)	(772)	(1,087)	40.8	(387)	(402)	4.0
Uruguay	(119)	(337)	(1,240)	(1,227)	(1.1)	(453)	(649)	43.2

Notes: ^{al} First half.

^{bl} Intrabloc exports and imports do not tally owing to differences in each country's records.

Sources: INDEC (Argentina), SECEX-MDIC (Brazil), BCP (Paraguay), and BCU (Uruguay).

Extrazone trade

The 27 countries of the European Union (EU) were the main destination of MERCOSUR exports in 2007, with US\$51.4 billion, or 26.8% of the total. Next, with shares of around 20% of the total, come the NAFTA and Asian countries, while the other LAIA countries accounted for 12.2% of the total. The highest growth

in relation to 2006 was in fact seen in sales to the EU (29%) and the Asian market (25%). The variation in sales to NAFTA was a mere 0.9% (Table 5).

In terms of MERCOSUR imports, almost 30% (US\$42.8 billion) came from the Asian countries in 2007, 35% up on the previous year. In recent years, Asia came to occupy the place of the EU whose share in the bloc's imports fell from over 30% at the start of the decade to 24.2%. The Other Countries also had a significant share in 2007 (21.5%), at 18%, higher than the NAFTA countries. LAIA countries had a limited share of just 6.4%.

TABLE 5
MERCOSUR EXTRAZONE TRADE FLOWS BY ECONOMIC BLOC AT SELECTED TIMES
(US\$ Billions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{a/}	2008 ^{a/}	% Var.
<i>Exports</i>	60.982	78.712	164.483	191.777	16.6	86.992	109.305	25.6
NAFTA	14.383	22.713	38.233	38.593	0.9	18.239	19.294	5.8
EU	20.627	21.251	39.829	51.388	29.0	23.016	29.535	28.3
LAIA ^{b/}	7.195	8.727	20.789	23.303	12.1	10.677	12.612	18.1
Asia	9.933	13.598	30.014	37.509	25.0	16.821	23.249	38.2
Other Countries	8.844	12.423	35.618	40.984	15.1	18.240	24.615	35.0
<i>Imports</i>	74.982	49.406	109.362	143.964	31.6	62.442	95.630	53.2
NAFTA	17.883	12.482	19.808	25.918	30.8	13.711	18.970	38.4
EU	27.140	16.017	26.734	35.080	31.2	15.568	21.670	39.2
LAIA ^{b/}	3.297	2.424	8.087	9.224	14.1	4.248	5.925	39.5
Asia	13.576	9.565	31.736	42.842	35.0	18.154	29.176	60.7
Other Countries	13.087	8.918	22.997	30.900	34.4	10.762	19.888	84.8
<i>Trade Balance</i>	(14.001)	29.306	55.120	47.813	(13.3)	24.550	13.675	(44.3)
NAFTA	(3.499)	10.231	18.425	12.675	(31.2)	4.528	324	(92.9)
EU	(6.513)	5.234	13.095	16.308	24.5	7.448	7.865	5.6
LAIA ^{b/}	3.898	6.304	12.701	14.079	10.8	6.429	6.688	4.0
Asia	(3.643)	4.033	(1.722)	(5.333)	209.7	(1.333)	(5.928)	344.7
Other Countries	(4.243)	3.505	12.620	10.084	(20.1)	7.477	4.727	(36.8)

Notes: ^{a/} First half.

^{b/} With the exception of MERCOSUR and Mexico. Mexico is included in NAFTA.

Sources: INDEC (Argentina), SECEX-MDIC (Brazil), BCP (Paraguay), and BCU (Uruguay).

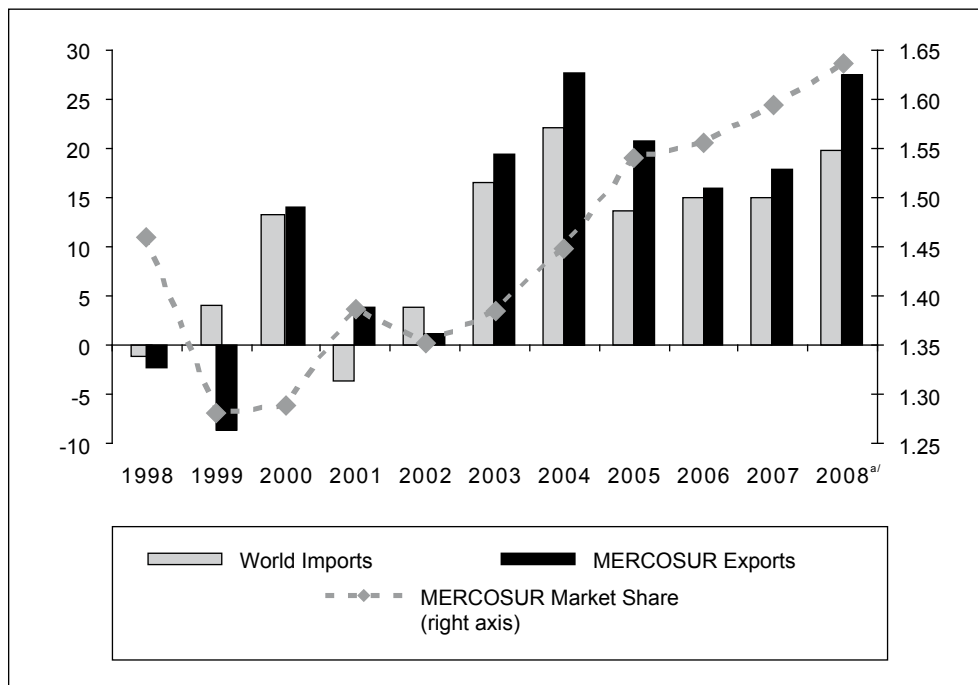
It comes as no surprise then that MERCOSUR recorded a high trade deficit with Asian countries, which reached US\$5.3 billion in 2007. On the contrary, the balance with the other blocs recorded a fairly high surplus, especially with the EU (US\$16.3 billion) and with LAIA (US\$14.1 billion). The balance with these two blocs was up on 2006, while the surplus with NAFTA and the Other Countries fell and the deficit with Asia rose considerably.

The movements seen in 2007 deepened in the first half of 2008, with more pronounced growth in exports to the EU (28.3%) and Asia (38.2%), and with a more moderate increase to LAIA (18.1%) and NAFTA (5.8%). Imports from all blocs grew rapidly, but the rate was much higher in purchases from Asia (60.7%) and Other Countries (84.8%), reflecting, in the latter case, the sharp rise in petroleum prices. MERCOSUR's trade surplus with the EU and LAIA saw a slight increase, and fell with NAFTA and the Other Countries, whereas the deficit with Asia tripled, reaching a total of US\$5.9 billion, an amount higher than the deficit recorded in the whole of 2007.

Exports, world trade, and market share

MERCOSUR exports have clearly been fuelled by the strong pace of growth experienced by world trade from 2003. This variable rose 16.4% c.a. in 2003-2007 and 19.9% in the first half of 2008. However, the countries in the bloc were able to expand their exports more rapidly, obtaining continuous increases in their market share, as shown in Graph 11. Indeed, between 2003 and 2007, MERCOSUR exports grew at an annual average rate of 20.3%, i.e. 3.9 p.p. above world imports, and in the first half of 2008 they grew 27.5%, i.e. 7.7 p.p. above world growth. Although there was a significant increase in the quantities exported by MERCOSUR in this period, much of this growth differential is due to the sharp increase in international commodity prices, the main component of MERCOSUR exports.

GRAPH 11
MERCOSUR EXPORT AND WORLD IMPORT GROWTH,
AND EVOLUTION OF MERCOSUR'S MARKET SHARE
1998-FIRST HALF OF 2008
 (%)



Note: ^{a/} First half.

Source: IMF, INDEC (Argentina), SECEX-MDIC (Brazil), BCP (Paraguay), and BCU (Uruguay).

MERCOSUR's market share was 1.64% in the first half of 2008, three tenths of a p.p. up on 2002. Though not highly significant in relative terms, this increase is important when measured in absolute values. At 2007 levels, a 0.3% share in world imports represents approximately US\$42 billion.

Box C

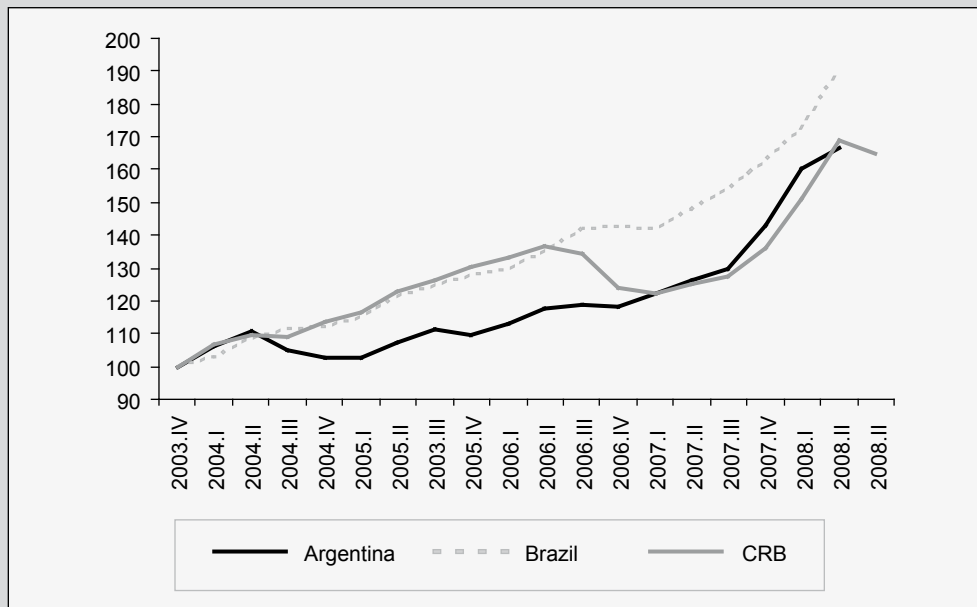
INTERNATIONAL CRISIS, COMMODITY PRICES, AND PROSPECTS FOR MERCOSUR EXPORTS

The financial crisis beginning in the USA in mid-2007 caused no significant damage to exports from MERCOSUR countries until the first half of 2008, with the exception of the slowdown in sales to NAFTA countries, which grew just 0.9% in 2007 and 5.8% in the first half of 2008. As stated in Chapter 1, the first phase of the crisis brought benefits to the MERCOSUR countries due to inflated commodity prices.

The Graph below shows that the main international commodities prices, as measured on the index of Reuters' Commodity Research Bureau (CRB), grew significantly in recent years, with the exception of the second half of 2006 as a result of a 15% drop in petroleum prices. However, growth was especially significant from 2007, with an accumulated increase of 34.9% between the second quarter of that year and the same period of 2008. This movement was closely shadowed by Argentine export prices, which grew 32.1% in the same period, followed by Brazilian export prices, which saw a rise of 28.9%.

Nevertheless, the deepening of the crisis from September 2008 considerably increased instability compared to the export performance of MERCOSUR countries. The problems extended to the financial systems of Japan and Europe, and a recessive process was unleashed across the developed world with a reversal of commodity prices. As a first reflection of this movement, the CRB index recorded a 2.7% fall in the third quarter of 2008 in relation to the previous quarter.

**QUARTERLY EVOLUTION OF MAIN COMMODITY PRICES
(CRB INDEX), ARGENTINE AND BRAZILIAN EXPORT PRICES
(2003. IV = 100)**



Sources: INDEC (Argentina), FUNCEX (Brazil) and Reuters (CRB).

Foreseeing what may happen to MERCOSUR exports from now on is a highly complex task. The figures for 2008 will still show considerable growth, not just because performance was extremely favorable in the first half of the year, but also because the negative effects of the international crisis tend to have a delayed impact on exports. But performance in 2009 will certainly be hit and will be conditioned by three main aspects: (i) the depth of the recession in the DDCs; (ii) the degree of resistance of the DGCs, i.e. to what extent their growth will be affected by the crisis, especially in the case of Asian countries; and (iii) the scope of the drop in commodity prices. The point is to ascertain the intensity of the slowdown in exports. In this sense, it is possible to imagine three scenarios.

Box C (CONTINUED)

In a benign scenario, the recession in DDCs would be light and the financial crisis would not spread to DGCs, which would experience an economic slowdown despite continuing to grow at reasonable rates supported by their internal demand. Commodity prices would see further falls until early 2009, but would rise again over the year due to the still vigorous demand in the DGCs and to short-term restrictions in order to increase supply. In this scenario, MERCOSUR exports would see significant growth in 2009 (albeit below the average for 2003-2008) of approximately 20% c.a. (still largely sustained by the rising prices).

In a pessimistic scenario, the recession in DDCs would be deeper than expected and would spread to the DGCs, who would not be able to sustain their growth merely through their internal demand. This would also shrink due to a more cautious attitude from consumers and companies. As a result, commodity prices would continue to fall and could revert to levels close to those seen in 2007, or even lower. This would represent a fall of between 20% and 25% of export prices against the levels reached in the second half of 2008. In this scenario, MERCOSUR exports would undergo a significant drop in 2009.

An intermediate scenario would be characterized by a relatively light recession in DDCs and a more intense slowdown in DGCs, although such a recession would not in the end be widespread. Commodity prices would undergo no additional falls in 2009, although it would imply a slight reduction in average prices applied during that year in relation to the average for 2008. In this context, MERCOSUR exports would suffer a more decisive slowdown and a low level of growth, albeit not negative, backed up by an increase in the volume exported.

In any of these scenarios, however, two aspects seem certain. First, the economies of Argentina and Brazil are unlikely to suffer such negative effects as those seen in the years following the Asian crisis, as the state of their external accounts is far more comfortable today than it was then, due either to the reduced need for external funding or to the existence of a firm cushion of international reserves, worth US\$47.5 billion in Argentina and over US\$200 billion in Brazil at the end of June. Second, these countries will inevitably experience a reduction in the pace of their economic growth, due both to the lower momentum of exports on internal production and to the need to slow down import growth in order to avoid a rapid speedy deterioration of the trade balance.

B. MERCOSUR trade by country

Argentina

Argentina's foreign trade flows in 2007 continued the extremely positive dynamics seen since 2003, with a marked expansion of exports and imports, and therefore of trade flows, and reasonable stability of the trade balance.

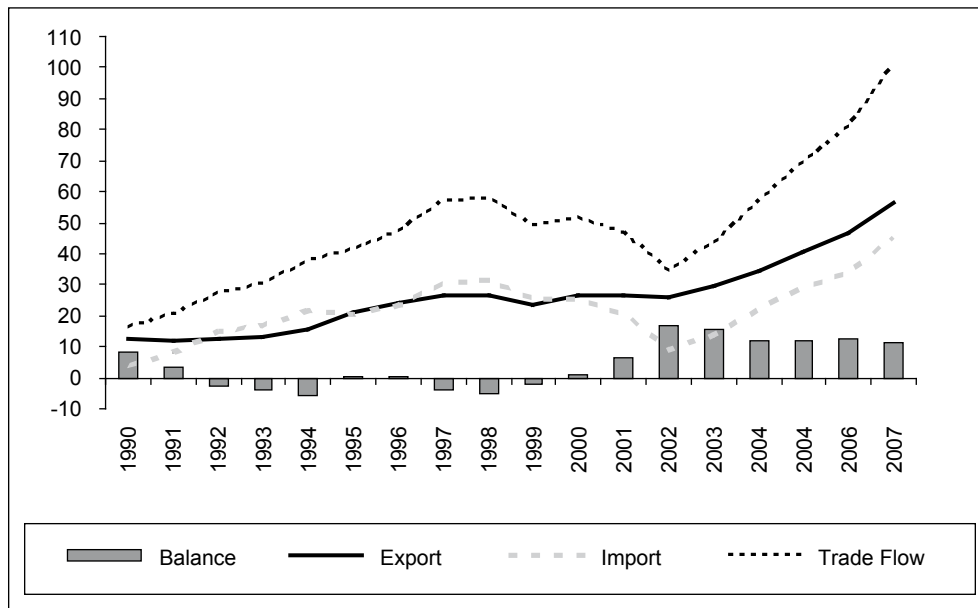
Exports from Argentina reached US\$56.2 billion in 2007, 20.8% up on the previous year. Graph 12 shows that this was the fifth consecutive annual increase in Argentina's external sales, a period in which the annual average rate was 17%. Imports grew even more rapidly in 2007 at a rate of 31.1% and maintained their trend of rapid expansion in the last five years, a period in which annual average growth was 37.9%. The trade balance was US\$11.5 billion in 2007, 7.7% down on the previous year. From 2004, Argentina's balance has fluctuated between US\$11 billion and US\$12 billion, after peaking at US\$16.7 billion in 2002. In 2007, the total trade flow reached the US\$100 billion mark for the first time, with 25.2% growth in relation to 2006 and 23.9% c.a. since 2002.

The pace accelerated in the first half of 2008, when exports saw a 34.2% rise in relation to the same period for 2007, reaching the figure of US\$33.2 billion, and imports increased 45.3%, with a total of US\$28.1 billion. The result was a slight 5.2% drop in the trade balance, equivalent to US\$5.1 billion.

That is not a recent trend. Every year since 2003 (with the exception of 2005), the price rise exceeded the growth of the *quantum*. In 2003-2007, prices were responsible for half of the increase in the country's exports, a trend that deepened in the first half of 2008, when prices experienced an unprecedented rise of 31.6% in relation to the first half of 2007, shortly after the boom in international prices of agricultural products. In the same half, the *quantum* saw a rise of just 1.9%. This means that prices were responsible for

93% of the growth of Argentine exports in the period. This poor performance may be to do with the dispute between the government and the agricultural sector over the duties on export-related earnings, which, for several weeks, caused the external sales of these products to shrink.

GRAPH 12
ARGENTINA: TRADE FLOWS IN 1990-2007
 (US\$ Billions)



Source: INDEC.

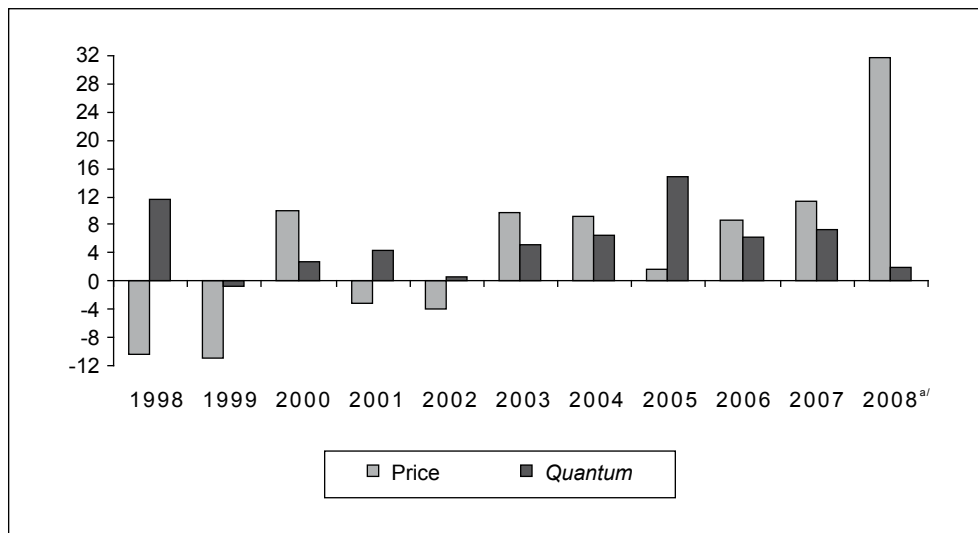
On the contrary, where imports are concerned, most of the growth seen in recent years is associated with the increase in the quantities imported, whereas prices accounted for only slightly over 10% of growth in the value imported. In 2007, the rise of the import *quantum* was 21.6%, whereas prices grew 7.3%, equal to a rise of just 26% of the value imported. In the first half of 2008, the *quantum* accelerated, recording a rise of 26.3%, but prices also increased more significantly (14.9%) by 37% of the growth in imports.

The faster growth of the prices of exported products as against the prices of imported products meant that Argentina has seen significant gains in its terms of trade in recent years. In 2007, the rise was 3.7%, reaching 14.4% in just the first half of 2008. Between 2003 and the first half of 2008, the terms of trade accumulated growth of 34.9%.

MERCOSUR partners were the destination of 22.1% of Argentine exports in 2007, equivalent to US\$12.4 billion, representing growth of 25% in relation to 2006. This rate was higher than the one recorded in the country's total sales and contributed to that the partners' share increasing eight tenths of a p.p. in the period. Table 6 shows that, in 2007, Brazil was the destination for 84.4% of Argentina's exports to MERCOSUR countries, a rise of 28.6%, and that it continues to be the main recipient of the country's total external sales, with an 18.6% share. In the first half of 2008, sales to MERCOSUR grew 34.3%, slightly above the general average, bringing about a further 22.3% rise in the bloc's share. This percentage is exactly the same as that recorded in 2002.

Argentine imports from its MERCOSUR partners reached US\$16 billion in 2007, representing 35.8% of the country's total imports. Brazil had a 90.6% share in Argentina's intrazone imports (US\$14.5 billion), 23.6% up on 2006. This means that it keeps its place as the main country of origin for Argentine imports in global terms, with 32.4% of the total. During the first half of 2008, the MERCOSUR partners were responsible for 35.9% of Argentina's imports, down on the 37% seen in the same period of 2007. The main increase in the period was due to purchases from Paraguay (80.7%), while those from Brazil grew by 37.8%.

GRAPH 13
ARGENTINA: INCREASE IN PRICES AND IN THE EXPORT QUANTUM
1998-FIRST HALF OF 2008
 (%)



Note: ^{af} First half.

Source: INDEC.

Argentina's trade balance with its MERCOSUR partners produced a negative result of US\$3.6 billion in 2007, owing basically to the imbalance in its trade with Brazil, with a US\$4 billion deficit. It should be stressed, however, that, for the first time in many years, there was also a slight deficit with Paraguay. Argentina's balance with Uruguay remains positive, despite falling in 2007. During the first half of 2008, the debit balance with its partners rose considerably to US\$2.7 billion. Deficits with Brazil (47.8%) and Paraguay (171.9%) rose considerably, but the surplus with Uruguay grew 33.2%.

In spite of exports to its MERCOSUR partners performing well, Argentina continues to lose market share in its partners' imports. In the case of Brazil, the percentage in 2007 was just 8.6%, well below that seen at the end of the 1990s, when it topped 13%. During the first half of 2008, it fell again to 7.9%. In Paraguay, the loss of market share has been even more rapid, from 14.3% in 2007 to 12.3% in the first half of 2008, after reaching figures of over 25% in 1998-2000. Uruguay, where Argentina's share in imports is the highest of the MERCOSUR partners, the market share reached 22.1% in 2007 and rose to 26.7% in the first half of 2008.

Argentine exports to extrazone markets reached US\$43.8 billion in 2007, 19.6% up on the previous year. Asia consolidated its place as the main destination for Argentine exports, with a percentage of 20.8% of the total in 2007, as against 17.6% for the EU, 13.8% for LAIA, and 10.3% for NAFTA. It is important to underline the significance of the Chilean market for Argentina, as sales to that country totaled US\$4.2 billion in 2007, higher than sales to the USA (Table 7).

Extrazone imports reached US\$28.7 billion in 2007, an increase of 33.1%. A predominant share was also seen for Asian countries, representing 20.4% of the country's total imports in that year, significantly up on the previous year (+43.2%). In recent years, Asian countries have become Argentina's prime extrazone suppliers (a place occupied by the EU in the past) with annual average growth of 53.4% in 2003-2007.

TABLE 6
ARGENTINA: TRADE FLOWS WITH MERCOSUR COUNTRIES AT SELECTED TIMES
(US\$ Millions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{al}	2008 ^{al}	% Var.
<i>Exports</i>								
MERCOSUR/ total (%)	35.6	22.3	21.3	22.1		22.3	22.3	
MERCOSUR	9,415	5,718	9,940	12,426	25.0	5,527	7,421	34.3
Brazil	7,949	4,846	8,152	10,485	28.6	4,627	6,195	33.9
Paraguay	622	343	616	776	26.1	356	492	38.2
Uruguay	843	529	1,172	1,165	(0.6)	544	734	35.0
<i>Imports</i>								
MERCOSUR/ total (%)	25.3	32.2	36.8	35.8		37.0	35.9	
MERCOSUR	7,930	2,895	12,555	16,037	27.7	7,167	10,103	41.0
Brazil	7,055	2,517	11,750	14,523	23.6	6,458	8,901	37.8
Paraguay	348	255	504	1,056	109.5	522	943	80.7
Uruguay	528	122	301	458	52.2	187	259	38.3
<i>Trade Balance</i>								
MERCOSUR	1,485	2,823	(2,615)	(3,611)	38.1	(1,640)	(2,682)	63.5
Brazil	895	2,329	(3,598)	(4,038)	12.2	(1,831)	(2,706)	47.8
Paraguay	274	87	112	(280)	(351.0)	(166)	(451)	171.9
Uruguay	316	407	871	707	(18.8)	357	475	33.2

Source: INDEC.

Argentina's trade surplus with the countries outside MERCOSUR reached US\$15 billion in 2007, almost the same amount as seen in 2006. There is a significant surplus balance with all blocs, except NAFTA, where there is a US\$1.1 billion deficit. The best result obtained was with the LAIA countries (US\$6.5 billion), which, to a large extent, is a reflection of good trade performance with Chile, although the surplus of over US\$1 billion in trade with Venezuela must also be underlined. Next are the balances with the Asian countries (US\$2.6 billion) and the EU (US\$2.4 billion).

During the first half of 2008, exports to all groups of countries outside MERCOSUR grew markedly, especially to the EU (54.8%) and Other Countries (45.3%). However, imports rose even more rapidly, especially from Other Countries (111.8%) and Asia (47.6%). Even so, the extrazone trade balance grew 10.8%, up US\$7.8 billion, with more significant surpluses in the cases of the LAIA and the EU, a lower balance with Asia, and a growing deficit with NAFTA.

TABLE 7
ARGENTINA: EXTRAZONE TRADE FLOWS BY COUNTRY
AND ECONOMIC BLOCS AT SELECTED TIMES
(US\$ Millions)

	1998	2002	2006	2007	Var. % 2007/2006	2007 ^{a/}	2008 ^{a/}	Var. %
<i>Exports</i>								
Extrazone/total (%)	64.4	77.7	78.7	77.9		77.7	77.7	
Extrazone	17,019	19,932	36,629	43,820	19.6	19,224	25,816	34.3
NAFTA	2,679	3,744	5,932	5,804	(2.2)	2,733	3,232	18.3
EU	4,633	5,114	8,002	9,895	23.7	4,286	6,636	54.8
LAIA ^{b/}	3,373	4,247	7,234	7,765	7.3	3,648	4,477	22.7
Asia	4,007	4,435	8,568	11,713	36.7	5,034	6,353	26.2
Other Countries	2,328	2,393	6,893	8,643	25.4	3,523	5,118	45.3
<i>Imports</i>								
Extrazone/total (%)	74.7	67.8	63.2	64.2		63.0	64.1	
Extrazone	23,449	6,093	21,595	28,744	33.1	12,179	18,010	47.9
NAFTA	7,163	2,012	5,550	6,893	24.2	3,108	4,297	38.3
EU	8,871	2,028	5,813	7,452	28.2	3,313	4,491	35.6
LAIA ^{b/}	1,138	255	1,129	1,273	12.8	574	705	22.8
Asia	4,792	1,072	6,365	9,115	43.2	3,835	5,660	47.6
Other Countries	1,485	727	2,738	4,011	46.5	1,349	2,857	111.8
<i>Trade Balance</i>								
Extrazone	(6,430)	13,839	15,034	15,076	0.3	7,045	7,806	10.8
NAFTA	(4,484)	1,733	382	(1,089)	(385.3)	(375)	(1,065)	184.0
EU	(4,238)	3,086	2,189	2,443	11.6	973	2,145	120.5
LAIA ^{b/}	2,234	3,992	6,105	6,492	6.3	3,074	3,772	22.7
Asia	(785)	3,363	2,203	2,598	17.9	1,199	693	(42.2)
Other Countries	842	1,666	4,155	4,632	11.5	2,174	2,261	4.0

Notes: ^{a/} First half.

^{b/} With the exception of MERCOSUR and Mexico. Mexico is included in NAFTA.

Source: INDEC.

An analysis of the composition of Argentina's exports according to product-type shows that agricultural manufacturing (AM) forms the most important group, representing approximately a third of the basket in recent

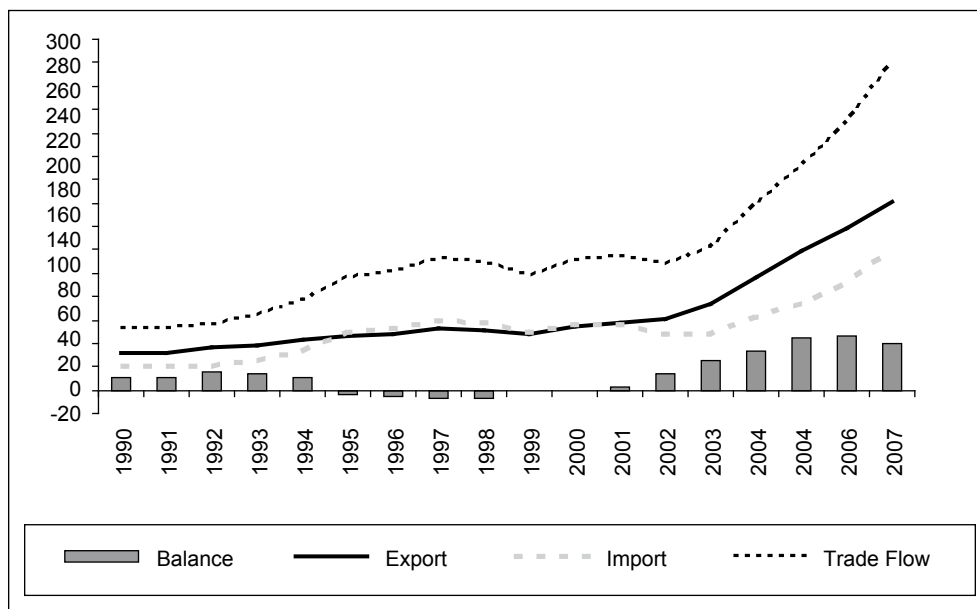
years, including 2007 and the first half of 2008. The second group corresponds to the industrial manufacturing (IM), whose share in 2007 was 31%, slightly down on the first half of 2008. Since 2003, however, the share of these products has increased about five p.p. Commodities represented 22% of exports in 2007 and 25% in 2008, which reversed the process of gradual loss of share seen up to 2006. However, fuels and energy, which usually represented 18% of exports, fell to 11.5% in 2007 and 10.8% in the first half of 2008.

In terms of the composition of imports, capital goods were the main heading, slightly above 40% of the total from 2004 to the first half of 2008. Raw materials and intermediate goods are also extremely important, at around 35%. Consumer goods increased gradually their share to 17.5% of the total in 2007 and the first half of 2008. Fuels, however, fairly insignificant share, albeit a growing one in recent years, reaching 7.5% of the total in the first half of 2008.

Brazil

Brazil's foreign trade flows remained highly dynamic in 2007, the fifth consecutive year of growth at relatively high rates. Exports reached US\$160.6 billion, up 16.6% on the previous year. Although this represented a slowdown in terms of previous years, performance was still quite favorable when compared to the 1990s or the first years of the current decade, as can be seen in Graph 14. Imports, in turn, reached US\$120.6 billion in 2007, up 32.1% on the previous year. This was the highest annual rate seen by Brazil since 1995 and was well above the annual average of 20.6% for 2003-2007. The fact that imports have grown almost twice as fast as exports meant that the trade balance fell for the first time in ten years, although the surplus remained a steady US\$40 billion. In turn, the total flow of trade reached a record US\$281.3 billion, an annual increase of 22.7% and an average growth of 21.2% throughout 2003-2007.

GRAPH 14
BRAZIL: TRADE FLOWS IN 1990-2007
(US\$ Billions)

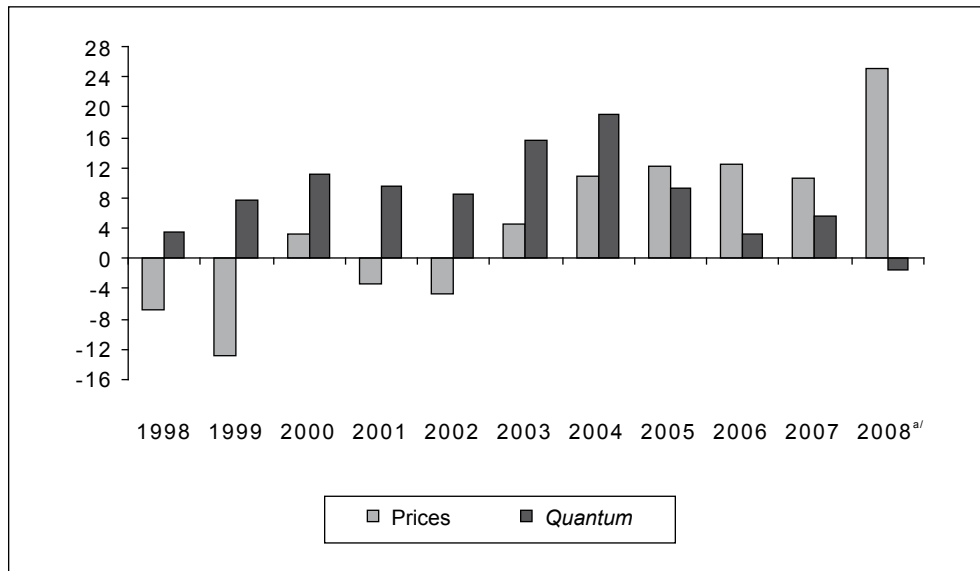


Source: SECEX-MDIC.

The downward trend of Brazil's trade balance deepened in the first half of 2008, not due to the poor performance of exports, which were up 23.8% on the same period the previous year, but to the acceleration of imports, which were up 50.7% in the period, a reflection of steeper growth in internal demand. The trade balance thus stood at US\$11.3 billion, 44.9% down on the first half of 2007. Preliminary data for July and August show a steep reduction in this balance, but a reduction is expected of at least a third in relation to 2007 is expected by the end of the year.

The growth of Brazilian exports in 2007 was clearly fuelled by price rises, up 10.5% on the previous year, while the export *quantum* rose just 5.5% (Graph 15). This means that prices accounted for 65% of the rise in values exported in the year. Similarly, this was repeated in 2005 and 2006, when prices respectively represented 56% and 78% of the rise in exports. Throughout 2003-2007, prices rises were responsible for half of the growth in the values exported by Brazil, up 10.1% c.a. These figures contrast with the ones for 1998-2002, when prices contributed negatively to variation in exports.

GRAPH 15
BRAZIL: GROWTH OF PRICES AND OF THE EXPORT QUANTUM
1998-FIRST HALF OF 2008
 (%)



Note: ^{al} First half.

Source: FUNCEX, based on SECEX-MDIC data.

The reverse was true of imports, whose growth in 2007 was due to a 22% rise in quantities imports, although prices made a significant contribution with a rise of 8.2%. From 2003 to 2007, the import *quantum* rose 11.2% c.a. and prices were up 8.5% c.a. Prices played an even more important part in the first half of 2008. In fact, all growth in the values exported in the period was due to a 25.2% rise in prices, with the *quantum* falling 1.5%. In terms of imports, price rises in the period were also quite marked (22.3%), accompanied by similar growth of the *quantum* (22.9%).

Brazilian exports to MERCOSUR partners were far more dynamic than those to the rest of the world. Table 8 shows that exports in 2007 reached US\$17.4 billion, 24.1% up on the previous year, a rate well above the 16.6% of the country's total exports. In 2003-2007, sales to its trade partners rose 39.3% c.a., also well up on the total average (21.6%), which allowed the share of Argentina, Paraguay, and Uruguay to rise to 10.8% of the total in 2007. Nevertheless, its share continues to be well below the 17.4% of 1998, despite the price of commodities hitting a historic low that year, as mentioned above.

TABLE 8
BRAZIL: TRADE FLOWS WITH MERCOSUR COUNTRIES AT SELECTED TIMES
(US\$ Millions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{a/}	2008 ^{a/}	% Var.
<i>Exports</i>								
MERCOSUR/ total (%)	17.4	5.5	10.1	10.8		10.4	11.5	
MERCOSUR	8,877	3,311	13,986	17,354	24.1	7,596	10,459	37.7
Argentina	6,747	2,347	11,740	14,417	22.8	6,311	8,589	36.1
Paraguay	1,249	560	1,234	1,648	33.6	699	1,112	59.2
Uruguay	881	413	1,013	1,288	27.2	587	758	29.1
<i>Imports</i>								
MERCOSUR/ total (%)	16.3	11.9	9.8	9.6		9.9	8.9	
MERCOSUR	9,428	5,615	8,968	11,630	29.7	5,204	7,037	35.2
Argentina	8,034	4,744	8,054	10,410	29.3	4,694	6,238	32.9
Paraguay	351	383	296	434	46.7	162	320	97.0
Uruguay	1,042	485	618	786	27.2	347	478	37.6
<i>Trade Balance</i>								
MERCOSUR	(551)	(2,304)	5,018	5,723	14.1	2,392	3,422	43.0
Argentina	(1,287)	(2,397)	3,686	4,007	8.7	1,617	2,351	45.4
Paraguay	898	177	938	1,214	29.5	536	793	47.7
Uruguay	(162)	(72)	394	502	27.4	239	279	16.7

Note: ^{a/} First half.

Source: SECEX-MDIC.

Argentina was the destination for 83.1% of Brazilian exports to MERCOSUR, a share that has been growing over the years, whereas Paraguay received 9.5% and Uruguay, 7.4%.

Brazilian imports from MERCOSUR partners totaled US\$11.6 billion in 2007, a rise of 29.7% that compares unfavorably with the 32.1% rate of total Brazilian imports. Throughout 2003-2007, MERCOSUR purchases grew at a rate of 15.7% c.a., also below the average rate of total imports (20.6%). As a result, the partners' share in the Brazilian import basket has been steadily falling in recent years (in 2007, it stood at 9.6%,

after reaching 16.3% in 1998). Almost 90% of all Brazil's imports from MERCOSUR in 2007 came from Argentina, while Uruguay had a 6.8% share and Paraguay just 3.7%.

The Brazilian balance trade with all MERCOSUR partners continued to be extremely positive, reaching the record level of US\$5.7 billion in 2007. In comparison with the previous year, Brazil's surplus was up, against both Argentina (8.7%), and Paraguay and Uruguay (29.5% and 27.4% respectively).

The general picture for intrazone trade showed no major changes in the first half of 2008. Brazilian exports to MERCOSUR grew 37.7% (above the general average) and imports rose 35.2% (below the general average). This caused the trade balance to grow 43% in relation to the same period for 2007. The most remarkable thing was that MERCOSUR was the only economic bloc with which Brazil managed to improve its trade balance in the period.

In spite of strong performance in exports to Argentina, the Brazilian market share in imports from its neighbor fell after peaking at 35.5% in 2005. Its share was 32.4% in 2007 and contracted even further over the first half of 2008 to 31.7%, the lowest level in six years. In the case of Paraguay, the Brazilian market share had, for several years, already been seeing a downward trend, but grew slightly in 2007 to 28.5% and remained at 28% in the first half of 2008. In Uruguay, the Brazilian share has gradually increased, reaching 23.5% in 2007, but falling to 18% in the first half of 2008.

Table 9 sets out the distribution of Brazil's trade flows according to the main economic blocs outside MERCOSUR. In 2007, exports reached US\$143.3 billion, 89.2% of the country's total sales, 15.7% up on the previous year. The EU is the main destination of Brazilian sales, with a share of 25.2% of the total, followed by NAFTA with 19.9% of the total, Asia with 15.6%, and LAIA with 9.2%. Other Countries' share was 19.3%. In fact, Brazilian exports have been fairly well-distributed across the world for some years now: almost 25% go to the EU, 20% to NAFTA, 20% to Latin America (including MERCOSUR), 15% to Asia, and another 20% to the rest of the world.

In spite of this reasonably stable distribution of extrazone flows, great variability was seen in 2007 in the growth of sales to the various blocs, with steep growth in those to the EU (30.2%) and Asia (20.5%), low growth in sales to NAFTA (just 1.3%), and a moderate performance in sales to LAIA and Other Countries. The best result in trade with Europe and Asia are due to the composition of exports to those regions that are concentrated in commodities, whose prices rose significantly in 2007.

In terms of imports, the distribution by economic bloc of origin is also quite highly diversified. In 2007, the country's main suppliers were the Asian countries, with 25.5% of total Brazilian imports, followed by the EU with 22.2%, NAFTA with 18.7%, and LAIA with 5.8%. 18.2% corresponded to Other Countries.

The composition of Brazil's trade balance showed significant changes in 2007 in comparison with the previous year. The surplus with NAFTA dropped 33.9% (US\$4.8 billion) and, as a result, NAFTA ceased to be the destination with which Brazil has its largest trade balance. That place has been taken by the EU, which, in 2007, recorded a deficit US\$13.7 billion (+US\$2.8 billion) with Brazil. There was also an increase, favorable to Brazil, in the balance in trade with the LAIA countries (+US\$809 million). Offsetting this, the deficit with Asian countries more than doubled, to US\$5.7 billion.

In the first half of 2008, Brazilian exports to destinations outside MERCOSUR accelerated, 22.2% up on the same period for 2007, due mainly to the improved performance of sales to Asia and Other Countries. Offsetting this, extrazone imports grew no less than 52.4%, and Asian countries were once again prominent,

their sales to Brazil growing by 64.7%. The result was a fall of over US\$10 billion in the extrazone trade balance, with a worsening of the result with all blocs, including LAIA and the EU. The surplus with NAFTA fell US\$3 billion, whereas with Asian countries it was up US\$3.6 billion.

TABLE 9
BRAZIL: EXTRAZONE TRADE FLOWS BY ECONOMIC BLOC AT SELECTED TIMES
(US\$ Millions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{a/}	2008 ^{a/}	% Var
<i>Exports</i>								
Extrazone/total (%)	82.6	94.5	89.9	89.2		89.6	88.5	
Extrazone	42,243	57,128	123,822	143,296	15.7	65,617	80,186	22.2
NAFTA	11,411	18,687	31,512	31,936	1.3	15,074	15,852	5.2
EU	15,250	15,609	31,045	40,428	30.2	18,178	22,146	21.8
LAIA ^{b/}	3,506	4,226	13,051	14,812	13.5	6,734	7,590	12.7
Asia	5,613	8,798	20,816	25,086	20.5	11,460	16,306	42.3
Other Countries	6,464	9,807	27,397	31,033	13.3	14,172	18,293	29.1
<i>Imports</i>								
Extrazone/total (%)	83.7	88.1	90.2	90.4		90.1	91.1	
Extrazone	48,287	41,628	82,375	108,991	32.3	47,433	72,273	52.4
NAFTA	16,008	11,760	17,355	22,575	30.1	10,250	14,035	36.9
EU	17,184	13,495	20,201	26,736	32.3	11,885	16,632	39.9
LAIA ^{b/}	1,959	2,033	6,020	6,972	15.8	3,195	4,566	42.9
Asia	7,881	7,996	22,887	30,715	34.2	13,041	21,481	64.7
Other Countries	5,254	6,344	15,912	21,993	38.2	9,063	15,560	71.7
<i>Trade Balance</i>								
Extrazone	(6,044)	15,500	41,447	34,305	(17.2)	18,184	7,912	(56.5)
NAFTA	(4,597)	6,927	14,157	9,361	(33.9)	4,823	1,817	(62.3)
EU	(1,934)	2,114	10,844	13,692	26.3	6,293	5,513	(12.4)
LAIA ^{b/}	1,547	2,194	7,031	7,840	11.5	3,540	3,024	(14.6)
Asia	(2,269)	802	(2,071)	(5,629)	171.9	(1,581)	(5,175)	227.4
Other Countries	1,209	3,463	11,485	9,040	(21.3)	5,109	2,733	(46.5)

Notes: ^{a/} First half.

^{b/} With the exception of MERCOSUR and Mexico.

Source: SECEX-MDIC.

Analysis of the composition of Brazilian exports by type of goods shows that commodities have performed far more favorably against manufactured or semi-manufactured goods recently, so that their share has gone from 29.2% in 2006 to 35.3% in the first half of 2008. This increase is equivalent to the loss recorded in manufactured products, whose share fell from 54.4% to 48.4% in the same period, whereas the share of semi-manufactured goods remains reasonably stable. That rapid change in the composition of Brazilian

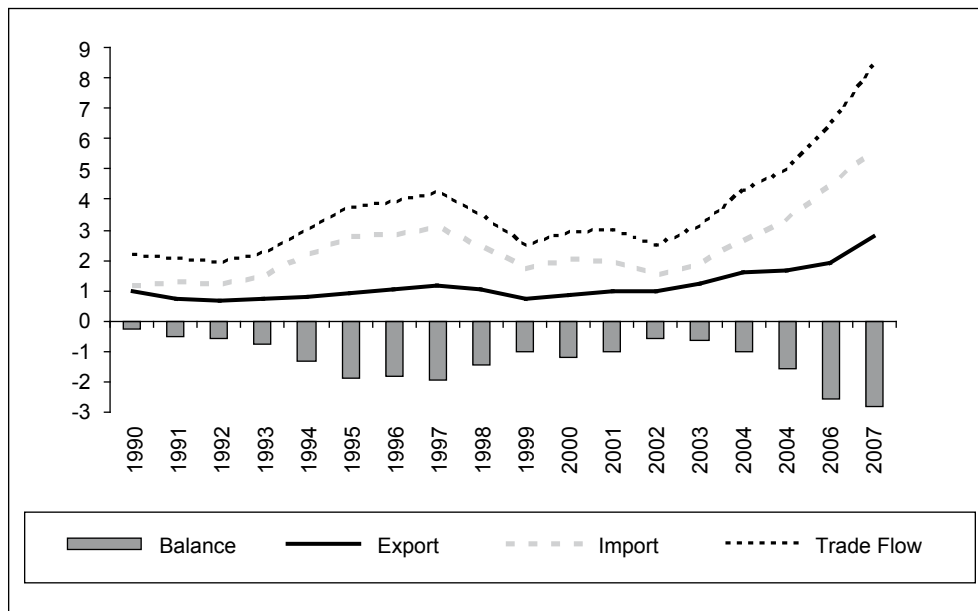
exports is due largely to the sharp increase in international commodity prices. In fact, between the first half of 2006 and the first half of 2008, the export prices of commodities grew 52.6%, i.e. double the price rise of manufactured products.

Furthermore, many experts have pointed out that the combination of foreign exchange appreciation and rising levels of use of the installed capacity in industry could be affecting the dynamism of manufactured product exports. In terms of imports according to categories of the economic use of goods, the composition has not seen very significant changes in recent years, although one cannot but point out the drop in the share of raw materials and intermediate goods, and the gradual increase in consumer and capital goods. Indeed, the last two categories saw the highest rates of growth in 2007 (38.1% and 35.9% respectively) and have performed best in terms of quantities imported, a reflection of the rapid growth of investments and of the internal demand for durable goods, mainly automobiles and electrical and electronic goods, at far higher rates than GDP growth.

Paraguay

Paraguay's flow of foreign trade performed exceptionally well in 2007, especially exports, which saw the highest growth rate in two decades (46.1%), reaching a record level of US\$2.8 billion. Graph 16 shows that this was the fifth consecutive year of export expansion, a dramatic contrast with the virtual stagnation of Paraguay's external sales between 1990 and 2002. The strong performance of exports, however, has not been enough to improve Paraguay's trade balance, which in 2007 reached a record deficit of US\$2.8 billion. This is due to the fact that in the last five years there has also been rapid growth in imports, which reached US\$5.6 billion in 2007, 24.2% up on 2006.

GRAPH 16
PARAGUAY: TRADE FLOWS IN 1990-2007
(US\$ Billions)



Source: BCP.

The evolution of trade was even more favorable in the first half of 2008. Exports totaled US\$2.3 billion, 85.7% up on the first half of 2007, and imports reached US\$3.8 billion, a rise of 54.9%. The trade deficit stood at US\$1.5 billion, with 24.1% growth.

Unlike Argentina and Brazil, the recent strong performance of Paraguayan exports cannot be explained primarily by price rises. In 2003-2007, the growth of the *quantum* was 17.9% c.a., while prices grew at just 5.1% c.a. In 2007, the *quantum* rose 36.6%, as against an increase of just 7% in prices. Imports behaved in a similar fashion: indeed, the *quantum* rose 20.6% that year, against a price rise of just 3%. Between 2003 and 2007, the import *quantum* grew 24.2% c.a., while prices increased by 4.6% c.a.⁴³

In fact, the evolution of the unit prices of Paraguay's exports and imports shows the country has made no significant earnings in the terms of trade in recent years. Although they rose 3.9% in 2007, throughout 2003-2007, the cumulative gain was just 2.6%. Although 2007 has seen a large rise in soya and corn prices, the increase in the petroleum price affected Paraguay's improved terms of trade.

In contrast, the steep price rises in agricultural products, roughly from the end of 2007, allows ones to infer that much of the growth of Paraguayan exports in the first half of 2008 was due to price rises. However, given the intensity of the growth of values, it is quite probable that the export *quantum* has also grown steeply.

MERCOSUR countries were the destination for almost half of Paraguay's exports in 2007, a total of US\$1.370 billion. Approximately 40% went to Argentina, a further 40% to Brazil, and the remaining 20% to Uruguay. Brazil and Argentina thus continue to be the main markets for Paraguayan products, together representing 40% of the country's total sales (Table 10).

In the last five years, MERCOSUR's share in Paraguayan exports has fallen 9 p.p., due basically to the low growth of sales to Brazil (9.6% c.a.) and Uruguay (9.9% c.a.). It is for this reason that Paraguay's market share in Uruguayan imports has fallen steadily in recent years, reaching just 0.5% in 2007. In Brazil, the share of Paraguayan exports has remained stable at extremely low levels (approximately 0.4%). Exports to Argentina, however, grew by 73.9% c.a. in the last five years, after falling to minimal levels in 2002. Because of this, Paraguay has gained in market share in Argentine imports, reaching the figure 2.4% in 2007 after being just 1.1% in 1998.

The YOY growth of Paraguayan imports in 2007 was substantial in purchases from MERCOSUR, with a 45.7% variation, while the total grew by 24.2%. The bloc's share in Paraguay's total imports thus reached 44.1% in 2007, still below the figure of around 56% seen in 1998 and 2002. Almost two thirds of the US\$2.5 billion in imported products from MERCOSUR originated in Brazil. Argentina contributed 32.5% and Uruguay had a share of just 3%. Brazil continued to be Paraguay's largest supplier, with 28.5% of the total, but China has been growing apace and exported similar amounts to Paraguay in 2007 as Brazil. Argentina is Paraguay's third largest supplier.

Paraguay's trade deficit with its MERCOSUR partners rose again in 2007 to US\$1.1 billion, an increase of 40.8%. This value represents almost 40% of Paraguay's total deficit and has been growing steadily since 2002. It is almost totally related to trade with Brazil (a debit balance of US\$1 billion), but there was also a significant deficit with Argentina (US\$248 million). Only with Uruguay did Paraguay obtain a surplus in 2007 (US\$191 million), and even so this was almost 50% down on the previous year.

⁴³ The export price index is calculated by ECLAC. The *quantum* was obtained by deflating the values exported with this price index.

TABLE 10
PARAGUAY: TRADE FLOWS WITH MERCOSUR COUNTRIES AT SELECTED TIMES
(US\$ Millions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{al}	2008 ^{al}	% Var.
<i>Exports</i>								
MERCOSUR/ total (%)	52.3	58.1	48.1	49.3		49.6	51.1	
MERCOSUR	531	553	917	1,374	49.9	608	1,164	91.4
Argentina	153	35	168	552	227.5	188	305	62.6
Brazil	349	353	328	558	70.1	325	495	52.4
Uruguay	29	165	420	264	(37.1)	95	364	281.0
<i>Imports</i>								
MERCOSUR/ total (%)	56.0	56.0	37.6	44.1		40.5	41.2	
MERCOSUR	1,383	845	1,689	2,461	45.7	995	1,566	57.4
Argentina	481	309	677	800	18.1	356	467	31.2
Brazil	822	478	960	1,588	65.4	610	1,064	74.5
Uruguay	80	58	52	74	42.3	29	34	19.4
<i>Trade Balance</i>								
MERCOSUR	(853)	(293)	(772)	(1,087)	40.8	(387)	(402)	4.0
Argentina	(328)	(275)	(509)	(248)	(51.3)	(169)	(162)	(3.7)
Brazil	(473)	(125)	(632)	(1,030)	63.0	(285)	(569)	99.6
Uruguay	(51)	107	368	191	(48.3)	67	329	394.0

Note: ^{al} First half.

Source: BCP.

There was marked growth in Paraguayan exports to MERCOSUR partners during the first half of 2008 (91.4%). Especially worthy of note was the 281% expansion of sales to Uruguay. Imports from MERCOSUR also grew considerably in this period at a rate of 57.4%. These figures meant that Paraguay's deficit with MERCOSUR remained almost stable at approximately US\$400 million as against the same period for 2007. Its composition, however, was different: although the deficit with Argentina (US\$162 million) has remained relatively stable in comparison with the same period in 2007, the deficit with Brazil doubled (US\$569 million). In contrast, the surplus with Uruguay rose significantly (US\$329 million).

Table 11 shows the distribution of Paraguay's trade flow according to the main economic blocs outside MERCOSUR. In terms of exports, the main destinations in 2007 were Other Countries (17.6% of Paraguay's total sales). The LAIA countries share was also outstanding, at 15.8% of the total, and sales to Chile, Peru, and Venezuela were especially worthy of note.

Most of the goods purchased by Paraguay outside MERCOSUR come from Asian countries, whose share in Paraguay's total imports in 2007 was 38.6%. China alone exported a value of US\$1.6 billion to Paraguay. The other extrazone imports are divided among NAFTA (6.2% of the total), the EU (5.6%), LAIA (4.4%), and Other Countries (1.1%). Asia also accounts for almost the whole of Paraguay's trade deficit in extrazone

trade, with a debit balance of US\$2 billion in 2007 (71.1% of the country's total deficit). There were slight deficits with NAFTA and the EU, and surpluses with LAIA and Other Countries.

TABLE 11
PARAGUAY: EXTRAZONE TRADE FLOWS BY ECONOMIC BLOC AT SELECTED TIMES
(US\$ Millions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{al}	2008 ^{al}	% Var.
<i>Exports</i>								
Extrazone/ total (%)	47.7	41.9	51.9	50.7		50.4	48.9	
Extrazone	483	398	990	1,411	42.6	619	1,114	80.1
NAFTA	83	42	74	80	8.3	32	29	(10.8)
EU	285	83	114	233	103.9	147	162	10.2
LAIA ^{bl}	66	99	153	441	189.0	167	331	98.7
Asia	18	48	101	166	65.0	50	227	349.3
Other Countries	31	126	548	491	(10.4)	222	366	64.6
<i>Imports</i>								
Extrazone/ total (%)	44.0	44.0	62.4	55.9		59.5	58.8	
Extrazone	1,087	665	2,800	3,116	11.3	1,459	2,236	53.2
NAFTA	282	92	375	343	(8.5)	163	210	28.6
EU	284	142	243	313	29.0	139	202	44.8
LAIA ^{bl}	30	29	227	246	8.4	172	288	67.0
Asia	449	305	1,739	2,152	23.7	952	1,444	51.7
Other Countries	42	95	216	61	(71.6)	33	92	181.8
<i>Trade Balance</i>								
Extrazone	(604)	(267)	(1,811)	(1,705)	(5.8)	(841)	(1,121)	33.4
NAFTA	(199)	(50)	(301)	(263)	(12.6)	(131)	(181)	38.3
EU	1	(59)	(129)	(81)	(37.4)	7	(40)	(654.9)
LAIA ^{bl}	35	69	(75)	195	(361.1)	(6)	44	(887.4)
Asia	(430)	(257)	(1,638)	(1,986)	21.2	(901)	(1,217)	35.1
Other Countries	(11)	30	332	430	29.4	189	273	44.3

Notes: ^{al} First half.

^{bl} With the exception of MERCOSUR and Mexico.

Source: BCP.

During the first half of 2008, the shape of Paraguay's extrazone trade presented no major alterations in relation to the pattern of previous years. The main export market continued to be Other Countries, followed by LAIA and the Asian countries, where Paraguayan sales were up no less than 349.3% on same period for 2007. The highest import growth was seen in imports from Other Countries, but Asia continued to have a share of almost 40% in Paraguay's total purchases. The trade balance with Asia highly negative, responsible for almost 80% of Paraguay's total deficit in the period.

Analysis of the composition of Paraguay's export basket by product shows that it continues to be extremely concentrated in agricultural or agroindustrial products. Just seven products accounted for 80% of the country's external sales in 2007: soya and derivatives (45%), meat (12.9%), corn (10.2%), wood (4.2%), hides (3%), wheat (2.5%), and cotton (2.2%). These products' share has remained fairly stable over the last fifteen years.

In terms of the composition of imports, the most remarkable thing is that, in recent years, capital goods have become the main heading, concentrating 45% of the total in 2007, and in the first half of 2008 too. Until a few years ago, this position was occupied by consumer goods, which in 2007 accounted for 25% of imports. These figures reflect the fact that Paraguay has been undergoing a more intense capital formation process, which is likely to have beneficial effects on its future economic growth. Raw materials, intermediate goods, and fuels have also gradually lost share in imports in recent years, and together represent 28% of the total.

Uruguay

In 2007, Uruguay's flows of foreign trade saw a period of marked growth, albeit at a more modest pace than the other MERCOSUR countries. Exports reached US\$4.5 billion, 12.9% up on 2006, but signifying a slowdown compared to previous years. In 2003-2007, annual average growth was 19.3%. Graph 17 shows that 2007 was the fifth consecutive year of export expansion, after the downturn of 1999-2002.

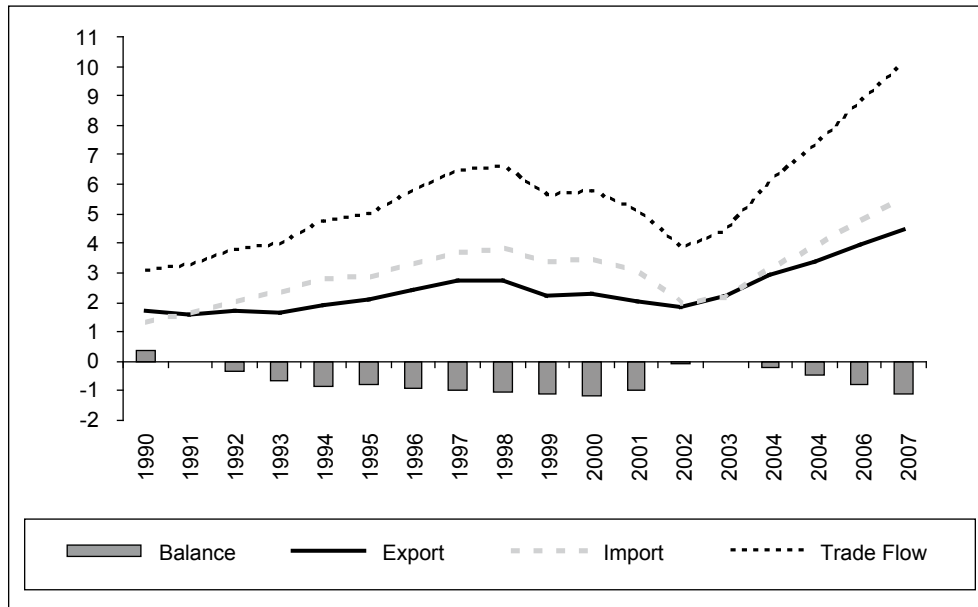
However, such strong exporter performance was not enough to improve Uruguay's trade balance, which in 2007 reached a US\$1.1 billion deficit, the worst result since 2000. This is due to the fact that imports grew at a systematically higher pace than exports. In 2007, they reached US\$5.6 billion, 17% up on 2006. Between 2003 and 2007, growth was 23.3% c.a. In 2007, Uruguay's trade flow exceeded US\$10 billion for the first time.

The evolution of trade flows during the first half of 2008 showed dramatic acceleration. Exports totaled US\$3 billion, up 43.6% on the same period for 2007, while imports reached US\$4.5 billion, an increase of no less than 92.6%. The trade balance thus suffered further decline, recording a deficit of US\$1.6 billion, the worst result in the historical series.

Export prices contributed very significantly to the growth of the value exported by Uruguay in 2007, with a 6% increase, similar to the 6.5% rise in the *quantum*. However, in 2003-2007, the growth of the *quantum* headed the rise in exports, given that its annual average growth was 12.8%, as against a 5.8% c.a. rise in prices. The same happened with imports: in 2007, the *quantum* rose 10.5% over the previous year, exceeding the 6% increase in prices. In 2003-2007, the *quantum* grew at a rate of 13.2% c.a., as against an 8.9% c.a. evolution in prices.⁴⁴

⁴⁴ See Note 43.

GRAPH 17
URUGUAY: TRADE FLOWS IN 1990-2007
 (US\$ Billions)



Source: BCU.

The evolution of export and import unit prices shows that Uruguay enjoyed no gains in the terms of trade in recent years. In fact, the terms of trade show a downward trend in recent years, after peaking in 2003. Since then, the cumulative loss in terms of trade is 14.2%. As with Paraguay, this is probably the result of the Uruguayan export basket being excessively concentrated in a few agricultural products, the prices of which did not evolve particularly favorably up to 2007.

MERCOSUR countries were the destination for slightly over a quarter of Uruguayan exports in 2007. Rather more than half of the US\$1.250 million went to Brazil, 16.2% of Uruguay's total exports. Argentina was the destination for slightly over a third of MERCOSUR exports and for 9.8% of total exports, while Paraguay received less than 2% of Uruguay's total exports (see Table 12). Despite this strong performance, MERCOSUR's share in Uruguay's total exports is still less than in 2002 (32.6%) and is far lower than 1998 (55.3%).

Uruguay has for some years had a relatively stable market share in its neighbors' imports, approximately 1% in Argentina and 0.7% in Brazil, while in Paraguay its share was down considerably on the start of the decade, from approximately 3.2% to just 1.3% in 2007.

In its pattern of imports, Uruguay's MERCOSUR partners continue to be the main suppliers, with 46.2% of the total imported by the country in 2007. The US\$2.6 billion was 18.2% up on the previous year, with growth in purchases from Brazil (21.9%) especially prominent. Brazil was Uruguay's main supplier in 2007, with a share of 23.5%, besting Argentina's 22.1%. Purchases by Paraguay represented just 0.5% of the total.

Uruguay's trade deficit with its MERCOSUR partners rose again in 2007, to US\$1.3 billion, an increase of 7.5%. Most of this is linked with trade with Argentina, whose US\$794 million balance was negative, but the result with Brazil was also on the negative side (US\$586 million). With Paraguay, the US\$46 million balance was slightly positive. In fact, Uruguay's trade deficit has been concentrated in MERCOSUR for several years now, as the extrazone balance has been positive, reaching US\$243 million in 2007.

In the first half of 2008, Uruguayan exports to MERCOSUR accelerated, up 45.8%, with an especially significant variation in sales to Brazil (51.8%). However, imports from its neighbors grew even more rapidly (74.4%): purchases in Argentina saw an increase of 118%, again making it Uruguay's number one supplier. The deficit with MEROSUR was almost double what it was in the same period for 2008, reaching US\$1.3 billion, a value close to the one recorded for the whole of 2007.

TABLE 12
URUGUAY: TRADE FLOWS WITH MERCOSUR COUNTRIES AT SELECTED TIMES
(US\$ Millions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{al}	2008 ^{al}	% Var.
<i>Exports</i>								
MERCOSUR/ total (%)	55.3	32.6	23.6	27.7		25.6	26.0	
MERCOSUR	1,532	607	942	1,247	32.4	528	770	45.8
Argentina	513	113	301	441	46.3	188	254	35.1
Brazil	935	432	583	728	25.0	307	466	51.8
Paraguay	84	62	58	77	32.4	33	49	48.5
<i>Imports</i>								
MERCOSUR/ total (%)	43.3	48.1	45.7	46.2		49.9	45.2	
MERCOSUR	1,652	944	2,182	2,580	18.2	1,174	2,047	74.4
Argentina	842	541	1,079	1,235	14.5	555	1,209	118.0
Brazil	793	390	1,078	1,314	21.9	604	817	35.3
Paraguay	16	14	26	31	18.4	15	21	40.0
<i>Trade Balance</i>								
MERCOSUR	(119)	(337)	(1,240)	(1,333)	7.5	(646)	(1,277)	97.8
Argentina	(328)	(427)	(777)	(794)	2.2	(367)	(955)	160.5
Brazil	142	42	(495)	(586)	18.3	(297)	(351)	18.2
Paraguay	67	48	32	46	43.6	18	28	55.6

Note: ^{al} First half.

Source: BCU.

In 2007, Uruguay's extrazone trade grew at a less intense pace than intrabloc trade. Exports rose just 6.9%, with an especially poor performance in sales to LAIA (18.7% down) and Asia (just 2.7% up). However, the growth in sales to the EU was quite marked (24.6%), making this bloc the main destination for Uruguayan exports after MERCOSUR, with a share of 18.5% of the total and displacing the NAFTA countries, with 17.2% (Table 13). Other Countries also had a significant share (18.2%), mainly the Middle East and Africa.

The pattern of imports is distributed slightly differently. The main suppliers outside MERCOSUR are the Asian countries, with 15.4% of Uruguay's total purchases, followed by the LAIA countries, with 13.1%, in which Venezuela is prominent: with 87% of the bloc's sales, it is Uruguay's third largest. The EU represented 10.4% of Uruguayan imports, and NAFTA just 9.2%.

Uruguay's extrazone trade surplus reached US\$243 million in 2007, 46% down on the previous year. This worsening was due mainly to the increase in deficits with the LAIA countries (US\$449 million) and Asian countries (\$316 million). Uruguay has a surplus with Other Countries (US\$497 million), and with the EU (US\$254 million) and NAFTA (US\$256 million).

Uruguay's extrazone trade also grew rapidly during the first half of 2008, especially imports, which grew 110.7%, driven mainly by purchases from NAFTA and Other Countries. Exports grew 42.9%, with a steep rise in sales to the EU, LAIA countries, and Other Countries, and a drop in exports to NAFTA. The trade balance was in deficit to the tune of US\$294 million, US\$650 million down on the positive balance in the first half of 2007, due mainly to the investment of the balance with NAFTA and the increase in the deficit with Asia.

Analysis of the composition of Uruguay's exports by product shows that they continue to be quite heavily concentrated in agricultural or agroindustrial products, representing approximately 60% of the total in 2007. Among them, commodities (meat, fish, cereals, and other agricultural products) represented almost 40% and industrial products of agricultural origin (mainly food and drink, hides and skins, and wooden products) constituted almost 20%. Among the other industrialized products are textiles (6.8%), plastics and rubber (5.5%), chemicals (5.3%), and transport material (2.7%).

In terms of the composition of imports, almost 45% of the total in 2007 was raw materials and intermediate goods, which traditionally represent half of the total. Consumer goods, and fuels and lubricants each represented almost 20% of the total, with relatively stable percentages over the last five years. Capital goods represented just 13% of the total in 2007, slightly up on the average for previous years. It should be remembered that the share of capital goods in Uruguayan imports is well below Argentina and Paraguay's, and is only comparable to Brazil's. It should be pointed out, however, that Brazil has significant internal production of these goods, which is not the case with Uruguay. This reflects the fact that investment levels in Uruguay remain relatively low, in contrast with the favorable evolution of this variable seen in the other MERCOSUR countries.

TABLE 13
URUGUAY: EXTRAZONE TRADE FLOWS BY ECONOMIC BLOC AT SELECTED TIMES
(US\$ Millions)

	1998	2002	2006	2007	% Var. 2007/2006	2007 ^{a/}	2008 ^{a/}	% Var.
<i>Exports</i>								
Extrazone/ total (%)	44.7	67.4	76.4	72.3		74.4	74.0	
Extrazone	1,236	1,254	3,043	3,251	6.9	1,532	2,189	42.9
NAFTA	210	239	715	773	8.1	400	181	(54.7)
EU	459	445	668	832	24.6	405	592	46.1
LAIA ^{b/}	251	156	351	286	(18.7)	128	214	67.2
Asia	295	317	530	544	2.7	276	363	31.4
Other Countries	21	98	779	817	4.8	323	839	160.0
<i>Imports</i>								
Extrazone/ total (%)	56.7	51.9	54.3	53.8		50.1	54.8	
Extrazone	2,159	1,020	2,593	3,008	16.0	1,178	2,483	110.7
NAFTA	526	200	407	516	26.9	189	428	126.3
EU	802	352	477	578	21.4	230	345	49.9
LAIA ^{b/}	170	106	712	734	3.1	307	366	19.3
Asia	454	191	745	860	15.4	326	592	81.4
Other Countries	208	171	252	319	26.7	126	751	498.3
<i>Trade Balance</i>								
Extrazone	(923)	234	450	243	(46.0)	354	(294)	(183.0)
NAFTA	(316)	39	308	256	(16.8)	211	(248)	(217.3)
EU	(343)	93	191	254	32.7	175	246	41.0
LAIA ^{b/}	81	49	(360)	(449)	24.5	(179)	(152)	(15.0)
Asia	(159)	125	(216)	(316)	46.4	(50)	(229)	358.3
Other Countries	(186)	(73)	527	497	(5.6)	197	88	(55.5)

Notes: ^{a/} First half.

^{b/} With the exception of MERCOSUR and Mexico.

Source: BCU.

Box D
THE MAJOR TRADE BALANCES IN FAVOR OF BRAZIL
AND THE QUESTION OF ECONOMIC ASYMMETRIES

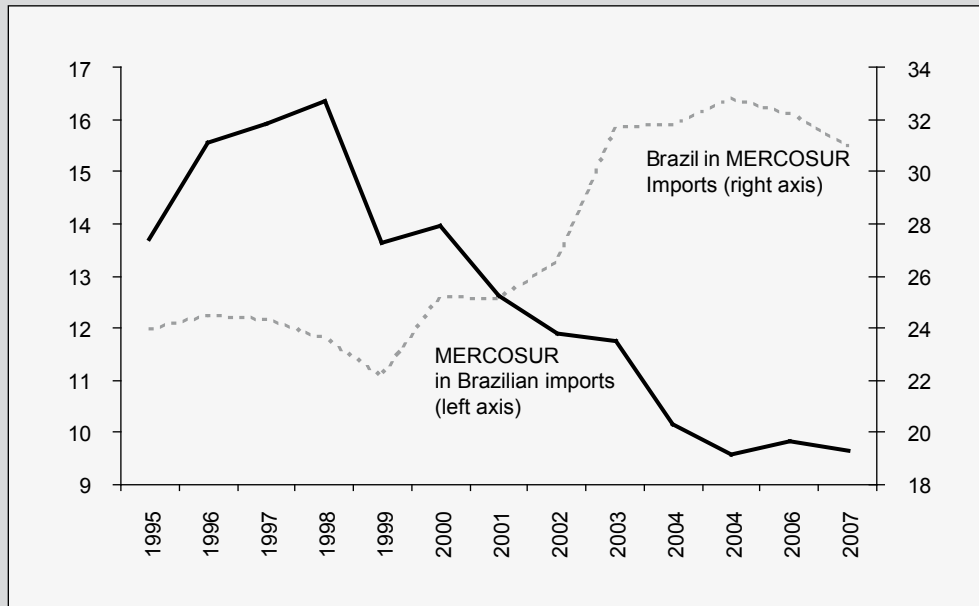
The marked acceleration of total Brazilian imports during 2007 and in the first half of 2008 brought about a pronounced reduction of the country's trade surplus, except with MERCOSUR partners. In fact, from 2003, Brazilian exports to their neighboring MERCOSUR countries have grown faster than imports from the same countries. The subsequent growth of Brazil's trade surpluses with each of its MERCOSUR partners is considered a synthetic indicator of existing economic asymmetries within the ambit of the bloc. In Argentina, the concern is to do with the potential risk the growing penetration of Brazilian industrial products in its market represents to its industrial strengthening strategy. In the cases of Paraguay and Uruguay, the deficits with Brazil would thus be proof that MERCOSUR is providing little or no economic benefit to these countries. Brazil would thus be the major beneficiary of integration in the bloc.

However, the benefits of trade integration are not only measured by the expansion of sales to partners, but also by the possibility of importing goods from those countries at lower costs, not only benefitting the country's consumers, but also the companies that need inputs and capital goods that are often not produced internally or are produced at very high costs. Furthermore, a trade surplus may only reflect lower growth of internal demand for the country as against the one seen in Other Countries.

A complementary way of evaluating the effective gains of a process of economic integration involves analyzing the evolution of a country's share of sales in its partners' total imports, i.e. its market share. Theoretically, it would be natural for a process of trade integration to generate an increase in intrabloc trade flow higher than that of extrabloc trade, precisely because each country has privileged access to its partners' markets under the tariff preference system. In this perspective, the data indicate that there are, in fact, asymmetric benefits in MERCOSUR.

The following Graph shows that Brazil's market share in the joint imports of Argentina, Paraguay, and Uruguay has risen considerably in the last eight years, reaching percentages of over 30% between 2003 and 2007, almost six p.p. up on the second half of the 1990s. On the other hand, these countries' market share in Brazilian imports experienced a significant drop in the same period, of approximately 6 p.p. using the same comparison. This puts it in the 9% to 10% range between 2004 and 2007. The good news is that the market share seems to have been stabilized at that level. The bad news is that there are no signs that it will return to the levels of the 1990s.

BRAZIL'S SHARE IN OTHER MERCOSUR COUNTRIES' IMPORTS VERSUS THEIR SHARE IN BRAZILIAN IMPORTS
 (%)



Sources: ABCECB (Argentina), INDEC (Argentina), SECEX (Brazil), BCP (Paraguay), and BCU (Uruguay).

Box D (CONTINUED)

It is as important to identify the problem as it is to analyze the factors causing it. In this case, the loss of market share in Brazilian imports may be due to two factors.^{a/} The first is to do with potential competitiveness problems of the products exported to Brazil by the partner countries against products provided by third suppliers from Brazil, either because competitors are able to apply lower prices or because MERCOSUR partners are limited in terms of the volume of exportable supply. As a result, these countries would undergo a drop in their market share in Brazilian imports of the products in question.

The second factor is to do with a possible imbalance between the structure of Argentina, Paraguay, and Uruguay's export supply and the structure of Brazil's import demand, so that countries' exports would be concentrated in products that are insignificant in the Brazilian import scheme, in other words, products whose growth in Brazilian imports was below that observed in the country's total imports.

Comparative analysis of the composition of Brazilian imports from MERCOSUR countries in terms of its total imports between 2002 and 2007 makes it clear that the loss of market share was due to a combination of these two factors, albeit with differing degrees of relevance in each country. The most emphatic case is that of Paraguay, where both factors were of supreme importance. In fact, 96% of Paraguayan exports to Brazil in 2002 were made up of products whose Brazilian imports grew more slowly than total imports between that year and 2007, and Paraguay was not able to alter the composition of its sales to Brazil, as these products covered quite a high percentage in 2007 (83%). In addition, almost all the products with a significant share in the structure of Paraguayan exports to Brazil in 2002 underwent losses of market share in Brazilian imports over the following years, especially vegetable oils, cotton, and meat.

The case of Uruguay displays similar characteristics, as almost 70% of exports to Brazil in 2002 were made up of products whose Brazilian imports grew more slowly than total imports in the following years. These products represented almost 70% of sales to Brazil in 2007, which means that Uruguay could not redirect its sales toward products with greater dynamism in Brazilian imports. Furthermore, no less than 82% of exports in 2002 consisted of products that lost market share in Brazilian imports between 2002 and 2007.

These two factors were also significant in the case of Argentina, albeit to a lesser extent, as a mirror image of the greater diversification of its sales to Brazil. Only half of exports to Brazil in 2002 were made up of products whose Brazilian imports grew more slowly than total imports, and the losses of market share included products that represented 55% of sales to Brazil in 2002.

In fact, the main explanation for Argentina's total loss of market share in Brazilian imports lies in the performance of the sales of just two products: petroleum, whose sales to Brazil fell 90% between 2002 and 2007, whereas Brazilian imports were growing rapidly with the substantial decrease in the Argentine market share; and wheat, a heading that lost share in the total structure of Brazilian imports in that period. If the Argentine market share in petroleum had held up and the share of wheat in the Brazilian import basket had not altered, Argentina's market total share in imports would have remained at approximately 10% in 2007, a similar figure to 2002.

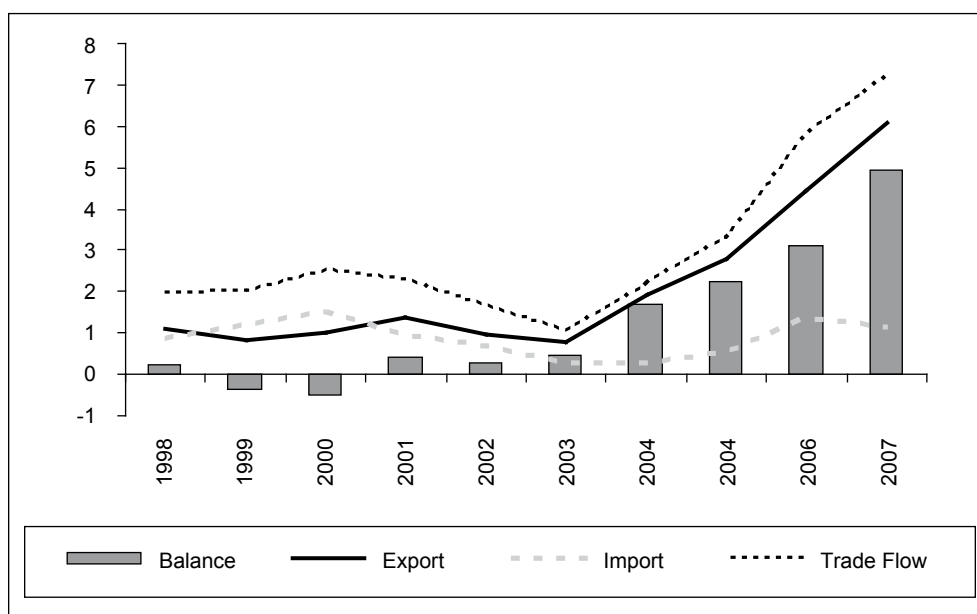
In short, the performance of Argentine, Paraguayan, and Uruguayan exports to Brazil have been damaged largely by problems related to these countries' export supply. On the one hand, they have had serious trouble diversifying their sales toward more dynamic goods in Brazilian imports; on the other, they are being displaced by competition from third countries, even in products in which they possess comparative advantages. This is essentially the problem of economic asymmetries in MERCOSUR, a question that has been on the bloc's agenda since its creation, but which, up until now, has been dealt with timidly. Chapter 3 goes into more depth about the current state of the discussions and initiatives in the ambit of MERCOSUR to tackle this problem.

^{a/} See *MERCOSUR Report 11* [2006], Chapter 2.

C. MERCOSUR-Venezuela trade

The trade flow between MERCOSUR countries and Venezuela has grown rapidly in recent years, and reaching the record figure of US\$7.2 billion in 2007, 24.6% up on the previous year and 34.2% c.a. up on 2003. Graph 18 shows that most of this increase is due to the expansion of MERCOSUR exports, which reached US\$6.1 billion in 2007, 36.7% up on 2006 and 44.4% c.a. up on 2003-2007. Venezuela's exports to the Southern Cone bloc in turn experienced only moderate growth between 2003 and 2007 (10.8% c.a.) and shrank in 2007 by 15.3% to US\$1.1 billion. As a result, the trade balance in favor of MERCOSUR grew substantially, to US\$4.9 billion in 2007. It is important to point out that the trade flows between MERCOSUR and Venezuela were much more balanced until the beginning of the current decade and, in some cases, showed slight surpluses in favor of Venezuela, as in 2000, when Venezuelan sales to the bloc reached a record level of US\$1.5 billion.

GRAPH 18
MERCOSUR: TRADE FLOWS WITH VENEZUELA IN 1998-2007
 (US\$ Billions)



Sources: INDEC (Argentina), SECEX-MDIC (Brazil), BCP (Paraguay), and BCU (Uruguay).

Brazil was responsible for 77.7% of MERCOSUR exports to Venezuela in 2007, followed by Argentina with 19.2% (Table 14). MERCOSUR has continually raised its share in imports from Venezuela since 2000, with 12.6% of the total in 2007. That year, the Brazilian market share in Venezuelan imports was 9.5%, more than double the figure at the end of the 1990s, as shown in Graph 19. Argentina's market share, on the other hand, has remained between 2% and 3% in recent years, slightly up on the end of the 1990s.

Conversely, MERCOSUR has become less and less important as a destination for Venezuelan exports, reaching just 1.7% of the total in 2007, in contrast with the higher levels of previous years, for example,

1998, when it topped 4.8%. This is largely to do with the increase in petroleum prices that impacted on the value of the country's total exports, but did not have the same effect on sales to MERCOSUR, where petroleum is of little relevance. The main destination of Venezuelan sales to MERCOSUR was Uruguay, which in 2007 accounted for 55.5% of everything the country sold to the bloc. Up to 2005, Brazil was the main destination, accumulating up to 90% of the total to this destination annually. However, its recent performance has been negative: between 2003 and 2007, Brazilian imports from Venezuela underwent a cumulative fall of 45.4%.

TABLE 14
VENEZUELA: TRADE FLOWS WITH MERCOSUR COUNTRIES AT SELECTED TIMES
(US\$ Millions)

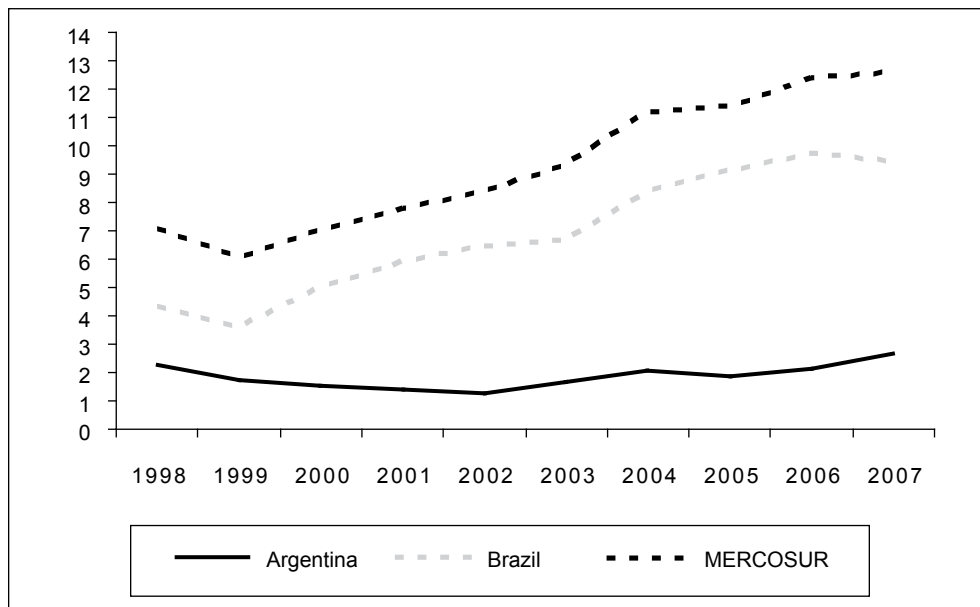
	1998	2002	2006	2007	% Var. 2007/2006	% Var. c.a. 2007/2002
<i>Exports to Venezuela</i>						
MERCOSUR	1,106	969	4,446	6,079	36.7	44.4
Argentina	364	149	793	1,169	47.4	51.0
Brazil	706	799	3,565	4,724	32.5	42.7
Paraguay	8	10	10	87	803.0	55.0
Uruguay	28	11	78	99	26.2	54.6
<i>Imports from Venezuela</i>						
MERCOSUR	855	689	1,356	1,149	(15.3)	10.8
Argentina	58	7	25	24	(4.9)	26.4
Brazil	756	633	592	346	(41.5)	(11.4)
Paraguay	3	5	140	142	1.3	97.2
Uruguay	38	44	599	638	6.4	70.5
<i>Trade Balance</i>						
MERCOSUR	251	280	3,091	4,930	59.5	77.5
Argentina	305	142	768	1,146	49.1	51.9
Brazil	(49)	166	2,974	4,378	47.2	92.4
Paraguay	5	5	(130)	(55)	(57.7)	(262.0)
Uruguay	(10)	(33)	(521)	(539)	3.4	74.8

Sources: INDEC (Argentina), SECEX-MDIC (Brazil), BCP (Paraguay), and BCU (Uruguay).

It is no coincidence that Venezuela has an extremely limited market share in imports from the MERCOSUR countries. In 2007, this was 0.7%, down on the 1% of 2006. Over the last 10 years, the highest market share (1.4%) was seen in 2000. Among MERCOSUR countries, Venezuela has a very low market share in Brazil and Argentina (less than 0.3%) and a much higher one in Uruguay (11.4% in 2007). In the Paraguayan imports, Venezuela's market share was 2.5% in 2007.

In terms of MERCOSUR's trade balance with Venezuela, most of the surplus recorded in recent years was obtained by Brazil, the balance of which was US\$4.4 billion in 2007, a value that contrasts with the figures recorded just five years earlier, which showed a surplus of just US\$166 million. Argentina's surplus also grew substantially in recent years, from US\$142 million in 2002 to US\$1.1 billion in 2007. Paraguay and Uruguay, however, have had debit balances with Venezuela in recent years, and Uruguay's US\$539 million deficit in 2007 is especially worthy of note.

GRAPH 19
MERCOSUR'S MARKET SHARE IN VENEZUELAN IMPORTS IN 1998-2007
 (%)



Source: LAIA.

The composition of MERCOSUR exports to Venezuela is reasonably diversified, but it is possible to identify a certain concentration in four types of products: agricultural, food, machinery and equipment, and automobiles and autoparts. In the case of Argentina, the last group had a share of almost 20% of exports to Venezuela in 2007, but there was also a significant share in food products (basically soya petroleum, meat, dairy products, cereals and malt), iron and steel products, tractors, machinery, and pharmaceutical products.

In Brazilian exports, the products of the automotive sector (not only automobiles and autoparts, but also trucks and buses) are the most important, contributing 27% of the total of sales from the country to Venezuela in 2007. But food products also had significant share (basically beef and poultry, sugar and milk), electronic products (mainly cellular telephones), machinery and equipment (especially construction and agricultural machinery), chemical products and basic metallurgy (aluminum and sheet steel). Together, these five groups accounted for almost 50% of exports. Soya petroleum represented almost 90% of Paraguay's exports, while purchases from Uruguay were mainly pharmaceutical products (40% of the total), dairy products (11.5%), plastic products, bulldozers, and various animal products, especially meat.

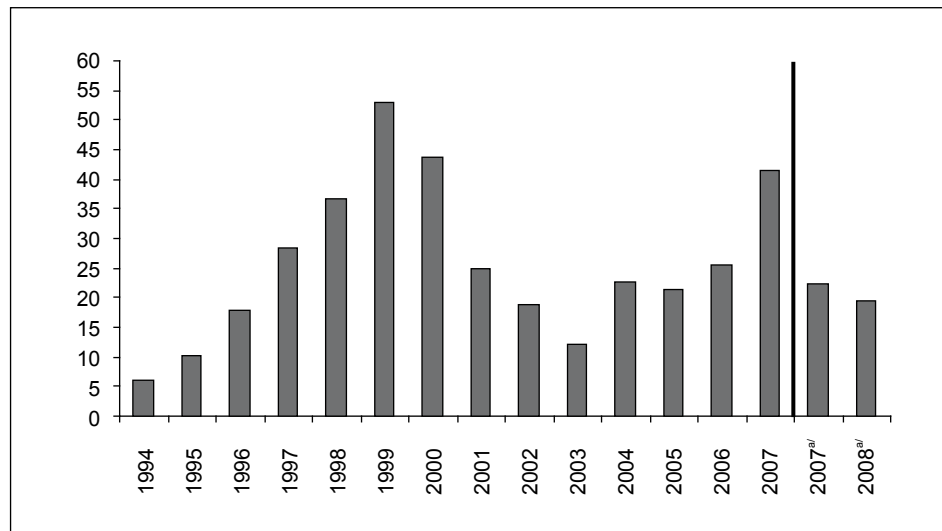
Like its total exports, the composition of Venezuela's exports to MERCOSUR is fairly heavily concentrated in just a few products. However, while these are basically petroleum-related (almost 90% of the total in 2007), sales to MERCOSUR include significant numbers of other products. Only in the case of Uruguay does petroleum dominate, with 98% of total sales in 2007. In Argentina, the petroleum coke and petroleum-derived chemical products had a share in exports of just 30%, while other products, like diamond drills, electric razors, aluminum disks, radiators, pigments, and chromium-based preparations, iron tubing, steel, and tires performed outstandingly, altogether making up almost 40% of exports in 2007.

In terms of sales to Brazil in 2007, directly petroleum-derived products had a share of just 27%, with other products of greater importance, such as mineral coal (15%), aluminum and aluminum alloys (12%), inorganic chemical products (10%), and urea (8%). Exports to Paraguay, for their part, were concentrated in tires (two thirds of the total in 2007) and plastic products (11%).

D. Foreign direct investment in MERCOSUR⁴⁵

2007 was a very favorable year for MERCOSUR countries in terms of foreign direct investment. The US\$41.5 billion coming in that year was 62.7% up on 2006 and, for the first time in many years, came close to the investments received at the end of the 1990s of over US\$50 billion (Graph 20). In that period, however, investments were stimulated by privatizations of public sector companies, especially in Brazil and Argentina. In recent years, however, investments were in response to the improved prospects of countries' growth.

GRAPH 20
FOREIGN DIRECT INVESTMENT IN MERCOSUR
1994-FIRST HALF OF 2008
 (US\$ Billions)



Note: ^{a1} First half. The data from the 1st half of 2007 and 2008 do not include Paraguay.

Sources: INDEC (Argentina), BCB (Brazil), BCP (Paraguay), and BCU (Uruguay).

⁴⁵ For a definition of FDI, see Note 17, Chapter 1. Whereas Chapter 1 considers net FDI flows, this section limits itself to a discussion of FDI inflows into each country's economy.

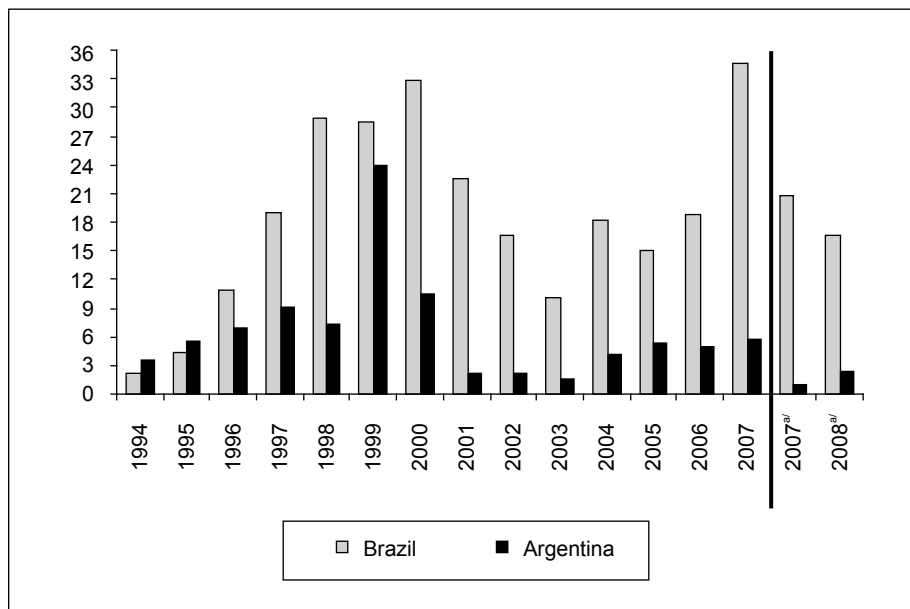
In terms of world FDI flows, MERCOSUR's share increased to 2.1% in 2007, two tenths of a p.p. up on the previous year, but remained below the share of around 2.7% recorded between 2001 and 2005, and is still well below the second half of the 1990s (approximately 4.5%). The same is true of MERCOSUR's share in the total FDI received by DGCs. This was 8.3% in 2007, below the average for 2001-2005 (9.4%) and well below the 17.7% average for the second half of the 1990s.

The momentum of investments cooled a little in the first half of 2008,⁴⁶ when was 13.2% down on the same period for 2007. This was already a clear knock-on effect of the financial crisis in the USA, which began in the middle of the previous year, but worsened throughout 2008. Even so, the US\$19.3 billion were quite important and point to still quite a solid result for the 2008 total.

It is worth remembering that Brazil's larger size, besides generating large trade flows, makes it the top recipient of foreign investment in MERCOSUR. In 2007, for example, it received US\$34.6 billion, a share of 83.2% of MERCOSUR's total recorded income.

This amount broke the previous record of US\$32.8 billion in 2000 (Graph 21). In fact, virtually the whole increase of the investments in MERCOSUR between 2006 and 2007 must be attributed to Brazil, as the flows to Argentina showed modest growth (just 13.4%) and grew 7.4% to Paraguay, whereas Uruguay recorded a drop of 29.6%. Since 2000, Brazil has been the recipient of at least 75% of investment in the bloc.

GRAPH 21
FOREIGN INVESTMENT IN BRAZIL AND ARGENTINA
1994-FIRST HALF OF 2008
 (US\$ Billions)



Note: ^{a/} First half.

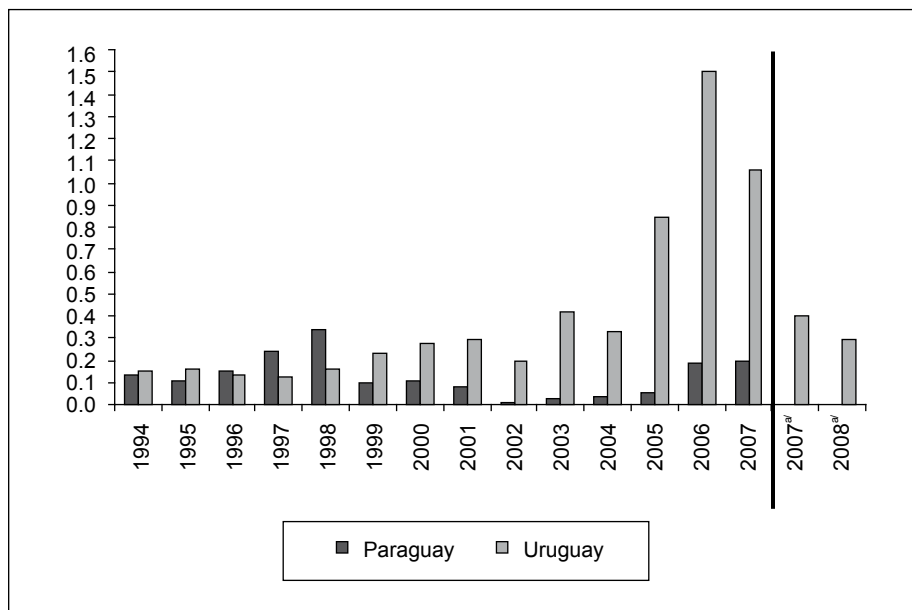
Sources: INDEC (Argentina) and BCB (Brazil).

⁴⁶ Data only referring to Argentina, Brazil, and Uruguay.

Despite showing lower amounts, the investments received by Argentina also evolved favorably in the recent period, in excess of US\$5 billion per year between 2005 and 2007. This represents a remarkable recovery given the rather low levels seen between 2001 and 2003. Nevertheless, Argentina is still a long way from recovering the volume of investments received in the second half of the 1990s (which averaged US\$10.5 billion) due to privatizations of public sector companies: these were a record US\$24 billion in 1999 after the sale of YPF to Repsol.

A similar situation applies in Paraguay (Graph 22), which received investments of almost US\$200 million per year in 2006 and 2007, well up on the practically insignificant levels of 2002-2005, but still well below the record US\$342 million that came in in 1998. Uruguay, on the other hand, received unprecedented volumes of investments (around US\$1 billion, almost 6.5% of GDP) in the three years 2005-2007, in sharp contrast to the average of just US\$226 million in 1994-2004.

GRAPH 22
FOREIGN INVESTMENT IN PARAGUAY AND URUGUAY
1994-FIRST HALF OF 2008
(US\$ Billions)



Note: ^{af} First half.

Sources: BCP (Paraguay), and BCU (Uruguay).

Brazilian investments in MERCOSUR

One of the characteristics of the evolution of Brazilian external accounts in recent years, especially since 2004, is the sharp growth in foreign direct investment beyond its borders. In 2007, Brazil invested a total of US\$7.1 billion in other countries, a figure that, while below that of 2006 (US\$28.2 billion, inflated by a single operation, namely, the purchase of the Canadian company, INCO, by VALE) is well above the annual average for investments between 1998 and 2003 of just US\$1.2 billion.

It is common knowledge that much of this investment targeted South American countries, but the statistical data gathered by the Central Bank of Brazil do not enable an adequate calculation, as much Brazilian investment passes first through countries that offer fiscal advantages, or tax havens, and only then reaches its true destination. Indeed, in 2006, this type of countries accounted for almost two thirds of the total stock of FDI by Brazilian companies. In contrast, Argentina, Paraguay, and Uruguay together represented just 4% of the total.

However, reality shows that there is a high number of Brazilian companies making investments in MERCOSUR, especially Argentina, among which are large companies like Petrobras (petroleum and energy), Camargo Correa (mining and construction), Ambev (beverages), Gerdau (iron and steel), Coteminas (textiles), the meat processing plants JBS-Friboi and Marfrig, as well as a significant number of medium companies. In fact, Brazilian companies' share in the Argentine economy is not a recent phenomenon. A study performed by the Buenos Aires Studies Center (CEB) in 2005⁴⁷ shows that there were 53 Brazilian companies operating in Argentina at the time, and more than half had started operations in the country in the 1980s and 1990s. However, in terms of the investment volumes, over half came from companies entering the country between 2002 and 2005.

The creation of MERCOSUR in 1991 fuelled Brazilian investments in Argentina, which grew significantly between 1994 and 1997, accompanying the rapid expansion of the Argentine economy and the growth of bilateral trade. During the most critical years of the convertibility regime in Argentina (1998-2000), there were net outflows of Brazilian capital. But in 2002, when the country was submerged in a deep recession, Brazilian investment made a spectacular leap as a result of acquisitions by Petrobras (the largest Brazilian investment made in Argentina to date) and by other companies taking advantage of the fall in prices of Argentine assets.

Graph 23 shows that, in 2002, Brazil was responsible for almost half of all foreign investment received by Argentina, with flows of approximately US\$1 billion. This performance, however, became even more favorable from 2005. Although this is not official data but information based on investments announced by the companies,⁴⁸ Brazilian investments in Argentina grew to levels close to US\$2 billion p.a., somewhere between 30% and 40% of all foreign investment received by the country.

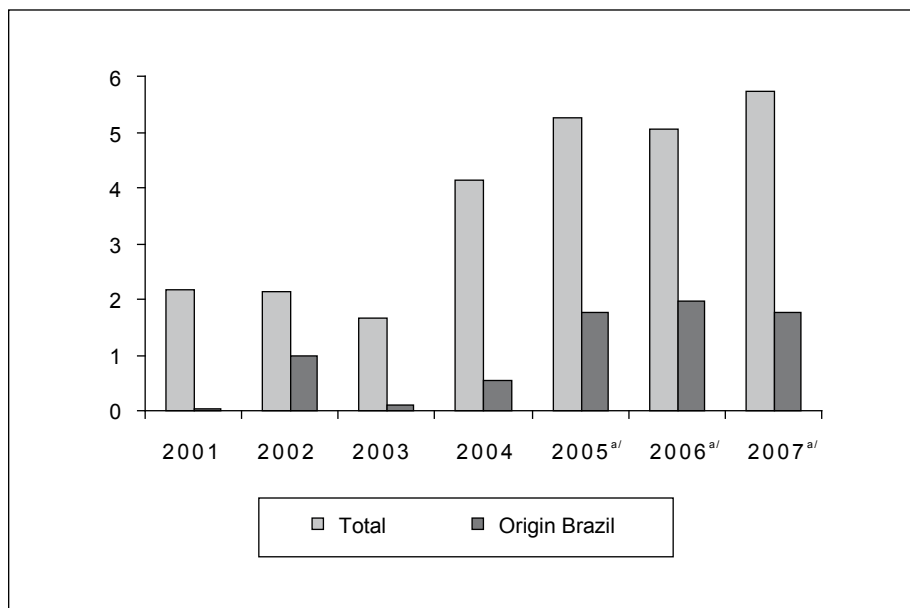
In Paraguay, Brazil has traditionally played an important role as an investor. Of the total stock of investments received by Paraguay up to 2007 (US\$1.8 billion), Brazil is responsible for 11.8%, just behind the USA. Brazilian investments grew still further in recent years: in 2005-2007, the country was responsible for 22.4% of all foreign investments received by Paraguay (US\$67 million).

In Uruguay, unlike the other MERCOSUR partners, Brazilian investments have not been very significant. In 2004-2006, Brazil's share in total investments received by Uruguay was only 3.3% (US\$88.6 million). However, the figures for 2007 should be much more favorable, bearing in mind the three major operations announced over the year: the acquisition of Saman by Camil Alimentos, with an estimated investment of US\$160 million, and the purchase of two Uruguayan meat processing plants by Marfrig, which is committing resources of around US\$120 million.

⁴⁷ Cited in Iglesias, R. [2007].

⁴⁸ Systematically obtained by the Center for Production Studies (CEP) of Argentina's Economy Ministry.

GRAPH 23
TOTAL FOREIGN INVESTMENT IN ARGENTINA BY ORIGIN
(US\$ Billions)



Note: ^{a/} Data relative to investments announced by businesses.

Source: Ministry of Economy of Argentina.

CHAPTER 3. THE INTERNAL AGENDA

This chapter is a record of the evolution of the main issues on MERCOSUR's internal agenda between July 2007 and July 2008. In this period, the *Pro Tempore* Presidency (PPT) was first held by Uruguay (second half of 2007), then Argentina (first half of 2008). This is relevant because, as holders of the PPT, countries reveal their preferences in defining priority matters and issues, despite having to uphold any decisions jointly adopted in the ambit of the CMC, as well as keeping in mind the deadlines set to enact previous decisions issuing from the supreme body of MERCOSUR.

During Uruguay's PPT, emphasis was placed on the implementation of the second stage of CMC Dec. 54/04, whose main objectives were to draw up the MERCOSUR Customs Code and define the customs revenue distribution mechanism. In spite of Uruguay's efforts, neither of these objectives were achieved, a frustration repeated during Argentina's PPT. The present expectation is that Brazil, the country currently holding the MERCOSUR PPT, should succeed in overcoming the obstacles still blocking the final draft of the Customs Code and the definition of a consensus-based formula for distributing customs revenue. Progress on the CET and the Customs Code is described in Section C.

However, Argentina's PPT did successfully define a Production Integration Program, an issue of particular interest to this country, since the strengthening of regional production chains has always been considered by Argentina as a crucial instrument in overcoming asymmetries in MERCOSUR. These questions are developed in Section D of this chapter.

Alongside these matters, the chapter describes various other issues that have shown some evolution over the period considered, e.g. the treatment of asymmetries (Section A), the implementation of projects with FOCEM resources (Section B), the installation of a mechanism to pay for trade transactions in local currency (Section E), and the evolution of the discussion about the criterion of civic representation in the MERCOSUR Parliament (Section F). Finally, Section G deals with Venezuela's membership of MERCOSUR, the evolution of the institutional reform issue, and the approval of a biofuels plan.

A. The treatment of asymmetries

Background

The treatment of asymmetries was the subject of intense debate during Brazil's PPT, in the second half of 2006, and during Paraguay's in the first half of 2007. The documents describing the different approaches defended by the States Parties (SPs) were discussed in detail in *MERCOSUR Report 12* and clearly illustrate each country's different reading of the issue in light of their specific interests.

Paraguay is certainly the most active participant in the discussion of asymmetries. In this sense, it is necessary to remember that, based on a group of proposals submitted by the country in 2003 while it held the PPT, the issue was "installed" on the MERCOSUR agenda once and for all. On that occasion, Paraguay defended the principle of special and differential treatment for the smaller economies, invoking above all its condition as a land-locked country. As a result, Paraguay was granted differential treatment in negotiations with third countries (CMC Dec. 28/03), differential regional content in MERCOSUR's origin regime, and, jointly with Uruguay, additional CET exception lists, as well as reduced aliquots for extrazone imports of capital goods, information technology and telecommunications goods, and various raw materials and

agricultural inputs. The most significant result in Paraguayan demand was, however, the formation at the end of 2006 of the MERCOSUR Structural Convergence Fund (FOCEM), to which the country contributes 1% of resources, but receives 48% of disbursements in exchange.

In September 2006, Paraguay submitted a document attached to the Minutes of the 65th GMC Meeting, through which it called for aggressive community policies to overcome asymmetries, based on four "pillars" or lines of action: (i) community policies to foster development; (ii) competitiveness support programs; (iii) access to regional and other world markets; and (iv) institutional design. This document, registered as "preliminary", is fairly generic in character.

Next, in May 2007, on the occasion of the 5th CMC Special Meeting in Asunción, Paraguay, it submitted a new, rather more detailed document to its partners, in which it explicitly states its approach in terms of the treatment of asymmetries.⁴⁹

In this document, Paraguay defended transfer mechanisms as instruments that "*must, par excellence, characterize the deep integration projects like MERCOSUR, in the ambit of which objectives and commitments are contemplated superior to any other kind of integration and where the countries decided to give up their national policies in favor of the community project*". As a result, to overcome asymmetries, Paraguay suggests prioritizing two instruments in the short and medium term: the amplification and capitalization of the FOCEM, and the implementation of cooperation programs. In the long term, once these asymmetries have been eased or reduced, MERCOSUR should design strategic actions steered by supranational institutions.

It must be remembered that, with undeniable optimism, the first phase to reduce asymmetries is defined as a ten-year period (2008-2017) during which Paraguay should grow quickly, for which US\$2.3 billion p.a. in additional investments must be made available. The second phase would extend from 2018 to 2025. Based on this approach, the Paraguayan document of May 2007 presents a wide group of actions falling within the framework of the four "pillars" previously defined in the document of September 2006.

In short, where asymmetries are concerned, Paraguay cites its condition as a land-locked country with lower per capita income in the members of MERCOSUR to call for special and differential treatment, flexibilities, and exceptions, as well as technical support and, mainly, a very significant extension of the transfer mechanism.

Uruguay's position is quite different. The country has a small economy, but with relatively high per capita income in comparison with the other partners. As a result, its criticisms of MERCOSUR center much less on the treatment of structural asymmetries and more on the bloc's inability to move toward the formation of a genuine Customs Union and on the length of time it is taking to eliminate asymmetries arising from national policies that distort competition or limit access to intrazone markets. The currency of policy-derived asymmetries would be particularly harmful to Uruguay, whose main structural asymmetry lies in the limited size of its domestic market. Uruguay is, therefore, also calling for flexibility, but bases its argument on the failure of MERCOSUR to account for its own agenda, which produces an unbalanced distribution of the costs and benefits of regional integration, as well as damage for the smaller economies. The flexibilities called for to the benefit of the smaller economies are, therefore, considered fair and necessary compensation for the costs they incur by virtue of unresolved policy asymmetries.

⁴⁹ MERCOSUR/IV CMC Ext./ID 02/07. "Guidelines to overcome asymmetries in MERCOSUR", included as Annex III in the Minutes.

The Uruguayan stance was clearly expounded in the letter sent by President Tabaré Vázquez to President Lula da Silva in September 2006, and in two later documents distributed in October 2006 and May 2007.

In fact, the proposals included in President Vázquez's letter leave no doubts about the Uruguayan demand, which calls for the effective compliance with objectives envisaged on the internal agenda. The proposals include: (a) moving forward in the objective of the free circulation of goods and in the establishment of a Customs Union as determined in CMC Dec. 54/04; (b) centering the objectives of the Customs Union on the elimination of technical and bureaucratic barriers to trade and on the adoption of mechanisms for greater macroeconomic coordination; and (c) acknowledging that the levels of the CET are inadequate and should be revised. Moreover, the concession of flexibilities on the external agenda, mainly "*via the incorporation of bilateralities, be it in the framework of joint negotiations or allowing individual negotiations*", would constitute countervailing demands.

In the document of October 2006, Uruguay reiterates its "*highly critical*" focus on the integration process by virtue of the failure to comply with key aspects of the internal agenda and insists on calling for flexibility in the negotiations with third countries in order to "*allow the smaller partners to reduce the costs of the stagnation resulting from the failure to comply with other commitments*".⁵⁰

The document of May 2007 is also rather incisive and highlights the need to concentrate efforts "*on the elimination of incentive policies that distort the conditions of competition, and [on] the harmonization of indirect taxes, a requirement for the effective free circulation of goods and services within the bloc*".⁵¹

The document is particularly critical of proposals submitted by Argentina and Brazil at the MERCOSUR Trade Commission regarding "*Disciplines for the application of intrazone incentives*". It considers that the Argentine proposal is inadequate to solve the underlying problem caused by the impact of the concession of incentives on the steering of investment flows to the benefit of the larger economies. The Brazilian proposal, on the other hand, is criticized for proposing "*no significant alteration to the prevailing situation*". As a result, Uruguay is calling for countries to adopt a frank and realistic stance, and to explicitly state their restrictions in order to push forward in this matter.

Elsewhere the document states that "*the provisional measures regarding exceptions to the CET and special import regimes have enabled Uruguay to reduce the costs associated with the full implementation of a CET that does not reflect the reality of domestic production structure*". Nevertheless, the document stresses that special and differential treatment measures, and unilateral measures do not guarantee sustained growth, although they may contribute to solving specific relevant problems. In short, it can be said that Uruguay is defending the stance of effective compliance with the commitments adopted by MERCOSUR countries, rather than the granting of flexibilities or exceptions.

Argentina, as stressed in the previous Report, remained fairly inactive in the debate and only came out in favor in a document circulated in June 2007.⁵² This document criticizes the scant progress in regional policy coordination and states that the integration process concentrated almost exclusively on dismantling tariff barriers and establishing a common external tariff, placing less emphasis on production aspects. It

⁵⁰ Minutes of the 65th GMC Regular Meeting (Annex IV).

⁵¹ MERCOSUR/V CMC Ext./ID 03/07. "Measures to overcome asymmetries in MERCOSUR", included as Annex IV in the Minutes.

⁵² MERCOSUR/LXVIII GMC/WP No. 11/07. "Production integration as a necessary tool to overcome asymmetries in MERCOSUR", included as Annex XXI in the Minutes.

therefore insists on any future measures being geared toward providing incentives for MERCOSUR's global production, increasing regional added value, and stimulating the steering of new investments toward the smaller economies.

The Argentine document quite emphatically states that the proposals that "*induce higher levels of extrazone imports do not meet the above objective*". It therefore recommends the adoption of policies based on "*a greater degree of liaison between the countries' production sectors, the balance of investment flows, the promotion and development of regional suppliers, and the deepening of integration of companies and sectors*".

In short, the Argentine document emphasizes "production integration" based on the development of value chains. It is a document aimed at Brazil, the MERCOSUR country with most leadership capacity to structure regional production chains and the only member that has a large number of big companies already established in partners' territory and potentially interested in developing regional suppliers.

In the issue of asymmetries, while Paraguay, Uruguay, and Argentina act as petitioners, Brazil is capable of selecting, filtering, and driving the initiatives it considers most realistic or least expensive in light of its own interests. In this sense, its leadership is purely reactive.

In December 2006, Brazil tabled two initiatives intended to ease asymmetries: the granting to Paraguay and Uruguay of more flexible treatment over origin, and anticipation of the elimination of double levying of the CET in those countries' favor. Only the first of these proposals was endorsed in 2007, with the adoption of a *de minimis* approach of 10% in the bloc's Origin Regime (CMC Dec. 16/07).

Evolution

The intense debate over the question of asymmetries seen between mid-2006 and mid-2007 during Brazil and Paraguay's PPTs was not echoed to any significant extent during Uruguay's PPT in the second half of 2007 or Argentina's in the first half of 2008. Strictly speaking, during the exercise of their respective PPTs, both Uruguay and Argentina opted to give priority to their own particular approaches to the issue. Uruguay thus concentrated its efforts on attempting to meet the objectives laid down in CMC Dec. 54/04, aimed at providing incentives for the elimination of double levying of the CET and the adoption of a mechanism to distribute customs revenue, while Argentina opted to give real direction to its proposal to move forward in regional production integration.⁵³

During Uruguay's PPT, the initiatives regarding the "overcoming of asymmetries" were limited to the adoption of a CMC decision to set in train a proposal by the Paraguayan delegation to the GMC and the submission of an Economic and Social Consultative Forum (FCES) Recommendation to the 32nd Special GMC Meeting, held in Montevideo at the end of 2007.

CMC Dec. 57/07 simply extended the mandate granted to the High Level Group for the Elaboration of the Strategic Plan to Overcome Asymmetries in MERCOSUR (GANASIM) for it to carry out its work and set a deadline of late 2008 for the submission of a Strategic Plan. However, on Paraguay's initiative, an express recommendation was made to the GANASIM toward "*giving priority to the use of the FOCES as community instrument for the funding of the identified projects*".

⁵³ These issues are tackled elsewhere in this Report.

In its turn, the Paraguayan proposal, which was not taken up, defended the creation of a new Program in the ambit of the FOCEM ("*Program for the Development and Integration of Economies with no Maritime Coastline*") and increased contributions to the FOCEM from the States Parties up to the equivalent of 0.05% of MERCOSUR GDP in 2006. In concrete terms, the Paraguayan proposal contemplated a timeline for rising contributions to the FOCEM, starting with a sum of US\$76 million in 2009 and reaching US\$607 million in 2016. Those resources would be exclusively destined for the new Program and distributed as follows: 70% for projects submitted by Paraguay and 10% for projects submitted by each of the remaining three MERCOSUR members.⁵⁴

The main concern of the FCES Recommendation was to guarantee some participation and/or coordination with other MERCOSUR organizations, like the Consultative Forum of State and Provincial Governors and Mayors and the High Level Employment Group. In the first half of 2008, during Argentina's PPT, the only reference to the issue is in the Minutes of the 71st GMC Regular Meeting, which record the results of the GANASIM meeting in April 2008. According to the Minutes, the States Parties' delegations claimed to be in agreement that "*the Strategic Plan shall focus first on specific actions with a direct effect on asymmetries, mainly through any cooperation mechanisms or funding identified*" - precisely Paraguay's demand, as explicitly stated in the May 2007 document.

B. The MERCOSUR Structural Convergence Fund (FOCEM)

Background

MERCOSUR Report 12 highlighted the efforts made in 2006 and the first half of 2007 both by the FOCEM's *Ad Hoc* Group of Experts (GAHE-FOCEM) and the Presidency of the Commission of Permanent Representatives of MERCOSUR (PCRPM) and the MERCOSUR Secretariat (SM) to speed up the full operation of the FOCEM.

First, through the CRPM, negotiations were held for the speedy incorporation in the States Parties' legal systems of the CMC decisions providing for the creation of the FOCEM (CMC Dec. 18/05) and instituting its Regulations (CMC Dec. 25/05). Both decisions came into force in December 2006 and in August 2007, respectively.

Second, in late 2006, at the 31st CMC Meeting in Brasilia, the FOCEM's first budget was approved, consisting of the total endowments foreseen for 2006 (US\$50 million) and 2007 (US\$75 million).

Third, immediately after the FOCEM's Regulations were approved, the selection began of technicians to form its Technical Unit in the ambit of the MERCOSUR Secretariat. TU-FOCEM effectively began to operate in September 2007, initially with four senior technicians, one from each State Party. Later on a further four assistant technicians were taken on.

In September 2007, after the TU had just begun to operate, the CMC had already approved 15 projects, which illustrates the high priority MERCOSUR members gave the FOCEM.

⁵⁴ MERCOSUR/LXX GMC/WP 15/07.

Evolution

During Uruguay's PPT, there was intense activity in the TU/MS, mainly in organizational and functional matters. The main initiatives were:

- a) The distribution of tasks among the team members;
- b) The organization of bank accounts with the resources contributed by member countries; and
- c) The documentary, legislative, and regulatory analysis of the FOCEM.

In addition, the methodological bases for project evaluation were designed, a task in which the TU had the support of the FOCEM *Ad Hoc* Group of Experts. The procedures were also adopted for disbursements to begin in projects already approved, and last, the TU began to play an active party in the technical and financial evaluation of new project proposals.

In their turn, the MERCOSUR Secretariat and the CRPM worked on drawing up and signing the MERCOSUR Structural Convergence Fund Agreements (COF), legal instruments whose purpose it is to regulate compliance with approved projects. By the end of 2007, 13 agreements had been signed.

The CPRM also drew up a draft decision to be submitted to the CMC at the end of 2007, authorizing the SM Director to hold the FOCEM's resources in accounts that could give interest, with liquidity guarantees and deposit security. It was established that interest accrued in one year would be added to the FOCEM's budget the following year.

In the meeting in Montevideo in December 2007, the Presidents' Communiqué stated that, to date, 18 projects had been approved. The total number of projects was US\$145.3 million, with FOCEM contributions of US\$111.6 million.

In the following half, during Argentina's PPT, the TU/MS drew up a FOCEM Visibility Application Guide, with the intention of guaranteeing an optimum project communication and visibility strategy. The introduction to the Guide highlights the importance of strengthening MERCOSUR's identity and of disseminating the existence of the FOCEM, raising awareness and sensitizing the population in terms of the projects and their benefits, and guaranteeing transparency by informing people about the origin of the resources financing these projects. The Guide was approved at the 35th CMC Meeting in San Miguel de Tucumán (CMC Dec. 04/08).

The same Meeting approved the procedures to be adopted by the States Parties when publishing international tenders (CMC Dec. 05/08). The main objectives of the measure are to establish "*mechanisms to guarantee the transparency and advertisement of the recruiting processes carried out in the framework of the projects approved for funding with FOCEM resources*". Furthermore, the procedures approved ensure that States Parties "*have access to the necessary information for those interested to be able to participate in the bidding process on an equal footing*".

At the end of Argentina's PPT, a further five projects were approved, bringing the total of projects approved by the CMC by the end of June 2008 to 23. The projects totaled US\$169.3 million, US\$130 million of which was contributed by the FOCEM and the remaining US\$39.3 by national counterparts. It is necessary to notice that the counterparts make up over 23%, in excess of the minimum 15% demanded.

Up to now, the main recipient of FOCEM resources has been Paraguay, which benefitted from 13 projects totaling US\$134 million, or almost 80% of the resources approved.

Uruguay is second, with 6 projects totaling US\$18.7 million, slightly over 11% of the total approved. Next comes a regional project to support the eradication of foot-and-mouth disease in the ambit of MERCOSUR, the MERCOSUR Foot-and-Mouth-Free Action Program (PAMA), which is slightly under 10% of the resources granted by the FOCEM. Last, the MERCOSUR Secretariat is handling the development of three projects totaling just US\$170,000.

TABLE 15
SUMMARY OF FOCEM PROJECTS BY TARGET AND PROGRAM
(US\$ Millions)

Target	Program I		Program II		Program II		Program IV		Total		
	N°	Value	N°	Value	N°	Value	N°	Value	N°	Value	%
Paraguay	7	92.7	3	11.1	3	30.2	-	-	13	134.0	79.2
Uruguay	2	12.3	1	1.5	3	4.9	-	-	6	18.7	11.1
Regional	-	-	1	16.3	-	-	-	-	1	16.3	9.6
SM	-	-	-	-	-	-	3	0.2	3	0.2	0.1
<i>Total</i>	9	105.5	5	28.9	6	35.2	3	0.2	23	169.3	100.0
%		62.0		17.1		20.8		0.1		100.0	

Source: TU/SM.

In terms of the distribution per program, Program I (*Structural Convergence*) absorbed over 60% of resources and respected the priority that, during the first four years, the FOCEM's operation should be granted to projects designed to develop the smaller economies and less favored regions, the main reason for the Fund's creation (see Articles 12 and 13 of CMC Dec. 18/05).

On the other hand, Program II (*Competitiveness Development*) and Program III (*Social Cohesion*) enjoyed 17.1% and 20.8% of approved resources respectively. Last, Program IV (*Strengthening of the Institutional Framework and the Integration Process*), the execution of which is the job of the MERCOSUR Secretariat, was granted just 0.1% of resources, below the maximum set for this Program (0.5%) in the FOCEM's first four years.

Some brief remarks on the three projects of Program IV are relevant. First is the notable project "Identification of Structural Convergence Needs in MERCOSUR", which aims to make a report of the basic needs in the States Parties in the areas of highway infrastructure, construction, modal and multimodal transport road modernization and recovery, which promote physical integration among the members of MERCOSUR. Ideally, the project, approved on the initiative of the Argentine representation, will serve as a basis for each State Party (SP) to identify priority projects to be financed by the FOCEM in the future.

The second project, the "MERCOSUR Jurisprudence Database", aims to computerize, systematize, and enable free access to the MERCOSUR Secretariat database, which contains the jurisprudence of the States Parties' national courts relating to MERCOSUR law. Last, the third project, the "Common External Tariff

Information System", similar in format to the previous project, is intended to systematize all the information relating to the CET and the Common Tariff Policy, and to enable free access to this information in the future via the Secretariat's web page.

An examination of the disbursements made to date (see Table 16) is less auspicious: resources for 11 projects were partial or totally disbursed, but the total amount available corresponds to just 4.8% of the total value of the projects approved.

A preliminary balance of the FOCEM should highlight the following:

- The instrument is a reality and constitutes a benchmark for various MERCOSUR initiatives, so much so that there are numerous suggestions for expanding its resources or creating new subprograms in order to fund a wide variety of proposals.
- In the last year, there was a clear effort to speed up the institutionalization of the instrument by completing the Regulations and drawing up guidelines and operational manuals.
- The deadlines for project evaluation and approval seem satisfactory, and the administrative costs are low.
- There is a concern about transparency and about avoiding the "natural" propensity to the clientelistic use of resources.
- However, most projects are small in scale, which may lessen the instrument's effectiveness and impact. One exception is the "Uruguay-Brazil 500MW Electrical Interconnection Project", with a value of approximately US\$93 million, submitted by Uruguay and already receiving a favorable report from the CRPM. The project is currently undergoing technical analysis in the TU/MS.
- The pace of disbursements is slow, but the process of institutional construction needed for the effective operation of the projects in less developed countries is likely to be one of the causes behind sluggishness.
- Last, the amount of FOCEM's resources seems small when compared to similar instruments. It is worth remembering, however, that the resources are not irrelevant in the case of Paraguay. Furthermore, apparently, it is not resources that are currently in short supply, but projects.

TABLE 16
SUMMARY OF PROJECTS APPROVED TO 06-30-2008

N°	Country	Description	Program	Total Project Value (US\$ Millions)	Total FOCEM Investment (US\$ Millions)	CMC Approval		Disbursements to 07-31-08 (US\$ Millions)
						Dec. N°	Date	
1	Paraguay	MERCOSUR - <i>Habitat</i> . Social Promotion and strengthening of human capital in poor family settlements	III	12.915	7.500	8/07	01-18-07	3.505
2	Paraguay	MERCOSUR - <i>Roga</i> . Housing and infrastructure construction in areas of extreme poverty	III	9.706	7.500	8/07	01-18-07	0
3	Paraguay	Great Asunción: Slip roads and ring road	I	14.860	12.631	8/07	01-18-07	0
4	Paraguay	Integral support for microenterprises	II	5.000	4.250	8/07	01-18-07	0.425
5	Paraguay	Installation of biosecurity laboratory and infrastructure for food check laboratory	II	4.800	4.080	8/07	01-18-07	0.047
6	Paraguay	Renovation of roadways	I	16.990	14.442	11/07	05-22-07	0
7	Regional	Action Program A foot-and-mouth-free MERCOSUR (PAMA)	II	16.340	13.889	8/07	01-18-07	2.395
8	Uruguay	Route 26 Melo Stretch. Sarandí de Barceló River	I	7.929	5.310	8/07	01-18-07	0.508
9	Uruguay	Technological development and training in the software, biotechnology, and electronics sectors	II	1.500	1.275	8/07	01-18-07	0.701
10	Uruguay	Strengthening of local communities in border regions	III	1.647	1.400	8/07	01-18-07	0.140
11	Uruguay	Training of informal manpower for urban waste classification	III	1.882	1.600	11/07	05-22-07	0.220
12	Uruguay	Interventions in border region settlements	III	1.412	1.200	11/07	05-22-07	0.035
13	Uruguay	Route 12 - Route 54-Route 55 Connection	I	4.371	2.928	23/07	06-28-07	0
14	SM	CETI information system	IV	0.050	0.050	8/07	01-18-07	0.050
15	SM	Jurisprudence database	IV	0.050	0.050	8/07	01-18-07	0.050
16	SM	Identification of basic lacks and needs in SPs to steer structural convergence actions	IV	0.071	0.071	39/07	10-25-07	0
17	Paraguay	Drinking water and basic sanitation system in rural and indigenous communities	I	39.471	28.516	47/07	12-17-07	0

TABLE 16 (CONTINUED)

N°	Country	Description	Program	Total Project Value (US\$ Millions)	Total FOCEM Investment (US\$ Millions)	CMC Approval		Disbursements to 07-31-08 (US\$ Millions)
						Dec. N°	Date	
18	Paraguay	Surfacing Route 8, San Salvador - Rojas Potrero Branch Road	I	6.345	4.903	48/07	12-17-07	0
19	Paraguay	Development of tourist products in the Iguazú - Misiones integrated circuit	II	1.303	0.992	7/08	06-30-08	0
20	Paraguay	Surfacing Routes 6 and 7, Presidente Franco - Cedrales Regional Integration Corridor	I	5.847	4.517	8/08	06-30-08	0
21	Paraguay	Surfacing Route 2 feeder sections (Itacurubi - Valenzuela - Caballero)	I	5.187	4.008	9/08	06-30-08	0
22	Paraguay	Resurfacing Routes 1 and Graneros del Sur	I	4.004	3.093	10/08	06-30-08	0
23	Paraguay	MERCOSUR Yporá. Access to drinking water and basic sanitation in regions of poverty and extreme poverty	III	7.589	5.835	11/08	06-30-08	0
<i>Total</i>				169.266	130.040			8.076

Source: TU-FOCEM/SM.

C. The Common External Tariff

This section sets out various issues to do with the Common External Tariff (CET): the problems to do with double levying of the tariff, special import regimes, exception lists, non-objections in footwear introduced to the CET, textiles and fashions, and the rules in force in capital goods and information technology and telecommunications equipment.

Elimination of double levying of the CET and distribution of customs revenue

- Background -

Since the establishment of the Common External Tariff in 1994, the question of the modification of rules for the circulation of goods has become a permanent fixture in MERCOSUR, in order to eliminate the "problem of double levying of the CET" within the territory of the Customs Union.⁵⁵ The treatment of the issue only began to make progress as of 2000, when the CMC allocated analysis of it to the CCM, as well as the related problem of defining a mechanism for the distribution of any customs revenue affected by modifications to the circulation rules.

The first substantive advance came in 2004 with the approval of CMC Dec. 54/04, which set the guidelines for the transition to full operation of the Customs Union. This decision established the principle that imported extrazonal goods complying with the Common Tariff Policy (PAC) would receive treatment as original MERCOSUR goods, both in terms of their circulation in the States Parties' territories and their incorporation in production processes. Furthermore, Article 2 of CMC Dec. 54/04 ruled that the goods for which the CET set a 0% aliquot, as well as extrazonal goods with a 100% common preference, would receive treatment as original MERCOSUR goods as of January 1, 2006, it falling to the CCM to define a positive list before that date that included goods that met these criteria. It should be noted that, in both cases, the impact on the distribution of customs revenue is nil, considering that the measure affects imported extrazonal goods that generate no revenue through import tax. However, the measure had strategic and policy importance, as it was in response to a demand by the EU and marked the start of the transition to full operation of the Customs Union.

Last, CMC Dec. 54/04 established the requirements to extend the free circulation rule to the other goods, aside from those contemplated in Article 2. Indeed, by virtue of Article 4, a deadline was set (2008) to execute the following requirements: (i) approval of the MERCOSUR Customs Code (CAM); (ii) online interconnection of the customs administration computer systems; and (iii) the definition of a mechanism for the distribution of customs revenue.

In December 2005, CMC Dec. 37/05 regulated CMC Dec. 54/04 and included three annexes: (i) Annex I listing the goods whose CET was 0% in all States Parties; (ii) Annex II listing the goods the four countries granted a simultaneous 100% tariff preference and governed by the same origin requirement (therefore excluding those governed by temporary quotas or origin requirements); (iii) Annex III listing the goods from Annexes I and II that were subject to some trade defense measure (antidumping right, countervailing duty, or safeguard measures) in one or other of the States Parties.

⁵⁵ Imported extrazonal products should be able to circulate freely in MERCOSUR, once payment of the CET has been made at the entry point to the Customs Union. But this does not occur, as many extrazonal products are subject to double CET levying when exported from one MERCOSUR country to another.

Under CMC Dec. 37/05, goods included in Annex I and II would receive treatment as original MERCOSUR goods, excluding those in Annex III. This, in short, was how the "scope" of CMC Dec. 54/04 was defined.

Other chapters of CMC Dec. 35/05 defined: (i) customs procedures, mainly the characteristics and rules for the issuing of the Certificate of Common Tariff Policy Compliance (CCPAC) and the Certificate of MERCOSUR Origin Regime Compliance (CCROM); (ii) the establishment of complementary rules relating to the origin regime; (iii) information exchange between customs houses; and (iv) general provisions determining, among other things, the follow-up on the impact of regulations on trade flows, a responsibility attributed to the CCM.

CMC Dec. 37/05 initiates the "second compliance stage of CMC Dec. 54/04", regarding compliance with the three requirements above. Where the drafting of the Customs Code is concerned, an *Ad Hoc* Group was set up in 2006 to submit a consensus-based text to the GMC as early as the first half of 2006. This deadline was later extended until the first GMC Meeting in the second half of 2007 (CMC Dec. 15/07). In terms of the definition of mechanism for customs revenue distribution, a special group was set up in the ambit of the CCM.

- Evolution -

Of the three requirements laid down by CMC Dec. 54/04, the one that made most rapid progress during Uruguay and Argentina's PPTs, i.e. between mid-2007 and mid-2008, was that related to the online interconnection of the States Parties customs houses. Indeed, in 2008, CMC Dec. 01/08, intended to detail the technical specifications of the computer infrastructure for the Customs Register Information Exchange (INDIRA) System, stated that the System "*is under way and available in all four States Parties*". Also, CMC Dec. 02/08 was approved in Tucumán, laying out the procedures to resolve technical differences in customs valuation in MERCOSUR.

In terms of the Customs Code and the definition of the mechanisms of customs revenue distribution, progress was not very satisfactory. In fact, where the CAM is concerned, the report of Uruguay's PPT in late 2007 bears witness to six meetings of the *Ad Hoc* Group and a further two meetings of the Acting National Coordinators, without completing the final draft of the Code within the specified deadline. As a result, CMC Dec. 55/07 again extended the deadline and ruled that the CAM should be concluded in May 2008 for approval at the first CMC Regular Meeting the same year.

In Tucumán, however, the report of Argentina's PPT admitted that the four meetings of the *Ad Hoc* Group went not enough to reach a final draft of the Code. However, it concluded on an optimistic note, estimating that the progress achieved enabled a "*glimpse of the completion of the work by late 2008*".

In terms of the customs revenue distribution mechanism, Argentina's PPT stated that the formula to be adopted should reflect intrazone circulation, and implicitly enshrine the principle of fiscal neutrality. In accordance with Argentina's PPT, there was also consensus over two issues to be dealt with by the rules defining the mechanism. These issues are: (i) the scope; (ii) the amount to be distributed; (iii) the distribution formula; (iv) the creation of a clearance fund to account for the modifications in the circulation of goods; (v) the definition of an organization for administration and control, and (vi) the definition of customs and origin procedures.

The confidential nature of most of the documents related to the drafting of the CAM prevents inferences being drawn about the effective progress made since mid-2006, when the GMC approved Res. 40/06.

It is worth remembering that, on that occasion, significant guidelines were defined to be followed in drafting CAM. These included:

- *Taxable event:*⁵⁶ Imports or exports **for consumption** will be the taxable event. This is the effective definition in Argentina's customs code, but not in Brazil's, for which the taxable event is the movement of merchandise across the border.
- *The scope of the Customs Code:* The CAM will be a "framework" code, i.e. the code will leave some matters pending definition. These will be tackled in the future, when a definitive code customs is established, an aspect that has earned criticism from the private sector.
- *The spatial ambit of application of the CAM:* Customs legislation will be applied throughout the territory of the States Parties and in any enclaves granted to them. The concept of "enclave" was defined as "*that part of the customs territory of a State that is not a member of MERCOSUR, where the application of MERCOSUR customs legislation is permitted*".
- *Customs territory:* This was defined as that part of the spatial ambit in which a single tariff regime and economic restrictions on imports and exports of this regime will be applied. Excluded from the customs territory were free zones and "exclaves", i.e. that part of the States Parties' territory where the application of a third state's customs legislation is permitted by virtue of some international agreement.
- *Customs infractions, financial sanctions, prescription of actions to call for payment of tax credits:* By virtue of the asymmetries existing in national legislations, these aspects will not be regulated by the CAM, not at this first stage, at least. It must be stressed, however, that even in the EU some of these aspects have remained under the umbrella of national legislations.
- *Territorial waters:* It was agreed that the CAM will provide for a special customs regime for the treatment of the entry, storage, and exit of goods in territorial waters "*keeping in mind each State Party's effective legislation*".
- *Customs deposits:* It was agreed that the different modalities in force regarding Customs Deposits will "*take into particular account the characteristics of port, airport, and/or land legislations in each of the States Parties*".

After the approval of Res. 40/06, national negotiators stated, with a degree of optimism that over 80% of the CAM had already been agreed. Two years later, however, in Tucumán, negotiators declared that there were still obstacles to be overcome in at least three areas: (i) the precise delimitation of the MERCOSUR customs territory; (ii) the definition of the special customs areas (including the territorial waters); and (iii) the issue of export duties.

The confidential character of the documents related to the CAM prevents a more precise evaluation of the obstacles in the way of the final draft of the rule. Nevertheless, in terms of export duties, national negotiators

⁵⁶ The "taxable event" is the situation that, by law, justifies the levying of tax.

made explicit the points of divergence in Tucumán. Indeed, according to the declaration of the Argentine representative reported in the press, the draft of the CAM provided for three alternatives: (a) not including export duties in the code; (b) determining that such duties be defined at community level; or (c) permitting each country to establish its export duties. The Argentine representative declared that his country was in favor of the latter alternative. Uruguay, on the other hand, stated its preference for export duties to be subject to CMC approval. Hence the deadlock.

It was also revealed in Tucumán that there was consensus for the creation of an "Authorized Economic Operator" (AEO), which would have a preferential channel for border traffic in goods.

Where the customs revenue distribution mechanism is concerned, all that is known is that rehearsals were performed based on alternative formulas and that Paraguay opposes the main resistances.

Special Import regimes

- Background -

In December 2000, the States Parties undertook to totally eliminate any unilaterally adopted special import regimes *"that imply the total or partial suspension of customs duties that tax the temporary or definitive importation of merchandise and that does not aim at the improvement and subsequent reexportation of the resulting merchandise to third countries"* (Article 1 of CMC Dec. 69/00) as of January 1, 2006. Special Customs Areas (free zones), which are governed by other provisions, were excepted from this regulatory framework.

CMC Dec. 33/05 extended the deadline to January 1, 2008, and CMC Dec. 14/07 extended it to December 31, the same year. Worthy of note is the fact that CMC Dec. 02/06 had already previously defined the sectors of interest for which the CCM had to negotiate the relevant common regimes. These sectors were: (i) goods making up investment projects; (ii) goods for scientific and technological research; (iii) goods for the naval industry; (iv) goods for the aeronautical industry; (v) goods for education; (vi) goods for health; and (vii) goods subject to transborder land trade.

- Evolution -

During Uruguay and Argentina's PPT, the CCM held ten meetings. The minutes of this entity periodically report on the progress in the negotiation of common import regimes, including the following circulating proposals:

- Brazil submitted a proposal for a common regime of goods for scientific and technological research, which already received observations and comments from the other countries' representatives.
- Argentina submitted an initial proposal for a common import regime of goods making up investment projects and already drew up a revised draft that takes into account partners' various observations.
- The import regime of goods for the naval industry merited proposals from almost all the countries. There were at least two meetings in which the private sectors of the member countries took part and progress was promising.

- Brazil distributed a proposal for a common regime of goods for the aeronautical industry, which was received with interest by the other countries. Brazil is promoting a meeting with the participation of EMBRAER.
- The CCM minutes do not mention proposals for the areas of health and education, but Brazil already communicated that it will shortly submit proposals for both sectors.
- There are no proposals tabled for goods subject to transborder land trade. As a result, the countries decided to take the works of the *Ad Hoc* Transborder Integration Group as a precedent.

In short, except in the case of the common regime of goods for the naval industry, it is possible to infer that the negotiation of special import regimes will demand yet another extension of the deadline.

Exception lists for the Common External Tariff

The exception lists for the CET continue to be postponed. In late 2007, the CMC established new deadlines and limits for lists whose timelines were effective until the end of 2008 (CMC Dec. 38/05). Indeed, CMC Dec. 59/07 set new deadlines, stipulating that the lists of Argentina and Brazil may contain at most:

- * 100 items from the MERCOSUR Common Nomenclature (NCM) up to 01.31.2009;
- * 93 items from the NCM between 02.01.2009 and 01.31.2010;
- * 80 items from the NCM between 02.01.2010 and the 07.31.2010;
- * 50 items from the NCM between 08.01.2010 and the 12.31.2010;

On the other hand, in line with the provisions of the same decision, Uruguay and Paraguay may keep 100 headings from the NCM up to December 31, 2015. It must also be stressed that the States Parties are authorized to alter up to 20% of the NCM positions included in the lists every six months.

It has to be remembered that Articles 2 and 3 of CMC Dec. 31/03 are still in force. The first of these authorizes Paraguay to include up to 150 additional items on its exception list, while Uruguay is authorized to include 125 additional items. In both cases, the deadlines for these additional exceptions extend to 2010. Article 3, in turn, keeps Paraguay's 399 exceptions to the CET foreseen in Article 4 of CMC Dec. 07/94 until 2010.

Modification to the CET for footwear, textiles, and fashions

MERCOSUR Report 12 recounted Brazil's negotiations with its partners to analyze the possibility of promoting an increase in the CET for a relatively high number of products included in the textiles, fashions, and footwear sectors, in order to contain the advance of imports of these goods.

The partners accepted the Brazilian initiative and, as a result, the CMC set new levels for the CET in various products from those sectors (CMC Dec. 37/07) as of November 30, 2007. The new levels were set at 26%

for the textiles sector and at 35% for fashions and footwear, and will remain in force until the last CMC Regular Meeting in 2010, when the situation will be reevaluated depending on the evolution of trade flows.

In this period, under the provisions of the same CMC decision, "*Paraguay and Uruguay will be able to maintain the levels of the national tariffs previously in force for products from the textiles and fashions sectors*". Subsequently, CMC Dec. 27/08 extended the same treatment in favor of both countries to the footwear sector, although limited to just eight of the 29 tariff positions whose import aliquot had been previously increased.

Capital goods

- Background -

The rule in force for capital goods is CMC Dec. 34/03, agreed in December 2003. The rule stipulates the following:

- A Common Regime of Non-Produced Capital Goods providing for a wide list of such goods was established with an import aliquot fixed at 0% and coming into force as of January 1, 2006.
- It authorized the States Parties to uphold their capital goods import regimes up to the 12.31.2005 and included unilateral measures previously authorized by CMC Dec. 02/03, essentially a waiver authorizing the application of aliquots below the CET for the import of extrazone capital goods to Argentina, Paraguay, and Uruguay.
- It authorized Uruguay and Paraguay to apply a 2% aliquot for extrazone imports of capital goods up to 12.31.2010, excepting those included in the above list of the common regime, whose aliquot had been fixed at 0%.

However, at the end of 2005, CMC Dec. 40/05 delayed the entry into force of the common regime until 01.01.2009 and, as a result, authorized the States Parties to maintain their import regimes for capital goods (as well as the waiver) until December 31, 2008.⁵⁷ This decision also ruled that as of January 1, 2011, the only imports that would enjoy the common regime would be new capital goods and their parts appearing on the Common List and having the code "BK" in the NCM. Last, the High Level Group to Examine the Consistency and Dispersion of the Current Structure of the Common External Tariff (GANAEC) was entrusted with drafting a proposal to revise the CET for Capital Goods that would be ready by December 31, 2006. The deadline granted to the GANAEC was extended to the end of 2006 and subsequently to December 2007 (CMC Dec. 34/06).

- Evolution -

Strictly speaking, the only substantive evolution in this area was, once again, the extension of the deadline granted to the GANAEC, "*until the last GMC Meeting of the second half of 2008*" (Article 1 of CMC Dec. 507/8).⁵⁸

⁵⁷ Non-application of the CET for capital goods enables Argentina, Paraguay, and Uruguay to apply lower import tariffs than Brazil, the only country that has truly significant domestic production in capital goods.

⁵⁸ The submission of a Brazilian proposal titled "Operating Procedures for the Common Regime for the Importation of Non-Produced Capital Goods in MERCOSUR" (XCIX CCM/WP 04/08) at the 99th CCM Meeting should also be mentioned.

In May 2008, Argentina requested a further extension of the deadline to maintain its incentives for two more years and its application should meet with no opposition from the other governments. In that same month, however, the Brazilian and Argentine representatives of the capital goods sectors (ABIMAQ and ADIMRA) signed an engagement contract in order to outline a common incentive regime. The two countries' representatives agreed over the advisability of developing a single entity to represent the MERCOSUR capital goods sector. To this end, representatives from the Paraguayan and Uruguayan capital goods sectors would also be invited. The following step would be the redesign of a common capital goods regime similar to the automotive regime, which would not only cover tariffs, but also the taxation system and credit incentives.

Nevertheless, the statements by the spokespeople of the sectoral entities are not totally consistent. The Argentine representative insisted on the importance of "*there being no difference between opening a factory in Brazil or in Argentina*", but questioned the harmonization of the incentives in the two countries, which, in Brazil's case, includes the concession of incentives for the state governments. On the other hand, the spokesperson of the Brazilian entity highlighted the importance of technological innovation and suggested the need to promote exchange for the breakthroughs made in each country, as well as bringing new technologies from third countries that can be incorporated into local production to give greater competitiveness to the machinery and equipment manufactured in the region.⁵⁹

Information technology and telecommunications goods

- Background -

The situation regarding information technology and telecommunications goods (ITTG) is quite similar to the one prevailing in capital goods.

At the end of 2003, CMC Dec. 33/03 stipulated the following:

- Instruct the CCM to negotiate a Common Information Technology and Telecommunications Goods Regime to be approved by the GMC by December 31, 2005.
- Before March 31, 2004, the States Parties should submit an ITTG list to the CCM, subject to quadripartite consultations, for which an aliquot of 0% could be applied up to December 31, 2005.
- Authorize Paraguay and Uruguay to apply an aliquot of 2% for extrazone ITTG imports up to December 31, 2010, with the exception of the tariff headings included in the previous list, whose aliquot, until the end of 2005, would be 0%.

At the end of 2005, the deadline for the CCM to negotiate a common regime was extended to December 31, 2006, and Paraguay and Uruguay's authorizations to import ITTG with an aliquot of 2% were extended up to December 31, 2011. On the other hand, the GANAEC is responsible for drafting a proposal to revise the CET for ITTG before June 30, 2006. This is to come into force as of January 1, 2006, but that it would have a convergence timeline that should be implemented as July 1, 2007.

⁵⁹ Jornal Valor Econômico [2008].

At the end of 2006, the GANAEC's deadline was extended to December 2007. As a result, the deadline to initiate the convergence timeline (January 1, 2008) and the deadline for the full validity of the new CET for ITTG (January 1, 2010) were also extended. Until the convergence program starts up, the States Parties will be able to apply the 0% aliquot, subject to quadripartite consultations. Finally, Paraguay and Uruguay's authorization (2% aliquot) was extended to December 31, 2012, (CMC Dec. 27/06).

- Evolution -

At the end of 2007, CMC Dec. 61/07 established a further extension of GANAEC's deadline and introduced certain modifications with regard to the previous extension:

- GANAEC's proposal regarding the revision of the CET will come into force for Argentina and Brazil as of January 1, 2011, and for Uruguay and Paraguay as of January 1, 2016.
- GANAEC's proposal shall include a convergence timeline that will be applied for Argentina and Brazil as of January 1, 2009.
- The CCM has a deadline of September 30, 2008, to negotiate a Common ITTG Regime, to be approved by the GMC by December 31, 2008.
- The States Parties will therefore be able to apply an aliquot of 0% to ITTG up to December 31, 2008, while respecting the procedure for quadripartite consultations. The deadline for Uruguay and Paraguay, however, to apply the 0% aliquot is extended to December 31, 2015.
- Also, Paraguay and Uruguay will be able to apply a 2% aliquot to extrazone ITTG imports up to December 31, 2015, excepting those goods whose tariffs are 0% by virtue of the previous provision.

D. Initiatives in strengthening regional production integration

Background

After weathering the severe regional economic and financial crisis of 1999-2002, two diagnoses begin to prevail in MERCOSUR: first, the recognition of serious and deeply-rooted asymmetries between the partners, whose treatment could not forgo the adoption of policies and instruments similar in essence (albeit not in scale) to those adopted in other integration processes, mainly the European experience; second, the verification that more than a decade after the constitution of the bloc, the coordination of production among the partners' economies was still fairly limited, which therefore required the adoption of public initiatives to strengthen regional production integration.

As described in the previous section, the issue of asymmetries was eventually formally incorporated in the bloc's internal agenda in 2003 after the intensification of the statements by the smaller partners. But in

production integration, there was no truly significant evolution.⁶⁰ The issue was cited recurrently, every time an increase in sectoral disputes between the two main MERCOSUR partners occurred. This was when the need to promote the formation of regional "value chains" became a commonplace.

The need to strengthen regional production integration is doggedly defended by Argentina. Even the mention of the production complementation agreements of the 1980s, central as they were to the Argentina-Brazil Integration and Economics Cooperation Program (PICE), is always present in local analyses that argue in favor of recovering that "foundational approach" and call for the issue to be reinstated on the bloc's internal agenda. In any case, as mentioned earlier, progress in this matter has been extremely timid, partly due to the wide variety of initiatives proposed and to the diversity of official applications or forums where this question is raised. These two factors demonstrate the intrinsic difficulty of designing and executing public regional policies in this area.

In fact, in line with the content of the previous Report, the debate surrounding the strengthening of production integration has embraced questions as wide and complex as the stimulus to form regional production chains, the coordination of scientific and technological policies, the drawing-up of instruments to promote joint ventures among small and medium enterprises (SMEs), the promotion of cooperatives, the creation of regional funds to finance the production sector, and many others.

The same Report mentioned the following initiatives adopted between mid-2006 and mid-2007, during the PPT of Brazil and Paraguay:

- * At the 30th CMC Meeting in July 2006, the MERCOSUR Secretariat received the request to design specific actions to coordinate production with the States Parties' public and private sectors, including a development program for regional suppliers' of Petrobras, a program to strengthen the automotive chain, and a program to create a business space to discuss the problem of production integration.
- * At the end of 2006, in the framework of SGT 7 (Industry), Brazil submitted an *Agenda Proposal for the MERCOSUR Development and Production Integration Plan* comprising six lines of action: (i) a regional human resources training program; (ii) national and regional financial support for production integration; (iii) the coordination of trade facilitation measures; (iv) the coordination of various WGs and committees; (v) the coordination of national SME development policy, and (vi) the follow-up on the production process, including integration the homogenization of statistics and the development of indicators.
- * In the first half of 2007, the *MERCOSUR Film and Audiovisual Sector Competitiveness Forum* (GMC Res. 24/07) was set up, which a similar initiative already in force in the timber and furniture sectors.
- * By mid-2007, when the 32nd CMC Meeting was held in Asunción, the GMC was requested to draw up proposals to form a *MERCOSUR Support Fund for SMEs* committed to production integration initiatives.

⁶⁰ Although the issue of production integration has evolved little on the MERCOSUR agenda, the importance of certain processes induced by the constitution of the extended market is undeniable, among them being intrafirm trade (mainly between regional subsidiaries of multinationals) and the increase in intrazone investment flows. The recent wave of Brazilian investments in the region is of particular importance. Both cases, however, have to do with big companies.

This basically constitutes the limited progress in the issue of "production integration" up to July 2007, when Uruguay's PPT began.

- Evolution -

Uruguay's PPT, during the second half of 2007, gave little priority to the issue of production integration, to such an extent that the Presidency Report made barely any mention of the issue.

Nonetheless, the 34th CMC Meeting (December 2007) approved CMC Dec. 52/07 which set up the *Ad Hoc* Production Integration Group (GAHIP) on the basis of the proposal submitted by Argentina at the GMC. The GAHIP was given the job of drawing up a **Production Integration Program** that takes into account (a) the Guidelines for Production Integration submitted by Brazil in SGT 7 (Industry); (b) the Pilot Production Integration Projects identified in the studies directed by the MERCOSUR Secretariat; and (c) the works developed in the framework of the Timber and Furniture Competitiveness Forum, as well as potential initiatives submitted in the recently created MERCOSUR Film and Audiovisual Sector Competitiveness Forum.

Strictly speaking, throughout the second half of 2007, the main focus of activity regarding the issue of production integration centered on the CRPM, which organized a seminar and a cycle of workshops to deal with the issue. The reports of existing projects were discussed at these events, various financial entities were invited (CAF, FONPLATA, IDB, etc.) to relate their experiences in SME support, and a document was drawn up on the issue ("*Contributions of the CPRM Presidency regarding the alternatives for the constitution of an SME Fund*"). The report of the CRPM Presidency, submitted at the end of 2007, also mentions a project to set up a Permanent Observatory for Production Integration in MERCOSUR to identify opportunities for SMEs and collaborate in the design of policies public to promote and strengthen production integration.

In the first half of 2008, Argentina's PPT chose production integration as the most important issue of its administration, an aspect underlined in the Presidency Report submitted at the 35th CMC Meeting, in June 2008 in San Miguel de Tucumán, Argentina.

Two decisions related to the issue of production integration were approved at that meeting:⁶¹

- a) CMC Dec. 12/08 approving the MERCOSUR Production Integration Program and creating the Production Integration Group (GIP), and
- b) CMC Dec. 13/08 setting up the MERCOSUR Support Fund for SMEs, whose first stage will implement a Guarantees System and set up an *Ad Hoc* Group to draw up a regulatory framework for this mechanism.

In addition, the Annexes of the Minutes to the 35th CMC Meeting record two preliminary proposals by Brazil for projects to be submitted to the FOCEM: the *Program for Automotive Intensification and*

⁶¹ The report by Argentina's PPT included CMC Dec. 03/08 in the issue of productive integration, which approves a Framework Program of Science, Technology, and Production Innovation, discussed in another section of this chapter.

*Complementation in MERCOSUR and the MERCOSUR Program for Supplier Development for the Petroleum and Gas Sectors.*⁶²

Last, the CRPM Presidency Report also submitted in Tucumán carries out a further institutional proposal consisting of the creation of a "MERCOSUR Agency for the Promotion of Production Integration" (AMPIP) to promote policies and actions that encourage production complementation.

a) MERCOSUR Production Integration Program (PIPM) (CMC Dec. 12/08)

The MERCOSUR Production Integration Program seeks to embrace a wide and varied group of preexisting initiatives under one umbrella program.

The Program's **justification** mentions that production integration in MERCOSUR currently encounters obstacles arising from differences of scale, asymmetries in technological development, as yet unharmonized national schemes, market failures, inadequacies in companies to tackle associative schemes, difficulties in access to funding, non-tariff border barriers, and so on. Consequently, it proposes sectoral intraindustrial cooperation as a key element in overcoming these obstacles.

The general Program's **objective**, which makes room for no less than 17 specific objectives, is to "*contribute to strengthening the production complementarity of MERCOSUR companies and, especially integration in the production chains of SMEs and companies from economically smaller countries in order to deepen the bloc's integration process*" (p. 2 of the PIPM).

Notable among the **actions** contemplated by the Program are seven lines of action at the horizontal level and two types of sectoral initiative. The **lines of action at the horizontal level** are clearly based on six actions described in the document duly submitted by Brazil in SGT 7 (Industry), plus institutional suggestions submitted by the CRPM Presidency along the following lines:

1. Cooperation between the national organizations/entities coordinating the instruments linked to the development of companies, in particular micro and SMEs to support the production integration process;
2. Complementation of instruments and national entities linked to research and development and technology transfer;
3. Regional Human Resources Production Integration Training Program;
4. Coordination with other instances of MERCOSUR, such as the FCES, the CRPM, the MERCOSUR Parliament, and the Consultative Forum of MERCOSUR Municipalities, Federated States, Provinces, and Departments (FCCR);
5. The creation of a Permanent Regional Observatory on Production Integration in MERCOSUR (ORPIP) whose structure and operating model will be defined by the GIP and approved by the

⁶² Annexes X and XV of the Minutes.

GMC. However, some of its functions are stated in advance: (a) setting up and maintaining a Geographical System of MERCOSUR Production Information; (b) designing and maintaining panels with production integration indicators and measurements; and (c) drawing up periodic reports on production integration;

6. Trade facilitation measures to eliminate obstacles (logistical flaws, border obstacles, the absence of technical standardization, etc.) that hold back the integration of production chains; and
7. Funding and cooperation (funding lines for intraregional investment in support of joint ventures, the installation of plants, or the expansion of investments already made).

In terms of **actions at the sectoral level**, the Program incorporates two initiatives already under way:

1. The MERCOSUR Production Chains Competitiveness Forums, including the already ongoing Timber and Furniture Competitiveness Forum, as well as the possibility of the GIP proposing the creation of further forums; and
2. The sectoral production integration initiatives, for which a methodology is defined that makes explicit the forms of representation and coordination for government representatives and production sectors involved in such initiatives. The initiatives under way are explicitly mentioned, that is: the Development Program for Suppliers of the Petroleum and Gas Sectors, the Executive Group for Automotive Chain Production Integration (GEIPA), the Tourist Routes Program, and the MERCOSUR Program for Business Coordination for Production Integration.

The Program concludes with the definition of the GIP's tasks: coordinating, proposing new lines of action, drawing up reports, and even the analysis of the CRPM Presidency's proposal on the possibility of creating a "MERCOSUR Production Integration Promotion Agency".

The main merit of the Program is to have gathered a high number of initiatives under the supervision of a single group, the GIP. It is worth pointing out, however, that the tasks allocated to the group are highly coordination-intensive. By way of example, there is the suggestion, included in the Program, to set up a regional network that links entities providing support for companies, mainly small and medium operating in Argentina (SIC, SAGYPA, SEPYME, and Pro-Argentina), Brazil (SEBRAE, ABDI, and SENAI), Paraguay (ONA, INTN, INAN, SENAIVE, and SENACSA) and Uruguay (DNI and DINAPYME).

In terms of production integration initiatives, those centering on the automotive chain and the petroleum and gas sectors are certainly the most important (see Boxes E and F). In this sense, three aspects are worth highlighting: (a) the initiatives show a clear willingness on Brazil's part to meet the demands of the other

members of the bloc; (b) the initiatives recognize that the participation of the private sector is absolutely indispensable and rate it as the main actor in the production integration process, and (c) the initiatives show a clear concern not to marginalize the smaller economies.

Box E

PROGRAM FOR AUTOMOTIVE INTENSIFICATION AND COMPLEMENTATION IN MERCOSUR

The tentative proposal for the **Program for Automotive Intensification and Complementation in the Ambit of MERCOSUR** submitted to the FOCEM by Brazil in June 2008 during the 35th CMC Session in Tucumán, Argentina, with the backing of the Brazilian Ministry of Development, Industry, and Foreign Trade (MDIC), indicates the Brazilian Agency for Industrial Development (ABDI) as the executing organization and proposes the agency's president, Dr. Reginaldo Arcuri, as responsible for its implementation. To formalize it in the framework of the FOCEM the project is linked to Program II (Program of Competitiveness Development) and, more specifically, with the component "Promotion of production chain development in dynamic and differentiated economic sectors".

The proposed Program will be regional in scope, viewing the four MERCOSUR member countries as beneficiaries. Nevertheless, the Program does foresee the "later and progressive insertion of Venezuela". The Program's costs are calculated in principle at US\$3.5 million for the activities to be developed between the second half of 2008 and the end of 2010. The FOCEM's contribution is estimated at between US\$1.6 million and US\$2 million, i.e. 46% and 57% of the project's total cost.

The Program is grounded in the importance of the automotive sector and its production chain in the industry of MERCOSUR, the size of the regional market, and the capacity of the production system to broaden its conditions of competitiveness against other regional blocs (EU, NAFTA, and Asia). The Brazilian government is mentioned specifically as the author of the initiative and the indispensable participation of the private sector is stressed (business associations, union representations, and civil society organizations).

The project's technical description envisages four themes or components: (i) institutional strengthening, (ii) the promotion of competitiveness, (iii) information systems for trade integration, and (iv) support for innovation and technological development.

In **institutional development**, the Program proposes as the main objectives consolidation of the Executive Group for Automotive Chain Production Integration in MERCOSUR (GEIPA), the comparative study of national industrial policies, and the holding of a Seminar on MERCOSUR Automotive Policies. The GEIPA, *"as its fundamental characteristics, will have consensus in the definition of the common objective, the presence of significant institutions and leaderships in the nucleus of coordination, the definition of concrete targets, the building of trust as a basis for growing cooperation, systematic progression on the basis of a negotiated agenda, and flexibility in the formation of thematic subgroups"*.

The development of local suppliers of the automotive chain will be the focus of the **competitiveness** component. Among the objectives listed are the formation of technical teams for manufacturing, small-scale supplier training via managerial and technological training, and, as a more general objective, the strengthening of subregional production agreements.

In relation to the development of **information systems for trade integration**, the objective is to give greater visibility to business opportunities and provide local suppliers with more possibilities to participate in regional purchasing of autoparts and subsystems. In the instrumental aspect, the implementation has been mentioned of a temporary showroom for autoparts makers, the holding of business wheels and trade missions, and the assembly of an information system on trade supply and demand, technology, and innovation in the ambit of MERCOPARTS. Increasing Uruguay and Paraguay's share in the automotive chain is mentioned as a specific objective.

Last, in the **support for innovation and technological development** component, the objectives include the holding of training programs in innovation management, the coaching and training of technical teams, and the integration of research, development, and engineering activities involving assemblers, systems suppliers, and autoparts makers.

Box F
MERCOSUR PROGRAM FOR SUPPLIERS DEVELOPMENT
FOR THE PETROLEUM AND GAS SECTORS

As in the previous case, the tentative proposal of the **MERCOSUR Program for Supplier Development for the Petroleum and Gas Sectors** was submitted by Brazil in June 2008 during the 35th CMC Meeting in Tucumán, Argentina. The proposal was sent by the Brazilian Agency for Industrial Development (ABDI) and is linked to various components in the FOCEM's Program II (Program of Competitiveness Development).

The proposed Program will be regional in scope and will have the four MERCOSUR member countries as beneficiaries. The proposal states that Argentina, Paraguay, and Uruguay *"will benefit from the four components of the project (competitive intelligence; innovation and technology; information coordination and dissemination; management and competitiveness), while Brazil will only benefit from the competitiveness management component through the creation of a network of cooperation, learning, and compatibilization and harmonization of technical standards"*.

The proposal submitted in Tucumán does not define the Program's costs. Its central actor is Petrobras, considered the largest anchor company in MERCOSUR's petroleum and gas sectors, although it does not exclude participation by other large companies operating in the sector, such as Repsol-YPF. The document defines the anchor company as *"a large company that utilizes a vast number of suppliers of goods and services with which it establishes a formal contractual relationship, but which also involves a process of exchange and learning that occurs in accordance with the positioning of the company and of a business attitude dedicated to improving the economic, social, and environmental scenario in which it finds itself"*. In the case of Petrobras, the company currently acquires most of its inputs from companies established in Brazil. Even in the 18 countries in which it operates, with the sole exception of the USA, Petrobras *"has to import the vast majority of the goods it utilizes or to acquire them from foreign suppliers established in its place of operation, due to the difficulty of finding local suppliers that meet the requirements demanded by the sector"*. As Petrobras operates both in Argentina, and in Uruguay and Paraguay, the objective of the Program would be to privilege local suppliers who will nevertheless have to meet the international requirements and standards.

The proposal describes the type of operation of Petrobras in each of the MERCOSUR member countries. The company has been operating in Argentina since 1993 and its current activities span the exploitation and production of petroleum and natural gas, refining and prosecution, the distribution of derivatives, administration of the pipeline network, and petrochemical activities. The company has a network of approximately 720 service stations and operates in all of Argentina's active petroleum and gas fields, as well as having exploratory rights in 21 blocs and 25 petroleum fields. Petrobras has been operating in Paraguay since 2006, when it acquired Shell's business related to fuel operations (retail and commercial market). The acquisition included service stations, the commercialization of LPG, and of aviation products at the Asunción and Ciudad del Este airports. Last, Petrobras has been operating in Uruguay since late 2004, distributing natural gas within the country. The distributor controlled by Petrobras (Distribuidora Uruguay Conecta) has exclusive rights in the distribution of natural gas by gas pipeline, LPG, and gas manufactured outside the capital, Montevideo.

As already mentioned, the project's technical description highlights four components. The first **component**, competitive intelligence, aims to survey companies making up the regional petroleum and gas production chain with a view to identifying potentialities, weaknesses, and business opportunities. Indeed, this surveillance would detect companies interested in becoming suppliers of the chain, identify real opportunities, verify the level of employee training and the management aspects of applicant companies, as well as learning the main difficulties faced by the anchor companies (Petrobras and Repsol-YPF from Argentina) in the acquisition of goods and services. The second component, **innovation and technology**, centers on the training of suppliers (permanent and stand-by staff) in the areas of administration, foreign trade, and development and innovation support. The third component, **coordination and dissemination of information**, comprises the mobilization of the anchor companies in terms of giving preference and stimulating the acquisition of goods and services from national rather than foreign companies. The fourth and last component of the Program, **competitiveness management**, aims to stimulate supplier organizations to create formal channels of liaison and define criteria for the international codification of technical standards.

The Program stresses that Brazil already has highly-developed know-how in the implementation of these components. Therefore, the proposal suggests replicating the methodology applied in this country in the project of "Internationalization of the Production Chain of Petroleum, Gas, and Energy", as a result of an agreement between Petrobras and the Brazilian Service of Support for Micro and Small Enterprises (SEBRAE). Two other Brazilian projects are also mentioned, which may serve to orientate the Program: (i) the "Trade Promotion Program for Exports in the Petroleum and Gas Segment", jointly developed by the Brazilian Trade and Investment Promotion Agency (APEX) and the National Organization of the Petroleum Industry (ONIP), which aims to increase the export capacity of companies in the sector; and (ii) the "Mobilization Program for the National Petroleum and Natural Gas Industry" (PROMINP) whose objective is to increase the participation of Brazilian industry, on a competitive basis, in the implementation of petroleum and gas projects both in Brazil and abroad.

b) Support Fund for Small and Medium Enterprises (SMEs) (CMC Dec. 13/08)

At the 33rd CMC Regular Meeting in Asunción at the end of the first half of 2007, the CMC decided to commission a proposal from the GMC with alternatives for the constitution of a MERCOSUR SME Support Fund (CMC Dec. 22/07).

In September 2007, the CRPM Presidency submitted a report at the GMC Meeting entitled "*CRPM Presidency Contributions regarding the alternatives for the constitution of the SME Fund*".

In this report, the CPRM related that it organized a workshop, which met on three occasions with the participation of members of the SGT 7 (Industry), representatives of the States Parties linked to organizations responsible for implementing public policies geared to SMEs and officials from various different national and regional financial institutions. The report set out the Fund's objectives, instruments, and sources of finance. In terms of objectives, it stated that the central one must be the improvement of SMEs' access conditions to regional and international markets, the promotion of investments to increase their competitiveness and enable the diversification of products and processes, and the development of innovations through associative strategies between companies.

In terms of funding, the report listed funding lines for projects with various different characteristics: support for the generation of regional value chains, insertion in third markets, joint purchasing of capital goods, quality certification, supplier development, etc.

In terms of the possible, but not exclusive, sources of financing, the report offered three options: (i) the States Parties' budgetary resources, in order to set up a fund similar to the FOCEM, or of creating a subprogram within the FOCEM itself; (ii) the use of resources available in regional credit organizations, such as IDB, CAF, and FONPLATA; and (iii) the extension of credit lines by local public banks.

Finally, the CRPM President's report recommended that the Fund begin to operate by implementing pilot projects.

In January 2008, the Brazilian government submitted its ideas and suggestions to the GMC "*which may undergo modification as the debate on the issue deepens*".⁶³

If it is compared to the suggestions previously submitted by the PCRPM, the Brazilian proposal must be considered clearly "minimalist", as it only suggests setting up a Fund that will give guarantees to support accredited banks granting loans to Small and Medium Enterprises. The proposal leaves the credit analysis of beneficiaries up to the banks, as well as the decision on the use of the Fund. What is more, the guarantee will not be complete, but may represent a significant part of the funding. The proposed model suggests establishing a Management Council made up of representatives from the States Parties, preferably linked to public financial institutions or supportive of industry, as well as creating an administrative organization.

In Tucumán, CMC Dec. 13/08 supported the Brazilian proposal by opting for the creation of a Fund "*that will implement a System of Guarantees in its first stage*". Through this decision, an *Ad Hoc* Group is also created, which is to submit a draft Statute for the System of Guarantees before the CMC at its last regular meeting of 2008. Even so, the possibility of opting for other modes of funding for SMEs involved in production integration processes is not being discarded. Indeed, it will be the *Ad Hoc* Group's job to go into the issue

⁶³ LXXI GMC/ID 02/08. "Possible ideas for an operating model of the MERCOSUR Fund for Small and Medium Enterprises".

more deeply and submit a preliminary report to the GMC in the second half of 2008 in order to explore additional alternatives.

E. Local Currency Payment System (SML)

Background

The discussion about the use of local currencies in transactions between Argentina and Brazil began in 2005, after verification of the importance of bilateral international trade and empirical corroboration of the existence of transaction costs associated with operations that were effectively limiting small companies' access to bilateral trade.

Indeed, commercial trading between the two main MERCOSUR partners represents on average 80% of intrazone trade, reaching US\$24.8 billion in 2007. On the other hand, the surveys carried out in a joint document elaborated by the central banks of Argentina and Brazil showed that, in 2006, over 5,000 Brazilian companies imported products from Argentina across approximately 3,000 tariff lines. In terms of exports, the figures were even higher: in the same year, approximately 5,800 companies exported products to the Argentine market across 4,600 tariff lines. The aforementioned document highlighted the lack of low-cost financial instruments for peso-real transactions, while pointing out that the transaction costs were obstacles that restricted and discouraged SME access to bilateral trade (Borba & D'Orio [2007]).

The work by the two countries' central banks to develop a mechanism allowing foreign trade operations in local currencies, thus meeting the objectives to simplify and debureaucratize bilateral exchange, underwent various stages.

In 2005, the international experience was evaluated (USA, Europe, Mexico, Canada, and others) in order to understand the workings of the mechanisms already under way with a view to identifying a model better adjusted to the objectives and conditions prevailing in both countries. The characteristics, workings, and instruments available in the two countries' markets were also researched in order to verify the existence of similar mechanisms. In that case, these did not need to be developed, but merely finetuned.

It was stipulated that the establishment of a local currency clearinghouse for Brazil and Argentina aimed to: (i) facilitate financial settlements in local currencies between the two countries; (ii) increase liquidity and efficiency and, consequently, deepen the real-peso foreign exchange market; (iii) reduce the costs of transactions and thus increase the level of access to trade for the small and medium agents; and (iv) move forward in the regional integration process by familiarizing agents with local currencies.

The deepening of the discussions helped define the desirable characteristics for a local currency clearinghouse and certain premises were established as a result:

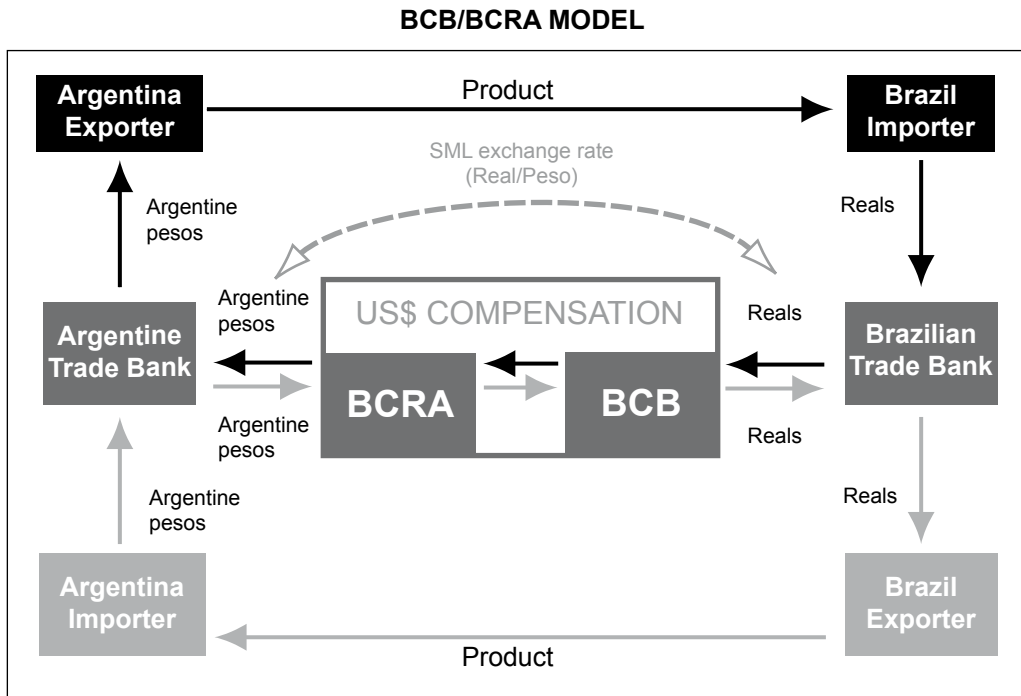
- Voluntary participation by agents.
- Absence of credit risk.
- Absence of risk of exposure to local currencies.

- Absence of subsidies for participants.
- Absence of arbitration between currencies within the clearance system.

In short, it was agreed to develop a clearance and securities transfer system that would incorporate no risk or financial coverage mechanism between the participants.

In this clearance system, unlike the foreign exchange market, the agent of international trade would transfer/receive currency local to/from the intervening financial institution. In turn, the financial institution would transfer/receive local currency to/from the central bank and the clearance between reals and pesos would take place on a daily basis in the ambit of the central banks.

The following outline illustrates the clearance system agreed:



Source: BCB and BCRA.

Once the characteristics of the system to be set up were defined, the central banks, in August 2006, defined the stages needed to carry out their operation. The work plan envisaged: (a) meetings with exporters and importers from both countries; (b) meetings with both countries' private banks; (c) a survey of the changes needed in the two countries' foreign exchange legislation; (d) foreign exchange rates model tests; (e) development of the technological infrastructure needed for the clearinghouse to operate, and (f) the precise definition of the terms of the agreement to create the clearinghouse, including rules, restrictions, operating modes, etc.

One aspect that demanded attention from the formulators of the Local Currency Payment System (SML) was the need to preserve the absence of risk for central banks as a basic principle of the system. In this sense, when the contingency procedures was analyzed in more depth, questions arose about the system's operative continuity in the face of foreseeable eventualities, such as human or operational errors, technological flaws, situations where payments for smaller amounts were attested, or even the absence of payment of the results of the daily clearing.

In the case some of these eventualities, the only solution that would produce no risk for the central banks would be settlement of the operations recorded in the SML, which, however, would compromise the system's credibility. It was therefore concluded that it was necessary to establish a "contingency margin" among the central banks. It was agreed that there would be interest on this margin's value, calculated at LIBOR + 1%, a level established to discourage the use of said mechanism. It was also ruled that the contingency margin would initially be established on an estimated basis, according to which approximately 15% of the volume of Brazilian-Argentine trade would migrate to the new mechanism, a percentage applied to the weekly average of the balances between the payments and charges arising from the commercial transactions between the two countries.

Last, it was agreed that the daily SML rate would be calculated on the basis of real-dollar rates (PTAX Interbank Rate released daily by the Central Bank of Brazil) and peso-dollar rates (Benchmark Rate released by the Central Bank of Argentina) and that the financial settlement would be performed within three working days (D+2).

The formalization of these agreements in the ambit of MERCOSUR followed the sequence described in the previous Report and summarized below:

- In July 2006, on the occasion of the Presidents Summit in Córdoba City, Argentina, a Letter of Intent was signed, defining the lines of a pilot project for a mechanism to allow foreign trade transactions to be carried out in local currency.
- Subsequently, at the 31st CMC Meeting CMC Dec. 38/06 was approved, which stipulated carrying out studies to develop a mechanism with these characteristics to be initially implemented at bilateral level in Brazil-Argentina trade. If the new system works satisfactorily, it could be extended to any other MERCOSUR countries that so desired.
- The next step was in the framework of the Asunción Summit, when CMC Dec. 25/07 was approved, which created the SML for trade between MERCOSUR States Parties. It also was stipulated that this system's transaction conditions would be optional and would be defined via voluntary bilateral agreements between the respective countries Central Banks.
- This Decision was established by the 59th Additional Protocol to ECA 18 in the ambit of LAIA, the adoption of the procedures needed to incorporate it in their respective legal systems being left to the two countries.

Evolution

In 2008, it was announced that, after a trial period, the SML would come into operation during the second half of that year. In Brazil, more than ten banks were to participate in the tests.

On June 26, 2008, the Provisional Measure 435 was enacted, authorizing the Central Bank of Brazil "to provide credit to the Central Bank of the Argentine Republic up to a limit of US\$120 million in the form of a reciprocal contingency margin in the ambit of the Local Currency Payment System (SML)".

Finally, on September 8, 2008, on the occasion of President Cristina Kirchner's visit to Brazil, the two countries' central banks announced the signing of the "Local Currency Payment Convention between the Argentine Republic and the Federative Republic of Brazil".

The Convention sanctioned the previous commitments between the central banks, highlighted the voluntary nature of the mechanism, and made explicit the central banks' desire not to take on risks:

- *"The disputes between importers and exporters, between exporters and the relevant Authorized Entities, or among Authorized Entities regarding the registration or execution of payments made via the SML will be directly resolved among them, the Central Banks taking no responsibility for the differences or damages such disputes may cause"* (Clause Ten).
- *"The SML is not a foreign exchange risk coverage mechanism. The Central Banks take on no reciprocal credit risk, with the exception of the provisions in Clause Thirteen, nor credit risk of its country's Authorized Entities"* (Clause Fourteen).

The above exception is in fact related to the contingency margin:

- *"The Central Banks shall, by common agreement, establish a reciprocal potential margin to be used in accordance with the Operative Regulations"* (Clause Thirteen).

On September 2008, 11 the Central Bank of Brazil circulated Res. 3,608, which included some provisions clearly geared to facilitating bilateral transactions to the benefit of private individuals and/or small companies. It is worth highlighting at this point the exemption from presenting commercial transaction documentation in transactions whose value in reals should not exceed US\$3,000, as well as the possibility of collecting cash values not above R\$10,000.

The Resolution will come into force on October 3, the date announced for the start of the operation of the new system.

Finally, when the new system was announced, the authorities of the Central Bank of Brazil released the following information:

- * The expectation of a reduction in the transaction costs under the operation of the SML was estimated at approximately 4%.
- * Adherence to the new system was estimated at between 10% and 20% of the daily movement of bilateral trade, currently in the order of US\$120 million.
- * The initial value of the credit line (contingency margin) in favor of the Central Bank of the Argentine Republic would be set at US\$10 million.

On September 26, 2008, Argentina, for its part, released Communiqué 4,847 through the BCRA on the same issue.

The creation of the mechanism was welcomed in both countries. In Brazil, it was highlighted that SMEs would benefit from the reduction in costs, even though this advantage was slight due to the absence of a genuine real-peso parity and the requirement of the dollar for triangulation. The optimists pointed out that the new system of payments also had a symbolic value, representing as it did the first step toward the establishment of a single currency in MERCOSUR.

F. The MERCOSUR Parliament

Background

The constitution of a MERCOSUR Parliament was the subject of discussion among the members of the old Joint Parliamentary Commission (CPC) for almost three years.

In 2003-2004, the CMC took two important decisions: first, CMC Dec. 26/03, which included in the "2004-2006 MERCOSUR Work Program" the objective to constitute a Parliament in the ambit of MERCOSUR; second, CMC Dec. 49/04, in which it was formally decided to go ahead with the creation of the MERCOSUR Parliament as the representative organ of the peoples of the States Parties. On that occasion, it was decided that the Parliament would be governed by the provisions of its Constitutive Protocol and would form part of MERCOSUR'S institutional framework. CMC Dec. 49/04 vested the Joint Parliamentary Commission with the responsibility of drawing up the Draft Protocol and December 31, 2006, was established as the date of its effective establishment and the winding-up of the CPC.

The CPC drew up the Constitutive Protocol of the MERCOSUR Parliament (PCPM) and submitted it to the CMC at the end of 2005, whereupon it was approved (CMC Dec. 23/05). The last step included in CMC Dec. 49/04 was taken at the end of December 2006 with the effective establishment of the MERCOSUR Parliament.

The Protocol enshrined the principle of "civic representation" (Art. 5), a criterion that still lacked a more precise definition, as it would have to be drawn up by the Parliament itself, but which was different from States Parties' principle of equal representation, the kind of representation that had prevailed in the CPC and would prevail in the Parliament until the implementation of the new criterion. In short, civic representation would turn the Parliament into something different than the other organs of MERCOSUR, where representation was always governmental.

The election mechanism for MERCOSUR parliamentarians through universal, direct, and secret ballot, adopted by the Protocol (Art. 6), enshrined the principle of democratic legitimacy. The expectation is that this mechanism will contribute to building a regional identity. The constitution of the Parliament is also expected to lend greater legitimacy to the community rules. Many of these rules can currently only be incorporated through approval by the respective legislative bodies, but their legitimacy is nevertheless widely questioned on the basis of the inadequacy of the debate preceding their approval. It is worth pointing out, in this respect, that one of the Parliament's main powers is to do with its advisory capacity (Art. 4, Section 12). Through this power, the Parliament is entitled to draw up reports on all draft rules under negotiation. In exercising this capacity, the

Parliament can organize public hearings to debate any rules being processed with civil society. The Parliament's performance can therefore strengthen the legitimacy and transparency of the integration process.⁶⁴

Under Article 1 of the Protocol, the Parliament will be constituted out in stages, defined explicitly in the Temporary Provisions. The period from December 31, 2006, the date of the Parliament's establishment, and December 31, 2010, forms the "first transition stage". At this stage, the Parliament is made up of 18 parliamentarians per State Party. The national legislative bodies choose these parliamentarians and each Parliament defines the modalities and criteria for the choice. Its mandate lasts four years.

Before the end of the first transition stage, the criterion of "civic representation" will be defined and approved so that the States Parties can set about electing the national parliamentarians of the following legislature through the election mechanism of universal, direct, and secret ballot. The election of parliamentarians in the States Parties must be completed by the end of December 2010, so they can take up their functions at the start of 2011, but the precise date of this election is depends on each State Party's electoral calendar.

The second transition stage will last four years, from January 1, 2011, to December 31, 2014. It is worth pointing out that, by this stage, the Parliament will already be made up of legislators elected by universal, direct ballot. Before the end of 2012, it will be the Parliament's job to propose a date to the CMC for holding simultaneous elections in the States Parties to elect the parliamentarians in 2014 for the next legislature (2015-2018). "Civic MERCOSUR Day" will thus be established, and the first simultaneous elections will take place before December 31, 2014, when the second transition stage draws to a close.

Evolution

In August 2007, the Parliament approved its Internal Regulations, establishing the organization of ten permanent thematic commissions and including ways of participating in organized society. To this end, the Regulations contemplate the holding of public hearings and seminars with the participation of civil society. More precisely, Article 83 of the Regulations states that any Commission "*may hold public meetings with civil society organizations, production sectors, NGOs, and social movements in order to deal with matters concerning its area of performance, via a proposal by any member or at the request of an entity or interested sector*".

On the other hand, the Regulations (Art. 33 and subsequent) determine the rules for the formation of "policy groups". The expectation is that the formation of these groups, based on political and ideological affinities between members of the various different national representations, should encourage a community vision that goes beyond the limits of a merely national approach. It is hoped, therefore that the Parliament will be a counterweight to intergovernmental approach adopted by the other MERCOSUR organs.

In line with the Regulations, for a political group to be formed it must contain at least (a) 10% of the Parliament's members if they are representatives of a single State Party, or (b) 5 parliamentarians if they are representatives of more than one State Party.⁶⁵

⁶⁴ It should be pointed out, however, that the sanction of MERCOSUR rules is restricted to the ambit of the CMC, as the MERCOSUR Parliament has no legislative powers in the ambit of the community.

⁶⁵ For the time being, just one political group has been formed, the National Party, made up exclusively of eight Uruguayan parliamentarians.

The Regulations also stipulate that no parliamentarian may belong to more than one political group at a time.

But the MERCOSUR Parliament's main task in this first transition stage is to precisely define the criterion of civic representation. In effect, in line with the Protocol, the criterion of proportionality "*will be established by Decision of the Common Market Council after proposal by the Parliament adopted by qualified majority. This Decision will be approved by December 31, 2007, at the latest*" (Article 2 of the Temporary Provisions). Qualified majority was defined as the affirmative vote of the absolute majority of members of the parliamentary representation of **every** State Party.

The deadline set by the Protocol was not met and, by decision of the Parliament and the CMC, it was extended to December 31, 2008. The lateness in defining the criterion of proportionality demonstrates the difficulty faced by the States Parties to agree a different form of representation to equal representation for the first time.

The delay has already given rise to an unprecedented situation, as Paraguay held elections in April 2008 and, anticipating the definition of the criterion of proportionality, opted unilaterally to elect 18 parliamentarians. This floor is viewed as high, even in the almost inevitable eventuality that the form of representation chosen will be proportional representation (RP), similar to that in the European Parliament.

It is a matter of urgency to define the criterion of proportionality before the end of 2008, for, once this has been agreed, each State Party will define its internal proportionality and the electoral law that will regulate the election. These definitions must, in turn, respect the States Parties' electoral schedules. Uruguay and Argentina will be having elections in 2009. Brazil, for its part, will define internal proportionality by law in 2009 so that the election of its representatives can be held in 2010.

It should be noted in this sense that the Brazilian Constitution does not provide for elections to institutions or entities outside its borders. Consequently, the definition of the number of parliamentarians in the Brazilian representation requires the drafting of a law, which will also stipulate whether the electoral district will be state, regional, or national.

The difficulty in defining the criterion of proportionality lies in the reluctance of the smaller countries to establish a direct link between the size of each country's population (which varies from 3 million in Uruguay's case to 180 million in Brazil's) and the number of its seats. If this were to happen, the largest partners would have a far greater number of seats than the other countries. The concern, therefore, is that the smaller countries will be politically "swallowed up" by the larger countries, mainly by Brazil. This difficulty even raises the suspicion that the Parliament may modify the temporary provision that determines the deadlines for its ultimate constitution, which would make explicit "*the incapacity or lack of will of the States to strike up substantial political agreements*" (Casal [2008]).

Currently, a Draft Rule is being put through the Parliament, whose secretary is its current President, Dr. Rosinha, a member of the Brazilian representation. The draft adopts "*the criterion of attenuated representation, which starts from a floor and adds seats for each population group above the floor at increasingly wider intervals in order to favor the desired attenuation in proportionality*", in accordance with the justification of the draft.

TABLE 17
DISTRIBUTION OF SEATS IN THE MERCOSUR PARLIAMENT
 (Based on the criteria of the Draft Rule)

Countries	Inhabitants	Seats	Inhabitants per MERCOSUR parliamentarian ^{a/}
Brazil	183,987,291	75	2,529,930
Argentina	39,531,000	33	1,197,909
Paraguay	6,127,000	18	340,388
Uruguay	3,340,000	18	185,555
Venezuela	27,657,000	27	1,024,333
<i>Total</i>	<i>260,642,291</i>	<i>171</i>	<i>1,557,893</i>

Note: ^{a/} In the case of Brazil, there is an inconsistency in the source between the total and the coefficient of representation.

Source: Dr. Rosinha [2008].

The Draft Rule also provides that the entry of any new State Party in MERCOSUR will involve revision by the CMC and at the suggestion of the Parliament of the number of seats corresponding to the representation of each member country, which will come into effect in subsequent elections.

At present, discussion of the Draft Rule is the MERCOSUR Parliament's main task.

G. Other issues on the internal agenda

Venezuela's membership of MERCOSUR

Venezuela's membership of MERCOSUR is still pending approval by the Paraguayan and Brazilian congresses. The President of Venezuela requested approval of the Adherence Protocol immediately after the Paraguayan President took office. In spite of the interest in this approval shown by the Brazilian and Paraguayan governments in their respective congresses, no serious progress has yet been over issue in the two countries' legislative bodies.

Recently, Brazil's Minister of Foreign Relations declared that he would strive to have the Protocol of Adhesion approved by the Brazilian Congress in 2008. After being approved by certain commissions, the Protocol will be voted on in a plenary session of the Chamber of Deputies, after which it will be sent to the Federal Senate. The period of municipal elections in Brazil, which lasts until mid-November, added to the backlog of projects being processed in the Brazilian Parliament furnishes little hope that this objective will be achieved.

Institutional reforms

In December 2005, the CMC created a High Level *Ad Hoc* Group for Institutional Reform of MERCOSUR (GANRI) within the space of a year (CMC Dec. 21/05). The deadline was excessively short and its scope too broad.

By mid-2006, the CMC issued another decision that was wide and vague in its scope, this time instructing the GMC to "*identify the level of evolution of the institutions and principles of MERCOSUR in light of the objectives of the Treaty of Asunción, and the evolution of their derived rules*" (CMC Dec. 22/06). In the same rule, the CMC states that the institutions and principles to be evaluated are: free circulation, the common trade policy, macroeconomic, sectoral and investment policy coordination, the application of regulations, and social matters.

At the end of 2006, once the GANRI's initial deadline was up, the CMC recognized that "*owing to the complexity and breadth of the issues considered*" the deadline needed to be extended (CMC Dec. 29/06). This time, however, the CMC defined a set of priority issues, implicitly abandoning the demand for an integral proposal by admitting the possibility of the GANRI sending proposals (in the plural) to the CMC. The guidelines for institutional reform defined by the CMC were now:

- To restructure MERCOSUR's decision-making organs and subordinate forums, including their jurisdiction.
- To finetune the system of incorporation, effectiveness, and application of the MERCOSUR regulations.
- To analyze the creation of potential organs in the ambit of MERCOSUR in order to negotiate common policies.
- To optimize the functions and jurisdiction of the MERCOSUR Secretariat in line with the process's needs.
- To finetune the MERCOSUR dispute settlement system and strengthen its institutional organs.
- To adopt a budget that will integrally finance MERCOSUR's institutional framework.

The deadline set for the GANRI was again one year, until the end of 2007.

In January 2007, the CMC commissioned the GANRI to send a proposal for adjustments to the Protocol of Olivos before the end of 2007. However, five months later, it opted to extend this deadline to June 2008.

At the end of 2007, the CMC granted the GANRI a fresh extension, deferring the deadline to June 2009, but called on the Group to submit proposals before June 2008 on four issues detailing and restricting the scope defined at the end of 2006 (CMC Dec. 56/07):

- The restructuring of MERCOSUR's decision-making organs and their subordinate forums, including their jurisdiction, which, among other things, contemplates the functions of support for MERCOSUR States Parties' Permanent Representations and adjustments to the CMC Regulations.

- The finetuning of MERCOSUR's dispute settlement system and the strengthening of its institutional organs, including the works in the framework of CMC Dec. 17/07 relating to a proposal for adjustments to the Protocol of Olivos.
- The finetuning of the system of incorporation, effectiveness, and application of the MERCOSUR regulations.
- A MERCOSUR budget that, at this stage, must provide for the budgetary requirements of the MERCOSUR Secretariat and the Permanent Review Tribunal Secretariat.

Until June 2008, the results obtained by the Institutional Reform were restricted to two CMC Decisions (CMC Decs. 54/07 and 14/08) and to administrative measures of a budgetary nature mentioned in the report submitted by Argentina's PPT in San Miguel de Tucumán.

CMC Dec. 54/07 extended the functions of the Permanent Representatives accredited by the States Parties in Montevideo, allowing them to attend the GMC when requested. To this effect, they will be able to meet in the headquarters of the MERCOSUR Secretariat under the coordination of the State holding the PPT.

CMC Dec. 14/08, on the other hand, modifies the CMC's Internal Regulations in order to institutionalize the participation of Ministers attending MERCOSUR Ministerial Meetings in the bloc's supreme organ to deal with the matters in their respective jurisdictions. To this effect, the regular meetings of the CMC will be held in three sessions.

The first session will be held with the Ministers of Foreign Relations and the Economy or their counterparts in the States Parties. In view of the issues on the agenda, a second session will be held, in which, alongside the Ministers of Foreign Relations and the Economy or their counterparts, the similar-ranking Ministers or authorities appointed by each State Party. The last session of the CMC will be held with the Ministers of Foreign Relations and the Economy, or their counterparts, and the Presidents of the States Parties.

The decision also stipulates that "consensuses reached at the Ministerial Meetings will be termed Proposals and will be submitted to the *Common Market Council for consideration. These proposals may consist of international draft agreements, Decisions, Recommendations, or other instruments*".

Last, the modification to the CMC's Internal Regulations stipulates a process of notice for extraordinary CMC meetings.

Argentina's PPT also reported that the GANRI debated various draft amendments to the Protocol of Olivos, mainly to do with the composition and operation of MERCOSUR Tribunals and the establishment of disciplines regarding compliance with rulings and countervailing measures, without reaching any consensus between countries.

A proposal by Argentina was also debated. This admitted the possibility of directly applying the rules not requiring legislative approval in the States Parties' legal systems. However, there was no consensus over this matter either.

Last, the budgets of the Permanent Review Tribunal Secretariat and the MERCOSUR Secretariat were agreed, and it was decided that, as from 2009, the Commission of Permanent Representatives will receive funding.

Biofuels

As described in MERCOSUR Report 12, the issue of biofuels was included on the bloc's internal agenda through the Brazilian government initiative submitted at the 65th GMC Regular Meeting in November 2006. The following month, the States Parties of MERCOSUR and Venezuela signed a "*Memorandum of Understanding to establish a Special Biofuels Working Group*", responsible for drawing up a cooperation program in the area of biofuels that would consider the strategic importance of energy cooperation among MERCOSUR members.

At the 34th CMC Meeting in Montevideo in December 2007, the Special Working Group submitted a *MERCOSUR Action Plan for Cooperation in Biofuels*, which was approved (CMC Dec. 49/07). The CMC also opted to create an *Ad Hoc Biofuels Group* (GAHB) to define the criteria and instruments to facilitate countries' cooperation in this area.

The approved Action Plan envisages nine activities, each of which breaks down into specific objectives. At the first meeting of the GAHB in March 2008, the participating delegations (including Venezuela) decided to give priority to drawing up a work plan based around three activities:

- *Evaluation of the technical specifications for biofuels*: The main objective of this activity is to draw up a document on the compatibilities and differences of technical specifications for biofuels in the ambit of MERCOSUR.
- *Identification of entities and companies with competition in technological research and development in biofuels production chains*: The objective of this activity is to identify ongoing lines of research and the entities or companies able to commit to the Action Plan.
- *Aspects linked to sustainable biofuel production*: The objective foreseen for the second half of 2008 is to identify key elements to define the sustainable production and use of biofuels in the ambit of MERCOSUR.

The Science, Technology, and Innovation Framework Program

In 2006, the Specialized Science and Technology Meeting (RECyT) was commissioned to draw up a science and technology program for MERCOSUR. In Tucumán, at the end of June 2008, the CMC approved the MERCOSUR Science, Technology, and Innovation Framework Program for 2008-2012 (CMC Dec. 03/08).

Box G

SCIENCE, TECHNOLOGY, AND INNOVATION FRAMEWORK PROGRAM

Fundamentals

The Framework Program (PM) is to promote integration, give visibility to strategic regional transformation projects, and establish a harmonized joint position. Its actions must be totally consistent and coherent with the major integration projects in the ambit of MERCOSUR.

Sustainable, high impact projects are needed to give priority to science-, technology, and innovation-based social and production development like sustainable development guarantees.

The PM is a multiannual public program. It is to have permanent resources to facilitate the execution of projects and activities common to the States Parties without the limitations imposed by national budgets.

PM Actors

PM actors in each State Party include:

- National science and technology offices.
- Higher education institutions and of technical training, national academies, vocational colleges, scientific societies, laboratories, and research and development centers, both public and private.
- Private sector organizations, companies, technological service providers, and information and assistance networks.
- Public or private corporate bodies that undertaking activities of science, technology, and innovation, and their applications.
- Organized communities that raise problems capable of being dealt with by science, technology, and innovation.

Funding

The PM needs to have a permanent funding mechanism that can ensure the allocation of resources, with stable, continuous foundations, just as the structural initiatives that normally govern multiannual actions require. The States Parties will undertake efforts to identify a variety of promotion sources, and will also evaluate the use of the MERCOSUR Structural Convergence Fund (FOCEM). Until a permanent fund is available, each country's permanent entities will undertake efforts toward making viable specific contributions to fund the Program's initiatives, such as resources from intra- and extraregional cooperation projects.

Programmatic themes

Four programmatic themes are defined, along with their main questions or issues.

Theme I - Strategic dimension

Issue: Advanced, alternative energies, hydrocarbons, hydraulics, nuclear and biomass; sustainable development (natural non-renewable resources, urban development, sewerage, and other); information and communication technologies; biotechnology; nanotechnology and new materials; health and medicines; space; biodiversity; water.

Theme II - Industrial and agricultural dimension

Issue: Agroindustry; local production agreements; technological extension; poles, parks, and incubators; university-business (U-B) cooperative projects.

Theme III - Social dimension

Issue: Diffusion of appropriate technologies; food security; digital inclusion; habitation and sewerage research.

Theme IV - National systems of science, technology and innovation (STI) dimension

Issue: Science infrastructure, technology and innovation; human resources training; funding; legal framework; international cooperation; information in science, technology, and innovation; science indicators, technology and innovation.

Complementary considerations

- The actions contemplated in the PM will involve groups of at least three countries, one of which is the least developed.
- RECyT will work as an authority responsible for setting priorities, support, and evaluation of the PM.
- The selection of projects will be based on three alternatives: a) Definition of the project or program through the selection of actors, with a leading role being played by the RECyT's own authorities; b) Definition of the R+D problem or issue that is the target of the action, and an invitation to actors previously identified and listed; and c) Definition of the R+D problem or issue that is the target of the action and an open public announcement for selection.
- There will be a system of project evaluation and follow-up. The evaluation process will be coordinated by RECyT and will be performed by peer evaluation as recognized by the National Science and Technology Bodies (ONCyT) from each State Party, for aspects related to the intrinsic quality of the actions to be evaluated, and by experts or other relevant actors for those aspects related to social importance and relevance to the integration process.

The Framework Program defined the following seven issues or priority questions for 2008 -2012:

- Biotechnology
- Energy
- Nanotechnology
- Water resources
- The information society
- The popularization of science and technology
- Technological development and innovation

CHAPTER 4. SECTORAL CONFLICTS AND TRADE DISPUTE NEGOTIATIONS

A. General outline

Compared to previous years, there was less evidence of trade disputes within MERCOSUR both in terms of political repercussions and impact on the internal negotiating agenda. The partners' significant rates of economic growth, the expansion of Brazilian investment in the region, and an appreciation of the real against the dollar with repercussions for Argentine real/peso parity combined to foster growth in regional trade as a whole and Brazilian imports from the other MERCOSUR countries. Thus, until July 2008, the bloc saw significant growth in economic and trade terms without any major disputes, in spite of structural asymmetry thanks to which the largest partner has a robust trade surplus over the other three member countries.

In the first half of 2008, Brazilian foreign trade was characterized by a marked growth in imports (50.6%) against the same period for 2007, whereas exports showed lower expansion (27.5%). As a result, there was a slowdown in the growth of the global trade surplus.

However, in terms of Brazil's trade with MERCOSUR countries in 2008, its exports to the bloc grew more than imports (37.7% and 35.2% respectively). This performance was responsible for a more favorable trade balance for Brazil in exchange with Argentina⁶⁶ and with its other two MERCOSUR partners. The general picture in the bloc is then one of higher levels of trade and balances ever more favorable to Brazil (see Chapter 2).

Some factors helped create a less tense, less pressurized atmosphere in terms of trade disputes. These include the partners' economic growth, the increase in Brazilian investments in the region, and follow-up on the Bilateral Monitoring Commissions.

Recent data⁶⁷ show that Argentina's loss balances in trade with Brazil are concentrated increasingly in products with higher added value. This is indicative of Argentine industry's difficulties in recovering a share in the two countries' markets, in spite of the investments in machinery and equipment after the macroeconomic crisis of 2002. In this sense, there is a feeling that Argentina has been losing ground in Brazilian industrial manufacturing purchases, whereas Brazil expanded its share in the structure of Argentine imports in this segment.

On the other hand, there is a slowdown in Argentine imports from Brazil in the sectors subject to the current trade monitoring systems, with a slight downward trend in Brazilian market share. Even so, the scheme of the old Trade Monitoring Commission (now called the Brazil-Argentina Bilateral Meeting) shows that, in fact, trade disputes decreased. Many voluntary export restriction agreements were not renewed (the agreement in the paper and pulp sector still stands) and the agenda increasingly includes issues of interest common regarding third countries. This is true of trade with China, which is a cause for concern in both countries.

The textile sector, which had been the butt of serious trade discrepancies, became a space for cooperation on the basis of Brazilian investments in Argentina. The perceived "China effect" on the sector has facilitated the development of coordinated action between the two countries' private sectors, notwithstanding the bilateral overview for samples of import deviation and losses of Brazilian market share in the Argentine market.

⁶⁶ Brazil's trade balance with Argentina reached US\$2.3 billion in the first half of 2008, as against US\$1.6 billion in the same period of 2007.

⁶⁷ ABECEB [2008].

Perhaps the Common Automotive Policy agreement, with its setting of a time limit on free trade, was the issue that left the greatest mark on relations between MERCOSUR's two senior partners in terms of trade disputes between July 2007 and June 2008. This sector, responsible for a significant portion of bilateral trade and characterized by administrated trade that had difficulty adapting to free trade, had been postponing negotiations for the lifting of intra-MERCOSUR restrictions.

Setting a date for free trade proved difficult for Argentina, which was concerned to maintain and grow foreign direct investment in the sector. The terms of the conclusion of this negotiation were not considered exactly desirable by representatives of the industry in Brazil, whereas in Argentina they were seen as a possible limit. It was felt that, for the sake of calm in the market and the maintenance of investments, it was better to have an agreement aimed at free trade in the future, but which created a predictable horizon for trade rules, rather than maintaining the earlier situation with temporary agreements subject to constant extensions. It now remains to monitor the implementation of the agreement and create the conditions for the commitments to be met.

This chapter describes in detail the evolution of the Brazil-Argentina Common Automotive Policy, weighs up the trade disputes in the industry indicating the progress of negotiations in the textile sector, and looks at two other issues selected for their repercussions on negotiations between the governments during the GMC meetings (the pulp mill dispute between Argentina and Uruguay, and the issue of used or retreaded tires, since, in the framework of the WTO, Brazil is required to eliminate special MERCOSUR import conditions. The report is not exhaustive, but, as mentioned, the trade climate among the partners has been milder than in previous years.

B. The evolution of the Brazil-Argentina Common Automotive Policy: latest agreements

The Common Automotive Policy between Brazil and Argentina was established in 2001 with the signing of the 30th Additional Protocol to ECA 14. Bilateral automotive trade has been administrated throughout the construction process in the free trade area and the MERCOSUR Customs Union, including trade quotas up to the level of vehicle brands.

As of the 30th Protocol, an organized structure for the Common Automotive Policy was created, the levels of the Common External Tariff (CET) for extrabloc imports, the methodology of national tariff adjustment to these levels, and the mechanisms to set intrabloc preferential trade quotas for 2001-2005 all having been defined. There was no commitment over the date of establishment of the free trade area.

The issue was finally included in the 31st Protocol of November 2002. Article 13 says that "*as of January 1, 2006, trade in automotive products between the Parties will no longer be subject to tariffs or to quantitative limitations*" (see Box H, describing the Brazil-Argentina Common Automotive Policy's evolution in detail).

The period 2002 to June 2006 was characterized by intense negotiations between governments and representative entities from the two countries' private sectors. Negotiations on the free trade issue have traditionally been difficult. These difficulties are explained by a significant flow of investment attraction in the automotive sector based on maintaining high levels of protection in relation to abroad, and barriers and quotas in trade with Brazil.

Box H
EVOLUTION OF THE BRAZIL-ARGENTINA COMMON AUTOMOTIVE POLICY

	31st Protocol of November 11, 2002 Effective from August 1, 2000 to December 31, 2005 (articles 12 at 23 starting January 2001)	35th Protocol of June 28, 2006 Effective from July 1, 2006 to June 30, 2008	38th Protocol of June 23, 2008 Effective from July 1, 2008 to June 30, 2014
<p>Issue</p>	<p>The Protocol incorporated the Agreement on the Common Automotive Policy between Argentina and Brazil.</p> <p>The CET was set at 35% for automobiles, buses, trucks, chassis, trailers and semi-trailers, and bodywork and cabs, and at 14% for tractors, harvesters, agricultural and self-propelled machinery, on a total of 81 tariff items.</p> <p>Differentiated treatment is admitted in the case of provisional preferences, temporary exemptions and tariff reductions for goods not produced in MERCOSUR (former Brazilian tariffs). A periodic revision directed by the Automotive Committee is foreseen (Art. 3).</p> <p>An ascending convergence timeline was also defined for Argentina to adopt these levels from 2000 to 2006 (Art. 9).</p> <p>For autoparts, the original varied levels of the CET were maintained (Art. 3) for a total of 514 tariff items (varied CET levels).</p>	<p>CET levels remained the same and were adopted by both countries with the finalization of Argentina's convergence timeline (Art. 3).</p> <p>The same reference to provisional preferences was maintained for temporary exemptions and tariff reductions for goods not produced in MERCOSUR (ex Brazilian tariffs) (Art. 3).</p> <p>The sample of the agreement (automobiles, etc. and autoparts) was not modified.</p>	<p>The CET levels (35% and 14%) were not modified. Autoparts remain at the original CET levels.</p> <p>The same reference to preferences, exemptions, and reductions is maintained.</p> <p>With slight adjustments, the sample of automobiles, buses, trucks, chassis, tractors, trailers, chassis, and self-propelled machinery was maintained, covering 79 tariff items.</p> <p>The composition of the autoparts sample was modified to incorporate 534 tariff items.</p>
<p>Extrazone trade in vehicles and autoparts</p>	<p>Ascending timelines of Import Tax (IT) for imported autoparts from third countries and destined for automotive production in Argentina and Brazil. In Argentina's imports, authorization was given to add 0.5 p.p. to the IT (Art. 5 and 6).</p>	<p>Protocols 31 and 35 foresee the 2% IT for autoparts non-produced in MERCOSUR to be applied in products, a list of which will be defined by means of proposals from the two countries' private sectors (Art. 6 of this Protocol, and Art. 8 of the 31st Protocol).</p> <p>Imports of non-original MERCOSUR autoparts for the production of tractors, harvesters, and agricultural and self-propelled machinery may enjoy the 8% aliquot of the IT. This benefit requires producers to register with each party's Protocol application authorities (Art. 8).</p> <p>Before December 31, 2006, countries will make efforts to reach consensus, working jointly with private sectors, on the definition of a common autoparts policies to eliminate existing asymmetries (Art. 7).</p>	<p>The special treatment of 2% IT on autoparts not produced in MERCOSUR is maintained (Art. 6).</p> <p>The list of goods not produced in MERCOSUR was not yet defined.</p> <p>The same benefit on the importation of non-original MERCOSUR autoparts was maintained, with an 8% aliquot for the production of tractors, harvesters, agricultural and self-propelled machinery (Art. 7).</p>
<p>Imports of autoparts for production</p>			

Box H (CONTINUED)

	31st Protocol of November 11, 2002 Effective from August 1, 2000 to December 31, 2005 (articles 12 at 23 starting January 2001)	35th Protocol of June 28, 2006 Effective from July 1, 2006 to June 30, 2008	38th Protocol of June 23, 2008 Effective from July 1, 2008 to June 30, 2014
<p>Issue</p>	<p>Products subject to monitoring from January 2001 to December 2005: automobiles and light utility vehicles, buses, trucks, semi-trucks, chassis, and autoparts (Art. 12). Products subject to trade monitoring until January 2002: trailers and semi-trailers, chassis, agricultural tractors, harvesters, and self-propelled agricultural machinery, and self-propelled machinery (Art. 12).</p>	<p>Products subject to monitoring: automobiles and light utility vehicles, buses, trucks, tractors, chassis with engines, and autoparts. The period defined for this control was from July 1, 2006, to June 30, 2008 (Art. 11).</p>	<p>The sample to be monitored was not modified. The products subject to global monitoring from July 1, 2008, to June 30, 2013, are: automobiles and light utility vehicles, buses, trucks, semi-trucks, chassis, and autoparts (Art. 10).</p>
<p>Intrazone trade administration (scope of application)</p>	<p>US\$1 of imports = US\$2.6 of exports, in 2005 (coefficient growing between 2001 and 2005) (Art. 13). There is no total limit for preferential exports, provided the Flex defined in the Protocol (Art. 13) is met.</p>	<p>US\$1 of imports = US\$1.95 of exports from July 1, 2006, to June 30, 2008 (Art. 12 a). Provided the coefficient of export deviation during the first twelve months does not exceed 2.1, the coefficient of deviation will may be calculated based on the biannual period between July 2006 and June 2008 (Art. 12 b). The same reference on the absence of a total limit for preferential exports was maintained, provided the Flex is met.</p>	<p>Up to June 30, 2013, the coefficient of deviation will be as follows, depending on the trade result: Bilateral trade deficit for Argentina: Flex not above US\$1.95. Bilateral trade deficit for Brazil: Flex not above US\$2.50. The same reference on the absence of a total limit for preferential exports was maintained, provided the Flex is met.</p>
<p>Coefficient of export deviation (Flex)</p>	<p>Annual periods from January to December 2001 to 2005 (Art. 13 a).</p>	<p>Two twelve-month periods from July 1, 2006, to June 30, 2007, and from July 1, 2007, to June 30, 2008.</p>	<p>Five twelve-month periods from July 1, 2008 (Art. 11).</p>
<p>Trade Period to calculate the deviation of exports</p>	<p>Free trade forecast in January 2006 (Art. 13 a). 100% preference for trade in MERCOSUR under the rules of the agreement, within the quantitative limits and in compliance with the rules of origin (Art. 11).</p>	<p>No date foreseen. The sole indication is that, before June 30, 2008, the countries will carry out a full evaluation of the evolution of the industry and commercial trading, including trade with the rest of the world, in order to make adjustments to the Automotive Policies defined in the Protocol (Art. 28). The same 100% preference for trade is maintained within the rules (Art. 10). Up to June 30, 2008, the 100% preference margin is preserved intrabloc (Art. 10) within the monitoring system and in accordance with the rules of origin.</p>	<p>From July 1, 2013, the automotive trade will have no quantitative limits (Art. 11 c). The 100% preference margin was preserved intrabloc by Article 9.</p>
<p>Free Trade</p>			

Box H (CONTINUED)

	31st Protocol of November 11, 2002 Effective from August 1, 2000 to December 31, 2005 (articles 12 at 23 starting January 2001)	35th Protocol of June 28, 2006 Effective from July 1, 2006 to June 30, 2008	38th Protocol of June 23, 2008 Effective from July 1, 2008 to June 30, 2014
Issue			
Index of regional and Argentine content	60% regional content for all products. For autoparts, with the exception of groups and subsets which must also meet the 60%, the same MERCOSUR general rule will be applied for those products. 5% minimum content of Argentine autoparts and 65% maximum content of imported autoparts, including MERCOSUR partners (in 2005) (Art. 23).	The 35th Protocol maintained the same orientation toward regional content as the previous Protocol. The demand for minimum Argentine content for autoparts was not renewed.	The 38th Protocol maintained the same orientation toward regional content as the previous Protocol.
Temporary admission and drawback	Elimination of these operations in vehicle and autoparts exports for MERCOSUR countries (Art. 24).	Automotive exports to a MERCOSUR partner will be subject to the MERCOSUR general rules for such operations (Art. 22).	Similarly, the 38th Protocol refers drawback operations to MERCOSUR rules (Art. 22).
Technical regulations	Demand for compliance with MERCOSUR Technical Regulations related to the environment, and active and passive security, regardless of the origin of the product (Art. 31).	Before December 31, 2006, the countries must agree the provisions linked to the Technical Regulations to be incorporated in the Agreement (Art. 29).	The countries undertake to resume the work of harmonization for the Technical Regulations linked to the environment and the active and passive security (Art. 27).

The idea of maintaining limits on free trade (100% preference) through the Flex regime while it was not possible to obtain more balanced levels in bilateral exchange lies at the root of Argentina's policies for the sector.⁶⁸ This justifies the terms of the 35th Protocol of June 2006, according to which the free trade commitment was eliminated by a specific date and a more severe trade deviation than the previous one adopted, i.e. US\$1 of imports = US\$1.95 of exports between July 1, 2006, and June 30, 2008.

The Brazilian capacity to attract investments and the size of its market were considered threats to the recovery of the sector in Argentina. Nonetheless, the announcements of investments for the development of new models fuelled by the country's economic recovery in 2006 and by the growth of Brazilian internal demand in the sector in 2007 brought about a more favorable climate for the negotiation of the Common Automotive Policy in the second half of the last year and the first half of 2008. This climate also benefitted from the exchange parity between currencies, which was more favorable to Argentina.

Indeed, this period was crucial for negotiations between Brazil and Argentina in the automotive area. The Brazilian automotive industry was applying pressure to set a scope on free trade, arguing that to maintain a scenario of instability regarding "the rules of the game" would be more negative than competition with Brazil. In the Brazilian view, the capacity to attract investment and maintain a favorable climate for the operation of multinational plants was linked to the macroeconomic environment and regulatory predictability.

Before June 30, 2008, countries had to make a complete evaluation of the evolution of the industry and trading, including trade with the rest of the world, in order to make adjustments in the Automotive Policies. That was the mandate that served as a basis for the great efforts by negotiators. In spite of the Brazilian pressure to guarantee a shorter deadline, the negotiations fixed free trade in July 2013, seven and a half years after what had been agreed in 2002.

With the active participation of the two entities from the private sector, the National Association of Automotive Vehicle Manufacturers (ANFAVEA) of Brazil and the Association of Automobile Manufacturers of Argentina (ADEFA) of Argentina, the agreement was considered positive compared with other available alternatives. Not to have an agreement or simply to set new extensions that reflected provisional agreements without the slightest reference to the objective of freeing up bilateral trade did not seem acceptable alternatives to the Brazilian party. The moment of reheating of internal demand for automobiles and the major appreciation of the real against the Argentine peso encouraged importation by the neighboring country and facilitated the conclusion of the negotiations.

An unusual rule included in the 38th Protocol of June 2008 was the setting of an asymmetric Flex. 1.95 is the limit for Argentina's trade deficit in the sector. This means that, for Brazil, the proportion is US\$1 of imports for US\$1.95 of exports. The level of 2.5 corresponds to the limit of the Brazilian trade deficit, which means that, for Argentina, US\$1 of imports should correspond to US\$2.50 of that country's exports.

Even in light of the recovery of investment in Argentina, the production asymmetry between the two countries continued to be significant. The possibility to enjoying a higher level than the Flex in exports should encourage greater trade balance and complementarity in the sector.

⁶⁸ The "regime of Flex" consists of a coefficient of export deviation, via which a limit on exports from each of the countries is defined per US\$1 of imports.

Table 18 shows the loss of market share in trade in vehicles, both by Brazil in the Argentine market and by Argentina in the Brazilian market, in the period of ECA 35's application (July 2006 to June 2008). Even so, the higher level of the Brazilian market share (approximately 75%) against the Argentine market share (approximately 55%) is notable, considering that the two countries' levels of imports from the rest of the world are very similar. On the other hand, the growth of Brazilian imports from the rest of the world was more marked than that of Argentine imports from the rest of the world, indicating a greater trade deviation than Brazil in relation to its partner.

TABLE 18
IMPORTS OF PRODUCTS INCLUDED IN THE COMMON AUTOMOTIVE POLICY
VEHICLES
(US\$ Billions)

Cuts	Argentina			Brazil		
	Jul. 2006 to Jun. 2007	Jul. 2007 to Jun. 2008	% Var.	Jul. 2006 to Jun. 2007	Jul. 2007 to Jun. 2008	% Var.
World	3.815	5.495	44.1	3.180	5.616	76.6
Partner	2.914	4.074	39.8	1.820	3.022	66.0
Market Share						
Brazil in Argentina	76%	74%				
Argentina in Brazil				57%	54%	

AUTOPARTS
(US\$ Billions)

Cuts	Argentina			Brazil		
	Jul. 2006 to Jun. 2007	Jul. 2007 to Jun. 2008	% Var.	Jul. 2006 to Jun. 2007	Jul. 2007 to Jun. 2008	% Var.
World	6.558	8.466	29.1	13.987	19.052	36.2
Partner	2.330	3.017	29.5	1.073	1.350	25.9
Market Share						
Brazil in Argentina	36%	36%				
Argentina in Brazil				8%	7%	

Note: The products contained in the 35th Additional Protocol to ECA 14 are included.

Source: Prepared using WTA, MDIC, and LAIA data.

In trade in autoparts, the differences in market share are wider (36% and 8%). The very much higher level of Brazilian imports from the rest of the world, which include autoparts not manufactured in either of the two countries, is remarkable. One of the pending tasks of the Common Automotive Policy's 38th Protocol is in fact to define the list of products not manufactured within MERCOSUR, whose import tax will fall to 2%. The imports of autoparts not produced in the bloc for the production of tractors, harvesters, and agricultural machinery already enjoy the benefit of lower tax of 8%.

C. Trade in products subject to the previous licensing system and voluntary restriction agreements: footwear, white goods, and paper

Trade in footwear between Brazil and Argentina has been traditionally marked by quantitative limits on Brazilian exports in the form of voluntary restriction agreements and non-automatic import licensing.

The first instrument is characterized by an effort to control trade by the entities representing the private sector. The Brazilian Footwear Industries Association (ABICALÇADOS) and the Argentine Chamber of the Footwear Industry (CIC) (this last by common agreement with its government) for years defined the annual quotas of sales from Brazil to Argentina in thousands of pairs of shoes.

In 2004 and 2005, Brazil was responsible for close to 80% and 70% of Argentine shoes imports respectively.⁶⁹ During that time, anything from voluntary restriction agreements to non-automatic licensing was in force. The main objective of the performance of the business entities was to maintain trade within the agreed limits, avoiding the activation of the Argentine government's licensing instruments, which in turn acted as "incentives" for negotiations and trade monitoring.

Argentina's footwear industry advocated the need to contain imports at a level of 14.5 million pairs (Brazil was seeking a quota of 16 million pairs) and the issue was debated between the two countries' Ministers of State on various occasions.

Table 19 shows that Brazil's market share in the Argentine market in 2006 and 2007 was adjusted, at between 60% and 65%. It is worth mentioning that, in the first half of 2008, compared to the same period in the previous year, the growth of Argentine imports from the rest of the world was a good deal higher than the growth of purchasing from Brazil. This determined a more modest level of the Brazilian market share.

This sector is still on the agenda of the Brazil-Argentina Bilateral Meeting, which identifies a significant expansion of Brazilian investment in Argentina. The two countries are in the process of evaluating imports from China in 2006, 2007, and 2008, on an annual and six-monthly basis.

In the area of white goods (stoves, refrigerators, and washing machines), the trade dispute began with the Argentine Economy and Production Ministry's Res. 444 of July 5, 2004, which ruled that imports of stoves (NCM 7321.11.00), refrigerators (NCM 8418.10.00 and NCM 8418.21.00) and washing machines (NCM 8450.11.00) would be subject to non-automatic licensing.

In 2005 and 2006, ELETROS, the Brazilian private sector entity, and the Argentina Chamber of Refrigeration and Air Conditioning Industries (CAIRAA) agreed a balanced share in the Argentine market for local production and for Brazilian production, also devoting a small market reserve to other suppliers. Considering the possibility of import restrictions through the regime of non-automatic licensing, the Brazilian private sector chose to accept the voluntary restriction agreements that would preserve the market and would facilitate the modernization effort of the Argentine park.

In September 2006, all those agreements expired and ELETROS was unwilling to renew them. Even so, imports from Argentina in 2006 and 2007 expanded a good deal. Imports from the rest of the world grew

⁶⁹ See *MERCOSUR Report 12* [2007].

32% from one year to the next in comparison with 21% of imports from Brazil. The shrinking of this segment in the Argentine market caused falls in purchases in 2008, both from the rest of the world and from Brazil. The Brazilian market share in white goods remained high in general, although it fell in the washing machine heading due to a rise in imports from Chile. Argentina and Chile maintain a significant trade flow in that product. Unlike trade with Brazil, in which Brazil does not import white goods from Argentina, trade in washing machines between Argentina and Chile is two-way.

TABLE 19
PRODUCTS SUBJECT TO THE NON-AUTOMATIC LICENSING REGIME
AND VOLUNTARY RESTRICTION AGREEMENTS
(Argentine imports)

Products	2006			2007			% Variation	
	US\$ Millions			US\$ Millions			2007/2006	
	World	Brazil	Market Share	World	Brazil	Market Share	World	Brazil
Footwear	228.7	138.6	60.6%	280.7	183.9	65.5%	22.8%	32.7%
White goods	174.4	139.3	79.8%	231.7	168.2	72.6%	32.8%	20.8%
Paper	32.4	30.3	93.6%	40.6	39.2	96.6%	25.3%	29.3%

Products	January-June 2007			January-June 2008			% Variation	
	US\$ Millions			US\$ Millions			2008/2007	
	World	Brazil	Market Share	World	Brazil	Market Share	World	Brazil
Footwear	113.0	72.4	64.1%	153.9	84.5	54.9%	36.2%	16.7%
White goods	99.3	71.6	72.1%	93.4	63.6	68.0%	-5.9%	-11.2%
Paper	17.3	16.8	97.6%	21.3	19.8	92.8%	23.5%	17.4%

Source: Argentina Ministry of Economy and Production (MeyP). Prepared using WTA and MDIC data.

The paper sector is one of the few to keep its voluntary restriction agreement in exports. The Brazilian private sector, as represented by Brazilian Pulp and Paper Association (BRAECLPA), feels the agreement is positive. Table 19 shows why: Brazil is practically the sole supplier of Argentina.

D. Trade in products subject to antidumping and safeguard measures in Argentina

The spectrum of products subject to antidumping duties, countervailing duties, and safeguard measures in Argentina and affecting Brazilian exports has changed little since 2006. The Competitive Adaptation Mechanism (MAC), approved to enable the adoption of certain restrictions on trade between Brazil and

Argentina through negotiations and under certain circumstances, was not implemented by the countries.⁷⁰ The regular survey by the National Foreign Trade Commission (CNCE) shows that, in 2006, there were 40 tariff items subject to the application of these measures, as against 36 in 2008.

For the vast majority of products, the imposition of restrictive measures began in 2005, with a deadline of 3 to 5 years. Antidumping duties were imposed on three products in 2007 and 2008: transformers (MEyP Res. 02/07 of July 23, 2007), manual saw blades (MEyP Res. 61/08 of February 14, 2008) and glasses and glass pitchers (MEyP Res. 121/08 of March 13, 2008). In 2007, the Brazilian market share of those products was 18%, 16%, and 49% respectively. In the case of transformers, the measures had an effect after the drop in Brazilian imports that same year. In the first half of 2008, this trend was reversed and Brazil practically supplied the Argentine market.

From the second half of 2007, the most conflictive issue in this area, the final decision for which is due in August 2008, is to do with color TV sets. Manufactured in the Manaus Free Trade Zone, this product was the object of research to establish safeguard measures the result of which was the establishment of an export quota for Brazil for a 3-year period (MEyP Res. 43/05 of February 9, 2005). Quotas of 100,000 units in 2005, 169,000 in 2006, and 235,000 in 2007 were established for Brazilian exports.

Exports exceeding this quota are subject to 21.5% import duty. Plasma and LCD TV sets were excluded from the restriction. With the start of production of these TV sets in Argentina, the two countries' private sectors signed a voluntary restriction agreement. The previous tariff position (NCM 8528.12.90), covering all color products, was divided into the following positions in 2007: NCM 8528.71.90 (CRT) and NCM 8528.72.00 (LCD/Plasma).

The safeguard expired at the start of this year, but the Argentine government set a new quota of 175,000 units up to September, while it evaluates the national industry request. The revision of the safeguard, suggesting the possibility of automatically extending it to LCD/ Plasma TV sets (NCM 8528.72.00) was opened up by Res. 25/07 of December 21, 2007.

Table 20 presents the aggregate data for this type of TV set, but it can be seen that, in 2007, it saw a drop in Argentine imports, no doubt deriving from the start of local production of LCD and plasma sets. In 2008, imports were up on the first half of 2007 and, according to statements from the Brazilian private sector, other suppliers, like China and Mexico, contributed to this result.

⁷⁰ The MAC between Brazil and Argentina was the solution hit upon by the two largest partners in the block to attend to Argentina's demand to "institutionalize" an intra-MERCOSUR safeguard. Decision 28/00 of June 2000 had defined the need to discipline the application of antidumping and countervailing measures and to define a system for their gradual elimination from intrazone trade before the end of 2001. Subsequent decisions extended this deadline. The MAC was approved on February 1, 2006. This mechanism includes the following rules: consultation between private sectors, opening-up of research, damage or damage risk checks, organ of appeal, etc. The MAC was protocolized in LAIA and became the 34th Additional Protocol to Economic Complementation Agreement 14 (ECA 14), signed on April 11, 2006. Its entry into force must be simultaneous in all countries and will come about when the countries inform LAIA of the Protocol's incorporation in their respective internal legislations. As this demand has not been met, the MAC has not yet come into force. In the ambit of MERCOSUR, the 43rd Additional Protocol to Economic Complementation Agreement 18 (ECA 18) of June 25, 2003, had defined a system to discipline these measures in the sphere of intrabloc trade, but this has not been incorporated into the partners' legal systems.

TABLE 20
PRODUCTS SUBJECT TO ANTIDUMPING AND COUNTERVAILING RIGHTS,
AND DEFINITIVE SAFEGUARD MEASURES
(Argentine imports)

Products	2006			2007			% Variation	
	US\$ Millions			US\$ Millions			2007/2006	
	World	Brazil	Market Share	World	Brazil	Market Share	World	Brazil
Ceramic sanitary articles	1.6	1.2	74.0%	2.4	1.6	66.5%	43.9%	29.3%
Manual saw blades	2.0	0.3	13.9%	2.3	0.4	16.1%	13.3%	31.2%
Polyethylene terephthalate - PET	114.7	16.3	14.2%	158.1	18.7	11.8%	37.8%	14.6%
New bicycle tires	111.2	20.7	18.6%	127.2	18.9	14.9%	14.4%	-8.7%
Laminated iron and steel products	80.7	72.5	89.9%	183.9	120.9	65.7%	128.0%	66.7%
Transformers	10.0	7.4	74.7%	13.2	2.4	18.4%	32.7%	-67.3%
Seam-welded stainless steel tubing	15.4	4.5	29.0%	22.8	6.3	27.6%	48.5%	41.6%
Color TV	168.8	59.4	35.2%	72.0	19.7	27.4%	-57.3%	-66.8%
Glasses and glass pitchers	12.7	6.5	51.3%	16.7	8.2	49.1%	32.2%	26.5%

Products	January-June 2007			January-June 2008			% Variation	
	US\$ Millions			US\$ Millions			2008/2007	
	World	Brazil	Market Share	World	Brazil	Market Share	World	Brazil
Ceramic sanitary articles	1.0	0.8	80.1%	1.6	0.9	56.8%	58.9%	12.6%
Manual saw blades	1.1	0.2	21.9%	1.7	0.2	13.4%	49.5%	-9.0%
Polyethylene terephthalate - PET	56.0	5.5	9.8%	67.9	2.5	3.7%	21.3%	-54.4%
New bicycle tires	30.3	6.2	20.5%	46.1	7.5	16.3%	52.0%	21.3%
Laminated iron and steel products	78.7	58.7	74.6%	118.4	85.4	72.1%	50.5%	45.4%
Transformers	10.8	0.0	0.0%	21.1	18.6	87.9%	95.8%	n.d.
Seam-welded stainless steel tubing	12.0	3.0	25.2%	13.2	3.4	25.9%	9.9%	12.7%
Color TV	10.9	5.2	48.0%	70.2	15.3	21.7%	547.0%	193.1%
Glasses and glass pitchers	5.8	2.7	45.4%	9.0	4.6	51.6%	53.5%	74.4%

Source: Argentine National Foreign Trade Commission (CNCE). Prepared using WTA and MDIC data.

E. The textile sector

Brazilian-Argentine relations in the textile sector have, for many years, been characterized by a prolonged trade dispute. The first stage was marked by the inclusion of certain products from the textile sector in the two countries' Adjustment Regimes. Between 1995 and 1999, Argentina protected the clothing sector in the ambit of intra-MERCOSUR trade, whereas Brazil protected the woolen fabrics sector.

After the end of the Adjustment Regime, a second stage of the dispute started in 2000. The sector became the target for an array of measures adopted by Argentina to contain Brazilian imports. These included antidumping measures, especially on denim and cotton fabrics, which were gradually replaced by trade monitoring agreements, non-automatic import licensing, quotas, price agreements, and so on.

This change in trade control instruments was encouraged by the role of the Brazil-Argentina Trade Monitoring Commission. The idea behind this new dialogue mechanism was to make the technical treatment of questions relating to the two countries' private sectors viable so as to avoid the adoption of unilateral measures that had so far been raised at the political level.

The conflict began to be closely followed by the entities representing the private sector in each country, namely, ABIT in Brazil and FIT in Argentina. These, together with their governments, negotiated the bilateral trade conditions for the following product categories:

- Denim: category subject to annual quotas;
- Acrylic yarns: group of products subject to price agreements;
- Corduroy: price control and non-automatic licensing;
- Cotton fabrics: quotas and trade control;
- Towel: control based on prices and quotas;
- Rugs and carpets: price agreements.

This exercise in bilateral understandings intensified between 2004 and 2006. There are currently no more quantitative restrictions agreements; the last (on denim) was suspended in January 2008.

Nor are there any more bilateral commitments over prices. The "price criterion" system adopted by Argentine customs is applied to any import, including those from MERCOSUR. This system sets a benchmark price for each product (usually above the market price) and requires that imports below this be taxed at double the rate of VAT and advance income tax. Brazil also applies a compulsory "floor price" system, under which importing below this limit is not authorized. This, however, is aimed essentially at imports from Asia and is not applied to purchases from other origins.

A decided improvement in bilateral relations can be seen in the sector from around 2007. Two reasons seem to have favored this change: (i) the expansion of Brazilian investment in the Argentine textile industry; and (ii) the greater awareness that the major problem for the Brazilian and Argentine sectors alike lies in the economic impact caused by rising Chinese imports.

To illustrate the "China effect" on bilateral relations and demonstrate the need for a closer rapprochement/cooperation to develop a common trade defense policy (in this sense, it would be ideal to approve a MERCOSUR Protocol), the following table shows the fall in the Brazilian market share in Argentine imports and the corresponding advance of Chinese textile products.

Even in this scenario, Brazilian exports of textiles and related products to Argentina, included in Chapters 50-63 of the NCM, are significant, exceeding US\$5 billion in 2007. The levels of imports of Argentine products by Brazil are, however, more modest, at around US\$160 million that year, or 1.5% of Brazilian purchases from Argentina.

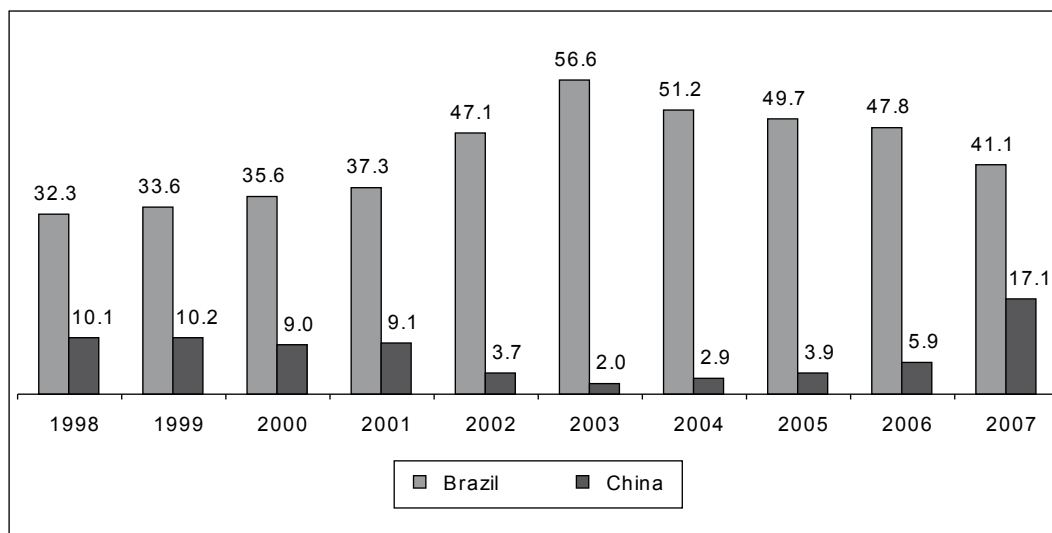
Last, in spite of the warm climate of bilateral relations in the textile sector, Argentina has embarked on a new investigation of dumping against Brazil and Indonesia over the entry of pure, single and twisted acrylic yarns, through Res. 68/08 of March 25, 2008.

TABLE 21
ARGENTINE TEXTILE AND CLOTHING IMPORTS
(US\$ Millions)

Origin	Years									
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
World	1,109.34	926.68	989.65	814.13	253.07	611.87	761.35	911.54	1,066.74	1,314.47
Brazil	358.16	311.04	351.83	303.33	119.15	346.24	389.61	452.82	510.38	540.45
China	111.90	94.39	89.07	74.28	9.32	11.99	22.20	35.57	62.46	225.39
<i>Market share in Argentina</i>										
Brazil	32.29	33.57	35.55	37.26	47.08	56.59	51.17	49.68	47.84	41.12
China	10.09	10.19	9.00	9.12	3.68	1.96	2.92	3.90	5.86	17.15

Source: "Brazil-China Observatory" - CNI.

GRAPH 24
EVOLUTION OF MARKET SHARE IN ARGENTINA



Source: "Brazil-China Observatory" - CNI.

F. The used or retreaded tire dispute

A variety of Brazilian resolutions and rules have banned the importing of used or retreaded tires in Brazil since 1991, a regulatory framework that has not, however, been applied to MERCOSUR. In January 2006, a panel was established in the WTO at the EU's request, which questioned Brazil's ban on importing used tires from Europe, while it does allow imports from MERCOSUR. The Brazilian argument, based on an environmental concern (retreaded or used tires have a less useful lifespan and become difficult-to-use waste) was accepted by the WTO, but was called on to adjust the Brazilian measure to the non-discrimination rule between countries.

On January 15, 2008, Brazil declared it would accept the WTO decision, but that it needed a deadline to do so, especially to debate gradual treatment in MERCOSUR. The aim was to define a common policy for the sector, as to extend this ban to the bloc would be incompatible with statements made by the MERCOSUR Permanent Review Tribunal. A new regime for used tires had to be created, one that should be approved by the GMC, MERCOSUR's executive organ.

This issue came to form part of the GMC table and became controversial on the eve of the presidential elections in Paraguay. Paraguayan sales to Brazil are deemed extremely important in terms of foreign currencies and jobs, and the possibility of Brazil adopting restrictions carried great political resonance in Paraguay, only comparable to the recent discussions over Paraguayan demands to revise the Itaipú tariffs and the sale of surplus electric power quotas from that country to any destination.

Since the GMC Meeting in April 2008, Brazilian representatives have been proposing the creation of a Working Group to study a common policy on trade in used and reformed or recast goods. Brazil will accept the WTO's decision, but alternatively proposes that a community policy be studied to be submitted to the multilateral organization in the shortest possible time.

There are no guarantees that a proposal of this nature will be accepted in the WTO. As stated in the GMC Minutes, the bloc has not yet found a way of dealing with the issue. Paraguay remains adamant about not modifying the current trade conditions.

Brazil has a deadline of December 17 to enforce the WTO ruling and the Brazilian government has been alerting its partners that, in the event of an intra-MERCOSUR understanding not being reached, the country will comply with the international demands.

It is important to remember that Uruguay and Argentina too have been in conflict since 2004 over Argentina's ban on importing retreaded tires, with ramifications in the sphere of the Protocol of Olivos and the MERCOSUR Permanent Review Tribunal. Argentina is maintaining restrictions on used tires and its extension to retreaded tires has been the object of a complaint by Uruguay. Uruguay won the case, in line with the TRP ruling issued in April 2008.

Last, in the retreaded tires issue, Brazil approved a resolution in the Chamber of Foreign Trade (CAMEX) that will discipline its imports. In the text published in the Official Journal on September 18, 2008, Brazilian imports of retreaded tires for automobiles are limited to 250,000 units p.a., of which Uruguay will be able to export 130,000 units and Paraguay 120,000. These quotas were defined on the basis of average imported values over the last three years. As there is not record of imports from Argentina, it was unnecessary to set a limit for this country. When adopting this measure, the CAMEX took the following into account:

- a) The negative impact on the environment and public health related to the import of reformed or retreaded tires;
- b) Ruling by the MERCOSUR Ad Hoc Arbitration Tribunal of January 9, 2002, on the Brazilian import ban on retreaded tires;
- c) WTO report issued on June 12, 2007, recognizing the justification for the exceptional authorization granted to Brazil to import retreaded tires from MERCOSUR in 2004; and
- d) Negotiations under way in MERCOSUR to adopt an environmental management policy for special waste and a common policy on trade in tires and their waste.

G. Repercussions of the pulp mill dispute

By way of protest against the installation of two paper factories on the banks of the River Uruguay, Argentine environmentalist groups organized a roadblock for vehicular traffic on the bridges across the river during the first half of 2006.

Uruguay submitted this dispute over the "*omission of the Argentine State to take appropriate measures to prevent and/or halt the obstacles to free circulation arising from the blocking of access roads in Argentine territory to the international bridges of General San Martin and General Artigas, joining the Argentine Republic and the Oriental Republic of Uruguay*" to MERCOSUR's Ad Hoc Tribunal.

The Ad Hoc Tribunal accepted the Uruguayan arguments and recognized that the roadblocks and the Argentine omission were incompatible with the commitments undertaken by the countries to guarantee the free circulation of goods and services in their respective territories. However, it imposed no sanctions or corrective measures. Argentina nevertheless submitted an appeal to the Permanent Review Tribunal, whose ruling of July 2006 expressly stated its non-acceptance.⁷¹

Although the investments in Uruguay have been made, this question became one of the greatest sources of intra-MERCOSUR conflict of recent years and gave rise to complaints about the lack of Brazil's role in the case and to constant debates in the GMC about the barriers to the free circulation of goods and the flimsiness of the dispute settlement instruments in MERCOSUR.

Perhaps the economic impact of this conflict has not been thoroughly evaluated, but its political repercussions were significant in the subsequent discussions on asymmetries and the Uruguayan demands for more compensation for the "losses" deriving from the integration process.

H. Final remarks

The Common Automotive Policy between Brazil and Argentina was, without a doubt, the great sectoral issue of the period. The economic importance of intraindustrial relations and Argentina's concern to maintain and

⁷¹ The conflict is also being resolved in the International Court of The Hague.

expand investments are aspects that explain the priority of the negotiations, the negotiators' effort, and the commitment of both countries' private sectors. It is understandable that this negotiation will influence the bilateral agenda and in that of MERCOSUR itself.

As mentioned at the start of this chapter, the context of greater growth and greater trade flows reduced the traditional picture of conflicts, in spite of the growth of the Brazilian trade surplus with the other partners, mainly Argentina. The increase of the surplus accumulated by Brazil can be explained by greater Brazilian competitiveness in industrial products, Argentina difficulty in maintaining a diversified export structure, and the reduced share of products subject to trade restriction measures (with the exception of the automotive sector) in trade as a whole.

Conflict levels were lowered by the effects of the trade monitoring and administration mechanisms, the strong performance of activity levels in the two countries, and the growth of Brazilian direct investment in various economic sectors in Argentina.

The bilateral trade data show, however, that the products monitored by the Brazil-Argentina Bilateral Meeting are those that display a loss of Brazilian market share and import deviations to the benefit of other suppliers. It is worth remembering that, from now on, this mechanism will diversify its agenda, with the treatment of common issues relating to the world market, e.g. trade with China, in order to continue to play an important role in the bilateral sphere.

Last, the depreciation of the real against the dollar deriving from the world financial crisis of September-October 2008 and its effects on parity between currencies may impact on the trade climate within MERCOSUR. The prospect of greater expansion of the Brazilian trade surplus may stimulate the escalation of sectoral disputes between the partners.

CHAPTER 5. THE EXTERNAL AGENDA

There has been little progress in MERCOSUR's external agenda, despite the various negotiating fronts opened up by the bloc in recent years. Apart from the increasingly unfavorable international climate for trade liberalization movements, the bloc is facing growing difficulties in achieving the convergence of interests among its partners in terms of international integration projects.

On the one hand, Uruguay continues to seek authorization to move forward in bilateral negotiations, independently of MERCOSUR. On the other, Argentina has fewer incentives to commit itself to new trade liberalization movements. And Brazil has been concentrating its efforts on obtaining results at the Doha Round, amid criticism from certain business segments calling for results in the country's external agenda.

In spite of the variety of initiatives under way, the only progress seen was the signing of the free trade agreement (FTA) with Israel toward the end of 2007. The negotiations with a view to a fixed preference agreement between MERCOSUR and the Southern African Customs Union (SACU) reached an end, but the agreement remained unsigned. The future of the WTO's Doha Round, the top priority of the bloc's trade agenda in recent years, is still uncertain.

The other regional or bilateral negotiating fronts with the EU, the Gulf Cooperation Council, India, Morocco, Egypt, Pakistan, or Mexico, made no progress. Besides these, two new negotiating fronts were opened as a result of the last MERCOSUR Summit: the FTA negotiations with Jordan and Turkey.

In the South American region, the constitution of the Union of South American Nations (UNASUR) on May 23, 2008, was announced by governments as an important step in the regional integration project. The Constitutive Treaty of UNASUR⁷² is quite ambitious in terms of its thematic agenda, but is vague on the subject of its members trade and economic integration. In the ambit of LAIA, the debates toward creating a Free Trade Space (FTS) is facing assorted resistance from most of its members.

A. The international climate and the strategies of MERCOSUR member countries

The significant growth of the economy and trade that dominated the international scenario from 2003 should have facilitated new trade liberalization movements. However, in spite of the proliferation of bilateral trade agreements, there was a deepening of protectionist stances and the predominance of the respective internal agendas in the formulation of the main actors' strategies in international negotiating forums. The emergence of the new Asians economic powers contributed, on one hand, to growth in international trade, but on another, fuelled protectionism in most countries.

In the last year, the international financial crisis and the uncertainty about the extent of its effects on the world economy altered the mood of optimism and stimulated anti-globalization views.

⁷² The Constitutive Treaty must be approved by the Congresses.

In the USA, opinions about the need to revise US trade policy strategies are gaining ground.⁷³ US presidential candidates are defending a review of NAFTA. The approval of trade agreements already negotiated with South Korea, Panama, and Colombia is in trouble in the US Congress. The new climate also consists of statements opposed to foreign direct investment in sectors considered strategic in the USA.

In Europe, trade policy turned to non-traditional protection instruments: technical rules such as Registration, Evaluation and Authorization of Chemicals (REACH), sanitary and phytosanitary measures such as those affecting Brazil's meat exports, and environmental rules (for ethanol imports) are increasingly rigorous. These restrictions have getting in the way of the export of MERCOSUR products to Europe and are fuelling debate on new issues that should be part of the negotiating agendas between the two blocs, when talks are resumed.

The rise of international commodity prices has brought to the fore the issue of food security in food-importing countries and ignited the debate on the self-sufficiency in the production of agricultural products. The reduction of food import barriers would be the desired reaction, but it was not what was seen. Wariness of dependence on food imports in a context of excess demand reinforced internal production protection policies in several importer countries.

The concern about internal supply also manifested itself in food-exporting countries. Quantitative restrictions and export taxes (also known as "withholdings") were formulas used by some countries to fight the inflationary and distributive impact of rising international prices. This was the case with Argentina (see Chapter 1, Box B).

Divergent strategies

Faced with the international context and the evolution of their internal macroeconomic climate, MERCOSUR countries have been adopting divergent trade policy strategies. Such differences, which had already become apparent in Uruguay's repeated requests to negotiate separate bilateral trade agreements with countries outside the bloc, were also became clear at the WTO mini-ministerial meeting in Geneva in July 2008, when Brazil and Argentina took opposite stances.

In the case of Argentina, rising agricultural prices brought an additional difficulty for its anti-inflationary policies. The increase in export taxes (subsequently rejected by the Congress) generated a degree of concern among the other MERCOSUR partners. In this context, the trade negotiations aiming to obtain better access conditions (the reduction of import tariffs and/or extension of quotas) and reduce subsidies in international agricultural markets are becoming less relevant. Likewise, the Argentine government was less willing to make concessions in trade liberalization of industrial goods.

The Brazilian government, for its part, is seeking a bigger role in trade negotiations in response to the demand for results in trade policies from diverse economic sectors. The negotiations for the WTO's Doha Round became central to Brazil's trade policy agenda and the government mobilized much of its negotiating capacity to act in the multilateral forum. At the same time, the Brazilian authorities tried to highlight Brazil's desire to move forward with the trade negotiations on a variety of fronts, from the EU to the Middle East, India, and South Africa.

⁷³ The articles by Lawrence Summers [2008a] and [2008b] show that this debate is gaining ground and involves old defenders of the broad trade liberalization.

After failure to obtain an agreement on trade liberalization modalities at the WTO's mini-ministerial meeting in July 2008, many analysts and representatives of the business world⁷⁴ argued that Brazil made the mistake of centering its efforts in multilateral negotiations. In line with this evaluation, the Brazilian government relegated the negotiation of regional or bilateral trade agreements with important markets that could guarantee better access conditions for Brazilian products. It is true that the Doha Round was at the top of Brazil's trade policy priorities, but that did not mean losing the desire to move forward in regional or bilateral trade negotiations.

The differences between the Brazilian and Argentine stances, which had already manifested in the negotiations between MERCOSUR and the EU, were again in evidence in the reaction of the two countries to the document submitted by WTO General Director, Pascal Lamy, at the mini-ministerial meeting of July. While Brazil expressed its support for the document, the Argentine authorities submitted objections.⁷⁵ These differences reignited the debate about the viability of maintaining the bloc's common trade policy or the advisability of introducing flexibilities to allow member countries to accommodate their different interests.

The Uruguayan President, Tabaré Vázquez, called, in September 2006, for flexibility in the external negotiations via the incorporation of bilaterality, either in the framework of the joint negotiations or by allowing individual negotiations.⁷⁶ From then on, the issue has been back on MERCOSUR's agenda at the insistence of Uruguay.

The Uruguayan request, which has the support of Paraguay, has not been welcomed by the governments of Argentina and Brazil. To compensate for this, the Brazilian government has gone to some lengths to design a Strategic Plan to Overcome Asymmetries in MERCOSUR. The Plan includes: (1) actions for the integration of the economies of countries with no maritime coastline; (2) actions for the development of infrastructure; (3) actions for the support of competitiveness; (4) market access; (5) actions in the institutional framework, and (6) the definition of community instruments.

The Plan was discussed again at the GMC Meeting of June 2008, but was not approved.⁷⁷ The Uruguayan claim appears in the market access chapter: the possibility to starting trade negotiations separately and bilaterally. This claim was responsible for lack of approval for the Plan so far. At the GMC Meeting, the countries undertook to pursue work on this issue in the second half of 2008.

The debate about flexibility in MERCOSUR's common trade policy will continue in the foreseeable future. According to Peña [2008], two types of flexibilities could be considered: (i) authorization for each partner to negotiate with other countries or blocs bilaterally, which meets the Uruguayan demand, or (ii) the possibility that, in MERCOSUR's joint negotiations with other countries or blocs, each partner will adopt differentiated commitments. The latter option has already been put into practice in some of the bloc's negotiations, e.g. the agreement between MERCOSUR and the Andean Community of Nations (CAN).

⁷⁴ See *Jornal Valor Econômico* [4-08-08], p. 2.

⁷⁵ In a declaration of July 30, at the WTO Trade Negotiations Committee in Geneva, Foreign Minister, Jorge Enrique Taiana, expressed Argentina's objections to the "Lamy Package". According to Taiana, it is "*it is clearly necessary to introduce modifications to the texts to approve modalities. In particular, the text on non-agricultural markets access (NAMA) requires structural changes so that it can serve as a basis for negotiation*". See the declarations at <http://www.mrecic.gov.ar>.

⁷⁶ For a detailed description, see *MERCOSUR Report 11* [2006], pp. 86-88.

⁷⁷ MERCOSUR / GMC/MINUTES 02/08 of the 72nd GMC Regular Meeting, June 19 and 20, 2008.

B. The Doha Round: recent movements and impacts for MERCOSUR

In the first half of 2008, there was intense activity among trade negotiators at WTO headquarters in Geneva to reach an agreement on methods and modalities for the trade liberalization of agricultural and industrial products before the vacation period in the northern hemisphere. These efforts were based on the objective of reaching a solid agreement in the issues deemed crucial to the Round before the presidential elections in the USA.

An agreement on the methods and modalities for the liberalization of trade in goods that year would pave the way for the conclusion of the Doha Round in 2009, when it would be under a new administration in the USA. This is due to the fact that the crucial issues, which are the focus of the main negotiations between the member countries, would be already defined. In view of the fact that this agreement was not reached, the beginning of a new US government, the elections in India, and the changes of leadership in the European community in 2009, will all combine to make the general climate rather un conducive to the Round's conclusion next year.

Many analysts felt that the significant increase in the international prices of agricultural products over the last year and the debate on food security could facilitate a trade liberalization agreement. In this context, food-importing countries might be more willing to reduce their tariffs in order to cut costs and, in the countries that subsidize agricultural production, there would be less demand for government assistance. The concern to protect internal production prevailed, however.

Assembled in Geneva from July 21 through 29 last, the trade ministers of more than 30 member countries of the WTO were close to achieving consensus on a package of trade liberalization commitments submitted by WTO Director General, Pascal Lamy. The differences between the USA and India in terms of a special safeguard mechanism for the import of agricultural products in DGCs led to the breakdown of the initiative, according to the announcement of July 29 (WTO [2008]).

Differences blocking the agreement

Although the Doha Round's agenda is more comprehensive, throughout 2008, the negotiations in Geneva focused on defining liberalization modalities for agricultural and industrial products. The balance of trade liberalization efforts that countries' should carry out in these two areas is key to the conclusion of the Round.

The balance is not only necessary between the two negotiation areas, but also within each of them. For example, the USA has a pro-liberalization stance regarding the reduction of import tariffs for agricultural products, but seeks to commit itself with the lowest possible level of subsidy reduction for its internal production. India, on the other hand, is interested in the reduction of US subsidies to local producers, but refuses to accept significant tariff reduction commitments for agricultural products, using the argument that it needs to protect local family agriculture.

The differences between the USA and India over the special safeguard mechanism for agricultural products were responsible for the suspension of the ministerial meeting in Geneva in late July. In 2004, the member countries agreed to incorporate on the negotiating agenda the implementation of a safeguard mechanism to protect the farmers of poor countries from a substantial increase of imports.

This mechanism foresees the automatic raising of tariffs, above the level consolidated in the Uruguay Round in the event of a steep rise in imports. The differences centered on how to define the growth rate of

imports, on the basis of which the application of the mechanism would be "triggered", and the percentage rise in import tariffs.

The proposal that was being discussed when the talks were suspended, the "Lamy Package", envisaged that DGCs could only raise their tariffs above the consolidated level when imports grew 40% or more above imports in the last three years. This growth would act as the trigger that would allow consolidated tariffs to be raised by as much as 15% above the consolidated tariff, or 15 p.p., whichever is higher.

The US representatives claimed that a 40% increase in imports was the lowest rate they could accept (as their initial position was 60%). In turn, on behalf of the G-33 (Group of DGCs importing agricultural product), the delegates from India insisted on the percentage being 10% and on the limit for the tariff increase being 30% above the consolidated tariff.

After some efforts at negotiation, India agreed to the trigger being increased to 15%, but the negotiations went no further. As the positions were still far-removed from each other, the WTO's Director General, whose objective it was to preserve the consensus obtained in other issues on the agenda, decided to suspend the negotiations.

This was an important issue for MERCOSUR countries, which joined forces to prevent the G-20 adopting a safeguards proposal that would damage the bloc's exporter sectors. MERCOSUR exports to DGCs have growing considerably in recent years and now represent over 50% of total agricultural exports. The adoption of a safeguard mechanism allowing the increase of tariffs to levels higher than those consolidated in the Uruguay Round would have been a decision radically against MERCOSUR'S interests.

The "Lamy Package"

The presidents of the Agriculture and NAMA Negotiating Groups, on July 10, revealed a final draft of the texts that were to serve as the basis for the work of the high level representatives and ministers at the meetings, which would be held in Geneva before the end of the month. These documents incorporated significant breakthroughs in several issues, but still left open serious questions to be defined by ministers.

A few days into the ministerial meeting, pessimism dominated the negotiating climate in Geneva and there was no progress in the talks. With the intention of contributing to the convergence of positions, the WTO's Director General presented a package of commitments to a small group of ministers comprising the G-7. The package contained some of the main points for which it was necessary to reach a definition in the texts on agricultural and non-agricultural (NAMA) products. The G-7 was made up of delegates from Australia, Brazil, China, the USA, India, Japan, and the EU.

Although the seven countries' representatives were dissatisfied with certain specific aspects of the package, only India, among all the G-7 members, immediately raised strong objections to Pascal Lamy's proposal. However, the country did not refuse to go on discussing the proposal. Brazil was the first country to announce its backing of the document. Argentina was not part of the G-7, but Foreign Minister Jorge Taiana said his government would reject the "Lamy Package".

The document presented by Lamy tried to strike a balance between the offensive and defensive interests of the various actors and to adjust the various different sensitivities. The special agricultural safeguard

mechanism was the issue that sparked the disagreement that led to the talks being suspended. But there were also difficulties in connection with other issues. These included the value of distorting agricultural subsidies allowed the USA, the anti-concentration clause for sensitive products in industrial goods, and the requirement to participate in sectoral agreements.

Box I
MAIN POINTS OF THE "LAMY PACKAGE"

1. Agricultural goods

- *Overall trade-distorting support (OTDS)*
 - i. USA: US\$14.4 billion (80% cut on what was consolidated in the Uruguay Round).
 - ii. EU: €22 billion (70% cut).
- *Market access*
 - i. 70% reduction for the highest tariffs (above 75%) charged by the DDCs.
 - ii. For non-sensitive products, DDCs will have to consolidate a maximum tariff of 100% and may exercise this ceiling for 1% of tariff lines to offset increases greater than expected in tariff quotas for sensitive products.
 - iii. Sensitive products
 - 1. DDCs will be entitled to designate up to 4% of tariff lines as sensitive products and an additional 2% as compensation for subsequent liberalization.
 - 2. Broadening of tariff quotas for sensitive products from DDCs equivalent to 4% of domestic consumption.
 - iv. Special products:
 - * DDCs may nominate up to 12% of tariff lines as "products special". In this group of products, 5% of tariff lines could be exempted from tariff reduction.
 - * The group of special products will experience an average tariff cut of 11%.
 - * For recently acceded members (RAM) of the WTO, the number of special products would be 13%, with an average cut of 10%.
- *Special safeguards for DDCs*
 - i. Trigger for automatic application of safeguards: 40% increase of imports on the value of the last three years.
 - ii. 15% or 15 p.p. increase on the current consolidated tariff, whichever is higher.
 - iii. 2.5% limit on tariff lines that might exceed currently consolidated levels in a given year.
- *Safeguards for DDCs*
 - i. Elimination of special agricultural safeguard (SSG) from a maximum of 1% of tariff lines until their total elimination in 7 years.
 - ii. It would not be permitted to exceed this consolidated tariff during the period.

Box I (CONTINUED)

2. Industrial goods (NAMA)

- Coefficient for application of the Swiss Formula^{a/} of tariff reduction for DDCs: 8.
- Coefficients of the Swiss Formula and flexibilities for DGCs.

Tariff reduction coefficients	Flexibilities
DGCs may choose one of the three coefficients for the application of tariff reduction in the Swiss Formula: X = 20	According to the coefficient selected for tariff reduction, the following treatment will be adopted for sensitive products: Minor cut for 14% of tariff lines not exceeding 16% of the aggregate value of imports of the country non-agricultural products; or exclusion of 6.5% of products should the import value of these products not exceed 7.5% of total imports.
Y = 22	Minor cut for 10% of products not exceeding 10% of the import value; or exclusion of 5% of products should the import value not exceed 5% of total imports.
Z = 25	Z = Not entitled to flexibilities.

- *Clause anti-concentration*: DGCs must apply an integral reduction of the Swiss Formula for at least 20% of tariff lines, or 9% of the value of imports of each chapter of the Harmonized System.
- *Sectoral agreements*: Recognition of the voluntary nature of the sectoral agreements and the commitment to participate in the negotiations of at least two sectoral agreements. Any DGCs that participate in sectoral agreements will be entitled to increase the coefficient of the Swiss Formula applicable to its non-agricultural products proportional to its share in level of participation in those agreements.

Note: ^aSwiss Formula $T_{final} = \frac{\alpha \times T_{Consolidated}}{\alpha + T_{Consolidated}}$. This formula would define a country's new consolidated tariff (T_{final}) with the parameter α taking the alternative value X = 20; Y = 22 or Z = 25.

The significance of the "Lamy Package" for MERCOSUR

- Industrial products -

Taking the document submitted by the NAMA Group's president as a basis, the "Lamy Package" sets out three options for Swiss Formula coefficients.⁷⁸ Each coefficient is linked to a certain number of tariff lines that would benefit from smaller cuts of up to 50% of those resulting from applying the Formula, subject to the import value of the sensitive products not exceeding a certain amount. The lower the coefficient

⁷⁸ The Swiss Formula is: $T_{final} = \frac{\alpha \times T_{Consolidated}}{\alpha + T_{Consolidated}}$, where T is a country's consolidated tariff in the WTO and $\alpha = 1, \dots, 8, \dots,$

$30, \dots$. This formula defines the new consolidated tariff (T_{final}) with the parameter α taking the values X = 20; Y = 22 or Z = 25, should the proposal included in the "Lamy Package" be accepted.

selected, the higher the reduction in tariffs and also the number of products that the countries could classify as sensitive.⁷⁹

Table 22 shows the impact on the CET of MERCOSUR⁸⁰ of the three options submitted by Lamy as the coefficients for the Swiss Formula. For the CET, the application of the three coefficients clearly produces very similar results in terms of tariff reduction.

TABLE 22
SIMULATION EXERCISE:
EFFECT OF APPLICATION OF THE "LAMY PACKAGE" ON MERCOSUR
(Tariff reduction in non-agricultural goods excluding sensitive products)

Statistics	CET	Swiss Formula Coefficient		
		X = 20	Y = 22	Z = 25
Average	10.77	11.74	12.41	13.34
Maximum	35.00	12.73	13.51	14.58
Average tariff reduction (%)		59.09	56.81	53.71
Tariff lines affected by the reduction		4,953	4,953	3,441

Note: Total items: 8,849. (HS 2002. December 2006).

Source: Prepared by Negint/CNI based on MDIC data.

Without considering sensitive products, which will see half of the tariff cut determined by applying the Swiss Formula, the maximum consolidated tariff⁸¹ would become 12.73% for coefficient 20 and 14.58% for coefficient 25. The maximum tariff consolidated by the members of MERCOSUR in industrial goods is currently 35%. The average consolidated tariff would become 11.74% in the first case and 13.34% in the second.

This means that, in either option, the average tariff consolidated in the WTO would be even higher than the average CET of 10.77%. But there are various products that would see a significant tariff reduction, as the maximum ceiling would be cut by over 20 p.p. The deadline for implementation of the tariff reduction by DGCs would be 10 years from the conclusion of the Round.

For various products, the new consolidated tariff would continue to be higher than the CET, but for 4,953 products, or 56% of total tariff lines, there would be a reduction in the applied tariff. Interestingly, the number of products subject to tariff cuts is the same for coefficients 20 or 22.

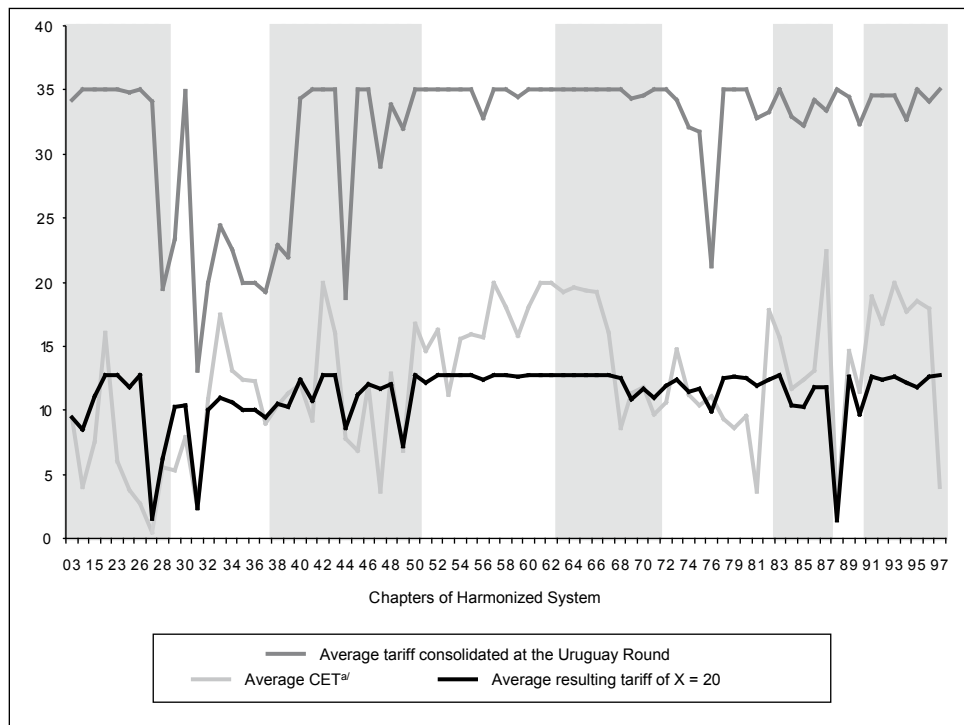
⁷⁹ For a detailed description of the elements of the NAMA negotiation and the characteristics of the Swiss Formula, see *MERCOSUR Report 11* [2006], pp. 103-105.

⁸⁰ The tariff considered in this exercise is MERCOSUR's nominal CET, excluding exceptions.

⁸¹ The MERCOSUR partners consolidated their own tariff structures in the WTO. The tariff consolidated by Brazil was taken for the purposes of this exercise, which in any case is fairly similar to that of the other countries in the block.

Graph 25 shows the average tariffs by chapter of the Harmonized System and consolidated by Brazil in the Uruguay Round (dark gray line), the CET (light gray line), and the new tariff consolidated in the WTO that would result from applying the Formula with coefficient 20 (black line). This might possibly be the coefficient chosen for MERCOSUR countries, as the difference in the impact on tariff levels in relation to coefficient 25 is small and the coefficient 20 option means that 14% of total tariff lines can be designated as sensitive products.

GRAPH 25
BRAZILIAN TARIFFS COMPARED CONSIDERING THE APPLICATION OF THE SWISS FORMULA, X = 20, EXCLUDING SENSITIVE PRODUCTS



Note: ^aCET, position: December 2006 (INC 2002).

Source: Ministry of Development, Industry and Foreign Trade (MDIC).

If the MERCOSUR countries were to opt for coefficient 20, they would be entitled to include 1,238 items on the list of sensitive products, which would see a cut equal to half that set by application of the Formula. The value of imported products included on this list may not exceed 16% of each country’s total imports. This means that, when considering sensitive products, the maximum CET for industrial products would fall from the current 35% to 23.86%, rather than 12.73% resulting from the full and comprehensive application of the Formula’s cut.

Throughout 2008, MERCOSUR negotiators sought to increase the number of products that might make up the sensitive list and requested special treatment for the bloc as a Customs Union. The proposal, which came to be incorporated in one of the preliminary documents of the NAMA Group’s President, consisted of

submitting a single list of sensitive products for MERCOSUR, as intrabloc trade would be excluded from the calculation of the aggregate value of the bloc's imports.

The objective was partly to place a larger number of articles on the list of sensitive products. If the concentration of Argentine imports in certain products that might make up the sensitive list is taken into account, the percentages of the maximum import value up for discussion represented too low a ceiling to include the country's sensitive products.

In response to the difficulties of obtaining consensus over the proposal, negotiators began to work toward enabling the four MERCOSUR countries to submit a common list and use the Brazil's volume of imports as a benchmark to calculate the limit of sensitive products. The objective was to include a larger number of products on the sensitive lists of Argentina, Paraguay, and Uruguay, as Brazil's volume of imports is very much higher than the bloc's other partners. The proposal was welcomed by the NAMA Group's President in the document released on July 10, which was the last draft published before the mini-ministerial meeting in Geneva.

To prevent DGCs including all products in any given sector on the list of sensitive products, European negotiators insisted on an anti-concentration clause. This clause would define a ceiling for products that could be considered sensitive in the same chapter of the HS.

The "Lamy Package" proposes that at least 20% of tariff lines or 9% of import value in any given chapter be subject to the full cut set by the application of the Swiss Formula. The European negotiators demanded significantly higher percentages than had been incorporated in the document. This was one of the points that focused the negotiators' attention in the last months.

Another highly sensitive issue for MERCOSUR is sectoral agreements to reduce and/or eliminate tariffs on industrial products.⁸² As from 2003, US negotiators have insisted on including sectoral agreements as a central modality to reduce tariffs on industrial goods. But faced with resistance from various DGCs, it was agreed to make adherence to these agreements voluntary.

The Lamy document recognizes the voluntary nature of participation in the agreements, but includes an obligation to participate in negotiating at least two sectoral agreements. In other words, under the proposal, a country could participate in the negotiation without committing to signing the agreement. This alternative may constitute a risk, as a country relevant to trade in a given sector could be pressed to sign the sectoral agreement at the end of the negotiations in which it was participating.

These two issues (the anti-concentration mechanism and sectoral agreements) were promoted at the negotiations by pressure first from the European and second the US business sectors. For the Europeans, the main question is to prevent some more export-oriented sectors being integrally incorporated on the sensitive products lists of DGCs with a significant domestic market. MERCOSUR is concerned to maintain the highest possible degree of freedom in the composition of its sensitive products lists.

The US business sector, for its part, sees in sectoral agreements the opportunity to obtain effective access to DGCs' markets, with the total elimination or a considerable reduction of import tariffs in export-oriented sectors. Most DGCs have no interest in sectoral agreements for industrial products. Brazil might be interested in an agreement for, say, the ethanol sector. But ethanol is considered agricultural in the WTO

⁸² Although voluntary in nature, such agreements aimed to eliminate or reduce tariffs in certain sectors in addition to the cuts established by applying the Swiss Formula. Among the sectors of interest to the USA are chemicals, forestry products, and electronic products.

negotiations and does not belong to the products negotiated in the framework of NAMA, where sectoral agreements are discussed.

- Agricultural products -

In the area of agriculture, the "Lamy Package" submitted proposals for the main issues on the agenda: the reduction of internal support measures, export subsidies, access to DDCs and DGCs' markets, including special products. There was also progress on other issues, like trade liberalization for tropical products, bananas, and the treatment of preference erosion. The main issues pending resolution were to do with setting the intraquota tariff and tariff capping, as well as the reduction of subsidies, specifically for cotton, the creation of tariff quotas for certain products (including ethanol), and geographical indications.

As well as the special safeguard mechanism described earlier, the definition of the cutting of subsidies for production in the USA was among the main controversies of the "Lamy Package". The Lamy document incorporates a ceiling of US\$14.5 billion for total internal aid, whereas the last US proposal was US\$15 billion and the G-20 insisted it being US\$13 billion.

In 2007, the value of subsidies for internal production in the USA was just US\$8 billion, given the high level of international agricultural commodity prices. By 1999, however, this amount had reached US\$24.2 billion. For the representatives of the Brazilian agricultural sector, defining caps by product was more important than defining the total value of subsidies.

According to estimates by the Institute for Studies of International Trade Negotiations (ICONE),⁸³ looking at just three products (ethanol, beef, and poultry), earnings for Brazilian agriculture could reach US\$4.9 billion. These earnings, catered for by the parameters of the "Lamy Package", would be concentrated in US and European markets, because, according to ICONE's evaluation, the increased access to DGCs' markets would be not very significant. Although the Brazilian sector agricultural felt that this was a modest result, it supported the government's decision to accept the "Lamy Package".

Brazil raised the question of ethanol as being fundamental in reaching an agreement in the Doha Round. The USA showed no willingness to negotiate the rate of US\$0.54 per gallon of the product imported, and argued that this value is not defined with an import tariff, but would constitute a levy to be included in "other rates", and there would therefore be no reason to negotiate it in the WTO. For Brazil, however, the Round's exclusion of ethanol is unacceptable. The EU, for its part, would be willing to create a tariff quota for ethanol.

The assessment of the "Lamy Package" as expressing a reasonable balance of concessions and the idea that it was important to make the most of this window of opportunity to save the Doha Round led to the Brazilian government lending its support to the document.⁸⁴

The Argentine government's assessment was different. For the Argentine negotiators, the earnings from the cuts in subsidies and agricultural market access would be insignificant and would demand an effort of trade liberalization in industrial products, which the country is not willing to implement.

⁸³ See ICONE: <http://www.iconebrasil.org.br>.

⁸⁴ The "Lamy Package" presented no commitments for specific products and its approval would not therefore solve the question of ethanol. However, information circulating in the press indicates that this issue had been the subject of negotiations between representatives from Brazil and other countries for some time.

Apart from trade liberalization for agricultural and industrial products, the Doha Round's agenda includes other issues such as rules (antidumping measures, countervailing duties, and subsidies) and trade and services facilitation. Significant progress in the Round is not expected in these areas, with the exception of services, where countries should raise consolidation levels in their sectoral commitments. The predominant expectation is that, once the main questions in the areas of agriculture and industrial goods have been resolved, the issues pending in other areas would be quickly solved.

The Doha Round's prospects

Immediately after the announcement of the collapse of the mini-ministerial meeting and the traditional exchange of allegations that characterizes such failures, several of the main actors hastened to express their interest in preserving the progress made at the time in Geneva. To do this it would be necessary to resume the talks as quickly as possible.

In the following weeks, intense activity was seen from the WTO's Director General and certain leaders, including negotiators from the USA, Brazil, and Australia. It is hoped that the high officials will meet again in Geneva after mid-September and that the most important progress will be seen three or four weeks after that.

The haste to resume the negotiations is based on the observation that it is vital now to move forward toward an agreement on modalities that will be a good basis for concluding the final agreement at the start of next year. Otherwise, it will be necessary to wait another two or three years before it is possible to resume the talks.

The elections in the USA this year, in India next, and the change of leadership in the European Commission in 2009 will stand in the way of any significant progress over next two years. They are key actors in the talks and will probably not be in a position to or will not be interested in returning to the negotiating table until 2010.

More recently, the intensity and ramifications of the US financial crisis, which are beginning to affect the real economy not just of DDCs, but also of DGCs, have added new elements of uncertainty to the international panorama and blurred predictions about the fate of the Doha Round.

In this period, it will be difficult to keep the Doha Round's agenda, which in many people's minds is already obsolete, intact. The negotiating mandate defined in 2001 reflected an international trade reality very different from the one that will predominate at the start of next decade. The possible inclusion of other issues in the agenda will tend to increase the complexity of the negotiations even further.

C. Latin American integration

In the 1990s, the efforts of South American integration centered almost exclusively on trade. The main initiatives were MERCOSUR and the negotiation of bilateral agreements between MERCOSUR members, and Bolivia, Chile, and, more recently, the CAN.

The difficulties of moving forward in the process of subregional integration and intraregional trade liberalization have risen in recent years. The agenda of the MERCOSUR Customs Union encounters recurrent difficulties in moving forward and the prolonged negotiations between MERCOSUR countries and

the CAN were signs of growing internal resistance to move beyond certain limited agreements previously signed in the ambit of LAIA.

In recent years, the priority assigned during the ten years from 1990 to the trade agenda in intraregional relations was eventually criticized by various social actors and the governments of various different countries in the region. At the same time, other South American countries deepened their option for integration with the international economy, and sought partnerships through fixed trade agreements with countries outside the region. The growing differences in trade policies and national investment regimes have led to a virtual paralysis of integration and trade liberalization initiatives in the region in recent years.

More recently, signs of macroeconomic instability are resurfacing in a few countries, a trend that contrasts with the favorable picture seen across South American countries up to 2006. In a general way, although the region's economies are continuing to grow at significant rates, inflationary pressures in certain countries are disrupting the prospects of macroeconomic evolution, which had been favorable until then. These pressures add a new factor of uncertainty to concerns about the impact of the financial crisis and rising commodity prices on the maintenance of the region's economic growth (see Chapter 1).

In contrast with the unfavorable climate for trade liberalization initiatives in the region, the flows of trade and intraregional investments have been taking on ever greater importance. Economic relations are expanding beyond traditional trade and incorporating trade in services and direct investments, fuelled by Brazilian companies' recent trend toward internationalization.⁸⁵

These investments are geared toward a growing number of countries and translate an interesting diversification in terms of the sectors and companies involved.

A deterioration in the macroeconomic climate in the region through inflationary pressures and the worsening of the international financial crisis may not only affect trade flows, but also the recent flows of direct investment by Brazilian companies in neighboring countries. This would be particularly true should this decline be accompanied by increased uncertainty for foreign investors in terms of regulations, as has been occurring in certain countries in the region.

Under these conditions, it has been difficult for more ambitious economic integration projects to do well. After a long period of negotiations, UNASUR had difficulty in May 2008 incorporating ambitious economic integration objectives. The project added a significant number of issues and watered down economic integration objectives. In the sphere of LAIA, the debates surrounding the creation of an FTS are showing no progress and reflect divergent views about the model of regional integration desired by the various member countries.⁸⁶

⁸⁵ A FUNCEX study by Roberto Iglesias at the request of Brazil's National Confederation of Industry presents detailed information about the recent flow of Brazilian investments in South America and includes recommendations to stimulate it.

⁸⁶ The Center for Integration and Development Studies organized a joint task force for 25 members from various different segments to draw up proposals for regional integration in trade and investment, infrastructure and transport services, energy and climate change. The document from this initiative can be accessed at: <http://www.cindesbrasil.org>.

UNASUR incorporates comprehensive objectives

After more than three years of negotiations, the Constitutive Treaty of the Union of South American Nations was signed on May 23, 2008, incorporating broad and ambitious objectives. The extent of its agenda reveals the difficulties the project faced in covering the array of requirements of the various participants. Throughout these years, there was a trend to incorporate a variety of social, policies, and cultural issues, and to water down trade-related questions.

The Treaty establishes as a general UNASUR objective the building of "*a space of cultural, social, economic, and political integration and union among its peoples, giving priority to political dialogue, social policies, education, energy, infrastructure, funding, and the environment, among other things, with a view to eliminating socioeconomic inequality, achieving social inclusion, and civic participation, strengthening democracy, and reducing asymmetries in the framework of strengthening the States' sovereignty and independence*".

In addition to the general objective, the Treaty includes 21 specific objectives, the first of which is "*the strengthening of political dialogue between the Member States to ensure a space for coordination to reinforce South American integration and the participation of UNASUR in the international scenario*".

Questions relating to economic and trade integration appear in the twelfth specific objective: "*Economic and trade cooperation to achieve the progress and consolidation of an innovative, dynamic, transparent, equal, and balanced process that contemplates effective access, and promotes growth and economic development to overcome asymmetries through complementation of the South American economies, as well as the promotion of the wellbeing of all sectors of the population and the reduction of poverty*".

Although the mission "*to compatibilize and coordinate the initiatives of UNASUR with other effective regional and subregional integration processes in order to promote the complementarity of efforts*" has been assigned to the Council of Delegates, the role of UNASUR in terms of trade issues and the convergence of subregional integration schemes is not clear.

One of the most important issues for South American economic and trade integration is the development of physical connection infrastructure. UNASUR's fifth specific objective is to do with the "*development of an infrastructure for the interconnection of the region and among our peoples based on sustainable social and economic development criteria*". In this area, it will be important for UNASUR to coordinate its actions with the Initiative for the Integration of Regional Infrastructure in South America (IIRSA), which already selected 31 priority projects comprising the "Consensus-Based Implementation Agenda", several of which are under way.⁸⁷

The recent political crisis in Bolivia may be the first test of UNASUR's policy coordination capacity. Chile assumed the UNASUR PPT during the second half of 2008. Although a Presidents' Summit was agreed for October, President Michelle Bachelet of Chile called a special meeting for September 15 to analyze the crisis in Bolivia and seek measures to help normalize the situation. In the words of the Chilean President,

⁸⁷ IIRSA began its work after the Summit of South American Presidents in 2000. In this framework, and with the support of the financial institutions that make up the Technical Coordination Committee of IDB, CAF, and FONPLATA, IIRSA has given impetus to projects and sectoral processes geared to the physical integration of South America. For detailed information on IIRSA, see <http://www.iirsa.org> and IDB/INTAL [2008].

"the central concern for all the region's heads of State is that we want a Bolivia at peace and that it is a task for UNASUR".⁸⁸

At the next regular meeting in October, the UNASUR Summit will have to address itself to approving the Action Plan, whose priority issues are energy, education, social policies, infrastructure, and funding.

Box J
MAIN CHARACTERISTICS OF UNASUR

Objective	<ul style="list-style-type: none"> UNASUR's objective is to build a space for integration and union in the cultural, social, economic, and political spheres among its peoples, giving priority to such areas as policies dialogue, social policies, education, energy, infrastructure, funding, and the environment. The Treaty lists 21 specific objectives.
Decisions	<ul style="list-style-type: none"> The UNASUR decision-making system must be consensus-based. Decisions may be adopted with the presence of ¾ of the countries (9 countries). Any absentee countries must be consulted and their answers be sent in the 30 following days. Any country may exempt itself from totally or partially applying an approved policy for a definite or indefinite period without this affecting its subsequent total or partial incorporation in the policies.
Presidency and countries involved	<ul style="list-style-type: none"> The PPT will be held successively by each of the Member States in alphabetical order for the period of a year. The presidency prior to the signing of the Treaty was held by Bolivia and the next country would be Colombia; however, the mandate passed to Chile. Argentina, Bolivia, Brazil, Colombia, Chile, Ecuador, Guyana, Paraguay, Peru, Suriname, Uruguay, and Venezuela.
Structure and powers	<p><i>Council of Heads of State and Government (annual ordinary and extraordinary meetings)</i></p> <ul style="list-style-type: none"> Establishing the policies guidelines, action plans, programs, and projects of the process of South American integration and deciding the priorities for their implementation. Calling Sectoral Ministerial Meetings and setting up Ministerial-level Councils; Convocar Reuniones Ministeriales Sectoriales y crear Consejos de nivel Ministerial. Deciding on the proposals submitted by the Council of Ministers of Foreign Relations and adopting policies limits for relations with third countries. <p><i>Council of Ministers of Foreign Relations (six-monthly ordinary and extraordinary meetings)</i></p> <ul style="list-style-type: none"> Proposing draft Decisions and preparing the meetings of the Council of Heads of State and Government. Adopting Resolutions to implement the Decisions of the Council of Heads of State and Government. Coordinating positions in issues central to South American integration. Developing and promoting political dialogue and agreement on issues of regional and international interest. Carrying out the follow-up and evaluation of the integration process as a whole and approving the annual activity program and the budget. <p><i>Council of Delegates (executive organ formed by 12 delegates, one representative from each country, with preferably two-monthly meetings in PPT territory or another location agreed upon)</i></p> <ul style="list-style-type: none"> Implementing the Decisions of the Council of Heads of State and Government, and the Resolutions of the Council of Ministers of Foreign Relations through the adoption of the relevant Provisions. Preparing the meetings of the Council of Ministers and drawing up draft Decisions, Resolutions, and Regulations. Compatibilizing and coordinating UNASUR initiatives with other regional and subregional integration processes. Forming, coordinating, and following up on the Working Groups, promoting civilian participation, and proposing the budget of the General Secretariat with differentiated quotas of the countries according to their economic capacities.

⁸⁸ See the O Globo Portal: <http://www.g1.globo.com>

Box J (CONTINUED)

Structure and powers	<p><i>General Secretariat, based in Quito, Ecuador, secretary appointed by the Council of Heads of State and Government at the suggestion of the Council of Ministers of Foreign Relations, with a 2-year renewable mandate</i></p> <ul style="list-style-type: none">Supporting the Council and the PPT, participating with the right to intervene, and acting as secretary at the meetings of the organs of UNASUR, submitting the Annual Report, acting as recipient of the Agreements and preparing their publication, preparing the budget proposal and adopting any measures necessary for their proper administration and execution, etc. <p>Note: The South American Energy Council, created in the Margarita Declaration (04.14.2007) is part of UNASUR.</p>
Diferences	<ul style="list-style-type: none">System of direct negotiation. In the event of not finding a solution, the Council of Delegates will formulate a recommendation within 60 days of its receipt and may bring the difference before the Council of Ministers.
Effectiveness	<ul style="list-style-type: none">The Treaty will come into force 30 days after receipt of the ninth ratification instrument.

A Free Trade Space in LAIA: far from consensus

The objective of creating a Free Trade Space (FTS) in the ambit of LAIA⁸⁹ was approved at the 13th Meeting of LAIA's Council of Ministers of Foreign Relations in October 2004. On that occasion, it was foreseen to move forward in trade liberalization, through the transformation of fixed preference agreements existing at the time in fixed trade agreements and adopt convergence programs, as well as common rules regarding origin regime, safeguards, and dispute settlement.

At the Council's 14th Meeting on March 11, 2008, seven draft resolutions were debated in order to move forward in building the FTS:

- Access to goods markets ("Directives for the Evaluation and Convergence Conference");
- Trade in services;
- Origin regime;
- Safeguards Regime;
- Dispute settlement mechanism;
- Action plan in favor of the less economically developed countries; and
- Guidelines for the strengthening of regional production integration, trade promotion, and a greater participation of civil society.

In spite of having detailed proposals to move ahead with the constitution of the FTS, the LAIA faced difficulties coordinating minimum consensus among its members and moving forward in that direction.

⁸⁹ The information on the FTS in the ambit of LAIA was taken from the *Carta de Montevideo* Nos. 3 and 5, MERCOSUR and LAIA: News of the Brazilian Delegation in Montevideo, December 2007 and May 2008.

There are at least three different outlooks among member countries: (i) those that already have fixed trade agreements with the USA and advocate the FTS adopting the NAFTA model; (ii) those that advocate more modest liberalization models, including MERCOSUR, and (iii) those that have no interest in making progress in trade liberalization and advocate an alternative agenda for regional integration.

According to the information published in *Carta de Montevideo 5*, the Meeting of the Council of Ministers was unable to approve the projects because Bolivia, Ecuador, and Venezuela objected to the text on market access. They argued the need to incorporate the social question in the economic-trade agenda under way in LAIA to "promote a more balanced integration process".

Faced with the differences, Ministers limited themselves to requesting that the Committee of Representatives continue working toward the formation of the Free Trade Space (FTS) and that it call a meeting of Vice ministers and a special meeting of the Council itself for the second half of 2008, occasions on which the seven draft resolutions, supplemented by a social agenda, will once again be the subject of debate.

The evolution of the debates on the FTS in LAIA faces a process similar to that seen in the draft constitution of UNASUR: faced with the difficulty of achieving a convergence of positions in economic and trade issues, it is sought to incorporate other issues in the agenda.

Other subregional negotiations

- Brazil-Mexico -

The interest in negotiating the deepening of ECA 53 (a fixed preference agreement currently governing Brazil-Mexico trade) expressed by the Brazilian business sector is one of the main novelties in trade policy-making in Brazil.⁹⁰

The recent initiative of rapprochement of the Brazilian private sector is geared toward a bilateral FTA in a period of no more than ten years and represents an important change of tack in the Brazilian business position in comparison with the positions prevalent in the period leading up to the signing of ECA 53 in 2002.

At the start of the decade, when the current agreement was under negotiation, there was concern in the Brazilian private sector about the imbalance in competitiveness with Mexican producers in terms of both Mexico's participation in NAFTA and the benefits that the foreign trade policies in force in that country gave to local producers. The perception of the Brazilian business sector has altered in the last four years and the view is currently prevalent that there are many business opportunities between the two countries and that Brazilian producers are in a position to take advantage of them.

After their entry to NAFTA, Mexico adopted an aggressive trade negotiating policy, signing fixed trade agreements with most of the DDCs and with many emerging economies. As a result, Brazilian producers

⁹⁰ For all that it is a bilateral agreement, ECA 53 does not compromise the objective of convergence for an agreement in the 4+1 format between MERCOSUR and Mexico. As is common knowledge, the MERCOSUR partners also have bilateral agreements with that country. Furthermore, ECA 54, signed in July 2002 by MERCOSUR and Mexico, provides the institutional framework to move toward FTAs, but so far progress in negotiations on this type of agreement in the 4+1 format has not been possible.

face less favorable access conditions to the Mexican market than their main competitors, which reinforces the interest in negotiating an agreement that evens up the conditions of competition.

In November 2007, the Brazilian Business Coalition (CEB) submitted a proposal to the Brazilian government for the negotiation of an FTA with Mexico, based on expanding and deepening ECA 53, which contains the following:

- * Complete tariff elimination in a ten-year maximum deadline;
- * Respect for the levels of preferences already negotiated between the countries with a 30% minimum preference during the first year of the agreement;
- * Automatic application of the tariff elimination timelines to all products;
- * Admission of a list of sensitive products with a ten-year deadline and two year's grace for tariff elimination. This list will respect the 5% limit of tariff items and trade value;
- * Inclusion of chapters on the liberalization of trade in services and protection of investments.

In November 2007, the Minister, Celso Amorim, was in Mexico, a visit that gave rise to the following commitments agenda for 2008:

- * Program of meetings of the ECA 53 Administrating Commission in the first half of 2008. The Commission's 5th Meeting will be held in the first few months of next year;
- * Meetings of the Bilateral Trade Monitoring Commission in parallel with the meetings of the ECA 53 Administrating Commission;
- * 1st Meeting of the Energy Working Group in the first quarter of 2008 to deal with cooperation in biofuels;
- * Visit by Mexican president, Felipe Calderón, to Brazil in the second half of 2008.

In May 2008, "*the CEB proposal for a Second Generation Agreement*" was sent to the Mexican private sector, starting to a process of consultations between the two countries' private sectors. Though certain sectors of Mexican production have an interest in deepening the preferences negotiated under ECA 53, the leading business organizations and Mexican government representatives have shown little in the way of enthusiasm in negotiating a broader agreement.

While understandings for a broader agreement are not doing well, the two countries' governments have been working on broadening the lists of products with tariff preferences under ECA 53. To do this, they have provided incentives for representatives from the two countries' industrial sectors to already seek out sectoral agreements that can be incorporated in the existing agreement. The two governments have exchanged lists of requests and offers, based on consultations with each country's private sector.

In the automotive sector, ECA 55's Administrating Commission will define preferential treatment for buses and trucks under the 1st Additional Protocol to the agreement. Moreover, the preferential treatment for an

autoparts list already agreed between the two countries' private sectors is under negotiation. Mexico has an interest in the accumulation of origin for automotive products.

The Mexican President, Felipe Calderón, has scheduled a visit to Brazil for November 2008, when an extension of ECA 53 is expected to be announced.

- MERCOSUR-Chile services liberalization agreement -

After over two years of negotiation, the MERCOSUR countries and Chile concluded the ECA 35 Protocol on Trade in Services in July 2008, which before that only covered trade in goods. The Protocol includes commitments on market access and national treatment in important sectors, such as professional services, services rendered to companies, engineering, distribution, transport, and tourism. This is the MERCOSUR's first services agreement with another country.

- United States-Peru agreement: impact for the interests of MERCOSUR countries -

Given the difficulties faced by the project of regional trade integration in South America, some countries in the region are seeking to implement their international economic integration strategies by negotiating fixed trade agreements with countries outside the area, with its consequent negative effects for the trade interests of MERCOSUR partners.

In the latter months of 2007, the US House of Representatives ratified the bilateral FTA with Peru. As MERCOSUR had signed a trade liberalization agreement with Peru (ECA 58) in August 2003, the main effect of the USA-Peru agreement on the interests of MERCOSUR countries will be the erosion of the tariff preferences granted by Peru to members of the bloc. Furthermore, the bilateral FTA may affect the competitive position of service providers and investors, including those from MERCOSUR countries.

The USA-Peru agreement reproduces the FTA model adopted in recent years by the USA, with some adaptations in labor and environmental issues, the clauses of which are more demanding than they were in the previous agreements signed by that country. The agreement includes a wide variety of trade and not directly trade-related issues and adopts WTO-plus disciplines in several areas, such as services, investments, intellectual property, and competition policy.

This is an important difference with ECA 58, which is limited to the area of goods. It is difficult to claim that that difference will disadvantage MERCOSUR companies in their business with Peru but, in any event, US service providers and investors will have access guarantees and protection levels for their interests in Peru that others from the business world do not, including those from MERCOSUR.

In the area goods markets access, the main effect for MERCOSUR of the USA-Peru bilateral agreement is the erosion of preferences over time. An exercise by the National Confederation of Industry⁹¹ for Brazil⁹² shows that

⁹¹ Detailed information is available in the publication, *Comércio Exterior em Perspectiva*. National Confederation of Industry, Year 17, Nos. 06 and 07, March/April 2008.

⁹² Brazil and Argentina received more unfavorable treatment in the agreement with Peru than Paraguay and Uruguay. Therefore, the case of Brazil illustrates the worst situation among MERCOSUR partners in terms of discriminatory treatment in relation to the USA.

much of the erosion of Brazilian preferences in the Peruvian market will take place immediately: for 78% of tariff items, the USA will receive immediate elimination, a benefit only granted to Brazil for 11% of tariff items.

TABLE 23
USA-PERU AGREEMENT
SUMMARY OF AGREEMENT BY ELIMINATION TIMELINE

Deadlines	Products		Total imports from Peru - 2007	
	Items	% Share	US\$ Millions	% Share
Immediate	5,415	78	9,984	49
2 years	3	0	0	0
3 years	14	0	30	0
5 years	830	12	991	5
7 years	44	1	331	2
8 years	11	0	0	0
9 years	1	0	0	0
10 years	596	9	4,611	23
12 years	3	0	0	0
15 years	6	0	1	0
Longer deadlines	47	1	770	4
Non-located ^{a/}	-	-	3,748	18
<i>Total</i>	<i>6,970</i>	<i>100</i>	<i>20,464</i>	<i>100</i>

Note: ^{a/} Products not located in the translator.

Source: Text of the agreement, WTA.

The products to be immediately eliminated for US exports represent practically half of Peru's total imports, whereas the products for immediate elimination included in ECA 58 for Brazil represent just 7% of that country's total imports. In any event, as MERCOSUR's agreement with Peru has been effective since 2006, the MERCOSUR countries already have a degree of tariff preference in the Peruvian market.

The asymmetric treatment by Peru of MERCOSUR and US products will decrease over time. In 2014, the 74% tariffs of the tariff items will be reduced to zero for Brazil in ECA 58, whereas this will be 90% for the USA. Almost 4,000 tariff items to be eliminated immediately for the USA will only be fully deregulated for Brazil in 2014, the year of much of the liberalization granted to Brazil by Peru.

The USA-Peru agreement therefore not only erodes the preferences that MERCOSUR partners enjoyed in the Peruvian market by virtue of ECA 58, but will grant privileged treatment to US products over the next few years. The same will happen to Colombia in the event of the agreement signed by that country with the USA being approved by the US Congress.

In the case of Chile, which has been adopting an aggressive of fixed trade agreement negotiating strategy with its main trade partners, the problems for the MERCOSUR countries center on the erosion of preferences because approximately 97% of products have, since 2006, already had their trade totally liberalized.

TABLE 24
ELIMINATION TIMELINES OF PERU-USA AND PERU-BRAZIL AGREEMENTS COMPARED
 (Number of tariff items p.a. for full elimination)

Elimination year	Peru-USA	Peru-Brazil					Non-located ^{a/}	Total
		2008	2010	2014	2019			
2008	5,415	761	57	3,984	591	22	5,415	
2010	3	-	-	-	3	-	3	
2014	844	21	7	687	120	9	844	
2019	652	5		492	150	5	652	
Longer deadlines	56	-	-	1	51	4	56	
<i>Total</i>	<i>6,970</i>	<i>787</i>	<i>64</i>	<i>5,164</i>	<i>915</i>	<i>40</i>	<i>6,970</i>	

Note: ^{a/} Products not located in the translator.

Source: Text of the agreement, WTA.

D. The extraregional negotiations agenda

Since the mid-1990s, MERCOSUR has been committed to various trade agreement negotiating initiatives with an extremely varied set of extraregional partners: the FTAA, the EU, India, the Southern African Customs Union (SACU), Canada, Egypt, Morocco, Israel, and countries in the Gulf Cooperation Council.

Of all these initiatives, the only FTA concluded outside South America was with Israel, at the end of 2007. A fixed preference agreement with India was also signed and more recently the finalization of the negotiations with SACU was announced. But these two agreements are very limited in scope and neither has yet come into force.

MERCOSUR-Israel: first extraregional FTA

The FTA between MERCOSUR and Israel was signed on December 18, 2007, during the MERCOSUR Summit in Montevideo. This result has great significance, as it is the first FTA outside South America in which MERCOSUR has participated. Israel, on the other hand, has already implemented various such fixed trade agreements, e.g. with the USA, the EU, Canada, and Mexico.

The strategy adopted by MERCOSUR was to negotiate and sign fixed trade agreements with the Gulf Cooperation Council (GCC) and Israel simultaneously in order to avoid susceptibilities in the area of foreign policy. However, the two initiatives displayed different dynamics and, once the differences with Israel were overcome in a scenario where the outlook with the GCC is uncertain, the agreement with Israel was signed.

It is an agreement on access to the goods market and foresees the possibility of incorporating services and investments in the future. The trade rules foreseen are: a trade liberalization program applied to goods, rules of origin, safeguards, cooperation over technical rules and sanitary and phytosanitary rules, technical and technological cooperation, and customs cooperation. The agreement foresees tariff elimination baskets in the following categories: A (immediate); B (4 years); C (8 years); D (10 years) and E (special fixed preference quota regimes).

Israel had difficulty liberalizing agricultural products, arguing that its internal legislation limits the concessions in the meat and dairy sectors, whose production is for the domestic market. As a result, Israel excluded 866 codes from the tariff elimination program, whereas MERCOSUR excluded 326 items. Table 25 below shows the coverage of the respective offers in terms of tariff lines. The products excluded by Israel from full liberalization are concentrated in the agroindustrial sector.

TABLE 25
MERCOSUR-ISRAEL NEGOTIATION
SUMMARY OF OFFERS IN THE GOODS SECTOR
(December 2007)

Line	Offers			
	MERCOSUR		Israel	
	Items ^{1/}	% Share	Items ^{2/}	% Share
Immediate Elimination	2,395 ^{a/}	24.6	6,674	75.7
Elimination in 4 years	927 ^{b/}	9.5	1,061	12.0
Elimination in 8 years	3,447 ^{c/}	35.3	136	1.5
Elimination in 10 years	2,606 ^{d/}	26.7	-	
Differentiated Regimes	375	3.8	995	10.8
Excluded	326 ^{e/}	3.3	866 ^e	9.8
Total	9,750	100.0	8,866	100.0

Notes: ^{1/} NCM Nomenclature; ^{2/} Israel Nomenclature.

^{a/} 1 (one) product excluded by Brazil; ^{b/} 35; ^{c/} 52; ^{d/} 7 - Products with different baskets than the bloc's offer; ^{e/} These products do not form part of the offers.

Tables 26 and 27 below show that Israel was not a major destination for MERCOSUR partners' exports: on average over the last two years, the country was a destination for 0.27% of the bloc's total sales. Israel's share in Uruguayan exports is higher than in the other MERCOSUR countries, but even so only reached 1.42% in 2006 and fell to 1% in 2007. Nor is Israel a significant supplier of products for MERCOSUR, with just 0.48% of the bloc's total imports.

TABLE 26
MERCOSUR EXPORTS TO ISRAEL
(US\$ Millions FOB)

Countries	Israel			World		Share	
	2005	2006	2007	2006	2007	2006	2007
Argentina	208.409	134.854	212.511	45,756.509	54,851.046	0.29%	0.39%
Brazil	260.842	271.623	354.166	134,853.690	157,265.358	0.20%	0.23%
Paraguay ^{a/}	13.475	16.221	8.900	1,903.530	2,122.658	0.85%	0.42%
Uruguay	25.892	56.574	44.914	3,974.683	4,494.430	1.42%	1.00%
Total	508.618	479.272	620.491	186,488.412	218,733.492	0.26%	0.28%

Note: ^{a/} Data to August 2007.

Source: LAIA.

TABLE 27
MERCOSUR IMPORTS FROM ISRAEL
(US\$ Millions CIF)

Countries	Israel			World		Share	
	2005	2006	2007	2006	2007	2006	2007
Argentina	79.938	94.880	125.338	33,885.735	44,439.628	0.28%	0.28%
Brazil	508.102	511.499	737.270	95,822.566	126,652.030	0.53%	0.58%
Paraguay ^{a/}	4.532	21.701	6.642	5,756.903	4,636.536	0.38%	0.14%
Uruguay	8.158	7.909	8.130	4,774.535	5,620.286	0.17%	0.14%
<i>Total</i>	<i>600.730</i>	<i>635.989</i>	<i>877.430</i>	<i>140,239.739</i>	<i>181,348.480</i>	<i>0.45%</i>	<i>0.48%</i>

Note: ^{a/} Data to August 2007.

Source: LAIA.

MERCOSUR-EU: links with the Doha Round

The negotiations aiming at a Biregional Partnership Agreement between the EU and MERCOSUR have been at a standstill for three years. The deadlock they have reached reflects the strength of the two sides' defensive interests, but also the perception that the conclusion of the biregional negotiations would depend on a clearer definition about what will happen in the multilateral sphere in the ambit of the Doha Round.

The main area that links the two negotiating fronts is the liberalization of agriculture. European negotiators introduced the concept of an EU "single pocket" in biregional agreements, from which come all agricultural offers for the multilateral and the biregional negotiating fronts. Therefore, the higher the offer they make in the multilateral sphere, the lower the capacity to offer concessions in the biregional sphere.

As the agricultural question is extremely important in the biregional negotiations, the "Doha variable" is a supremely influential factor in the outlook for the negotiations. Despite being a crucial element, the loss of European interest in the negotiating process with MERCOSUR is apparent. The trade policy agenda circulated by the European Commission in October 2006 includes MERCOSUR among the priorities for the negotiation of fixed trade agreements, but clearly states that the new European strategy is geared to the major emerging Asian economies.

On MERCOSUR's side, however, the interest in these negotiations is not uniform either. The Brazilian and Uruguayan authorities made repeated statements in favor of resuming the talks. Argentina maintained more reticent stances. However, in the Joint Declaration emerging from the President Cristina Kirchner's visit to Brazil on September 8, 2008, a paragraph was inserted that explicitly mentioned the willingness of both countries to resume negotiations with the European bloc.

In any event, the future agreement between MERCOSUR and the EU seems to be exactly linked to what can happen in the multilateral Round. As long as the outcome of the Doha talks remains undefined (either its conclusion or suspension) biregional understandings will remain on hold. After the failure of the WTO's mini-ministerial meeting in Geneva in July 2008, there were various speculations about the possibility of restarting the talks between the two blocs immediately. But there have been no concrete initiatives in this direction as yet.

MERCOSUR-Gulf Cooperation Council (GCC): frustrated expectations

2007 began with the firm expectation that the FTA between MERCOSUR and the GCC would be signed at the MERCOSUR Summit to be held in January. The expectation was unfulfilled. Instead of the agreement a joint declaration was circulated stating that the regulatory part was finished, and included a chapter on trade in goods, with parameters for tariff liberalization in 8 years, as well as chapters on services and investments.

The declaration also pointed out that this group of instruments would be supplemented with annexes on dispute settlement and safeguards, and with specific commitments on services and investments. The annexes relating to the timelines for tariff elimination and rules of origin had seen significant progress and were close to being concluded. The declaration closed by stating that the agreement, with all its texts and commitments, would be concluded before June 2007.

Since then there has been no progress between in the understandings pending between the two blocs. The difficulties in the negotiations arose out of the exclusion by MERCOSUR of its product offer in the petrochemical complex. The GCC, in contrast, excluded from its offer important products for Brazilian exports to the region, such as chickens, sugar, ceramics, and iron and steel products. In a second stage, the two blocs' exception lists were shortened. The MERCOSUR list, which was 1,600 products, was cut back to just 534 articles, 195 of which are from the petrochemical sector, which is the GCC countries' main focus of interest. The GCC, on the other hand, excluded 222 items from its offer, including meat, fish, dairy products, tobacco, ceramics for coverings, refrigerators, and iron and steel products.

Another sensitive issue in the understandings with the GCC has to do with rules of origin. The proposal to adopt a more flexible origin regime than MERCOSUR's, based on rules of 35% regional content (added value), brought strong reactions in the Brazilian private sector, which views the adoption of rules for tariff classification and specific rules as fundamental. Furthermore, the adoption of more flexible rules of origin for extrabloc trade than those applying in intrabloc trade makes no sense.

The dynamism of the Middle Eastern economies and the opportunities for exports of goods and services are arousing the interest of various production sectors in MERCOSUR in this agreement. However, expectations that the agreement would be concluded by 2007 were reversed in view of communication problems between the two blocs since the start of the year. As with the EU, the mood of the GCC negotiators seems to have cooled.

India and the Southern African Customs Union (SACU): modest agreements still not in force

The MERCOSUR-India Agreement defined three levels of preferences: 10%, 20%, and 100%. MERCOSUR's list of concessions consists of 452 tariff items.⁹³ The thirteen items granted by MERCOSUR with a 100% preference margin have an applied tariff of 0% in the bloc. The other concessions were also made in products with an average MERCOSUR external tariff of between 5% and 7.5%. In India's offer, concessions were made on 450 tariff items. The lowest preferences (10% and 20%) were applied on products with higher tariffs, while the 100% preference was granted for products with a 3.1% tariff average.

⁹³ The MERCOSUR concessions cover half of Brazil's imports to India. The Brazilian Congress ratified the Preferential Trade Agreement between MERCOSUR and the Republic of India, signed in 2004, through the Legislative Decree (LD) 221 of September 3, 2008, published in the Official Journal of September 4, 2008. According to Article 30 of the Agreement, this will come into force thirty days after the countries give formal notice of the finalization of the internal ratification procedures.

At an intra-MERCOSUR meeting held at the end of June 2006, a modality proposal to broaden and deepen the agreement was agreed. It includes the following: (1) the 10% and 30% preferences already existing in the Agreement would be enlarged to 30% and 50% respectively; and (2) the minimum 20% preference margin would be granted to 50% of the tariff sample by exchanging request lists. After defining the offer lists, each party's priority products would be indicated in order to deepen the preference margins reciprocally.

In the last two years, India has steered the negotiations to broaden and deepen preferences to the entry into force of the agreement already negotiated. With the approval of the Agreement by the Brazilian Congress in September 2008, it will be possible to resume these negotiations.

The negotiations between MERCOSUR and SACU began on the basis of the understandings achieved by the Negotiating Commission of the MERCOSUR-South Africa Framework Agreement, signed on December 15, 2000, to set up a free trade area. In October 2003, the talks incorporated all SACU members (South Africa, Namibia, Botswana, Lesotho, and Swaziland).

The negotiations defined preferences for trade on 1,900 articles, 958 of which were granted by MERCOSUR under the NCM and 951 for SACU in its nomenclature. The preference margins are 10%, 25%, 50%, and 100%. In the MERCOSUR offer, a 100% preference margin was granted on almost the entire value of trade, although the CET average for these products (1.7%) is low. Something similar in the SACU offer. A significant volume of the offer was given a 100% preference margin, but it has low ad valorem tariffs or specific tariffs.

After twelve rounds of talks, the two blocs' governments signed a Joint Communiqué in June 2008 in Tucumán, Argentina, confirming the end of the negotiations of a Tariff Preference Agreement. The governments must expedite internal procedures for its signature, which is to become effective before the end of the Brazilian presidency in MERCOSUR in December 2008. The Agreement is also to be sent to the Congresses of the countries of both blocs for approval.

The first meeting between officials of MERCOSUR, SACU, and India took place in August 2005 to study the possibility of signing a trilateral agreement on the initiative of MERCOSUR (Brazil) that would include market access to goods and services, and investments. The agreement, based on the principle of free trade, will cover 80% of trade and the next stages of studies in each country are to identify sectors and products that can make up the offers of market access.

The difficulties of moving forward in deepening MERCOSUR's agreements with India and Southern Africa create highly optimistic expectations for this project to constitute an trilateral free trade area, a project that has been encouraged by the dialogue in the ambit of the IBSA (India, Brazil, and South Africa) initiative.

Other ongoing negotiating initiatives

The **MERCOSUR-Egypt Framework Agreement** was signed in 2004, negotiation of which was defined in two stages: the signing of a fixed preference agreement and the subsequent free trade negotiation. There was no progress in the talks until August 2008, when, during a visit to Argentina and Brazil by the Egyptian Trade Minister, Brazilian negotiators mentioned their willingness to resume the negotiations that might lead directly to the creation of a free trade area.

The **MERCOSUR-Morocco Framework Agreement** was also signed in 2004, during King Mohammed VI's visit to Brazil, which also included the negotiation of a fixed preference agreement, as a first step

toward free trade. April 2008 saw the first contact between the parties in order to move forward in the negotiations, an occasion on which the MERCOSUR representatives also expressed the desire to go straight to the constitution of a free trade area. The Moroccan authorities rejected the proposal, arguing the need to comply with the provisions of the Framework Agreement.

The **MERCOSUR-Pakistan Framework Trade Agreement** was signed in July 2006 at the MERCOSUR Summit in Córdoba, Argentina. The Agreement set out the groundwork for preferential agreement negotiations that will progressively lead to an FTA. The agreement establishes the creation of a Negotiating Committee to exchange information on tariffs and market access conditions, criteria for the negotiation of a Free Trade Area.

The intra-MERCOSUR meeting was held in September 2006 to study a negotiating methodology similar to the one the bloc is proposing to India. Pakistan, for its part, has already sent the list of products of export interest (1,024) to improve MERCOSUR market access conditions, and has indicated that it can offer reciprocity of treatment.

At the last MERCOSUR Summit, two Framework Agreements between MERCOSUR and **Jordan** (CMC Decision 28/08) and MERCOSUR and **Turkey** (CMC Decision 29/08) were signed. The two decisions are similar: they aim to strengthen bilateral relations by promoting trade and establishing conditions for the negotiation of a free trade area. These two negotiating fronts will represent important challenges for certain MERCOSUR industrial sectors, as the two countries are highly competitive in some areas where MERCOSUR countries are sensitive, e.g. the textile sector.

Rapprochement initiatives with no negotiating mandate

On the initiative of **South Korea**, a MERCOSUR-South Korea Feasibility Study carried out and completed in October 2007. Since then, the countries have been holding consultations with their respective private sectors to identify their interests in negotiating a trade agreement. The MERCOSUR countries have shown an interest in the openness of South Korea's agricultural products market, a sector highly protected by tariff and non-tariff barriers. Furthermore, Korean industrial products are highly competitive and spark resistance from MERCOSUR's industrial sectors over the negotiation of a broader agreement with that country.

MERCOSUR is showing interest in starting negotiations toward an agreement with the **Central American Integration System** (SICA). A meeting to be held in September 2008 will analyze the instruments that might lead to an agreement between the two blocs. Furthermore, MERCOSUR is signing a Cooperation Agreement with the Russian Federation.

E. Prospects for the MERCOSUR external agenda

MERCOSUR's external agenda has made little progress. The deepening of integration in South America is facing difficulties due to ever more divergent trends in the region's economic models and its international economic integration strategies. The failure of the Doha talks, a central issue on the bloc's external agenda, multiplies the positions that favor the need to advance in regional and/or bilateral agreements. But MERCOSUR is having difficulties negotiating the world of bilateral agreements.

Protectionist pressure in world trade tends to deepen with the failure of understandings in the WTO. The slowdown of the world economy and the concern over food security raised by rising international food prices may hatch protectionist initiatives in the climate of a weakening WTO.

One of the protectionist trends already manifesting itself in international trade is the introduction of technical and sanitary rules and regulations for products and production processes. These trends are linked to trade in agricultural and agroindustrial products, but also to trade in industrial products, particularly in the field of the environment.⁹⁴ Such measures have a significant bearing on MERCOSUR's trade interests, strongly centered on natural resource-intensive products.

To move ahead in trade negotiations with countries with large markets, MERCOSUR members must be willing to make concessions in areas attractive to their potential partners. To do this it will be necessary to adjust their stances on several issues on the negotiating agenda. The bloc has avoided making commitments in areas not strictly trade-related in order to preserve policies space, i.e. the capacity to implement autonomous internal policies.

The priorities of MERCOSUR'S external agenda will also have to be evaluated. As we have seen, the priority for multilateral negotiations did not paralyze the bloc's external negotiation agenda. Various initiatives are under way, but their relevance varies greatly. Targeting certain more economically significant initiatives and revising the bloc's positions on certain issues on the thematic agenda may be the path to efficiency in the external agenda.

Last, the question of flexibility over a common trade policy will have to be tackled in order to move forward in the external agenda. Indeed, a certain degree of flexibility has been introduced in the agreements the bloc has signed in the last five years. But this strategy is only valid in those initiatives where there is consensus between all the partners.

⁹⁴ The regulations and rules on certain sectors' production processes, as with the REACH in the EU, are beginning to affect chemical exports to the European bloc. MERCOSUR recently released a document setting out the rules on production and acceptance of biofuels in the European marketplace.

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